

Alliance for Economic Stability, Inc.

January 4, 2010

FINRA Moral Hazard Reforms

Enclosed are proposed new rules for the Financial Industry Regulatory Authority, Inc. (“FINRA”) and proposed amendments to certain existing FINRA rules (collectively, “FINRA Moral Hazard Reforms” or the “Reforms”).

The FINRA Moral Hazard Reforms are aimed at improving provisions for investor protection in FINRA rules in accordance with the provisions of the Securities Exchange Act of 1934 (the “Act”).

Specifically, the FINRA Moral Hazard Reforms address deficiencies in FINRA rules that allow for conflicts-of-interest at FINRA, and that thereby may give rise to a condition often termed “moral hazard.” The Reforms also address what we view as an improper level of discretion granted to FINRA in its enforcement procedures, reviews of sanctions, and reviews of membership continuance applications. The Reforms pay particular attention to the potential for bad-faith investigations and bias in actions by the FINRA Division of Enforcement, including in actions against members that report on misconduct by FINRA executives, staff, affiliates, or by other FINRA members that FINRA staff fails to investigate.

We believe that FINRA’s rule deficiencies have allowed FINRA to abet and defend serious violations of the Act, including the Madoff and Stanford schemes and those practices that were a leading contributor to the ongoing economic crisis.

FINRA Moral Hazard Reforms introduce regulations that are necessary to protect investors and restrict bad faith actions. The reforms only restrict FINRA's ability to improperly act on bias in actions that violate the Act but have not been reviewed by the U.S. Securities and Exchange Commission. We view such actions as unwarranted in law and without justification in fact, which prompted the creation of these proposed new rules and rule amendments.

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1. INTRODUCTION

The Alliance for Economic Stability, Inc. (“AES”) is a non-profit corporation advocating improvement of financial regulatory systems, including the monitoring and examining of the U.S. government’s investigation of the causes of the current economic crisis and its legislative and administrative responses. AES is filing with the U.S. Securities and Exchange Commission (“SEC” or the “Commission”) proposed amendments to certain rules of the Financial Industry Regulatory Authority, Inc. (“FINRA”), as well as a proposed new rule.

The proposed FINRA rule amendments and the new proposed rule are being submitted in order to improve FINRA’s compliance with the Securities Exchange Act of 1934 (the “Act”), specifically to aid FINRA in better protecting investors, the Act’s ultimate purpose.

Under the provisions of the Act, the Commission is given responsibility for exercising oversight of FINRA and for proposing or approving new FINRA rules or amendments to existing rules consistent with Section 15A(b)(6) of the Act.

AES is an interested party insofar as the AES is an organization devoted to advocating regulatory improvements to better the U.S. financial system for all Americans.

Prior to a review of certain FINRA rules and the rules’ implications for investor protection, AES conducted a study of conflicts-of-interest within FINRA and necessary changes to improve the American financial regulatory system. The AES study paid particular attention to the concept of “moral hazard,” which a former SEC official used to describe conflicts-of-interest within FINRA, and to the conduct of certain FINRA officials during the price-fixing scandal and resulting Department of Justice investigation of FINRA during the 1990’s, for the purpose of examining how certain conflicts-of-interest within FINRA enabled the global financial crisis of 2007 to 2009. The AES report on FINRA is attached as an appendix to these proposed rule changes and proposed new rule.

AES proceeded with formulating proposed changes to FINRA rules following AES’s work with the House Financial Services Committee and the Senate Banking Committee as their members consider new legislation that would give FINRA additional regulatory powers to oversee investment advisors and

that would require an investigation of the SEC's failure to prevent the financial crisis, but not require a similar investigation of FINRA. AES formed an opinion that there is sufficient existing evidence that in its current form FINRA is not a reliable regulatory authority and that there is a risk that the proposed legislation will not reform FINRA. It is furthermore AES' opinion that the proposed legislation does not sufficiently address FINRA, either in statutory directives or mandated investigations, in addition to the mandates for the Financial Crisis Inquiry Commission, which was created by Congress to investigate the events that led to the 2008 collapse of the financial markets, and which is not scheduled to report back to Congress until the end of 2010.

AES therefore believes that more immediate and detailed regulatory reform must be done to improve investor protection than can be currently addressed through the legislative process. Thus, AES proceeded with formulating the proposed rule changes.

The proposed rule amendments address deficiencies at FINRA in providing investor protection, specifically related to investigations, enforcement actions, sanctioning, and readmission processes surrounding FINRA Rule 8210. There is a particular focus on protecting FINRA members that oppose anti-investor conduct exhibited by FINRA's executive staff. These executives are paid multi-million-dollar salaries funded by the members they are charged with regulating.

The proposed new rule addresses potential conflicts-of-interest arising from FINRA executives serving on boards of directors at companies with publicly traded securities and from FINRA executives receiving stock-based compensation from such companies.

2. PROPOSED AMENDMENT TO FINRA RULE 8210.

2.1 Summary:

We are proposing a change to FINRA Rule 8210, “Provision of Information and Testimony and Inspection and Copying of Books.”

As it currently stands, Rule 8210 allows FINRA to assert wide-ranging discovery powers without independent review prior to the imposition of sanctions for alleged violation of Rule 8210, while FINRA makes use of its most severe and punitive sanction, the unqualified bar, for violations of Rule 8210. Furthermore, Rule 8210 currently entails no protections against anti-investor or bad-faith conduct in the investigative process.

We therefore believe that Rule 8210 works against the statutory intent of the Securities Exchange Act of 1934 (the “Act”), which provides for a multi-tiered investigation and review process between FINRA and the SEC. We also believe that alterations to Rule 8210 would better serve the Act’s mandate that FINRA rules serve the interests of investor protection and competition.

We propose that Rule 8210 be amended to include provisions for independent adjudication of objections by FINRA members to requests made by FINRA pursuant to Rule 8210. Such adjudication should be made available where FINRA members’ objections are based on questions of FINRA’s jurisdiction and on questions of whether FINRA is conducting unduly burdensome investigations on a bad-faith basis. A bad-faith basis may be defined as initiating an investigation that exceeds a reasonable standard for the number, depth, and type of inquiries, where such investigation serves no clear purpose for investor protection, but is initiated by FINRA for the sake of imposing an unreasonable burden upon a member firm or individual. Independent adjudication should be performed by the Commission.

We are furthermore proposing that Rule 8210 be amended to restrict communication from one FINRA-member firm to FINRA’s Division of Enforcement encouraging the investigation of another FINRA-member firm. Such an amendment serves to discourage the creation and exercise of bias by FINRA towards a member-firm.

Together such amendments to FINRA Rule 8210 would make FINRA better comply with the Act and better serve the stated purpose of the Act.

2.2 Background:

As FINRA Rule 8210 is currently written, FINRA can request whatever information it sees fit from a member firm or any associated individual, regardless of i) whether such information lies within FINRA's jurisdiction, ii) whether the member firm or associated individual is in control of such information, iii) whether the request ultimately can be answered, iv) whether the request serves the purpose of protecting investors, and v) whether the requests are so numerous and extensive that it imposes a burden on the effective operation of the member's business.

FINRA has in specific instances made requests which ultimately cannot be answered by the member firm or associated individual, and where requests in number and depth are out of line with any potential underlying violation or potential investor harm. Exhibit 1 provides discussion of one case involving such instances, where FINRA's exercise of Rule 8210 did not serve investors' interests.

FINRA can elect to pursue disciplinary action and statutory disqualification of members based on any lack of response, or simply based on whether FINRA in its sole discretion judges that any response is incomplete, regardless of whether the request made by FINRA was ultimately answerable by the member firm or associated individual. FINRA can subject an individual to a permanent bar, what has been called the securities industry equivalent of capital punishment, based on any incompleteness, where the alleged incompleteness is judged solely in the discretion of FINRA.

The freedom afforded FINRA under the current Rule 8210 allows for flagrant institutional and individual biases by FINRA. This is not a theoretical, competitive bias of one broker to another, but the real institutional bias exercised by FINRA to specific member firms and associated individuals.

Such bias may in practice be instigated by a member firm exercising improper influence on FINRA's Division of Enforcement, creating a bias towards another member firm. This may especially be

the case where the firm exerting improper influence (“Firm 1”) has had misconduct exposed by another firm (“Firm 2”). For instance, Firm 1 may have encouraged customers to buy securities of a fraudulent issuer, while Firm 2 later exposed the fraudulent acts of said issuer. Firm 1 may then seek to have FINRA’s district officers and Division of Enforcement initiate action against Firm 2. Firm 1 may also be a very large firm, while Firm 2 is very small. Therefore, FINRA has a clear and inherent financial interest in protecting the interest of Firm 1 over Firm 2. FINRA’s Division of Enforcement may then initiate action against Firm 2 through the improper creation of institutional bias.

No rules or oversight currently exists at FINRA to prevent the creation or exercise of such bias, particularly in the case of one member firm exposing the misconduct of another.

The perpetuation of such bias runs counter to the purposes of the Act and the Act’s provisions for the rules of self-regulatory organizations, stated in Section 15A(b)(6).

Therefore, in furtherance of the Act’s purposes and provisions, FINRA Rule 8210 should be amended to discourage bias by FINRA. This can be accomplished through amendments to the Rule to allow for independent adjudication of objections to information requests based on reasons of jurisdiction, undue burden, or an underlying bad-faith basis shown by FINRA. The creation of such bias can also be discouraged through the inclusion of an amendment to discourage improper communication from one FINRA-member firm to FINRA’s Division of Enforcement that in effect encourages the Division of Enforcement to investigate another member-firm.

The act of adjudicating objections to FINRA’s Rule 8210 requests should be done by the Commission to prevent furtherance of bias shown by FINRA.

2.3 Statutory Basis:

The proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires that FINRA rules be designed to prevent fraudulent and manipulative acts, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open

market, and in general to protect investors and the public interest, and not be designed to permit unfair discrimination between customers, issuers, brokers or dealers.

Absent the proposed amendment to FINRA Rule 8210, FINRA can make requests for information which are unnecessary and unduly burdensome, which are not designed to prevent fraudulent and manipulative acts, and which may indeed perpetuate fraudulent and manipulative acts. Such undue burden impedes a free and open market, and runs counter to the protection of investors and the public interest. Such undue burden furthermore creates unfair discrimination between broker-dealers.

2.4 EXHIBIT TO PROPOSED AMENDMENT TO FINRA RULE 8210:

The decision of FINRA's National Adjudicatory Council (NAC) in the statutory disqualification of Mr. Manuel P. Asensio contains a sufficient documentary record to determine that FINRA exhibited bias toward Mr. Asensio and that FINRA exercised abuse of procedure and regulatory authority with Rule 8210 requests.

The NAC decision notes that on May 12, 2003, Tirone Veasley, an NASD investigator, sent a letter to Mr. Asensio containing information requests pursuant to Rule 8210. The requests concerned the Polymedica reports. On the same day, Veasley sent another letter to Mr. Asensio with further requests. Among other questions, the second May 12 letter asked whether Asensio Brokerage had any clients who were institutional investors, and whether any such clients "receive part of their funding from 'taxpayer-paid salaries.'" A footnote in the NAC decision appears with the preceding statement. The footnote states, "Veasley asked similar questions concerning Asensio & Company in his February 11, 2003 request sent to Asensio at Asensio Brokerage."

The NAC decision also states that Veasley sent another letter to Mr. Asensio on May 29, 2003. Veasley included 98 separate, new requests for information in the May 29 letter.

These facts acknowledged by FINRA's NAC show abuse in several respects.

First, Veasley's multiple requests for information concerning whether any of Asensio's clients receive part of their funding from "taxpayer-paid salaries" is inappropriate and would be impossible for Mr. Asensio to answer accurately. The vague question ostensibly requests whether any Asensio Brokerage clients had clients whose salaries were 'paid by taxpayers.' Mr. Asensio would have no way of knowing this directly. Mr. Asensio would have no legal or procedural basis for compelling his clients to provide such information. However, Veasley is acknowledged to have asked the same question repeatedly to Mr. Asensio in the form of an 8210 request.

Besides the instance of FINRA's impossible-to-answer 8210 requests, there is further acknowledged evidence that FINRA's requests to Mr. Asensio were unduly numerous and extensive. In addition to sending multiple requests on the same day, FINRA also included 98 new requests in one letter. This was for an investigation about which a FINRA staffer stated, "this isn't that big a deal."¹

Under FINRA rules as they are currently practiced, a member such as Mr. Asensio can be barred for any partial failure to answer an 8210 request. FINRA has no provision for prohibiting unnecessary, unreasonable or impossible-to-answer questions pursuant to Rule 8210. Moreover, the SEC has tended not to question the bases for FINRA's 8210 requests.²

Though FINRA's sanction guidelines only call for a bar related to an 8210 request when there is a total failure to respond, Mr. Asensio received bar despite there only being an alleged partial failure to respond. FINRA made no apparent attempt to consider and resolve issues surrounding the information requests. Those issues were FINRA's lack of jurisdiction over the subject entity, and that certain information requested by FINRA was not under Mr. Asensio's control.

