June 14, 2017

Via Electronic Mail (pubcom@finra.org)

Jennifer Piorko Mitchell
Vice President and Deputy Corporate Secretary
Office of Corporate Secretary
FINRA
1735 K. Street NW
Washington, DC 20006-1506

Re: Special Notice – Engagement Initiative

Dear Ms. Mitchell:

Thank you for the opportunity to comment on FINRA's Special Notice (the "Notice) soliciting information from all interested parties on FINRA's transparency and engagement programs. I am an Associate Professor of Law at the University of Nevada, Las Vegas William S. Boyd School of Law. I research and write about business and securities law, including the regulation of investment advice and the governance of financial self-regulatory organizations. In the past, I have served as the Director of an Investor Advocacy Clinic and supervised cases filed by small investors harmed by stockbroker misconduct. The comments in this letter represent my individual views and are not intended to and do not reflect the views of my institution.

The FINRA360 organizational improvement initiative offers an opportunity for FINRA to build upon existing strengths and become a more effective force for market integrity and investor protection. FINRA's successes generate widespread public benefits by giving investors the confidence to invest for their futures. Investor protection also plays a vital role in business capital formation—keeping bad actors out of the market increases investor confidence and willingness to invest. Because FINRA's policies and enforcement affect far more than its member firms, the public has a strong interest in its regulatory performance.

This letter briefly summarizes the benefits and risks of FINRA's self-regulatory model before responding to FINRA's request for information on FINRA Board activities.

I. The Benefits and Risks of Self-Regulation

Evaluating changes to FINRA's governance requires an understanding of the principal benefits and risks of its self-regulatory model. Although the self-regulatory organization model has existed for some time, it has not received as much attention as other governance models.[1] Despite this, financial self-regulation has grown to play such an

[1] *See* Jonathan Macey & Caroline Novogrod, *Enforcing Self-Regulatory Organization's Penalties and the Nature of Self-Regulation*, 40 HOFSTRA L. REV. 963, 963 (2012) ("Few issues are as poorly understood and under-theorized as the concept of 'industry self-regulation.'"); Andrew F. Tuch, *The Self-Regulation of Investment Bankers*, 83 GEO. WASH. L. REV. 101, 105 (2014) (explaining that FINRA's "self-regulation of

important role in governing our financial markets that some have begun to refer to financial self-regulatory organizations as a "fifth branch" of the government.[2] Moreover, FINRA's President and CEO recently invited additional "scrutiny of the [self-regulatory organization] model" and welcomed discussion about the model because "there are likely opportunities to make it more effective and efficient."[3]

A. Benefits of Self-Regulation

Self-regulation offers significant benefits that traditional regulatory bodies might struggle to provide.

1. Access to Expertise

Self-regulatory organizations may more readily access industry expertise in crafting, reviewing, and enforcing market regulations.[4] By incorporating its members into the regulatory process FINRA may succeed at generating more nuanced regulation. Its member firms will know the most about their businesses; giving them a voice in regulation may avoid imposing regulations that generate substantial costs with few benefits.

2. Stable Funding & Budgeting

Unlike regulatory bodies funded through Congressional appropriations, FINRA and other self-regulatory organizations may rely on members to provide consistent funding over time.[5] This consistent funding may allow FINRA to make stable commitments and long-term investments that public regulatory bodies might not.

3. Regulatory Flexibility

FINRA's status as a self-regulatory organization may exempt it from many of the constraints that bind traditional public regulatory bodies. This freedom may allow it to raise the standard of conduct for its member firms in ways that purely public bodies could not. For instance, FINRA Rule 2010 requires FINRA members to "observe high standards of commercial honor and just and equitable principles of trade." While this rule might be too vague for a public body to enforce, FINRA enjoys the freedom to apply this rule to "deter dishonest and unfair practices that might not amount to fraud, but nonetheless can undermine investor confidence and compromise capital formation."[6]

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investment bankers has thus far attracted scant scholarly attention"); Saule T. Omarova, *Wall Street As Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 414-15 (2011) ("what is conspicuously absent from the . . . broader debate among academics and policy-makers is a meaningful discussion of the role and shape of industry self-regulation in the emerging postcrisis regulatory order").

[2] *See* William A. Birdthistle & M. Todd Henderson, *Becoming a Fifth Branch*, 99 CORNELL L. REV. 1 (2013).

[3] FINRA CEO & President Robert W. Cook, Remarks at New Special Study Conference (Mar. 24, 2017), https://www.finra.org/newsroom/speeches/032417-remarks-new-special-study-conference [hereinafter Cook, Remarks].

