2012

Becoming the Fifth Branch

M. Todd Henderson

William A. Birdthistle

CHICAGO

INSTITUTE FOR LAW AND ECONOMICS WORKING PAPER NO. 618
(2D SERIES)

Becoming the Fifth Branch

William A. Birdthistle and M. Todd Henderson

THE LAW SCHOOL
THE UNIVERSITY OF CHICAGO

November 2012

BECOMING THE FIFTH BRANCH

*William A. Birdthistle & M. Todd Henderson**

Abstract

Observers of our federal republic have long acknowledged that a fourth branch of government comprising administrative agencies has arisen to join the original three established by the Constitution. In this article, we focus our attention on the emergence of perhaps yet another, comprising financial self-regulatory organizations. In the late eighteenth century, long before the creation of state and federal securities authorities, the financial industry created its own self-regulatory organizations. These private institutions then coexisted with the public authorities for much of the past century in a complementary array of informal and formal policing mechanisms. That equilibrium, however, appears to be growing increasingly imbalanced, as financial SROs such as FINRA transform from "self-regulatory" into "quasi-governmental" organizations.

We describe this change through an account that describes how SROs are losing their independence, growing distant from their industry members, and accruing rulemaking, enforcement, and adjudicative powers that more closely resemble governmental agencies such as the Securities and Exchange Commission and the Commodity Futures Trading Commission. We then consider the confluence of forces that might be driving this increasingly governmental shift, including among others, demographic changes in the style and size of retail investments in the securities markets, the one-way ratchet effect of high-publicity failures and scandals, and the public choice incentives of regulators and the compliance industry.

The process by which such self-regulatory organizations shed their independence for an increasingly governmental role is an undesirable but largely inexorable development, and we offer some initial ideas for how to forestall it.

* Respectively, Associate Professor of Law, Chicago-Kent College of Law and Professor of Law, University of Chicago Law School. Funding for this paper was provided through a grant from the CME Group Foundation, which was established by the Chicago Mercantile Exchange Trust.

Table of Contents

> *Government [should] keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.*
>
> – SEC Chair William O. Douglas, describing his vision of self-regulation, immediately prior to joining the Supreme Court.[1]
>
> *Is FINRA becoming a "deputy SEC"?*
>
> – SEC Commissioner Daniel M. Gallagher.[2]

I. INTRODUCTION

Observers of our federal republic have long argued that a fourth branch of government, comprising administrative agencies born of the New Deal, has arisen to join the original three established by the Constitution. [3] In this article, we argue that another branch – comprising financial self-regulatory organizations – is emerging due to a confluence of forces, which we attempt to identify and describe. The process by which such organizations exchange their independence for an increasingly governmental role is an undesirable but largely inexorable development. We therefore offer some initial ideas for how to forestall it.

Many historians trace the rise of the fourth branch to New Deal legislation that created a variety of

[1] WILLIAM O. DOUGLAS, DEMOCRACY AND FINANCE 82 (1940).

[2] Commissioner Daniel M. Gallagher, *Market 2012: Time for a Fresh Look at Equity Market Structure and Self-Regulation*, Speech to SIFMA's 15th Annual Market Structure Conference, Oct. 4, 2012.

[3] The origin of the "headless fourth branch" phrase was a 1937 report commissioned by President Roosevelt. Report of the President's Committee on Administrative Management 7, 83 (1937). *See also* FTC v. Ruberoid Co., 343 U.S. 470, 487-89 (1952) (Jackson, dissenting) ("Administrative bodies . . . have become a veritable fourth branch of the government, which has deranged our three-branch legal theories."); Peter L. Strauss, *The Place of Agencies in Government: Separation of Powers and the Fourth Branch*, 84 COLUM. L. REV. 573 (1984).

new administrative agencies.[4] These rule making and adjudicating bodies staffed with experts have given rise to great academic discussion over the past eight decades. [5] Notwithstanding these debates, few would disagree that the vast majority of federal regulatory tasks are undertaken by the host of administrative agencies in Washington,[6] and that courts give these agencies broad deference in rulemaking because of their expertise on matters within their ambit. [7]

Congress delegated its authority in broad strokes to allow specialists in various fields, such as finance, aviation, and the environment, to fill in the regulatory details based on practical experience and knowledge.[8] The Securities Exchange Commission is just such an agency. Assigned the task of protecting investors and regulating financial markets in the public interest, the SEC was vested with attributes of the other three branches: it promulgates rules, it enforces those rules, and it sits in judgment of individuals and institutions alleged to have violated those rules.[9]

Although staffed with experts, these administrative agencies are nevertheless one step removed from the markets and firms that they regulate. And because of the realities of governmental

---

[4] *See, e.g.*, Steve Fraser and Gary Gerstle, eds., THE RISE AND FALL OF THE NEW DEAL ORDER, 1930-1980 (Princeton, 1990); Alan Brinkley, THE END OF REFORM: NEW DEAL LIBERALISM IN RECESSION AND WAR (Vintage, 1996); James T. Kloppenberg, *Who's Afraid of the Welfare State?*, 18 Reviews in American History 395 (1990).

[5] Compare RICHARD A. EPSTEIN, HOW PROGRESSIVES REWROTE THE CONSTITUTION (2006) with Peter L. Strauss, *The Place of Agencies in Government: Separation of Powers and the Fourth Branch*, 84 COLUM. L. REV. 573 (1984); see generally Jacob E. Gersen & Adrian Vermeule, *Chevron as a Voting Rule*, 116 YALE L.J. 676 (2007).

[6] Familiar examples include the Securities Exchange Commission (SEC), Environmental Protection Agency (EPA), Federal Communications Commission (FCC), and Federal Trade Commission (FTC).

[7] Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984).

[8] CASS R. SUNSTEIN, AFTER THE RIGHTS REVOLUTION: RECONCEIVING THE REGULATORY STATE (1993).

[9] For a description of the SEC, see http://www.sec.gov/about/whatwedo.shtml. For one of the definitive histories of the SEC, which describes these features, their origins, and their change over time, see JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET (3d ed.) (2003).

budgets and the dynamics of bureaucratic entities, many commentators argue that the agencies have long been understaffed and outgunned.[10] This imbalance is especially acute in the world of finance, where the pecuniary stakes are so high for private parties that governmental agencies by themselves have always seemed overwhelmed. To give just one example, nearly seventy years elapsed before the SEC established a division to keep abreast of the latest Wall Street innovations: a law professor, not a financier, was assigned to head it, assisted by just a handful of staff to keep up with the armies of innovators deployed on Wall Street.[11]

In the area of finance, where this imbalance is particularly potent, the fourth branch of government has operated for decades in tandem with various purely private bodies that also regulate the behavior of financial professionals. These member-based regulatory entities long preceded any government regulation of financial markets.[12] Direct legal regulation of financial markets is a product of the early twentieth century: state legislation first appeared with Kansas's blue-sky law of 1911,[13] and the federal securities laws were passed from 1933 to 1940.[14] Private regulation, in contrast, is a product of the late eighteenth century.[15] The early stock exchanges in New York were formed privately as early as 1792 primarily as a means to impose private, member-based type of regulation upon the nascent financial industry.[16] (These early efforts were based on British

---

[10] *See, e.g.*, Sarah N. Lynch, *Headaches at the SEC's Think Tank*, Reuters, May 3, 2011 (describing the early results from the Division of Risk, Strategy, and Financial Innovation, which was designed to keep abreast of the latest innovations on Wall Street).

[11] For a description of the Division of Risk, Strategy, and Financial Innovation, see http://www.sec.gov/news/press/2009/2009-199.htm.

[12] See infra, Section II.

[13] 1911 Kans. Sess. Laws 210.

[14] 15 U.S.C. §§78a-78pp (2006 & Supp. I 2009), et seq.

[15] For a general history, see SELIGMAN, TRANSFORMATION OF WALL STREET, *supra* note __.

[16] STUART BANNER, ANGLO-AMERICAN SECURITIES REGULATION:

practices going back even further.)[17] By creating a more secure forum in which to trade securities, the industry – or at least the members of the exchanges – aspired to improve their business by excluding unreliable, uncreditworthy, and unscrupulous brokers.

When federal law did arrive, it borrowed heavily from these private regulatory agencies, officially christened self-regulatory organizations (SROs).[18] During the New Deal era, the New York Stock Exchange and the National Association of Securities Dealers both were given a significant role to continue their regulatory mission in conjunction with administrative agencies.[19] According to a leading history of the SEC, the SROs "retain[ed] the initial responsibility for preventing fraud or unfairness, both because [they] could act swiftly and more subtly than a government bound by due process standards and could avoid the 'bureaucratic blight' of too intrusive a government police force."[20]

For some of the past eight or so decades, these private police officers of our financial system have operated solely on the private side of the government/private border.[21] But the story we tell in this article is one of change. We describe several

CULTURAL AND POLITICAL ROOTS, 1690-1860, 171-75 (1998). *See also* Claire Priest and Bruce Mann on early American financial law: *e.g.,* Priest, *Currency Policies and Legal Development in Colonial New England*, 110 YALE L.J. 1303 (2001); Mann, NEIGHBORS AND STRANGERS: LAW AND COMMUNITY IN EARLY CONNECTICUT (1987).

[17] *See* BANNER*, supra* note __.

[18] For stockbrokers, the SRO is now called FINRA, which is a combination of the regulatory arms of the NYSE and NASD. *See, e.g.*, *Speech by SEC Chairman: Statement at News Conference Announcing NYSE-NASD Regulatory Merger*, Nov. 28, 2006, *available at* http://www.sec.gov/news/speech/2006/spch112806cc.htm.

[19] See § 15A of the Securities Exchange Act of 1934, 15 U.S.C. 78o-3(3)(1). According to Paul Mahoney, the NASD originated as a trade association of investment banks in 1912. Paul G. Mahoney, *The Political Economy of the Securities Act of 1933*, 30 J. LEGAL STUD. 1, 23-24 (2001).

[20] SELIGMAN, TRANSFORMATION OF WALL STREET, *supra* note __ at 158 (quoting William O. Douglas).

[21] *See generally* Michael P. Vandenbergh, *The Private Life of Public Law*, 105 COLUM. L. REV. 2029 (2005).

mechanisms that appear to be driving the "self" out of financial SROs, rendering them ever more quasi-governmental in nature. Moreover, this process of "governmentalization" appears to be accelerating. In one of the most recent instances, the MF Global debacle quickly prompted a report from the Commodity Futures Trading Commission (the administrative agency charged with regulating commodities markets), which called for reforms that would increase the direct governmental role of derivatives SROs, such as the Chicago Mercantile Exchange.[22] Whether they fully appreciate it or not, financial SROs are transforming into a fifth branch of government.

In this article, we explore the factors that may be contributing to this increasing governmentalization of SROs.[23] Indeed, the MF Global case illustrates at least one such mechanism behind the increasing puissance and governmentalization of SROs: many SRO "failures" are addressed with awards of greater power to their governmental regulator and threats of dissolution of the SRO, while SRO "successes" are largely ignored. This one-way ratchet reinforces the idea that, for an SRO, self-preservation may demand more aggression – that is, behaving more like the government – within its jurisdiction, even when other prudential concerns may not warrant such a reaction.

Proponents of heightened financial regulation may celebrate the prospect of more powerful and governmental SROs, while those who favor less governmental intrusion will lament it. In this article, we argue that regardless of one's disposition toward financial regulation, the mismatch between SROs'

---

[22] *See infra*, text accompanying notes __.

[23] For other academic discussions of financial self-regulatory organizations, see Roberta Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J. L. BUS. & FIN. 151 (2008); Saule Omorova, *Rethinking the Future of Self-Regulation in the Financial Industry*, 35 BROOK. J. INT'L L. 665 (2010); Saule Omorova, *Wall Street As Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411 (2011).

governmental powers and private unaccountability is leading our financial regulatory system towards an unstable and unsustainable structure at a time when it most requires strength and stability.

If FINRA, CME, and other financial SROs do wield greater authority than their members anticipated or believe lawful, legal challenges may arise under theories of due process and the Appointments Clause, as presaged in the Supreme Court's recent decision regarding the constitutionality of the newly created SRO for the accounting industry, the Public Company Accounting Oversight Board.[24] More problematically, however, the financial firms that are members of SROs may begin to withdraw, either in spirit or in fact, from those organizations, depriving our regulatory apparatus of vital expertise in the oversight of complex financial transactions.[25]

In Part II of this article, we examine the scope, rationale, and history of financial self-regulation. In Part III, we attempt to understand the mechanisms that are driving the increasing governmentalization of SROs. In Part IV, we consider the implications of these changes upon our financial regulatory system. In Part V, we consider alternatives to the quasi-governmental outcome by considering other models for cooperation between industry and regulators, such as through the use of greater numbers of – and thus increased competition between – SROs.

[24] Free Enterprise Fund v. Public Co. Accounting Oversight Bd., 130 S.Ct. 3138 (2010). *See also* Richard Pildes, *Free Enterprise Fund, Boundary Enforcing Decisions, and the Unitary Executive Branch Theory of Government Administration*, 6 Duke J. Const. L. & Publ. Pol'y 1 (2010); Rao, *A Modest Proposal: Abolishing Agency Independence in* Free Enterprise Fund v. PCAOB, 79 Ford. L. Rev. 2541 (2011); Nourse & Figura, *Toward a Representational Theory of the Executive*, 91 B.U. L. Rev. 2733 (2011).

[25] As described *infra* at ___, trust is an important element of efficient and low-cost regulation, and self-regulation is thought to be superior to adversarial government regulation on this score. For a more general treatment on the importance of trust in social foundations, see FRANCIS FUKUYAMA, TRUST: THE SOCIAL VIRTUES AND THE CREATION OF PROSPERITY (1996).

II. THE SELF-REGULATION OF FINANCE

In this part, we examine the scope, rationale, and history of financial self-regulation in this country. Our goal is not to provide a comprehensive historical account, but rather to focus upon the way in which self-regulation fits into the overall scheme of financial regulation, and to observe its significant changes over time.

A. The Private Character of Law

The promulgation and enforcement of law is, of course, a core function of government.[26] But it is one shared widely by private actors. Government and governance are not the same thing, and substantial regulation of behavior is exercised by non-governmental regulations or what is commonly known as private law. If "law" is simply the set of rules that regulate the actions of a community, then law is made by families, by firms, by universities, by private clubs, and countless other non-governmental authorities. Entities and organizations of all sizes establish and enforce their own disciplinary codes, often through their own legislative, executive, and judicial efforts. Private clubs, for instance, write rules, conduct investigations, and discipline members with fines or expulsion after adjudicating cases. Indeed, this comparatively informal exercise of rulemaking and enforcement is perhaps the predominant type in our society.

To be sure, all private law operates atop an underlying foundation of formal, governmental law. Thus, should private regulation prove ineffectual or itself violate broader societal interests embodied in formal rules, laws, or constitutions, then parties can appeal to the government.[27] This layer of informal

[26] *See, e.g.*, M. Elizabeth Magill, *The Real Separation in Separation of Powers Law*, 86 VA. L. REV. 1127 (2000).

[27] Such review is embedded in current SRO models of regulation. FINRA is responsible for bringing initial disciplinary actions against brokers, acting through its Division of Enforcement. FINRA "hearing officers" act as judges.

ordering atop the formal system explains Douglas's shotgun.[28] Since government always enjoys the power to compel, all private law presupposes government approval or, at the very least, tolerance. A discussion such as this leads quickly towards the realm of natural rights and the nature of the state, but we need not proceed so far. For the purposes of exploring SROs, we need only acknowledge that as a practical matter private law can serve as a compliment to or substitute for direct government regulation. As we will see in this article, the array of private financial regulation reflects much of this spectrum, beginning as it did as a substitute, developing as a vital compliment, and then seemingly morphing into government regulation itself.

