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Self-Regulation for the Mortgage Industry

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Abstract

This Article proposes an alternative to direct government regulation of mortgage brokers: self-regulation of the mortgage industry that mimics the arguably successful self-regulation of the securities industry that has occurred over the past two centuries. Although not without its problems, self-regulation of securities brokers operates more efficiently than government regulation. For example, self-regulation allows for industry expertise to be deployed at low cost and is built on trust and reciprocity, which reduce enforcement costs. In addition, self-regulation locates power at its smallest point and encourages efficient resolution of disputes by ensuring commensurable regulatory intervention. Most crucially for the mortgage industry, self-regulation is capable of policing behavior that does not rise to the level of fraud but is nevertheless socially undesirable. This Article explores the reasons why self-regulation can be effective, as well as some of its limitations in the context of securities brokers. It then looks at its potential application to mortgage brokers, comparing the self-regulatory approach with the governmental approach taken by the Dodd-Frank Act and the Consumer Financial Protection Bureau. However effective the federal approach to mortgage industry regulation is likely to be, there are aspects of such regulation that would be better administered by the industry itself, subject, of course, to oversight by the government to protect against the cartelization threat.

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Introduction

Wells Fargo, the country's largest mortgage lender, recently paid about $175 million to settle claims that it steered more minority borrowers into riskier mortgage products than it did white borrowers with similar credit risks.[1] According to data revealed during the Department of Justice's investigation of this alleged wrongdoing, black borrowers who qualified for a plain-vanilla loan were nearly three times more likely to take out a subprime loan than similarly situated white borrowers; Hispanic borrowers were about twice as likely.[2] The Wells Fargo bankers allegedly targeted vulnerable consumers—"those with less education, without previous mortgage experience, or without fluent English"—for riskier and more expensive loan products.[3] Minority borrowers also paid more in broker fees than white borrowers: in 2007, for instance, black and Hispanic borrowers in Chicago paid between $2,000 and $3,000 more in broker's fees (on $300,000 loans) than similar white borrowers.[4]

More generally, the use of riskier mortgage products expanded dramatically during the housing boom of the early 2000s. From 2000 to 2006, the number of borrowers who qualified for conventional mortgages but nevertheless took out subprime adjustable-rate mortgages increased by approximately 50 percent.[5] Many of these mortgages were interest-only requiring no or very little down payments, and requiring no income verification. Millions of these mortgages became unsustainable when house values started to fall.[6] When

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1 Charlie Savage, Wells Fargo Will Settle Mortgage Bias Charges, NY Times B3 (July 13, 2012).

2 Id.

3 Nicholas D. Kristof, A Banker Speaks, With Regret, NY Times A39 (Dec 1, 2011).

4 Savage, Wells Fargo Will Settle Mortgage Bias Charges, NY Times at B3 (cited in note 1) (stating borrowers "paid an average of $2,937 more in broker fees if African-American, and $2,187 more if Hispanic, compared with white borrowers with a similar credit risk").

5 Rick Brooks and Ruth Simon, Subprime Debacle Traps Even Very Credit-Worthy, Wall St J A1 (Dec 3, 2007) ("[T]he proportion [of subprime borrowers who would likely have qualified for conventional mortgages] rose even higher by the end of 2006, to 61%. The figure was just 41% in 2000.").

6 Liz Moyer, Beware Interest-Only, Forbes (Forbes Dec 7, 2005), online at http://www.forbes.com/2005/12/06/interest-only-mortgages-cx_lm_1207mortgage.html (visited Feb 24, 2013) (noting the share of interest-only mortgages rose to 23 percent of all loans in the last six months of 2004).

the housing market turned for the worse shortly thereafter, thousands of borrowers were forced into default. As of late 2011, nearly 30 percent of mortgagors were "underwater," meaning they owed more than their homes were worth.[7] This series of events led to huge losses for individual borrowers and for the economy as a whole. Indeed, according to one study, mortgage fraud caused losses of about $112 billion over the three year period from 2005 to 2007.[8] The Financial Crisis Inquiry Commission put it bluntly: "Lenders made loans that they knew borrowers could not afford."[9]

The regulatory response has been twofold. To get at the most egregious cases of abuse, federal and state prosecutors have brought many lawsuits alleging fraud by mortgage brokers and others in the mortgage supply chain.[10] These lawsuits are important, but cannot be the only response to misbehavior in mortgage markets. Many activities that fell short of fraud resulted in significant consumer losses, including foreclosures, loss of paper equity, and dashed dreams. For example, it is not necessarily fraudulent to sell someone a mortgage for which that person is ill suited. The line between salesmanship or persuasion and fraud is blurry, but much undesirable conduct is not illegal. If disclosures are made, if the terms are customary, and if the deal is neither unconscionable nor discriminatory, then courts will likely not punish the seller. Fraud requires intent to deceive, which is difficult to prove under these circumstances.[11] Yet many of these nonfraudulent practices led to significant—and potentially avoidable—consumer losses.

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[7] Kristof, A Banker Speaks, With Regret, NY Times at A39 (cited in note 3).

[8] See The Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis In the United States xxii (Feb 25, 2011), online at http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf (visited Feb 24, 2013).

[9] See id.

[10] See, for example, US Atty's Office for the District of Maryland, Mortgage Fraud (Jan 29, 2013), online at http://www.justice.gov/usao/md/Mortgage-Fraud/index.html (visited Jan 22, 2013) (compiling examples of federal mortgage fraud prosecutions in MD).

[11] See, for example, Ernst & Ernst v Hochfelder, 425 US 185, 191 & n 7 (1976).

To get at the nonfraudulent but undesirable set of cases, Congress passed two significant pieces of legislation. The Dodd-Frank Wall Street Reform and Consumer Protection Act[12] (the "Dodd-Frank Act") created a new administrative agency, the Consumer Finance Protection Bureau (CFPB), to regulate mortgage lenders and mortgage transactions, among other things.[13] As discussed below, the Dodd-Frank Act also established fiduciary duties for mortgage lenders, regulated rates, set minimum standards for loans, prohibited certain types of loans and fees, and created a new bureaucracy to educate consumers.[14] The newly created CFPB, along with various federal and state bank regulators, administers these changes and programs. To give one instance, in 2012, the CFPB issued the Qualified Residential Mortgage rule (QRM), which provided a legal safe harbor for lenders who issue loans meeting the QRM standard, including a debt limit of 43 percent of borrower income, a cap on mortgage points and fees of 3 percent, and other rules.[15]

The other significant statutory reform was the Secure and Fair Enforcement for Mortgage Licensing Act of 2008[16] (the "SAFE Act"), which created a new federal licensing scheme for mortgage brokers.[17] Prior to the SAFE Act, mortgage brokers were licensed by state regulatory authorities, if at all. About one-third of the states, including large states like California, did not even require mortgage brokers to be licensed.[18] This prompted Senator Dianne Feinstein, a co-sponsor of the SAFE Act, to draw an analogy to securities brokers:

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[12] Pub L No 111-203, 124 Stat 1376 (2010), codified in scattered sections of the US code.

[13] Dodd-Frank Title X, Pub L No 111-203, 124 Stat 1376, 1955–2113, codified in various sections of Title 12.

[14] See Part II.C and accompanying text.

[15] *See* Proposed Amendments to the Ability to Repay Standards under the Truth in Lending Act (Regulation Z), Bureau of Consumer Financial Protection, 12 CFR Part 1026, Docket No. CFPB-2013-0002, at *8, available at http://files.consumerfinance.gov/f/201301_cfpb_concurrent-proposal_ability-to-repay.pdf

[16] Pub L No 110-289, 122 Stat 2810, codified at 12 USC § 5101 et seq.

[17] SAFE Act § 1502, Pub L No 110-289, 122 Stat at 2810.

[18] John Gittelsohn, U.S. Mortgage Brokers Get Criminal Check, Tests Under New Rules, Bloomberg (Bloomberg July 21, 2010), online at http://www.bloomberg.com/news/2010-07-21/mortgage-brokers-get-criminal-checks-with-new-u-s-rules-to-cut-loan-fraud.html (visited Jan 22, 2013).

> When someone buys 100 shares of stock, they must go through a licensed securities broker. . . . Until recently, some purchased their home—a far more valuable asset—through an independent mortgage broker or lender who may have had a criminal background or no license at all. This lack of accountability enabled unscrupulous brokers to commit fraud at the expense of unsuspecting homebuyers.[19]

Under rules implementing the SAFE Act that were promulgated by the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, and several other federal agencies, mortgage brokers must obtain a unique federal number, undergo a background check, and be fingerprinted.[20] In addition, states are required to have licensure regimes and nonbank brokers must obtain a state license.[21]

Senator Feinstein's analogy between securities and mortgage brokers raises an interesting issue, which is the subject of this Article. While it is true that securities brokers are licensed and heavily regulated, the regulation is conducted by a private, nongovernmental corporation known as the Financial Industry Regulatory Authority (FINRA).[22] Although FINRA is a relatively young organization, it is merely the latest form of stockbroker self-regulation, which has existed since the late eighteenth century.[23] In contrast, Congress has responded to misbehavior in the mortgage brokerage industry by establishing new government regulators, mostly at the federal level. In other words, in response to alleged broker misbehavior in stock markets (in the 1920s), Congress chose a nongovernmental regulator; while in response to allege broker misbehavior in mortgage markets (in the 2000s), Congress chose a governmental regulator.

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[19] Id (quoting Senator Feinstein).

[20] See Bradley K. Sabel, Mortgage Lending Practice after the Dodd-Frank Act, Harvard Law School Forum on Corporate Governance and Financial Regulation Blog (Harvard Nov 16, 2010), online at http://blogs.law.harvard.edu/corpgov/2010/11/16/mortgage-lending-practice-after-the-dodd-frank-act/ (visited Jan 22, 2013) (discussing registration of mortgage loan originators).

[21] Id.

[22] FINRA, the self-regulatory organization (SRO) for securities brokers, is a combination of the regulatory arms of the New York Stock Exchange and the National Association of Securities Dealers. See Christopher Cox, Speech by SEC Chairman: Statement at News Conference Announcing NYSE-NASD Regulatory Merger (SEC Nov 28, 2006), online at http://www.sec.gov/news/speech/2006/spch112806cc.htm (visited Jan 22, 2013).

[23] See William Birdthistle and M. Todd Henderson, Becoming the Fifth Branch *16 (Chicago Institute for Law and Economics Working Paper No 618 Nov 2012), online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2172935 (visited Jan 22, 2013).

