SROs and Due Process

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As discussed in prior articles, the constitutional legitimacy of the SEC and other independent administrative agencies depends in large part on the "due process" of their actions. The Fifth Amendment of the US Constitution states, in part, that "no person shall . . . be deprived of life, liberty or property, without due process of law."

In interpreting the meaning of "due process," as it pertains to an administrative agency, the Supreme Court has examined whether due process has been satisfied when an agency engages in rule-making, judging and enforcement, which correspond to the three principal powers of government: Legislative, judicial and executive. Due process is satisfied when agencies make rules after the public has been provided notice of proposed rule-making and an opportunity to make comments. In agency judicial hearings, a defendant must have adequate notice and an opportunity to be heard, which includes the important rights to obtain the advice of counsel, to present evidence and to examine adverse witnesses. The SEC's enforcement authority is limited to civil procedures, but even so, the Division of Enforcement is required to conduct investigative and prosecutorial activities in a manner that protects the rights of the accused.

So far, neither the courts nor the SEC has been willing to subject self-regulatory organizations (SROs) to the Constitutional requirements of due process.

When federal securities law was created in the 1930s, Congress initially viewed the concept of self-regulatory organizations as a good way to make the securities industry pay for its own regulation. In a time of economic hardship, this avoided having the strapped public taxpayer foot the bill for the regulation of an industry viewed by many as composed of fat cats.

In the 1930s, the New York Stock Exchange was a private company owned by its members. So, to achieve self-regulation, all Congress needed to do is require that the New York Stock Exchange create rules for its members. To make sure that these rules would be appropriate, the New York Stock Exchange, and all other national securities exchanges, were required to obtain the SEC's approval for these rules. And, SROs were required to establish a system for enforcing these rules.

To make sure that this self-regulatory scheme covered the entire industry, every broker-dealer was required to become a member of some SRO. This covered all of the broker-dealers that were members of exchanges, but something needed to be done to cover over-the-counter brokers and dealers. So, the National Association of Securities Dealers, Inc. (NASD) was established for that purpose, initially with federal subsidy. It soon became self-supporting, like the exchanges.

This neat and tidy method of regulating the securities industry at little cost to the public purse left open the question of the character of an SRO. If it is a regulator, then its actions should be subject to all of the due process rights guaranteed to protect life, liberty and property under the Constitution. If it is a membership organization, then its relationship with members is contractual. The whole idea of a contract is that you give up some property, and in the case of an employee, some liberty, in exchange for other benefits. Under the Constitution, people are free to contract as they will, subject to occasional considerations of public policy. You can't lawfully contract for murder, for example.

At first blush, it would seem that Congress believed that SROs would be treated like agencies and therefore subject to due process. Section 19(b) of the Exchange Act requires the SEC, before issuing an order approving a rule change by an SRO, to publish the proposed rule change for public notice and comment.

The recent trend, however, is to treat the relationship between an SRO and its members as a matter of contract. So, for example, the SEC has stated that an SRO is not required to permit its members to obtain the advice of counsel. Registered representatives are required, as a matter of contract, to arbitrate disputes with their employers in FINRA-administered proceedings, rather than resort to the courts.

Stranger still, the Second Circuit Court of Appeals, the federal appellate court with jurisdiction over Wall Street, has held that SROs have absolute immunity for actions taken pursuant to their regulatory authority. This is an odd result. If the relationship between the regulated and the regulator is a matter of contract, then either party should be able to resort to the courts. On the other hand, if an SRO is an administrative agency operating under the US Constitution, the regulated ought to have access to the courts to protest abuses of due process.

The reasoning behind all of this is extremely dubious. I doubt that many industry participants think of FINRA as anything but a regulator. After all, it is not possible to hold down a job on a trading desk without entering into a "contract" with FINRA.

It will come as no surprise to discover that the doctrine is subject to abuse. In some cases, FINRA has required registered representatives to provide information to them that related to a criminal case, forcing the representative with the Hobson's choice

of being barred from the industry or providing testimony that would assist in his prosecution. In a modern economy, the threat of being deprived of an ability to make a living is only somewhat less onerous than jail time. So far, when the press has gotten involved because the defendant was of interest to the media, the SEC has stepped in and reversed FINRA's decisions. This is not always the case.

Criminal case or not, a contractual counterparty is entitled to remedies for breach in the case of default. A regulator, however, is not entitled to force testimony that would tend to incriminate the litigant. Faced with the halogen scrutiny of the press, the SEC has treated FINRA as a regulator. When the case is not news, FINRA is just another private contractor. It is unfair to have it both ways.

In recent years, the NYSE and NASDAQ have argued that they are being left behind by competitors because of the time it takes to have rule changes approved. So, the trend is to publish the rule as a final product on an abbreviated two-week SEC review schedule, with public notice and comment to occur later. The theory seems to be that if the rule is abusive, the SEC can abrogate it later.

This trend is also troublesome. The exchanges are no longer member organizations. Instead, they are public companies with thousands of shareholders demanding increasing profits. There is always a temptation for them to use their rule-making power as a competitive weapon. The requirement of public notice and comment is a check on rapacious behavior that is blunted by allowing the rule to go forward before the public is allowed to comment on it.

Due process was drafted into the Constitution for a reason. Regulatory proceedings that deny private persons access to counsel and other basic rights of the accused rapidly deteriorate into star chambers. Rules promulgated in a manner that avoids public scrutiny become royal decrees. Corruption, rather than efficiency, follows in the wake of unchecked governmental power.

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