TRUST AND THE INVESTMENT ADVISER INDUSTRY: CONGRESS' FAILURE TO REALIZE FINRA'S POTENTIAL TO RESTORE INVESTOR CONFIDENCE

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The similarities between the stock market crash of 1929 and the recent financial recession are striking.[1] In the wake of the lowest levels

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[1] *See, e.g.*, Thomas J. Schoenbaum, *The Global Financial Crisis and Its Impact on World Trade and the World Economy—An Overview*, 41 UCC L. J. 375 (2009) (describing a crisis of confidence during the recent recession as "[e]veryone ran for the exits at once, short selling became endemic, and demand for all securities shriveled. The U.S. stock markets

of investor confidence in recent times, Congress has wrestled with equally historic financial regulatory reform.[2] As bank accounts begin to recover and stock indices rise, however, public opinion toward our financial infrastructure remains at recession levels.[3]

Congressmen on both sides of the aisle agree that the restoration of consumer confidence is crucial to a meaningful financial recovery.[4]

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lost almost $7 trillion in value as Wall Street had its worst year since 1931."); Jarad D. Hunter, Comment, *"No Crying in Baseball"—And No More Crying On the Stock Markets: An Alternate-Hybrid Approach to Self-Regulation*, 74 U. CIN. L. REV. 639, 643 (2005). In the immediate aftermath of the Crash of 1929, investor confidence was at such a low that federal intervention, a first in the securities markets, was needed. *Id.* The Investor Confidence Index measures the level at 92.1 in August 2010, compared to 86.9 in January 2009, and 135.5 in January 2001. *Investor Confidence Index Historical Data*, STATE STREET (2010), http://internet.statestreet.com/industry_insights/investor_confidence_index/historical data.pdf (last visited Oct. 21, 2010). In October 2009, the Financial Trust Index was at 22%. Paola Sapienza & Luigi Zingales, *The Results: Wave IV*, CHI. BOOTH/KELLOGG SCH. FINANCIAL TRUST INDEX (Oct. 19, 2009), *available at* http://www.financialtrustindex.org /resultswave4.htm. *See also* Mark Gongloff, Alex Frangos & Tom Lauricella, *Markets Swoon on Fears*, WALL ST. J., Aug. 11, 2010, http://online.wsj.com/article /NA_WSJ_PUB:SB10001424052748704901104575423422838391134.html ("Market sentiment has soured quickly [as of August 2010]. It underscores just how jittery investors remain nearly two years after the collapse of Lehman Brothers Holdings Inc. sent markets world-wide crashing."); Peter Wallsten & Eliza Gray, *Grim Voter Mood Turns Grimmer*, WALL ST. J., Aug. 11, 2010, http://online.wsj.com/article/SB10001424052748704901104575423674269169684.html ("Nearly two-thirds of Americans believe the economy has yet to hit bottom, a sharply higher percentage than the 53% who felt that way in January [2010].").

2 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124. Stat. 1376 (2010). The Act was signed into law on July 21, 2010. *Id. See also* Kevin Drawbaugh, *U.S. Congress Nears Financial Rules Reform Milestone*, REUTERS, Nov. 30, 2009, http://www.reuters.com/article/idUSN3045283120091130 (detailing House proposals and "measures dealing with the systemic risks from the collapse of large, troubled financial firms" in committee); Kevin G. Hall, *House to Wall St.: 'Party is Over'*, POST-GAZETTE, Dec. 12, 2009, http://www.post-gazette.com/pg/09346/1020450-84.stm?cmpid=nationworld.xml (describing the House's passage of the Wall Street Reform and Consumer Protection Act of 2009, "designed to bring the most sweeping rewrite of financial regulation since the New Deal era following the Great Depression."); Marshall McKay, *Financial Reform Passed, Implications Still Unclear*, FINANCE & COMMERCE (July 29, 2010, 2:07 PM), http://finance-commerce.com/2010/07/financial-reform-passed-implications-still-unclear/ (detailing passage of the Act); *20 Ways U.S. House, Senate Financial Reforms Differ*, REUTERS, Jan. 6, 2010, http://www.reuters.com/article/idUSN2919483620100106 (detailing markedly different Senate proposals); discussion *infra* Part II.A.

3 *See Investor Confidence Index Historical Data*, *supra* note 1.

4 *See, e.g.*, Bill Bradley, Op-Ed., *Five Ways to Restore Financial Trust*, WALL ST. J., Feb. 19, 2009, at A19 ("Restoring trust in the financial system is the key to solving the current economic crisis."); Press Release, U.S. Dep't of the Treasury, Remarks by Assistant Secretary Michael Barr on Regulatory Reform to the Exchequer Club (July 15, 2009), *available at* http://www.ustreas.gov/press/releases/tg213.htm ("To rebuild trust in our

However, Congress' solution—the Dodd-Frank Wall Street Reform and Consumer Protection Act—fails to adequately address the importance of investor confidence and instead threatens to preserve the status quo.[5] The status quo—an industry that has betrayed investors' trust—will not serve the nation's interests in restoring investor confidence and in long-term financial recovery.

Although the Securities and Exchange Commission (hereinafter "SEC") has proven itself to be largely successful in its oversight of securities investment professionals, recent missteps in the midst of the financial crisis[6] necessitate organizational change in the regulatory regime. Just as the SEC was born out of the market crash of 1929,[7] this crisis of confidence calls for a response that actively culls a perception of a trustworthy and accountable infrastructure; the industry must hold itself accountable through the increased intermediary oversight involving self-regulatory organizations.

Self-regulatory organizations (hereinafter "SROs") set rules governing member firms in the financial industry and provide oversight, supplementing that of the SEC.[8] SROs report to the SEC, which subjects

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markets, we need strong and consistent regulation and supervision of consumer financial services and investment markets."); Press Release, The White House, Remarks by the President After Regulatory Reform Meeting (Feb. 25, 2009), *available at* http://www.whitehouse.gov/the-press-office/remarks-president-after-regulatory-reform-meeting ("[T]o rebuild trust in our markets, we must redouble our efforts to promote openness, transparency and plain language throughout our financial system."); Press Release, The White House, Remarks by the President on 21st Century Financial Recovery Reform (June 17, 2009), *available at* http://www.whitehouse.gov/the_press_office/Remarks-of-the-President-on-Regulatory-Reform/ (stating that the goal is to restore honest markets).

5 *See* discussion *infra* Part III.

6 *See* discussion *infra* Part I.C.2.

7 *See* 15 U.S.C. § 78b(4) (2006) (describing national emergencies as reasons for regulation); Jill E. Fisch, *Top Cop or Regulatory Flop? The SEC at 75*, 95 VA. L. REV. 785, 787 (2009) ("Indeed, the SEC owes its existence to the stock market crash of 1929 and the subsequent Great Depression."); *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. AND EXCHANGE COMMISSION, http://sec.gov/about/whatwedo.shtml (last visited Oct. 11, 2010) [hereinafter "SEC"] (describing SEC's creation as a result of Congressional findings for the need to restore public confidence following the market crash of 1929).

8 *See About the Finanical Industry Regulatory Authority*, FINRA, http://www.finra.org/AboutFINRA/ (last visited Oct, 11, 2010) [hereinafter FINRA]. From FINRA's website:

> FINRA touches virtually every aspect of the securities business—from registering and educating industry participants to examining securities firms; writing rules; enforcing those rules and the federal securities laws; informing

SRO rules to an approval process.[9] SROs, in one incarnation or another, existed before the SEC and federal regulation of securities.[10] The largest and most well-known securities SRO today is the Financial Industry Regulatory Authority (hereinafter "FINRA"), created in 2007 through the consolidation of the National Association of Securities Dealers (hereinafter "NASD") and the New York Stock Exchange (hereinafter "NYSE").[11] FINRA provides oversight of member brokerage firms, and nearly every brokerage firm in the United States is required to be a member.[12]

Although broker-dealers are subject to dual oversight by FINRA

> and educating the investing public; providing trade reporting and other industry utilities; and administering the largest dispute resolution forum for investors and registered firms. We also perform market regulation under contract for the major U.S. stock markets, including the New York Stock Exchange, NYSE Arca, NYSE Amex, The NASDAQ Stock Market and the International Securities Exchange.

Id. See also Mun. Sec. Rulemaking Bd., *About MSRB*, MSRB, http://emma.msrb.org/AboutEMMA/AboutMSRB.aspx (last visited Oct. 21, 2010) [hereinafter MSRB]. The Municipal Securities Rulemaking Board (MSRB) "develop[s] rules for broker-dealers and banks that underwrite, trade and sell municipal securities – bonds, notes and other securities issued by states, cities, and counties or their agencies to help finance public projects or for other public purposes." *Id.*

9 *See Rulemaking Process*, FINRA, http://www.finra.org/Industry/Regulation/FINRARules/RulemakingProcess/ (last visited Oct. 11, 2010) ("SEC staff reviews the rule proposal to determine whether it is consistent with the requirements of the Securities Exchange Act of 1934. The SEC staff may request changes or amendments to the rule proposal."); MSRB, *supra* note 8.

10 *See* William I. Friedman, *The Fourteenth Amendment's Public/Private Distinction Among Securities Regulators in the U.S. Marketplace—Revisited*, 23 ANN. REV. BANKING & FIN. L. 727, 730 (2004); *infra* notes 22-25 and accompanying text. In the beginning, the stock exchanges governed themselves with no federal or state government oversight. Friedman, *supra*. As part of the regulatory reform after the 1929 market crash, Congress set in motion legislation to create SRO's as "full-fledged quasi-governmental entities charged with enforcing federal securities laws . . . ." *Id. See also History*, NYSE EURONEXT, http://www.nyse.com/about/history/1089312755484.html (last visited Oct 11, 2010) [hereinafter "NYSE"] (tracing the NYSE's origins to 1792).

11 *See* FINRA, *supra* note 8 ("[FINRA] is the largest independent regulator for all securities firms doing business in the United States. All told, FINRA oversees nearly 4,750 brokerage firms, about 167,000 branch offices and approximately 634,000 registered securities representatives."); *see also* Cory Alpert, *Financial Services in the United States and the United Kingdom: Comparative Approaches to Securities Regulation and Dispute Resolution*, 5 B.Y.U. INT'L L. & MGMT. REV. 75, 77 (2008) ("FINRA is the largest non-government regulator for all securities firms doing business in the United States.").