B. Rationales for Financial Self-Regulation

The logic for the self-regulation of finance is based in some part on the rational self-interest of market participants. Industry professionals have strong incentives to police their own, since many of the costs of misbehavior are born by all members of the profession, while the benefits inure only to the misbehaving few. So long as the few do not control the regulatory process, self-regulation could in theory work as well or better than external regulation.

To illustrate the concept, imagine there are two types of brokers: "good" brokers and "bad" brokers. Further, assume customers cannot readily distinguish between the two before choosing a broker. This supposition is reasonable inasmuch as brokers purvey an intangible service, making it difficult to distinguish good from bad through mere inspection. In the

Decisions of hearing panels may be appealed to a 14-member "court" — the National Adjudicatory Council (NAC) — which comprises seven industry representatives (elected by members) and seven non-industry members (appointed by FINRA). (Disclosure: Professor Henderson is currently a non-industry member of the NAC.) Decisions of the NAC may be appealed to the SEC, and from there to the circuit courts of appeals and ultimately the US Supreme Court.

[28] *See supra* note 1.

absence of an ability to discriminate, rational customers should discount the amount they will pay for brokerage services because of the possibility of choosing a bad broker and thereby being cheated.

For instance, consider customers who would pay $10 for the services of a good broker, knowing they will not be cheated, but only $5 for the advice of a bad broker, who might cheat them. If customers cannot distinguish between the two types of brokers, they should only pay $7.50 for the advice of an average broker, assuming they think there are an equal number of good and bad brokers. If good brokers cannot credibly signal their quality, they will be unable to charge the full value of their services, and therefore good brokers are likely to exit the market, to reduce the quality of their service, or to cheat. As such, the overall quality of brokers is inclined to drop. In this hypothetical, good brokers are effectively subsidizing bad brokers. Good brokers therefore possess strong incentives to identify bad brokers or to remove them from the industry, since doing so will allow good brokers to charge more for their services. (Assuming, of course, that the all-in costs of this oversight are fewer than lost profits.) Industry self-regulation is an organic part of a successful brokerage industry, and government is not obviously necessary to deliver it.

The logic of self-regulation does not apply in every regulatory situation. In some other industries, self-regulation may not be very effective. Consider, for instance, environmental pollution. Pollution may be profit maximizing for firms in the absence of regulation because costs (such as damage to the air, vegetation, or water) are imposed on others. If no mechanism exists to force an Illinois factory to pay for damage its emissions do to apple trees in upstate New York, the Illinois factory is likely to emit more than the socially optimal level.[29] The farmers, their customers, or

[29] *See, e.g.*, Ronald H. Coase, *The Problem of Social Cost*, 3 J. LAW & ECON. 1 (1960).

taxpayers will in turn pay for some of the benefits that inure to factory's customers. Only when costs are internalized to the production function, and therefore priced by the market, are production and consumption likely to be optimized.

Brokerage and other financial activity is amenable to self-regulation because the harm caused by bad brokers (that is, ones taking too little care or engaging in too much deleterious activity) is primarily born by the individuals who are in a contractual relationship with the broker. When the broker cheats, the customer loses.[30] In contrast, when a factory pollutes, its customers *gain*. This reversed outcome occurs because the costs of the factory's products are lower than they would otherwise be, since some of those costs of production are born by others. Polluters therefore do not have strong incentives to police other polluters, and thus self-regulation may be less effective in contexts such as environmental regulation.[31]

Yet empowering "good" brokers to police "bad" brokers risks giving those good brokers the ability to reduce competition and to raise their own profits. For example, there is the possibility that relatively larger or more well-established firms might exert disproportionate influence on the SRO, and manipulate the organization into imposing costs on relatively smaller or less established firms. In such a way, self-regulation might also give rise to anti-competitive behavior.

As an example, suppose that compliance with rules carries both a fixed and a variable cost. A simple way to appreciate this dynamic is to imagine that the

---

[30] To be sure, there may be some risk, called systemic risk, that customers' losses will harm other customers, but for most brokerage deals, this harm, what we might call "financial pollution," is slight.

[31] There may still be some work for non-governmental regulation, such as through third-party attestation about compliance or voluntary environmental controls designed to increase firm or industry reputation. The briefly lived Chicago Climate Exchange, where firms voluntarily agreed to reduce greenhouse gas emissions, is an example of this. *See, e.g.*, Nathanial Gronewold, *Chicago Climate Exchange Closes Nation's First Cap-and-Trade System but Keeps Eye to the Future*, NY TIMES, Jan. 3, 2011.

only cost of compliance is personnel in a compliance department. If we make the modest assumption that the number of compliance officers does not scale directly with the assets under a particular firm's management, then smaller firms will find themselves at a competitive disadvantage, all else being equal, due to their greater compliance costs. Consider two firms: one with $100 in assets under management and one with $1000 in assets under management. If each officer can oversee $250 in assets, but there is a minimum of at least one compliance officer, then the regulatory costs for the smaller firm are one, while those costs for the larger firm are four. On a per asset basis, the regulatory costs are lower for the larger firm. Smaller firms in this kind of system must substantially outperform larger firms in order to maintain competitive parity. In this example, the smaller firm must outperform the larger by 60 basis points.[32]

This handicap in scale is a significant problem only if larger firms dominate the regulatory process, either through the making or the enforcing of rules.[33] Such discrepancies may, of course, be inevitable. SROs are generally funded by fees levied upon their members, and these fees are often disproportionately borne by larger firms.[34] In addition, the U.S.

---

[32] To illustrate, consider a 10% return before compliance costs. This rate returns $110 to the smaller firm and $1100 for the larger firm. Subtracting the compliance costs yields a net return of $109 for the smaller firm and $1096 for the larger firm. These dollar amounts translate to a return of 9% for the smaller firm and 9.6% for the larger firm.

[33] Importantly, this is true regardless of whether the regulator is the government or an SRO. The public choice literature abounds with evidence of regulatory capture by large, concentrated interests. For some recent evidence of this in the regulation of broker-dealers by the SEC, see Stavros Gadinis, "The SEC and the Financial Industry: Evidence from Enforcement Against Broker-Dealers," 67 BUS. LAWYER 679 (2012) (finding larger firms fared better in enforcement actions (e.g., fewer individuals charged, more use of administrative sanctions instead of court proceedings, and lower sanctions) compared with similarly situated smaller firms).

[34] *See, e.g., Melanie Waddell, FINRA to Hike BD Fees in Effort to Recoup "Significant Loss,"* available at http://www.advisorone.com/2012/04/27/finra-to-hike-bd-fees-in-effort-to-recoup-signific (describing the current fee structure, ranging from membership to trading activity, and noting

population of financial firms comprises relatively few large firms amongst thousands of smaller firms.[35] Thus, the large firms enjoy low coordination costs and highly aligned interests. Moreover, the political influence of larger firms, be it with the SRO, the SRO's governmental overseer, or Congress, is likely to be much greater.

In some instances, efforts have been made to minimize this problem. For instance, after several scandals, the SEC required FINRA to include more members of the public on its board of directors.[36] Similarly, the quasi-judicial body that hears appeals from FINRA disciplinary and membership matters (known as the FINRA National Adjudicatory Council) also comprises an equal number of industry insiders (seven) and outsiders (seven).[37] Whether these governance mechanisms constrain large firms from dominating the rule making process is unclear.

Self-regulation is easily justified if it protects investors and maximizes social welfare, but may not be if it is used merely to transfer wealth from investors to brokers. This "cartelization" problem is present in almost every area of broker-dealer regulation. Thus, most of the regulatory debates concerning self-regulation feature contention over which of these two forces – the efficiency of self-regulation versus the risk of cartelization – is more prominent or likely in a particular situation. The problem observers have in evaluating the efficacy and legitimacy of self-regulation is that the steps to create and enforce a cartel are hard to distinguish from steps necessary to help investors through the policing of bad brokers.

---

recent FINRA fee increases).

[35] FINRA has approximately 4300 members, the overwhelming majority of which are smaller firms. See http://www.finra.org/ ("FINRA is the largest independent regulator for all securities firms doing business in the United States. We oversee nearly 4,345 brokerage firms, 163,410 branch offices and 635,140 registered securities representatives. Our chief role is to protect investors by maintaining the fairness of the U.S. capital markets.").

[36] See *infra* __.

[37] See http://www.finra.org/Industry/Enforcement/Adjudication/NAC/naccommittee/.

Whatever the theoretical limitations upon financial self-regulation, no other arena of vital economic activity in this country has regulated itself for so long or so comprehensively. To those who believe that effective regulation is possible only when imposed externally or governmentally, the regulation of financial brokers stands as a powerful counterexample.[38] Next, we provide a sketch of the history of broker regulation, paying particular attention to how the relationship between government and private regulators has changed over time.

C. Evolving from SRO to QGO: The Case of FINRA

An account of the regulation of stockbrokers in the United States illustrates the phenomenon of governmentalization that we are attempting to explain in this article. Although a history of financial SROs is far beyond the scope of this article,[39] a brief sketch of the major inflection points of regulation demonstrates how the self-regulatory nature of financial SROs has grown increasingly governmental. This particular SRO is becoming, or some have argued has become, a quasi-governmental organization (QGO).

Professor Roberta Karmel described the evolution of the SRO for Wall Street professionals this way: “From 1934 until the present, Congress and the SEC have struggled to convert SROs from ‘private clubs’ to public bodies, frequently exploiting scandals to impose governance reforms on exchanges and the

[38] In the case of financial regulation, government and private regulation are imperfect substitutes for one another. Where one is powerful or effective, there less need for the other. In this sense, brokerage is more akin to the sale of typical products, where any harm caused by defects is born primarily by the consumer of the product. Note, however, that products liability is not an area in which we see powerful self-regulation. Although there is widespread third-party attestation – for example, the Good Housekeeping Seal of Approval or Consumers Reports – the law of products liability contains no real self-regulatory component.

[39] For more complete treatments, see Arthur Laby, Reforming the Regulation of Broker-Dealers and Investment Advisers, 65 Bus. Law. 395 (2010); James Park, Rules, Principles, and the Competition to Enforce the Securities Laws, 100 Cal. L. Rev. 115 (2012).

NASD."[40] In a recent speech, SEC Commissioner Daniel M. Gallagher asked "[i]s FINRA becoming a 'deputy SEC'?"[41]

A brief history of stockbroker regulation may be divided into five major periods, spanning approximately two centuries, from the earliest trading on Wall Street in the late 18th century until today. Those periods are roughly as follows: (1) the Pre-New Deal period (1780s to 1930s); (2) the New Deal and Post-New Deal period (1930s to 1963); (3) the Reform period (1963 to 1996); (4) the 21A Report period (1996 to 2007); and (5) the FINRA period (2007 to present). At each inflection point, one or more of the mechanisms we describe below appears to cause the SROs to change in fundamental ways.

Pre-New Deal period. Regulation of stockbrokers in the United States arose originally not from government but from the brokers themselves. The first rules emerged through a private "club" of "stockjobbers" attempting primarily to increase their value via membership and private rules and discipline.[42] (In fact, as late as the 1930s, commentators referred to the stock markets as "a private club [with] elements of a casino."[43]) Beginning with the first centralized trading in Lower Manhattan in the late 1700s, brokers policed themselves in an effort to build trust with clients and to eliminate bad actors from the profession. As the SEC Historical Society's history of self-regulation describes it, the first SROs provided "a refuge for securities traders vulnerable to the popular suspicion of their

---

[40] Roberta Karmel, "Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?," 14 STAN. J. L. BUS. & FIN. 151 (2008).

[41] Commissioner Daniel M. Gallagher, *Market 2012: Time for a Fresh Look at Equity Market Structure and Self-Regulation*, Speech to SIFMA's 15th Annual Market Structure Conference, Oct. 4, 2012.

[42] For a general discussion, see BANNER, ANGLO-AMERICAN SECURITIES REGULATION, *supra* note 10 at 171-75.

[43] SELIGMAN, TRANSFORMATION OF WALL STREET, *supra* note __ at 73.

profession."[44] From the late 1780s until 1938, these private membership rules were the primary means by which brokers were regulated.[45]

The self-regulation of stockbrokers began not so much to fill a regulatory void but rather to forestall regulation. In 1792, the New York state legislature made contracts for the sale of stock owned by others unenforceable in New York courts.[46] Accordingly, the only way that the growing stock brokerage industry in New York could continue to grow and flourish was by creating its own parallel legal system that could, through private rules, enforce such bargains. This early form of private enforcement built primarily on efforts at cartelization by brokers.

Just prior to the enactment of the New York stockjobbing act, the industry engaged in nascent efforts at forming a self-regulatory.[47] Finally in 1817, a

---

[44] "The Institution of Experience: Self-Regulatory Organizations in the Securities Industry, 1792-2010," available at http://www.sechistorical.org/museum/galleries/sro/sro02a.php.

[45] There was, then as now, some state law overlay policing fraud and other abuses by brokers. So-called "blue sky" laws—as in trying to prevent brokers from selling investors "the clear blue sky"—originated in Kansas in 1911, and were adopted by almost every state thereafter. See THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 8.1 (4th ed. 2001). Although states retain significant authority to license and regulate broker dealers, the the National Securities Markets Improvement Act of 1996 (NSMIA) preempted various securities regulations of brokers. See NSMIA, Pub. L. No 104-290, 110 Stat. 3416 (1996). Specifically, section 15(h) of the Securities Exchange Act now preempts state-based rules on various financial responsibility metrics (such as capital and margin requirements) and reporting requirements. See id, section 15(h).

[46] See NY Laws, 40th Sess., c. 275, §§ 11, 20 (April 15, 1817) (continuing in force statute passed in 1792). For a discussion of the laws, see BANNER, ANGLO-AMERICAN SECURITIES REGULATION, *supra* note 10 at 171-75.

[47] A few months earlier, the earliest-known effort was published on a broadside, which called for "a meeting of the dealers in the public funds in the city of New-York held at the Coffee-House." See Werner & Smith, Wall Street, 190-91. At this meeting, a group of dealers in government debt, the first type of publicly traded securities in the United States, agreed to be bound by fourteen rules, including a prohibition against dealing with non-participating brokers and a limitation upon the number of securities that could be sold in a given day. See Banner at 250-51. This early attempt at cartelization failed after a crash in the public debt markets in 1792. Several other attempts to build an exclusive exchange followed. In May 1792, twenty-four brokers agreed to fix commissions (at one quarter of one percent). Known as the "Buttonwood Agreement," popular mythology holds that this agreement was signed under a

group of nearly 30 brokers formed the New York Stock and Exchange Board.[48] The Board grew and changed as the market for securities increased over the next few decades. The average daily trading volume increased more than fifty fold during this period, as the number of securities listed grew from about twenty-five to more than one hundred.[49] In response, the Board increased the formality of its membership processes and the rules by which it conducted its business. But the Board never acquired a majority of the stock trades on Wall Street, with about three times as many trades taking place "in broker's offices, in coffee houses, and in the street."[50] In addition, rival brokerage associations, such as ones for mining stocks created in late 1850s, and rival exchanges, such as ones created in the mid-1830s and mid-to-late 1840s, rose and collapsed.[51] By 1860, the Board "dominated securities trading in New York," in part because its reputation allowed it to determine the prices at which other trades would happen most effectively.[52]

The Board created this reputation in part through its creation of a "miniature legal system" that included rules governing trading and disputes among brokers.[53] As noted above, for the entire first half of the nineteenth century, so-called time contracts, which included most broker transactions, were

---

Buttonwood tree and that it grew into the New York Stock Exchange. Both are untrue, and the agreement proved equally untenable. See Peter Eisenstadt, "How the Buttonwood Tree Grew: The Making of a New York Stock Exchange Legend," 19 *Prospects: An Annual of American Cultural Studies* 75 (1994). A third agreement by brokers tried to create an exclusive club, with membership interests, for the trading of securities. Known as the Tontine Coffee-House, its members included John Jacob Astor and Brockholst Livingston. Banner at 252-53 This trading group had rivals, and no single group of brokers was able to dominate trading during the first part of the 19th Century.