This Article proposes an alternative to direct government regulation of mortgage brokers: self-regulation of the mortgage industry that mimics the arguably successful self-regulation of the securities industry that has occurred over the past two centuries. Although not without its problems, self-regulation of securities brokers operates more efficiently than government regulation. For example, self-regulation allows for industry expertise to be deployed at low cost and is built on trust and reciprocity, which reduce enforcement costs. In addition, self-regulation locates power at its smallest point (a feature known as "subsidiarity") and encourages efficient resolution of disputes by ensuring commensurable regulatory intervention.[24] Just as SWAT teams are not deployed to arrest jaywalkers, so too does it make sense to handle small-scale violations with non-governmental sanctions. Most crucially for the mortgage industry, self-regulation is capable of policing behavior that does not rise to the level of fraud but is nevertheless socially undesirable.

This latter benefit—the ability to police ethics—is the reason self-regulation of securities brokers survived the New Deal legislation that radically reformed securities regulation. Speaking to the Hartford Bond Club in 1938, then-Securities and Exchange Commission (SEC) Chairman William O. Douglas defended the New Dealers' decision to perpetuate the historical practice of self-regulation of securities brokers, which many viewed as a failure in light of the Stock Market Crash of 1929. Douglas praised self-regulation because of its ability to get into the cracks where government cannot reach:

> 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

[24] For a discussion of these benefits, as well as the costs of self-regulation, see Birdthistle and Henderson, Becoming the Fifth Branch at *67–68 (cited in note 23)

> and morality. Into these large areas of self-government, and self-government alone, can effectively reach.[25]

Specifically, when brokers act in ways that are legal (that is, nonfraudulent) but not in the interest of their clients, their fellow brokers have the power to discipline them, including the levying of fines and the removal of licenses. If all that were available to regulate the sales of securities were statutory proscriptions against fraudulent conduct, Douglas argued there would be socially undesirable amounts of customer losses. While society tolerates puffery, aggressive sales tactics, and convincing people to buy things that aren't necessarily good for them in most consumer transactions, the idea is that securities are too complex, too important to the larger economy, and too significant in terms of potential losses for sales to be unregulated or regulated only by fraud.

Consider, for instance, the way in which stock broker self-regulation deals with behavior analogous to the nonfraudulent mortgage behavior described above. Securities brokers are under an obligation to ensure their recommendations are "suitable" for their customers.[26] A broker who puts a poor widow in a speculative penny stock will likely lose his license and be barred from the industry. This is true even if the widow asked to be exposed to the risk and the broker's actions did not rise to the level of fraud. And it will be other members of the industry who throw him out. Because all brokers suffer from the presence of bad apples in the industry, they rationally want to raise the standards of behavior. If it were left to government to police this transaction, brokers would ironically have much greater leeway to recommend unsuitable securities, since fraud is much more difficult to prove than a lack of suitability.

The ability to use suitability to police bad (but nonfraudulent) behavior is just one example of the ways in which self-regulation can be more powerful than government

[25] Joel Seligman, The Transformation of Wall Street 186 (Aspen 3d ed 2003) (quoting William O. Douglas).
[26] See Part IIIB–C.

regulation, and it has particular appeal in the mortgage industry, where consumers may be particularly vulnerable, as recent experience has shown. Yet the analogous scenario in mortgage lending—putting a borrower in a mortgage that is not suitable for his financial position—cannot be punished the same way; in fact, it is much more difficult for government regulators to get to this conduct, even though the downside may be far worse for the consumer.

Government regulation has serious weaknesses. As Douglas argued, government regulation is too blunt to police ethics efficiently. Current law—requiring intent to deceive, which is difficult to show—forbids a federal suitability scheme, and passage of a federal statute that would permit the government to do so is unlikely. Moreover, even if such a statute were passed, government regulation of this interstitial activity would still be less efficient than self-regulation. For one, the Constitution applies to government action, while private regulation is not subject to due process limitations and other restrictions on searches and testimony. In addition, if brokers are forced into a defensive crouch and must don legal armor for every compliance issue, then the costs of regulation are likely to increase. Given such a hostile dynamic, there will be no such thing as informal enforcement.

The rules issued by the CFPB to date (and that are under consideration) also point to another weakness of government regulation – a one-size-fits-all approach designed to limit losses (including political losses) given the constraints of government enforcement of the rules. In other words, rule makers understand the inherent limitations of government enforcement, and therefore must write rules that will be optimal under those circumstances. The new QRM rules, for instance, are thought to be effective bans on a vast amount of former and current mortgage activity. Mortgage bankers report that the new rules will further constrict lending to only the most qualified borrowers, and even then, not for certain types of loans available in the past.[27]

This may be why the market for subprime mortgage loans has dried up entirely, while the markets for other types of subprime credit, which are not subject to the new regulations, have begun to thrive.[28] There may be borrowers for who subprime mortgage loans are appropriate, but the banks and brokers may fear lending to these borrowers on terms that may later be judged, by juries or prosecutors, to be fraudulent. This fear would be lessened if other mortgage brokers sat in judgment of lending decisions. Compared with industry outsiders, other brokers have better information, and therefore are likely to be more trusted by the accused.

The argument in this Paper is that however effective the federal approach to mortgage industry regulation is likely to be, there are aspects of such regulation that would be better administered by the industry itself, subject, of course, to oversight by the government to protect against the cartelization threat. To make the case for self-regulation as a compliment to government regulation in the mortgage industry, this Article proceeds as follows. Part I briefly discusses some of the problems that occurred during the recent mortgage crisis, comparing these problems to pathologies in the securities markets. Part II discusses in more detail the reforms implemented to reduce losses in the mortgage market, pointing out some pros and cons. Part III then offers an alternative: self-regulation of the mortgage industry, drawing on the experience of self-regulation in the securities industry. This Part does so by briefly discussing the FINRA example, looking specifically at how the

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[27] *See* Clea Benson, "Housing Industry Awaits Down-Payment Rule for Mortgages," BLOOMBERG, Jan. 18, 2013, available at http://www.bloomberg.com/news/2013-01-18/housing-industry-awaits-down-payment-rule-for-mortgages.html. Interviews of several mortgage bankers and independent mortgage brokers conducted by the author in January 2013 support this view.

[28] Jessica Silver-Greenberg and Tara Siegel Bernard, Lenders Again Dealing Credit to Risky Clients, NY Times A1 (Apr 11, 2012) ("The push for subprime borrowers has not extended to the mortgage market, which remains closed to all but the most creditworthy.").

doctrine of "suitability" is an important concept that could be deployed in the mortgage context. Part IV offers some tentative conclusions.

I. POTENTIAL PROBLEMS IN THE MORTGAGE INDUSTRY

This Part briefly explores the various pathologies of the mortgage market as it existed prior to the regulatory reforms of the Dodd-Frank Act, the SAFE Act, and the rules promulgated thereunder.

A. Baseline Problems

Buying a home is the largest and most important consumer transaction most Americans will ever make. Although the government strongly encourages homeownership,[29] investing in an individual house is also one of the most foolish investments one can make. There are at least four reasons for this.

First, for nearly all Americans a housing investment is undiversified, making it particularly likely to cause losses for the homeowner as investor. If house prices fall in one's neighborhood, the losses are generally not offset by potential gains elsewhere, since people typically do not hedge their investment in a house with an offsetting portfolio of other investments, whatever those might be. In contrast, when most people invest in stocks or other securities, they do so in a diversified way, holding a basket of uncorrelated bets, such as offered by mutual funds, which neutralizes the idiosyncratic risk of investment in a particular company.[30] As a matter of uncontested theory, investing in a house is a terrible idea.[31]

[29] The decision to buy (rather than to rent) a home is one encouraged by years of federal tax policy, various federal statutes, and by a variety of quasi-governmental agencies set up during the Great Depression to help people realize the "American dream" of home ownership. *See, for example*,

[30] This is the central lesson of Modern Portfolio Theory. See generally, Harry M. Markowitz, Portfolio Selection, 7 J Fin 77 (1952).

[31] Jon Hilsenrath, Fed Economist: Housing Is a Lousy Investment, WSJ Real Time Economics Blog (Wall St J Jan 5th, 2010), online at http://blogs.wsj.com/economics/2010/01/05/fed-economist-housing-is-a-lousy-investment/ (visited on Mar 14, 2013).

Second, a housing investment is illiquid. Selling a home into a downwardly trending market is time consuming and can result in a sharply reduced price. In addition, moving entails financial, social, and psychological costs that reduce the ability of individuals to get out of housing investments quickly. Individuals may endure large investment losses in housing investments that they would not in other areas because their jobs, friends, school, social networks, and other aspects of their lives are wound up in where they live. If a city or neighborhood starts to decay and home prices begin to drop, any unwinding of the investment will take time and likely generate far larger losses than if the investment were in a similarly collapsing stock or bond.

Third, housing investments are often quite complex. While long-term, fixed-rate mortgages with 20 percent down payments were the norm for generations, the high interest rates of the 1970s and the financial innovation of the past few decades have dramatically expanded the number of mortgage products and the menu of choices available to borrowers.[32] Adjustable-rate mortgages, which became common in the early 2000s, are one example. The recent housing boom also saw the use of teaser rates and complex interest rate formulas tied to indices such as LIBOR and huge variation in the down payments, and terms of, typical loans.[33] As complexity increases, vulnerable borrowers will suffer greater expected losses, both because of mistakes and because they will become targets of unscrupulous brokers.

Fourth, innovation made housing more readily available as an investment, but with increased risk. During the subprime mortgage boom, the quality of mortgage underwriting fell dramatically. Down payments averaged just 2 percent in 2005, compared with 20

[32] See Souphala Chomsisengphet and Anthony Pennington-Cross, The Evolution of the Subprime Mortgage Market, 88 Fed Reserve Bank of St Louis Rev 31, 33 (Jan–Feb 2006) (charting the interest and foreclosure rates of subprime and prime mortgages over time). See generally Joe Peek, A Call to ARMs: Adjustable Rate Mortgages in the 1980s, New Eng Econ Rev 47 (Mar–Apr 1990).

[33] The Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report at 10411 (cited in note 8).

percent over the past several decades.[34] In that same year, almost half of buyers made no down payment at all.[35] These investments may have made sense for some investors, but for those investors who were lured into homes based on false assurances of ability to repay, the results were the loss of more suitable investment opportunities and residential displacement.