12 *See* 15 U.S.C. § 78o(b)(8) (2006) (prohibiting a broker-dealer from effecting most securities transactions unless such broker-dealer is a member of a registered SRO); FINRA, *supra* note 8.

and the SEC, a regulatory gap exists with respect to investment advisers.[13] No SRO exists for investment advisers; the SEC is the only federal regulator vested with oversight authority over them.[14] Investment advisers have recently come to the forefront of the debate over investment regulation reform. Any reasonably informed American is familiar with the Bernie Madoff fraud, which largely took place in his firm's investment adviser department and remained undiscovered by the SEC despite numerous and credible warnings.[15] As such, much debate exists over the future of investment adviser regulation and which agency should be entrusted with that authority.[16] Some call for expanding SEC resources,[17] while others call for the extension of FINRA's authority to encompass registered investment advisers.[18]

Congress has responded with its passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (hereinafter "Dodd-Frank Act").[19] An early version of the House's Wall Street Reform bill vested FINRA with regulatory and enforcement authority over investment advisers, but that provision has since been eliminated.[20] Instead, the final

13 *See infra* notes 49-50 and accompanying text.

14 *See* discussion *infra* Part I.A.2.

15 *See* discussion *infra* Part I.C.2.

16 *See* discussion *infra* Part II; *see also Addressing the Need for Comprehensive Regulatory Reform: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 7-8 (2009) (statement of Timothy F. Geithner, Sec'y, U.S. Dep't of the Treasury), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/geithner032609.pdf (arguing for the closing of regulatory gaps); *Interim Report of the Committee on Capital Markets Regulation*, COMMITTEE ON CAPITAL MARKETS REGULATION, 2-6 (Nov. 30, 2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf [hereinafter "*Interim Report*"] (advocating for the creation of a self-regulatory organization for investment advisers).

17 *See* discussion *infra* Part II.C. The SEC itself is one of the most vocal opponents of this position. *See* Rich Edson, *SEC Gives Wish List of 'Wish List' of 42 Changes It Wants in Securities Law*, FOXBUSINESS.COM (July 16, 2009), http://www.foxbusiness.com/story/markets/industries/government/sec-gives-wish-list--changes-wants-securities-law/.

18 *See* discussion *infra* Part II.B. Likewise, FINRA is its own greatest advocate. *See Enhancing Investor Protection and the Regulation of Securities Markets – Part II: Hearing Before the S. Comm. on Banking, Hous. and Urban Affairs*, 111th Cong. (2009) (statement of Richard G. Ketchum, Chairman and Chief Exec. Officer, FINRA), *available at* http://www.finra.org/Newsroom/Speeches/Ketchum/P118298 [hereinafter "Ketchum"] (advocating for FINRA's oversight authority to encompass investment advisers).

19 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124. Stat. 1376 (2010).

20 *See* discussion *infra* Part II.A; *see also House Passes Wall Street Reform Legislation*, 16 No. 7 MONEY MANAGER'S COMPLIANCE GUIDE NEWSLETTER 2 (2010) (stating that "[t]he Wall Street Reform and Consumer Protection Act had a provision that would have given

Dodd-Frank Act calls for a six-month study regarding the need for enhanced oversight resources for investment advisers.[21] This response is not a solution; it threatens to return regulation of investment advisers to the status quo, sidelining critical concerns for investor trust and failing to respond to calls for real regulatory reform.

This Article addresses the importance of investor trust in the context of current investment regulatory reform efforts. Part I.A provides an overview of the securities regulatory framework, focusing on self-regulatory organizations and the regulation of investment advisers and broker-dealers. Part I.B discusses the role of trust in economic transactions and recovery. Part I.C examines the strengths and weaknesses of SRO and SEC enforcement tools, with particular emphasis on recent frauds. Part II discusses relevant provisions of the Dodd-Frank Act, as well as the recent reorganization within the SEC, and introduces the debate surrounding the expansion of FINRA's authority. Finally, Part III discusses the ramifications of the Congressional response to the crisis. This Article argues for the extension of FINRA's oversight authority to encompass the investment adviser industry so as to restore trust in the securities regulatory infrastructure, lest investors fail to regain the confidence needed for long-term financial recovery.

[FINRA] 'sweeping rule-making authority'" over investment advisers.); Melanie Waddell, *FINRA Provision Deleted from Reform Bill*, INVESTMENT ADVISOR (Dec. 11, 2009), http://www.investmentadvisor.com/News/2009/12/Pages/FINRA-Provision-Deleted-From-Reform-Bill.aspx ("The provision that would have given FINRA the authority to inspect and regulate any investment advisor associated with a broker/dealer was successfully deleted from the huge financial services reform bill . . . ."); *U.S. House Nixes FINRA Regulation of Advisers*, FA NEWS (Dec. 14, 2009), http://www.fa-mag.com/fa-news/4902-us-house-nixes-finra-regulation-of-advisors.html ("Legislation that would have empowered self-regulatory organizations, such as the Financial Industry Regulatory Authority, to regulate investment advisors was defeated . . . ."). Indeed, the Obama administration has pushed for greater harmonization of the broker-dealer and investment adviser professions, including standards of care. *See generally* Nikhil Bhargava, *Broker-Dealers and Investment Advisers: The Administration's Plans for the Future of Regulation*, 61 ADMIN. L. REV. 907 (2009); Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. L. 395 (2009). The Dodd-Frank Act requires the SEC to conduct a study regarding the obligations of brokers, dealers, and investment advisers. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §913, 124. Stat. 1376, 1824-30 (2010). The comment period expired on August 30, 2010. Study Regarding Obligations of Brokers, Dealers, and Investment Advisers, Exchange Act Release No. 62,577, 2010 WL 2927949 (July 27, 2010), *available at* http://www.sec.gov/rules/other/2010/34-62577.pdf.

[21] *See infra* note 124 and accompanying text. The Senate's working version of the bill did not include a similar provision vesting FINRA with such authority. *See infra* note 122 and accompanying text.

I. STRUCTURE AND ELEMENTS OF THE SECURITIES MARKET

A. Regulatory Framework of the Industry

Since their inception in 1790, the securities exchanges have had self-governing rules and requirements for listing securities.[22] By the time the federal government enacted its own securities legislation, there were twenty-one such self-governing exchanges.[23] The Securities Acts represented a compromise, requiring the registration of all national exchanges and codifying their self-regulating infrastructure, while vesting the SEC with oversight and enforcement powers.[24]

1. An Overview of Select Securities Industry Regulation

Preceding and alongside the federal government's foray into securities and investment regulation, the industry has implemented policing procedures of its own.[25] These self-regulatory procedures—once voluntary and now mandatory—are designed to protect investors and ensure fair capital markets, thus mirroring the goals of federal securities laws.[26] Self-regulatory organizations are privately funded entities, entrusted with quasi-governmental authority, which generally

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22 *See* Ernest E. Badway & Jonathan M. Busch, *Ending Securities Industry Self-Regulation As We Know It*, 57 RUTGERS L. REV. 1351, 1352 (2005); Marianne K. Smythe, *Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for an Accommodation*, 62 N.C. L. REV. 475, 480-81 (1984) ("Much of the governance was done by committees appointed by the governing committee. These included committees on business conduct, stock list, admission, arrangements, publicity, law, and arbitration. . . . [T]he NYSE . . . [had] an impressive infrastructure for regulating the activities of its members.").

23 *See* Badway & Busch, *supra* note 22, at 1352; Smythe, *supra* note 22, at 480.

24 *See* Badway & Busch, *supra* note 22, at 1353 ("[T]he Exchange Act did not completely overhaul the securities industry's system of 'self-regulation.' In fact, the Exchange Act codified the self-regulatory structure wanted by these exchanges, but with the SEC acting as a watch-dog government agency."); Smythe, *supra* note 22, at 481 ("The regulatory structure crafted for the securities industry in 1934 was more a function of political compromise than of logic.").

25 *See* Roberta S. Karmel, *Turning Seats Into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L.J. 367, 400 (2002) ("[T]he stock exchanges continued to have rulemaking and regulatory authority with respect to their members, their trading markets and their listed companies."). Prior to federal regulation, the stock exchanges were uniformly considered to be "private membership organizations under state law." *Id.*

26 *See* 15 U.S.C. § 78s(g)-(h) (2006) (requiring SRO compliance with the Exchange Act's rules and regulations to maintain registered status).

adopt and enforce these rules to govern member firms.[27] SROs count among their ranks entities like the NYSE and FINRA, the former being one of the first SROs.[28]

In response to the stock market crash of 1929 and the subsequent crisis of confidence, Congress passed the Securities Act of 1933,[29] marking the first federal regulation of securities.[30] Shortly after its enactment, Congress passed the Securities Exchange Act of 1934,[31] which—in contrast to the Securities Act's focus on the issuance and initial registration of securities— regulates the securities industry and the secondary trading of securities.[32] The Securities Exchange Act created the SEC and vested it with broad authority over the nation's securities markets, including the authority to regulate and supervise industry professionals, securities exchanges, and SROs.[33]

In 1940, Congress passed the Investment Company Act in response to investors' growing reliance on investment companies for financial management.[34] The Investment Company Act governs the behaviors of

[27] *See* Friedman, *supra* note 10, at 737-38; FINRA, *supra* note 8. For a discussion of the quasi-governmental characteristics of SROs, including FINRA, *see generally* Andrew J. Cavo, Note, *Weissman v. National Association of Securities Dealers: A Dangerously Narrow Interpretation of Absolute Immunity for Self-Regulatory Organizations*, 94 CORNELL L. REV. 415, 417 (2009).

[28] *See* NYSE, *supra* note 10; FINRA, *supra* note 8.

[29] 15 U.S.C. § 77a (2006).

[30] *See* Michael Duffy, *'Fraud on the Market': Judicial Approaches to Causation and Loss from Securities Nondisclosure in the United States, Canada and Australia*, 29 MELB. U. L. REV. 621, 623 (2005) ("The laws were designed to restore investor confidence in capital markets by proscribing certain practices and introducing greater levels of government oversight, particularly through the establishment of the Securities and Exchange Commission."); Smythe, *supra* note 22, at 481 ("[T]he long-standing institutions of self-regulation existed, were still intact, and were forces to be reckoned with in 1934 when Congress undertook to devise a new and, it was hoped, more effective structure for the regulation of the securities markets."); SEC, *supra* note 7.

[31] 15 U.S.C. § 78a.