As made clear in the Asensio case, FINRA can target a member with 8210 requests in whatever manner it chooses. FINRA can ask whatever questions it chooses with no standard for reasonableness. FINRA has no obligation to limit such questions in number. If any response is deemed incomplete -

¹ Transcript of Disciplinary Hearing, September 21, 2004, p. 157.

² PAZ Securities v. SEC, U.S. Court of Appeals.

where FINRA can choose whatever arbitrary standard it chooses to assess completeness – then FINRA can bar the member targeted.

Though FINRA has a limited regulatory mandate, in practice FINRA usurps greater authority than it is granted under federal law, and exercises power counter to the purpose of the Securities Exchange Act, namely investor protection.

FINRA can victimize individual members with a bar, even where such a bar is counter to the interests of investors. The victimized member has no recourse to have FINRA's abuse, unreasonableness, and anti-investor conduct challenged by any governmental authority through established procedures prior to FINRA's imposition of a bar sanction.

In order to rectify FINRA's anti-investor conduct, limitations and changes to its regulatory procedures must be put in place.

First, there must be specific statutory provisions to avert FINRA's victimization of whistleblowers, meaning FINRA members like Mr. Asensio who expose misconduct perpetrated or abetted by other FINRA-member firms, and disregarded by FINRA. These provisions should include monitoring and control of contact between FINRA staff and member firms to ensure that there is no unfair targeting of whistleblowers.

Secondly, there must be limitations on 8210 requests, and there must be an independent forum for resolving disputes about jurisdiction and excessiveness shown by FINRA in 8210 requests prior to FINRA conducting hearings on alleged rule violations. This is in order to stop FINRA from wrongfully imposing a disciplinary sanction before such disputes are resolved.

Finally, the most important step that could be taken to undermine FINRA's conflicts-of-interest would be to remove all enforcement responsibilities from FINRA and delegate those responsibilities to a government agency, such as the SEC.

3. PROPOSED AMENDMENT TO FINRA RULE 8310.

3.1 Summary:

We propose an amendment to FINRA Rule 8310, “Sanctions for Violation of the Rules,” to prohibit explicitly the imposition of an unqualified bar sanction for a supposed violation of FINRA Rule 8210.

As noted in our Proposed Change to FINRA Rule 8210, Rule 8210 as it currently stands allows FINRA considerable discretion in determining whether responses made by a member or individual to a FINRA request for information pursuant to Rule 8210 should be considered complete. FINRA also has considerable discretion in the information it chooses to request, which may be outside of FINRA’s jurisdiction, outside the control of the individual being asked for the information, or may even be unanswerable. FINRA may then pursue an unqualified bar sanction for violation of Rule 8210, if FINRA judges that a response is in any way incomplete, regardless of whether there is any alleged act of investor harm committed or abetted by the member or individual.

To comply with the provisions and purposes of the Securities Exchange Act of 1934 (the “Act”), FINRA must be prohibited from imposing unqualified and permanent bar sanctions for supposed violations of Rule 8210, where no act of investor harm has occurred and where the alleged failure has not been independently reviewed. The Act states that FINRA rules should be designed to protect investors. Without an amendment to FINRA Rule 8310, FINRA can impose sanctions based on arbitrary standards, where such a sanction does not serve the interests of investor protection, and may ultimately prove counter to the interests of investors.

3.2 Background:

Under FINRA Rule 8210, FINRA can request whatever information it chooses from a member or associated individual. If FINRA judges the response to be incomplete, then FINRA can sanction the

member or individual with a permanent bar, regardless of whether the information requested was outside of FINRA's jurisdiction, whether the individual was in control of the information requested, or whether the question asked by FINRA was even answerable. FINRA can impose a permanent bar on an individual, restricting the individual from ever associating with a member firm, if any answer to a Rule-8210 request is judged to be incomplete, where the sole discretion for determining the completeness of the answer is FINRA's. FINRA provides no forum for independently adjudicating jurisdictional or other issues with information requests pursuant to Rule 8210.

FINRA's current sanction guidelines call for a bar to be standard for any violation of Rule 8210 where no response was made to an information request. However, FINRA has aggressively pursued bar sanctions against individuals even where the individuals have made responses to information requests³.

Therefore, FINRA's most severe sanction, barring an individual from associating with any member firm – what has been referred to as “the securities industry equivalent of capital punishment”⁴ – may be imposed by FINRA according to standards that are not clearly defined and arbitrary. Similarly arbitrary procedures are evident in FINRA's freedom to request whatever information it chooses from members without limitation under Rule 8210, and to decide what answers to Rule 8210 requests are incomplete.

Unless FINRA Rule 8310 is changed to prohibit unqualified bar sanctions for Rule 8210 violations, FINRA can arbitrarily impose its most drastic sanction where no investor harm has been alleged or has in fact occurred.

The imposition of unqualified bar sanctions in Rule 8210 cases does not meet the standard established in the Act for investor protection. The arbitrary sanctioning by FINRA in Rule 8210 cases may involve no investor harm. Individuals may be sanctioned even where their work promotes investor

³ The FINRA record of the investigation and sanctioning of Mr. Manuel P. Asensio provides evidence of FINRA imposing a bar sanction against an individual for a Rule 8210 violation, despite the individual having answered Rule 8210 requests and despite there being no underlying conduct involving investor harm discovered during or following the investigation.

⁴ *PAZ Securities, Inc. v. SEC*, 494 F.3d 1059 (D.C. Cir. 2007).

protection and they have committed no investor harm. As such, FINRA's use of unqualified bar sanctions in Rule 8210 cases works counter to the Act's purpose of investor protection.

Furthermore, FINRA's imposition of unqualified bar sanctions for Rule 8210 violations does not meet the standard of sanctions serving a remedial rather than punitive purpose⁵.

The Commission has argued that unqualified bar sanctions meet the remedial standard by remedying a perceived likelihood of future harm to investors. The Commission has stated, "To ensure the continued strength of the self-regulatory system, members and their associated persons who fail to respond in any manner to Rule 8210 requests should be barred (or expelled) unless there are mitigating factors sufficient to rebut the presumption that such violators present too great a risk to the markets and investors to be permitted to remain in the securities industry. Because we conclude that removing those who present such a risk is necessary to further 'the Exchange Act's basic purpose of protecting public investors,' a bar (or expulsion) in such circumstances – a complete failure to respond and no mitigation – has a remedial, and not a punitive, purpose."⁶

The Commission's argument avoids addressing the fundamental contradiction that a supposedly remedial purpose may be served by permanently excluding an individual from the securities industry based on a *perceived likelihood of future investor harm*.

The Commission assumes in its argument that a Rule 8210 violation involves a cover-up of actions that harm investors, stating that there is a "presumption" that the alleged violator presents too great a risk to the market and investors to be allowed to remain in the securities industry. Not only is this not necessarily the case, but in fact, as detailed in the Exhibit to our Proposed Amendment to FINRA Rule 8210 herein, actual harm to investors and markets has and can be caused by FINRA's own use of Rule 8210 against members acting to protect the market and investors from harm.

⁵ In *Wright v. SEC*, 112 F.2d 89, 94 (2d Cir. 1940), the Court of Appeals found that the Act "authorizes [the Commission to order] expulsion not as a penalty but as a means of protecting investors.... The purpose of the order is remedial, not penal."

⁶ SEC Rel. No. 57656 / April 11, 2008, Admin. Proc. File No. 3-22852, *In the Matter of the Application of Paz Securities, Inc. and Joseph Mizrachi For Review of Disciplinary Action Taken by NASD*, Reconsideration of Sanctions Pursuant to Remand.

Imposing the most severe sanction based on a perceived likelihood of future investor harm serves to pre-empt what is supposed to have a probability of occurring. It does not prevent or remedy future occurrence of conduct already committed. Therefore, bar sanctions for Rule 8210 violations preemptively punish an individual based on a presumption of a propensity for certain conduct rather than actual conduct. The imposition of bar sanctions in such cases is thus not only punitive, but punitive based on presumption rather than actual conduct. Individuals are judged guilty before the fact; the sentence is imposed before the act is committed. Such a rationale runs counter to due process of law, and preemptively denies an individual of his livelihood.

The Act's requirements of investor protection must be balanced against affording too much discretion to FINRA, as FINRA has been shown to abuse the regulatory process through exercising such discretion in a way counter to the Act's purposes.

FINRA Rule 8310 should thus be amended to specify that unqualified, permanent bar sanctions may not be imposed by FINRA for violations of FINRA Rule 8210 absent other violations involving direct investor harm.

3.3 Statutory Basis:

The proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires that FINRA rules be designed to prevent fraudulent and manipulative acts, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market, and in general to protect investors and the public interest, and not be designed to permit unfair discrimination between customers, issuers, brokers or dealers.

Amending FINRA Rule 8310 to prohibit permanent, unqualified bar sanctions for Rule 8210 violations would prevent FINRA's abuse of regulatory process counter to interests of investor protection and just and equitable principles of trade. The amendment would prevent bars based on arbitrary standards serving a preemptively punitive purpose. This would prevent bars of individuals who have committed no investor harm, who have indeed aided investor protection, but who face a bias within

FINRA. The amendment would alter an unfair preemption of trade and livelihood, the imposition of which is counter to the most basic tenet of due process.

4. PROPOSED AMENDMENTS TO FINRA RULES 9522 AND 9524.

4.1 Summary:

We propose amendments to FINRA Rules 9522 and 9524 to allow for specific conditions related to individuals who are subject to statutory disqualification based on alleged non-compliance with FINRA Rule 8210.

FINRA Rule 8210 as currently written allows FINRA considerable discretion in the imposition of bar sanctions. FINRA can bar an individual based on any perceived non-compliance with Rule 8210, irrespective of whether there was any potential or real investor harm. Because of the discretion or arbitrariness allowed for in the imposition of bar sanctions related to Rule 8210, separate guidelines for the readmission of individuals disqualified for alleged non-compliance with Rule 8210 should be established. This will ensure that the same considerable discretion or arbitrariness applied in statutory disqualification decisions related to Rule 8210 are not also applied in the readmission decisions for individuals disqualified under Rule 8210.

Such amendments will allow FINRA to better comply with the provisions and purposes of the Securities Exchange Act of 1934 (the “Act”).

FINRA Rule 9522, “Initiation of Eligibility Proceeding; Member Regulation Consideration,” should be amended to specify that where an individual is subject to a bar based on a violation of Rule 8210, said disqualified person may submit an application for readmission without a sponsoring member, or may cause an entity controlled by him to file a new member application that will include an application for the individual’s readmission.

FINRA Rule 9524, “National Adjudicatory Council Consideration” should be amended to allow for specific provisions relating to the evaluation of readmission applications by disqualified individuals subject to bars for alleged violations of FINRA Rule 8210. Rule 9524 should provide that where it is the finding of the NAC that the individual applying for readmission presents an unreasonable risk of harm to investors or the markets, the NAC must state what such harm is supposed to encompass, or what specific

acts of investor harm may be supposed to have the potential to occur should the individual be readmitted. If the NAC should find that insufficient time has elapsed since the bar related to Rule 8210 for the disqualified individual to show he is capable of operating responsibly in the securities industry, then the NAC must state what length of time must elapse which would be sufficient. If the NAC should find that proposed supervisory procedures are inadequate, then the NAC must state what must be added to the supervisory procedures to make them adequate.

4.2 Background:

As noted in our Proposed Change to FINRA Rule 8210, Rule 8210, as it is currently written, allows for disciplinary actions to be initiated by FINRA against a member or associated individual, where FINRA has broad discretion or arbitrary authority to allege non-compliance based on a supposed incompleteness of a response made to an information request. FINRA's considerable discretion extends to asserting the potential for investor harm based on any supposed act of non-compliance with Rule 8210, even where no underlying investor harm is found to exist.

FINRA has freedom to issue unduly burdensome or even unanswerable information requests pursuant to Rule 8210. FINRA also has the freedom pursue sanctions related to Rule 8210 based on how complete it perceives answers to Rule 8210 requests to be, where FINRA has sole and absolute discretion to determine completeness of an answer. This discretion allows FINRA to conduct unnecessary and unduly burdensome investigations and issue bar sanctions based on bias towards an individual or member firm.

Given this discretion in sanctioning pursuant to Rule 8210, FINRA should not be allowed such absolute and unchecked discretion when examining readmission applications for individuals barred due to perceived non-compliance with Rule 8210. Absent amendment to Rule 9522 and Rule 9524, FINRA retains the same broad and absolute discretion in readmitting as it does in sanctioning individuals under Rule 8210.

Currently, FINRA faces no requirement of specific guidelines in evaluating readmission applications.

FINRA's NAC may deny readmission by asserting that an individual represents an unreasonable risk of harm to investors, but the NAC is not obliged to state what specific acts of investor harm could potentially occur should the individual be readmitted, based on specific instances in the individual's record.