The bursting of the housing bubble in 2008, which led to the worst financial crisis in the past eight decades, is a stark example of the danger of investing in housing. In the past few years, consumer losses from investments in housing have been substantial. Recent experience suggests the process of buying a home is fraught with potential pitfalls for consumers and that financial innovation had the effect of pushing losses further down the income distribution, to parties less able to bear them.

B. Potential Market Pathologies

A variety of potential pathologies or pitfalls exist in the mortgage market. Importantly, these are quite similar to the problems that occur in transactions involving consumers investing in securities.

First, there is widespread ignorance on the part of consumer-investors. As noted above, news accounts are filled with stories of homeowners allegedly duped into taking out mortgages they could not expect to pay, especially after teaser rates expired.[36] Some recent evidence bears out this claim. Kristopher Gerardi, Lorenz Goette, and Stephan Meier found in a 2010 paper a "large and statistically significant negative correlation between numerical

[34] Steve Cook, Down Payments Fall to Three Year Low, Real Estate Economy Watch (Reecon Advisors, Inc Nov 12, 2012), online at http://www.realestateeconomywatch.com/2012/11/downpayments-fall-to-three-year-low/ (visited Jan 22, 2013).

[35] Id.

[36] For one anecdote, see bravenewfilms, Dan's Foreclosure Story (YouTube Mar 5, 2009), online at http://www.youtube.com/watch?v=5iZBRrP5J5Q (visited Jan 25, 2013). If I am permitted a personal anecdote, during the height of the housing bubble, a broker offered to reduce the payments on my mortgage by about 30 percent using a loan with a 1 percent teaser rate. When I asked what happened after the teaser rate expired in three months, he told me he would automatically roll over the loan to another lender offering a similar teaser rate. One can see how this type of deal could be particularly appealing, especially for those without knowledge of financial markets.

ability and various measures of delinquency and default" on mortgages.[37] They found that foreclosures were two-thirds less likely for individuals with the highest facility with numbers than for individuals with the lowest facility, even after controlling for social and economic differences.[38] Strikingly, nearly 30 percent of the worst performers on simple math questions believed they had fixed-rate mortgages while they actually had adjustable-rate mortgages.[39]

This problem of vulnerable consumers is present in the securities context as well. A recent Dodd-Frank Act-mandated study on financial literacy, conducted by the SEC, found a stunning lack of basic financial literacy among average investors.[40] The report concluded that "investors have a weak grasp of elementary financial concepts and lack critical knowledge of ways to avoid investment fraud."[41] Other reports support this finding. In 2009, FINRA's survey of investors found that only about half of those surveyed understood that investing in a portfolio of securities (through a mutual fund) provides a safer return than investing in a single company.[42]

Second, bad actors in both the mortgage and securities brokerage industries target particularly vulnerable types of individuals. The archetypal case of widows and orphans being taken advantage of is not just the stuff of legend. Many of the cases pursued by FINRA, alleging fraud or less, involve vulnerable individuals, be they unsophisticated, inattentive, non-English speakers, or the like. The same is true for the mortgage industry, as noted above. The reason these individuals are targeted is plain. As Gerardi, Goette, and

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37 Kristopher Gerardi, Lorenz Goette, and Stephan Meier, Financial Literacy and Subprime Mortgage Delinquency: Evidence from a Survey Matched to Administrative Data *1 (Federal Reserve Bank of Atlanta Working Paper 2010–10 Apr 2010), online at http://www.frbatlanta.org/pubs/wp/working_paper_2010-10.cfm (visited Jan 22, 2013).

38 Id.

39 Id at *3.

40 See SEC Staff, Study Regarding Financial Literacy Among Investors iii (SEC Aug 2012), online at http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf (visited on Jan 22, 2013).

41 Id.

42 Applied Research and Consulting LLC, Financial Capability in the United States: Initial Report of Research Findings from the 2009 National Survey, 40 (FINRA Investor Education Foundation Dec 2009), online at http://www.finrafoundation.org/web/groups/foundation/@foundation/documents/foundation/p120536.pdf (visited Jan 22, 2013).

Meier noted, individuals with poor math skills make easier prey. In addition, the elderly generally have worse financial literacy. For instance, in a 2007 study by the Investor Protection Trust, nearly 50 percent of elderly investors mistakenly believed securities registered with the SEC are therefore "safe" solely by virtue of such registration.[43] While all investors may be equally vulnerable to outright fraud, unsophisticated investors—in mortgages or in securities—are more susceptible to nonfraudulent wrongs, such as making too many trades ("churning") or suggesting economically illogical investment decisions. These are the cases where policing ethics is vital.

Third, investors, and even courts and regulators, may be ignorant about the nature of good regulations. More specifically, the type of information and protection investors say that they want is often not what they should want. For instance, in the SEC's recent study of financial literacy, very few respondents believed they needed trade confirmation information about "whether their financial intermediary received compensation from a third party for sending the order to them [or] the capacity in which their financial intermediary acted."[44] Instead, respondents preferred receiving information such as the price at which their stock trades were made. This may seem sensible, but it is not. The way stock trades are made by brokers leaves significant room for nonfraudulent advantage-taking, which would be revealed by the first type of information, but not the second. For instance, knowing whether the broker was paid by a third party to route a particular trade to a particular exchange or whether the broker was acting as a broker (that is, simply matching trades) or a dealer (that is, selling shares from his own dealer inventory) is essential to knowing whether the sale occurred at the best price available. Knowing the sale price will not reveal this information to the investor.

[43] Infogroup/OCR, Elder Investment Fraud and Financial Exploitation, 42 (Investor Protection Trust June 15, 2010), online at http://www.investorprotection.org/downloads/EIFFE_Survey_Report.pdf (visited Jan 22, 2013).

[44] SEC Staff, Study Regarding Financial Literacy Among Investors at xviii (cited in note 41).

A good example is the case of Shivangi v Dean Witter Reynolds, Inc.[45] An investor sued his broker for failing to disclose in a post-sale trade confirmation that the broker received higher compensation for trades in which the broker, Dean Witter, was a market maker than for other trades.[46] The court dismissed the claim based on the conclusion that "the evidence did not establish that the compensation system affected the price of the stock."[47] In fact, the court noted that in the factual situation of the case, the "customer pays less than he would in [the other situation]."[48] But what the court missed, and what the SEC study suggests investors miss as well, is that the Dean Witter compensation system—which the investor did not know about—created an incentive for the broker to steer customers to stocks in which Dean Witter was a market maker. This served Dean Witter's, as opposed to the investor's, interest. In other words, the broker may have given Mr. Shivangi the best possible price on the worst possible stock. Neither Mr. Shivangi nor the court realized this possibility, but any broker sitting in judgment of Dean Witter would recognize the potential mischief.

The mortgage context is replete with similar examples. Individuals might press for clearer disclosure about the interest rate charged, when they would actually benefit more from other disclosures, such as those that would allow a mortgagor to determine whether the product being sold is one that is in the interest of the mortgagor or the mortgagee. Of course, the operative question then becomes who is best positioned to deliver the optimal disclosure to consumers. As an ex ante matter, there are reasons to believe the answer is other brokers, who have experience and expertise in these matters. In addition, brokers acting as industry policemen may be less susceptible to the political pressures of ignorant

[45] 825 F2d 885 (5th Cir 1987).

[46] Market makers are brokers that agree to buy and sell stock at any price, thereby creating an orderly and liquid market for the security. This is in contrast to when the broker merely acts as an intermediary, matching a buyer and a seller. A broker prefers, all elswe being equal, to sell shares from the brokers' inventory, since this reduces the risk of holding those shares.

[47] Id at 889.

[48] Id at 887.

citizens or special interests, especially if the policing is done in a way that reflects the brokerage industry as a whole. In addition, ex post industry policing of disclosure—self-regulators sitting in ethical judgment of the kind of behavior in Shivangi—may be the lower cost option, as opposed to letting prosecutors try to make federal cases.

Fourth, it is quite tricky to sort between ex ante "rational" and "irrational" investment decisions, whether such investments are in securities or homes. Since disputes only arise when investments turn out badly, adjudications face a serious hindsight bias issue. Expertise, experience, and knowledge can make this problem less severe, and self-regulation is the most effective way of quickly and efficiently imbuing the adjudicative process with these qualities. Although self-regulation creates the potential for brokers to protect their own and subvert the regulatory process, this concern exists in any regulatory system—governmental or otherwise—as the large public choice literature demonstrates.[49] In addition, the FINRA experience offers a variety of mechanisms for reducing the risk of such self-serving behavior.[50]

C. Summary

From this analysis of the problems afflicting the mortgage industry, four key points come into focus.

First, the problem of misbehaving brokers is a generic one. Whether the intermediary in the financial transaction is a mortgage broker or a securities broker, the potential for agency costs to translate into abuse exists just the same. There are faithful and unfaithful brokers; a key regulatory challenge is finding the most efficient way to differentiate between the two. Conditions and context matter, of course, but when it comes

[49] See, for example, James M. Buchanan, "The Constitution of Economic Policy," 77 Am. Econ. Rev. 243 (1987) (Nobel Prize lecture).

[50] See Birdthistle and Henderson, Becoming the Fifth Branch at *[insert pin cite] (cited in note 23).

to the legal challenges, there are more similarities than differences between the two scenarios.

Second, it is in the rational self-interest of brokerage industry participants to regulate themselves. Unlike those industries where misbehaving actors impose costs only on those outside of the industry, while benefiting their customers,[51] the misbehavior of brokers harms customers and thereby imposes costs on other brokers. The natural tendency of brokers to want to increase the overall quality of brokers in the industry can be used by the law—in a type of outsourcing transaction—to reduce the overall cost of regulation.

Third, the difference between good and bad brokers from a social welfare perspective is not necessarily something that can be cleanly differentiated by the law. Many of the difficult problems in brokerage relationships lie deep in the cracks, where legal rules are too blunt to operate. This is the point Douglas made in his speech in Hartford.[52] The law is adversarial, works from the outside in, is subject to constitutional constraints, is bounded by ex post facto concerns, and is made and administered by nonexperts. While judges may claim to "know it when they see it," individuals who do the same work every day for their living are much more able to see, and know when they see, unethical actions. In addition, by acting collectively through a sanctioned self-regulatory organization with a government imprimatur, this approach can overcome the problems associated with other private regulatory efforts.

Fourth, the current model of securities regulation is a complex mix of public force and private ordering that tries to obtain the benefits of self-regulation while reducing the ability of self-regulation to become self-serving regulation. Douglas again provides the imagery—his model of self-regulation is one in which "[g]overnment . . . keep[s] the

[51] For example, when a factory emits pollutants that harm downstream or downwind farmers, but does not have to bear these costs, the factory's customers benefit through lower costs (paid by the farmers).