[32] *See* 15 U.S.C. § 78b (regulating "transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets"); SEC, *supra* note 7 ("With this Act, Congress created the Securities and Exchange Commission. The Act empowers the SEC with broad authority over all aspects of the securities industry.").

[33] *See* 15 U.S.C. § 78a-78z.

[34] *See* Mark S. Vander Broek, *The Demand Requirement in Investment Company Act Shareholder Actions*, 50 U. CHI. L. REV. 1500, 1502-03 (1983) (quoting Burks v. Lasker, 441 U.S. 471, 480-81 (1979)) ("Congress passed the Investment Company Act of 1940 in response to concern over 'the potential for abuse inherent in the structure of investment companies'. . . . [and] to prevent abuse of the investment company structure . . . .").

investment companies and requires their registration with the SEC.[35] Similarly, the Investment Advisers Act of 1940 regulates the actions of investment advisers.[36] An investment adviser is defined in the Act as "any person who, for compensation, engages in the business of advising others . . . or who . . . as part of a regular business, issues or promulgates analyses or reports concerning securities . . . ."[37] Those broker-dealers whose advisory services are solely incidental to their work are exempt from the Act's investment adviser registration.[38]

The federal securities laws can be said to have simply added an extra layer of regulation over that provided by the exchanges and SROs. For instance, the Securities Exchange Act puts the onus on registered exchanges to adopt rules designed to "'prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade,' and to provide for appropriate discipline of its members for any violations of its own rules or the securities laws."[39] Although the SEC has gradually gained more authority over SROs by way of oversight of their rulemaking and disciplinary proceedings and the ability to autonomously enforce SRO member rules,[40] the federal

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35 *See, e.g.*, 15 U.S.C. § 80a-8(a) (2006) (prescribing registration procedure); 15 U.S.C. § 80a-21 (prohibiting certain insider loans); 15 U.S.C. § 80a-34 (prohibiting certain false representations).

36 *See* 15 U.S.C. § 80b-1-80b-21 (2006).

37 15 U.S.C. § 80b-2(a)(11).

38 15 U.S.C. § 80b-2(a)(11)(C).

39 Badway & Busch, *supra* note 22, at 1353-54 (quoting 15 U.S.C. § 78o-3(b)(6)-(7) (2000)). The Securities Exchange Act initially provided for only "a limited degree of SEC supervision." NORMAN S. POSER, BROKER-DEALER LAW & REGULATION § 13.01 (2d ed. 2001). The over-the-counter market is also within the purview of the Securities Exchange Act. *See* 15 U.S.C. § 78o-3 (2006).

40 *See* Roberta S. Karmel, *Securities Regulation: Should the New York Stock Exchange Be Reorganized?*, 10/16/2003 N.Y. L.J. 3 (2003); Friedman, *supra* note 10, at 740-745 (detailing SROs' transition from relatively autonomous organizations to strictly regulated quasi-governmental entities following the 1975 Securities Reform Act). The Securities Reform Act gave "the SEC the power to initiate as well as approve SRO rulemaking, expanding the SEC's role in SRO enforcement and discipline, and allowing the SEC to play an active role in structuring the market." Karmel at 3. *See also* 15 U.S.C. § 78s(c) (granting the SEC authority to modify SRO rules as it deems necessary); 15 U.S.C. § 78s(d)-(f) (granting the SEC authority to review and modify SRO disciplinary actions as it deems necessary). If an SRO is found not to be in compliance with the provisions of the Securities Exchange Act, the SEC has authority to: (1) revoke or suspend the SRO's registration; (2) commence an administrative proceeding against the SRO, to censure or restrict the activities, functions, and operations of the organization, a member or an associate; (3) remove or censure an officer or director; or (4) enjoin the SRO from an activity which has been determined to violate the Securities Exchange Act. *See* Friedman, *supra* note 10, at

government relies upon the industry's self-regulation. Rather than phasing out or replacing SRO authority with federal oversight, SROs have remained an integral part of the market's regulatory structure, recognized by Congress for their "individual commitment to vigilance in the surveillance of securities markets."[41]

2. Regulation of Broker-Dealers and Investment Advisers

Among the primary functions of SROs is the regulation of broker-dealers, serving as intermediaries between the SEC and regulated members of the industry.[42] A broker is defined as "any person engaged in the business of effecting transactions in securities for the account of others,"[43] and a dealer as "any person engaged in the business of buying and selling securities for such person's own account."[44] Many firms operate as both brokers and dealers. The Securities Exchange Act requires broker-dealers to register with the SEC and join either a registered national securities exchange or an SRO.[45] Broker-dealers are statutorily obligated to pay dues to the Securities Investor Protection Corporation,[46] and are further subject to numerous duties, including suitability, best execution, fair dealing, and the prohibition of excessive markups and churning of customer accounts.[47] Moreover, they are

743 (paraphrasing 15 U.S.C. § 78s(g)-(h)).

41 *See* Friedman, *supra* note 10, at 739.

42 *See* FINRA, *supra* note 8; SEC, *supra* note 7.

43 15 U.S.C. § 78c(a)(4)(A).

44 15 U.S.C. § 78c(a)(5)(A).

45 15 U.S.C. § 78o(a)(1) ("It shall be unlawful for any broker or dealer . . . to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security . . . unless such broker or dealer is registered . . . ."). Nearly all U.S. broker-dealers are members of FINRA. *See Interim Report*, *supra* note 16, at 119. The requirement for brokers and dealers to register as members of a self-regulatory organization was not initially mandated under the Exchange Act; amendments to the Act in 1938 under the Maloney Act imposed the requirement, resulting in the formation of the National Association of Securities Dealers (NASD), now FINRA. *See* 15 U.S.C. §78o-3; Laby, *supra* note 20, at 402.

46 *See* 15 U.S.C. § 78aaa-lll. The Securities Investor Corporation ("SIPC") maintains a fund to reimburse harmed investors as a result of the failure of a member brokerage firm. *Id.*

47 *See, e.g.*, 17 C.F.R. § 240.15c1-7(a) (2010) (prohibiting churning and charging excessive fees); NASD Rule 2310, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3638 (imposing the standard of suitability for customer recommendations); NYSE Rule 405, *available at* http://rules.nyse.com/NYSETools/PlatformViewer.asp?searched=1&selectednode=chp_1_5_7_6&CiRestriction=405&manual=/nyse/rules/nyse-rules/; *see also* Brown v. E.F. Hutton Grp., Inc., 991 F.2d 1020, 1031 (2d Cir. 1993) (delineating a five-part test required to prove a violation of a broker's standard of suitability). For an expert discussion of broker-dealer duties, *see*

subject to the Exchange Act's antifraud provisions, as well as financial soundness regulations set by the SEC.[48] Thus, broker-dealers are subject to layers of rules-based regulation, allowing for both SRO and SEC oversight and discipline.

SRO jurisdiction is limited to brokers and dealers, leaving a regulatory gap with regard to investment advisers.[49] Investment advisers, therefore, remain somewhat of an anomaly in the securities regulation framework, in that they are subject only to either SEC or state oversight pursuant to the Investment Advisers Act.[50] In general, an investment adviser is required to register with the SEC if he manages more than $100 million in assets.[51] Below that asset threshold, the Investment Advisers Act precludes federal regulation, allowing the state to assume the responsibility if registration is required at all.[52] Otherwise, the

generally DAVID A. LIPTON, BROKER-DEALER REGULATION §§ 5:1 – 5:29 (2007).

48 *See* 17 C.F.R. 240.10b-5 (prohibiting any act or omission resulting in fraud or deceit in connection with the purchase or sale of any security); 17 C.F.R. 240.17a-5(c) (2010) (requiring filing and disclosure of certain financial statements).

49 *See* Carolyn W. Mendelson, *Wasn't My Broker Always Looking Out for My Best Interests? The Road to Become a Fiduciary*, 12 DUQ. BUS. L.J. 41, 48 (2009); *see also* 15 U.S.C. § 78o(b)(8) (requiring only broker-dealers to maintain SRO membership); Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Address Before the New York Financial Writers' Association Annual Awards Dinner (June 18, 2009), *available at* http://www.sec.gov/news/speech/2009/spch061809mls-2.htm (discussing the disparate regulatory framework of broker-dealers and investment advisers); Doug Halonen, *Madoff Scandal Spurs SRO Talk, Pensions & Investments*, PENSIONS & INVESTMENTS (Jan. 12, 2009, 12:01 AM), http://www.pionline.com/article/20090112/PRINTSUB/901109970 (discussing the fact that registered investment advisers are not subject to SRO oversight).

50 *See* 15 U.S.C. § 80b-3 (2006) (prescribing thresholds for state and federal registration). Individual and institutional investors alike retain investment advisers to assist them in the planning of their financial affairs. *See Background & Mission*, INVESTMENT ADVISER ASS'N, https://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=BackgroundMission (last visited Oct. 21, 2010) ("Today, the IAA consists of more than 475 firms that manage assets for a wide variety of institutional and individual clients, including pension plans, trusts, investment companies, endowments, foundations, and corporations.").

51 *See* 15 U.S.C. § 80b-3a (prohibiting investment advisers from registering with the SEC unless they manage at least $100 million in assets). As of April 2009, there were 11,257 registered investment advisers. *See* Inv. Adviser Ass'n. & Nat'l. Regulatory Servs., *Evolution Revolution 2009: A Profile of the Investment Advisory Profession*, INVESTMENT ADVISER ASS'N, https://www.investmentadviser.org/eweb/docs/Publications_News/Reports_and_Brochures/IAA-NRS_Evolution_Revolution_Reports/evolution_revolution_2009.pdf (last visited Oct. 21, 2010). Before the Dodd-Frank Act, the asset threshold was $25 million. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 410, 124 Stat. 1376, 1576-77; Kara Scannell, *States Will Be Hedge-Fund Police*, WALL ST. J., Aug. 19, 2010, at C3.

52 *See* 15 U.S.C. § 80b-3a (requiring federal registration unless assets under

Investment Advisers Act is largely principles-based. That is, the Act's prohibition of any registered investment adviser to "employ any device, scheme, or artifice to defraud any client or prospective client," to engage in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," and to engage in principal trades without the client's consent,[53] relies on the fact that registered investment advisers owe a fiduciary duty to their clients. This fiduciary duty imposes subjective requirements on investment advisers to avoid conflicts of interest with their clients in order to act in their clients' best interests.[54] As such, an effective investment adviser undertakes to gain a thorough understanding of the client's resources, risk tolerance, and investment goals in order to make appropriate recommendations.[55] Thus, this principles-based framework permits clients and firms to define the scope of their relationship, in that clients may consent to existing conflicts of interest with their investment adviser.[56]

B. Trust as an Essential Element of the Economy

Trust can be defined as "the voluntary ceding of control over

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management amount to less than $100 million).

