CHAPTER 11:
Transparency and Accountability at the SEC and at FINRA

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We know that governments "deriv[e] their just powers from the consent of the governed"[1]—but what happens when the governed have no means of providing, or withholding, their consent? Currently, those bodies that govern the country's securities sector—in particular the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA)—lack the structural safeguards necessary to ensure that they exercise their authority only with the consent of the American public. There are solutions to these problems. The solution for the SEC is easier than the solution for FINRA, but the first step is persuading both entities that there *is* a problem. This chapter outlines the problems of accountability and transparency that plague both entities, and provides recommendations for ameliorating these deficiencies.

THE SEC: ADMINISTRATIVE PROCEEDINGS

The SEC was established in 1934 amid the wave of new agencies created under the auspices of the New Deal. Like many of this new breed of federal agency, it has, from its inception, incorporated rule-making, investigatory, and adjudicatory functions. The mix of all three branches—legislative, executive, and judicial—in a single agency has always inspired some skepticism. Indeed, James Madison warned against such a mix of powers in the *Federalist Papers*, arguing that the "accumulation of all powers, legislative, executive, and judiciary, in the same hands, whether of one, a few, or many, and whether hereditary, self-appointed, or elective, may justly be pronounced the very definition of tyranny."[2] The inclusion of the adjudicatory power may pose the greatest threat to liberty.

When an agency's adjudicatory power is limited, when it is used only to interpret the rules established by the agency itself and not to mete out punishment, the risk it poses is reduced. Unfortunately, the role of the Administrative Law Judge (ALJ), who presides over this function, has increased enormously at the SEC, and administrative adjudication has now in many respects overtaken the role carved out in the constitution for the judiciary. This increase in power represents a serious threat both to the liberty of individuals and companies brought before the SEC's ALJs, as well as to the credibility of the system as a whole.

While the SEC has always had the power to conduct internal hearings, the ALJ did not exist until somewhat later. The Administrative Procedure Act (APA), passed in 1946, provided some guidance on conducting internal adjudications.[3] Amendments to the APA in 1966 established further procedural rules for hearings presided over by agency employees, then called "hearing examiners."[4] But it was not until 1978 that the corps of quasi-judicial employees was dubbed ALJs.[5]

In the nearly 40 years since ALJs were established, the role has seen a marked increase in power. Although SEC administrative hearings were for decades viewed as providing remedial, not punitive, relief, that view began to change in the 1980s.[6] Between 1984 and 1990, the SEC's enforcement power expanded to include the ability to seek monetary penalties for violation of the securities laws, the ability to bar directors and officers of public companies from serving in those roles as a consequence of having engaged in activity prohibited by the securities laws, and the authority to issue cease-and-desist orders, temporary restraining orders, and orders to disgorge ill-gotten gains.[7] In the wake of the corporate scandals that dominated the beginning of the 21st century, the Sarbanes–Oxley Act of 2002 handed the SEC more authority still, creating new obligations for corporate executives and directors, and providing the SEC with the tools to enforce those rules. And in 2010, the Dodd–Frank Act gave the SEC the power to impose fines on individuals who had not previously been subject to SEC authority.[8]

The SEC is not unique among federal agencies in using administrative hearings presided over by ALJs. But not every administrative hearing is created equal. The vast majority of ALJs work for one agency: the Social Security Administration (SSA). That agency alone employs more than 1,500 of the roughly 1,800 ALJs employed by the federal government.[9] The SEC, by comparison, employs only five. The types of cases the SSA hears, however, differ substantively from the type heard by the SEC. In the case of the SSA, the role of the ALJ is to determine whether a person is eligible to receive benefits.[10] At the SEC, however, it is not the individual appealing a decision to the agency, but the agency bringing an action *against* the individual. The individual, as a respondent, has no choice but to participate in the administrative hearing. Additionally, while the SSA hearings typically address whether the government must give benefits *to* the citizen who brought the appeal, the SEC hearings typically address whether the government will *take* fines or withhold licenses from the citizens brought before it.

