Finra: Who's watching the watchdog?

The regulator wields enormous power over the securities industry with little meaningful oversight

By **Mark Schoeff Jr.** **and** **Bruce Kelly** — September 2, 2017

IF you're a broker, there are three things in life that are certain: death, taxes — and answering to Finra.
Finra is the self-regulatory organization that makes sure the nation's 3,700 broker-dealers and 631,000 brokers comply with securities laws and regulations to ensure that investors are protected and treated fairly. It has the power to levy fines and, in serious cases, bar brokers and individuals from the industry. If you want to be a broker or operate a brokerage firm, you must join Finra.

No one argues against the need for regulation, but over the years the **Financial Industry Regulatory Authority Inc.** has grown into a huge institution, one that generates hundreds of millions of dollars a year in revenue through membership fees and fines. It also maintains a reserve of about $1.6 billion and employs upward of 3,000 people, some of whom receive exorbitant salaries by industry standards.

Finra wields enormous power over the lives of brokers and broker-dealers. Last year alone, it issued more than 1,400 disciplinary actions and barred more than 500 brokers from the industry.

And yet people in the industry know little about how Finra operates, how it spends the millions it collects in membership fees and fines, and how it sets its regulatory agenda. Finra writes its own rules, meets behind closed doors and releases information if and when it deems necessary.

Finra is the watchdog that no one is watching.

“It is largely unaccountable to the industry or to the public,” David Burton, a senior fellow in economic policy at the Heritage Foundation, **wrote in a February report**. “Due process, transparency and regulatory-review protections normally associated with regulators are not present, and its arbitration process is flawed. Reforms are necessary.”

In an *InvestmentNews* survey of 363 readers who are regulated by Finra, nearly half — 48% — said the organization is not doing a good job of regulating brokers, compared with 29% who said it was. Meanwhile, 61% said Finra is not transparent about its finances, and the same percentage said the SEC's oversight of Finra is inadequate.

"IS IT [FINRA] A GOVERNMENT OR NOT A GOVERNMENT AGENCY? AS LONG AS THERE'S NOT A CHOICE FOR BROKERS, IT'S A MONOPOLY – AND MONOPOLIES NEED TO BE REGULATED."JIM R. WEBB, CEO, CAPE SECURITIES INC.

Jim R. Webb, CEO of broker-dealer Cape Securities Inc., is frustrated that Finra acts like a government agency but does not have to follow the laws that govern public agencies. For example, it is not subject to laws that would allow the public to attend its meetings, nor is it subject to the Freedom of Information Act, which allows anyone to request information about any matter from a federal agency.

Finra protects itself from lawsuits from members by claiming that as an SRO it has absolute immunity from private lawsuits challenging the conduct of its regulatory mission.

"There needs to be definition," Mr. Webb said. "Is it a government agency or not a government agency? As long as there's not a choice for brokers, it's a monopoly — and monopolies need to be regulated."

Mr. Webb ran unsuccessfully last month for a seat on Finra's board representing small brokers, calling for more disclosure. "I want to make the funding of Finra more transparent," he said. "Other than the annual report, what do you know?"

Kenneth E. Bentsen Jr., CEO of the Securities Industry and Financial Markets Association, the leading trade group representing the securities industry, also decried a lack of information coming out of Finra.

"There is virtually no public information currently available about how Finra specifically uses the revenues it receives from its fees and other income," he **wrote in a comment letter about Finra 360**, a comprehensive review of the SRO's **operations being conducted by CEO Robert Cook**.

Finra declined to respond to specific criticisms from members and experts contacted for this story, nor did it make Mr. Cook available for an interview. It did, however, emphasize that **Finra 360** has already produced reforms.

For example, the SRO said it has streamlined its enforcement operation, enhanced examiner onboarding and training, and reformed registration rules to make it easier for people with no securities industry experience to take a general knowledge exam. Finra also recently announced it will begin publishing summary reports on common exam findings by the end of the year.

“The ongoing, multi-year project has already resulted in a number of changes and improvements ... and reflects our commitment to be the best-informed, and most effective and efficient self-regulatory organization we can be,” Finra spokeswoman Michelle Ong said in a statement.

FINRA'S FINANCES

Make no mistake, executives at Finra are running a business — and a very big business at that. Depending on its size, a broker-dealer can expect to pay anywhere from a few thousand dollars to tens of millions of dollars a year in membership fees.