[48] BANNER, ANGLO-AMERICAN SECURITIES REGULATION, *supra* note10 at 253.

[49] *Id* at 255.

[50] *Id* at 256.

[51] *See generally* ROBERT SOBEL, THE CURBSTONE BROKERS: THE ORIGINS OF THE AMERICAN STOCK EXCHANGE 17-18 (1970).

[52] BANNER, ANGLO-AMERICAN SECURITIES REGULATION, *supra* note10 at 257.

[53] *Id.* at 271.

unenforceable in New York. Accordingly, purely private law was the only mechanism for guaranteeing the performance of such contracts. A majority vote of the Board's members originally determined the outcome of disputes: "All questions of dispute in the purchase or sale of Stocks" were "decided by a majority of the Board."[54] As the membership grew and the number of disputes accumulated, subsets of the Board took on this quasi-judicial role and the decisions in individual cases took on the nature of precedent.[55] This extra-governmental regulation increased public confidence in brokers associated with the Board, and thereby attracted business.[56]

New York's highest court explicitly blessed the non-governmental character of the early SROs in *Belton v. Hatch*, decided in 1888.[57] In *Belton*, a broker who was suspended from the Exchange for unsound practices sued to recover the value of its seat, which was sold by the Exchange to another broker.[58] Denying the claim for recovery of the sum, the court enforced the contract between the plaintiff and the Exchange, holding that the Exchange could use the privilege of membership as a regulatory tool. The court concluded that "there is nothing against public policy [in this conclusion], for the reason that whatever a member acquires is subject to the self-imposed condition that his title and the rights which accrue from his membership are regulated by and dependent upon the laws adopted by [the Exchange], and expressly consented to by him when he joined."[59]

Notably, however, the self-regulation of the exchanges did not cover the vast majority of stock transactions, which happened in so-called "over-the-

---

[54] 1817 Const. art. 17.
[55] BANNER, ANGLO-AMERICAN SECURITIES REGULATION, *supra* note10 at 272, 274.
[56] *Id*. at 261.
[57] Belton v. Hatch, 17 N.E. 225 (N.Y. 1888).
[58] *Id.* at 595.
[59] *Id.* at 596-97.

counter" transactions.[60] These transactions would find no real regulatory oversight until the late 1930s.

New Deal period. This self-regulatory scheme did not survive as the primary, if not sole, source of oversight of stock transactions following the stock market crash of 1929 and the subsequent economic depression. Although contentious in light of more recent research,[61] at the time the conventional wisdom of the cause of the crash and the depression was "unregulated speculation in securities."[62] Accordingly, the Roosevelt administration drew up legislation that would largely displace the private regulators, by, among other things, requiring that government employees (specifically the Federal Trade Commission, in its guise as precursor to the SEC) approve all exchange rules and regulations.[63] According to the Seligman history of the SEC, this proposal was "tantamount to a declaration of war" on Wall Street,[64] and led to an intense lobbying campaign by brokers to kill the bill.[65] The "happy compromise" reached in the Securities Exchange Act of 1934 was the creation of an SEC with the power to write and enforce new rules, but with the preexisting regulatory apparatus largely in place.[66]

Self-regulation also expanded in this period. During the early days of the SEC, Chairman James Landis proposed using self-regulation as a way of efficiently regulating the nearly 6000 unregulated securities dealers in the over-the-counter market. Landis proposed the SEC "help in the organization of a self-disciplinary agency of dealers . . . [j]ust as the disciplinary committees of the exchanges have been

[60] SELIGMAN, TRANSFORMATION OF WALL STREET, supra note 6 at 141.

[61] *See generally* MILTON FRIEDMAN & ANNA J. SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES, 1867-1960 (1971).

[62] SELIGMAN, TRANSFORMATION OF WALL STREET, supra note 6 at 76 (quoting Franklin Roosevelt).

[63] *Id.* at 85.

[64] *Id.* at 86

[65] *Id.* at 88-96.

[66] *Id.* at 100

invaluable to us in our efforts to supervise the activities on the exchanges."[67] The problem of direct regulation in the absence of a private supplement was "a little bit trying to build a structure out of dry sand."[68]

To create the "cohesive force" that would bind the sand together, Congress amended the Securities Exchange Act with the Maloney Act of 1938. The Maloney Act authorized the creation of one or more SROs for the over-the-counter market. The regulatory conceit was to use a private body's "ample contractual powers over members to take a hand in enforcing the law."[69] Chairman Douglas defended the Maloney Act to the Harford Bond Club this way:

> By and large, government can operate satisfactorily only by proscription. That leaves untouched large areas of conduct and activity; some of it susceptible of government regulation but in fact too minute for satisfactory control; some of it lying beyond the periphery of the law in the realm of ethics and morality. Into these large areas of self-government, and self-government alone, can effectively reach.[70]

Fourteen months after passage of the Act, the SEC approved the registration request of the National Association of Securities Dealers (NASD), the one and only SRO for the over-the-counter market ever approved. By offering NASD members a discount on stock trades executed with other members, the NASD soon counted more than eighty percent of securities

[67] Id. at 142.
[68] Id. at 185.
[69] Id. at 186.
[70] Id. at 186.

dealers as members.[71] Regulators initially wanted to require membership, but could not do so until scandals in 1983 made that goal more politically tenable.

Over the next twenty or so years, some serious failures of self-regulation appeared. Perhaps the most prominent example involved the American Stock Exchange (formerly the rival to the NYSE known as the "Curb Exchange, as in stocks sold outside the exchange floor on the curb) and brokers Elliot and Company and Gilligan, Will. The SEC ultimately uncovered rampant failures, including the manipulation of securities prices, illegal touting, bribery, illegal use of inside information, and publication of misleading prospectuses.[72] The problem was not merely a few bad apples but amounted to "a general deficiency of standards and a fundamental failure of controls."[73] The director of the SEC's Division of Trading and Exchanges called it a "breakdown" of the self-regulation of the Exchange.[74]

Reform Period. William Cary, President Kennedy's choice as the new chair of the SEC, immediately seized upon these failures to conduct a "special study" of the "adequacy, for the protection of investors, of the rules of the national securities exchanges and national securities associations."[75] The *Special Study* did not completely shake the "continued belief in self-regulation as an ingredient in the protection of the investor," but it did conclude that "industry self-regulation consistently had been self-interested and self-protective, often failing to produce standards of conduct superior to those that existed before the enactment of the securities laws."[76] The study recommended enhanced government oversight in areas

[71] Id at 188.
[72] Id at 285-86.
[73] Id at 288.
[74] Id at 288.
[75] Id at 295.
[76] Id at 299.

ranging from suitability rules to licensing requirements for new brokers.[77]

Although the bulk of the Securities Act Amendments of 1964 flowing from the *Special Study* focused on enhanced disclosure by firms and a breakdown between the categories of listed and unlisted securities, they did enhance the ability of NASD to deny membership for unqualified brokers. (Another proposed provision to require NASD membership was not adopted by Congress.) Specifically, sections 15 and 15A required the NASD to ensure all brokers and associated persons meet "specified and appropriate standards with respect to training, experience, and such other qualifications" as necessary to protect investors.[78]

The SEC was, however, unable to achieve several proposed objectives, such as the ban on floor trading or an increase of the public role in governance of the exchanges and the other SROs.[79] As with earlier attempts at regulation, these would have to wait for additional crises to make them possible.

The "back-office crisis" of 1967-70 was one such event. The crisis, notably similar to a paperwork problem in the most recent financial crisis, was about lax back office documentation of trades. Over the period 1964 to 1968, average daily volume on the NYSE grew by 265 percent. Reflecting "an industrywide loss of control of record-keeping procedures," the number of complaints against brokers rose from about 4000 in 1968 to over 12,000 just one year later.[80] According to Seligman's history of Wall Street, this amounted to "the most serious failure

---

[77] Id. at 299-300.

[78] Hugh F. Owens, "The Securities Act Amendments of 1964," Speech by SEC Commissioner Owens to the Practicing Law Institute, NY, NY, Oct. 16, 1964, at 12, available at http://www.sec.gov/news/speech/1964/101664 owens.pdf.

[79] SELIGMAN, TRANSFORMATION OF WALL STREET, supra note 6 at 326-28; 343.

[80] Id at 451.

of securities self-regulation in the [SEC]'s history."[81] The government's study of the problem concluded that "the industry concentrated its resources on sales, and paid insufficient attention to properly handling and processing the business brought in by its sales efforts."[82] According to Seligman, "the back-office crisis had focused attention [in Congress] on the securities industry, and many members of Congress were openly hostile to the [NYSE]'s long-advanced arguments about [self-regulation]."[83]

In response to the crises of the late 1960s (including a stock market crash in 1969-70), Congress increased government control of and the governmental nature of Wall Street SROs in two ways. The Securities Investors Protection Act of 1970 created an FDIC-analog for customer funds held by brokers. In addition, Congress gave the SEC the power to require any SRO to adopt rules or procedures regarding the inspection of brokers and the licensing requirements for the industry; to require reporting to regulators of brokers' financial condition; and to require inspection of specific brokers.[84]

The Securities Acts Amendments of 1975 were another watershed change in the nature of broker SROs. The statute gave the SEC its long-sought-after power to initiate as well as to approve SRO rules and

---

[81] Id. at 450.

[82] See SEC, Study of Unsafe and Unsound Practices of Broker-Dealers ("SEC Study"), H.R. Doc. No. 92-231 (1971).

[83] SELIGMAN, TRANSFORMATION OF WALL STREET, supra note 6 at 478-79. It is worth noting that this failure was not something that was obviously avoidable in a world of direct regulation by the SEC, a point we will return to below. It is also worth noting there were numerous reported successes of self-regulation over the period. One incident involved the NYSE's response to the failure of the brokerage firm Ira Haupt & Company. Even critics of self-regulation point out that it "seemed to establish the wisdom of the SEC's policy of deferring to the Exchange on oversight of member firms' operations and finances." Seligman, supra note __ at 451. As we discussed below, it is likely that successes are less salient in terms of governmentalization than failures.

[84] See Securities Investor Protection Corporation, 15 USC § 78ccc (1971).

rulemaking procedures.[85] As Professor Karmel describes it, "the SEC obtained greater authority to regulate and supervise the NYSE and other exchanges and the NASD."[86] The statute also "expanded the SEC's role in SRO enforcement and discipline, and allowed the SEC to play an active role in the structuring of public securities markets."[87] Perhaps most importantly, the statute altered the governance of the SRO, by mandating particular compositions of boards of directors. The Exchange Act thus provided that the SROs must "assure a fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer."[88]

Just a few years later, Congress further tightened the regulatory grip of SROs, by requiring that every broker dealer be registered with an SRO.[89] This requirement had been desired by the New Dealers, but it took the various crises of the nineteen-fifties, sixties, and seventiesto make it a reality.

21A Report period. Over the next several years, the markets underwent tremendous changes. The growth of the mutual fund industry, the end of fixed commissions on the exchanges, the birth and growth of the OTC markets, known as NASDAQ, and the growth of so-called "day traders" brought tremendous

---

[85] See Securities Act Amendments of 1975, Pub. L. No. 94-29, 1975 U.S.C.C.A.N. 179. See S. Rep. No. 94-75 (1975).

[86] Karmel, "Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?," 14 STAN. J. L. BUS. & FIN. 151 (2008).

[87] Id at 160.

[88] Pub. L. No. 94–29, June 4, 1975, 89 Stat 97, 15 USC § 78(f).

[89] Pub.L. No. 98-38, §3, 97 Stat. 205-07 (amending §§ 15(b)(8), (9) of the Securities Exchange Act, Exchange Act § 15(b), 15 U.S.C. §§78o-4(b)(8), (9) (1988)) ("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 . . . ."); See also, Koebel, James T. (2010) "Trust and the Investment Adviser Industry: Congress' Failure to Realize FINRA's Potential to Restore Investor Confidence," Seton Hall Legislative Journal: Vol. 35: Iss. 1, Article 3.at 10.

regulatory pressure upon SROs and the SEC. More and more Americans became involved in the stock market, and increasingly they were using brokers' services.

Under the chairmanship of Arthur Levitt, the SEC began to increase its enforcement efforts on top of SRO efforts.[90] In 1996, for instance, the SEC, NASD, and NYSE conducted a "sweep" of over 100 small and medium-sized brokers, finding that many were engaging in substandard hiring and monitoring practices.[91] In addition, the Department of Justice increased prosecutions, convicting 17 "rogue brokers" in ten states in 1997 alone.[92]

But the most significant regulatory development involved a fundamental remake of broker SROs. The change started with a NASD committee led by former Senator Warren Rudman, which concluded that "[f]undamental change is required" to "NASD's governance structure" as a result of growth in markets and expansion of NASD's dual role as regulator and owner of NASDAQ.[93]

Following shortly upon the Rudman report, a study by professors William Christie and Paul Schultz entitled "Why Do NASDAQ Market Makers Avoid Odd-Eighths Quotes?" concluded that there was "an implicit agreement among market makers to avoid using odd-eighths" in order to increase their profits.[94] This study prompted a 1994 investigation by the DOJ

[90] Statement by Chairman Arthur Levitt U.S. Securities Exchange Conference Regarding the NASD Washington, DC (Aug 8, 1996)

[91] See NASD Regulatory & Compliance Alert, "NASD Joins SEC, Others, In National Regulatory Sweep," Apr. 1996, available at http://c0403731.cdn.cloudfiles.rackspacecloud.com/collection/papers/1990/1996_0401_NASD_RCA.pdf.

[92] SELIGMAN, TRANSFORMATION OF WALL STREET, supra note 6 at 645.

[93] September 19, 1995 Executive Summary of the Report of the NASD Select Committee on Structure and Governance (Rudman Committee) to the NASD Board of Governors, available at http://www.sechistorical.org/collection/papers/1990/1995_0919_RudmanNASD.pdf.

[94] William G. Christie & Paul S. Schultz, "Why Do Nasdaq Market Makers Avoid Odd-Eights Quotes?," 49 J. FIN. 1813 (1994).

and a landmark study by the SEC, known as the "21(a) Report," after the provision authorizing the study.[95] The administrative proceeding following the report concluded that "NASD was aware of information suggesting that its members were engaged in misconduct which had potential anticompetitive implications and could be detrimental to the interests of investors," and yet took no regulatory action against them.[96] The SEC censured the NASD, fined it, and required it to "enhance its systems for market surveillance."[97] In the wake of the report, the SEC required NASD to make fundamental changes to governance, membership and licensing rules, its investigation and enforcement policies, and to its procedural code.[98] For instance, prior to the 21(a) Report, in disciplinary matters members sat as quasi-grand juries to decide whether to bring an enforcement case against individuals or firms. This arrangement was a prototypical example of *self*-regulation. But after the failure to enforce cartel behavior in bid-ask spreads, the SEC required that enforcement actions be made via a centralized department, in the Washington, DC headquarters of NASD. The SEC also "insisted on new management at NASD," and it handpicked Frank Zarb, a friend of Chairman Levitt's for the job.[99]

FINRA period. After the bursting of the dot-com bubble, the accounting scandals, and the series of corporate collapses in the early 2000s, another important change came to broker SROs. In 2007, the SEC approved the merger of the NASD (the

---

[95] "Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market," available at http://www.sec.gov/litigation/investreport/nd21a-report.txt.

[96] In the Matter of National Association of Securities Dealers, Inc., Order Instituting Public Proceeding Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions," SEC Release No. 37538 (Aug. 8, 1996), available at http://www.sec.gov/litigation/admin/3437538.txt.

[97] Id. at part D.

[98] SELIGMAN, TRANSFORMATION OF WALL STREET, supra note 6 at 700-01.