Although the SEC's enforcement power has grown over the past several decades, it has done so without an attendant examination of the agency's administrative hearings. The role of administrative hearings within the SEC has become indistinguishable from the role of trials before federal judges. In fact, in most cases brought against a respondent by the SEC, there is concurrent jurisdiction between the agency and the court. That is, the case is one that could be heard by a federal judge in federal district court, but is instead brought before an ALJ within the SEC. It is not clear how these actions are distinguishable from the judicial power of the United States, which, according to the Constitution, is vested in the federal courts, not in the federal agencies. In fact, a number of respondents have recently challenged the SEC's administrative hearing process, alleging that the hearings provide insufficient due process and that the appointment process for ALJs is unconstitutional.[11]

There has also been concern that the SEC has an easier time prevailing in its own administrative proceedings. A recent article in *The Wall Street Journal* noted that the SEC enjoys a 90 percent success rate in administrative proceedings but prevails in only 69 percent of cases before federal judges.[12] It is possible that a portion of this discrepancy can be attributed to the agency's internal selection process and that the cases brought in-house are for some reason those that would be easier for the SEC to win regardless of venue. But the perception of fairness is often as important to the integrity of an adjudicatory process as the actual existence of fairness, and in this case the difference at least raises questions about whether individuals receive fair treatment.

The distinction between court and administrative proceedings is especially important because federal court proceedings include a number of protections for the benefit of the defendant that are lacking in administrative proceedings. Most important among these is the discovery phase of litigation. Broadly, discovery is the process by which the parties obtain information from each other about what evidence might be presented at trial.[13] The process is highly formalized and includes both written and oral portions. In the written portion, parties exchange lists of questions to be answered under oath by the other party, and write requests for documents, which must be produced again under oath. Any failure by either party to comply with these written requests can be brought to the court. The oral portion includes depositions, in which potential witnesses provide hours of sworn testimony. The questions that can be posed during this process are wide-ranging and allow much greater leeway than is afforded at trial.

Although respondents in administrative hearings may request that certain documents be subpoenaed and that certain witnesses be called for the hearing, the process is limited when compared with the process permitted in federal court. The lack of discovery in administrative proceedings means that respondents and their counsel may go into settlement negotiations partially blind. Approximately 80 percent of all cases begun as administrative proceedings ultimately settle, making the fairness of settlement negotiations a key determinate of fairness overall.[14] It is exceedingly difficult to know what a fair settlement is without knowing what evidence is likely to be presented in a hearing. And because the discovery process uncovers not only the evidence likely to be presented in support of the plaintiff's case, but also information that weakens the plaintiff's position, access to this information is crucial to a defendant's ability to leverage the weaknesses to obtain a more favorable deal.

The government, however, does not approach settlement blindly. The government has the authority to issue subpoenas for both documents and for witnesses to appear and give testimony in the course of its investigation, before the SEC has even decided to pursue charges. This testimony is typically provided in a closed session with just the SEC's lawyer, the witness, and the witness's lawyer present. The government also reviews thousands, or millions, of documents provided by the respondent and other individuals and firms. By the time the parties begin settlement negotiations, the SEC usually has a much clearer understanding of what would be presented at a hearing than the respondent does.

Administrative proceedings present other challenges as well. Because the hearing and investigation are conducted by the industry regulator, witnesses in the industry may be nervous about testifying in favor of a respondent. Of course, even in federal court a witness who works in the securities industry may be hesitant to testify against the SEC, but the court provides the added safeguard of being presided over by a federal judge. The experience of testifying before a judge or a jury in a courtroom is simply different from showing up on the doorstep of the SEC building to testify before an SEC employee. Finally, administrative hearings provide no option for a jury trial; the ALJ alone makes the final decision in the case, unless it is appealed.

ALJs do not, as has been noted, operate without certain checks on their authority. Any decision rendered by an ALJ can be appealed to the SEC itself.[15] Even that decision can ultimately be appealed to a federal court. But recourse to either of these avenues depends on the respondent proceeding with a complete hearing instead of settling. As mentioned above, only 20 percent of cases proceed to hearing; the other 80 percent settle with no opportunity to appeal even to the full SEC.

This is a vitally important point. As discussed earlier, respondents and their lawyers go into settlement negotiations without a full command of the evidence. In the rare cases in which a respondent proceeds to a full hearing, the respondent at least has the benefit of seeing the evidence against him or her and has an opportunity to respond to it. A respondent who instead opts for settlement may have no such opportunity.

