Commentary: The Magic of Self-Regulation

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The Conference Report on what has become the "Dodd-Frank Wall Street Reform and Consumer Protection Act" has been released and approved by the House of Representatives. After the Independence Day week-long break, the Senate is widely expected to vote in favor, sending the most important legislation dealing with the financial services industry since the 1930s to President Obama to sign into law.

Self-regulation shows up in several sections of the Act.

First, the legislation requires the General Accounting Office (GAO) to conduct a study on the feasibility of forming a self-regulatory organization to oversee private funds. The GAO will report the results of this study to the Senate Banking Committee, now chaired by Senator Dodd, and to the House Financial Services Committee, chaired by Congressman Frank, within one year after the Act's enactment.

Second, the Act requires the SEC to conduct a study considering whether designating a self-regulatory organization to oversee investment advisers would "improve the frequency of examinations of investment advisers." This report is due within 180 days after the Act's enactment.

You heard it here first. The GAO will find that it is feasible to form a self-regulatory organization to oversee private funds. Why on earth wouldn't it be feasible? And, requiring FINRA to augment the SEC's examination cycle will improve the frequency of investment adviser examinations. How could adding additional examination cycles have any other effect than to improve the frequency of examinations?

What is going on here is that the investment management industry is, and always has been, opposed to self-regulation. Industry lobbyists managed to pare down legislation that would have required self-regulation in the earlier drafts of financial reform legislation. But, they weren't able to kill it altogether. So, this will be an issue deferred into the next Congress.

Congress finds self-regulation very attractive because it is a nifty way of requiring the industry to pay for its own regulation. Unlike the SEC, Congress is not required to fund FINRA or any of the national securities exchanges from the public fisc. If a self-regulatory organization needs more money, it submits a rule change

to the SEC. The industry can make comments on the rule, but it is very hard for the industry to play "starve the beast" with its self-regulator.

For its part, the SEC has a love-hate relationship with self-regulation. The SEC enjoys being able to influence the industry indirectly by requiring FINRA to adopt rules governing the conduct of its members, rules that often have an adverse impact on industry profits. The hate part finds expression in enforcement actions the SEC brings against self-regulatory organizations from time to time.

The NASD, FINRA's predecessor, and the New York Stock Exchange have each paid staggering fines for dereliction of their regulatory duties. Most of us remember well when a decade ago the NASD was required to pay a fine of $100 million and was subjected to special supervision for its failure to regulate the NASDAQ market making industry effectively. Among other things, this led to the formation of NASD Regulation, which ultimately morphed into FINRA. The NASDAQ market making industry was subjected to a plethora of new rules that it had successfully resisted for years. Examinations were transformed during this period from friendly efforts to help firms with their compliance efforts into snarling inquisitions intended to uncover malfeasance at every turn.

The fact is that self-regulatory organizations, much more than the government agencies charged with their supervision, are subject to regulatory capture. The concept of self-regulation requires that at least some of their directors will be industry representatives. Their committees, including judicial committees charged to determine whether or not firms have violated the rules, are peopled with regulated employees. It goes without saying that industry representatives will be more sympathetic to industry needs and will find industry arguments about rule interpretations more persuasive than outsiders.

Of course, it's not all good for the industry. Otherwise, the investment management industry would embrace self-regulation with open arms. Self-regulation is all about more regulation. It also frees the SEC to operate at a higher level and use its resources more effectively. All other things being equal, this adds up to more intense regulation, which adversely affects industry profits.

Self-regulation therefore tends to have a somewhat schizophrenic quality, and FINRA is a good example of that. Its charter in some ways makes it sound like a trade organization. So, one of its purposes is to "provide a medium through which its membership may be enabled to confer, consult, and cooperate with governmental and other agencies in the solution of problems affecting investors, the public, and the investment banking and securities business." However, this "friendly" role is overweighed by three sections of the charter describing FINRA's regulatory mission "to promote high standards of commercial honor, . . . encourage and promote . . . observance of federal and state securities laws, . . . adopt, administer and enforce rules of fair practice and rules to prevent fraudulent and manipulative acts and practices" and so on.

The relatively recent transformation of FINRA from helpful, smiling, profit-oriented trade organization into fierce regulator is most-evident in its public statements. Its website, for example, emphasizes FINRA's role in protecting investors. Nary a word can be found about its efforts to represent its member's interests before the SEC and other governmental regulators.

The investor protection role for FINRA is a bit like the fox guarding the hen house. As a general proposition, the financial services industry dislikes fraud and unfair practices because they are bad for business. But this is a far cry from enforcing rules that reduce industry profits by mandating costly reporting to enhance transparency.

Nonetheless, in recent years, FINRA has, at the urging of the SEC, instituted and vigorously enforced costly rules that favored investors over its members, and we have witnessed entire industry occupations disappear as a result. Of the Big Five NASDAQ markets makers that roamed the earth a decade ago, only one remains, and that organization spends a lot of time playing down that role. Many rules introduced since the transformation required real time reporting, which is costly to produce and diminishes profits by increasing competition. Some rules denied industry market makers an opportunity to profit on most trades, which led to automated systems that eliminated the role of human traders. These rules are gradually being introduced into other industry sectors. Bond traders are dealing with the increasingly heavy hand of TRACE reporting. Over the counter equity traders have recently experienced the introduction of Manning rules into their remote markets. For all its sympathy for the industry, if FINRA were a trade organization, it would have been disbanded long ago.

It should therefore come as no surprise that lobbyists for the investment management industry are so determined to prevent self-regulation. It is a whip held by a velvet glove.

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