[52] See note 25 and accompanying text.

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."[53] The government has monitored and altered the nature of self-regulation in the securities brokerage context over the past century, guiding the self-regulatory process in a way ostensibly designed to improve regulatory efficiency.[54] Although the New Dealers originally proposed displacing private regulation with government regulation, today's hybrid model prevailed and has thrived in large part because of the real efficiencies available from self-regulation in the brokerage context.[55]

The next Part of this Article describes how the government's response to broker misconduct in the mortgage context unfortunately failed to use the analogous securities broker context as a model. Instead, the government's response deployed a pure governmental model.

II. MORTGAGE SOLUTIONS

In contrast to the continued use of private regulators to regulate stock brokers following the stock market crash of 1929, the federal response to consumer losses in mortgages has been purely governmental. There have been three primary responses to the problem of misbehaving mortgage brokers.

A. Litigation

The first response to mortgage broker misbehavior has been criminal prosecution by federal and state governments of brokers who committed fraud. Hundreds of these types of suits are now pending and countless other investigations are ongoing.[56] One infamous case

[53] William O. Douglas, Democracy and Finance: The Addresses and Public Statement of William O. Douglas as Member and Chairman of the Securities and Exchange Commission 82 (Yale University Press 1940).

[54] See Birdthistle and Henderson, Becoming the Fifth Branch at *16–26 (cited in note 23).

[55] See id at *20.

[56] The Department of Justice (DOJ) has several working groups specifically focused on mortgage fraud. For information on the Mortgage Fraud Working Group and the Residential Mortgage-Backed Securities Working Group, see Financial Fraud Enforcement Task Force, Task Force Leadership (Stopfraud.gov), online at http://www.stopfraud.gov/leadership.html (visited Jan 23, 2013). The DOJ's 2013 budget request included an entry for $55 million in additional resources to focus on mortgage fraud. This money was intended to support "40 FBI agents, 184 attorneys, 49 in-house investigators, 31 forensic accountants, 16 paralegals, and 8 support staff." Department of Justice, FY 2013 Budget Request: Financial and Mortgage Fraud Fact Sheet *1, online at http://www.justice.gov/jmd/2013factsheets/financial-mortgage-fraud.pdf (visited Jan 23, 2013).

involves a convicted armed robber who ran a mortgage brokerage firm in California.[57] At the time, California—like many other states—did not require a license to be a mortgage broker. This individuals involved allegedly ran a bogus brokerage that "lure[d] borrowers into refinancing their homes on false promises of low interest rates and minimal fees."[58] In addition, the brokers forged documents and fraudulently obtained over $1 million in fees on tens of millions in phony loans.[59] The brokers are facing over 60 federal counts of fraud.[60]

This lawsuit and others like it are justified, and any sensible regulatory regime will include criminal penalties for fraud. This Article's proposal for self-regulation neither precludes nor crowds out this type of regulation. Indeed, misbehavior in securities markets is policed by many different regulators—not just FINRA, but also the SEC, the Department of Justice, as well as state regulators and prosecutors. Going after the worst fraudsters is an important government regulatory response, because government sanctions (including prison time) may be important where harm is large, where specific deterrence is important, and where general deterrence is served by imposing large penalties (for example, where the probability of detection is low).[61] Since self-regulation does not preclude government enforcement in cases where such penalties are warranted (and only available from government regulators), we can consider just the incremental gain from adding self-regulation to the regulatory mix.

The important role played by self-regulation in these cases, however, is notable. Consider securities fraud: FINRA has about 150 professional staff and a sophisticated computer system that together monitor and investigate all stock transactions to identify

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[57] Gittelsohn, US Mortgage Brokers Get Criminal Check (cited in note 18).
[58] Id.
[59] Id.
[60] Id.
[61] See generally, Gary S. Becker, Crime and Punishment: An Economic Approach, 76 J Political Econ 169 (Mar–Apr 1968).

suspicious trading activity.[62] These private "police" are not subject to the typical limitations on government investigators, which include both constitutional rules (for example, limiting searches, giving defendants rights to remain silent and to counsel, and so on) and civil service rules that set work rules, limit compensation, and the like. Although FINRA has its own internal constraints on investigations and prosecutions, these are much looser in all dimensions than analogous government actions because FINRA is not a state actor. Most obviously, this means the Constitution does not constrain FINRA. But, in addition, FINRA employees can be fired, can be paid for performance, and are not subject to as significant political constraints, since their actions bet the reputation of only FINRA rather than the entire US government.[63] Importantly, FINRA investigations can not only result in disciplinary sanctions, such as civil fines or license revocations, but also frequently lead to referrals to government agencies for civil and criminal proceedings.[64]

B. Licensure

In response to misbehavior by mortgage brokers, Congress also passed a national licensing scheme. The SAFE Act requires that all mortgage brokers obtain a license.[65] Prior to the SAFE Act, such licensure was a matter of state law, which was inconsistent, both as to whether a license was needed and, if so, as to the requirements to obtain and maintain one.[66] The SAFE Act draws a distinction between brokers employed by banks—"covered financial institution[s]"—and independent mortgage brokers.[67] The former are only

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[62] For descriptions of FINRA's Securities Observation News Analysis and Regulation program—dubbed SONAR—and market surveillance group, see Ben Protess, For Wall Street Watchdog, All Grunt Work, Little Glory, NY Times B7 (Dec 2, 2011).

[63] On this last point, see, for example, Edward M. Iacobucci, "Reputational Economies of Scale, with Application to Law Firms, 14 *Am Law Econ Rev 302, 304* (2012).

[64] For examples of recent FINRA referrals, *see* 2012 FINRA Year in Review, Jan. 8, 2013, available at *http://www.finra.org/Newsroom/NewsReleases/2013/P197624*.

[65] SAFE Act § 1504, 122 Stat at 2654, codified at 12 USCA § 5103.

[66] Gittelsohn, US Mortgage Brokers Get Criminal Check (cited in note 18).

[67] Section 1504 of the Dodd-Frank Act, Public Law 110-289, July 30, 2008, provides that "an individual may not engage in the business of a loan originator without first (1) obtaining . . . (A) a registration as a registered loan originator or (B) a license and registration as a State-licensed loan originator. . . ." Section 1503(7) defines "registered loan originator" as an individual who, among other things, works at a depository institution, such as a bank. *See* id. For the rules implementing the SAFE Act, see Registration of

obligated to register with the federal government as brokers under the Nationwide Mortgage Licensing System and Registry, which involves obtaining federal registration numbers, undergoing background checks, and being fingerprinted. Independent brokers, on the other hand, are required to obtain state-issued licenses as well as register with the federal government.[68]

There is some logic to the distinction between bank and nonbank brokers. Banks are heavily regulated by various state and federal agencies and Congress may have reasonably believed that this supervision is sufficient to prevent the worst types of abuse by mortgage brokers. Even more important as an economic matter are the reputational constraints that operate on large banks and encourage intrabank monitoring of agents to ensure compliance with the law and the bank's internal rules. For example, it is unlikely any convicted bank robbers are working as mortgage brokers at Wells Fargo or any other bank.

But there is also a less charitable explanation of the different rules for bank-based brokers and independent mortgage brokers. Lower regulatory costs give banks a competitive advantage vis-à-vis independent mortgage brokers.[69] Under this view, arguments about alternative forms of regulation and reputational constraints are simply a convenient shield for the anticompetitive benefits of differential regulation. Banks therefore had an incentive to lobby Congress and other rule makers to design rules that give banks a cost advantage over their rivals.

Even if the licensure and regulation process for independent brokers is identical in cost to the process for bank brokers and only different in form, these regulations may still have an anticompetitive effect. To the extent that bank-based brokers have a larger asset

Mortgage Loan Originators, 75 Fed Reg 44656 (2010), finalized in various sections of 10 CFR. See also 12 CFR § 1007.103. The rules were promulgated by the Office of the Comptroller of the Currency; the Federal Reserve System; the Federal Deposit Insurance Corporation; the Office of Thrift Supervision; the Farm Credit Administration; and the National Credit Union Administration

[68] 12 CFR § 1008.103.

[69] For a discussion of this dynamic, see Birdthistle and Henderson, Becoming the Fifth Branch at *56–57 (cited in note 23).

base over which to spread regulatory costs, they will have a competitive advantage over independent brokers.[70] It may be the case that the regulation is designed to have exactly this effect—to drive independent brokers out of the business and to centralize mortgage brokerage at banks. If this is the case, it is not obvious why that is a policy improvement. Independent brokers, to be sure, perpetrated many frauds, but so too did banks. Moreover, independent brokers provide services and competition that may be valuable for certain segments of the market. If there exists a mechanism for efficiently regulating independent brokers commensurate with their risk and sensitive to the differential impact of regulatory costs, it would be preferable to use this approach, as opposed to a one-size-fits all approach or an outright ban on certain transactions regardless of variable costs.

In contrast, FINRA licenses stockbrokers through a unitary system that is the same in every jurisdiction.[71] Brokers take one or more tests, depending on the type of work they want to do. The tests are administered by FINRA, as are decisions about admission, maintenance, suspensions, and revocations. In these and other matters, FINRA's decision makers are industry and nonindustry officials, including equal numbers of representatives from large, medium, and small-sized firms. FINRA also maintains a readily available database of brokers, known as the Central Registration Depository.[72] Notably, this database includes all customer complaints and disciplinary actions, making it a potent tool for encouraging compliance by brokers.[73]

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[70] Id at *45-46.

[71] The basic broker license is the Series 7 license. See Securities and Exchange Commission, Series 7 Examination (SEC Mar 26, 2008), online at http://www.sec.gov/answers/series7.htm (visited Jan 23, 2013).

[72] See Securities and Exchange Commission, Checking Out a Brokerage Firm, Individual Broker, Investment Adviser Firm, or Individual Investment Adviser (SEC Feb 14, 2012), online at http://www.sec.gov/answers/crd.htm (visited Jan 23, 2013).

[73] For FINRA's BrokerCheck database, which provides background information on register stockbrokers, see FINRA, FINRA BrokerCheck® - Research Brokers, Brokerage Firms, Investment Adviser Representatives and Investment Adviser Firms (FINRA), online at http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/ (visited Jan 23, 2012).