[53] 15 U.S.C. § 80b-6.

[54] *See* Lori A. Richards, Director, Office of Compliance Inspections and Examinations, U.S. Sec. & Exch. Comm'n, Fiduciary Duty: Return to First Principles (Feb. 27, 2006), *available at* http://www.sec.gov/news/speech/spch022706lar.htm; Mendelson, *supra* note 49, at 48-49. Although the term "fiduciary duty" is not used in the Investment Advisers Act, courts have found the duty to be inherent. *See* Mendelson, *supra* note 49, at 49 (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963)). The Supreme Court stated that:

> The Investment Advisers Act of 1940 thus reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship, as well as a congressional intent to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.

Capital Gains, 375 U.S. at 191-92. *See also* Jessica Holzer & Fawn Johnson, *Brokers, Critics Spar Over 'Fiduciary' Rule*, WALL ST. J., Aug. 18, 2010, at C15 ("Fiduciary duty for investment advisers has never been strictly defined in the law. Court rulings and SEC enforcement actions have provided guidelines. One is that advisers should provide clear disclosure so clients can compare advisers' disciplinary history and pay arrangements.").

[55] *See IAA Standards of Practice*, INVESTMENT ADVISER ASS'N, https://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=StandardsPractice (last visited Oct. 21, 2010) (describing registered investment adviser standards of practice).

[56] *See* 15 U.S.C. § 80b-6(3) (requiring a registered investment adviser to disclose any conflicts of interest and obtain client consent before making certain transactions in securities).

something valuable to another person or entity, based upon one's faith in the ability and willingness of that person or entity to care for the valuable thing."[57] Simply put, trust is having faith and believing in others. Trust's corollary, trustworthiness, can be defined as an "unwillingness to exploit a trusting person's vulnerability even when external rewards favor doing so."[58] Trustworthiness is displayed through an individual or entity's integrity and fulfillment of assigned responsibilities.

The concept of trust has always been an essential element of our economy.[59] Research has shown that cooperative, trustworthy behavior between individuals leads to more of the same behavior and an increase in the perception of trust between the individuals.[60] Research has also shown that, among individuals, "communications and expressions directed towards encouraging cooperative behavior lead to greater trustworthiness."[61] Building on this behavioral foundation, research has found that on an individual level, trust plays an integral part of economic interaction.[62] That is, "[t]rust acts as a lubricant,"[63] enabling individuals, as investors, to transact efficiently, and thus, more often. For analogous reasons, the proper organizational regime can similarly promote trust among individuals. In other words, "[when] people are confident in the [law] to punish cheating, people are more trusting"[64] as a result of their faith in the monitoring system.

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57 Raymond H. Brescia, *Trust in the Shadows: Law, Behavior, and Financial Re-Regulation*, 57 BUFF. L. REV. 1361, 1369 (2009) (quoting Frank B. Cross, *Law and Trust*, 93 GEO. L.J. 1457, 1461 (2005)). *See also* MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 432 (11th ed. 2003) (defining the term "trust" as "assured reliance on the character, ability, strength, or truth of someone or something.").

58 Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1740 (2001). *See also* MERRIAM-WEBSTER, *supra* note 57 (defining the term "trustworthy" as "worthy of confidence.").

59 *See generally* Kenneth J. Arrow, *Gifts and Exchanges*, 1 PHIL. & PUB. AFF. 343, 357 (1972); Lawrence E. Mitchell, *The Importance of Being Trusted*, 81 B.U. L. REV. 591, 596 (2001); Brescia, *supra* note 57, at 1366 (quoting 1 JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY ch. VII, § 5, at 108-09 (Cosimo 2006) (1848)).

60 *See, e.g.*, Thomas Gautschi, *History Effects in Social Dilemma Situations*, 12 RATIONALITY & SOC'Y 131 (2000); Nina Mazar, On Amir & Dan Ariely, *The Dishonesty of Honest People: A Theory of Self-Concept Maintenance*, 45 J. MARKETING RES. 633 (2008); Brescia, *supra* note 57, at 1397-1400.

61 Brescia, *supra* note 57, at 1397.

62 *See id.* at 1363.

63 *Id.*

64 *Id.* at 1402.

These observations have been tested and applied in the context of financial reform. One general conclusion is that "[j]ust as the level of trust present in a society generally has a positive impact on growth, nations that have strong investor protections, and which honor the rule of law and contract and property rights, tend to have higher rates of economic growth than low trust/weak rule of law nations."[65] The idea of trust has been commonly measured by the World Values Survey, which asks citizens of a given country whether they generally trust others.[66] In his survey of the subject and underlying research, Frank B. Cross details the association between trust and economic growth.[67] Using the World Values Survey data, Cross established a significant and positive association between trust and economic growth.[68] A similar study looked at twenty-nine market economies and found a significant and positive association between trust and both investment and economic growth.[69] Another study found a positive link between high levels of trust and higher economic growth rates.[70] Thus, Cross and others have found that, to a large extent, "[t]rust itself is critical to economic success,"[71] due to its ability to temper economic uncertainty.

History tells a similar story. It was the public's loss of trust that acted as a catalyst for comprehensive securities regulation beyond that provided by the self-regulating arm of the industry.[72] In response to the rising prevalence of fraud and highly speculative and unfair investments that were unlisted on exchanges,[73] various states enacted "blue-sky" laws for the purpose of imposing registration requirements on securities and their salesmen.[74] Within just two decades, all but one state had

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65 *Id.* at 1405.

66 *See* Rafael La Porta et al., *Trust in Large Organizations*, 87 AM. ECON. REV. 333, 334-35 (1997).

67 *See* Cross, *supra* note 57, at 1475-85.

68 *See* Cross, *supra* note 57, at 1479 (citing La Porta, *supra* note 66, at 334-35).

69 *See* Cross, *supra* note 57, at 1478 (citing Stephen Knack & Phillip Keefer, *Does Social Capital Have an Economic Payoff?*, 112 Q.J. ECON. 1251 (1997)).

70 *See* Cross, *supra* note 57, at 1478 (citing Paul F. Whitely, *Economic Growth and Social Capital*, 48 POL. STUD. 443, 444-52, 460 (2000)).

71 *See id.*

72 *See supra* notes 29-30 and accompanying text; *infra* note 77 and accompanying text.

73 *See* LOUIS LOSS & EDWARD M. COWETT, BLUE SKY LAW 7 n.22 (1958); Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 353-54 (1991); Paul G. Mahoney, *The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses*, 46 J.L. & ECON. 229 (2003).

74 *See* Mahoney, *supra* note 73, at 229-231. In 1911, Kansas became the first state to adopt a statute regulating the sale of securities. *Id.* The term "blue-sky" is said to have

enacted blue-sky laws.[75] The public had come to perceive the exchanges as untrustworthy, blaming them for facilitating the fraudulent and speculative investments characteristic of those in the early twentieth century leading up to the market crash of 1929.[76]

Following the crash, the public's trust in the nation's securities markets continued to fall precipitously.[77] Small and large investors alike were wary throughout the ensuing Great Depression of reinvesting any money they had salvaged.[78] As Congress and the Roosevelt administration explored methods of financial recovery, it became clear that the public's confidence in the markets would first have to be restored.[79] The Roosevelt administration's response included an attempt to garner trust through the use of the Blue Eagle symbol,[80] which sought to symbolize compliance with codes of conduct.[81] The Blue Eagle was marketed by complying companies across all industries to show consumers that they were trustworthy.[82] Companies that complied with the requirements of the program were authorized to display a Blue Eagle decal to their employees and to the public, symbolizing their devotion to the nation's recovery and signifying that they were "a

derived from one individual's disparaging characterization of securities salesmen of the day, who would sell "building lots in the blue sky." *Id.* (quoting LOSS & COWETT, *supra* note 73, at 7 n.22). *See also* Thomas Mulvey, *Blue Sky Law*, 36 CAN. L. TIMES 37, 37 (1916).

75 *See* Mahoney, *supra* note 73, at 229. By 1931, 47 of the 48 existing states had adopted such laws. *Id.*

76 *See* Badway & Busch, *supra* note 22, at 1353. Congressman Adolph Sabath, on the floor of the House of Representatives, argued that the securities exchanges:

> [B]elieve[d] that it [was] their own privilege and their God-given right to control this gambling den that brought about destruction to America, brought about the closing of our banks and manufacturing plants, nearly ruined all of the insurance companies, brought about the unemployment of 16,000,000 men in the United States and that caused untold hardships and suffering and, above all, that was responsible for thousands of suicidal deaths.

Id. (quoting 78 CONG. REC. 7689 (1934)).

77 *See, e.g.*, Hunter, *supra* note 1. In the immediate aftermath of the Crash of '29, investor confidence was at such a low that federal intervention, a first in the securities markets, was needed. *Id.*

78 *See* SEC, *supra* note 7; Duffy, *supra* note 30, at 623 ("During the 1920s approximately 20 million large and small shareholders purchased securities on the United States stock market, with some $50 billion in new securities offered during this period. Following the stock market crash of October 1929, it is estimated that approximately half of the $50 billion became worthless.").

79 *See* Duffy *supra* note 30, at 623; Hunter, *supra* note 1, at 643.

80 *See* Brescia, *supra* note 57, at 1361-62.

81 *See id.* at 1361.

82 *See id.* at 1361-62.

business worthy of consumer trust."[83] Thus, the Blue Eagle symbol acted not only to cull the individual consumer's confidence in the regulatory system, but to ensure the consumer of the organization's trustworthiness.[84]

These examples illustrate the predominant role of trust in economic transactions and recovery.[85] Additionally, they convey the importance of analyzing trust via the perception of the individual consumer.[86] Although the underlying concept is intuitive, it demonstrates our regulatory framework's unique potential to reestablish investor confidence.