FINRA's NAC may also assert that insufficient time has elapsed since the bar to allow for the disqualified individual to show that he is capable of operating responsibly in the securities industry. However, the NAC is not obligated to state what constitutes a sufficient amount of time to allow for a sufficient demonstration.

The NAC may also state that proposed supervisory procedures for the disqualified individual are inadequate to allow readmission, but the NAC is not obliged to state what would constitute sufficient supervisory procedures.

Current procedure as allowed under Rule 9522 stipulates that a disqualified individual must apply for readmission through a member firm. This creates a strictly punitive onus for the disqualified individual to solicit proposed employment with a member firm and for that member firm then to go through the lengthy readmission procedure on behalf of the disqualified individual, all before the disqualified individual could assume the proposed employment. This punitive onus is all the greater in that the disqualified individual must solicit potential employment with the stigma of being subject to statutory disqualification, even if such statutory disqualification is based on a perceived Rule 8210 violation where no investor harm ever occurred.

As such, a disqualified individual faces a severe burden to make an application for readmission, and the application can be evaluated and denied based on arbitrary and undefined standards.

Our Proposed Change to Rule 8210 highlights the potential for FINRA to investigate and sanction an individual with a bar based on arbitrary, undefined standards. Such a sanction could proceed from a bias, for which there are no safeguards currently in place at FINRA. The FINRA rules governing

readmission allow for similar arbitrary, undefined standards. Absent the amendments here proposed, such arbitrary, undefined standards will continue at FINRA, allowing for abuse of regulatory procedure.

It is not in the interest of investors or the market to allow FINRA to continue to apply such arbitrary standards. The intent of the Act is to provide for investor protection. The Act includes provisions that the rules of a self-regulatory organization should in general protect investors and the public interest.

Because FINRA rules permit the barring of an individual on a subjective standard where no act of investor harm occurred, and because the FINRA rules governing readmission of disqualified individuals allow the denial of a disqualified individual's readmission based on subjective, undefined standards, FINRA rules as they stand do not support the protection of investors.

Under current FINRA rules, an individual who is an advocate for investor protection may be barred based on subjective, undefined standards, and may then be denied readmission based on subjective, undefined standards.

Because such an instance has occurred⁷, FINRA rules are not compliant with the Act.

An official from the Commission has confirmed that FINRA has no definitive standard for timing or any other issue considered in readmission, stating that FINRA has "considerable discretion" in making any determination.

To comply with the Act, FINRA Rule 9522 should specify that a disqualified individual subject to a bar based on a supposed violation of Rule 8210 where no investor harm occurred should be able to apply for readmission individually without a member applying on his behalf, or may cause an entity controlled by him to file a new member application that will include an application for the individual's readmission.

This provision would lessen the punitive onus placed on an individual barred on a supposed Rule 8210 violation where no investor harm occurred.

⁷ This is in reference to the statutory disqualification and readmission (MC400) denial of Mr. Manuel P. Asensio, whose career illustrates advocacy of investor protection, but who was subject to a bar on supposed violation of FINRA Rule 8210, and who was later denied readmission to FINRA.

FINRA Rule 9524 should be altered to show clear, specific standards for readmission for disqualified individuals seeking readmission following a bar based on a supposed Rule 8210 violation where no underlying investor harm occurred. These standards should include a definitive amount of time to have passed since the bar before readmission is considered appropriate, specific standards for supervisory procedures to be met by the applicant, and a specific requirement for stating what instances of investor harm can be reasonably supposed to potentially occur, if the NAC finds that the applicant's readmission is denied based on a perceived threat to investors or the market.

Such alterations to include specific standards would lessen the arbitrary, subjective nature of FINRA's current readmission procedures for disqualified individuals. This would lessen the punitive, non-remedial nature of FINRA bars where no investor harm occurred being reinforced by readmission evaluations based on subjective, arbitrary guidelines. The proposed rule amendments would thereby make FINRA comply with the Act's requirements for FINRA rules to protect investors and the public interest, by ensuring that disqualified individuals who have worked for investors' interests are not arbitrarily and indefinitely excluded from the industry in a punitive manner⁸.

4.3 Statutory Basis:

The proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires that FINRA rules be designed to prevent fraudulent and manipulative acts, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market, and in general to protect investors and the public interest, and not be designed to permit unfair discrimination between customers, issuers, brokers or dealers.

Absent the proposed amendments to FINRA Rules 9522 and 9524, FINRA has absolute discretion to use arbitrary standards to deny readmission to an individual subject to a bar for a supposed Rule 8210 violation, where the individual has not harmed investors, even where the individual has

⁸ In *Wright v. SEC*, 112 F.2d 89, 94 (2d Cir. 1940), the Court of Appeals found that the Act "authorizes [the Commission to order] expulsion not as a penalty but as a means of protecting investors.... The purpose of the order is remedial, not penal."

worked to better investor protection. Denying readmission of an individual who has worked for investor protection and who has not harmed investors is not compliant with the Act's explicit provision that FINRA rules "protect investors and the public interest."

5. PROPOSED NEW FINRA RULE: ADDRESSING CONFLICTS-OF-INTEREST IN FINRA EXECUTIVES SERVING AS DIRECTORS OF PUBLIC ISSUERS.

5.1 Summary:

We propose that a new FINRA rule be created to prohibit FINRA executive officers from serving on the boards of directors of companies with publicly traded securities (“Public Issuers”).

Prohibiting FINRA executives from serving as directors of Public issuers would prevent direct and material conflicts-of-interest that could interfere with the regulatory functions of FINRA. A FINRA executive serving as a director of a Public Issuer would receive compensation in cash, stock, and options from the Public Issuer. This would create a conflict-of-interest because the FINRA executive would be overseeing broker-dealers that have in the past and would in the future provide investment banking services to the Public Issuer. The FINRA executive may not place investors’ interests first in overseeing a broker-dealer connected to a Public Issuer from which the same FINRA executive obtains compensation.

The prohibition would help to eliminate one particular conflict-of-interest at FINRA, and in doing so, it would serve the purposes and provisions of the Securities Exchange Act of 1934 (the “Act”) by improving investor protection.

5.2 Background:

Former FINRA CEO and current SEC Chairperson Mary Schapiro served on the boards of Kraft Foods Inc. and Duke Energy Corporation while performing duties as a FINRA executive officer. Kraft Foods reported total compensation to Ms. Schapiro of \$218,957 in 2008⁹. Duke Energy reported total compensation to Ms. Schapiro of \$224,527 in 2008¹⁰.

⁹ Kraft Foods Inc. Schedule 14A, filed Mar 31, 2009.

¹⁰ Duke Energy Corporation Schedule 14A, filed Mar 20, 2009.

Ms. Schapiro resigned from these directorships upon being nominated to serve as Chairperson of the SEC. According to the *Wall Street Journal*¹¹, an SEC spokesperson stated that Ms. Schapiro would recuse herself “from matters involving any of these issuers.”

Ms. Schapiro was reportedly paid more than \$3 million in compensation from FINRA in 2008. This level of compensation alone for a supposed regulator serving the public interest has generated controversy that undermines the public’s confidence in the fairness of FINRA’s market oversight and supervision.

That Ms. Schapiro would resign from these directorships upon assuming her position at the SEC and thereafter pledge to recuse herself from matters involving the issuers illustrates a particular conflict-of-interest in a securities regulator serving as a director of a Public Issuer while performing regulatory functions. Since creating this conflict-of-interest seems effectively prohibited at the SEC, it should also be explicitly prohibited at FINRA.

Though FINRA is a private organization, it performs regulatory functions assigned under federal statute, and as such FINRA has governmental powers. There should be no less of a burden for a FINRA executive to avoid direct conflicts-of-interest than there would be for a senior SEC official.

While FINRA does not directly regulate Public Issuers, it regulates the broker-dealers that provide services to or concerning the Public Issuers. For instance, FINRA-regulated broker-dealers may provide investment banking services to the Public Issuers. The broker-dealers may make buy and sell recommendations to investors on the Public Issuers’ securities. Finally, FINRA broker-dealers may themselves buy and hold the Public Issuers’ securities.

A FINRA executive receiving directorship compensation from a Public Issuer could less effectively regulate broker-dealers providing services to or concerning Public Issuers. Therefore, it is not in the interests of investor protection for FINRA executives to be allowed to serve as directors of Public Issuers.

¹¹ *Wall Street Journal*, “Schapiro Getting Large Finra Payout,” by Cam Simpson: Jan 29, 2009. Pg. C5.

5.3 Statutory Basis:

The proposed new rule is consistent with the provisions of Section 15A(b)(6) of the Act, which requires that FINRA rules be designed to prevent fraudulent and manipulative acts, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market, and in general to protect investors and the public interest, and not be designed to permit unfair discrimination between customers, issuers, brokers or dealers.

Prohibiting FINRA executives from serving as directors of Public Issuers would eliminate conflicts-of-interest that could harm investors. Such a prohibition is therefore consistent with the Act's provision that FINRA rules be designed to protect investors.

6. PROPOSED NEW FINRA RULE: COMPENSATION DISCLOSURES

6.1 Summary:

We propose that a new FINRA rule be created requiring disclosures in FINRA's public annual report of all compensation paid to FINRA executive officers. The public versions of FINRA's annual reports currently make no such disclosures.

Furthermore, we propose that FINRA be required to disclose compensation paid to members of any special review committee, such as the committee involved in the production of the report dated September 2009, titled "Report of the 2009 Special Review Committee on FINRA's Examination Program in Light of the Stanford and Madoff Schemes."

Disclosures of executive and committee compensation would give FINRA greater transparency and integrity as a public regulator. It would enable FINRA members and public citizens to make a determination of whether FINRA's compensation practices are fair or excessive. Required compensation disclosure would also enable interested parties to determine whether FINRA's compensation structures enable conflicts-of-interest. Therefore, such disclosures would serve the provisions the Securities Exchange Act of 1934, (the "Act"), which call for FINRA rules generally to serve the purpose of investor protection.

6.2 Background:

Reports exist of FINRA executives being paid multi-million dollar salaries. For instance, reports have appeared in the press that Mary Schapiro, former CEO of FINRA, was paid more than \$3 million in compensation from FINRA in 2008. This compensation disclosure does not appear in the public form of FINRA's annual report.

Such levels of compensation could easily be viewed by FINRA members or public citizens as excessive, particularly given FINRA's quasi-governmental status as a regulator, and particularly in comparison to the salary levels of FINRA's counter-parts at the SEC.

Furthermore, FINRA's compensation levels could be seen as encouraging conflicts-of-interest at FINRA that are counter to investor protection. Because FINRA executives are paid multi-million dollar salaries, and because FINRA executive compensation is tied to the revenues of FINRA member firms, the FINRA compensation system could be seen to encourage FINRA executives to place the interests of FINRA member firms ahead of those of investors and the public.

Similarly, when FINRA retains a committee to complete an investigation and report, as with the September 2009 Special Review Committee report, the present and past compensation paid by FINRA to the committee members should be disclosed in order for the public to assess the extent to which the committee may be considered independent, and the extent to which the committee members may be subject to conflicts-of-interest in conducting an investigation of and producing a report for FINRA.

6.3 Statutory Basis:

The proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires that FINRA rules be designed to prevent fraudulent and manipulative acts, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market, and in general to protect investors and the public interest, and not be designed to permit unfair discrimination between customers, issuers, brokers or dealers.

By making disclosures of executive and committee compensation, FINRA may lessen appearances of conflicts-of-interest, which would serve the greater purpose of investor protection.

7. PROPOSED NEW FINRA RULE: PROCEDURE TO ADDRESS DISCOVERY RELATED TO FINRA ENFORCEMENT ACTIONS CONDUCTED IN BAD-FAITH

7.1 Summary:

We propose that FINRA adopt a rule that establishes a procedure through which an individual subject to an action of FINRA’s Division of Enforcement may seek to pursue discovery and legal redress against FINRA for investigations or sanctions which the individual believes were conducted on a bad-faith basis. Such a procedure should involve appeal to the SEC, and thereafter the U.S. Court of Appeals or U.S. District Court.

Such a procedure would allow an individual who is subject to a bad-faith investigation and/or sanction to seek proper remedies. The proposed procedure would also act to deter bad-faith actions by FINRA. This deterrence would be consistent with the provisions for fair markets and investor protection of the Securities Exchange Act of 1934 (the “Act”).

7.2 Background:

The U.S. District Court ruled in *SEC v. Mark Cuban* that Cuban could seek discovery from the SEC related to Cuban’s assertion that the SEC conducted an investigation on a bad-faith basis. The Court’s Order states, “In assessing subjective bad faith, a court may sanction parties for conducting litigation with an improper motive even if the complaint was legally adequate. *See Chambers*, 501 U.S. at 53 (‘[T]he imposition of sanctions under the bad-faith exception depends not on which party wins the lawsuit, but on how the parties conduct themselves during the litigation.’). Cuban should be allowed to obtain discovery that would enable the court to fairly judge some of his allegations regarding how the SEC conducted its investigation.”

