Opinion: Why Didn't FINRA Catch Madoff?

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Press reports have raked the SEC over the coals because of the Madoff scandal. Much has been made over the fact that Shana Madoff is married to a former SEC official, a private matter of no relevance to the issues involved.

I submit that this focus is misplaced. Instead, we should be asking, why didn't FINRA catch up to Madoff? A few days ago, after weeks of tireless reporting, the *Wall Street Journal* finally tried to probe Mary Schapiro on this question. Mary has been in charge of FINRA and its regulatory predecessor, NASD Regulation, for many years. She did not respond to the *Wall Street Journal*'s inquiries.

Equity traders rarely are a focus of attention during a financial crisis. They accept and execute orders; they don't make investment decisions. Occasionally a trader "goes rogue" and wildly exceeds his or her trading authority, but the business ordinarily doesn't provide much opportunity for fraud of a magnitude sufficient to bring a financial institution to its knees. For that reason, the Madoff scandal is unique. A trader well-known in equity trading circles apparently has engineered a fraud sufficient to make him front page news in the financial press for weeks.

That said, there is no evidence that the Madoff scandal involved its trading operations. After all, the Madoff firm was famous for executing lots of small orders in listed securities. These are orders that by their nature tell us little or nothing about market direction. The various frauds that typically occur on a trading desk – front-running, marking the close, manipulation of thinly traded securities – are difficult to accomplish at a firm that handles small orders from other broker-dealers for extremely liquid, listed equities. Moreover, institutional trading firms like Madoff typically do not hold client funds, but trade delivery versus payment. So that rules out frauds that involve stealing from customer accounts. While the magnitude of the Madoff fraud is truly staggering, it is difficult to see how the Madoff trading operation was involved in any significant way, except perhaps as a front for what was really going on.

The Madoff firm, however, was a broker-dealer, and therefore it was entitled to do more than merely make markets in stocks, provided that it received permission from FINRA to engage in other activities. It seems that FINRA granted Madoff permission to hold funds and securities for clients, and to manage those accounts as a discretionary broker.

The financial press is very confused about all of this. I still see news reports calling Madoff a hedge fund. It was not. It was, besides making a market in equities, a broker-dealer holding customer funds and securities in discretionary accounts. This is a traditional brokerage activity.

Of course, to those who are not used to the fine distinctions that exist in the financial services industry, discretionary brokerage looks a lot like investment management. But discretionary brokerage was a traditional brokerage activity in 1934, when our current system of regulation was enacted, and continues to be part of the business of many broker-dealers to this day. In 2003, about 70 years after the Securities Exchange Act of 1934 was enacted, the SEC finally came around to the notion that discretionary brokers ought to register as investment advisers under the Investment Advisers Act of 1940, as well as being registered as broker-dealers. When this regulation became effective, the Madoff firm registered as an investment adviser, while retaining its registration as a broker-dealer.

The press also seems to think that investment adviser registration, if it had been accomplished earlier, would have made a difference. The fact is that broker-dealers are the most heavily regulated entities in the securities business and their brokerage operations were subject to intense regulatory oversight long before the dual-registration requirement went into effect. However, the heavy hand of regulation for broker-dealers does not belong to the SEC.

It is true that the SEC can be expected to show up from time to time to perform an examination of broker-dealers. But, for every examination performed by the SEC, FINRA examiners can be expected to show up three or four times. Moreover, SEC compliance reviews generally are light-hearted affairs by comparison with FINRA examinations, which in recent years have become a major ordeal.

Back in the days when it was the NASD, FINRA examinations were less tough and frequent, but they were always, in my experience, more exacting and frequent than the SEC's exams. FINRA examinations really ramped up after the scandal alleging price-fixing by NASDAQ market makers. This gradual toughening accelerated when Mary Schapiro became the head of NASD Regulation. Mary is a very tough cop.

So, what went wrong?

The job of regulation is government service. The sad fact of life is that the government pays its employees a fraction of the amount that is paid to employees of financial services firms. Economics being what it is, those who seek a career in government service either are very idealistic and public-spirited or lack the talent required of the typical Goldman Sachs employee.

Worse yet, the idealistic, public-spirited types are not likely to seek careers as FINRA examiners. In the government service pecking order, compliance examinations are tough duty. Like internal auditors in corporate America, the examining staff hopes their work will lead to more glamorous assignments elsewhere. And for the government career employee, a job at the SEC carries much more status than the same position at FINRA, all other thing being equal. Mary Schapiro obviously thinks that the top job at the SEC is to be preferred to the top job at FINRA. I suspect that her staff would feel much the same way.

Nor is FINRA the way-station of choice for those who try a stint in government service as a means to obtain a well-compensated position in the financial services industry. It is rare to the point of non-existent to hear of a prominent Wall Street lawyer accepting a job with the examination staff of either the SEC or FINRA, even as the head of a department.

Of course, those examiners who do yearn for a better life in financial services are not likely to want to rankle future employers by performing an examination with too much diligence. Some commentators would fix this problem by prohibiting employees of regulators from accepting jobs in the industry they regulate. If we paid regulatory employees compensation roughly equivalent to their regulated counterparts, it might make sense to insist that they not accept jobs in the industry they regulate. Otherwise, any such restriction would only exacerbate the difficulty regulatory agencies currently have attracting qualified applicants.

Bernie Madoff was a clever man who fooled lots of very smart, sophisticated, highly compensated, and experienced people who should have known better. Under the circumstances, it is hardly shocking that the overworked and underpaid examination staffs of the SEC and FINRA failed to catch up to him.

If as a people we are going to get serious about regulation, and this current crisis should provide some incentive for serious discussion, the financial imbalance between the employees of the regulator and those of the regulated needs to be addressed. It seems to me that the idea of "self-regulation" by a membership organization such as FINRA obscures this issue and in some ways makes it worse.

The institution of self-regulation in 1934 seemed a clever idea at the time. It caused the industry to pay for the costs of its own regulation, and it was hoped that having the industry participate in its own regulation would lead to a more enlightened and expert regulatory regime. The fact is that the industry is not truly a participant in its own regulation, except as a lobbyist for business friendly, and often anti-competitive, rule-making. And, sadly, self-regulatory examination has proven incapable of preventing frauds until they are brought to light by horrendous losses.

Our system of broker-dealer regulation just hasn't worked, and it is time to face up to that grim reality.

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