[99] Id at 702.

enforcement arm of the pre-NASDAQ NASD) and the enforcement arm of the NYSE into a single industry SRO known as FINRA. Efficiency was the official justification for the merger.[100] The idea was to "increase efficient, effective, and consistent regulation of securities firms, provide cost savings to securities firms of all sizes, and strengthen investor protection and market integrity." According to NASD, additional benefits were to "streamline the broker-dealer regulatory system, combine technologies, and permit the establishment of a single set of rules and a single set of examiners with complementary areas of expertise within a single SRO." The SEC Chairman, Christopher Cox, noted that the SEC "will work closely with FINRA to eliminate unnecessarily duplicative regulation, including consolidating and strengthening what until now have been two different member rulebooks and two different enforcement systems."[101]

The creation of FINRA created a monopoly for broker SROs, with both the upside and downside effects. As discussed below, this change made SEC control perhaps more likely and the interaction between the SEC and the SRO closer. As a condition of the merger, the SEC required that FINRA's by-laws increase public representation on the board, such that now 11 of the 23 seats are for Public Board members. In addition, the interaction between FINRA and the SEC has increased, perhaps most notably through the recent appointment of former FINRA chief executive officer Mary Schapiro as Chair of the SEC.

* * *

The FINRA story is one of dramatic transition from self-regulation to quasi-governmental regulation.

[100] See, e.g., "Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc.," U.S. Securities and Exchange Commission. 2007-07-26.

[101] See, e.g., "SEC Gives Regulatory Approval for NASD and NYSE Consolidation, "U.S. Securities and Exchange Commission. 2007-07-26.

Although the transition is not complete, and federal courts have not conclusively deemed FINRA to be a purely governmental actor, the increasing departure from self-regulation is unmistakable.[102] Whether SROs become fully governmental is a matter for their members, legislatures, and regulators to determine in the years ahead. That they have grown increasingly governmental in the years past is clear. We next attempt to describe the mechanisms that are driving this transformation.

III. MECHANISMS OF GOVERNMENTALIZATION

In this part, we identify the mechanisms that may influence the character and behavior of self-regulatory organizations. Our thesis is that several of these factors are increasingly leading SROs to resemble the governmental agencies that oversee their activities, to the extent that SRO might more accurately be dubbed quasi-governmental organizations. Over the past few decades, some financial SROs appear to have lost much of the "self" in self-regulatory organization, and that element of independence has been replaced with a more governmental approach. We call the process by which this is happening the "governmentalization" of SROs. By "governmentalization," we mean a process through which ostensibly private activities or organizations acquire the characteristics, functions, or appearance of government.[103] While any regulatory body, be it an SRO or a private club (such as a golf club or a university), that administers rules of conduct necessarily engages in governance, we contemplate a more formal invocation of the powers and punishment of a sovereign. Along the spectrum of governance, one pole may be thought of as purely governmental action

[102] Karmel, *supra* note 74 at __.

[103] We borrow and adapt this term from Michel Foucault. See Michel Foucault, "Governmentality," translated by Rosi Braidotti and revised by Colin Gordon, *in* Graham Burchell, et al. (eds.), THE FOUCAULT EFFECT: STUDIES IN GOVERNMENTALITY 87–104 (1991).

(such as formal charges brought by federal prosecutors) while the other is purely private (such as the informal rules of decorum encouraged at a family dinner table). Much of the operations of financial SROs lie somewhere between these extremities, but it is our contention that the nature of those activities is evolving more toward the governmental direction.

Government action, for these purposes, exhibits several key characteristics that differentiate it from non-government action. As a matter of practice, the federal government takes action through a highly formal bureaucracy subject to compendious legislation governing civil service rules and protections. As the quotations from William O. Douglas and others above suggest, government action is also more blunt, being less capable of the enforcement of ethical and moral judgments due to the external, third-party nature of the enforcement.

Government action is also uniquely powerful because it acts, at its fundament, based upon its monopoly on lawful violence and because it is not beholden to competitive market forces. Because of these factors, government action has been historically perceived by many in this country to be more potentially dangerous or coercive for those subject to its authority. Accordingly, government action is concomitantly subject to constitutional, legislative, and other legal bulwarks. This array of protections from the awesome power of the state establishes a set of presumptions that are held, to a greater or lesser extent by the public, depending on their own prior beliefs, the regulatory circumstances, and other relevant facts. Broadly, though, individuals in the United States are likely to view many governmental regulatory processes as more adversarial and potentially consequential than private or non-governmental process, notwithstanding the panoply of constitutional protections.

Governmentalization is the process by which non-governmental actors acquire more government-like characteristics; that is, the way in which they become more rule-bound, more adversarial, more bureaucratic, and, most importantly, more capable of depriving their subjects of life, liberty, or happiness. Our examination of governmentalization focuses primarily upon the lessons that can be drawn from the experience of FINRA as the securities industry's most prominent self-regulator. These lessons demonstrate forces that may, in some combination, be driving what we perceive to be a move from self-regulation to quasi-governmental regulation, and perhaps eventually to outright governmental regulation. We consider several potential forces in turn, while recognizing that they might act in isolation or any variety of temporal or circumstantial combinations. In short, we do not purport to unveil a mechanical formula that produces governmentalization but rather attempt to explore the variety of contexts that may do so.

A. Possible Mechanisms of Governmentalization

1. The Nature of Financial Victims

The first potential driver of a change in the nature of self-regulation is the type of individuals or institutions being regulated. We should expect the locus and intensity of regulation to correspond in some degree to the characteristics of potential victims of wrongdoing. If potential victims are notably weak and vulnerable, we should expect to see one set of regulatory actors and choices; while if potential victims are comparatively strong and able to fend for themselves, we should expect to find another. Government has a greater interest in protecting the weak and vulnerable, so we would expect this interest to be correlated with more direct control of regulation by government officials.

Similarly, if potential victims are not central actors within the industry being regulated, then they are less likely to be able to participate in any self-regulatory system, so we should expect greater governmental involvement and greater regulatory intensity. Self-regulation is likely to be more effective where the interests of those who govern and those who are governed are closely aligned. In addition, if the potential victims and wrongdoers are easy to categorize ex ante, then government regulation is more likely. If two participants cannot tell whether they will be on the wrong side of a particular transaction, then the case for non-governmental regulation is stronger, since reputational forces and a balanced approach is more likely to arise naturally.

These predictions are consistent with the observed pattern of the allocation of private and public law. We should not be surprised to see purely private law governing disputes between different merchants in an industry. Lisa Bernstein's work describing the almost completely autonomous self-regulation of the cotton and diamond industries demonstrates many of these characteristics: they are situations in which the potential victims are sophisticated, repeat players, and difficult to characterize ex ante.[104] At the other end of the private-public law enforcement spectrum are traditionally government-only subjects, such as prohibitions on the use of violence or in areas like products liability or environmental law. Securities regulation, we believe, is a milieu that falls somewhere between these extremes, though it was not always such. And, it is our contention in this article, that it will not always remain so.

The federal securities laws impose significant restrictions on every aspect of the process by which companies seek to raise money from investors.[105] Rules mandate extensive disclosures, govern the timing and nature of all issuer communications, restrict who can buy and how much they can buy, and

[104] *See, e.g.*, Lisa M. Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. LAW REV. 1724 (2001).

[105] See, e.g., The Securities Act of 1933, 15 U.S.C. § 77a et seq. For a general overview, see http://www.sec.gov/about/laws.shtml.

impose strict liability for material misstatements or omissions by issuers.[106] The regulatory burden is enormous. But broad exceptions exist in cases involving investors who are wealthy or financially sophisticated.[107] The border of the SEC's jurisdiction is based on a determination of whether or not the potential victims in question need the protection of the securities laws or, if instead, they can "fend for themselves."[108] In broad terms, the securities regulations deem wealthy or sophisticated investors as able to fend for themselves, but less wealthy or less sophisticated investors as unable to do so.[109] Accordingly the intensity of government regulation is strong in the latter case and weak in the former case.

If the nature of potential victims is relevant to the type and locus of regulation, then we would expect SRO regulation to exhibit more private-like characteristics when the parties are sophisticated, industry-insiders, or capable of fending for themselves (such as diamond merchants), and self-regulation to be more quasi-governmental where the opposite is true. In short, the SRO model should dominate in markets with relatively fewer vulnerable victims, and the QGO model should be prevalent in circumstances with relatively more vulnerable victims.[110]

The evolution of FINRA, as we have described it, is one in which there has been a significant shift in the governmental nature of its regulatory approach. This increasing governmentalization has developed

[106] See, e.g., HAZEN, LAW OF SECURITIES REGULATION, *supra* note 32.

[107] See, e.g., Regulation D, 17 CFR § 230.501 et seq.

[108] See Securities and Exchange Commission v. Ralston Purina Co., 346 U.S. 119 (1953).

[109] So-called "accredited investors" are able to invest in private offerings that are exempt from the disclosure and other regulations. The definition of accredited investor includes, among other things, "any natural person who had an individual income in excess of $200,000 in each of the two most recent years." Rule 501(a)(6).

[110] Importantly, as discussed below, "vulnerable" is likely to be a context and product specific inquiry. While sophisticated investors, like banks or institutions may be "sophisticated" when dealing with plain vanilla investments in stocks and bonds, they may not be when dealing with complex derivatives transactions, as the Financial Crisis teaches.

contemporaneously with two significant changes in the securities industry over the same period. The number of vulnerable individuals entering the investment market has increased and the importance of the broker as intermediary has consequently increased as well.

First, the number of individuals investing in securities products has increased dramatically, and therefore the number of investors who appear to need the protection of the securities laws has increased as well.[111] The number of brokerage accounts has increased over 1000 percent since 1980, at a compound annual growth rate of about 9 percent per year. Specifically, in 1980, fewer than 10 million Americans owned individual brokerage accounts; in 2009, approximately 110 million did so. This growth cannot be explained by population growth, which grew just 38 percent or about 1 percent per year (or nine times slower) over the same period. Another way to see this development is to compare individual investment accounts as a percentage of the population. If every investment account were held by a single individual, in 1980 about 4 percent of the country's population held such accounts, while in 2009 about 36 percent did.[112] Accordingly, the type of investors who may need the protection of the securities laws—that is, relatively unsophisticated investors—appears to have increased as well.

Not only has the number of individual accounts grown dramatically but the growth correlates well with the timing of observable changes in the nature of the self-regulation of securities markets. As noted above the most substantial changes in the self-regulatory

---

[111] The only way it could be otherwise is if the first entrants into a market are the less sophisticated. Although we do not have evidence on this point, this strikes us as extremely unlikely.

[112] Population in 1980 was about 227 million and there were about 10 million accounts; in 2009, the population was roughly 300 million and there were 110 million accounts. http://www.census.gov/population/www/censusdata/hiscendata.html

model occurred during the decade from 1996 to 2006. In the period leading up to 1996, the number of individual accounts increased by more than five times, while it has less than doubled in the period since then.[113]

Second, the large and growing investment in securities by individuals is increasingly intermediated by brokers. In 1965, "households" directly held about 84 percent of U.S. equities, while "institutions" held the remaining 16 percent. In 2009, households held just under 38 percent, while institutions held the remaining 62 percent.[114] This nearly 50-percentage point increase in the intermediation of the securities business is associated with the rise of the mutual fund industry and other forms of collective investing, such as ETFs and other pooled investment funds. As more "average" Americans have entered the investment world, they have done so primarily using regulated intermediaries. The fact that accounts are more likely to be held by brokers for the benefit of individual investors rather than by the individual investors themselves increases the potential for abuse by brokers, especially in ways that might implicate the integrity of a regulatory process dominated by brokers.

The traditional approach to retirement investing was through the use of "defined benefit" plans in which a worker is promised a set amount of money in regular increments during retirement. This arrangement admits fewer occasions for cheating by brokers or other securities professionals, and if it does occur it does so at the employer level, where

[113] This data does not necessarily imply causation. It is plausible that the change in the regulatory model caused the increase in the growth in the number individual accounts. But the timing of the growth in accounts does not fit well with this story about causation. In addition, it seems quite a stretch to believe that the changes in the self-regulatory model were sufficiently quick and transparent to the public that they caused a big change in the investment behavior of individuals. The data do not discount the possibility that there has been some impact on investment decisions by the regulatory change, say through a lowering of brokerage fees and the like.

[114] Federal Reserve Board of Governors, Survey of Consumer Finances (SCF), available at http://www.federalreserve.gov/econresdata/scf/scfindex.htm.

sophistication and risk bearing are both generally higher. The more recent approach to retirement investing, however, is via "defined contribution" plans, most popularly though 401(k) plans and individual retirement accounts, in which individual workers set aside a set amount of their salary in regular installments, which they can they invest through a menu of default options (most of which are usually mutual funds) available in their 401(k) plan or IRA. Although such plans are governed by ERISA, which imposes fiduciary duties upon their administrators, individuals (rather than professional pension managers) are responsible for investment decisions and, accordingly, more vulnerable to financial intermediaries who may be determined to take advantage of less-sophisticated customers.

Take, for example, the recent case of *Epstein v. SEC*.[115] The defendant-broker worked for Merrill Lynch making mutual fund recommendations to Merrill's customers. He was compensated largely by commissions, which he earned when customers changed their fund allocations or moved assets from one fund to another. The majority of the broker's customers "ranged in age from 71 to 93 years old and were widowed, retired, and earned low annual incomes," and yet he made recommendations that they incur relatively large transaction fees (and thus commissions for the broker) by switching mutual funds, often into funds with higher fees.[116] This type of misconduct is unfortunately likely to be more common in a world in which average investors, like the elderly victims in this case, are directly involved in their investment decisions.

In short, the past several decades have seen a dramatic increase in the number of individuals

[115] 416 Fed. Appx. 142 (3rd Cir. 2010).

[116] FINRA barred broker from industry for making unsuitable investments. See In the Matter of Department of Enforcement v. Scott Epstein, Complaint No. C9B040098, NAC Decision (Dec. 20, 2007), available at www.finra.org/web/groups/industry/@ip/.../p037691.pdf.

directing the investment of their own assets through the use of a retail intermediary. These factors understandably prompted regulatory changes, not surprisingly in a more governmental direction.

2. Size of Potential Losses

The size of potential investor losses is a related factor that might influence the nature of regulation. For the class of unsophisticated investors—the kind of investors described above who have entered the market recently—the potential for relatively larger losses may be explain a more formal, government-like regulatory role. Put simply, the state's interest as "the investor's advocate"[117] is greater when potential harm is greater. Therefore, when performing the cost-benefit analysis regarding the delegation of regulatory responsibility to an SRO, the cost side of the equation increases as potential losses increase. Assuming the benefits of SRO regulation remain constant, this rise in costs will occasion a shift on the margin toward the QGO model or even regulatory usurpation by the government entirely.[118]

The only way in which greater potential losses would support the continued use of the SRO model is if somehow the benefits of the SRO model, such as knowledge, information, and lower enforcement costs, were increasing concurrently with the size of potential losses. To analyze this, we can apply the simple model of punishment developed by economist Gary Becker.[119] In Becker's model, deterrence is a product of the probability of detection and the punishment imposed. To compare the relative efficacy of SRO versus governmental regulation along this dimension for a given harm, one simply estimates these two inputs.

[117] See "The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation," available at http://www.sec.gov/about/whatwedo.shtml.

[118] We discuss the rough tradeoffs in this choice below, noting the latter may be preferable to the former.

[119] See Gary S. Becker, "Crime and Punishment: An Economic Approach," 76 J. POL. ECON. 169 (1968).