Because the Court established that an individual subject to an SEC investigation and resulting legal action should be allowed discovery related to an assertion of a bad-faith basis in the SEC investigation, a procedure should be established at FINRA to make a similar allowance for discovery to

individuals subject to a bad-faith investigation and disciplinary action conducted by FINRA. The procedure should entail Commission and judicial review.

Establishing such a procedure is particularly important because of FINRA's quasi-governmental status, where only FINRA is responsible for initiating investigations and imposing disciplinary sanctions. Without the onus of a judicial venue, FINRA is more likely than the SEC to conduct bad-faith investigations, as there is no truly independent party involved in examining FINRA Enforcement actions prior to FINRA's imposition of a sanction. FINRA is less constrained in conducting bad-faith investigations.

Our Proposed Amendment to FINRA Rule 8210 and the Exhibit to the Proposed Amendment contained herein explain circumstances under which FINRA may, and in fact, has, conducted bad-faith investigations arising out of bias.

By establishing a procedure to seek discovery and legal redress related to a bad-faith investigation by FINRA, the new rule would deter such bad-faith investigations. This, in turn, would in turn create a fairer marketplace and encourage greater investor protection, by focusing FINRA resources on investigations not initiated in bad faith.

7.3 Statutory Basis:

The proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires that FINRA rules be designed to prevent fraudulent and manipulative acts, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market, and in general to protect investors and the public interest, and not be designed to permit unfair discrimination between customers, issuers, brokers or dealers.

By creating a procedure for an individual to seek discovery and legal redress related to a bad-faith investigation conducted by FINRA, the Act's purposes would be served in promoting just and equitable principles of trade and not allowing unfair discrimination between broker-dealers. It would also serve to better investor protection by focusing FINRA resources on investigations not initiated in bad faith.

APPENDIX

Securities Regulatory Reform:

Addressing FINRA's Inherent Conflict and Moral Hazard.

Abstract:

According to the standard narrative, the economic meltdown was caused by unanticipated regulatory “gaps.” This standard narrative, however, ignores the specific failings and deficiencies under the current regulatory system. We examine the failings and deficiencies of one U.S. regulator, the Financial Industry Regulatory Authority, Inc. (“FINRA”). FINRA had primary oversight of all the Wall Street investment banks that collapsed in 2008 and direct oversight of the Madoff firm. This report studies FINRA's performance and examines the specific conflicts-of-interest within FINRA giving FINRA a “moral hazard” of protecting the interests of securities firms and their executives over the interests of the public, and additional conflicts-of-interest within the regulatory system that impair the ability of the SEC and the U.S. court system to exercise oversight of FINRA. The report finds that unless U.S. securities laws are changed to address the conflicts-of-interest at FINRA, future financial crises cannot be prevented. This report discusses particular changes needed in the proposed new legislation and at the SEC in order to reign in FINRA's moral hazard.

Alliance For Economic Stability
January 4, 2010

Securities Regulatory Reform: Addressing FINRA’s Inherent Conflict and Moral Hazard.

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SECTION 1: FINRA's Inherent Conflict, Moral Hazard and the Financial Crisis.

On October 1, 2009 Richard Ketchum, chairman and CEO of the Financial Industry Regulatory Authority, Inc. ("FINRA"), released a report titled "**Report of the 2009 Special Review Committee on FINRA's Examination Program in Light of the Stanford and Madoff Schemes.**"¹ Largely unknown, FINRA acts like the nation's largest securities regulator. FINRA is controlled by the broker-dealers themselves as a so-called self-regulatory organization ("SRO") and has been called "inherently conflicted"² by the North American Securities Administrators Association, Inc. ("NASAA"). Speaking about SROs, John J. Mack, Morgan Stanley's CEO, has said that broker-dealers "cannot control ourselves." Mr. Mack called for regulators "to step in and control the Street."³

Mr. Mack made the statement after having replaced FINRA as Morgan's primary regulator saying Morgan's new regulator now "test our models. They question everything we do. I've never been regulated like that before. It's a different environment. Someone said to me, 'What do you think of it?' I love it."⁴ In a further comment that also relates directly to FINRA's inherent conflicts, Mr. Mack stated that "Regulators have to be much more involved."

The Report, which was funded by FINRA, limits its exam to just Stanford and Madoff, and doesn't mention the sub-prime crisis. Its named four authors are a group with long and

¹ Special Review Committee. Report of the 2009 Special Review Committee on FINRA's Examination Program In Light of The Stanford and Madoff Schemes. September 2009. (Located at www.asensio.com/Commentary/DOJ/FINRA2009Report.pdf)

² In a letter to Congress NASAA, the oldest international organization devoted to investor protection, wrote that SROs embody "a flawed approach to regulation – SROs are inherently conflicted and are not independent." ([Click here to see the letter from NASAA to Congress.](#))

³ Andrew Ross Sorkin, "Morgan Stanley's Mack: 'We Cannot Control Ourselves,'" New York Times 19 November 2009.

⁴ Michael L. Moore, "Morgan Stanley's Mack Welcomes Regulation by Fed," Bloomberg 19 November 2009.

prosperous relationships with FINRA. The committee in turn was advised by a group of brokers. No action is pending against FINRA. The Report seems to be FINRA's proactive defense.⁵

The Report's lack of independence illustrates exactly what it avoids mentioning: what's wrong with FINRA, namely FINRA being controlled by the brokers that FINRA regulates. This conflict of interest is what a former SEC official called FINRA's moral hazard.⁶

On October 2, 2009, Ketchum gave remarks at Fordham University's "Ethics and Regulatory Conference." Ketchum called for market participants to develop a new personal "commitment to ethics, integrity, and professional responsibility" in order to avoid future crises.

While Ketchum's remarks have academic appeal, they did nothing to address FINRA's own ethical problems and its responsibility in the global economic crisis, or what changes should be made at FINRA to address its systemic deficiencies. Ketchum's remarks actually deflect justified criticism of FINRA's systemic shortcomings onto a sense of 'personal commitment.' This raises questions concerning the Report's purpose particularly and exemplifies FINRA's moral hazard. Ketchum's own record reveals how FINRA's moral hazard, which is the conflict between the immediate need to serve the interest of the brokers that directly pay one's salary and the remote obligation to serve the investment public, adversely affects personal ethics and professional responsibility. A study of this record titled "FINRA's Response to the Price-Fixing Scandal of 1994-1995 as Case Study of Moral Hazard," is contained in Section 3.

⁵ Emails and testimony from members of an SEC team that examined the Madoff firm shows that the SEC did not find FINRA's exam reports helpful and that the FINRA review consisted of "checklist-type reviews," and that these reviews lacked depth and specifics. An SEC memorandum concluded that FINRA's examination should be revised. [See U.S. Securities and Exchange Commission Office of Investigations [Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme](http://www.sec.gov/news/studies/2009/oig-509.pdf), 31 August 2009. (Located at www.sec.gov/news/studies/2009/oig-509.pdf)]

⁶ Rob Wells, "SEC's Market Regulation Chief Steps Down," [The Associated Press](http://www.theassociatedpress.com) 29 November 1995.

Ketchum was a principal figure at FINRA during the Department of Justice's price-fixing investigation. Instead of acting to protect investors Ketchum repeatedly defended the practice long after it was shown to be illegal. He called an academic study on FINRA's pricing fixing "slanderous,"⁷ and warned of the dire consequences of changing the system, and then as now, went on a speaking tour that today serves as a testament to FINRA's moral hazard.

Throughout the price-fixing saga FINRA defended its brokers' interest against those of investors. Ketchum was reported to have made private statements that conflicted with statements he made to the press, and was at the center of accusations of not properly responding to the DOJ's investigation,⁸ improper lobbying of Congress to intervene in the investigation, and antagonizing and stonewalling the SEC.⁹

FINRA's conduct led Arthur Levitt, then chairman of the SEC, to state that it was not blind to price-fixing; he called FINRA "the cop on the beat" that "simply looked the other way." Levitt said that the evidence showed FINRA "did not fulfill its most basic responsibilities"¹⁰ and accused Ketchum of doing others' "bidding."⁵ In the end Attorney General Janet Reno said the DOJ had "found substantial evidence of coercion."¹¹

⁷ Scot J. Paltrow, "Taking Stock of Nasdaq," Los Angeles Times 20 October 1994.

⁸ Rob Wells, "Justice Seeks Court Order Forcing NASD to Comply With Investigation," The Associated Press 24 October 1995.

⁹ Gary Weiss, "Commentary: Will This New Broom Sweep Clean?," Business Week 26 January 2004.

¹⁰ Arthur Levitt, Securities and Exchange Commission Press Conference Regarding the NASD. Washington, D.C. 1996.

¹¹ Brett D. Fromson, "Settlement Ends NasdaqPrice Probe, Brokerage to Let U.S. Tape Trader's Calls," The Washington Post 18 July 1996.

The reports about FINRA's relationship with the SEC are even more troubling.

The DOJ was spurred to act by the SEC's years-long unwillingness to move against FINRA's price-fixing scheme and protect investors. Reports about FINRA's dealings with the SEC raised questions about Ketchum's association with the SEC official responsible for overseeing FINRA, Brandon Becker, who then resigned under fire. Ketchum was Becker's boss before he went to FINRA. So Ketchum went to work at the place he was formerly charged with overseeing, and then lobbied Becker, his replacement, who worked for him while he was at the SEC. Ketchum didn't mention this at Fordham's ethics conference.

Richard Lindsey, who had recently been appointed the SEC's chief economist, replaced Becker. Just six weeks before, Lindsey wrote a Wall Street Journal editorial critical of FINRA titled "...But Beware of Moral Hazards."¹² Lindsey's view was that because FINRA is controlled by brokers who are supposed to regulate themselves, the FINRA system and its officials, such as Ketchum, will tend inevitably to serve brokers' interests, rather than the public's interest. FINRA will tend toward the "moral hazard" of protecting its own powerful members' interests, rather than the public.

Moral hazard explains why FINRA "simply looked the other way"⁶ and why Ketchum was labeled with doing others' "bidding"⁵ instead of protecting investors. Indeed, Ketchum's anti-investor bidding proved profitable. He has remained and prospered at FINRA, in the face of an additional fifteen years of extreme instances of regulatory failures.

¹² Richard Lindsey, "...But Beware of Moral Hazards," The Wall Street Journal 14 September 1995.

FINRA is a private regulator whose revenue exceeds the SEC's budgetary resources. It's isolated from Congressional or judicial oversight. Ketchum was handpicked to run FINRA by the sitting SEC chairperson, who ran FINRA until moving to the SEC. This situation poses its own moral hazard.

FINRA, its members and their various lobbying organizations, including the Securities Industry and Financial Markets Association, form one of the nation's wealthiest and most influential interest groups.

FINRA has not garnered much attention for its actions or inactions that were a leading contributor to the global financial crisis, the central cause of which was the business practices of FINRA-regulated firms.

Close examination reveals FINRA's motives and incentives. At the heart of the sub-prime economic catastrophe is a broker's incentive to misprice securities in order to generate larger commissions. This too was the motive behind its price-fixing scandal and the incentive that drove FINRA's moral hazard. Excessive commissions completely dried up in the U.S. equity markets a few years after the DOJ closed down FINRA's price-fixing. The Report ignores these highly instructive cases and limits itself to the Madoff and Stanford Ponzi-schemes, which were also ignored by FINRA.

Bernard Madoff had close ties to FINRA through his family,¹³ while he ran his Ponzi scheme. Peter Madoff, Bernard's brother, served FINRA in several capacities before going to work in Bernard's compliance department. Mark Madoff, Bernard's son, served on FINRA's National Adjudicatory Council, which is responsible for FINRA disciplinary actions. Bernard was a former NASDAQ Chairman, where FINRA's price-fixing scandal was executed.

The relationships between the Madoff family and FINRA are only mentioned briefly in a footnote in the Report.

The Stanford case also shows how moral hazard leads to self-serving blindness. FINRA missed the Stanford fraud during its examinations, despite numerous detailed tips from inside and outside Stanford's firm.

These two cases illustrate what is both the broadest and deepest criticism of FINRA: that FINRA has an inherent conflict-of-interest because it is controlled by brokers, while also regulating brokers, and that this always renders FINRA an ineffective regulator. The Special Committee, which is made up of conflicted individuals, simply ignored this defect. Why? Moral Hazard.

FINRA's Special Committee Report lobbies the SEC for an expansion of FINRA's jurisdiction.

The Report argues that a broader jurisdiction could help FINRA to detect fraud in the future.

¹³ A photograph of Mark Madoff of Madoff Investment Securities with Ketchum and Stephen Luparello, now the top two FINRA officials, is available at <http://www.asensio.com/FINRAphoto.jpeg>.

In practice FINRA's jurisdiction over its members is already virtually unlimited. It can request whatever personal and business information it sees fit from its members under threat of a FINRA sanction without the hindrance of the many safeguards that limit government investigations.

FINRA does not have to issue subpoenas or justify to anyone the probative value of its demands for information. FINRA has unfettered access to the books and records at the members' location. FINRA can demand production under any conditions without any limitations. There is no procedure within FINRA to dispute its jurisdictional claim or investigation tactics.