C. Investigation and Enforcement

1. SRO Regulatory Tools

The authority granted to FINRA under the Exchange Act allows it to be an effective intermediary between the SEC and its registered broker-dealers. While the SEC does not have the general authority to adopt rules governing the conduct of registered broker-dealers in relation to their customers,[87] FINRA, and other SROs like it, require their members to adopt rules of conduct and to retain the power to enforce these rules (and other supervisory policies and procedures) using designated enforcement and examination staff.[88] Among the requirements FINRA imposes on its members are those which mirror the general anti-fraud prohibitions under the Securities Acts,[89] as well as those which govern treatment of customer accounts.[90] Further, FINRA's

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83 *See id.* at 1361.

84 *See id.* at 1361-62.

85 *See* discussion *supra* Part I.B.

86 *See supra* notes 72-84 and accompanying text.

87 *See id.* Instead, SROs are required to enforce SEC and SRO rules. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78s(g) (2006) ("Every self-regulatory organization shall comply with the provisions of this title…the rules and regulations thereunder, and its own rules . . . .").

88 *See e.g.*, Hunter, *supra* note 1, at 646-47 (citing *About NYSE Regulation*, NYSE EURONEXT, http://www.nyse.com/regulation/nyse/1045516499685.html#mktsur (last visited Oct. 16, 2010)).

89 *Compare* FINRA Rule 2020, *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=6914&element_id=5513&highlight=2020#r6914 (prohibiting fraudulent and manipulative devices), *with* SEC General Rules and Regulations, 17 C.F.R. § 240.10b-5 (1993) (prohibiting employment of "any device, scheme, or artifice to defraud").

90 *See* FINRA Rule 2060, *available at* http://finra.complinet.com/en/

Supervision Rule requires member firms to "establish, implement and enforce a supervisory system reasonably designed to achieve compliance with securities laws and regulations."[91]

SROs are able to succeed in part because of their unique investigative and enforcement processes. Within this self-regulatory regime exists a broad jurisdictional mandate to discipline fraudulent acts, unethical conduct, the inadequate supervision of accounts, the failure to maintain books and records, and violations of any provision of the Exchange Act or any rule or regulation pursuant thereto.[92] Additionally, "virtually any underlying act or omission disciplinable by one SRO is disciplinable by any other SRO."[93] Because all brokerage firms belong to at least one SRO, and most belong to several, regulators have the opportunity to oversee broker-dealers with a fine-tooth comb, which stands in stark contrast to the SEC's relatively limited oversight of registered investment advisers.[94] For example, FINRA conducted approximately 2500 examinations of its 4900 registered broker-dealer firms in 2008, whereas the SEC conducted fewer than 1500 examinations of its 11,300 registered investment advisers in 2007.[95]

Moreover, these privately funded, quasi-governmental organizations are not constrained by constitutional mandates to the same extent as the SEC.[96] For instance, although registered broker-dealers have a duty to cooperate with SRO investigations, they are not entitled

display/display_main.html?rbid=2403&element_id=8849 (prescribing proper usage of information obtained in a fiduciary capacity); *supra* note 47.

91 William Jannace & Anita Moore, *Overview of SRO and Broker/Dealer Regulation*, 1748 PLI/CORP 31, 38 (2009); *see also* FINRA Rule 3130, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6286 (requiring annual certification of compliance and supervisory processes).

92 *See* Securities Exchange Act of 1934, 15 U.S.C. § 78o-3(b)(6)-(7) (requiring SROs to "prevent fraudulent and manipulative acts and practices [and] to promote just and equitable principles of trade . . . ."); Badway & Busch, *supra* note 22, at 1353-55.

93 Joan F. Berger et al., *A Dialogue with Securities Industry—Self-Regulators: Disciplinary Investigations and Proceedings Conducted by the American Stock Exchange, the National Association of Securities Dealers, and the New York Stock Exchange*, 501 PLI/CORP 359, 361 (1985).

94 *See id.* at 363 ("SROs have a large common membership, all those subject to SRO jurisdiction must realize that they are subject to multiple, sometimes co-extensive subject matter jurisdiction.").

95 *See* Ketchum, *supra* note 18; *see also* Scannell, *supra* note 51 (internal quotation marks omitted) ("Over 3,000 investment advisers have never been examined by the SEC.").

96 *See* Badway & Busch, *supra* note 22, at 1356-58 (describing due process obligations of SROs).

to invoke their Fifth Amendment privilege against self-incrimination.[97] Nor does the commencement of an SRO investigation require a formal order of the kind required by the SEC.[98] Further, despite not possessing the SEC's subpoena power, SROs can compel a broker-dealer's cooperation in an investigation through a range of available sanctions, including expulsion, barring employment with a member organization, suspension, or a fine.[99] As such, industry incentives including the preservation of reputation and avoidance of the imposition of fines have helped SROs regulate member conduct as effectively as—and with greater efficiency than—the SEC.

2. Recent Missteps in SEC Enforcement

Despite the SEC's zeal and overall effectiveness as an enforcement agency, recent fraud reveals regulatory deficiencies currently facing the securities industry.[100] Two separate, high-profile cases involving businesses owned by financiers Bernard Madoff and R. Allen Stanford highlight these deficiencies.

Bernard Madoff was the sole owner of registered broker-dealer and investment adviser firm Bernard L. Madoff Investment Securities LLC (hereinafter "BMIS").[101] BMIS' business was comprised of proprietary trading, market making, and investment adviser services.[102] Madoff conducted the investment adviser wing of BMIS separately from its other activities, even locating the wing on a different floor of the BMIS office building.[103] From the 1990s until 2008, BMIS operated an estimated $50 billion Ponzi scheme that paid old clients with the principal of new clients' investments in order to give the appearance of

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97 *See* Badway & Busch, *supra* note 22, at 1356-58 (citing NASD Rule 8221(b), 8310(b); NYSE Disciplinary Rules 476, 477).

98 *See* Kirkpatrick & Lockhart Preston Gates Ellis LLP, *Enforcement by Self-Regulatory Organizations, in* THE SECURITIES ENFORCEMENT MANUAL, TACTICS AND STRATEGIES 473, 483 (2007).

99 *See* Berger et al., *supra* note 93, at 376-77.

100 The SEC has borne its share of criticism. *See, e.g.*, Ashby Jones, *SEC Workers Investigated for Porn-Surfing*, WASHINGTON TIMES, Feb. 2, 2010, http://www.washingtontimes.com/news/2010/feb/02/sec-workers-investigated-for-viewing-porn-at-work/?feat=home_headlines (describing salacious work habits of some libertine SEC employees).. To be sure, the agency's daily efforts go relatively unnoticed.

101 *See* Complaint at 4, United States v. Madoff, 586 F. Supp.2d 240 (S.D.N.Y. 2009) (No. 08 Mag. 2735).

102 *See id.*

103 *See id.* at 4-5.

legitimate returns.[104] Not a single investment was made, making the entire operation a fraud.[105] In fact, no regulatory agency can take the credit for cracking the Madoff case—his sons turned him in upon learning of the scheme.[106]

What is probably the most dismaying aspect of the entire scam is that the SEC had investigated Madoff's activities eight times during a period of sixteen years, without ever making an enforcement recommendation.[107] The SEC had been warned on several occasions that BMIS' investment advisory arm was producing impossibly favorable results.[108] Further, one SEC staffer had noticed a red flag and warned superiors of irregularities at BMIS, but was directed to overlook the matter.[109] Because Madoff's asset management business was registered as an investment adviser with the SEC, that agency had sole regulatory jurisdiction over the fraud-perpetrating arm of BMIS under the Investment Advisers Act of 1940.[110] As such, although FINRA had access to BMIS' broker-dealer operations, which it had investigated in

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[104] *See id.* at 1-2.

[105] *See id.*; David Ellis, *Congress Looks for Answers in Madoff Scandal*, CNNMONEY (Jan. 5, 2009), http://money.cnn.com/2009/01/05/news/companies/madoff_hearing/index .htm.

[106] *See, e.g.*, David Voreacos & David Glovin, *Madoff Turned in by Sons After Confessing $50 Billion Fraud*, BLOOMBERG.COM (Dec. 12, 2008), http://www.bloomberg.com/apps/news?pid=20601087&sid=aDekXqQt6w7o.

[107] *See* Kara Scannell, *Madoff Chasers Dug for Years, to No Avail*, WALL ST. J., Jan. 5, 2009, at C1; Bhargava, *supra* note 20, at 911; Scannell, *supra* note 51 ("The SEC inspected Bernard Madoff's operations several times, and eventually made him register as an investment adviser, but never figured out he was running a multibillion-dollar Ponzi scheme."); *see also* Gerald P. O'Driscoll, Jr., *Why Government Regulation Fails*, WALL ST. J., Apr. 20, 2010, http://online.wsj.com/article/SB10001424052748704508904575192430373566758.html ("Financial services regulators failed to enforce laws and regulations against fraud. Bernie Madoff is the paradigmatic case and the Securities and Exchange Commission the paradigmatic failed regulator. Fraud is famously difficult to uncover, but as we now know, not Madoff's.").

[108] *See* Bhargava, *supra* note 20, at 911 ("Investment banker Harry Markopolos had warned the SEC during the six years prior to BMIS's collapse that the company was reporting impossible returns."); Kara Scannell, Liz Rappaport, & Thomas Catan, *SEC Blasted on Goldman*, WALL ST. J., September 23, 2010, at A1.

[109] *See* Zachary Goldfarb, *Staffer at SEC Had Warned of Madoff*, WASH. POST, July 2, 2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/07/01/AR2009070104223.html. Genevievette Walker-Lightfoot, a staffer in the Office of Compliance Investigations and Examinations, found irregularities in the firm's responses to a review she conducted. *Id.* Walker-Lightfoot drafted a set of questions to ask the firm, directed at matters which later turned out to be elements of the fraud. *Id.* However, the questions were never asked. *Id.*

[110] *See* 15 U.S.C. § 80a-41(a) (2006); Bhargava, *supra* note 20, at 911.

the past, it was statutorily prohibited from concerning itself with BMIS' investment advisory activities.[111] Although it is impossible to know whether the fraud would have been discovered if FINRA had access to BMIS' investment advisory arm, the Madoff scheme raises questions as to the efficacy of the SEC as the sole regulator of investment advisers.