The SRO maintains a strong balance sheet and **had $1.6 billion in net assets** held in a reserve fund on Dec. 31, 2016. To some Finra members, that is a point of contention.

“If you're a not-for-profit, why isn't that money being rebated to members?” said Carrie Wisniewski, president of B/D Compliance Associates Inc. and a Finra member.

Finra returned money to members from 2007 through 2014, with totals ranging from $5.4 million to $20 million. But it hasn't done so in the last two years.

Thanks to a dramatic 85% **increase in fines**, Finra's net revenues totaled $1.02 billion in 2016, a 2.6% increase from $992.5 million the year before. The increase in net revenue was fueled by a big jump in fine revenue to $173.8 million, from $93.8 million in 2015.

Finra fine amounts growing

Source: Finra

The aggressiveness with which Finra issues fines, and its use of what many describe as strong-arm tactics to collect them, has not gone unnoticed.

In 2008, Finra issued 577 fines that averaged $48,500. In 2016, the SRO issued 624 fines — an increase of 8%. But the average amount of those fines has skyrocketed to $278,500, an increase of 474% over that period.

“Finra is fining the big firms a little bigger; instead of $1.5 million, it's now $2.5 million,“ said David Sobel, a former chairman of Finra's small firm advisory board and Finra specialist with the law firm Jacko Law Group. “But they are nickel-and-diming the small broker-dealers. Some of it is the enforcement division getting overaggressive in fines and penalties.”

Then there's the matter of how Finra spends the fine money it collects. It does not report in detail where that money goes, except to say it is used for capital projects.

Finra declined a request by *InvestmentNews* to shed more light on how it spends its fine revenue. “We do not view fines as part of our operating revenues,” **Finra wrote in this year's annual report**. “The use of fine monies is limited to capital expenditures and regulatory projects, such as our efforts to leverage technology innovations and the cloud initiative, and other projects” approved by the board.

But that's simply not good enough for Stephen Kohn, president of broker-dealer Stephen A. Kohn & Associates, who won a small-firm seat on the Finra board last month. Prior to the election, he pressed Finra for more details.

“I've asked specifically: Where do the funds go? I don't really get a straight answer,” Mr. Kohn said at the time.

Although Finra says it doesn't use fine revenue to offset expenses, if it does use it for capital projects, then it is freeing up other revenue that would otherwise be used to pay for those projects.

“Money is fungible,” said Alan Wolper, a partner at Ulmer & Berne. “It all goes to the bottom line. The more money on the bottom line, the more money that is available.”

The Financial Services Institute, a trade group that represents independent broker-dealers, told Finra in a recent comment letter related to Finra 360 that fines are being used as an intimidation tool.

“It has been a concern in the past that large fines are proposed to firms, and that they need to sign [a settlement] or face a larger fine if the discussions with Finra continue,” Robin Traxler, FSI vice president of regulatory affairs and associate general counsel, said in an interview.

Another FSI worry is that Finra is using enforcement as a way to effectively establish new rules.

“There is a perception, if not the reality, that enforcement has morphed into a regulatory mechanism rather than making investors whole,” Ms. Traxler said.

REGULATORY APPROACH

Finra's approach to regulation is a sore spot, particularly among small broker-dealers. In the last 10 years, the number of firms Finra regulates has declined 24%. Some of those firms have gone out of business because of Finra, according to Ira Lee Sorkin, an attorney and former head of the New York office of the Securities and Exchange Commission.

“Many small firms have not been able to survive Finra sanctions,” Mr. Sorkin said. “[Those sanctions] have been singularly successful in putting small firms out of business.”

Critics complain that Finra is too quick to bring punitive action instead of working with firms to bring them into compliance.

“Finra has to decide if it's a compliance or an enforcement organization,” said Mr. Sobel. “Finra should go in and help the broker-dealers first. And after you help and there's a problem, then do enforcement.”

Last year, **Finra logged 1,434 disciplinary actions**, barred 517 brokers and returned $27.9 million to harmed investors.

“Their prosecutorial role clashes with their regultory role of trying to help firms,” said Daniel Nathan, a partner at the law firm Morvillo and a former Finra vice president and director of regional enforcement. “For the last five to 10 years, they have increasingly been trying to play in the same arena as the SEC and the criminal agencies.”