Holding the probability of detection constant, achieving optimal deterrence depends on the range of expected sanctions. For larger losses, the size of the sanctions must increase to achieve greater deterrence. Since SROs are constrained in their types and severity of sanctions—criminal sanctions are unavailable and large fines are rare and subject to recent criticism[120]—Becker's analysis suggests that increasing losses will prompt increasing governmentalization.[121]

Another factor also suggests an increasing government-like role for regulators in tandem with a rise in the prevalence of retail investing. As the losses for individuals increases, the political stability of the SRO model may prove more fragile. To appreciate this conjecture, consider a case in which the regulator enjoys the same success rate at vindicating investor losses, regardless of the stakes. This parity would mean that the chance that an investor who feels cheated is satisfied with the outcome of the regulatory action is constant over time as the amount at stake increases. For example, assume the average loss was $10,000, but that over time it increased to $50,000, and say 80 percent of victims were satisfied at both times. Although only 20 percent of victims are dissatisfied in both cases, in the second period, the expected loss is $10,000 ($50,000 x 0.20), while in the earlier period, the expected loss is $2000 ($10,000 x 0.20).[122] Insofar as the unsatisfied or uncompensated victims blame the SRO generally for their lack of satisfaction, then such dissatisfaction may increase pressure on the SRO model, since the unsatisfied regulatory expectations are five times as great. This discontent might be true, for instance, if victims

[120] See, e.g., Fiero v. FINRA, 680 F.3d 569 (2d Cir. 2011) (holding that FINRA does not have the authority to bring court actions to collect fines for disciplinary violations by members).

[121] The precise contours will, of course, depending on the institutios and individuals involved, since other factors include whether the parties are repeat players and will suffer extra-legal sanctions, such as reputational losses, from the conduct.

[122] Beyond this numerical example, the issue could simply be phrased as a belief that the punishment was not sufficient.

believe that the SRO in question is merely a club of insiders designed to protect themselves by forestalling government regulation. The important point is that even assuming the number of people who believe this and the intensity of their beliefs remain constant over the period, the increased amount of losses increases the likely impact of regulatory failure, and therefore increased pressure to move toward a different regulatory model. Note also that if the belief that the SRO model is biased in favor of insiders increases with increases in unsophisticated investment, then the expansion of the investment business to larger numbers of individuals (as described above) may lead to an increase in the number of individuals holding negative opinions of the SRO or SRO model generally in the wake of investment losses.

This argument does not prove that all large losses can be regulated effectively only by governmental regulators, inasmuch as SROs have a long tradition of policing very large trades by regulated parties. It simply points out that for average investors an increase in the expected amount at stake may impact the SRO cost-benefit analysis on the margin. So, while an SRO model may be clearly superior with average losses of $10,000, when they increase to $50,000, more deterrence may be necessary, which might require greater government-like regulation.

Evidence does exist to suggest that the potential losses for individual investors may be rising. Not only has the number of individuals investing increased sharply, but the total amount of money invested in securities markets has as well. In 1965, the total value of U.S. equities held by Americans in individual accounts was $735 billion or about $4,946 billion in 2009 dollars.[123] In 2009, the total value of U.S. equities was $20,451 billion (down from a pre-collapse high of over $25,577 billion).[124] This growth amounts

[123] See Federal Reserve Board of Governors, Survey of Consumer Finances (SCF), available at http://www.federalreserve.gov/econresdata/scf/scfindex.htm.

[124] Id.

to more than a 500 percent increase in the value of accounts held by the public. Investing in securities has become much more important to Americans over this time, and so too have the regulatory stakes.

Evidence also exists to suggest that the relative importance of securities investing has increased as well. Over the past three decades, households have shifted more of their liquid assets (that is, assets excluding real estate and other real property) from cash and government securities into equity investments. In 1980, cash or cash-like assets[125] constituted about 58 percent of total liquid financial assets; by 2009, they had fallen to only 36 percent.[126] Or, looking at the data another way, in 1975, U.S. households held most of their liquid assets in bank deposits (51%), but by 2009, they held those liquid assets overwhelmingly in "securities products" (73%).[127]

This reallocation means that more average investors find themselves in the equities market, and that the stakes for them of effective regulation are higher than they were in the past. With personal financial stakes that much higher, we should not be surprised to find regulators pursuing an increasingly stringent – or governmental – role in order, as they see it, to vindicate investor preferences and to ensure well-functioning markets more effectively

3. One-way Ratchet I: The Financial Industry

One justification for reducing the *self* in SROs may come from industry participants who respond rationally to failures of the regulatory system. Failures appear to trigger a one-way ratchet that increasingly moves the regulatory system away from control by the

[125] This number is the sum of bank deposits plus US government securities plus money market funds.

[126] The data are from the Federal Reserve Flow of Funds Accounts available at http://www.federalreserve.gov/relases/Z1/;Table L.213CorporateEquities.

[127] See id. p. 64

industry toward the direction of government-like control.

This phenomenon is illustrated by the selfish rationale for regulation. In a world in which investors cannot readily distinguish between “good” and “bad” brokers before choosing one, perversely, good brokers are worse off and bad brokers better off. But if good brokers can somehow differentiate themselves in advance, they can charge more for their services. This discrimination might be hard to effectuate without a neutral third party to serve as a credible source of enforcing regulations that distinguish between the two.

For members of a particular industry, then, there are powerful incentives to oversee a self-regulatory system that works, even in the absence of government. Indeed, in the historical developments we have seen in this country’s financial system, the eighteenth century witnessed just such a confluence of incentives for financiers to self-regulate. Such a system is, of course, highly dependent on the credibility of its enforcement system. If would-be customers believe the regulatory threat is not serious, but rather motivated by other goals (such as protecting an industry of bad brokers from more serious external regulation), then the entire premise of self-regulation will be undermined. In such a case, the value of regulation is lost, since the good brokers can no longer credibly distinguish themselves from bad brokers.

Such a negative perception might increase over time, even if the SRO is very effective at policing the market and disciplining bad brokers. Assume, for instance, that a given SRO is ninety-five percent effective, and, given the costs of regulation, this level of regulation is an efficient one. Assume further that the remaining five percent of cases that result in fraud attract greater publicity and generate more political outrage than the corresponding positive coverage generated by the ninety-five percent of cases of effective regulation. If such an imbalance of coverage exists, as anecdotal impressions of media reports suggest, then customers may believe the level of fraud is much higher than five percent.

In that case, the rational policy for good brokers might be to increase the distance between the regulator and the regulated – that is, to sacrifice some of the "self" from the self-regulatory model to increase the credibility of the claim that the regulation is neutral and constructed to police bad conduct. A promise to operate subject to government regulation may be more compelling than one to have the industry regulate itself. If so, then perceived failures of regulation (whether or not actual failures) will tend to increase the governmentalization of an SRO and push it more toward becoming a QGO.

The history of the securities SRO described above is consistent with this dynamic. Each regulatory failure, from the back-office scandal of the late nineteen-sixties to the price-fixing scandals culminating in the 21A Report in the mid-nineteen-nineties, has led to a change in which the industry SRO has become more like a government regulator.

The industry might win greater deterrence value by fully moving to a government regulator, since presumably the SEC as regulator sends a more powerful signal about the policing of the industry than any SRO or even QGO could. But this consideration must be weighed against the reluctance of Congress to fund such an expansion and any efficiency savings from relying upon an SRO in the first place. In other words, the credibility of the regulator as a neutral enforcer of rules is just one factor that helps to explain the scope and nature of the SRO. The point of the one-way ratchet is simply that whatever the equilibrium position is at a given time in terms of the choice between government and SRO, the inevitable failures of an SRO regulator (even if efficient) may have a rational tendency to push the industry toward favoring a regulator that looks more like the government.

4. One-way ratchet II: The Financial Regulator

A similar dynamic may also be at work within the regulatory agency overseeing any SRO. The successes and failures of the self-regulatory process may also accumulate over time in a way that biases the locus of regulatory authority toward government or government-like conduct. If SRO successes in preventing or reducing the costs of misconduct are relatively less politically salient than SRO failures, then the SRO will face one-sided pressure to change its approach to regulation from government overseers.

To illustrate this version of the one-way ratchet, consider an SRO that has one hundred regulated activities, and wants to design a regulatory system to maximize the efficiency of the regulation (that is, to achieve the highest social welfare at the lowest regulatory cost). The SRO has two options: Option 1 is a characteristic SRO approach, imposing a regulatory cost of $1 per activity, a chance of failure of 20 percent, and a cost of failure of $1000; Option 2 is a more governmental approach, imposing a regulatory cost of $3 per activity, a chance of failure of 10 percent, and a cost of failure of $1000. If the SRO were deciding in a vacuum which regulatory option to use, it might choose Option 1; the additional cost of using Option 2 ($200 in additional regulatory costs) are greater than the expected benefits of reduced failure from Option 2 ($100 in lower expected losses from failure). But, if the political bodies overseeing the SRO fully internalize the expected losses but not the expected regulatory costs, then the calculation might be different. Imagine, for example, that the political costs of a public failure of a regulated entity are three times the dollar amount at stake, while all other factors remain the same as in the example above. In such a case, from the perspective of the political superiors, the benefits of moving to Option 2 are $300, while the costs are only $200. The SRO would therefore face pressure to adopt Option 2, even though it is the less efficient regulatory approach.

Several features of the SRO model may make this one-directional migration likely. SROs do not enjoy full and independent control of their regulatory authority but rather now exist as subordinate agents of the governmental entities that ultimately control their activities. Congress is the source of all regulations, though it has specifically created various administrative agencies to enforce statutory commands and to promulgate additional rules for the regulation of particular industries. The SEC (created in 1934), for instance, is responsible for regulating "securities" markets, while the CFTC (created in 1974) is responsible for regulating "commodities" markets. Each of these agencies, in turn, relies upon various SROs to perform day-to-day regulatory enactment, compliance, and enforcement.

FINRA, for example, serves as the primary SRO for securities brokers and dealers. FINRA writes rules for brokers and firms, though since 1975 these rules have been subject to final approval by the SEC, which is in turn accountable, to a certain extent, to the federal political branches of Congress and the president. In addition, FINRA conducts disciplinary proceedings, which are appealable first to the SEC and then to the federal courts and, ultimately, to the Supreme Court. Congress therefore enjoys tremendous influence over this entire process, since it controls funding for the various agencies, produces legislation governing all the parties, and wields subpoena power to compel adherence to its desires.

The recent failure of commodities broker MF Global provides a possible example of the one-way regulatory ratchet. MF Global was a leading commodities and securities broker, regulated by, among others, the SRO arm of the Chicago Mercantile Exchange (CME).[128] This SRO structure is relied upon by the CFTC, which is the primary regulator of the

[128] See, e.g., Ben Protess & Aza Ahmed, "MF Global Inquiry Turns to Its Primary Regulator," NY TIMES DEALBOOK (Jan. 5, 2012), available at http://dealbook.nytimes.com/2012/01/05/mf-global-inquiry-turns-to-its-primary-regulator/.

commodities industry and futures merchants such as MF Global. In essence, the CFTC outsources regulatory oversight to the exchanges, including CME, which serve as the markets in which brokers operate. This delegation relieves the CFTC from having to examine the brokers directly. But the MF Global failure has raised criticisms of this arrangement.

MF Global made a large ($6.3 billion) but disastrously incorrect bet on European sovereign debt that drove the firm into a hasty bankruptcy. As the firm approached insolvency, about $1.6 billion in customer funds disappeared. When facts surfaced suggesting that this customer money, which CME is charged with ensuring remains segregated from the firm's proprietary funds, was used to try to shore up the firm's finances, the incident created a political firestorm. Congressional committees convened numerous hearings, the former head of the FBI was appointed trustee of MF Global, and countless ongoing lawsuits and investigations were launched.

This incident caused the CFTC to conduct a wholesale review of the way in which futures brokers, such as MF Global, are regulated.[129] Both Republican and Democratic commissioners on the CFTC made public statements suggesting the SRO model failed in the MF Global case. Bart Chilton, a Democratic commissioner, said: "I think we've gone too far in allowing the exchanges to be so self-regulatory that it's obfuscated the need for the cop to be on the beat all the time."[130] Similarly, Scott O'Malia, a Republican commissioner, said: "The MF Global collapse was a huge broken window in the [CFTC's] neighborhood . . . [and] [t]o restore public confidence and deter future violations . . . [the CFTC] needs to continue taking action."[131] These comments and the CFTC's response

[129] Christopher Doering, "MF Global Triggers Regulatory Rehink at CFTC," REUTERS (Feb. 1, 2012), available at http://www.reuters.com/article/2012/02/01/us-mfglobal-cftc-policy-idUSTRE8102IV20120201/.

[130] Id.

[131] See http://blogs.reuters.com/christopher-doering/page/2/

no doubt have been influenced by strong pressure on Capitol Hill. Leading congressional Republicans and Democrats have used the incident to call for greater oversight of regulated entities by the CFTC, as well as for enhanced procedures by SROs to protect customer funds. For instance, Senator Pat Roberts (R-Kan.) used the failure of MF Global to denounce the CFTC in congressional hearings, demanding an accounting on behalf of "folks in Kansas . . . [who] have been severely damaged economically by the actions . . . of MF Global."[132] In numerous hearings and in countless news and opinion pieces, the CFTC has been severely criticized for its failure to ensure MF Global's customers were not harmed.

CME, for its part, however, has argued that it did everything it could reasonably do to prevent the collapse of MF Global. In economic terms, the CME argument is that its regulation was efficient, even though it failed to detect this particular allegation of fraud. According to the CME, examiners from its SRO audited MF Global's accounts in the days before the firm's bet on European debt went bad, and found that the customer fund accounts were "overcollateralized" by $200 million.[133] CME has defended the SRO approach, arguing that MF Global duped regulators, and that no amount of reasonable oversight could have prevented those who wanted to break the rules from doing so. For instance, CME points to an email it sent the general counsel of MF Global the day before several hundred million dollars in customer funds were illegally moved out of a customer account and used to pay down a collateral call from a British unit of JP Morgan. The email commanded that "effectively immediately, any equity withdrawals must be

[132] Ronald D. Orol, "Senators Target CFTC Over MF Global Failure," WALL ST. J. MARKETWATCH (Dec. 1, 2011), available at http://articles.marketwatch.com/2011-12-01/economy/30788017_1_mf-global-commodity-futures-trading-commission-customer-funds. See also http://www.youtube.com/watch?v=TYIYgX_Yyy4

[133] Terrence Duffy, "CME Chief Speaks Out on CFTC Inquiry," NYTIMES DealBook (Jan. 11, 2012), available at http://dealbook.nytimes.com/2012/01/11/cme-chief-speaks-out-on-c-f-t-c-inquiry/.

approved in writing by CME."[134] But CME did not learn of the nearly $200 million moved offshore to JP Morgan until three days after the transfer.[135]

Whether the SRO model was to blame or not for the violation of segregation rules in the MF Global case seems to be a minor factor relative to the political pressure the CFTC faces to reform in the wake of the event. If the CFTC is going to be blamed for the MF Global failure, it is more likely to try to reform the regulatory process to exert more direct control. Furthermore, if successes are not celebrated in a manner proportional to the way in which failures are denounced, then the forces will inevitably privilege a more governmental form of regulation, even if that approach may not be the most efficient regulatory approach.

Perception therefore may appear to matter more than reality in this system. Even if the SRO model is more efficient, say at reducing risk for a given expenditure on regulation, if average investors believe a more governmental approach is better, then government will have an incentive to make the SRO look more like government. Markets work in significant part because of trust and confidence, and therefore the perception about regulation may be as or more important than a purely mechanistic cost-benefit analysis that excludes market perception.

The power of investor beliefs, as channeled through politicians, acting for both the interests of their constituents and for themselves, is complicated by the diffusion of accountability inherent in the SRO approach. We consider this factor next.

5. Misguided Accountability

The lack of direct accountability on the part of various political actors who oversee financial SROs

[134] Aaron Lucchetti and Julie Steinberg, "MF Response to CME Edict Probed," WALL ST. J. (Mar. 29, 2012), available at http://online.wsj.com/article/SB10001424052702304177104577312073753226142.html.

[135] Id.

may also drive those SROs toward governmentalization. In short, if regulators such as the commissioners of administrative agencies like the SEC and CFTC that oversee SROs, are politically blamed whether or not they are involved directly in regulating a failed entity, then they will necessarily prefer a greater direct role in regulating the entity in question. There are several reasons why this might be true.