In essence FINRA is using its failure to detect two Ponzi schemes as a ploy to deflect criticism and a reason to seek to expand its jurisdiction unnecessarily, to become a larger private regulator, even as its conflicts and faults are more evident than ever.

FINRA has faced public criticism in the past. Now, following the global financial crisis when the stakes are far greater, there is no such scrutiny. FINRA deficiencies require legislative attention. Section 7 of this report provides proposals for addressing FINRA's Moral Hazard.

SECTION 2: FINRA’s Response to the Price-Fixing Scandal of 1994-1995 as Case Study of Moral Hazard.

In 1994, the U.S. Department of Justice (“DOJ”) began an investigation of the entity now known as FINRA, which at the time owned and controlled the NASDAQ stock exchange.

The DOJ investigation centered on allegations of a massive industry-wide collusion by FINRA members to manipulate an estimated 70% of their customers’ bids and offers in order to conduct an illegal price-fixing scheme, which manifested itself in irregularities in the spreads quoted by NASDAQ market makers.

An academic study first called public attention to irregular spreads in NASDAQ stocks and suggested collusion among market makers to manipulate prices, prompting the DOJ investigation and class-action lawsuits by investors, according to a **Los Angeles Times article from October 20, 1994.**¹⁴

The LA Times article notes that news of the academic researchers’ findings on NASDAQ price-fixing had surfaced in May 1994; the study, titled “Why do NASDAQ Market Makers Avoid Odd-Eight Quotes?” by William Christie and Paul Schultz, was published in December 1994 in *The Journal of Finance*.

The published study found an irregularity in a lack of “odd-eighth quotes” for 70% of stocks trading on the NASDAQ. The researchers stated this could not be explained by “trading activity,

¹⁴ Scot J. Paltrow, “Taking Stock of Nasdaq,” Los Angeles Times 20 October 1994.

or other variables thought to impact spreads.” Christie and Schultz suggested that this “raises the question of whether NASDAQ dealers implicitly collude to maintain wide spreads.”

The Los Angeles Times reported in its October 20, 1994 article that its reporter had confirmed that Richard Ketchum, then FINRA’s chief operating officer, made misleading statements to the press concerning the Christie and Schultz study’s findings. Ketchum told the Los Angeles Times in May 1994 that the Christie and Schultz report was “irresponsible – and in fact we believe it is slanderous.” The Times reported that the day before Ketchum made his statement that the academic report was “slanderous,” Ketchum himself addressed a closed-door meeting of NASDAQ market makers at the offices of Bear, Stearns & Co. to ask them to make changes in how they handle customer orders. Ketchum reportedly told the market makers that “the spreads on some stocks were too wide – and asked for voluntary action to narrow them.” Ketchum reportedly later confirmed to the Times that he made these statements.

Richard Ketchum is FINRA’s current chairman and CEO. The above and what follows exemplifies the moral hazard of the undeniable influence of the brokers on FINRA’s paid staff that control and run all of FINRA’s committees and its board of governors. This makes FINRA’s leaders and its staff at best conflicted and at worst, as show here, prone to act against the interests of their supposed constituents.

Before the allegations of price-fixing surfaced, Ketchum gave an **interview to PBS**,¹⁵ in which he suggested that an SEC proposal to introduce price quotations on NASDAQ in sixteenths, rather than in eighths, would be too costly. Ketchum was asked, “Such a move would be costly

¹⁵ Richard Ketchum Interview, The Nightly Business Report 27 January 1994.

wouldn't it Rick, very costly?" Ketchum responded, "There's a risk with respect to cost and many market makers are concerned it will reduce liquidity." Ketchum thus defended the illegal price-fixing with a concern for "liquidity."

Despite its legal obligation to regulate its members engaged in the price-fixing operation, FINRA not only failed in its own duties but did not cooperate with the subsequent DOJ investigation to the DOJ's satisfaction. The **Associated Press noted in October 24, 1995**¹⁶ that "The Justice Department, accusing the Nasdaq Stock Market's parent [FINRA] of foot-dragging, asked a federal judge to order market officials to turn over documents for the government's price-fixing probe."

A story appeared in the **Los Angeles Times on November 21, 1995**,¹⁷ stating, "Securities and Exchange Commission Chairman Arthur Levitt Jr. sternly lectured the National Association of Securities Dealers' [FINRA] board Friday about the need to reform the Nasdaq Stock Market." The article states that Levitt warned FINRA's board "that the SEC was likely to file disciplinary charges against it."

Rumors of the SEC taking action against price-fixing at NASDAQ had circulated several months prior to the November story. A **Los Angeles Times article from July 7, 1995**¹⁸ stated, "The Securities and Exchange Commission has found evidence of widespread violations of trading

¹⁶ Rob Wells, "Justice Seeks Court Order Forcing NASD to Comply With Investigation," The Associated Press 24 October 1995.

¹⁷ Scot J. Paltrow, "Sec Chief Lectured Securities Dealers' Board; Stocks: In Closed-Door Meeting, Chairman Issued Warning About The Need To Reform Nasdaq. He Said Disciplinary Action Likely," Los Angeles Times 21 November 1995.

¹⁸ Scot J. Paltrow, "Sec Plans Civil Charges In Its Nasdaq Probe," Los Angeles Times 7 July 1995.

regulations on the Nasdaq Stock Market and is working toward filing a major, highly unusual disciplinary case against Nasdaq's parent organization [FINRA].”

Shortly after the story concerning Levitt's FINRA lecture, reports appeared that the SEC official responsible for overseeing FINRA resigned abruptly.¹⁹ **On November 29, 1995, an Associated Press story**²⁰ appeared stating that Brandon Becker, head of the SEC's Division of Market Regulation, “resigned abruptly, but the agency says the departure wasn't related to the handling of a price-fixing investigation.”

The Associated Press article on Becker notes, “The SEC's market regulation division was criticized for acting slowly on allegations of wrongdoing... The SEC began an investigation of Nasdaq dealers only after the DOJ opened its own probe last year.” The article goes on to state, “Some harsh critics of the agency questioned Becker's independence due to his friendship with his former boss, Richard Ketchum, who left the SEC for a senior job at [FINRA].”

Prior to joining FINRA, Richard Ketchum worked at the SEC in the same role as Becker, director of the division of market regulation, which oversees FINRA.

Becker's replacement at the SEC was Richard Lindsey. Only a few months prior to taking Becker's former role, Lindsey had been appointed chief economist at the SEC. The Associated Press article quotes Lindsey saying, “I didn't expect I would be changing jobs quite so soon.”

¹⁹ Becker was also involved in a review of FINRA's oversight of Madoff. On July 19, 1994, Becker was officially notified that FINRA's Madoff oversight examinations should be revised to include issues not included in the routine broker-dealer examination. Becker's response to the memo had no affect on Madoff's Ponzi scheme. [See U.S. Securities and Exchange Commission Office of Investigations [Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme](#), 31 August 2009. (Located at www.sec.gov/news/studies/2009/oig-509.pdf)]

²⁰ Rob Wells, “SEC's Market Regulation Chief Steps Down,” [The Associated Press](#) 29 November 1995.

The Associate Press article also states that Lindsey had “surprised Nasdaq officials with an opinion page in The Wall Street Journal in September that questioned the NASD’s [FINRA’s] supervision of Nasdaq.”

Lindsey’s editorial, “...But Beware of Moral Hazards,”²¹ which claimed that an inherent moral hazard exists in self-regulation and at FINRA, was published on September 14, 1995, just six weeks prior to Lindsey assuming Becker’s role at the SEC.

The Associated Press article quotes an unnamed FINRA source remarking on Lindsey’s appointment, “We’re not terribly happy about this.”

Reports emerged that FINRA knew about problems with spreads at the NASDAQ many years before the DOJ and SEC investigations. **An Associated Press story from July 18, 1996,**²² reports that according to a DOJ court filing, FINRA assigned a committee to examine the “problem with spreads” as early as 1990.

A report from the **Washington Post dated July 18, 1996**²³ quotes Attorney General Janet Reno stating, “We found substantial evidence of coercion and other misconduct in this industry... we expect to deter future price-fixing on Nasdaq.”

²¹ Richard Lindsey, “...But Beware of Moral Hazards,” The Wall Street Journal 14 September 1995.

²² Rob Wells, “Justice Probe Says NASD Aware of Trading Prices Controversy,” The Associated Press 18 July 1996.

²³ Brett D. Fromson, “Settlement Ends NasdaqPrice Probe, Brokerage to Let U.S. Tape Trader’s Calls,” The Washington Post 18 July 1996.

SEC chairman Levitt issued a **prepared statement on August 8, 1996**²⁴ concerning the SEC's investigation of price-fixing by FINRA members. Levitt stated, "The evidence... shows that [FINRA] did not fulfill its most basic responsibilities – and I quote from its charter: to promote just and equitable principles of trade for the protection of investors."

Levitt also stated, "We have found a widespread code of conduct among market makers to coordinate their quotes... Where was [FINRA], the cop on the Nasdaq beat? [FINRA] was not blind to these practices in the marketplace. It simply looked the other way."

The question of why FINRA "simply looked the other way" is answered in a **January 26, 2004 article in BusinessWeek**,²⁵ where comments from Arthur Levitt are directed specifically at Ketchum.

The article reported that "Levitt and other ex-regulators contend that [FINRA] antagonized the SEC by not turning over information about securities dealers' collusion on stock prices." The article quotes Arthur Levitt saying that he thought Ketchum was doing Joseph R. Hardiman's "bidding," by "stonewalling the commission at the time." Hardiman was a former broker and CEO of FINRA, and was Ketchum's boss.

The 2004 BusinessWeek article goes on to report on Ketchum's effectiveness at overseeing FINRA while he was at the SEC. The article reports that in 1991 Ketchum's "market regulation

²⁴ Arthur Levitt, Securities and Exchange Commission Press Conference Regarding the NASD. Washington, D.C. 1996.

²⁵ Gary Weiss, "Commentary: Will This New Broom Sweep Clean?," Business Week 26 January 2004.

division was chided by the General Accounting Office (“GAO”) for deficiencies in its supervision of the stock exchanges in their oversight of brokerage firms' sales practices.”

The GAO report,²⁶ dated April 1991, identified problems in the SEC’s oversight of sales practices while Ketchum was at the market regulation division, and stated, “Left uncorrected, these problems could contribute to investor losses from abusive sales practices.”

As Lindsey wrote in his Wall Street Journal editorial, FINRA "stands alone in its direct oversight of a market, so the force of competition cannot promote efficiency." He goes on to write that since FINRA “is responsible for taking action against its own members, the conditions necessary for moral hazard exist at [FINRA].”

(The documents referenced in the section are available for viewing and downloading at www.asensio.com/DOJ.aspx)

²⁶ United States, General Accounting Office, Report to Congressional Committees: Strengthening Sales Practice Oversight April 1991.

SECTION 3: FINRA had Direct Regulatory Duties Over All Areas of Sub-prime, Stanford and Madoff Schemes.

FINRA had direct oversight responsibility of the securities firms engaged in abusive sales practices in the sub-prime securitization and in the OTC sub-prime derivatives market. These firms also had capital deficiencies and engaged in unfair conduct in securitizing the faulty mortgages²⁷ and dealing with rating agencies. FINRA's failure to perform this direct oversight duty led to the spectacular and costly collapse of two of its largest members, including the largest bankruptcy in U.S. history.

On January 27, 2009, before the U.S. Senate Committee on Banking, Housing and Urban Affairs,²⁸ Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law at Columbia University Law School, rejected FINRA's claim that it had no jurisdiction or reason to inquire in the Madoff Ponzi-scheme and offered his legal and factual analysis in support of his decision.

Mr. Coffee testified that he found that prior to 2006 Madoff Securities was only a broker-dealer and not a registered investment adviser. Madoff Securities, the broker dealer, as its "qualified custodian." But this conduct in holding securities and executing trades was the conduct of a broker-dealer and was fully within the FIRNA's jurisdiction. Thus, if Madoff Securities was not registered as an investment adviser, it had to be taking the position (rightly or wrongly) that it was servicing these clients "solely incidental to the conduct of" its business as a broker-dealer. If

²⁷ Greg Gordon, "Loans Goldman bought didn't get much scrutiny," The Miami Herald 2 November 2009.

²⁸ United States, Senate Committee on Banking, Housing and Urban Affairs, Testimony of Professor John C. Coffee, Jr. in "The Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform." 27 January 2009.

so, that brokerage business was by definition within FINRA's jurisdiction. Thus, during this period, FINRA had no reason for abstained from examining and monitoring the advisory side of Madoff Securities. Madoff Securities was only required to register as an investment adviser by the SEC in 2006. FINRA had jurisdiction over Madoff Securities for several decades, was its failure to closely inspect the firm's advisory activities justifiable based on the argument that it lacked jurisdiction over investment advisers.