LACK OF ACCOUNTABILITY

By law, the SEC is in charge of Finra and has the power to approve or reject any rules Finra wants to adopt. But it applies little more than a rubber stamp to Finra's rules, critics say.

“In practice, Finra operates with substantial independence from the SEC,” Hester Peirce, a senior research fellow at the Mercatus Center at George Mason University, **noted in a 2015 paper**. “Finra rules do not typically attract close attention from the SEC commissioners.”


“FINRA OPERATES WITH SUBSTANTIAL INDEPENDENCE FROM THE SEC."
HESTER PEIRCE, SEC NOMINEE

Ms. Peirce may be in a position to change that soon. She has been nominated by President Donald J. Trump to serve on the five-member commission that governs the SEC. “Finra is an issue that they need to be paying attention to,” she said in an interview prior to her nomination.

The Government Accountability Office likewise found that the SEC could be doing a better job of overseeing Finra in a 2012 report and **a follow-up report in 2015**. In the follow-up report, the GAO said the SEC had improved its monitoring of Finra but that it still needed to develop specific performance goals and measures for Finra oversight, formalize documentation of oversight determinations and perform an assessment of Finra's internal risks related to staffing and priorities.

The SEC did not respond to a request for comment. Last year, the SEC established a special unit to consolidate monitoring of Finra's examination efforts after the SEC transferred more authority for broker exams to Finra so that the SEC could increase its examinations of registered investment advisers.

Although Finra is not directly accountable to Congress, it does invest a lot of money in lobbying. In 2012, it spent $960,000 as it pushed for legislation that would allow it to expand its regulatory reach to include RIAs, who are now primarily regulated by the SEC. In 2016, **Finra's spending on lobbying dropped to $670,000**.

But even here, Finra is not transparent. In its disclosure form, it stated that it talked to lawmakers about “regulation of broker-dealers, securities industry and markets” as well as “investor protection and education.”

That's the same description it has used to describe its lobbying efforts every year since 2013.

FINRA'S BOARD

Finra's governance is also lacking. The organization is governed by a 24-member board, which consists of 10 industry governors, 13 public governors and Finra's CEO. Some governors are elected by Finra members while others are appointed by Finra.

By order of its own charter, a Finra public governor must not have any material relationship with a broker or another SRO. In assembling its group of public governors, however, Finra seems more intent on following the letter of the law rather than its spirit.

“Many of Finra's public governors have had long industry careers and serve on the boards of other financial services firms,” Ben Edwards, an associate professor of law at the University of Nevada, Las Vegas, wrote in a September 2016 draft paper about Finra's board.

As an example, Mr. Edwards cited Randal Quarles, managing partner of the Cynosure Group, a Salt Lake City private equity firm. A former managing director at the private equity firm the Carlyle Group, he's also a member of the board of the U.S. Chamber of Commerce.

Other examples included Joshua S. Levine, managing director and founder of Kita Capital Management, an investment and consulting firm; William Heyman, the current board chair, who is also vice chairman and chief investment officer at the Travelers

Companies Inc.; and Eileen Murray, a management committee member at the hedge fund Bridgewater Associates.

“Is this the best way to represent the public on this board? Why not an investor advocate?” Mr. Edwards said. “The industry perspective is always present, it's always voiced, it's always there.”

Mr. Quarles has been nominated by the Trump administration for a position at the Federal Reserve. In a July 27 Senate hearing, he defended his independence.

“In representing the public on the Finra board, I have done that without any influence from or even discussion with the Chamber of Commerce,” Mr. Quarles said.

Todd Henderson, a law professor at the University of Chicago, is a former public member of Finra's National Adjudicatory Council, which reviews the regulator's initial disciplinary proceedings. He said that non-industry members of Finra bodies “are deferential to industry members in a good way,” meaning they count on them for expertise about the securities business.

He points to Finra public governor Hillary Sale, a professor of law and management at Washington University in St. Louis and currently a visiting professor at the Georgetown University Law Center.

“She's as independent as you can get,” Mr. Henderson said.

InvestmentNews attempted to reach Mr. Levine, Mr. Heyman and Ms. Murray. None of them responded to interview requests.

Ms. Sale agreed to talk to *InvestmentNews* accompanied by a Finra spokeswoman.

This is what readers in our online survey said about Finra

“Finra's mission is market integrity and investor protection but there is no protection for brokers who are always presumed guilty and must prove innocence. Finra needs an overhaul to be more fair to firms and brokers.”