Additionally, even when a case proceeds through a hearing, the available appeal is limited. In law, there are two types of findings that can be determined through trial: findings of fact, and findings of law. Findings of fact refer to the process of determining what actually happened: Did the defendant make a particular transaction? Did the respondent have certain knowledge? Did the defendant communicate with another person at a specific time? Findings of law refer to the process of determining whether those facts satisfy the elements of the case brought against the defendant: Was the information "material"? Was the communication "misleading"? Although the commissioners may hear an appeal, they typically give great deference to the ALJ's findings of fact, in particular to the ALJ's determination of witnesses' credibility, "absent overwhelming evidence to the contrary."[16] If the respondent claims not to have said particular words during a telephone call, but the ALJ has found the respondent's denial not credible, the commissioners will typically accept the ALJ's finding. What the commissioners will review is whether those words constituted, for example, a misleading statement about a material fact. If the case is appealed to federal court, the court will grant the same deference, accepting as true the findings of fact made by the ALJ. This means that even in the 20 percent of cases that proceed through a full administrative hearing, and are not settled, there is no real opportunity to appeal the ALJ's findings of *fact* even if it was the facts, not the law, that were in dispute. This does not differ from the practice in the judicial branch in that the findings of fact made at the trial court level are rarely disturbed by the appellate court, and appeals almost always turn only on the interpretation of the law and its application to the facts. But, as discussed, defendants facing trial in court have the full discovery apparatus available to them, rendering the findings of fact more reliable than those determined by an ALJ.

Given the lack of discovery and the handicap it presents the respondent in making a case to the ALJ, and crucially in refuting evidence presented by the SEC attorneys, review of findings of law by the commission or a federal court is cold comfort. Especially as it is the commission that decides to bring charges against a respondent in the first place. This results in what is at base "a top-level, agency-wide decision to side with Enforcement and against the respondent, prior to any adversarial hearing on the merits."[17] An appeal to the very body that already sided against the respondent is not much of an appeal at all.

Although agencies do not conduct the full recruitment process for ALJs, they do select the individuals from a list presented to them by the Office of Personnel Management. And while there are certain practices designed to preserve the independence of the ALJs—they can be fired only for cause, and, at least in the SEC, their offices are physically segregated in the building from other employees—the ALJs are nonetheless employees of the agencies they serve and are on the agency's payroll. This is not to impugn the integrity of any individual ALJ, nor of the entire corps, and yet such arrangement can elicit "fears of bias [which] can arise when—without the consent of the other parties—a man chooses the judge in his own cause."[18] Again, there is a distinction between the hearings held by agencies such as the SSA, and enforcement hearings such as those held by the SEC. This is clearly visible in the manner in which the agencies present their adjudications to the public. For example, the SEC often issues press releases touting the number of successful enforcement actions it has brought in the past year, congratulating its staff for their work in winning large penalties or settlements from defendants.[19] In comparison, there is no political capital to be gained by trumpeting the number of applicants for Social Security benefits who were turned away empty-handed each year. The incentives of the SSA in conducting its hearings are quite different from those of the SEC, resulting in a structural bias in favor of the SEC in its own administrative hearings.

The solution to the current problem is relatively simple: Give the respondent a choice of federal court or administrative proceeding. This is the choice that is always available to the SEC's enforcement attorneys and it is only fair to extend it to the respondent. In other areas of law with concurrent jurisdiction—when a case could be brought in state or federal court, for example—the parties are equally eligible to move for the case's removal to the other jurisdiction.

Those who support the use of administrative proceedings often tout their benefits to the respondent. For example, noting that the process is streamlined and therefore speedier, allowing the respondent to move on quickly without a cloud of suspicion hanging overhead. A quicker proceeding also means less attorney time and therefore a lower cost for the respondent. The ALJs, because they hear only securities cases, are typically more knowledgeable about the intricacies of securities regulation and can be a better arbiter than a federal judge who hears every kind of case under federal law with little opportunity to delve deeply into any. To the extent that these features are attractive to respondents, many may still choose to proceed through the administrative route. But these features are not universally attractive, as evidenced by the respondents suing for their rights to be heard in federal court. To the extent that a respondent would prefer the safeguards so precious to our concept of due process, the respondent should have the opportunity to elect them.