For one, greater control may mean less risk in the eyes of the ultimate accountable authority. The presence of agency costs means that the principal regulator (*e.g.*, the SEC) will be concerned that its agent (*e.g.*, FINRA) will act in a way that maximizes the agent's welfare instead of the principal's. Therefore, the principal will take steps to ensure alignment, including monitoring, incentives, and punishments; the agent may also take steps to prevent excessive involvement by the principal, in the form of various bonding mechanisms. All of these dynamics will increase as the expected costs of regulatory failure (crudely, the probability of failure times the costs of failure) increase. In other words, a greater potential downside will cause the principal to spend more time and money monitoring the agent to ensure faithful agency. Even so, when the ultimate authority for failure resides with the principal and not the agent, the locus of decision-making authority will also eventually shift to the principal as well. The more the blame falls on the principal, the more control it may seek to exercise.

This migration is the insight of economist Kenneth Arrow, who described the tradeoff between accountability and authority, noting that accountability

> must be capable of correcting errors but should not be such as to destroy the genuine values of authority. Clearly, a sufficiently strict and continuous organ of [accountability] can easily amount to a

> denial of authority. If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.[136]

Accountability and authority are in tension, and the more one party bears the costs of failure, the more that party will assert its authority.

The MF Global story told above may provide support for the existence of this factor as well. MF Global was overseen by numerous regulators in the various different parts of its business, none of which was responsible for the firm's entire business.[137] But when MF Global declared bankruptcy, it was the CFTC that received most blame. Members of both parties repeatedly grilled CFTC Chair Gary Gensler and other agency officials about the missing $1.6 billion. Though of the actual locus of regulatory failure may have been elsewhere – or, indeed, nonexistent – the political pressure landed most heavily on the CFTC. Accordingly, the CFTC exerted its authority to take command of the investigation of the incident, which had previously been conducted by CME, which was MF Global's most direct, though not sole, regulator. CME's executive chairman, Terrence Duffy, described the process this way: "In November, the CFTC requested that CME Group not conduct its own investigation, but rather take part in the agency's inquiry, and since then we have worked together closely."[138] The implication here is clear: if CFTC is going to be hauled before Congress to face the risk of

[136] KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 78 (1974).

[137] According to media accounts, "MF Global had nearly a half dozen regulators policing various parts of the firm, but no single regulator was responsible for the whole company." Christopher Doering, "MF Global Triggers Regulatory Rehink at CFTC," REUTERS (Feb. 1, 2012), available at http://www.reuters.com/article/2012/02/01/us-mfglobal-cftc-policy-idUSTRE8102IV20120201/.

[138] Terrence Duffy, "CME Chief Speaks Out on CFTC Inquiry," NYTIMES DealBook (Jan. 11, 2012), available at http://dealbook.nytimes.com/2012/01/11/cme-chief-speaks-out-on-c-f-t-c-inquiry/.

statutory revision or budgetary pressure for this perceived failure of regulation, then the CFTC is going to exert greater control over the regulation. As noted above, the CFTC is currently studying how to do precisely that.

6. Public Choice I: The Regulator

Public choice theory suggests that the governmentalization of financial SROs may also arise as consequence of political pressures involved in the allocation of regulatory authority. Assuming a regulator is interested, at least in part, in maximizing its own authority and power,[139] then its first preference would be for direct control of the regulated entities. This arrangement, however, may not be possible for a variety of practical reasons having to do with congressional preferences about the efficacy of self-regulation or the agency in question, the path dependence of the industry's development, budgetary issues, or other factors.[140] As trading volumes have grown enormously (from an average of about 300 million shares per day in 1990 to more than 10 billion shares per day in 2011),[141] for instance, regulatory budgets and resources have not kept pace.[142]

Accordingly, the agency's second-best option would be for the ability to exert greater control over its subordinate SROs. This expanded reach would expand the agency's control over an industry in which it may have certain rulemaking authority already. For instance, substantial SEC resources are spent in

---

[139] Such as though the scope of its oversight, its budget, and so on.

[140] The recently proposed legislation to create a new SRO for investment advisors could be an example of this. See Mark SChoeff Jr., "Bachus bill backs SRO for RIAs – and it could be Finra," INVESTMENT News (Apr. 25, 2012), available at http://www.investmentnews.com/article/20120425/FREE/120429948. Although the SEC might prefer to increase its regulatory authority, it may realize that practical constraints, such as politics or budgetary pressure, may limit this option. The SEC may realize this and get a second-best outcome by supporting SRO it is confident it can capture.

[141] See http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/CM-US-Key-Stats-SIFMA.xls

[142] According to the SEC, its expenses have increased from about $285 million in 1995 to about $1 billion in 2010. See http://www.sec.gov/foia/docs/budgetact.htm.

overseeing FINRA and its direct regulation of the securities industry. In addition, over time the agency may be relatively confident that it could expand its influence further by exercising greater authority over the SRO. For instance, although the blame for failures such as the Madoff often falls on the SEC, those occasions also provide the agency with openings for greater direct and indirect control over investment advisors. We are, of course, considering a public choice story. The regulatory agency, starting from a position of limited control, may use soft power to exert more and more authority.

The history of the securities SRO offers a good example of how the locus of regulatory control can be calibrated to reflect prevailing political views of the time. When the securities SRO was officially given the government imprimatur by the Maloney Act of 1938, SEC authority over the SRO – then still the NASD – was comparatively weak. For example, the NASD (and the SRO of the NYSE Exchange) promulgated their own rules, without much SEC review. This arrangement was the tradition for decades. But after the back-office scandal of the late 1960s, Congress increased SEC authority by adding section 19(b) and (c) to the Securities Exchange Act of 1934, providing that the SEC must approve all SRO rule changes and may "abrogate, add to, and delete from" any SRO rules.[143] Then after another scandal in the early 1990s involving industry price fixing, the SEC received more oversight of the SROs, involving authority over substantive changes to membership, governance and various rules and procedures. These are just two examples of the way in which the regulatory agency in question, here the SEC, has used perceived regulatory failures to exert additional control over the SRO. This process, as described above, is commonly available, since failures are likely to happen from time to time.

[143] Securities Exchange Act of 1934, § 19(b), (c), 15 U.S.C.A. § 78s(b).

Note also that similar dynamic may be occurring at a more granular level. Not only might the SEC as an entity covet the arrogation of greater authority over its subsidiary SROs, so too might the officials working within those entities. Consider, for instance, that the current Chair of the SEC is Mary Schapiro, who was appointed to that position from her role as chief executive officer of FINRA. One can readily appreciate why high-level officers of an SRO might perceive high-level positions within the administrative agencies above them as attractive promotions. History is filled with provincial governors eager for elevation to positions within the their imperial metropolises. Of course, to earn such a promotion, it certainly helps to be perceived as willing and able to execute the sought-after office. If one wishes to become the head of the SEC, success might be more likely with a more aggressive regulatory track record, even though a lower profile self-regulatory approach might in fact be more effective or preferable for the subsidiary.

What, though, of lower-level employees within these entities, who might be more inclined to migrate from the SEC to FINRA because of higher private-sector salaries? Such movement might not suggest that those officers' goal is to make FINRA more like the SEC. But that migration would certainly be easier if the two entities were more similar to one another than dissimilar. Thus, public-choice effects at the individual regulator level also offer explanations for why self-regulatory and governmentally regulated entities would tend to converge over time.

7. Public Choice II: The Compliance Industry

Another public choice dynamic may be at work within the regulated firms themselves. If there is a powerful group within a regulated firm that wants, for its own reasons that diverge from the interests of the firm or its customers, a more governmental form of self-regulation, then it will act to enable the process of governmentalization. Certain constituencies within a firm may prefer more regulation, more strict or bureaucratic rules for a given amount of regulation, and so on. This preference may be in their interest because it enhances their personal or group interests, because it means more interesting work, more budgetary authority, more control, or for other reasons. We speculate that this dynamic may be at work in the dramatic growth of compliance departments over the past two decades in the broker-dealer industry.

Within each broker-dealer there is a group of individuals, known colloquially as "compliance," whose job it is "to supervise the day-to-day conduct of business unit activities and to have in place policies and procedures reasonably designed to achieve compliance with applicable laws and regulations."[144] Compliance typically provides the following functions: to give advice to business units about rules and regulations; to develops internal policies and procedures that help the firm to comply with external rules; to help train business personnel regarding their legal duties; to help monitor business functions for compliance with legal rules; to conduct internal investigations; to handle licensing and registration of business professionals; to manage relationships with regulators; and so on.[145] In all of these functions, the role and importance of compliance, as a stand-alone function, is greater the greater the amount of external regulation. Moreover, holding the amount of regulation constant, the more intense, complex, bureaucratic, and adversarial the regulation, the greater the need for effective compliance. In other words, whether compliance personnel are designing training programs, offering advice to business units, or handling internal audits, their importance within the firm is proportional to the governmentalness of the external regulation.

[144] See SIFMA white paper: http://www.sifma.org/uploadedFiles/Societies/SIFMA_Compliance_and_Legal_Society/Role_of_Compliance_White_Paper%20(2).pdf at 1.

[145] Id. at 3-6.

Where the regulation is aggressive, high risk, adversarial, and "other" in a sense, compliance is a more vital function than when the regulation is less so. Compliance experts are generally relied upon more under government regulation rather than self-regulation.

Notwithstanding this implicit preference for more governmental-like regulation, compliance operates within a firm, and therefore must operate within the constraints set by the firm. In other words, firms may recognize this tendency and exert pressure for compliance to be structured and act in a way that privileges the interest of the firm (which may be for more self-regulatory regulation) over the interests of a particular department.

For several reasons, compliance departments may be successful at breaching their firms' constraints in the long term. First, compliance professionals are typically siloed in the organizational structure from the rest of their business to ensure that business interests or short-term profit motives do not corrupt the firm's internal regulatory processes. One industry white paper, for instance, describes as a best practice "separating Compliance Department functions from the supervisory functions of line managers, as well as distinguishing the roles of the Compliance Department from other control functions."[146] The logic here is powerful, since the overlap of regulated and regulator in a particular firm may give the firm less credibility with external regulators in the event of an investigation of the firm. Note, however, that the compliance subcommittee of the industry trade group, called SIFMA, wrote this white paper. As such, this position might simply be an effort by the compliance professionals to entrench their interests and to protect themselves from the scrutiny of the broader business. In either case, compliance is isolated and viewed as a stand-alone department. From such a position,

---

[146] Id.

compliance may be able to define and to exert its interests more easily than integrated departments within a firm. If compliance heads in a direction the rest of the business finds troubling, the ability to control it may be limited by concern about interfering – or appearing to interfere – with legal obligations.

Second, the actions of compliance are likely difficult and costly for business managers to monitor. Compliance is largely a legal function, and typical business managers in a broker-dealer do not possess similar training or experience. Compliance employees may use their specialty knowledge, the unique nomenclature and patois of law, as well as unfamiliarity with legal process to insulate their work from rigorous business oversight. The mantra of compliance professionals – to create and foster a "culture of compliance" – is consistent with this account. "Culture" is a particularly malleable and powerful explanation for a range of activities. Any pushback on a "culture of compliance," as defined *by compliance*, can be countered with concerns about legality and a FINRA rulebook that is, as of the 2012 printing, 1374 pages of 8 point font.

Such factors as these might still not permit an overly independent compliance department, however, if business managers of broker-dealers found it worthwhile to invest in disciplining compliance departments. But there is little reason for a rational firm to do so. For one, the compliance departments at all broker-dealers face the same incentives to influence outsiders setting the rules of the game, and therefore disciplining only one department would likely have little impact. What would be needed is a common effort by all or a critical mass of broker-dealers, which would be difficult to organize and perhaps subject to antitrust constraints.

Another reason firms are unlikely to try to counter the move toward greater complexity and governmentalization is that all similarly situated broker-dealers face the same increased cost as a result of the change, and therefore no individual broker-dealer would reap any advantage from halting the trend. All other firms would benefit freely through such efforts, and therefore no firm has an incentive to invest in countering the push because of the free-rider problem. Instead, broker-dealers reasonably may perceive increased compliance costs as an industry-wide tax, which they can likely pass on to their customers. Any such burden applies to every broker-dealer, and broker-dealers have a monopoly on executing stock transactions. So long as the firm keeps compliance costs within the range of competitive firms, there is no business disadvantage, no matter how much compliance costs.[147]

One final point is worth mentioning. For large broker-dealers, not only are compliance costs of little harm (if they amount to an industry-wide tax), but they may be valuable. If the compliance industry generates a demand for compliance services that has a large fixed cost per firm, then large firms can use this "culture of compliance" as a way to reduce the profit of smaller rivals or to create barriers for new entrants. Larger firms can spread any fixed costs over a larger asset base, and therefore bear any costs more easily. Assume, for example, two firms, one with 100 customers and assets at the firm of $100 each, and another firm with 50 customers with $100 each. Further assume compliance costs are $50, plus $2 per customer. In that case, total compliance costs for the first firm would be $250, and $150 for the second firm. As a percentage of assets under management, however, the first firm's compliance costs are just 2.5 percent, while the second firms are 3 percent. If the firms pass on the costs to their customer, the second firm will have to outperform the first firm by 50 basis points to offer competitive services.

[147] For another application of this argument, see M. Todd Henderson, *Justifying Jones . . .*

Another source of potential competitive advantage exists from the development of a "culture of compliance." In a business environment in which returns from investment strategies are increasingly commodified and asset managers have greater difficulty differentiating themselves, regulatory adroitness can itself be a source of competitive advantage. Perversely, for firms that are particularly expert at compliance, the larger the burden and complexity of regulation, the better. A firm with a 10 percent cost advantage on legal compliance can differentiate itself more if compliance costs are, on average, $1000 per firm rather than if they are merely $100 per firm.

Importantly, this observation does not imply or require any conscious plan on the part of any individual. The process by which interest groups protect their interests, expand their influence, and pursue goals narrowly, while being integrated into a larger whole is well described in the public choice literature, and it does not require deliberate action. Rather, these developments may occur unintentionally in a manner difficult to observe or to counter in any individual case, but with substantial consequences nevertheless.

Anecdotal evidence about the compliance industry corroborates such observations. Compliance as a separate function began in the 1960s.[148] (Before this time, compliance with rules and regulations was the responsibility of each professional broker. Although this is still true, the responsibility is now shared with a separate department focused entirely on rules.) Over the next three decades or so, the compliance industry remained relatively small, with even the largest broker dealers employing only a few individuals devoted to a separate compliance function. In part, this kind of slow growth can simply be explained by a rise in the size of the typical firm and

---

[148] Id. at 1.

the increasing complexity of its operations. But, according to interviews with compliance officers at large broker-dealers, starting in the mid-1990s, the number of compliance officers began to boom. At one large broker-dealer, just a handful of compliance officers worked in 1995, while today there are over 400 individuals. The timing of this explosion corresponds quite well with our account of the increasing governmentalization of the SROs for broker-dealers. The thrust of our argument in this section is simply that this temporal confluence is not a coincidence, but rather that the governmentalization has been driven in part by the private interests of "compliance" within and across firms, and that this growth creates a feedback loop in which the process of governmentalization increases over time. Putting aside issues of initial causality, once the process starts, increasing governmentalization begets more demand for compliance, which in turn fosters an interest in more rules and more government-like process. Given the importance of this feedback loop, as in other areas where feedback is important, the growth of compliance is unlikely to remain linear. And, in practice, we appear to be witnessing more explosive growth.

8. Industry Structure

A final potential influence on the nature and scope of SRO regulation is any change in industry structure. The nature of the underlying regulated industry will influence the shape of its self-regulatory structure, which will in turn influence the relationship with the government regulator. A consolidated industry structure, coupled with a single SRO is likely to lead to a different position vis-à-vis the ultimate government regulator than a more diffuse industry with multiple competing SROs. In other words, the nature of SROs is likely to reflect the fundamental industry structure.