Source: *InvestmentNews* Research online survey

The pay for Finra board members varies widely, ranging in 2015 from $112,500 for former chairman John J. "Jack" Brennan, a longtime Vanguard executive, to two board members who took no salary. Most made between $40,000 and $90,000, according to Finra's Form 990 tax filing.

Unlike the SEC, which must conduct meetings that are open to the public under the Sunshine Act, Finra holds its board meetings behind closed doors. Following the sessions, **Finra posts on its website a letter from Finra's CEO, Mr. Cook**, and a video featuring him and the board chairman describing the board's actions.

"Board meetings are like a secret society," Mr. Kohn said before winning a seat on the board. "We should know where board members stand on some of the issues."

PUSHING BACK

Finra members can grouse that the regulator is too tough on them, but its membership also can turn Finra back from aggressive regulation.

One of the biggest investor-protection efforts Finra undertook, the massive data-collection and investor-harm monitoring program known as CARDS, was abandoned in 2015 after strong protests from SIFMA, FSI, individual firms and even Capitol Hill Republicans.

Finra can't get too far ahead of the industry on investor protection, said Barbara Roper, director of investor protection at the Consumer Federation of America.

"They operate in a difficult environment," she said. "Their incentives for doing anything ground-breaking to advance a pro-investor agenda are non-existent."

COMPENSATION

FROM EXECS TO RANK AND FILE, FINRA PAYS WELL

Working for the Financial Industry Regulatory Authority Inc. can be lucrative.

Seven of the nonprofit's executives make more than $1 million a year, while three others earn more than $900,000.

Thomas Gira, Finra's executive vice president for market regulation and transparency services, earned close to $2.7 million, including deferred compensation and other benefits.

Senior staff at other regulatory groups do not come close to earning **what the top brass at Finra make**. The chairman of the Public Company Accounting Oversight Board, which is also overseen by the Securities and Exchange Commission, earned $673,000 last year. Pay for senior management at the PCAOB has not changed since 2009.

Compensation is one area where the SEC provides little oversight of Finra, according to the Government Accountability Office. Finra's board determines the pay of its executives. It hires a consultant and compares Finra to Wall Street firms.

Finra salaries have been a flash point over the years. A former Finra chairwoman, Mary Schapiro, took in nearly $9 million in 2009 before leaving to become SEC chairwoman, enraging financial advisers and stoking the perception that Finra is out of step with the securities industry.

Finra's payroll grows over time

Are Finra executives overpaid?

Source: Finra (above), *InvestmentNews* Research online survey (right)

The rank and file at Finra are also well compensated. Although salaries are not made public, dividing total compensation by the number of employees indicates that the average comp package is close to $200,000.

Finra has been slow to adjust its payroll to a declining membership. Although the number of brokerage firms that Finra regulates has fallen by 24% since 2007, the number of Finra employees has increased 16.7%.

INVESTMENTNEWS SURVEY BROKERS BRISTLE AT FINRA'S 'GOTCHA' MINDSET

Brokers aren't feeling a lot of love for the Financial Industry Regulatory Authority Inc. An *InvestmentNews* survey of 363 brokers who consider Finra their primary regulator revealed a significant amount of dissatisfaction with the performance and transparency of the self-regulatory organization.

That brokers are unhappy with the organization that imposes rules and regulations is not particularly surprising. What is noteworthy, however, is the extent to which they question their regulator's judgment and authority.

For example, nearly 90% of those who responded to the survey, which went out into the field last month, feel that Finra has too many rules. Sixty percent believe the organization treats brokers unfairly and 56% said it lacks transparency around its finances.

“Finra is no longer a membership organization,” wrote one respondent. “It should be abolished and started anew. I've seen this organization go from one that was helpful to one issuing fines ad nauseam.”

Finra declined to respond to the survey results.

One of the biggest majorities in the survey, 78%, believe that Finra should be made subject to the Freedom of Information Act, which applies to the Securities and Exchange Commission, because it is a government agency. As a self-regulatory organization, Finra currently is not subject to FOIA and does not have to honor public requests for information about its operations.

The securities industry is changing: Commissions are down drastically and the Department of Labor's fiduciary rule is expensive to put in place. Readers want to know how Finra is going to react to those changes.