FINRA: A BIGGER PROBLEM

In addition to the SEC, there is another organization that regulates the securities industry. Neither fish nor fowl, it straddles the line between government and private entity, in many instances taking the worst from both worlds and offering a considerable lack of transparency and accountability overall. FINRA is a non-governmental self-regulatory organization (SRO) that oversees firms and individuals operating in the securities industry. Organized as a private not-for-profit corporation, it, like the SEC, includes rule-making, enforcement, and arbitration functions all under one roof. It writes and issues rules that, with SEC approval, govern the securities industry. It administers the industry's licensing process, including writing and administering the relevant exams. It investigates the violation of its rules and conducts in-house enforcement actions, levying fines and barring individuals and firms from the industry in order to punish and deter wrongful conduct. It provides investor education to the public. And, it provides arbitration facilities for its members in order to mediate disputes between them. Like the SEC, compliance with its rules is compulsory for those in the securities industry. Unlike the SEC, its management is not answerable to, nor appointed by, an elected official.

The fact that FINRA is a non-governmental regulator is not, in itself, problematic. Although the federal securities laws date from the Great Depression, and state securities laws date from the turn of the 19th century, non-governmental regulation of the industry dates from just after the country's founding. In 1792, a group of brokers famously executed the Buttonwood Agreement, creating what is now known as the New York Stock Exchange (NYSE). While the NYSE has never been a government entity, it has always been a regulator. Although the terms of the Buttonwood Agreement were quite terse, the rules for trading on the NYSE expanded over time. By 1817, the rules already included a process for collecting fines, adjudicating disagreements, and ejecting members found to have engaged in fraud.[20] A hundred years later, by 1920, a disclosure regime was also firmly in place, with a number of monthly and other regular reports required by member firms.[21] There is, in fact, much to be recommended in the private regulation of the industry. Indeed, it was the practice in this country for more than 100 years.

While FINRA did not come into being until 90 years after the NYSE was established, the framework for such a public-private structure was laid much earlier. In 1934, Congress passed the Exchange Act, which established the SEC and introduced government regulation of the securities exchanges. In 1938, the Maloney Act amended the Exchange Act to provide for the creation of self-regulatory organizations that would provide oversight of the over-the-counter (OTC) markets in a manner similar to the oversight provided for exchange trading by the exchanges themselves. These organizations were charged with "prevent[ing] fraudulent and manipulative acts and practices [and] promot[ing] just and equitable principles of trade."[22] Although the Maloney Act contemplated "national securities associations" (plural) only one such association, the National Association of Securities Dealers (NASD), ever materialized.

FINRA took on its current form in 2007 when the NASD merged with the regulatory arm of the NYSE.[23] One of the chief reasons for the merger was to consolidate the regulations governing broker-dealers, bringing the exchange and OTC oversight under one roof.[24] The merger was expected to streamline the regulatory burden by "eliminat[ing] unnecessarily duplicative regulation, including consolidating and strengthening what until now have been two different member rulebooks and two different enforcement systems."[25] FINRA, like the NASD before it, is an SRO as defined by the Securities Exchange Act of 1934.

There are considerable advantages to industry self-regulation. One of the challenges of effective oversight is the risk that the overseers become detached from the industry and begin to create rules that are out of touch with the day-to-day realities of running a business. Done well, self-regulation draws on members' experiences to establish best practices that promote both good governance and ethical policies. But these benefits are difficult to realize when the self-regulating organization combines government power and entanglement with private ownership, as is the case with FINRA. Instead, it operates with nearly as much power as a government agency, but without essential checks on that power.

One of the reasons that checks on government power are so essential to liberty is that it is the nature of government regulation to be mandatory; there is no opt-out. When the NASD was first established, membership was voluntary. Beginning in 1945, however, membership became mandatory for principal and customer-facing employees of broker-dealers, and by 1983, it was mandatory for the entire industry, a requirement that has persisted with the creation of FINRA.[26] This has resulted in the creation of a quasi-governmental structure that lacks the safeguards that we insist upon for actual government institutions. Although FINRA's rules must be approved by the SEC,[27] the SEC does not choose FINRA board members, nor does it appoint any executives or other employees of the organization. This means that, despite the broad power that FINRA exercises over the industry, there is no accountability to an elected official or even to an officer of the United States.[28] Instead the executives are chosen by a board of directors, and the executives and other managers select the remaining employees.