[4] *See id.*

[5] *See id.*

[6] *Id.*

B. Risks of Self-Regulation

While the benefits of self-regulation may seem readily apparent to its members, it may be "much harder to objectively assess . . . what downsides the model may bring with it."[7] Some of my work critically considers the downsides associated with self-regulatory models.[8] I briefly review some concerns here.

1. Cartelization

One of self-regulation's dangers is that the model may allow member firms to prioritize their own interests over the public's interests. A self-regulatory organization may behave like a cartel if it acts to protect itself from external competition or regulation that would otherwise enhance social welfare.[9] As a self-regulatory organization, FINRA may face industry opposition when it considers regulations that would lower transaction costs for consumers and also reduce profits for its member firms.

2. Regulatory Capture

Regulatory capture occurs when industry gains significant influence over its regulatory body and subverts the mission of that body from its public purpose and toward advancing the interests of the industry or particular industry members. FINRA's governance structure seeks to mitigate some regulatory capture risks by apportioning industry representation by industry member size. These divisions may make it more difficult for larger firms to impose costly regulations that would reduce the ability of smaller firms to compete against larger firms.

3. Lax Enforcement

Self-regulatory bodies may face institutional pressures toward lax enforcement. In many instances, individual member firms will seek to minimize the amount of oversight faced. Given this, member firms should be expected to continually complain about the burden and intrusiveness of a self-regulatory organization's oversight. These firms should also be expected to use FINRA's engagement processes to press their complaints. Notably, Bernard Madoff participated in this dynamic when he complained about the intrusiveness of regulation before the revelation of his record-shattering Ponzi scheme. Madoff argued that "in today's regulatory environment, it's virtually impossible to violate rules . . . and this is something that the public really doesn't understand . . . it's impossible for a violation to go undetected."[10] FINRA may struggle to maintain rigorous enforcement standards in the face of complaints from its member firms.

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[7] *Id.*
[8] *See* Benjamin P. Edwards, *The Dark Side of Self-Regulation*, ___ U. CIN. L. REV. ___ (forthcoming 2017), draft available https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2829592.
[9] *See* JOHN C. COFFEE, JR., HILLARY A. SALE, & M. TODD HENDERSON, SECURITIES REGULATION: CASES AND MATERIALS 692 (13th ed. 2015) (discussing cartelization).
[10] Jessica Pressler, *Bernie Madoff: 'In Today's Regulatory Environment, It's Virtually Impossible to Violate Rules,'* NEW YORK MAGAZINE (Dec. 16, 2008), available: http://nymag.com/daily/intelligencer/2008/12/bernie_madoff_in_todays_regula_1.html.

4. Illusory Rulemaking Activity

Self-regulatory organizations may face pressure to engage in illusory rulemaking activity. This occurs when an organization makes rules for the avowed purpose of protecting a stakeholder constituency that lacks real power within the organization. These rules may generate the appearance of effort but without real substance. For example, FINRA's new rule for the protection of seniors and other vulnerable adults has been criticized because it does not actually require member firms to act if they become aware of financial exploitation.[11]

II. Governance Interventions to Mitigate Risks from the Self-Regulatory Model

At its core, FINRA exists to promote investor protection and market integrity. Its governance attempts to "strike the optimal balance between the benefits of active industry participation in regulatory decisions and [its] obligation to protect the investing public as a vigilant regulator."[12] To achieve this, FINRA embraced the need for a majority public board.

A key premise underlies the decision to appoint public representatives to the board. Public representatives must bring something different to the board than industry members—otherwise their appointment would serve no purpose. Ideally, public representatives zealously guard the public's interest and counterbalance industry influence within FINRA. To achieve this ideal, a public representative must have actual independence and a true public-interest orientation. If public representatives share the same perspectives, beliefs, and biases as industry members, they may represent the public's interest with less vigor. At worst, ideological, industry-aligned public representatives would provide a veneer of publicness, cloaking industry domination of a purportedly independent board.

Transparency may dispel unwarranted concerns. The public may fear that the industry dominates FINRA because they do not have ready access to information about its governance. FINRA may alleviate these concerns by embracing changes designed to amplify the public's ability to observe FINRA's governance. FINRA's Notice floats the possibility of changes that would substantially enhance public visibility into its governance.