For example, the government agency may enjoy more control over a single SRO, since it can devote all of its attention to it; the government agency might have more at stake if there is a single SRO, and therefore exert more influence on it; the government agency and the single SRO might work more closely together, and therefore the SRO might come to look more governmental; and so forth.

On the other hand, one can imagine that with fewer options for exit to different SROs, and therefore a greater stake in the policies of a single SRO, industry members might have a greater stake in optimizing the SRO's policies to meet their needs. While one might think this influence would be in the direction of a more pure *self*-regulatory model, the discussion above suggests this is not necessarily true. For instance, the public choice analysis of the compliance industry suggests that even firms that might otherwise prefer an SRO model ab initio might come to prefer a QGO over time. Although without more it is not entirely clear which way a change in industry structure cuts, combined with the factors mentioned above, consolidation is likely to lead to greater governmentalization.

Over the past several decades there has been significant consolidation in the securities and commodities industry. While a full description of this history is beyond the scope this paper, the point can be made with some basic facts. There has been consolidation of the major stock exchanges, with the New York Stock Exchange, NASDAQ, and CME Group buying rivals and building international dominance. The SROs have consolidated as well, with the most prominent example being the combination of the NASD (the regulator for over-the-counter securities transactions) and the SRO of the NYSE merging in 2007 to create a single securities regulator known as FINRA.[149] A final example of this trend is the recent congressional command in the Dodd-Frank Act that certain derivatives transactions be conducted on

[149] *www.sec.gov/rules/sro/nasd/2007/34-56145.pdf*

centralized clearinghouses.[150] In all these cases, the trend has been toward more consolidation and centralization, which has the effect of pushing towards a more governmentalized approach to self-regulation, under the reasonable assumptions described above.

B. Implications for Other SROs

The mechanisms that transform SROs into QGOs are not necessarily applicable in every case nor can they be applied mechanistically. The facts and circumstances for particular industries and SROs will determine whether particular mechanisms influence the nature and scope of regulation, whether a mechanism or combination of mechanisms transform an SRO into a QGO, and how quickly any such transformation will occur.

In the commodities industry, for instance, we have described some instances in which governmentalization seems to be occurring, but there may be other factors at work that do not support or even counteract such a transformation. For instance, while the securities business has become a more retail business in which larger numbers of average individuals are betting greater amounts in an intermediated way, the commodities and derivatives markets do not clearly reflect a similar evolution. Obviously, derivatives have seen huge recent growth: the total value of all derivatives rose from $5,737 billion in 1990 to an astonishing $687,811 billion by 2009.[151] But there is no good evidence to suggest that retail investors have driven this growth, as they have in the case of equities. This difference might suggest less pressure to move to a QGO model in derivatives.

Of course, the commodities industry's dramatic increase in size, alone, might suggest more systemic

[150] See Silla Brush, "CFTC Proposes Swaps Clearing Determinations Under Dodd-Frank," BLOOMBERG (Jul. 25, 2012), available at http://www.bloomberg.com/news/2012-07-25/cftc-proposes-swaps-clearing-determinations-under-dodd-frank-1-.html.

[151] See Federal Reserve Board of Governors, Survey of Consumer Finances (SCF), available at http://www.federalreserve.gov/econresdata/scf/scfindex.htm (page 98).

risks, which may in turn generate more demand for government-like regulation. The Dodd-Frank Act's treatment of derivatives is perhaps one an example of this sentiment. In addition, a lesson of the 2008 financial crisis may be that average investors are not the only ones who may need the protections of law, and thus merely the growth of the industry may be a factor favoring a more governmental approach to regulation.

Another element to consider is the relation between the evolution of various SROs across industries. The evolution of the SRO in the securities industry from SRO to QGO might, for instance make a similar change in the commodities industry more likely. If FINRA is a viewed as a model for SROs, as its prominent position among them sometimes suggests, then as it changes, so too might other financial SROs. For instance, if an SRO in another industry, such as commodities or derivatives, experiences a regulatory failure, whether or not the SRO was efficient ex ante, then the baseline comparison in terms of regulatory approach will be with other leading SROs, like FINRA. Again, perception here may matter more than the provable linkage between structure and outcomes. Further more, as FINRA becomes more like the SEC, the agency may use that transformation as an example for other financial industries to follow.

Based on our conjectures, we believe that the process of governmentalization is likely for other financial SROs. Of course we cannot be certain when such a transformation will happen, how fast it will occur, or what the primary impetus will be for the change, but our prediction is that these factors are a powerful influence on financial SROs.

IV. Implications of Increasing Governmentalization

In the previous two sections of this article, we first detailed the phenomenon of a growing governmentalization of financial self-regulatory organizations and then explored the mechanisms that appear most responsible for that transformation. In this section, we consider the implications of increasing governmentalization of the SROs in our federal administrative structure.

Certainly, in light of the performance and popular depiction of the U.S. and global financial markets over the past several years, some commentators may welcome any development that appears to increase the power of financial regulators, no matter what form it may take. There is no shortage of critics of financial regulation generally and self-regulation specifically, many of whom prescribe just such a greater role for governmental actors.

Indeed the new millennium's opening decade featured a series of high-profile financial scandals and failures: from the hangover of the bursting dotcommery to the Enron and WorldCom accounting investigations to mutual fund market timing allegations to the mortgage meltdown and its accompanying 2008 global crisis. Each of these cycles fostered public handwringing, prosecutorial investigations, and federal regulatory responses. Following several decades in which the original four securities statutes of the Great Depression dominated the legal landscape, the past ten years alone has given rise to several new landmark laws: Sarbanes-Oxley, Dodd-Frank, and the JOBS Act. State financial regulators, too, have grown increasingly active in their investigation of financial dealings: then-New York Attorney General Elliot Spitzer gained renown as the Sheriff of Wall Street; today, his successor, Eric Schneiderman is investigating major financial institutions for their role in the mortgage debacle.

Given this widespread and popular support for new investigations, new legislation, and new regulations to police financial behavior, we would fully expect at least some constituencies to applaud any increased governmentalization of financial self-regulatory organizations. In fact, to the extent some commentators may have believed SROs to be intrinsically feeble institutions dominated by their members, this development may appear simply to be the necessary and obvious corrective to an inept original design.

But we urge caution about the increasingly powerful and governmental SROs. The implications of this evolution are troublesome, no matter what one's disposition towards the regulation of financial markets. Certainly, those who would prefer fewer governmental constraints upon the financial markets are necessarily going to be disappointed with a significant increase in those constraints. But even those who welcome new financial legislation should not embrace greater SRO governmentalization as a self-evident good without considering what will be lost by the de facto elimination of true self-regulation in our financial markets.

We see at least three significant concerns with ever-increasing govermentalization. First, the loss of self-regulation prompts a recollection of what the benefits of self-regulation are and why, indeed, why the financial SROs were established in the first instance. In a similar vein, Congress had compelling reasons to permit self-regulation to co-exist with – rather than to be replaced by – governmental regulatory authorities such as the SEC and CFTC. Second, commensurability in our system of regulatory authority is a compelling consideration: there are persuasive reasons to deploy softer power on some occasions and in some settings, rather than always to unleash the full power of the state. Third, conversely, when every organ of our regulatory structure is imbued with the full authority of the state, then those citizens and institutions subject to that authority must be constitutionally entitled to the well-established panoply of protections that our democracy has long insured to check state authority.

A. Losing the Benefits of True Self-Regulation

If financial SROs fully transform themselves entirely into governmental organs, then self-regulation in those spheres will be rendered extinct. Any gains that governmental financial authority brings will, therefore, be offset by corresponding and potentially greater losses from the elimination of one of the financial industry's oldest tools. As lessons from biodiversity, drug-resistant diseases, and one-party rule teach, systems as complex and multivariate as the U.S. economy rarely benefit from a reduction in their diversity. One size almost never fits all, so caution should accompany any elimination of additional potential methods of control. As much as anyone might dearly enjoy chocolate, for instance, the perils of genetically modifying every plant into a cacao tree are readily envisioned. If more governmental control of our financial system is desirable, the devices are already in place – through existing regulatory agencies – to ratchet up that control. By converting structures that were not designed to operate as governmental actors, the unique attributes of those SROs that enrich the overall compliance landscape will be jettisoned. Indeed, the creation and preservation of SROs itself bespeak faith in their virtues. There are good reasons why SROs were originally given their jurisdiction, and they should be considered at a time when SROs may be facing termination by transformation.

Perhaps, however, one might contend that SROs have always been a compromise and that any creation of an SRO necessarily constituted a concession to overweening industry power. Self-regulation, in such a view, is in fact the absence of any regulation and is evidence that the particular industry successfully rebuffed any oversight of its activities. One would, in essence, be arguing that all financial operations ought to be overseen by entirely governmental regulatory agencies and that anything other than such oversight is an impotent alternative secured through political power and impure motives.

The compelling affirmative attributes of self-regulation must therefore be considered, as these attributes will be abandoned in a bailiwick patrolled by only governmental or quasi-governmental authorities. As a first principle, self-regulation evokes the rich tradition of order without (or with minimal) law, explored and extolled in the work of Robert Ellickson and Lisa Bernstein. We explore several of those benefits here.

1. Industry Expertise

Perhaps the greatest single benefit that self-regulation possesses over other forms of regulation is its access to direct industry expertise. By capitalizing on the participation of industry players, a financial SRO can enjoy a greater degree of information and experience about the way in which financial transactions are actually performed in today's incredibly sophisticated and specialized economy. Governmental actors, on the contrary, may be so far removed from day to day operations in this industry that their knowledge of financial practices may either be too theoretical or too outdated.

Indeed, one of the chief criticisms that emerged from post-mortems of the 2008 financial crisis was the fact that governmental regulators were woefully ill equipped to understand – let alone to monitor and to regulate effectively – the complicated financial machinations involved in, for instance, synthetic collateralized debt obligations. By more readily drawing upon the expertise, experience, and information of the regulated, SROs can reduce false-positive and false-negative error costs and thereby reduce dead-weight losses from erroneous punishment.

At some level of our overall system, we must be able to gather information on how finance is actually practiced in our global economy. By converting SROs into something else, we risk losing one of our only links to this reality and becoming even more ignorant of the state of the art in financial engineering.

2. Trust between the Regulating and Regulated

As any prosecutor knows, it is far easier to negotiate with and to monitor the actions of parties who share a degree of trust. When an SRO's membership and leadership truly represents industry participants, that trust will be a natural outgrowth of the familiarity the participants have with one another. The members of a community are likely to have greater trust of each other on specific issues than does the general polity at large. This trust will lead to greater common ground on issues such as the efficiency and justice of particular rules, therefore resulting less disagreement or deviation from expected behavior.

Where local compliance is possible without compulsion, the costs of governance are reduced. Conversely, when an entity charged with regulating and enforcing rules is staffed with people who report to the nation's political capital, the distance between the regulator and the regulated grows quickly.

3. Efficient Enforcement

With expertise and trust naturally comes efficiency and savings in the cost of operations. When regulators know more about how a system actually works, they will be less inclined to waste resources educating themselves or making errors in regulation. Similarly, if the regulated parties have faith in those who regulate them, they may be less inclined to challenge the process at every turn, to mount full-throated defenses, or to expend vast resources in checking the actions of the authorities. SROs, then, are well understood to police a far broader swath of activities at comparably much lower cost.

Similarly, private law is less costly to create and to enforce in many situations. Almost by definition, the members of a smaller community, such as a particular industry or even an individual firm, are likely to share a greater alignment of interests and to be more homogeneous along the dimension in which private law acts.

4. Regulatory Subsidiarity

The values of benefits such as these are often considered in the design of large political systems, such as the European Union and the Catholic Church, and have long been celebrated through the theory of subsidiarity. That theory posits that power should devolve to the lowest institution that is competent to exercise it. Through such a federalist process, authority is kept as close as possible to the constituency that is being governed.

Private laws, whether they are designed for a family, a firm, or an industry, can be tailored by knowledgeable regulators to meet the particular local circumstances. Government rules, by contrast, more typically embody a one-size-fits-all nature, and therefore have the potential to be overinclusive, underinclusive, or both. For instance, a rule requiring boards of directors to be a particular size or bed time to be a certain hour might be optimal on average, but deviate wildly from optimality in the majority of actual applications. Private law imposed via subsidiarity may permit greater opportunity for individual firms or families to achieve their best local arrangements in ways that improve the total social welfare. Sometimes these rules might be broader than governmental law—as in university rules prohibiting various forms of "hate" speech—and sometimes narrower—as in private associations that advocate certain types of religious or political viewpoints unpermitted in government settings. This tailoring principle is essentially the theoretical underpinning of federalism. But, government can only be so narrowly tailored, given the costs of creating and deploying governmental decision-making.[152]

[152] For instance, the optimal speed limit likely differs *by driver*, but this is (currently) deemed too costly, so local authorities set speed limits by road section, subject of course to federal oversight and to prosecutorial discretion

B. Losing the Commensurability of Regulation

Comprehensive mosaics of interlocking oversight are richest when they most effectively calibrate their enforcement to the relevant infractions. In our political system, we typically prefer traffic wardens to issue parking tickets, SWAT teams to resolve hostile domestic scenarios, and the military to defend our national interests abroad. Our multilayered system of democracy would suffer gravely from the deployment of armed forces to enforce the minor ordinances that govern our quotidian activities.

Similarly, SROs that are truly self-regulatory can enrich the web of financial regulation by operating as the constables on patrol, carrying relatively minor tools to handle lesser infractions with lower stakes. Their elimination jeopardizes the ability to oversee minor financial infractions with an appropriately commensurate response. If the only possible reaction to a financial transgression is the full force of the federal government or its quasi-governmental equivalent, we should expect unfortunate consequences.

First, such an overreaction obviously risks alienating the governed from their governors. Citizens – or financial firms in the case of financial SROs – will quickly lose confidence in the judgment of a system that cannot discriminate between major and minor problems. To the extent that participation in SROs is voluntary – if not technically then culturally – rational members of SROs will withdraw to the maximum extent possible from such an out-of-touch enforcement system. If even the most minor of compliance errors can escalate into federal enforcement actions, then financial firms will be hard-pressed to treat their SROs as anything other than prosecutors who must be repelled with the maximum legal protections available.

---

vested in the highway patrol.

Second, if financial firms are forced into a defensive crouch and to don legal armor for every compliance issue, then the costs to regulation are likely to increase. In such a hostile dynamic, there will be no such thing as informal enforcement. Just as mobilizing the military to enforce speeding tickets would consume vastly more resources than the occasion warrants, turning every opportunity for financial compliance into a battle between federal regulators and private law firms will also require greater resources. Of course, if greater resources are used, then fewer compliance matters can be addressed for the same budget, resulting in the ultimate undesired consequences: increasing the governmentalization of regulatory organizations could lead in a material decrease in regulatory oversight.

Another irony that might flow from the full governmentalization of SROs could be the realization subsequently that true self-regulation allowed for broader and more efficient regulation. Thus, our system would attempt in future to reinvent what it had in the past: an industry-based partnership to monitor low-level compliance issues. But, of course, establishing a new and trust self-regulatory absence after a wave of governmentalization would come with substantial cost and effort.

C. The Need for Mandatory Constitutional Protections

Academic commentators and courts have already noted that the phenomenon of increasing governmentalization of SROs is creating constitutional problems in the regulatory state. As SROs increasingly wield the power of the federal government, so too must they be restrained by constitutional checks on their authority. That is, if members of SROs may be deprived of liberty by an organization that is acting under the color of governmental power, then they must also be protected by the constitutional mechanisms that ensure liberty in our political system. Maintaining this constitutional balance as SROs grow evermore governmental will require modifying our jurisprudence and, simultaneously, also add to the costs of this modified system of regulation.