Mr. Coffee expressed that FINRA could not use a lack of jurisdiction as a justifications for its inattention. In addition to Mr. Coffee's testimony, Peter J. Chepucavage,²⁹ general counsel at Plexus Consulting Group, LLC, Pete Michaels,³⁰ partner at Michaels, Ward & Rabinovitz, LLP, and Samuel Y. Edgerton, partner at Edgerton and Weaver, LLP, all of who are competent to opine on FINRA's jurisdiction, have made statements concluding that FINRA had jurisdiction over Madoff.

Despite these legal expert opinions former SEC Chairman Harvey Pitt³¹, the nation's top securities regulator once charged with overseeing FINRA, has stated the FINRA "had no regulatory jurisdiction over Madoff's investment activities." Mr. Pitt did not comment on the legal opinions or the evidence contained in the SEC Inspector General Kotz report (see Section 5) that contains testimony and records of the SEC seeking information from FINRA, which FINRA controlled and did not provide to the SEC investigators. The SEC's OIG obtained an

²⁹ http://www.plexusconsulting.com/Biographies/Senior_Advisors/chepucavage.htm

³⁰ <http://www.michaelsward.com/michaels.html>

³¹ As a panelist on FOX Business "America's Nightly Scoreboard" with David Asman, on September 3, 2009 Mr. Pitt said that "the notion that somehow FINRA was responsible for Madoff's investment scam misses a very simple fact, and is the reason why other media haven't picked this up, because FINRA has no responsibility over investment advisors. It only has responsibility over broker-dealers, and there is an ongoing debate of whether its authority should be expanded." Mr. Pitt goes on the add "as a broker-dealer, they [FINRA] certainly had jurisdiction over him." <http://www.foxbusiness.com/scoreboard/transcript/20090903#page=2>

expert's opinion stating that if the SEC investigators had received this information from FINRA concerning Madoff's actual trading and holdings, it would have led the SEC to discover the Madoff fraud in 1993.

SECTION 4: FINRA and Becker were key contributors to the SEC’s failure of two Madoff investigations. After leaving the SEC under fire, Becker represented Madoff and transmitted materials and false “unsubstantial denial of wrong doing” to the SEC investigators that again caused the SEC to fail in detecting the Madoff scheme.

On August 31, 2009 the SEC's Office of Inspector General (“OIG”) released a report titled "Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme"³² (the “Report”).

The OIG’s investigation sought to explain the SEC’s failure to uncover the Madoff fraud despite the SEC having conducted at least 9 examinations of the Madoff firm. Several of the examinations were spurred by credible, well-informed complaints.

In a discussion concerning a missed opportunity to uncover the fraud, the Report states that the OIG’s expert concluded that FINRA could have “have provided order and execution data that would have indicated that Madoff did not execute the significant volume of trades for the discretionary brokerage accounts that he represented to the examiners, and the data would likely have provided the information necessary to reveal the Ponzi scheme.” (See SEC OIG’s August 31, 2009 report page 30.)

³² See U.S. Securities and Exchange Commission Office of Investigations Investigation of Failure of the SEC to Uncover Bernard Madoff’s Ponzi Scheme, 31 August 2009. (Located at www.sec.gov/news/studies/2009/oig-509.pdf)

The Report also contains testimony from the SEC's examiners acknowledging that if they had the same information that FINRA had, they "could have uncovered Madoff was not making the trades he claimed to be making." (See SEC OIG's August 31, 2009 report page 98.)

Mark Donohue, the SEC's Branch Chief and Assistant Director, Office of Compliance Inspections and Examinations, testified that if the SEC's examiners had had the information that was available to FINRA, then the SEC "would have been able to uncover that he [Madoff] was not trading" as he claimed. (See SEC OIG's August 31, 2009 report page 98.)

The FINRA report, which is the subject of Section 1 of this report, does not contain substantial examination of its own more numerous failures to uncover Madoff's Ponzi scheme, even though it had all the information necessary to uncover Madoff's fraudulent trade reporting to the SEC. The FINRA report also does not explain why FINRA's staff failed to provide the SEC with the assistance they required.

The Report also contains evidence of Brandon Becker's role in the SEC's failure to detect the Madoff fraud, both as a top SEC official charged with overseeing FINRA, and as a private attorney after he resigned under fire over questions about his role in the SEC's failure to take action in FINRA's price-fixing. Becker was also criticized in the media for maintaining a questionable relationship with his former SEC boss, Richard Ketchum, who while at FINRA, as is shown in Sections 1 and 2 of this report, conducted himself in a manner that was irregular for an official charged with defending the public's interest. Ketchum wrongfully defended the brokers engaged in FINRA's pricing-fixing scandal.

In one instance the Report states, "It is extremely curious that when the staff received a tip that Madoff had stolen from Levy, they simply accepted Madoff's claim that he had not managed money for Levy as an explanation for the tip. An accused fraudster's unsubstantiated denial of wrongdoing is insufficient grounds for concluding that the accusation is without merit. In this instance, the staff also knew that Madoff had previously lied to them about several issues, including the number and identity of his clients." (See SEC OIG's August 31, 2009 report page 353.)

This "unsubstantiated denial of wrongdoing" had come through Brandon Becker, who was then acting as Madoff's legal counsel - the same Becker at the SEC during the price-fixing scandal. The Report states that Madoff informed the Enforcement staff that he had retained Becker from the law firm of WilmerHale and that Becker "fought hard" to keep Madoff from having to register as an advisor with the SEC.

With regard to Becker's statements to the SEC, the Report states, "Contrary to Madoff's representations through his counsel [Brandon Becker], when news of Madoff's Ponzi scheme broke, it became evident not only that Madoff managed Levy's money, but also that Levy was actually one of Madoff's largest investors. Levy's foundation JEHT – which stood for "Justice, Equality, Human Dignity and Tolerance" – was forced to close in January 2009 due to the millions of dollars it lost in Madoff's Ponzi scheme." (See SEC OIG's August 31, 2009 report page 354.)

In the Report several members of the SEC's team testified about their dealings with Becker. They stated that they would "send him [Becker] a document request, do whatever we would have to do. As a member of a top firm, as a member of the Bar, we would expect him to investigate and report back to us and rely on the answer." (See SEC OIG's August 31, 2009 report page 353.)

As cited in the Report, the SEC's Doria Bachenheimer testified that she "investigated the [Levy] complaint by calling Brandon Becker, Madoff's counsel, on January 8, 2007 and having Becker ask Madoff if he managed money for Norman F. Levy.When Becker relayed that Madoff said he did not manage money for Levy, the complaint was not pursued further." (See SEC OIG's August 31, 2009 report page 435.) The Report also states that the SEC's Meaghan Cheung was also influenced by Becker. Cheung testified that because the response came "through Brandon Becker gave it more weight in my mind and coming through a reputable counsel gave it more weight in my mind. And Mr. Madoff involving reputable counsel actually gave me some more comfort about answers." (See SEC OIG's August 31, 2009 report page 353.)

On November 20, 2007, the Enforcement staff sent Madoff a letter indicating that the investigation was being closed without an enforcement action. The letter went from Bachenheimer to Becker.

Becker was also involved in the SEC's Madoff investigation while he was the SEC's Director of Market Regulation. An SEC investigation in 1993 had found that "none of [Madoff's] periodic risk management evaluations" were documented and suggested that FINRA's Madoff oversight

examinations be altered. (See SEC OIG's August 31, 2009 report page 437.) As a result of this investigation the SEC did not issue a report to Madoff and instead proposed a new rule requiring FINRA to incorporate expanded oversight examination procedures to directly address Madoff's alleged use of a FINRA based "broker-dealer trading system."³³ The proposed rule would have required the disclosure of the volume and the identity of traded securities necessary for the SEC to uncover that Madoff did not trade or hold the securities he claimed.

In 1994 the SEC's Madoff examiners sent a "**Special Purpose Inspections Memorandum**"³⁴ to Becker, advising of their findings. Becker, the Division Director, was advised that FINRA's "oversight examinations should be revised to include certain market structure issues not included in the routine broker-dealer examination conducted by [FINRA]." The Division staff also advised Becker, "Because the inspections were neither routine inspections of SRO programs nor routine examinations of broker-dealer operations, we will not issue formal inspection reports to Madoff."

Becker did not take action against FINRA or demand that FINRA conduct its own investigation into Madoff's undocumented "risk management." Had Becker spurred enactment of the proposed new rule or required FINRA to conduct this examination FINRA would have discovered that the securities trading and holdings reported by Madoff's firm were entirely fictitious.

In 2009, Brandon Becker was hired by TIAA-CREF as executive vice president and chief legal officer. The press release announcing Becker's appointment quotes TIAA-CREF's CEO, Roger

³³ Memorandum dated July 19, 1994 to Becker. (see <http://www.asensio.com/exhibit0505.pdf>)

³⁴ To see the "Special Purpose Inspection Memorandum" go to <http://www.asensio.com/exhibit0506.pdf>

W. Ferguson, Jr. speaking highly of Becker's past experience. Ferguson's wife is former SEC Commissioner Annette Nazareth, who prior to being appointed a Commissioner in 2005, held the same position that Becker did at the SEC, Director of the Division of Market Regulation.

SECTION 5: FINRA's Wrongful Madoff Denial Serves its Objective to Expand its Revenues and Officer Salaries.

FINRA uses regulatory fees to fund non-regulatory activity. These expenditures are not subject to detailed public disclosures or SEC or Congressional controls. FINRA revenues obtained through regulatory fees are used for advertising and compensation of its non-examining, non-regulatory staff.

FINRA has governmental powers, but it is not a government agency. It is not subject to the Administrative Act or due process restrictions. The government does not regulate its expenditures of regulatory fees on salaries. In the past at least one multi-million dollar compensation package was paid to an employee.

FINRA's Special Report and Ketchum wrongfully denied FINRA's direct failure to uncover the 20-year-long Madoff Ponzi scheme. In his Congressional testimony, Ketchum³⁵ claimed that Madoff "highlighted what can happen when a regulator like FINRA has only free reign to see one side of a business." Later in his testimony, Ketchum goes back to the theme stating "FINRA believes that one of the most important gaps to close in terms of investor protection is the disparity in oversight between broker-dealers and investment advisers."

FINRA examined Madoff and was advised by the SEC that its examinations needed to be revised. Yet FINRA failed to uncover the Madoff fraud. Madoff and his firm were prominent

³⁵ Testimony of Chairman and CEO Richard Ketchum Before the Committee on Banking, Housing, and Urban Affairs on March 26, 2009. <http://www.finra.org/Newsroom/Speeches/Ketchum/P118298>

FINRA leaders. Ketchum's successor at the SEC, Brandon Becker, who was involved in FINRA's price-fixing failure, was also involved in FINRA's Madoff failure.

The Kotz investigation referred to in Section 5 and the Coffee and other legal expert opinions referred to in Section 4 establish FINRA's jurisdiction over Madoff and establish FINRA's rule-making failure even after an SEC investigation uncovered FINRA's deficiencies. The incentive is for FINRA's staff to grow regulatory revenues to fund non-regulatory expenses, including salaries. Thus FINRA has an inherent incentive to increase broker commissions, especially among those brokers that vote on its salaries. As was the case during the FINRA price fixing scandal, these conflicts cause moral hazard.

SECTION 6: FINRA's Moral Hazard as a Cause of the Global Financial Crisis of 2007 – 2009.

Just as investigations were beginning in 1994 into the market manipulation and price-fixing done by FINRA-member firms in the over-the-counter (“OTC”) stock markets, some of the same firms, the largest and most powerful FINRA members, were working to ensure that a new OTC market would be kept out of the purview of government agencies: the OTC derivatives market.

It was this market that created the financial crisis that began in 2007 and is still ongoing in 2009. As much as this crisis has been a global phenomenon, it has very specific roots: the U.S. mortgage market, mortgage-backed securities, and the credit default swaps (a type of OTC derivative) linked to mortgage-backed securities.

Credit default swaps allowed the major FINRA-member firms to sell faulty subprime mortgage-backed securities recklessly without a sense of risk. Credit default swaps act as a form of insurance against default of the underlying bond.

One small unit of one company, the financial products unit of American International Group, Inc. (“AIG”), sold more credit default swaps on mortgage-backed securities than any other, and in doing so, was probably the single greatest cause of the global financial crisis. AIG's credit default swaps allowed Wall Street investment banks to obtain insurance on their faulty mortgage-backed securities, thereby creating an appearance that AIG would absorb all the risk from the faulty mortgages.

One employee of AIG's financial products division stated that their division's credit default swaps allowed for the first \$1 trillion in subprime mortgages.³⁶ Without the credit default swaps, the market for subprime mortgage-backed securities would not have existed.

The head of AIG's financial products division, Joseph Cassano, who more than any other individual is responsible for the reckless sales of credit default swaps, was and remains a member of FINRA in good standing.

The facts set out above warrant specific criticism of FINRA in three respects.