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[11] *See* UNIVERSITY OF MIAMI SCHOOL OF LAW INVESTOR ADVOCACY CLINIC, PROPOSED RULES RELATING TO FINANCIAL EXPLOITATION 5 (2015), available http://www.finra.org/sites/default/files/15-37_University-Miami-School-Law_comment.pdf (explaining that the proposed rule "would allow a broker-dealer to *ignore* evidence of financial exploitation" without reporting the suspected exploitation or putting a hold on the account) (emphasis in original); GEORGIA STATE UNIVERSITY COLLEGE OF LAW INVESTOR ADVOCACY CLINIC, COMMENTS ON PROPOSED FINRA RULE ON FINANCIAL EXPLOITATION OF SENIORS AND VULNERABLE ADULTS 1-2 (2015), available http://www.finra.org/sites/default/files/15-37_georgia-state-law_comment.pdf ("the Proposal also allows a Qualified Person to use their discretion to ignore a reasonable belief that financial exploitation is likely and do nothing").

[12] Cook, Remarks.

1. *Should FINRA provide additional information on its website about its Board membership, such as Board member biographical information and term limits?*

At present, FINRA does not provide much information about the public representatives on its board of governors. FINRA's annual reports discloses less information about its board members than public companies provide in their annual securities filings. In some instances, FINRA's annual reports tersely describe board members as "retired" without providing information about their backgrounds.

This is not to say that FINRA does not make any information available. FINRA does provide some information about the public-representatives on its board in the press releases announcing their appointment. These releases provide a snapshot in time and do not update if the member takes on additional board positions—such as board positions with investment firms that might have some interest in FINRA regulations.

By providing more information about the public representatives on its board, FINRA may generate significant benefits. The public oversight provided by making additional disclosures could deter board members from accepting additional appointments that would generate conflicts with FINRA's mission. Disclosure would also allow members of the press and academics to more readily ask questions about possible conflicts of interest flowing from the backgrounds of FINRA's public governors.[13] This increased oversight would decrease the odds that conflicts would go undetected and potentially taint FINRA's vital governance processes.

Importantly, FINRA's bylaw requiring public board members to have no "material business relationship" to "a broker, a dealer, or other self-regulatory organization,"[14] may inadequately capture relationships generating material conflicts. Other financial intermediaries such as insurance companies and registered investment advisers may have significant interests in FINRA regulation. To the extent that public board members occupy dual roles with these types of firms, disclosure requirements may help mitigate these conflicts of interest.

FINRA should consider whether additional disclosure would adequately mitigate these conflicts. FINRA might further mitigate these conflicts by strengthening its bylaws defining who may serve as a public representative on its board or by promulgating additional governance guidance.

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[13] *Cf.* Hillary A. Sale, *J.P. Morgan: An Anatomy of Corporate Publicness*, 79 BROOK. L. REV. 1629, 1631 (2014) ("Non-regulators, in particular, can play a significant role in constraining the choices of corporate actors, both through pressure for increased regulation and pressure for governance changes").
[14] FINRA, *By-Laws of the Corporation*, article I, § (tt).

2. *Should FINRA post the Board's committee charters on its website? How would this information be useful?*

FINRA should post its Board committee charters on its website. As an initial matter, because posting existing charters to FINRA's website may be accomplished at nominal cost, even modest benefits would justify making the information available.

Access to FINRA's committee charters and the membership of particular FINRA Board committees would facilitate understanding of other FINRA disclosures. For example, outsiders attempting to understand how FINRA selects its public representatives would benefit from the opportunity to review the actual proportion and composition of public and industry representatives on FINRA's nominating committee that selects its public governors. The views of this committee about the public's role in FINRA's governance may have an outsized impact on FINRA's governance because they select a majority of FINRA's board.

3. *Should FINRA make other governing documents, such as FINRA's corporate governance guidelines and Board member code of conduct, publicly available? How would this information be useful?*

FINRA should make its other governing documents publicly available because they would provide substantial benefits. Public access would improve the public's ability to review FINRA's governance and raise questions when appropriate. Simply making the governance documents available publicly might deter violations of the governance guidelines by board members who would prefer not to face public questions about dual appointments and possibly conflicting roles.

Access to FINRA's governance guidelines and Board member code of conduct would also improve FINRA's governance by increasing the likelihood of public review and comment that could assist FINRA in improving its practices and governance.

Conclusion

FINRA should adopt the transparency initiatives now under consideration in connection with the Notice and its FINRA360 review. To the extent that additional disclosures could be made available by the FINRA President and CEO, these reforms could be accomplished at marginal cost and improve FINRA's ability to strike the right balance between industry participation and investor protection.

I thank FINRA for the opportunity to comment and applaud its commitment to improving its transparency and governance.

Sincerely,

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