C. New Agency, New Rules

Finally, Congress passed the Mortgage Reform and Anti-Predatory Lending Act (the "Mortgage Act") as Title XIV of the Dodd-Frank Act.[74] The Mortgage Act delegates to the newly created CFPB, along with other federal regulators, the authority to interpret and implement provisions of the Mortgage Act. To date, about 40 percent of all consumer complaints received by the CFPB involved mortgages.[75] Although a full treatment of the Mortgage Act is beyond the scope of this Article, a brief discussion of its major provisions is instructive.

Subtitle A establishes residential mortgage loan origination standards, making brokers fiduciaries of their customers and regulating the maximum amount of broker compensation (known as a "yield spread premium").[76] Under the old regime, some brokers were more highly compensated when they steered individuals to high-yield loans.[77] The steering and compensation provisions of the Mortgage Act are designed to remedy this problem.

Subtitle B of the Mortgage Act puts in place minimum standards for mortgages.[78] The law requires the Federal Reserve Board to issue regulations that, among other things, require brokers to consider a consumer's financial situation, such as his ability to repay, when making a recommendation.[79] These provisions apply to all loans, regardless of the size, rates, or fees involved. In the past, only certain types of loans carried this obligation.[80] Subtitle B also bans certain mortgage features, such as prepayment penalties and negative

[74] Dodd-Frank Title XIV, 124 Stat at 1376, codified at 15 USCA § 1601 et seq.

[75] See Consumer Financial Protection Bureau, Financial Report of the Consumer Financial Protection Bureau: Fiscal Year 2012, 20 (Nov 15, 2012), online at http://files.consumerfinance.gov/f/201211_cfpb_financial-report-fy-2012.pdf (visited Jan 23, 2012).

[76] Dodd-Frank § 1401–1406, 124 Stat at 2137–2142, codified in various sections of Title 15. For a general discussion of the Mortgage Act and the new rules it entails, see Sabel, Mortgage Lending Practice after the Dodd-Frank Act (cited in note 20).

[77] See, for example, Howell E. Jackson and Laurie Burlingame, Kickbacks or Compensation: The Case of Yield Spread Premiums, 12 Stan J L Bus & Finance 289, 331 (2007) ("Rather, the evidence suggests that mortgage brokers earn substantially more on loans when yield spread premiums are paid.").

[78] Dodd-Frank § 1411–1422, 124 Stat at 2142–2156, codified in various sections of Title 15.

[79] Dodd-Frank § 1411, 124 Stat at 2142, codified at 15 USCA § 1639c(a)(1).

[80] This was the case under the old provisions of Regulation Z of the Truth In Lending Act. See 12 CFR Part 226.

amortization, and protects consumers against the loss of antideficiency protection.[81] As discussed below, although these are sensible rules, they are better administered through a self-regulatory model of suitability than through federal statutory or agency-based rules.[82]

Subtitle C deals with so-called high-cost mortgages, which are mortgages: whose interest rate exceeds the average prime offer rate by more than 6.5 percentage points; where the points paid exceed $20,000 or 5% of the value of the property; or where prepayment penalties, among other things, exceed 2% of the value of the transaction.[83] For these types of mortgages, balloon payments, debt acceleration, and deferral fees are banned and late charges are restricted.[84] In addition, a mortgagee cannot issue a high-cost mortgage until it receives certification from a government-approved counselor that the consumer-mortgagor has been counseled as to the advisability of taking out the mortgage.[85] These counseling services have been developed, implemented, and monitored by the new Office of Housing Counseling, which was created by Subtitle D of the Mortgage Act.[86] The Office of Housing Counseling was established within the Department of Housing and Urban Development to educate consumers, certify counselors, and collect information about foreclosures and defaults on home mortgages.[87] The counseling requirements in the Mortgage Act seem designed to address the suitability concern raised above. However, the approach adopted by the Office of Housing Counseling is to impose itself as a neutral third party between a customer and a broker, rather than to put the suitability obligation on the broker (as is done in the securities context).

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[81] Dodd-Frank § 1415, 124 Stat at 2146–2153, codified in various sections of Title 15.
[82] See Part IIIC–D.
[83] Dodd-Frank § 1431, 124 Stat at 2156, codified at 15 USCA § 1602.
[84] Dodd-Frank § 1432–1433, 124 Stat at 2159, codified at 15 USCA § 1639.
[85] Dodd-Frank § 1463, 124 Stat at 2162, codified at 15 USCA § 1639.
[86] Dodd-Frank § 1442, 124 Stat at 2162, codified at 42 USCA § 3533.
[87] Dodd-Frank § 1442, 124 Stat at 2162, codified at 42USCA § 3533(g)(3).

The remainder of the Mortgage Act sets forth additional limitations on mortgage practices that were deemed to have caused problems during the recent mortgage crisis. Subtitle E, among other things, requires that taxes and insurance costs be escrowed for the first lien mortgage on a principal dwelling unless the borrower waives this provision in writing.[88] This rule is designed to avoid a homeowner's being "surprised" by large property taxes and insurance bills, which had been hidden by a broker trying to reduce the apparent borrowing costs. Subtitle F puts new obligations on appraisers and regulates the interaction among brokers, customers, and appraisers.[89]

As noted above, the new QRM rules, which are not yet finalized as of this writing, are one example of the CFPB's governmental, rule-based approach to regulating the mortgage market. The current version of the QRM rules caps the available mortgage amounts as a percentage of borrower income, caps fees, and declares certain types of mortgages (including perhaps very large ones) as not protected by a safe-harbor against litigation.[90] Regulators are also considering a mandatory minimum down payment,[91] and mortgage bankers believe that the market will dry up entirely for loans not meeting the QRM standards.[92]

D. Contrasting Approaches

The Mortgage Act and the SAFE Act are governmental responses, more particularly federal, agency-based responses, to the problems in the mortgage market. These two statutes ban a variety of activities and types of products, and the bans are enforceable by

[88] Dodd-Frank § 1461, 124 Stat at 2178, codified at 15 USCA § 1639(d).
[89] Dodd-Frank § 1471–1480, 124 Stat at 2185–2202.
[90] *See* Proposed Amendments to the Ability to Repay Standards under the Truth in Lending Act (Regulation Z), Bureau of Consumer Financial Protection, 12 CFR Part 1026, Docket No. CFPB-2013-0002, at *8, available at http://files.consumerfinance.gov/f/201301_cfpb_concurrent-proposal_ability-to-repay.pdf. *See* Clea Benson, "Housing Industry Awaits Down-Payment Rule for Mortgages," BLOOMBERG, Jan. 18, 2013, available at http://www.bloomberg.com/news/2013-01-18/housing-industry-awaits-down-payment-rule-for-mortgages.html.
[91] *See* id.
[92] Id ("Whichever of these standards is the most conservative is the one that you're going to adhere to.").

federal and state agencies, especially the CFPB. They also require various efforts at monitoring brokers and educating consumers, again to be done by governmental entities.

This approach stands in stark contrast to the approach taken by the New Deal Congress in the wake of the closest historical analogue—the Stock Market Crash of 1929 and the ensuing Great Depression. Then, the solution was self-regulation.[93] When Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934, securities brokers had been self-regulating for nearly 200 years and the idea of imposing a federal regulatory structure on the thousands of securities brokers was "a little bit like trying to build a structure out of dry sand."[94] With the Maloney Act of 1938,[95] Congress chose to keep the self-regulatory model in place, and supplemented it with additional government oversight. In fact, the 1938 Maloney Act amendments to the Securities Exchange Act expanded self-regulation to cover several thousand previously unregulated brokers in the so-called over-the-counter market.[96]

In contrast, there was not a history of self-regulation of mortgage brokers for the Dodd-Frank Congress to use as its wet sand in building a new regulatory structure. Perhaps the mortgage industry lacked a self-regulatory organization (SRO) because mortgage lending existed largely within already-regulated banks. Independent brokers were a relatively small and new part of the mortgage game, which was traditionally played by banks, savings and loans, and other financial institutions. In contrast, self-regulation of brokers started in the late 1700s precisely because there was no existing regulatory apparatus in place.[97] The New York legislature made stock brokerage contracts unenforceable in 1792, necessitating private law as a mechanism for allowing the nascent

[93] See Birdthistle and Henderson, Becoming the Fifth Branch at *20–22 (cited in note 23).

[94] Seligman, The Transformation of Wall Street at 185 (cited in note 25) (quoting former SEC Commission George C. Mathews).

[95] Maloney Act, Pub L No 75–719, 52 Stat 1070 (1938), codified as amended at 15 USC § 78o-3, et seq.

[96] Id. See also Seligman, The Transformation of Wall Street at 183–89 (cited in note 25).

[97] Birdthistle and Henderson, Becoming the Fifth Branch at *16 (cited in note 23).

brokerage industry to continue.[98] This was the seed that produced more than 200 years of continuous self-regulation. With no such necessity for self-regulation in the mortgage industry, perhaps other reasons for self-regulation—for example, to build industry reputation—were insufficient to generate a robust SRO for the mortgage industry. Whatever the reason, this lack of an existing self-regulatory tradition presents an obstacle to self-regulation for the mortgage industry. But, as discussed below, it is not an insurmountable one.

III. AN SRO FOR THE MORTGAGE INDUSTRY

This Part proposes an alternative regime for regulation of the mortgage industry, namely, the creation of a self-regulatory organization analogous to those currently serving as the primary regulators of stock and commodities brokers. The trillions of dollars traded in US equity and commodities markets are regulated primarily by private, for-profit corporations funded by members of the industry and representing the industry. FINRA is the primary regulator of stockbrokers; the Chicago Mercantile Exchange (like other commodities exchanges) regulates brokers on its exchange.[99] Securities broker self-regulation has a long and successful history—almost two centuries—of regulating complex and perilous consumer transactions based on the rational self-interest of market participants.[100] In addition, a bill is currently pending in Congress to create a self-regulatory model for financial advisors as well.[101] The logic of self-regulation in these areas seems fairly applicable in the mortgage industry as well.

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[98] Id at *17.

[99] For a list of the major SROs, see Securities and Exchange Commission, Self-Regulatory Organization Rulemaking (SEC Dec 13, 2012), online at http://www.sec.gov/rules/sro.shtml (visited Jan 24, 2013).

[100] See Birdthistle and Henderson, Becoming the Fifth Branch at *16 (cited in note 23).

[101] See Investment Adviser Oversight Act of 2012, HR 4624, 112th Cong, 2d Sess (Apr 25, 2013), in 158 Cong Rec D563-01 (Jun 6, 2012). See also Mark Schoeff Jr, Bachus bill pushed back, Washington Insider (InvestmentNews June 11, 2012), online at http://www.investmentnews.com/article/20120611/BLOG07/120619989# (visited Jan 24, 2013).