Scholars such as Roberta Karmel have noted that FINRA's "increasingly government-like functions and operations raise the question of what checks and balances and due process procedures are necessary for such an SRO to have constitutional law accountability and administrative law legitimacy."[153] Although there has been some dispute about what functions of SROs may constitute government-like activity, there is broad consensus that any activities that are government-like do in fact trigger the need for constitutional protections.

Perhaps the threshold constitutional issue that arises from SROs transmogrifying into governmental entities is the consequence that such SROs might enjoy immunity from suit. Indeed, Karmel concludes that "it would appear that FINRA will not have too much difficulty claiming immunity for its activities which would appear to be primarily, if not entirely, adjudicatory, prosecutorial or regulatory."[154] Obviously, that sort of immunity would greatly alter the relationship between the organization and its members, very much to the latter's detriment.

But, on the member's side of the ledger, they might increasingly be entitled to Fifth Amendment pleas in response to SRO requests for documentary or testamentary evidence. Naturally, the reticence of members to cooperate with SRO investigations will obviously hamper investigations of wrongdoing.

To the extent SROs are governmental entities, then the targets of their enforcement actions would also enjoy due process rights that could prove counterproductive to the SROs. If every entity subject

[153] Roberta S. Karmel, Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?, 14 Stan. J.L. Bus. & Fin. 151, 154 (2008).
[154] Id. at 177.

to FINRA oversight were entitled to the full panoply of rights to notice, to statements of the charges against them, to full representation by counsel, to appeal, and so forth, then once again the costs of operating in this mode will increase for SROs. Indeed, Karmel concludes that such developments "would probably ossify the work of the SROs and would not necessarily be useful."[155]

Of course, the transformation to governmental status does not affect only the regulated but also the regulator. SROs that become true government agencies must themselves abide by the arcane and bountiful regulations that govern such entities. That is, they would need to abide by regulations that constrain the ways in which they hire personnel, compensate their employees, and conduct their operations because of the applicability of laws such as the Freedom of Information Act and Administrative Procedure Act. In short, SROs cannot indulge themselves of the attractive aspects of greater power over their subjects without themselves becoming entangled in the web of chains that keep us free.

D. FINRA Rule 2010: An Example

The most powerful and most commonly invoked FINRA rule is also perhaps the most vague. Rule 2010 provides simply: "A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."[156] Every violation of any other FINRA rule is almost by definition also a violation of Rule 2010, which raises the question of why the rule exists.[157] One practical answer is that rule operates to capture conduct that

---

[155] Id. at 186.

[156] FINRA Rule 2010. Standards of Commercial Honor and Principles of Trade, available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=5504 (formerly NASD Rule 2110).

[157] *Frank Thomas Devine*, Exchange Act Rel. No. 46746, 202 SEC LEXIS 2780, at *21 (Oct. 30, 2002).

cannot be efficiently or easily proved to violate another rule, but that FINRA believes is worthy of sanction.

Rules have necessary elements (such as, intent or scienter or the existence of a particular fact) that require proof, and FINRA rules are subjected to legal constraints by the SEC and federal courts. Accordingly, if FINRA alleges a broker engaged in "manipulation" of securities prices or illegal "churning" of a client's account, FINRA must prove by a preponderance of the evidence that all the elements of manipulation or churning are satisfied. This prosecutorial burden is disciplined by the fact that any member can appeal a FINRA adjudicatory outcome to the SEC, then to the federal courts, and even to the Supreme Court.

Proving all the elements of other rules, such as those proscribing manipulation, is costly and may be difficult in the brokerage context because of the ambiguity between desirable/legal conduct and undesirable/illegal conduct. Manipulation is a good example. Although it is a widespread belief that brokers are capable of manipulating prices, and that their doing so would be a bad thing for investors, drawing the line between manipulation and more benign trading is exceedingly difficult. Courts have struggled to develop workable definitions,[158] and academics have wondered whether any precise definitions are possible.[159] But, FINRA members charged with overseeing the discipline of other FINRA members possess an informed experience, which allows them to identify acceptable and unacceptable trading behavior at a more impressionistic level. Proving "manipulation" may be difficult, but brokers can fairly easily distinguish between good and bad broker behavior in a particular case.[160]

158

159 See Daniel R. Fischel & David J. Ross, "Should the Law Prohibit 'Manipulation' in Financial Markets?," 105 HARV. L. REV. 503 (1991).

160 The best analogy here is Justice Stewart's definition of obscenity –"I know it when I see it"—in *Jacobellis v. Ohio*, 378 U.S. 184 (1964) (Stewart, J. concurring). The problem

In such cases, Rule 2010 demonstrates its prosecutorial appeal. The rule allows members appointed to discipline other members to levy penalties against brokers who engage in socially undesirable conduct, which might otherwise be too difficult or costly to prove violates other, more specific rules. A general, ethical rule like this is especially important because brokers with knowledge of other specific rules can use the specifics as a roadmap to facilitate evasion. In other words, the vagueness of Rule 2010 is its power, in that it lowers monitoring and enforcement costs, as well as provides a broad net to catch bad brokers who would escape punishment in a more formalistic environment.

Importantly, a vague, ethical rule like 2010 may be peculiarly within the power of a SRO to use. To tolerate the use of such a powerful and ill-defined rule, members must have faith that the discretion it grants to those sitting in judgment will be exercised wisely. Behind the veil of ignorance, self-regulated brokers might be more likely to agree to be bound by such a rule than if the discretion were to be exercised by non-industry members, such as government agents. Reciprocity might potentially constrain abuse, and brokers might have greater faith in the expertise of industry members. Whatever the reasons, the loss of a powerful ethical rule would increase monitoring, enforcement, and adjudication costs, as well as the possibility of greater social losses in the event that more undesirable conduct will occur.

William Douglas made a similar point in his famous speech to the Hartford Bond Club noted above. As Douglas described it, some undesirable conduct is "too minute for satisfactory [government] control" and some unethical conduct is lies "beyond the periphery of the law," such that it can be reached only by self-

with such vague definitions in specialized areas is that their application by generalist judges may produce uncertainty in the minds of primary market participants, which results in increased costs.

regulation.[161] Rule 2010 is an example of this kind of powerful, extra-legal rule, the absence of which might undermine the efficient enforcement of broker behavior.

V. ALTERNATIVE FUTURES FOR SROS

If the increasing governmentalization of SROs is a problem, then what possible means might be deployed to halt or to reverse the unwelcome progress of this mutation? At least three different approaches might be worth considering: directly overturning regulatory interventions; indirectly addressing the mechanisms that have led to those regulatory interventions; and cultivating new mechanisms that may tend to produce more independent and self-regulatory SROs.

A. Reversing the Series of Regulatory Interventions

First, one might attempt to reinstate the "self" in self-regulatory organizations simply by imposing independence by fiat. That is, the Congress or the relevant administrative agencies could, respectively enact legislation or promulgate regulation that insulates financial SROs from governmental oversight. In essence, this step would involve repealing those incremental measures adopted (and set forth in Section II above) over the past few decades that have most decisively pulled SROs into the governmental orbit. So, for instance, the composition of SRO governing boards could be revised to allow a greater representation of the industries themselves. Similarly, the mechanisms by which agencies currently approve or disapprove of regulations and enforcement actions of SROs could be formally severed.

While this approach is direct and would likely achieve the most immediate de-governmentalization of SROs, it suffers for ignoring the cause and effect of the changes in SROs. As we have shown in this article, a variety of mechanisms has evolved to generate the

161 See SELIGMAN, TRANSFORMATION OF WALL STREET, *supra* note 6 at 186.

increasing governmentalization of SROs – any attempt to alter the product of those mechanisms could simply be reversed once again by the inexorable workings of those mechanisms in future.

If the political will is not available for these direct measures, as our survey of the mechanisms producing greater governmentalization suggests, then a deeper approach will be necessary.

B. Halting the Mechanisms of Governmentalization

A second approach, therefore, would be to attempt to effect change at the level of the particular mechanisms that we have described in Section III of this article. Of course, this technique would require a broad variety of efforts, put forth in some unknowable combination, in order to achieve a satisfying result.

Certain mechanisms, of course, may simply be beyond any regulatory remedy. The increasingly individualistic nature of investors in the financial markets together with their increasing exposure to greater losses, for instance, are profound changes being driven by massive paradigm shifts in our retirement system. As employers, both public and private, adopt defined contribution plans in the place of defined benefit plans, we will continue to see fewer professionally managed pension plans and greater numbers of individually managed retirement accounts. A few prototypes have recently emerged, however, that might reverse this development. In one such example, retirees in California are voluntarily enrolling in private plans that mimic the organizational structure of pension plans: that is, participants can combine their private accounts into a greater plan, managed by professionals, to take advantage of economies of scale and expertise. To the extent these pilot programs expand, they could reduce the direct exposure of individuals to loss and thereby reduce the need – or perceived need – for greater governmental control over financial regulation.

The one-way ratchet mechanisms are extremely difficult to counteract, inasmuch as they appears to be driven by psychological heuristics and biases that give greater attention and weight to failures than to successes. Since those failures are almost always more salient to investors, the media, and governmental authorities, it will be difficult to prevent authorities from overreacting to them. Of course, these sorts of overreactions are common across the law, whether it be shark bites, terrorist attacks, or disease outbreaks: authorities regularly have their cost-benefit analyses challenged by rare but dramatic events. One measure that can be deployed to counter these effects is, however modest, to draw attention to them. A great deal of recent psychological literature attempts to counter deleterious financial decisions primarily by alerting people to those choices, in the hope that greater awareness will dampen those effects.

To the extent that individual regulators or entire compliance industry's appear to be arrogating power to themselves by promoting more governmental regulation, certain steps can be taken. First, prohibitions on the revolving door between industry and regulation attempt to address this process at the individual level. Perhaps disclosure measures can be introduced to compute the additional number of compliance professionals that any new regulations will require. Publicizing this number might draw attention to the ways in which increasingly governmental regulation benefits the compliance industry.

C. Cultivating Regulatory Competition

A third approach would be to try to foster a market solution to the problem. If the number of SROs operating in any particular financial sector could be increased, then the dynamics of competition might work to produce something closer to an optimal blend of "self" in self-regulatory organizations. If any one SRO were to grow too governmental for the tastes of its constituency, then that organization would lose market share and thereby be disciplined into altering its approach. Competition, of course, requires more than one SRO in any given field. Unfortunately, the costs of establishing SROs are high and, indeed, possibly prohibitive without governmental subsidy. According to a report by Boston Consulting Group, the start-up costs of creating a new SRO might be as high as $300 million. Indeed, the investment advisory industry is currently resisting the creation of an SRO in some part because of the financial burden such a new institution would impose upon their firms. Similarly, there might be high switching costs to members that would prohibit free movement from one SRO to another, and such movement would be vital to imposing market discipline upon each SRO. Finally, there might be a dearth of expertise available to staff and manage multiple financial SROs across the economy.

If there is value to regulatory competition, then it might be worth revisiting the approval of the merger of the NYSE and NASD regulatory arms to create FINRA. Efficiency reasons, such as having a single set of rules, a single enforcer, and so on, justified the merger, and these are likely real and significant. But there is an offsetting cost to the consolidation that might have been underappreciated at the time. If we are correct that there FINRA is becoming increasingly governmental in its regulatory approach, and if the costs of this change cannot be checked by an alternative source of regulatory oversight, then we can be less confident in the efficiency of the regulatory model. If a regulator becomes inefficient, for whatever reason, and the regulated have the choice to switch regulators, this provides a check on regulatory overreach. (This is a race-to-the-top story of regulatory competition, which is not the only possibility.) We cannot be confident that the problem we've identified in this article would be sufficient to warrant undoing the creation of FINRA, and we are certain the political will to do so now is lacking. But if the governmentalization of FINRA continues, and some change is necessary, going back to multiple broker SROs might be an option worth considering.

But the impediments to increasing competition amongst SROs domestically do not necessarily rule out all possible sources of competition. As we have seen in other financial areas, international markets are a broader source of regulatory arbitrage. If a greater array of SROs is desired but unaffordable within the United States, then Congress and the financial administrative agencies should permit financial firms to choose amongst international SROs. As financial markets grow in size and sophistication in Asian and European markets, they might produce additional regulatory – and self-regulatory – institutions that might carry some of the burden of regulating U.S. entities. Of course, U.S. authorities would first have to agree to accede to the authority of those foreign institutions. We hope to have provided some rationales for reclaiming greater self-regulation of our financial markets, wherever that self-regulation can be found.

VI. CONCLUSION

In this article, we have attempted to enrich the academic focus upon self-regulation in the U.S. financial markets. Notwithstanding the enormous degree of academic output following the recent financial scandals and crises, relatively little of that work has focused upon the actual first point of contact between financial firms and regulators: self-regulatory organizations. Traditionally, Congress and the financial agencies receive greatest attention, despite the reality that self-regulatory organizations are the primary constables on patrol in this field.

Much of the scholarship on self-regulation that does exist, however, acknowledges that SROs have along certain axes adopted notably governmental traits. That work tends to consider the constitutional implications of such a development, without examining why it is occurring. We have attempted to rectify that oversight by examining why the process of governmentalization may be occurring and what it is costing us. Without understanding the mechanisms that are driving governmentalization, we will have a difficult time addressing or reversing the process. Our primary purpose, therefore, has been to explore those processes in an effort to enrich our understanding of a phenomenon that is vital to any effort to regulate our financial system effectively.

We have proposed some possible approaches to reverse the process of governmentalization in SROs, directly, indirectly, and through the use of countervailing market forces, but devising true solutions will be the charge of future scholarship.

Readers with comments should address them to:

Professor Todd Henderson
University of Chicago Law School
1111 East 60th Street
Chicago, IL 60637
toddh@uchicago.edu

Chicago Working Papers in Law and Economics
(Second Series)

For a listing of papers 1–599 please go to Working Papers at http://www.law.uchicago.edu/Lawecon/index.html

600. Joshua Elliott, Ian Foster, Sam Kortum, Gita Khun Jush, Todd Munson, and David Weisbach, Unilateral Carbon Taxes, Border Tax Adjustments, and Carbon Leakage, June 2012
601. David A. Weisbach, Should Environmental Taxes Be Precautionary? June 2012
602. Saul Levmore, Harmonization, Preferences, and the Calculus of Consent in Commercial and Other Law, June 2012
603. David S. Evans, Excessive Litigation by Business Users of Free Platform Services, June 2012
604. Ariel Porat, Mistake under the Common European Sales Law, June 2012
605. Stephen J. Choi, Mitu Gulati, and Eric A. Posner, The Dynamics of Contrat Evolution, June 2012
606. Eric A. Posner and David Weisbach, International Paretianism: A Defense, July 2012
607 Eric A. Posner, The Institutional Structure of Immigration Law, July 2012
608. Lior Jacob Strahilevitz, Absolute Preferences *and* Relative Preferences in Property Law, July 2012
609. Eric A. Posner and Alan O. Sykes, International Law and the Limits of Macroeconomic Cooperation, July 2012
610. M. Todd Henderson and Frederick Tung, Reverse Regulatory Arbitrage: An Auction Approach to Regulatory Assignments, August 2012
611. Joseph Isenbergh, Cliff Schmiff, August 2012
612. Tom Ginsburg and James Melton, Does De Jure Judicial Independence Really Matter? A Reevaluastion of Explanations for Judicial Independence, August 2012
613. M. Todd Henderson, Voice versus Exit in Health Care Policy, October 2012
614. Gary Becker, François Ewald, and Bernard Harcourt, "Becker on Ewald on Foucault on Becker" American Neoliberalism and Michel Foucault's 1979 *Birth of Biopolitics* Lectures, October 2012
615. William H. J. Hubbard, Another Look at the Eurobarometer Surveys, October 2012
616. Lee Anne Fennell, Resource Access Costs, October 2012
617. Ariel Porat, Negligence Liability for Non-Negligent Behavior, November 2012
618. William A. Birdthistle and M. Todd Henderson, Becoming the Fifth Branch, November 2012