Finra does a good job regulating brokers

Finra is fair to brokers

Does Finra have too many rules?

Does Finra issue too many fines?

Source: *InvestmentNews* Research online survey

“Finra should continue to regulate, but needs to go back to being a self-regulatory organization,” another respondent wrote. “Outside directors have pushed Finra into becoming a 'gotcha' regulator for consumer financial services, similar to the Consumer Financial Protection Bureau.”

Frank Akridge Jr., a former broker and chief compliance officer who is now president of a registered investment adviser, said Finra tends to be too adversarial in its approach to examinations.

“They tend to show up [for exams] with their guns loaded, figuratively,” he said. “That atmosphere puts brokers and advisers on the defensive. It's rare that I've heard any [of them] say, 'I felt Finra was here to help me.'”

THE FUTURE WHAT'S NEXT FOR FINRA?

The number of broker-dealers is shrinking and the securities industry is rapidly consolidating, leading many to wonder what's next for the Financial Industry Regulatory Authority Inc. if the industry it oversees continues to diminish at this speed.
The number of Finra-registered firms has dropped a stunning 24% since 2007, when there were 5,000 registered firms. Now there are less than 3,800 firms, and that number could slide to 3,000 in three to five years.

Many firms closed shop amid the fallout from the market crash and the Great Recession. Others have left the business due to increased compliance costs and regulatory risk, particularly the Department of Labor's new fiduciary standard. Finra-registered brokers continue to leave the business to become registered investment advisers, a much less compliance-intensive regulatory regime overseen by the Securities and Exchange Commission.

“Clearly the issue we're facing is a shrinking broker-dealer and financial adviser industry,” said Terry Lister, senior consultant at Freeman Mathis & Gary and a former NASD attorney. “How important is it for Finra to try to develop to ensure that it is relevant going into the future?

“If I were Finra, I would be trying to determine what impact that would have on my business, if the industry continues to shrink at its present pace,” said Mr. Lister. “Maybe it's time to rethink the business model.”

A key concern is Finra's shrinking revenue, said brokerage executives. Finra's operating revenues declined 6% in 2016. How will it plug that hole?

“For 2017, we are continuing to take steps to manage expenses closely,” **Finra CEO Robert Cook wrote in the regulator's annual report**. “Already this year, among other actions, we have reduced year-over-year compensation increases by freezing officer salaries, freezing promotions of existing officers (other than where necessary to backfill positions), and reducing annual merit increases for non-officers.”

How do you believe regulation of the brokerage industry should be handled

Source: *InvestmentNews* Research online survey

Finra could morph into one of three types of organizations, industry executives and observers say.

As the number of broker-dealers continues to decline, Finra could become a smaller, leaner operation, overseeing a smaller brokerage industry.

Or Finra could become part of the federal government and formally join the SEC, a move that would decimate lucrative salaries as staff would move to a government pay scale. Republicans in Congress are not likely to support such a move as they already criticize Finra for being too much like the SEC and not enough like a self-regulator guided by its membership.

Finally, if Finra is politically savvy, it could expand its reach as a regulator, gain more power and oversee RIAs as well as broker-dealers. In the process, it could ensure its role as the primary enforcer of the DOL's fiduciary rule.

But the 12,172 SEC-licensed registered investment advisers, most of whom started as Finra-registered reps, certainly don't want Finra as their primary regulator and would balk if Finra entered their side of the financial advice industry.

“Finra wanted to regulate the RIA industry and get larger and grow bigger back in 2012, and how did the investment adviser industry respond to that? No damn way,” said Larry Doyle, a former Wall Street executive and outspoken critic of Finra.

“Regulating the RIA industry would be a source of revenues for Finra and it could grow, but there are the inherent conflicts of interest in the model,” Mr. Doyle said.

At Finra's annual conference in May, Mr. Cook said that increasing Finra's reach is not something he's pursuing. But could it find a new source of revenue by using its expertise and technological resources to sell consulting services to its members?

Regardless of what Finra may develop into over the next decade, the hurdles it faces right now are steep.

“We're in a time of tremendous change with the new DOL standard and new leadership at the SEC,” said Mark Casady, the former CEO of LPL Financial and a former Finra board member.

“It's a crazy quilt of regulators covering retail investors; and, with the switch to advisory relationships and the fiduciary standard, Finra, the SEC and the DOL should work together to remake that quilt or sort that out.”