A. The Logic of Self-Regulation

There is a compelling argument for self-regulation in industries where brokers intermediate financial transactions. The argument is based on the self-interest of the brokers themselves.[102] Self-regulation can be effective if the costs of misbehavior are borne generally by members of the profession, while the benefits inure only to the misbehaving members. This is likely the case where an intangible service, such as brokerage services or investment advice, is being purveyed and customers cannot readily distinguish ex ante between "good" and "bad" service. In the absence of the ability to do so, customers will discount the amount they are willing to pay by the probability of being cheated by a bad service provider. If good brokers cannot credibly signal their quality, they will be unable to charge the full price of their services and will therefore exit the market, reduce the quality of their service, or cheat, such as recommending excessive trading (known as "churning") in customer accounts. Accordingly, the overall quality of brokers will fall. Good brokers therefore have strong incentives to identify bad brokers or to remove them from the industry, since doing so would allow good brokers to charge more for their services.

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 problematic activity) is primarily borne by the individuals who are in a contractual relationship with the broker. When the broker cheats, the customer loses.[103] In contrast, when a factory pollutes, its customers gain because some of the costs of production are borne by others. Polluters therefore do not have strong incentives to police other polluters and thus self-regulation makes less sense in contexts such as environmental regulation.

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[102] See Birdthistle and Henderson, Becoming the Fifth Branch at *10 (cited in note 23).

[103] To be sure, there may be some risk—called systemic risk—that customers' losses will harm other customers, but for most brokerage deals, this "financial pollution" is minimal.

To be clear, self-regulation is not a panacea. Regulatory failures abound in securities and commodities markets. Some of these are familiar to the public, like the Bernie Madoff Ponzi scheme and the meltdown of MF Global, while others, like the "back-office" crisis of the late 1960s, are not.[104] But the fact that self-regulation is not perfect is not surprising or necessarily an indictment of it. The relevant comparison is not between self-regulation and Nirvana, but between self-regulation and government regulation. From that viewpoint, self-regulation seems attractive both in practice and as a matter of theory.[105] Self-regulation can reach behaviors government regulation cannot, and it can do it with lower costs and greater precision, given the expertise the industry itself can bring to bear on regulatory questions.[106]

Government regulation, of some form, is perhaps a necessary backstop against two obvious problems. First is the possibility that the industry will not be sufficiently diligent in protecting the public interest. The industry may be willing to tolerate certain policies among its members that are good for the industry but bad for society—but not apparent to customers or of sufficiently small size so as not to motivate them to collective action to remedy the problem. One example is the practice, which existed for many years, of brokers quoting stock prices only in even eighths of a dollar, thus increasing spreads and therefore profits.[107] This "gentlemen's agreement" was revealed by an academic paper and then used by the government as leverage to change some practices of the SRO.[108] There is always a risk of cartelization when an industry acts collectively, but this is simply another cost that

[104] For a discussion of the back-office crisis and the MF Global meltdown, see Birdthistle and Henderson, Becoming the Fifth Branch at *44 (cited in note 23). The Madoff Ponzi scheme is widely covered in the media. See, for example, Diana B. Henriques and Zachery Kouwe, U.S. Arrests A Top Trader In Vast Fraud, NY Times A1 (Dec 12, 2008).

[105] See generally, Birdthistle and Henderson, Becoming the Fifth Branch (cited in note 23).

[106] See id at *66.

[107] William G. Christie and Paul H. Schultz, Why Do NASDAQ Market Makers Avoid Odd-Eight Quotes?, 49 J Finance 1813 (Dec 1994).

[108] Id. For a discussion of this paper and its influence on regulatory policy, see Birdthistle and Henderson, Becoming the Fifth Branch at *26 (cited in note 23).

must be compared with the benefits of self-regulation. Monitoring self-regulation to ensure the regulation does not become a shield against more effective government regulation or a tool of industry self-interest (or the self-interest of subgroups within the industry) is an important governmental function.

The second potential problem with self-regulation is the necessary limitation on the types of penalties that private regulators can impose. This suggests an inevitable role for government as well. Only the government can impose criminal sanctions, and the work of Gary Becker suggests that for certain, hard to detect violations, criminal sanctions may be necessary to ensure optimal deterrence.[109] Large fines may also work, but these have been subject to recent criticism in the self-regulatory context[110] and, in any event, are not likely to be effective against individuals or small brokers with few assets and not very valuable reputations. Despite the necessity of government involvement, self-regulators are currently playing a vital, if potentially constitutionally suspect, role in ongoing criminal investigations, such as those for securities fraud and insider trading. Even if self-regulation is rendered less effective, by further curtailment of its ability to collect fines (other than merely using fining as leverage) or by constraints on its ability to partner with government agents without complying with the Constitution, there is still a vital regulatory role that can be played (and would be played) by industry self-regulation in the area of ethics policing.

B. FINRA

In a <u>Becoming the Fifth Branch</u>, William Birdthistle and I describe in detail the reasons why self-regulation started and has flourished for securities brokers, using FINRA

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[109] See Becker, 76 J Political Econ at 169 (cited in note 61).

[110] See, for example, <u>Fiero v Financial Industry Regulatory Authority, Inc</u>, 660 F3d 569, 574 (2d Cir 2011) (holding that FINRA does not have the authority to bring court actions to collect fines for disciplinary violations by members).

as a sustained example.[111] FINRA is a private, for-profit corporation funded by securities brokers. It is the combination of the old National Association of Securities Dealers and the self-regulatory arms of the stock exchanges, such as the New York Stock Exchange. FINRA writes rules—its rulebook is 1374 pages of 8 point font![112]—audits brokers, investigates brokers for violations of its rules and federal and state law, brings enforcement actions, adjudicates brokers accused of rule or law violations, manages an arbitration process involving thousands of cases per year, and engages in widespread broker and customer education.[113] In short, FINRA does nearly everything that the SAFE Act and Mortgage Act require of a variety of state and federal regulators, plus much more.

As mentioned throughout this Article, FINRA does so in a manner that has significant benefits over a governmental regulatory model, at least in this case in which the industry's incentives are more aligned with social goals than could be said in other industries. FINRA employees are not civil servants, so they are not subject to the limitations on compensation and promotion that may reduce the efficacy of government regulators.[114] FINRA is managed by industry experts, meaning its rules and decisions are informed by inside information, as opposed to agency rules, which are informed only by the biased sample of industry expertise who participate in the Notice and Comment rulemaking procedures. FINRA prosecutors and judges are industry insiders to some extent, so they are more trusted than outside regulators would be; this lowers regulatory costs and reduces the possibility of type 1 and type 2 errors.[115] FINRA is also not subject to

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[111] See generally, Birdthistle and Henderson, Becoming the Fifth Branch (cited in note 23).

[112] See FINRA, FINRA Manual (FINRA 2013), online at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1 (visited Jan 24, 2013).

[113] For a description of FINRA, see FINRA, More About FINRA (FINRA 2013), online at http://www.finra.org/AboutFINRA/P125239 (visited Jan 24, 2013). See also FINRA, 2011 Year in Review and Annual Financial Report, 8 (FINRA 2012), online at http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p127312.pdf (visited Jan 24, 2013).

[114] See, for example, M. Todd Henderson & Frederick Tung, Pay for Regulator Performance, 85 S Cal L Rev 1003 (2011–2012) (discussing the low-powered incentives of bureaucratic pay and recommending pay-for-performance for banking regulators).

[115] Type 1 errors are false positives – finding a violation where there is none – and type 2 errors are false negatives – noting

the Constitution, since it is not a state actor. This means that its audits, investigations, and prosecutions—including such punishments as taking away brokers' licenses and imposing fines—are not subject to constitutional or statutory rules that limit searches and compelled testimony, provide for representation by counsel, protect due process, and impose any of the other myriad protections those being investigated by the government have.

These advantages, especially expertise and freedom of operation, allow FINRA specifically, and self-regulation more generally, to get into the regulatory cracks alluded to in William O. Douglas's Hartford Bond Club speech.[116] Being an ethics policeman is not a governmental function, but a private one: "Into these large areas[,] self-government, and self-government alone, can effectively reach."[117] To illustrate this, the next section considers the doctrine of "suitability" for stockbrokers. Suitability is a good example of the kind of work best done by self-regulation and the kind of problem that severely plagued the mortgage industry.

C. Suitability

"Suitability" is the core stockbroker duty.[118] The duty is easy to define: brokers have an obligation to take steps to ensure the securities they recommend to their clients are "suitable" for them.[119] Brokers who are adjudged to have made unsuitable recommendations to their customers are subject to punishment by the SRO such as fines,

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finding at violation where there is one in fact.

[116] See note 25 and accompanying text.

[117] See Seligman, The Transformation of Wall Street at 186 (cited in note 25).

[118] Suitability is a key contributor to FINRA fines and in 2011 thirty brokers were barred for making unsuitable recommendations. See Deborah G. Heilzer, Brian L. Rubin, and Andrew W. McCormick, Annual Sutherland FINRA Sanction Study Shows Enforcement Actions on the Rise (Sutherland Feb 28, 2011), online at http://www.sutherland.com/newsevents/News_Detail.aspx?News=5bf43ef6-e11d-4d58-815e-930a7e0183e0 (visted on Mar 14, 2013).; Deborah G. Heilzer, Brian L. Rubin, and Andrew W. McCormick, Sutherland Focus Report #4: FINRA Suitability Sanctions Rise in 2011 (Sutherland Mar 16, 2012), online at http://www.sutherland.com/newsevents/News_Detail.aspx?News=06f6963b-0a7a-4aa0-9a35-0090c43a16e7 (visited on Mar 14, 2013).

[119] See FINRA Rule 2111, online at http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=9859&print=1 (visited Jan 24, 2013). For a discussion of Rule 2111, see FINRA, Regulatory Notice 12–25 (FINRA May 2012), online at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p126431.pdf (visited Jan 24, 2012).

suspension, or a bar from the industry.[120] In extreme cases, unsuitable recommendations may also amount to fraud and therefore result in heavy civil and even criminal liability.[121] But because of the difficulty of proving fraudulent intent and the administrative costs of running a legal proceeding, as opposed to a private one, civil and criminal liability is rare. In addition to these ex post penalties—or more likely, because of them—firms also engage in private law enforcement by training and monitoring brokers to ensure compliance with the rules.