Within months of the discovery of Madoff's fraud, the SEC uncovered an unrelated fraud perpetrated by R. Allen Stanford.[112] Stanford was chairman of the privately held, wholly-owned Stanford Financial Group.[113] In February 2009, the SEC charged Stanford with fraud, alleging that he promised investors above-market returns on certificates of deposit issued by the Group's Stanford International Bank, all while running a Ponzi scheme which ultimately cheated investors out of $7 billion.[114] Reminiscent of the SEC's missed opportunities in the Madoff fraud, it has recently come to light that the SEC similarly overlooked red flags raised by Stanford's dealings.[115] A report issued by the SEC's inspector general states that "SEC examiners concluded four times between 1997 and 2004 that Mr. Stanford's businesses were fraudulent, but each time decided not to go further."[116] Moreover, in similar fashion to its treatment of the warnings of the Madoff fraud, the SEC dismissed warnings in 2003 from insiders at the Stanford Group, as well as warnings in a letter from the NASD—FINRA's predecessor—which stated that the "Stanford businesses 'will destroy the life savings of many.'"[117] The SEC's alleged investigatory

111 *See* Rachelle Younglai, *FINRA Defends Its Role in Madoff Scandal*, REUTERS (Jan. 14, 2009), http://www.reuters.com/article/topNews/idUSTRE50E0EQ20090115; Scannell, *supra* note 108 (noting that FINRA maintains that it was statutorily unable to investigate the BMIS fraud).

112 *See* Michael R. Crittenden & Kara Scannell, *Report Says SEC Missed Many Shots at Stanford*, WALL ST. J., Apr. 17, 2010, http://online.wsj.com/article/SB10001424052702303491304575188220570802084.html?mod=WSJ_latestheadlines.

113 *See* Kara Scannell, Miguel Bustillo & Evan Perez, *SEC Accuses Texas Financier of 'Massive' $8 Billion Fraud*, WALL ST. J., Feb. 18, 2009, http://online.wsj.com/article/SB123489015427300943.html.

114 *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges R. Allen Stanford, Stanford International Bank for Multi-Billion Dollar Investment Scheme (Feb. 17, 2009), *available at* http://www.sec.gov/news/press/2009/2009-26.htm; Crittenden & Scannell, *supra* note 112.

115 *See* Crittenden & Scannell, *supra* note 112.

116 *Id.*

117 *Id.* (citing U.S. Secs. & Exch. Comm'n Office of Inspector Gen., *Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme* (Mar. 31, 2010), *available at* http://www.sec.gov/news/studies/2010/oig-526.pdf); *see also* Faith Stevelman, *Globalization and Corporate Social Responsibility: Challenges for the*

lapse thus draws attention to possible institutional shortcomings.

II. FEDERAL REACTION: THE FINRA DEBATE

In response to the crisis, scandals, and subsequent plunge in investor confidence, and fueled by the Administration's anti-Wall Street rhetoric,[118] the wheels of Congress have turned. Legislation aiming to reform the financial services industry has been passed and signed into law. Although the legislation addresses the future of investment adviser regulation, Congress' response is tepid, at best.

A. Legislation and the SEC's Specialized Enforcement Units

In 2009, the Wall Street Reform and Consumer Protection Act was introduced in the House of Representatives.[119] The Act included a provision that extended FINRA's oversight authority to investment advisers, similar to that which it exercises over broker-dealers.[120] The provision's sponsor, Representative Spencer Baucus, explained that the provision was intended to close the regulatory gaps exposed during the Madoff investigation and scandal, because despite visits to BMIS by both FINRA and the SEC, those agencies examined separate groups of employees and missed a $50 billion Ponzi scheme.[121] Similarly, the Senate's working version of the bill required a study that would focus on the differences between the regulatory practices and effectiveness of FINRA and the SEC, with an eye toward the possibility of creating an SRO to oversee investment advisers. [122]

Academy, Future Lawyers, and Corporate Law, 53 N.Y.L. SCH. L. REV. 817, 832 n.65 (2009) ("The SEC itself has gone on record with the observation that Stanford's bank promised improbable, if not impossible returns to investors, which certainly raises questions about why the SEC did not act sooner.").

118 *See, e.g.*, Kimberly A. Strassel, *Bonfire of the Populists*, WALL ST. J., Jan. 28, 2010, http://online.wsj.com/article/SB10001424052748704878904575031640091592622.html. In his 2010 State of the Union address, President Obama lambasted "bad behavior on Wall Street," "'selfish' bankers [and] CEOs who 'reward' themselves 'for failure'." *Id.* (Barack Obama, President, State of the Union Address (Jan. 27, 2010)).

119 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124. Stat. 1376 (2010).

120 *See House Passes Wall Street Reform Legislation*, *supra* note 20 ("The Wall Street Reform and Consumer Protection Act had a provision that would have given [FINRA] 'sweeping rule-making authority'" over registered investment advisers.).

121 *See id.*; discussion *supra* Part I.C.2.

122 *See* S. 3217, 111th Cong. § 913 (2010). As initially filed, the provision

> [Directed] the SEC to conduct a study of the effectiveness of existing legal or regulatory standards of care for brokers, dealers, and investment advisers for

However, the aforementioned provisions were eliminated before the Dodd-Frank Act's passage.[123] Instead, all that remains are provisions requiring the SEC to study both the investment adviser examinations it has conducted over the past five years and the extent to which SRO regulation could result in more frequent investment adviser examinations.[124] The Dodd-Frank Act also requires a study of the SEC's institutional organization.[125] The study will consider the possibility of eliminating units within the Commission and whether the SEC's current level of reliance on SROs is appropriate.[126] Further, included are provisions that allow the SEC to write new rules imposing an across-the-board standard of conduct on brokers, dealers, and investment advisers in their capacities as client representatives.[127] The standard of conduct would essentially create a fiduciary duty, in that they would have "to act in the best interest of the customer without regard" to their own financial interest.[128] Although registered investment advisers are already held to a fiduciary standard,[129] such a duty would be new for broker-dealers.[130]

Amidst the legislative debate, the SEC undertook a reorganization of its Division of Enforcement.[131] The Commission established five specialized units—Asset Management, Market Abuse, Structured and New Products, Foreign Corrupt Practices, and Municipal Securities and

> providing personalized investment advice and recommendations about securities to retail customers imposed by the SEC and FINRA, and whether there are legal or regulatory gaps or overlap in legal or regulatory standards in the protection of retail customers. The section also requires the SEC to issue a report within one year that considers public input. If the study identifies any gaps or overlap in the legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers, and investment advisers, the SEC shall commence a rulemaking within two years to address such regulatory gaps and overlap that can be addressed by rule.

S. Rep. No. 111-176, at 105 (2010).

[123] *See House Passes Wall Street Reform Legislation*, *supra* note 20.

[124] Dodd-Frank Wall Street Reform and Consumer Protection Act § 914(a)

[125] *Id.* at § 967(a).

[126] *See id.*

[127] *Id.* at § 913(f)-(g).

[128] *Id.* at § 913(g).

[129] *See* 15 U.S.C. § 80b-6 (2006) (prescribing fiduciary duties of IAs owed to clients).

[130] *See* 15 U.S.C. § 78o (2006) (prescribing registration requirements and standards of conduct for brokers, which currently do not include fiduciary duties).

[131] *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Names New Specialized Unit Chiefs and Head of New Office of Market Intelligence (Jan. 13, 2010), *available at* http://www.sec.gov/news/press/2010/2010-5.htm.

Public Pensions—and created a new Office of Market Intelligence.[132] The goal of these specialized units is to make investigations more targeted and efficient, while the Office of Market Intelligence is tasked with monitoring, collecting, and analyzing referrals and tips received by the SEC.[133] This comprehensive reorganization, nothing short of a reaction to the Madoff and Stanford scandals, is an attempt to fill the gaps in federal investment adviser oversight.

B. Support for FINRA's Role

FINRA has lobbied extensively for the authority to oversee investment advisers.[134] It points to the fact that the current system regulates financial professionals who effectively perform many of the same services pursuant to inconsistent standards.[135] It further cites the fact that its Board of Governors is comprised of a majority of non-industry representatives,[136] thus distancing itself from claims that its interests are too closely aligned with those of the industry professionals it would attempt to oversee. FINRA argues that its position as the first line of defense for customers of broker-dealers would also allow it to fulfill that role for customers of investment advisers.[137] Specifically, FINRA argues that consistent and frequent exams are needed to effect proper oversight of all financial professionals, which the SEC simply cannot provide, and has not provided, in light of the disparate ratio of

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132 *See id.*

133 *See id.* ("These units and the new office will help provide the additional structure, resources, and expertise necessary for enforcement staff to keep pace with ever-changing markets and more comprehensively investigate cases involving complex products, markets, regulatory regimes, practices and transactions.").

134 *See* Ketchum, *supra* note 18. Specifically, FINRA has advocated for the following protections:

> [E]very person who provides financial advice and sells a financial product should be tested, qualified and licensed; the advertising for financial products and services should be subject to requirements that it is not misleading; every product marketed to a particular investor is appropriate for recommendation to that investor; and there should be full and comprehensive disclosure for the services and products being marketed.

Id.

135 *See id.* ("Our current system of financial regulation leads to an environment where investors are left without consistent and effective protections when dealing with financial professionals.").

136 *See id.*

137 *See id.*

registered investment advisers to SEC staff examiners.[138] Finally, FINRA highlights its statutory inability to have examined BMIS' investment advisory arm under the current regulatory regime, which, it has said, allowed BMIS to "cynically game the system . . . at great harm to investors."[139] In sum, FINRA contends that allowing for combined broker-dealer and investment adviser oversight authority would give the regulator "a complete picture of the business,"[140] ultimately benefitting the investor.

Support for FINRA's investment adviser oversight authority also exists elsewhere. SEC Chairman Mary Schapiro has recognized that there is no functional difference between professional investment adviser and broker-dealer operations and services.[141] Similarly, a widely-cited study, the "RAND Report," concluded that despite the stark regulatory contrast between investment advisers and broker-dealers, the typical investor does not understand the difference between the two professions.[142] Most telling, the study reported that investors felt that

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138 *See id.* Ketchum stated:

> Consider the contrast: FINRA oversees nearly 4,900 broker-dealer firms and conducts approximately 2,500 regular exams each year. The SEC oversees more than 11,000 investment advisers, but in 2007 conducted fewer than 1,500 exams of those firms. The SEC has said recently that in some cases, a decade could pass without an examination of an investment adviser firm.

Id.