First, FINRA failed to create a regulatory apparatus for OTC derivatives. With the fallout from the U.S. Department of Justice investigation into FINRA members' price-fixing in the OTC stock market, the dangers of a non-transparent OTC market should have become more apparent to FINRA than to any other regulator. Furthermore, FINRA, as an SRO, has the closest relationship with and most direct scrutiny of Wall Street investment banks. When these investment banks initiated discussions on policy regarding OTC derivatives in 1994, FINRA was in the best position among regulators to intercede and assure appropriate supervision. FINRA failed to do this, even after recommendations for oversight from the GAO.

Second, FINRA failed to oversee the risks posed by OTC derivatives, though all transactions were carried out through FINRA member broker-dealers or their affiliates. FINRA has the most expansive jurisdiction of any regulator. It can request whatever information it sees fit about its

³⁶ Michael Lewis, "The Man Who Crashed the World," *Vanity Fair* August 2009.

members' business affairs or even personal affairs, without the same constraints of due process imposed upon government agencies. As such, FINRA could have initiated investigations into the activities surrounding mortgage-backed securities and OTC derivatives. FINRA failed to do so.

Third, FINRA has failed to take any disciplinary action against Joseph Cassano from the AIG financial products division. Even if Mr. Cassano did not willfully intend to act as recklessly as he did, his behavior nonetheless shows a gross negligence which has had an impact upon the world financial system whose cost is beyond estimation. FINRA's disciplinary procedures focus on breaking of specific rules. FINRA has shown itself to be inept at properly addressing gross negligence done by its members, even when that negligence impacts the entire world economy.

The reason for FINRA not taking steps to address its apparent deficiencies is that FINRA serves to benefit the interests of its members. FINRA worked for the interests of its members to the detriment of the public in the price-fixing in the OTC stock market; it did the same in the OTC derivatives market; FINRA continues to do so now by not addressing its mistakes and toughening its rules.

The following section discusses the adoption of legislation governing OCT derivatives in more detail.

SECTION 7: The OTC Derivatives Market Remained Unregulated as a Direct Result of FINRA’s Rule Making Failures and its Sufferance, Benefiting the Broker-Dealers that Control It.

The Commodity Futures Modernization Act of 2000 (the “Act”)³⁷ ensured that no regulator was directly responsible for the OTC derivatives market. The passage of the Act was preceded by input from the SEC, the U.S. Commodity Futures Trading Commission (“CFTC”), the U.S. Treasury, and the Federal Reserve.

The content of the Act was formed directly from the suggestions made in 1995 by the Derivatives Policy Group,³⁸ whose six members were representatives from Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, Credit Suisse First Boston and Salomon Brothers.

These firms were all members of FINRA. FINRA had jurisdiction over their actions and could have interceded. Instead, the Derivatives Policy Group effectively went around FINRA and through the SEC in order to lobby for the adoption of specific legislation that would keep OTC derivatives out of the jurisdiction of any one single regulator.

³⁷ In December 2000, Congress passed the Commodity Futures Modernization Act, the most significant amendments to the Commodity Exchange Act in 25 years. This new law was created to address the risk posed by banks and broker activity in OTC derivatives and the regulatory deficiencies in the supervision of those markets.

³⁸ The Derivatives Policy Group “was organized to respond to the interest that has been expressed by Congress, agencies and others with respect to public policy issues raised by the OTC derivatives activities of unregulated affiliates of SEC-registered broker-dealers.”

There were many instances of informed parties, the President's Working Group on Financial Markets ("PWG"),³⁹ the SEC, and most notably, the U.S. Government Accountability Office ("GAO"), reporting that the OTC derivatives market posed systemic risk that could threaten the financial system as a whole.

A 1994 GAO report titled "Financial Derivatives: Actions Needed to Protect the Financial System"⁴⁰ found a deficiency in the regulatory supervision of broker-dealer's OTC derivatives market making. The report states that "major U.S. OTC derivatives dealers that were affiliates of securities firms were not required to hold a specific amount of capital to cushion against potential derivatives-related losses...in contrast, banks that were OTC derivatives dealers had capital requirements."

The report also chided "the largely unregulated activities of U.S. OTC derivatives dealers that are affiliates of securities and insurance companies." The report states, "if one of these large OTC dealers failed, the failure could pose risks to other firms-including federally insured depository institutions-and the financial system as a whole."

In a 1995 speech SEC Chairman Arthur Levitt noted that off-exchange derivatives made "sales practices one of the most contentious issues facing the industry today."⁴¹

³⁹ The PWC is composed of the U.S. Treasurer, the Chairmen of the SEC, the CFTC and the Federal Reserve Board.

⁴⁰ <http://archive.gao.gov/t2pbat3/151647.pdf>

⁴¹ <http://www.sec.gov/news/speech/speecharchive/1995/spch066.txt>

In November 1999 a PWG report on derivatives found that the derivatives trading of “banks and their affiliates are subject to consolidated supervision by banking regulators” but that the affiliates of broker-dealers who are required to be members of FINRA were “generally unregulated.”⁴²

Given the GAO report, why did FINRA not intercede? FINRA would have had the best understanding of how derivatives impacted securities firms, and FINRA should have known the specific mispricing and sales practice dangers associated with OTC markets after the U.S. Department of Justice investigation into price-fixing by FINRA member firms in the OTC stock markets. The answer would seem to be again that FINRA has a moral hazard of protecting the interests of its members over those of the public.

The six members of the Derivatives Policy Group were the same class of broker-dealer members that governed FINRA’s Board. Any policy action by FINRA’s staff leaders must be approved and governed by its Board.

FINRA’s rule making⁴³ obligation was to conduct “proactive analysis of data and trends,” and to respond “to market developments” in order to protect markets and investors. Once again FINRA’s moral hazard played a central role in its Board’s decision to overlook its members’ conduct and in this case not only “looked the other way,” but allowed its members to go around it.

⁴² <http://www.ustreas.gov/press/releases/reports/otcact.pdf>

⁴³ FINRA’s new rule are created through: 1.) FINRA firms, investors or other interested parties; 2.) FINRA staff initiatives, based on, for example, proactive analysis of data and trends by FINRA’s Emerging Regulatory Issues Task Force; 3.) TIP (Targeted Investor Protection) group, internal FINRA departments, and industry input; 4.) recommendations from the Securities and Exchange Commission (SEC) or other regulatory bodies and 5.) Recommendations from FINRA committees, Advisory Council, Small Firm Advisory Board (SFAB), or the National Adjudicatory Council; and 6.) Responses to market developments. <http://www.finra.org/Industry/Regulation/FINRARules/RulemakingProcess/>

SECTION 8: FINRA's Government Powers Are Irregular and Legally Questionable and Have Failed to Provide Regulatory Utility Compensatory With Its Risks.

While FINRA has certain government-like powers,⁴⁴ and makes rules that have the essential effect of law, it is not a government agency. It is a private company, but it is given government-like powers to regulate all brokers, investment bankers, and broker-dealers, under the “self-regulatory organization,” or “SRO,” provision U.S. securities law. These SRO provisions were a concession to the largely unregulated 1920s banking interests, including private commercial banking operations in the US without any US oversight that FDR's reforms brought under government control.

Legal studies have found many concerns regarding FINRA's activities that go beyond its threat to the financial system. These studies have raised questions regarding the legality of FINRA's activities.⁴⁵ Among these are FINRA's fees being equated to private taxation, its rule making amounting to creating new laws without the Congressional or administrative and judicial review, its ability to create and execute investigations without the constraints imposed on the FBI, and conduct prosecutions with the procedures and judicial oversight regulating the Department of Justice. A further complication is that while FINRA is acting like a government agency it is not governed by the same administrative laws that regulate America's government, and its actions and processes are not subject to direct judicial review.

⁴⁴ Roberta S. Karmel, “Is the Financial Industry Regulatory Authority and Government Agency?” Brooklyn Law School Legal Studies Research Paper No. 86, October 2007.

⁴⁵ Steven Lofchie and Moises Messulan, “Securities Self Regulatory Organizations,” Cadwalader, 1 May 2009.

FINRA resources also create risks and concerns. FINRA is the nation's largest securities regulator. Neither the SEC nor Congress has a say in how it spends its money. It is allowed to advertise and it and its members lobby government. It is supervised by the SEC through a convoluted system of overseeing FINRA's rulemaking and appeals process. However history has shown that even cases of egregious misconduct, such as the industry wide OTC price-fixing scandal of the mid-1990s, SEC's oversight scheme has been ineffective.

FINRA conducts on-site examinations of all the broker-dealers it regulates. It has power to request whatever information it chooses from broker-dealers without the hindrances placed on government agencies. If a firm or broker does not supply any information requested by FINRA, the broker or the entire firm can be expelled from FINRA - the securities industry equivalent of capital punishment. Despite these extraordinary and irregular powers, and the assumption of such risks, failed to protect the financial system from its brokers from turning faulty, and many times outright fraudulent, mortgages into the insured AAA-rated instruments that helped to cause the economic crises.

SECTION 9: Concerns Regarding the Obama Administration's Financial Regulatory

Reform Proposals.

The Obama administration believes that a major overhaul of nation's financial regulatory system is needed to address "gaps" and "insufficient government oversight" that caused the system's failure to prevent the specific practices that led to the economic crisis.

Each of the specific practices at issue are already covered by 22 major federal laws and 8 federal regulators that examine and have authority to govern the entities and individuals responsible for the Stanford, Madoff and sub-prime frauds, the last of which caused the crisis.

On top of existing regulations the administration has proposed 5 new major laws. One of these creates a new federal agency while another creates a new 8 member council called Financial Services Oversight Council ("FSOC"), which itself has authority to create committees composed of private parties. The FSOC will replace the President's Working Group on Financial Markets, which was created after the crash of 1987 and is composed of the leaders of nation's 4 main financial regulators. The President's Working Group which is commonly known as the "Plunge Protection Team," had the capacity to function in the matter proposed by the new FSOC.

SECTION 10: FINRA's Lack of Internal Controls and Conflicts-of-Interest in SEC Oversight.

The SEC has an Office of Inspector General, which is “an independent office within the [SEC] that conducts audits of programs and operations of the Commission and investigations into allegations of misconduct by staff or contractors,” according to the SEC website.

Unlike the SEC, FINRA has no inspector general. There is no internal FINRA body devoted to investigating potential misconduct. While the value of the SEC's Inspector General has been questioned, FINRA does not even attempt to create the appearance of an impartial internal body to investigate misconduct.

The SEC should by law exercise oversight of FINRA and deter misconduct by FINRA staff. However, there are certain conflicts-of-interest that prevent effective oversight by the SEC. Employees of the SEC often hope to move on to better-paid positions at FINRA or FINRA members. Gaining a senior position at FINRA means having a salary of more than \$1 million a year. By contrast, the most senior SEC official is paid approximately \$150,000 per year. SEC officials can also go on to make huge salaries working for the firms they used to regulate.

Richard Ketchum went from being director of the SEC's Division of Trading and Markets to FINRA. Brandon Becker, who held the same SEC position, went on to private practice as an attorney at a prominent firm, and even represented Bernard Madoff as a client.

Annette Nazareth also held the Division of Markets and Trading post from 1999 to 2005, and then served as an SEC Commissioner from 2005 to 2008. While at the SEC, Nazareth introduced a program to decrease SEC oversight of the largest investment banks, “Consolidated Supervised Entity Program.”⁴⁶ Nazareth reportedly withdrew from a Treasury Department post nomination in 2009 because of criticism over the investment bank regulatory program.⁴⁷ Nazareth has since gone on to work as a partner at Wall Street law firm Davis Polk & Wardwell, where profit per partner in 2008 was \$1.9 million.⁴⁸ Nazareth’s husband, the CEO of TIAA-CREF, hired Brandon Becker for a position at the firm in early 2009.

Each of these former Division Directors has gone on to make huge salaries working for or on behalf of FINRA or major securities firms.

The SEC’s Division of Markets and Trading and its Office of Interpretations and Guidance are the “cops on the beat” with direct responsibility for exercising the SEC’s oversight of FINRA. Yet even in the price-fixing, subprime, and Madoff scandals there is no public record of sanctions or disciplinary action by the SEC against FINRA or its personnel.

⁴⁶ SEC Press Release, October 2, 2007: <http://www.sec.gov/news/press/2007/2007-210.htm>

⁴⁷ Bloomberg News, March 5, 2009: <http://www.bloomberg.com/apps/news?pid=20601087&sid=afsQYds5ZIKo&refer=home>

⁴⁸ The Am Law 100 2009: <http://www.law.com/jsp/tal/PubArticleTAL.jsp?id=1202430073120>

SECTION 11: Schapiro's FINRA Record Exemplifies Conflicts-of-Interest.

Mary Schapiro was formerly the CEO of FINRA, until her appointment to serve as SEC Chairperson in 2009. Ms. Schapiro's career at FINRA exemplifies certain conflict-of-interest and moral hazard issues.