The typical objects of allegedly unsuitable investment recommendations are the proverbial "widows and orphans." The classic example of an unsuitable investment is a large holding of a speculative high-tech stock by an elderly widow on a fixed income. The personal circumstances of an investor are relevant to, and possibly determinative of, the amount of risk a broker recommends to that individual.[122] Younger investors should take more risk. They are currently earning money and have many years to continue doing so. They have more time for investments that start badly to recover. And they are less likely to have emergency expenses, such as large, unforeseen medical expenses. Young investors can therefore take bigger risks with their investments and still be relatively conservative in the long run. Older investors, by contrast, may be living on a fixed income and unable to bear large, short-term losses. Beyond age, several other factors are also relevant: for example, income, wealth, risk preferences, familial situation, employment history and prospects, and knowledge. A broker should take account of these to tailor recommendations to the

[120] For violations of the FINRA suitability rules, the FINRA Sanctions Guidelines recommend a fine of $2,500 to $75,000, and a suspension of 10 to 365 days. See FINRA, Sanction Guidelines, 94 (FINRA 2011), online at http://www.finra.org/web/groups/industry/@ip/@enf/@sg/documents/industry/p011038.pdf (visited Jan 24, 2013). In egregious cases, the guidelines recommend a suspension of up to two years or a bar from the industry. See id.

[121] See, for example, Clark v John Lamula Investors, Inc, 583 F2d 594 (2d Cir 1978).

[122] For a discussion of the contours of the suitability rule, see FINRA Regulatory Notice 11-25, Know Your Customer and Suitability: New Implementation Date for and Additional Guidance on the Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations (May 2011), online at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p123701.pdf (visited on Mar 14, 2013).

circumstances of the individual investor.[123] The concept is simple enough: what is a good investment for a wealthy man of thirty may be a terrible one for that same man at seventy or a different thirty year old living paycheck-to-paycheck.

The canonical cases are in just this vein. Consider the famous case Clark v John Lamula Investors, Inc.[124] The broker recommended to a retired school teacher in her late fifties that she invest nearly her entire divorce settlement of $138,000 in junk bonds promising a double-digit return.[125] When the bonds dropped in value, the investor sued, alleging that the broker committed securities fraud by making an unsuitable investment recommendation. She won.[126]

Although the case seems rightly decided on suitability grounds, the issue is not completely straightforward. Brokers rarely act without guidance, since they are in the business of pleasing their customers. In Clark, the plaintiff-investor instructed the broker to recommend an investment that would yield returns in excess of 10 percent per year.[127] Investments yielding an expected 10 percent annual returns are not low risk. So what was the broker to do? Most obviously, he could have given her what she wanted, based on his assessment that she was a competent adult capable of making her own decisions about her wellbeing. This course of action would position the broker as something between an advisor and an order taker—giving guidance within narrow parameters set by the customer.

The broker could have instead substituted his own judgment about her and refused to recommend a risky investment to her. Of course, this type of paternalism may be ineffective in terms of causing the customer to reduce her risk taking, but it would likely be quite effective at losing her as a customer. She could find another broker willing to risk the

[123] See id.
[124] 583 F2d 594 (2d Cir 1978).
[125] Id at 597.
[126] Id at 604.
[127] Id at 597.

possibility of an unsuitability finding. That a customer might do this is a good argument in favor of a suitability rule of broad applicability. The original broker might be more likely to make a suitable recommendation knowing that the probability of the customer leaving was lower than it otherwise would be because of the increased cost on other brokers from making unsuitable recommendations. One problem with this explanation is that there will be brokers who value an unsuitability finding less than other brokers. For example, a high-quality broker would consider a ban from the industry a much worse outcome than a low-quality broker. Therefore the rule may do nothing more than channel the most vulnerable investors to the lowest-quality brokers. Even if the rule worked well and all brokers decided not to recommend a risky investment to her, the customer could always seek risk in other ways, perhaps by using the divorce settlement to gamble or open a small business.

Finally, the broker could have taken steps, such as disclosure or even persuasion, to convince her of the stupidity of her choice, but then, ultimately, done as she asked. This would be akin to the informed-consent model in health care. Doctors can recommend dangerous procedures, but only if they have the patient's consent based on fully and clearly disclosed information about the risks.[128] Doctors, like brokers, fill in an important intermediary role, given their advantage of information and expertise, and such a rule would harness this advantage without foreclosing choice on the part of the customer. Under this potential course of conduct, patients or investor-customers are viewed as the ones who should ultimately be making decisions that affect themselves.

In Clark, however, the court held that the neither the follow-instructions nor informed-consent approaches were legal. The court's position was that the only legal—that is, nonfraudulent—action would be to refuse to invest as the customer wanted.[129] Clark

[128] *See, e.g.,* R.R. Faden & T.L. Beauchamp, A HISTORY AND THEORY OF INFORMED CONSENT (1986).
[129] Clark, 583 F2d at 601

thus implies that brokers have an independent duty to prevent customers from making unsuitable investments. This means that risky investments that could be considered unsuitable bring with them an insurance against loss[130] and that brokers who are adjudged to have made unsuitable recommendations may lose their livelihoods.

This is a duty far beyond that which normally passes for acceptable conduct in brokered arrangements in other contexts. Outside of the securities context, courts do not routinely upset contracts entered into between consenting adults unless, for example, there is an allegation that a weaker party to the contract suffered from an informational disadvantage. And yet the Clark court held that the broker committed fraud by not convincing the customer not to take the risk she wanted to take and not refusing to fill her request. Perhaps the best we can say about Clark is that there will be examples of investments—like an older widow on a relatively low fixed income investing in risky bonds—that are so irrational that they cannot be the product of an informed and careful decision, but rather must be explained by broker opportunism. In other words, despite some evidence that the customer drove this investment choice, it is more likely that the broker's interests drove it.

Although suitability cases sometimes result in findings of fraud, they more commonly result in FINRA administrative sanctions. Take, for example, the recent case of Epstein v SEC.[131] The defendant-broker worked for Merrill Lynch, making mutual fund recommendations to Merrill's customers.[132] He was compensated largely on commissions, which he earned when customers changed their fund allocations or moved from one fund to

[130] If an investment drops in value and is later held to have been unsuitable, the customer can recover the investment losses from the broker.
[131] 416 Fed Appx 142 (3d Cir 2010).
[132] Id at 144.

another.[133] 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," yet he recommended that they incur relatively large transaction fees (meaning that he received commissions) by switching mutual funds, often into funds with higher fees.[134] A FINRA hearing panel found the broker committed securities fraud and violated FINRA's suitability and professional conduct rules.[135] The National Adjudicatory Council (NAC)—FINRA's highest adjudicative body, which is comprised of fourteen members: seven nonindustry members, two large firm members, two medium firm members, two small firm members, and one at-large member—threw out the securities fraud, but barred the broker from the industry for making unsuitable investment recommendations.[136] FINRA, acting through the NAC, engaged in private, policing of ethics.

It is worth pausing for a minute to consider why the suitability doctrine is needed at all. After all, brokers do not generally have strong incentives to cheat their customers. No broker that consistently cheats its customers stays in business for long. Consider the Epstein case again. Although the broker in question was just a twenty-three-year-old recent college graduate, he was employed by Merrill Lynch, one of the oldest and most well respected securities firms in the world. Certainly Merrill Lynch valued its reputation in general, and with the specific investors in particular, and therefore had strong incentives to design its training, compensation, and supervision systems to avoid this type of situation.

But reputation may not work perfectly, even for large, well-established brokerages, not to mention smaller, less prominent ones. Insolvency is one reason. A broker who plans to leave the business after cheating customers is one who does not care about its reputation.

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[133] Id.
[134] Id at 145.
[135] Epstein, 416 Fed Appx at 145–46.
[136] Id at 146.

Economists call this the "final period" problem; whatever work nonlegal sanctions are doing in preventing misconduct is reduced in the last period before a broker or firm leaves the industry.[137] Cheating, of which making an unsuitable recommendation to earn a commission might be an example, is likely to be greater in final periods. Of course, firms like Merrill Lynch survive longer, so they can be expected to manage employees in a way that reduces each employee's individual final period problem.[138] But inevitable agency costs within large firms mean these mechanisms will be imperfect. The broker in Epstein may not—likely did not—value Merrill Lynch's reputation as much as the firm as a whole did and therefore may privilege the value of short-term commission payments at the expense of the firm. Brokerages have incentives to police their agents, but this policing may be imperfect in the presence of monitoring and other transaction costs.[139]

This problem may exist at the firm level as well. The lack of firm-level incentives to take care and make suitable recommendations may be more acute for smaller brokerage firms. Take the extreme case of a firm with a single registered broker. The firm could start with low cost, cheat customers, and then go out of business, leaving losses to fall on innocent investors and society. This extreme case is probably fairly rare given the burden of qualification and the fact that such a firm is unlikely to attract many customers, or much money, in the first instance. But there are many documented cases of smaller firms acting unethically, specifically making unsuitable recommendations, such as in the penny stock business.[140] And it is common practice for brokers who engage in marginal conduct to switch brokerage firms with some frequency.

[137] See M. Todd Henderson and James C. Spindler, Corporate Heroin: A Defense of Perks, Executive Loans, and Conspicuous Consumption, 93 Georgetown L J 1835, 1840 (2005).
[138] See id at 1859.
[139] See id at 1883.
[140] For an example of small firm misbehavior involving penny stocks, *see, for example*, FINRA News Release, "FINRA Fines Five Firms $385,000 for Sale of Unregistered Securities, Other Violations Relating to Penny Stocks," Apr. 27, 2010, available at http://www.finra.org/Newsroom/NewsReleases/2010/P121331.

Moreover, even if the extreme cases are rare, the problem exists on a sliding scale, with firm size serving as a proxy for this type of potential problem. The smaller the firm, the less the firm's reputational capital and the less the incentive not to cheat. If this is right, then the problem could be large. FINRA has about 5000 member firms, the overwhelming percentage of which is small firms, with a few registered brokers.

Final period problems that result from limited liability or within-firm agency costs may justify a prophylactic rule against offering unsuitable recommendations, such as the one currently found in FINRA Rule 2111. The rule is something that both investors and (good) firms would prefer to offer but it might not arise in a market of individual contracting. For investors, the costs of individually negotiating such a contract may be too high. Investors may not appreciate the issue in advance, may not want to take the time to write a contract to cover suitability concerns, or may fail to bargain for it for other reasons, such as systematic optimism bias. Firms too might prefer to agree by contract to be bound, but such a promise would be worthless without the agreement by all firms to be bound by a rule enforceable by a third party (for example, FINRA). This is where law can be a valuable tool, providing a mandatory rule that merely reflects what the parties would have agreed to, if given the choice and the circumstances of perfect information and perfect enforcement existed. In short, such a rule may be efficient and social welfare maximizing but not something that would arise without collective action.