139 *Id.*

140 Ketchum, *supra* note 18.

141 *See* Schapiro, *supra* note 49 (discussing broker-dealers' and investment advisers' convergence of practice); *see also* Elisse B. Walter, Comm'r, U.S. Secs. & Exch. Comm'n, Speech at the Manual Fund Directors Forum Ninth Annual Policy Conference: Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization? (May 5, 2009), *available at* http://www.sec.gov/news/speech/2009/spch050509ebw.htm (stating that investment advisers and broker-dealers "provide practically indistinguishable services to retail investors.").

142 *See* ANGELA A. HUNG ET AL., RAND REPORT: INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENTS AND BROKER-DEALERS 14 (2008) (concluding from survey data that many investors are unaware of the differences between broker-dealers and investment advisers); *see also* Richard F. Jackson, James E. Anderson & Andre E. Owens, *SEC Publishes RAND Report on Investment Advisers and Broker-Dealers*, WILMERHALE (Feb. 7, 2008), http://www.wilmerhale.com/publications/whPubsDetail.aspx?publication=8226. The RAND Report concluded that:

> [R]etail investors generally had difficulty understanding the distinctions between investment advisers and broker-dealers, including their duties, the titles they use, the services they offer, and the fees they pay for those services. RAND also found that investors had difficulty distinguishing between investment advisers and broker-dealers and understanding the varying affiliations and other relationships among the different firms.

investment advisers and broker-dealers should be similarly regulated.[143] Proponents view such investor confusion as a compelling rationale for bringing those industry professionals under the umbrella of one SRO and subjecting them to similar rules and standards.[144] Further, proponents contend that a rules-based standard of care—one FINRA is already equipped to enforce—would make enforcement that much easier, as there would be little need for the interpretation of principles-based fiduciary standards, and examination methods could be implemented readily and efficiently.[145] Subjecting investment advisers to requirements similar to those of broker-dealers would necessarily entail more thorough oversight, including licensing, filing, and recordkeeping requirements; this would be a positive outcome from an investor protection perspective according to proponents of these changes.[146]

The proposition of subjecting investment advisers to oversight similar to that governing broker-dealers has received government approval. In 2008, the Treasury issued the Blueprint for a Modernized Financial Regulatory Structure report, which focused on the "rapid and continued convergence"[147] of the broker-dealer and investment adviser professions and the "resulting regulatory confusion"[148] of investors. The report ultimately recommended the self-regulation of the investment adviser industry similar to that of broker-dealers.[149] The Blueprint Report cited the cost-effectiveness and potential for enhanced investor

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Id.

[143] *See* HUNG ET AL., supra note 142, at 20.

[144] *See* Jackson et al., supra note 142.

[145] *See* Bhargava, *supra* note 20, at 908-17 (arguing for the harmonization of broker-dealer and investment adviser standards of care); *Interim Report*, *supra* note 16, at 122-25.

[146] *See* 15 U.S.C. § 78o (2006) (prescribing registration requirements and other obligations of brokers and dealers). In 2008 the Department of Treasury released a report discussing these issues:

> Whereas government regulators are mainly focused on antifraud enforcement, SROs can adopt and amend industry rules that address a wider range of activity and professional conduct. As private bodies, SROs may adopt rules and aspire to standards that extend beyond statutory or regulatory requirements while at the same time maintaining a flexibility that can help to better protect investors and encourage innovation in the offering of financial services and products.

DEP'T OF TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 122 (2008), *available at* http://www.ustreas.gov/press/releases/reports/Blueprint.pdf [hereinafter BLUEPRINT REPORT].

[147] See BLUEPRINT REPORT, supra note 146, at 125.

[148] *Id.*

[149] *See id.* at 125-26.

protection as compelling reasons for reform.[150]

Finally, rather than focusing on the perceived benefits of SRO investment adviser oversight authority, some proponents simply point to current regulatory deficiencies, including the SEC's sheer lack of manpower to effectively oversee its registered investment advisers, as evidence that organizational reform is needed.[151]

C. Criticism of FINRA's Role

Conversely, the investment adviser industry generally opposes altering the current industry oversight standards and regime.[152] These organizations primarily argue that FINRA's rules-based standards are incompatible with the fiduciary duties inherently owed by registered investment advisers to their customers.[153] These opponents contend that the fiduciary duty of an investment adviser qualifies as the highest standard applicable to any financial services professional, thus providing investors with the greatest protections against misconduct.[154] As such, they assert, other standards of conduct are simply insufficient for an investment adviser's line of work.[155]

Aside from the insufficiency of a rules-based standard of care, opponents argue that combining broker-dealer and investment adviser oversight would further blur the line between the professions, thus doing a disservice to investors by confusing them.[156] Such blurring of the

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150 *See id.* at 126.

151 *See* Ketchum, *supra* note 18.

152 *See Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office: Before the H. Comm. on Fin. Servs.*, 111th Cong. 241 (2009) (statement of David Tittsworth, Executive Director & Executive Vice President, Investment. Adviser Association), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_house_hearings&docid=f:55810.pdf [hereinafter "Tittsworth"]; Letter from Daniel J. Barry, Dir., Fin. Planning Ass'n, to Marcia E. Asquith, Office of the Corporate Sec'y, FINRA, (June 13, 2008), *available at* http://www.fpanet.org/docs/assets/7AF3A08D-1D09-67A1-AC67E784F6EBD7E6/RN0824Comments.pdf [hereinafter "Financial Planning Association Letter"].

153 *See* Tittsworth, *supra* note 152, at 15 ("[O]bligations of investment advisers cannot be circumscribed by a rule book no matter how voluminous.").

154 *See id.* at 12-14 (arguing instead for a fiduciary duty standard to be applied to broker-dealers).

155 *See id.* at 15.

156 *See* Financial Planning Association Letter, *supra* note 152, at 2 (stating that the Financial Planning Association would be "disappointed" with a rule that "would add to this confusion").

lines is also undesirable to opponents because it increases the likelihood that investment advisers will become subject to the same three-tiered registration requirements and examination jurisdiction beyond what is currently being advocated, such as additional filing and licensing requirements and more burdensome electronic record-retention requirements.[157]

Moreover, the investment adviser industry sees FINRA, the most prominent SRO, as too closely tied to broker-dealers to be able to adapt its oversight capabilities to investment advisers.[158] Representatives of the industry argue that any commingling of the professions would favor the broker-dealer framework and require a rewrite of the Investment Advisers Act, effectively nullifying seventy years of subsequent interpretation.[159] Opponents allege that even if FINRA made a genuine attempt to accommodate the distinct legal standards demanded by the investment adviser profession, a variety of problems would abound.[160] For example, conflicts of interest with regard to a broker-dealers' balancing of customer, self, and representative interests cannot be squared with the duties of investment advisers.[161] Further, opponents contend that FINRA has limited expertise in assessing the quality of financial advice, which is a critical skill for the oversight of the profession.[162]

Finally, many opponents see the SEC as a perfectly able regulator plagued by a lack of funding.[163] Opponents point to the SEC's requisite expertise and experience in contending that the agency would be well-served by increasing its resources to match the sheer number of

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157 *See* W. Hardy Callcott & Suneeta Fernandes, *Who is a Broker-Dealer, Who is an Investment Adviser and How is That Likely to Change?*, *in* BROKER-DEALER REGULATION 31ST ANNUAL ADVANCED ALI-ABA COURSE OF STUDY 143, 151 (2009).

158 *See* Financial Planning Association Letter, *supra* note 152, at 31.

159 *See* Tittsworth, *supra* note 152, at 5 ("[T]he fiduciary duty under the Advisers Act is well-established and has been applied consistently over the years by courts and the SEC.").

160 *See* Financial Planning Association Letter, *supra* note 152, at 30 ("These drawbacks include inherent conflicts of interest based on industry funding and influence, questions regarding transparency, accountability and oversight, due process issues in disciplinary proceedings, and added cost and bureaucracy.").

161 *See id.*; *see also* discussion *infra* Part I.A.2.

162 *See* Financial Planning Association Letter, *supra* note 152, at 5-6 ("[B]ecause [FINRA has] no expertise in financial planning . . . they are not qualified to exercise meaningful supervision.").

163 *See* Edson, *supra* note 17; Tittsworth, *supra* note 152, at 28 ("The IAA strongly supports robust and appropriate oversight and regulation of the investment advisory profession by a fully-funded SEC.").

registered investment advisers it oversees.[164] As such, opponents of FINRA have advocated for a restructuring of the SEC, which has been accomplished by the Commission's recent creation of specialized units to increase the efficiency of its investigations.[165]

III. THE FEDERAL RESPONSE FAILS TO ADDRESS THE RESTORATION OF INVESTOR TRUST IN INVESTMENT ADVISERS

Investor confidence plummeted as a reaction to the recent economic crisis and remains unsettled despite Congressional reforms.[166] Americans need assurance, by way of meaningful organizational reform, that regulators and industry professionals understand that the status quo will not be tolerated. Congress was wrong to remove the provision granting FINRA authority over registered investment advisers; FINRA should be delegated that responsibility as part of broader regulatory reform that increases the role of SROs in general in order to foster investor trust and establish a more trustworthy industry. Through this method of reform, greater responsibility would be placed on SROs and the industry itself to police and assume responsibility for its own integrity, thereby demonstrating to investors that it is an industry worthy of investment. Although the SEC's efforts to bolster its enforcement division should be applauded, Congress has not demonstrated genuine concern for restoring investor confidence and has instead shown that it is content with the status quo.

A. The Investment Adviser Industry Depends on Trust

Just as trust and confidence have been shown to be driving forces behind economic growth, they are a critical component of our securities infrastructure.[167] In the wake of recent market scandals and fraud,

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164 *See* Tittsworth, *supra* note 152, at 28-29.

165 *See* Letter from David G. Tittsworth, Inv. Adviser Ass'n to The Hon. Mary L. Schapiro, Chairman, U.S. Secs. & Exch. Comm'n (Jul. 29, 2009) (on file with Seton Hall Legislative Journal); *see also supra* notes 131-133 and accompanying text.

166 *See Investor Confidence Index Historical Data*, *supra* note 1.

167 *See* Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1082 (2009). Donald Langevoort links the concept of confidence to the securities industry by explaining the justification for regulation:

> From this we may also gain some insight into what we mean by the elusive phrase 'investor confidence' that is so often invoked to justify regulation. On a near-term basis, investor confidence is a mix of sentiment and risk perception,

investors continue to collectively pull billions of dollars from the U.S. stock market.[168] This behavior departs from the usual trend following a bear market (i.e. a newly-emerged bull market like the U.S. has been experiencing since 2009) during which investors have continued to invest, pumping cash into equity stocks.[169] However, investors are saying that their "enthusiasm about the rally is tempered by uncertainty in Washington [and] on the economy . . . ."[170] That is, investors are not yet comfortable assigning their trust to—and taking risks in—the U.S. stock market, providing evidence that the market has lost its trustworthiness and, in turn, investors' trust.