FINRA's lack of accountability also means that it is at risk of providing poor protection to investors. While the SEC and other government actors are ultimately answerable to the investing public, FINRA faces no such scrutiny, and its officials risk no removal from office. There is therefore no direct political accountability to provide an incentive to FINRA officials to ensure that its rules are effective. Because investors have been encouraged to rely on the SEC and FINRA to enforce certain standards against the industry, they are likely to be lax in conducting their own due diligence in assessing the business practices of a broker.

FINRA also lacks the transparency that is required of government entities. It is not subject to the Freedom of Information Act that requires government offices to release requested documents to the public.[29] It is not required to follow the lengthy rule-making process mandated by the Administrative Procedures Act, which ensures that any proposed regulation be subject to public notice and comment.[30] Nor is it subject to the Sunshine Act's provisions that require certain meetings be open to the public.[31] Accompanying the lack of proper controls is the fact that, like the SEC, it houses multiple quasi-governmental functions, along with the attendant problems described in the previous section.

FINRA also lacks the checks on power and the considerable benefits that typically apply to private corporations. One of the great benefits of private enterprise is the discipline and push toward innovation that market forces supply. But because FINRA is a monopoly, it has no incentive to improve its structure to attract members. Because membership is compulsory, FINRA faces no risk that members will flee from unfair rules or enforcement. It has the freedom to establish compensation for its own employees at rates as high as its funds can support. And that compensation can be quite high. In 2015, FINRA's CEO earned nearly $3 million; of the organization's top 10 executives, eight had compensation squarely in the seven figures, and the remaining two were close behind.[32] While FINRA must compete with the private sector to attract and retain talent, and talented financial executives can command huge compensation in the private sector, it draws on the same talent pool used by other financial regulators, whose pay is not nearly so rich. For example, SEC commissioners earn just under $250,000, and the Secretary of the Treasury earns less than $200,000.[33] It is not clear why the FINRA CEO must earn 15 times the amount the Secretary of the Treasury does. In a truly private organization, which faces competitive pressures, compensation is held in check by the need to run the company efficiently. FINRA executives face no such countervailing force.

The means by which FINRA is funded creates its own conflicts, since FINRA's funding derives from fees levied on members and from proprietary investments, including investments governed by FINRA's own rules. FINRA has attempted to temper some of this conflict, at least with regard to fees imposed for violation of FINRA rules. Such fees can be used only for capital expenditures or for programs promoting investor protection.[34] But money is fungible and therefore fees that support capital improvements free up other funds to be used for other purposes, including pay roll.

FINRA therefore exists in a kind of golden limbo. As a private entity, it is protected from the accountability and transparency required of government. As a quasi-governmental entity, it enjoys enormous power without being subject to the usual market forces. It also enjoys immunity from suit, at least when acting in its quasi-governmental role.[35]

The solution to this problem is to withdraw FINRA's quasi-governmental authority and allow it to exist as a purely voluntary, private industry association. This will return accountability to its members, who will have the option of leaving if they are unsatisfied with its practices. FINRA would be able to continue to administer a certification exam, but would need to promote the value of this exam to investors and brokers alike, leading investors to seek out brokers who hold FINRA certification and leading brokers to be willing to sit for the exam. FINRA would be motivated to police the rigor of the exam because it would be valuable only if investors perceived it to demonstrate the broker's knowledge. FINRA would also be motivated to police its membership to ensure they meet the organization's standards, and members would be willing to submit to this oversight to communicate their trustworthiness and ability to clients. Additionally, without the government ties, entrance for new SROs would be easier, introducing competition and allowing refinement of rules and best practices. Finally, it would loosen the grip that FINRA currently has on members, requiring fairness and transparency in its disciplinary process.

Although private regulation can provide great benefits to an industry, many of those benefits are compromised when the regulator enjoys governmental authority. Likewise, governmental power without the essential checks on power we typically require risks tyranny. FINRA has the potential to improve the securities industry, protect investors, and promote the reputations of honest brokers. But, if it continues to operate unchecked and without needed transparency, it risks providing none of these.

CONCLUSION

Governmental power must be accountable to the electorate if it is to qualify as just. Accountability assumes transparency because the people cannot judge the government's actions if they cannot determine what the actions are. The SEC and FINRA both suffer in different ways from internal structures that obscure their activities and that prevent their accountability to the people whose lives and livelihoods they control. These problems must be addressed, or the powers these regulators wield must be deemed unjust.

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ENDNOTES

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