As with other legal rules, the ideal suitability rule is one that mimics what the parties would agree to in the absence of such a rule.[141] This should be considered from the perspective of both investors and brokers and brokers and other brokers as contracting

[141] In the context of contracts law, see Richard Craswell, Contract Law, General Theories, in Boudewijin Bouckaert and Gerrit De Geest, eds, Encyclopedia of Law and Economics, Vol 3: The Regulation of Commerce, 1, 3–4 (Edward Elgar 2000). See also Ian Ayres, default rules for incomplete contracts, in Peter Newman, ed, Vol 1: The New Palgrave Dictionary of Economics and the Law, 585, 585–588 (Macmillan Reference Ltd 1998).

parties. For each of these relationships, the optimal legal rule is one that mimics what a private contract would in ideal circumstances. If free to contract about how they would like to be treated, investors might desire brokers to commit to make only suitable recommendations. This is a costly request, however, since faced with the prospect of liability for investments that turn out badly, brokers can be expected to charge investors for this commitment. If litigation were perfect and costless, then brokers would only be charging for the value of the service provided, but neither of these assumptions is realistic. In addition, some investors might not want to pay even a fair price for the commitment, preferring to take the risk of unsuitable investment. Sophisticated investors might fall into this category, which leads to another reason to support a one-size-fits-all suitability rule. Requiring sophisticated investors to pay for a suitability commitment that they value at less than cost is simply a subsidy from sophisticated to unsophisticated investors. If unsophisticated investors are less wealthy—meaning they are less able to pay for the extra price for suitability protection but value it more highly than sophisticated investors—then this cross-subsidy might make sense. It would be a way of trying to level the playing field to make securities markets more accessible to all investors.

Brokers too might agree to be bound by a suitability promise in the absence of a rule requiring it. FINRA, acting as a rough proxy for the wishes of its industry members, could be seen as expressing just this preference with its suitability rule. Being bound by such a commitment is a way of signaling the quality of the recommendations brokers make. This might be hard to do absent a neutral third party, such as the government or FINRA, acting as a credible enforcer of the promise.

A suitability rule may also serve as an efficient way for firms to reduce agency costs. The shareholders or managers of a firm may prefer that brokers only offer suitable investments as a way of increasing the firm's reputation and therefore profits. But shareholders and their agents may be unable to write perfect contracts or perfectly monitor brokers to ensure this. Externally enforced suitability rules may provide a valuable tool for shareholders, brokers, and customers. Governmental or quasi-governmental entities can provide penalties, like bans from the industry, that private entities cannot. Such penalties further deter offering unsuitable investments. In addition, it may be cheaper for third parties, like FINRA, to monitor this internal compliance. For one, there may be economies of scale in enforcement. FINRA's computers, which monitor trades of all registered brokers, may be better able to detect (albeit after the fact) unsuitable investments or to do so at lower cost than the same systems deployed at the firm level.

Managers may also be reluctant to discipline employees with whom they work closely on a daily basis, either because of personal bias or because of the perceived negative impact it may have on the psychological wellbeing of other employees. A culture of internal discipline can be highly negative and the possibility that intermediate level, or even high-level bosses, would look the other way or tacitly encourage misconduct is a real risk. Third party enforcement reduces these problems, as well as provides managers with an excuse for restrictions or discipline. In the absence of a rule from the outside, a manager may be reluctant to monitor or discipline a broker engaging in questionable conduct; with an outside obligation, the manager can play the good cop to the FINRA bad cop, telling his employees that he is required to enforce the rule, not choosing to do so as a personal matter.

With this basic understanding of the doctrine of suitability, the next section briefly considers applying this approach to the mortgage industry.

D. Application to the Mortgage Industry

As noted above, suitability concerns were a significant problem in the run-up to the collapse of the housing bubble and led to significant negative consequences in its wake. News reports are replete with stories of individual borrowers who took out mortgages that were too risky for their personal circumstances and deliberately more expensive and risky than necessary. Crucially, not all unsuitable mortgages amounted to downright fraud: some were more like mistakes, bets gone bad, or products of informational asymmetries, which will not support findings of intent necessary for fraud. Taking advantage is not always illegal, but it can cause serious customer losses, especially when the stakes are large.

The bluntness of the current approach could cut both ways. Most obviously, applying only fraud law to unsuitable mortgage investments may leave a significant number of socially undesirable activities unpunished. On the other hand, courts and juries may over apply fraud law in some cases due to sympathy for individuals who have lost their savings and/or homes or to ex post bias that leads to an erroneous finding of intent. The first problem results in underdeterrence of socially suboptimal behavior; the second problem results in overdeterrence.

Mortgage reforms recognize these problems and try to reduce them by banning many practices outright, interposing a new federal agency between brokers and their customers, and mandating more information disclosure to, and counseling of, clients. However, significant work has been done refuting disclosure as a remedy.[142] And the imposition of a fiduciary duty, even if broadly construed, has two problems, in terms of its corrective ability. First, it is still a governmental approach, which raises the administrability, expertise, and efficiency concerns discussed above, and self-regulation is likely far superior. Second, a fiduciary duty solution is likely overbroad, since it would prevent lots of behavior that is perfectly efficient for brokers vis-à-vis their customers and therefore reduce brokers' services and raise the cost of a mortgage. For example, although

[142] See, for example, Omri Ben-Shahar and Carl E. Schneider, The Failure of Mandated Disclosure, 159 U Pa L Rev 647 (2011).

securities brokers do not (currently) have a fiduciary duty to their customers, the suitability doctrine is still successfully deployed to police unscrupulous brokers.

However effective the federal approach to mortgage industry regulation is likely to be, there are aspects of such regulation that would be better administered by the industry itself, subject, of course, to oversight by the government to protect against the cartelization threat. For instance, all of the new activities required by the Mortgage Act and SAFE Act are already done for brokers by FINRA. FINRA operates an efficient and highly successful broker licensing and registration system, conducts audits widely regarded as competent, conducts investigations and prosecutions, and administers an enormous arbitration system, all of which have adapted to changes in the marketplace and been fairly well reviewed. For instance, in 2011, FINRA had nearly 3000 employees providing direct oversight of securities brokers. In that year, FINRA examined and audited nearly 800 brokerages; it brought 1,488 disciplinary actions against brokers, barring 329 individuals and suspending 475 others; and it engaged in widespread public education about securities investing, including through over 100 grant-supported projects.[143]

In the simplest model, Congress could pass an analog to the Maloney Act of 1938, in which prospective regulators, such as the Mortgage Bankers Association, FINRA, and other entities, would be invited to apply for certification as a mortgage SRO. Congress is already considering this approach for the regulation of investment advisors, an analogous situation.[144] FINRA, as an example, has experience running an SRO and it has experienced staff and institutions familiar with examining brokers, bringing disciplinary actions, and writing rules that are designed to reduce losses in financial brokerage contracts.

[143] FINRA, 2011 Year in Review and Annual Financial Report at 4 (cited in note 113).
[144] See note 101 and accompanying text.

But the SRO need not be FINRA or another existing broker. Being an SRO can be a profitable business. In two of the past three years, FINRA earned tens of millions in profits from its regulatory operations.[145] The start-up costs for an SRO are likely quite large—a report by the Boston Consulting Group estimates the startup costs for a self-regulator for investment advisors would be about $300 million[146]—but this could be justified for a business that generates $50 to $100 million in net income per year.[147] Moreover, Congress could underwrite some of the initial start-up costs, if necessary to create a vibrant SRO. This is not an extraordinary amount relative to the alternatives. The CFPB budget for 2013 is nearly $500 million.[148] Since about 40 percent of its work involves mortgages, this amounts to a crude estimate of about $200 million spent per year on mortgage regulation.[149] This figure does not include the hundreds of millions spent elsewhere in the federal and state regulatory apparatus on mortgage regulation, whether it is through bank regulators (remember, brokers working at banks are subject to the regulatory authority of bank regulators) or the Department of Justice or state bank and mortgage regulators.

IV. CONCLUSION

The subprime mortgage market was prone to obvious abuse and excesses during the recent housing bubble, and this undoubtedly contributed to the Great Financial Crisis. Thousands of Americans, many who were particularly vulnerable to financial predators, took out loans that were ill-suited to their financial condition. And, since a home is a vital component of human flourishing, as well as the biggest investment almost everyone will ever make, this resulted in enormous social losses.

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145 FINRA, 2011 Year in Review and Annual Financial Report at 5 (cited in note 113).

146 Boston Consulting Group, Investment Adviser Oversight: Economic Analysis of Options, 5 (Boston Consulting Group Dec 2011), online at http://www.cfp.net/downloads/BCG_Investment_Adviser_Oversight_Economic_Analysis.pdf (visited Jan 24, 2013).

147 FINRA, 2011 Year in Review and Annual Financial Report at 36 (cited in note 113).

148 See CFPB, Financial Report of the Consumer Financial Protection Bureau: Fiscal Year 2012 at 49 (cited in note 75).

149 See id at 20.

As described in this Article, the regulatory response has been to create a new federal agency, to ban many practices, to create a national licensing system, to impose a fiduciary duty obligation on brokers, and to require "counseling" to reduce mortgagor mistakes or bad judgment. This federal, law-based approach has completely dried up the subprime market, and imposed large regulatory costs on mortgage brokers. The federal response is blunt relying as it does on federal agents to police mortgage transactions with bans or fraud as their primary tools.

This Article argues that there may be a better way of reforming the mortgage practices and efficiently differentiating between "good" and "bad" brokerage practices. Similar problems as exist in mortgage investments also plague securities investments, and brokered relationships in the securities context are regulated primarily by the industry itself. This model has been used for over two centuries, and it is has proved quite adept at bringing industry expertise to bear, at keeping regulatory costs low, and at trying to strike the optimal balance between the freedom of individuals to make investments and the paternalism necessary to ensure fraudsters do not take undo advantage of the vulnerable.

While self-regulation is not a panacea and may be ineffective, and in fact counterproductive, if not implemented wisely, this is true of all regulation. The central point of this Article is that there are significant efficiency gains, both in the delivery of goods and services and in the regulation thereof, from an effective deployment of self-regulation. It is not too late for Congress or the CFPB and other bank regulators to learn this lesson.

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