Investment advisers hold a particularly important place within the securities industry as it pertains to maintaining investors' trust. The Investment Advisers Act's fiduciary standard permits investors to expect loyalty from their investment advisers.[171] In other words, the relationship is necessarily one that depends on trust.[172] As articulated by Margaret Blair and Lynn Stout:

> [T]he essence of a fiduciary relationship is the legal expectation that

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> measurable empirically by reference to bid-ask spreads and other cost of capital measures. Over the longer-term, the test for investor confidence is whether investors might be inclined to flee the securities markets . . . . Regulation responds whenever there is a crisis that raises the possibility of such flight.

Id.

168 *See* Tom Lauricella, *Stocks' Run Draws Yawns From Buyers*, WALL ST. J., Mar. 8, 2010, http://online.wsj.com/article/SB10001424052748704706304575107452905427196.html; Ian Salisbury, *Stock Pickers Losing Fans to Index Funds*, WALL ST. J., Apr. 30, 2010, http://online.wsj.com/article/BT-CO-20100430-711078.html?mod=WSJ_latestheadlines; *see also* Gongloff et al., *supra* note 1 (describing investors' return in August 2010 "to the safe-haven assets they have sought frequently in recent years" despite that, in July 2010, "stocks and other risky investments were rallying in response to solid corporate profits").

169 *See* Chip Brian, *Buy Signal Still in Effect for U.S. Markets, Says Kollar*, BENZINGA, (Apr. 30, 2010), http://www.benzinga.com/press-releases/c255334/buy-signal-still-in-effect-for-u-s-markets-says-kollar; *Post-Massive Bear Market Rallies*, CHARTOFTHEDAY.COM, (Apr. 17, 2010), http://beforeitsnews.com/news/33818/Chart_Of_The_Day:_Post-massive_Bear_Market_Rallies.html; Lauricella, *supra* note 168.

170 Lauricella, *supra* note 168.

171 *See* Transamerica Mtg. Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979); HUNG, ET AL., *supra* note 142, at 117 (investment advisers "acknowledged that their business relationships with clients are built on trust rather than investor understanding of the services and responsibilities involved and that it is crucial for the financial service industry to maintain that foundation of trust"). *Cf.* Deborah A. DeMott, *Breach of Fiduciary Duty: On Justifiable Expectations of Loyalty and Their Consequences*, 48 ARIZ. L. REV. 925, 938 (2006) (arguing that an expectation of loyalty is justified when such a duty is imposed by law, as in the case of an investment adviser).

172 *See* discussion *supra* Part I.A.2.

> the fiduciary will adopt the other-regarding preference function that is the hallmark of trustworthy behavior. Moreover, the law encourages fiduciaries to do this not only or even primarily by threatening punishment but by framing the relationship between the fiduciary and her beneficiary as one that calls for a psychological commitment to trustworthy, other-regarding behavior.[173]

Because the fiduciary duty standard imposes subjective requirements to avoid conflicts of interest with clients and to act in their best interests, the badge of the relationship is the primacy of the clients' interests, lest regulatory penalties be imposed.[174]

This fiduciary—i.e. trusting—element is what distinguishes the relationships between other contracting parties in the securities industry.[175] In contrast stands the relationship between broker-dealers and their customers, which—as a result of compensation practices that incentivize a broker to trade more often for his customer despite the customer's investment objectives—often finds itself wrestling with the interests of the broker versus the customer.[176] However, SROs have in place strict rules against such broker "churning" of a customer's account, as well as rules designed to address other specific conflicts of interest.[177] Thus, SRO presence is crucial to providing rules-based prohibitions and discipline, in contrast to forcing investors to place what may amount to blind faith in their investment adviser.

B. Projecting the Right Image to Investors

Despite the extent to which the federal government assumed control over the markets with the Securities Acts, it notably left the internal structure intact, thus "set[ting] forth the view that self-regulation was the best first-line defense against unethical or illegal

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173 Blair & Stout, *supra* note 58, at 1743.

174 *See* discussion *supra* Part I.A.2.

175 *See* Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55, 61 (John W. Pratt & Richard J. Zeckhauser eds., 1985) (describing a fiduciary's obligations to beneficiary); Blair & Stout, *supra* note 58, at 1782-83 (distinguishing fiduciaries from non-fiduciaries in terms of a duty to abandon self-interest for the sake of one's client); discussion *supra* Part I.A.2.

176 *See* Christopher M. Gorman, Note, *Are Chinese Walls the Best Solution to the Problems of Insider Trading and Conflicts of Interest in Broker-Dealers?* 9 FORDHAM J. CORP. & FIN. L. 475, 481 (2004) (detailing the numerous ways in which a broker's interests can be at odds with a customers'.); POSER, *supra* note 39.

177 *See supra* note 47.

securities practices."[178] SROs have consistently been perceived as inherently well-suited regulatory bodies. As recognized by Congress, SROs are best suited to detect illegal practices due to industry experience and expertise.[179] The goal of organizational reform should be to "set in place institutional mechanisms that will induce [potential] parties to exchange . . . "[180] FINRA's combination of expertise and enforcement capabilities would fulfill this goal and should be utilized to display to investors that the industry will hold itself accountable and can be reformed into being more trustworthy.

Expanding FINRA's oversight to encompass investment advisers will send a functionally similar message to the investing public as Roosevelt's Blue Eagle symbol did to consumers.[181] The striking similarities between investor confidence and trust in the financial markets today and during the Great Depression merit similar organizational restructuring. The securities industry, through scandals like Bernie Madoff's investment fraud, has shown itself to be vulnerable to greed and manipulation. What better opportunity to show to investors that reform is serious and that their trust is genuinely desired? Only by restructuring investment adviser oversight to include a self-regulatory intermediary like FINRA, with its unmatched ability to incentivize compliance through formal sanctions and reputational harm, can the industry demonstrate the necessary intent to the public.

Moreover, self-accountability within the industry will better

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178 Friedman, *supra* note 10, at 738-39 (internal quotation marks omitted).

179 *See* Self-Regulation, 69 Fed. Reg. 71,256, 71,256-57 (proposed Dec. 8, 2004) (describing role of self-regulation in securities). SROs have a relatively infinite amount of experience regulating the securities industry – the NYSE alone has been doing it for over two hundred years. *See, e.g.*, Friedman, *supra* note 10, at 738-40; Hunter, *supra* note 1, at 646-47 (describing history and experience of SROs). James Miller discusses the benefits of self-regulation where he states that:

> [S]elf-regulation directly involves the parties who will generally have the best institutional knowledge about the need for action and about the efficacy of various potential actions. Although government can always hire the technical expertise needed to draft complicated regulations, it will almost always be slower in perceiving the need for some action than will the participants in the relevant market.

James C. Miller, *The FTC and Voluntary Standards: Maximizing the Net Benefits of Self-Regulation*, 4 CATO J. 897, 897 (1985), *available at* http://www.cato.org/pubs/journal/cj4n3/cj4n3-11.pdf.

180 NICHOLAS MERCURO & STEVEN G. MEDEMA, ECONOMICS AND THE LAW: FROM POSNER TO POST-MODERNISM AND BEYOND 255 (2d ed. 2006).

181 *See supra* notes 80-84 and accompanying text.

incentivize investors to once again invest and begin to trust financial professionals. The basic principal to be extracted from research linking trust to economic behavior is that a trustworthy industry begets investor trust and confidence.[182] Our federal securities laws impose fiduciary duties on investment advisers, but those duties should not appear to be forced; investment advisory firms can demonstrate their trustworthiness to investors by submitting themselves to the intra-industry enforcement of securities laws.

C. Inhibiting Trust

The current investment adviser regulatory regime provides insight into the shortfall of investor confidence: regulatory black holes exist that allow some financial professionals to operate virtually under the radar[183] and investors have increasingly fewer reasons, in the wake of the Madoff, Stanford, and similar scandals, to trust that their investments are protected and being managed by a true fiduciary. For this reason, the proper response is not a simple shift in resources and federal enforcement priorities as a reaction to the scandal *du jour*. Investors have weathered the Enrons and Madoffs and see that fraud, in one incarnation or another, is incentivized in the market; reactionary policies that address problems *ex-post* will preserve the status quo and similarly act as a disincentive to investment.

Expanding SEC resources for the purpose of increasing enforcement and investigation efforts may very well prevent future scandals in the securities industry. Efforts to streamline and enhance the enforcement and investigatory processes should be applauded for addressing shortcomings and correcting missteps. Further, these efforts send a powerful message to potential perpetrators regarding federal regulators' enforcement priorities. However, taken with the Administration's anti-Wall Street rhetoric,[184] the signal being sent to investors is that the industry is one that cannot be trusted and needs to be coerced to fulfill its statutory duties. A regulatory scheme that emphasizes SEC rather than SRO protection "precludes any opportunity for genuine trust and trustworthiness by ensuring that everybody acts under legal coercion."[185] As such, the social context of the SEC as the

182 *See* discussion *supra* Part I.B.
183 *See supra* notes 94-95 and accompanying text.
184 *See supra* note 118.
185 Larry E. Ribstein, *Law v. Trust*, 81 B.U. L. REV. 553, 573 (2001).

regulator of investment advisers fails to foster the requisite trust needed to restore investor confidence in their fiduciaries.[186]

IV. CONCLUSION

Without trust in our regulatory regime—rather, without a *trustworthy* regulatory regime—investor confidence will wane and prevent long-term financial recovery. Just as the SEC was born out of the market crash of 1929, the current crisis of confidence requires a significant organizational restructuring. By focusing on the role of trust in economic activity, the critical impact of self-regulatory organizations on investors' trust in the securities industry is uncovered. The need for investors to perceive systemic change and enhanced trustworthiness is as important as the actual reforms themselves; if investors will not invest their faith in a troubled industry, we risk being stuck with the status quo that has failed so many.

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[186] *See* Blair & Stout, *supra* note 58, at 1785 ("[T]he key to a successful fiduciary relationship lies in framing both economic and social conditions so as to encourage the fiduciary to make a psychological commitment to further her beneficiary's welfare rather than her own.").