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Finra, First Heal Thyself

By JIM MCTAGUE

IN 2007-08, REGULATORS AT FINRA WERE so distracted with empire-building and lining their pockets, they overlooked the world's two largest Ponzi schemers: Bernie Madoff and, allegedly, R. Allen Stanford. So what's the deeply flawed Financial Industry Regulatory Authority up to now? Building itself an even bigger empire.

The quasigovernmental body, which advertises itself as the white knight of 90 million investors, is lobbying Congress for the power to regulate 11,000 investment advisors who now fall under the jurisdiction of the Securities and Exchange Commission and state securities regulators. The states regulate those with less than $25 million in assets, but want Congress to bump that to $100 million. Why? The SEC does such a poor job, it visits an average of one advisor every nine to 11 years!

Finra currently regulates Nasdaq and New York Stock Exchange brokers and securities dealers, and pays its executive staff high-on-the-hog salaries, despite abysmal performances. This is the same behavior that contributed to the failure of big financial firms that operated under Finra's purview. If Congress accedes to its power grab, the kingdom of Finra will be able to fatten its coffers with millions more dollars in fees from its new charges. Given Finra's sorry enforcement record, there's little reason to believe investors would be any better off.

Why would investment advisors want to shell out money for the privilege of being regulated when the SEC does it free? The state regulators oppose Finra's grab because they say there's no adequate oversight of the organization.

"They aren't accountable to anyone but their own members," says Texas Securities Commissioner Denise Voigt Crawford. As for being investor-friendly, she points to their "abhorrent" mandatory system of dispute resolution by arbitration, a process she says is stacked in favor of the firms.

FINRA'S STORY is that had it been regulating investment-advisory firms in 2007, it might have caught on to Madoff. Although Madoff's brokerage business was regulated by Finra, his investment-advisory business, where the fraud took place, was regulated by the equally hapless SEC.

Says Finra spokeswoman Nancy Condon, "The absence of a comprehensive examination program for investment advisors impacts the level of protection for every member of the public who entrusts funds to one of those advisors. It's clear that dedicating more resources to a regular and vigorous examination program and day-to-day oversight of the investment advisors could improve investor protection for their customers, just as it has for customers of broker-dealers."

Finra's critics find this argument risible, pointing out that there's scant evidence that the regulator examined Madoff's brokerage business in recent years. Furthermore, they contend Finra failed to properly regulate a host of firms at the center of the financial meltdown, including Bear Stearns, Lehman Brothers, and Merrill Lynch.

The nonprofit Project on Government Oversight says an internal Finra review shows Finra missed key opportunities to uncover alleged fraud by Stanford, in part because it is too cozy with Wall Street.

Finra is what is known in the securities world as a self-regulatory organization, or SRO. Congress wrote a provision in the Securities and Exchange Act of 1934 permitting exchanges to create SROs to regulate member conduct and punish scofflaws. The SEC conducts regular inspections of Finra. But there are no regular oversight hearings by the Congress.

In 2006, the NYSE and the Nasdaq each had an SRO. In 2007, the two exchanges agreed to create Finra, to realize cost efficiencies and regulatory harmony. The merger required emendation of the Nasdaq market's bylaws by some 5,000 members.

Its SRO decided to prod the change by offering members $35,000 apiece from $2 billion in members' equity it had amassed as a result of the public listing of the Nasdaq stock market between 2001 and 2006. The SRO had owned shares of Nasdaq stock. In a prospectus and in road shows, Finra contended that the Internal Revenue Service threatened to yank its nonprofit status if it paid Nasdaq's members $35,000 each.

Several broker-dealers subsequently sued Finra, alleging the officers had lied and subsequently had used some of the money to give themselves exorbitant pay raises. Mary Schapiro, who ledFinra then, received $7.3 million in salary and accumulated benefits when she left; now chairman of the SEC, Schapiro makes $158,500 a year. This month, Judge Jed Rakoff of the U.S. District Court for the Southern District of New York dismissed the lawsuits, not on their merits, but because under the law, Finra and its officers enjoy "absolute immunity" from private actions challenging their official conduct as regulators. The judge's action startled the investment-advisory community.

"I don't think Finra is accountable to anyone," says David Tittsworth, executive director of the Investment Advisor Association in Washington. He's right. Congress should change this, not give Finra an expanded kingdom.

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