Schapiro coordinated the merger of the NASD and the NYSE's regulatory arm to create FINRA. After the merger, Schapiro's compensation from FINRA rose more than 50% to \$3.1 million, according to the *New York Times*⁴⁹. Schapiro also received compensation from serving on the boards of directors of two large corporations at the same time that she ran FINRA. In 2008, Schapiro received more than \$400,000 in compensation from serving as a director of Kraft Foods and Duke Energy Corporation, according to the companies' SEC-filed proxy statements.

Schapiro's compensation alone raises conflict-of-interest issues. Because Schapiro's compensation (and that of other FINRA executives) was so large, especially compared to SEC employee salaries, and because that compensation is tied to the revenues of FINRA member firms, it would appear that Schapiro and other FINRA executives would have an incentive to place member firms' interests ahead of those of investors and the public, though the Exchange Act grants FINRA governmental power for the sake of protecting investors. Similarly, in overseeing a merger of regulators where executive pay would be increased dramatically, Schapiro and other FINRA executives would have an incentive to complete the merger, regardless of whether it was in the best interests of investors.

⁴⁹ *New York Times*. "S.E.C. Choice Is Sued over a Merger of Regulators," by Stephen Labaton: Jan 12, 2009.

Schapiro's directorship compensation raises its own set of issues. When Schapiro assumed her position at the SEC, she resigned from her position as a director at Kraft and Duke Energy. An SEC spokesperson also stated that while Schapiro would not sell her holdings of Kraft or Duke Energy stock, she would recuse herself "from matters involving any of these issuers," according to the Wall Street Journal⁵⁰.

Remaining a director of these public companies while being a government official responsible for regulating the same companies would present a direct and material conflict-of-interest. This is why Schapiro resigned from the directorships and pledged to recuse herself from matters involving the companies.

However, the question arises of why Schapiro saw fit to serve as a director while she was running FINRA. While FINRA is officially private, it is nonetheless a regulator and has governmental powers. As the head of FINRA, Schapiro would have a direct and material conflict-of-interest in also serving as a director of a company with publicly traded securities. At FINRA Schapiro regulated broker-dealers providing investment banking services to the companies where she served as a director. The same broker-dealers would be involved in making buy or sell recommendations to investors on the stock of Kraft and Duke Energy. Schapiro would therefore have an incentive not to pursue regulatory action adverse to the broker-dealers associated with Kraft and Duke Energy.

Schapiro's FINRA record shows signs that concerns about conflicts-of-interest are warranted. The Wall Street Journal reported that Schapiro had a record of "being a regulator with a light

⁵⁰ *Wall Street Journal*. "Schapiro Getting Large Finra Payout," by Cam Simpson: Jan 29, 2009.

touch⁵¹.” The Wall Street Journal reports that FINRA levied fines against financial firms of only \$40 million in 2008, which was 73% below the total in 2005, the year before Schapiro became head of the NASD. The Wall Street Journal also suggests that Schapiro lessened settlement terms for regulatory violations at Morgan Stanley, after a meeting between Schapiro and Morgan Stanley’s general counsel, who had worked with Schapiro at the SEC.

Evidence has appeared that Schapiro’s apparent conflicts-of-interest in the merger that created FINRA may have led her to make misleading statements to member broker-dealers. Two lawsuits were brought against Schapiro alleging misleading statements about the payments to member broker-dealers as part of the merger. Schapiro reportedly told NASD member firms in the proxy statement that the IRS had determined that the NASD could not pay its members more than \$35,000 as part of the merger. However, the IRS ruling in the matter is dated months after members voted and the merger closed, and the IRS ruling reportedly establishes no such limit, though “[l]awyers representing Ms. Schapiro, Finra and other senior executives have fought vigorously to keep the I.R.S. ruling – and court references to details of that ruling – under seal,” according to the New York Times. Bloomberg News reported that the IRS would have allowed a range of payments to members up to \$76,000 – more than double the amount represented by Schapiro⁵².

Schapiro’s record demonstrates that FINRA must adopt compensation limits and limitations on outside directorships consistent with the standards at the SEC. FINRA should also improve its transparency, as demonstrated in the FINRA merger lawsuits, though Schapiro and FINRA seem

⁵¹ *Wall Street Journal*. “Obama’s Pick to Head SEC Has Record of Being a Regulator with a Light Touch,” by Randall Smith, Tom McGinty, and Kara Scannell: Jan 15, 2009.

⁵² *Bloomberg News*. “Hot Seat for SEC Chief Schapiro Won’t Cool Off,” by Susan Antilla, Dec 21, 2009.

to be fighting to keep information about FINRA out of public view. With Schapiro now running the SEC, it seems unlikely she would ever take any action against FINRA or work to limit its executives' compensation – showing Schapiro's greatest conflict-of-interest.

SECTION 12: FINRA Levies Regulatory Taxes But Has No Restrictions Non-Regulatory Expenditures Including on Lobbying or Executive Pay.

FINRA is a non-profit private company that is able to impose taxes on companies and individuals without Congressional oversight, but unlike government agencies, it has no restrictions on how much it spends to lobby members of Congress or on how much its leaders are paid, many of whom have been making more than \$1 million per year through the financial crisis.⁵³

FINRA pays no tax, under the section of the Internal Revenue Code pertaining to “Business Leagues, Chambers of Commerce, Real Estate Boards, etc.” (Section 501(c)(6)).

In 2008, FINRA drew \$779 million in fees from its member firms and their customers, which does not include additional revenues from regulatory fines. FINRA does not have to obtain Congressional approval to increase its fees; it only has to go to the SEC.

Each quarter in 2009, FINRA spent between \$200,000 and \$300,000 on lobbying.⁵⁴ At the current rate, FINRA is spending approximately \$1 million per year lobbying Congress, using money it levies in fees on brokerage firms and individual investors.

⁵³ Jed Horowitz, “With Finra in red, officials saw green,” Investment News, 6 December 2009.

⁵⁴ Lobbying Disclosure Filings. Office of the Clerk, U.S House of Representatives. <http://lobbyingdisclosure.house.gov/index.html>

No disclosure on lobbying expenditures is made in FINRA's annual report. The figures cited from records made public by the Clerk of the House of Representatives and the Secretary of the Senate.

The lobbying organization associated with FINRA called the Securities Industry and Financial Markets Association (SIFMA), which works on behalf of the largest FINRA members, spent nearly \$3.8 million on lobbying in the first three quarters of 2009 alone.

In another questionable use of FINRA funds, thirteen executives at FINRA were paid more than \$1 million each in compensation in 2008, as the financial system was falling apart, as FINRA itself generated net losses from operations, and as the FINRA investment fund lost more than 26% of its value.⁵⁵

⁵⁵ 2008 Year in Review and Annual Financial Report "Reforming Regulation to Better Protect Investors. Financial Industry Regulatory Authority, Inc. (See <http://www.finra.org/AboutFINRA/AnnualReports/index.htm>)

SECTION 13: FINRA and SEC Appearance of Expertise Renders Judicial Review Ineffective.

The U.S. Court of Appeals reviews cases of FINRA disciplinary sanctions on appeal, after an appeal review by the SEC. However, Court of Appeals reviews tend to be limited to questions on FINRA and SEC decisions on basic legal procedural issues in their decisions. The Court prefers not to disturb FINRA or SEC investigation and fact finding in enforcement actions, or the reasoning behind decisions, except as it applies to procedures.

The Court's reticence on overruling FINRA and the SEC is due to the appearance of expertise. FINRA and the SEC claim a two-tiered expert review, though FINRA and the SEC tend to move in lock-step on disciplinary sanctions. The SEC's rule making relies heavily on FINRA and its agents. The SEC typically lets FINRA sanctions stand on appeal review.

The Court has given considerable weight to the presumption of a review by two bodies with expertise in the securities industry. Therefore, the Court only questions broad legal procedural issues. The Court normally does not reverse sanctions, but remands the cases back to the SEC for further review where the SEC is allowed to rewrite the decision to address the Court's concerns. In most cases the SEC can satisfy the Court without changing or altering its decision.

This allows for another body that is supposed to oversee FINRA to actually be captive to it.

SECTION 14: Proposal to Strengthen the Obama Administration's Financial Regulatory Reform Proposal As It Pertains to FINRA's Moral Hazard.

The administration's proposals for a council of financial regulators by federal law codify the PWG, which is advised by private parties from within the financial industry. If this council is established in law, then there must also be provisions in the law providing safeguards in the communication between the council and private parties from the financial industry that advise council. If there is no governance of such communication, the council would become a vehicle of the same sort of moral hazard evident at FINRA.

While the proposed legislation enhances procedures related to whistleblower protection and compensation at the SEC, it determines that whistleblower status cannot apply to members of a self-regulatory organization, i.e. FINRA. In order for whistleblower policy to be effective, it must apply to FINRA members and FINRA's registered representatives. Furthermore, FINRA must be made to institute its own procedures for the protection of whistleblowers. FINRA currently has no such whistleblower protections.

SECTION 15: The Administration’s Proposal Highlights the Importance of Addressing FINRA’s Deficiencies.

The five (5) new laws proposed by the Obama Administration as a package titled “Financial Regulatory Reform Proposals” do not address FINRA’s moral hazard and therefore leave untouched the conflicts that made FINRA “simply look the other way.”⁵⁶

FINRA must move away from “rules based” examination and enforcement. This record keeper mentality allows FINRA to claim it’s doing its job while not preventing fraud, or far worse, namely using rules to protect unethical or grossly negligent behavior. A “principles recordkeeping based” approach focuses on investigation of the impact of a broker’s conduct instead of simple compliance with rules, which can be done while committing fraud. This would prevent FINRA from using compliance with record-keeping rules to hide from criticism and prosecution for its failures. Focusing on principles also addresses FINRA’s conflicted influence on the SEC’s rule making process.

The SEC must also take over all of FINRA’s examination and enforcement authority. This would eliminate FINRA’s inherent moral hazard and systemic shortcomings from the nation’s securities regulatory system.

Because FINRA is a quasi-governmental entity, limits should be placed on its lobbying expenditures and executive compensation. The taxes that FINRA effectively levies on broker-dealers should be subject to greater transparency and government oversight.

⁵⁶ Arthur Levitt, Securities and Exchange Commission Press Conference Regarding the NASD. Washington, D.C. 1996.

These changes can only be accomplished through legislative action and changes to SEC rules.

About Alliance for Economic Stability

The Alliance for Economic Stability (“AES”) is an organization devoted to advancing more effective securities regulation by working to address specific conflicts-of-interest within the current U.S. financial regulatory system. This work is a continuation of the research legacy of Manuel P. Asensio. The AES believes that specific investigations of economic organizations are required to identify solutions to regulatory deficiencies, and that regulatory failures, rather than speculative euphoria, led to destructive economic behavior.

In advocating investor interests while running Asensio & Company, Inc., which was the only FINRA member ever to have operated a website dedicated to exposing securities fraud, Mr. Asensio targeted companies that he felt were victimizing investors. In all cases, individual securities were overvalued due to FINRA’s failures to protect investors against its members’ unfair trading and sales practices.

Mispriced sub-prime mortgage-backed bonds and credit default derivatives are the central cause of the nation’s ongoing economic crisis.

Today the former website of Asensio & Company, **www.asensio.com**, continues to distribute securities research for the sake of advocating better corporate transparency to avoid investor victimization. The 38 cases examined on asensio.com have exposed conflicts-of-interest within regulatory agencies and self-regulatory organizations, as well as general frictions in fair price discovery in the securities markets. The asensio.com research has led to some important regulatory changes, but far more must be done to avert future financial crises.

Mr. Asensio is an investment manager with over thirty years experience in the securities industry. His investment strategy is focused broadly on deep investigation of businesses and their leaders to calculate fundamental value. Mr. Asensio's work has been profiled in publications such as the New York Times, Forbes, Worth, Money Magazine, The Wall Street Journal, Reuters, BusinessWeek and Bloomberg News. Mr. Asensio has been the President and Chief Executive Officer of Mill Rock, LLC. and its predecessor, Asensio & Company, Inc., for 17 years. He received a Bachelor of Science in Economics from the Wharton School at the University of Pennsylvania (1977) and a Master of Business Administration from Harvard Business School (1982).

Daniel Rodriguez is Founder and Managing Partner of MGR Group, a marketing, media and government-relations firm that provides strategic and crisis communications counsel and solutions to businesses, as well as campaign management to elected and non-elected individuals. Mr. Rodriguez is also Senior Vice President at Prestige Media Inc., a full-service advertising concern specializing in out-of-home programs. Before founding MGR in 1994, Dan held various Executive positions in marketing, corporate communications and government relations at Gannett Co., Hughes Television and PBS. He also worked on the staffs of Congressman Ben Gilman, Senator Daniel P. Moynihan, and Senator Alfonse D'Amato; as well as with various New York State and Westchester County governmental organizations. Dan brings extensive experience in government and the role that financial regulation played in the crisis of 2007-2008.

Dan is a graduate of Fordham University, where he received a Bachelor's in Communication, and in 1991 he was awarded a National Urban Fellowship, making him the youngest recipient ever to receive this prestigious award. As a NUF Fellow, Dan obtained a Masters Degree in Public Administration from Baruch College's School of Public of Affairs.