

CARDS Check: Taking a Look at FINRA



Emily Liner

Former Senior Policy
Advisor, Economic
Program

The House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises will hold a hearing on Friday, May 1, on oversight of the Financial Industry Regulatory Authority (FINRA). The hearing is likely to center on three topics: 1) FINRA's authority as a Self-Regulatory Organization, 2) the CARDS risk-monitoring system, and 3) the BrokerCheck investor protection database. This memo provides background on FINRA and these three issues.

FINRA's authority as a Self-Regulatory Organization

FINRA serves a unique role in the markets. Along with the Securities and Exchange Commission (SEC), it supervises trading activity and has the power to punish wrongdoers, but it is not a government entity. Rather, FINRA is a Self-Regulatory Organization (SRO) of broker-dealers. It was created following a 1938 law giving SROs the responsibility to protect investors in over-the-counter securities markets, where trades often happen over the telephone rather than on an exchange. FINRA's membership elects half of its Board of Governors; the other half consists of appointed public

representatives, including a former SEC chair and several academics.¹

As an SRO, FINRA exists between a trade association and the industry's government regulator. FINRA performs certain supervision and enforcement duties that complement the SEC, but it cannot prosecute offenders. FINRA regularly consults with the SEC to propose government regulations that protect investors, and it monitors the markets to make sure those rules are being followed.

Firms and individual broker-dealers who register with the SEC must also join FINRA—similar to attorneys' requirement to join the bar association. (As a reminder, brokers execute stock, bond, and option trades for clients, while dealers trade on their own accounts.) FINRA's authority comes from 1) its control over licenses to trade securities, like the Series 7 certification, 2) its ability to conduct annual examinations of member firms, and 3) its power to fine, suspend, and expel members who break the rules.

As regulators' budgets and resources get stretched further, SROs like FINRA have attempted to fill in the gaps. For example, FINRA notes that it helped the SEC identify 660 cases of fraud and insider trading in 2013.² However, the firms that FINRA regulates are also largely its funders. About three-fourths of its 2013 revenue came from transaction fees, registration fees, and fines.³ Former Federal Reserve Chairman Paul Volcker's new advocacy group the Volcker Alliance has voiced concern that some regulators have developed an over-reliance on SROs to perform supervisory duties, like annual examinations of firms, that government agencies should be doing themselves.⁴

Earlier this year, the Mercatus Center—a free market-oriented think tank—released a report arguing that FINRA lacks substantive accountability.⁵ Although FINRA reports to the SEC, it does not have the same checks and balances that a full-fledged government agency would have, such as Congressional oversight or Freedom of Information Act

disclosure requirements. This is likely to be the centerpiece of the discussion at Friday's hearing.

The controversy over CARDS

In the wake of the financial crisis, FINRA proposed a new “big data” system to collect information about trades to monitor risk. The Comprehensive Automated Risk Data System (CARDS) would require FINRA members to submit monthly reports of detailed information about all of their trades. It would allow FINRA to track activity at the individual account and order level. Supporters of this initiative hope this new tool will help identify patterns of risky and fraudulent behavior before they grow out of control. For example, data analytics could spot a “pump and dump” scheme to artificially inflate a stock's price, as well as monitor systemic risk trends across firms.

CARDS is about halfway through FINRA and the SEC's joint rulemaking process, so it has not yet been implemented. Opponents in industry and Congress have described CARDS as costly, complex, and potentially duplicative of the SEC's new Consolidated Audit Trail (CAT). FINRA has responded that CARDS was created to standardize and more efficiently analyze data that members already submit for their annual exams. Some privacy advocates are also concerned that CARDS may become a target for hackers looking to steal sensitive personal and financial data. FINRA has modified its proposal to remove personally identifiable information. It will need to respond to the latest round of public comments before the rulemaking process continues.

The goals and gaps of BrokerCheck

FINRA also runs a database called BrokerCheck, which allows the public to look up information about their investment brokers and advisors—the industry equivalent of running a background check. BrokerCheck pulls member records from FINRA's Central Registration Depository and combines them with information publicly available from the SEC. Investors can confirm previous employment and find out if their broker

has ever been charged with disciplinary actions by FINRA or the SEC, criminal convictions, or customer complaints that resulted in legal action.

BrokerCheck was launched as a public service to protect everyday American retail investors from the next Bernie Madoff. It complements the enforcement role of FINRA, which kicked out 429 members and suspended another 670 in 2013.⁶ But because brokers and firms self-report information to BrokerCheck, there is evidence that many bad actors simply do not submit incriminating information about themselves. In a 2014 investigation, *The Wall Street Journal* found more than 1,500 brokers in BrokerCheck whose records did not show their bankruptcies or criminal records.⁷ This has led to calls for FINRA to take a more proactive role in reviewing BrokerCheck's records. FINRA's member database contains some 650,000 records, and *The Wall Street Journal* found 11,700 individuals who properly reported past offenses in BrokerCheck.⁸

Conclusion

In many ways, FINRA acts like other professional organizations that handle licensure and compliance. The overarching debate boils down to differing philosophies over whether FINRA should act as an assistant to the SEC. Supporters believe that a powerful public-private intermediary improves behavior through enhanced enforcement. Some opponents worry about the “fox guarding the henhouse” problem in allowing an industry to regulate itself. Meanwhile, others voice concern that it is a burdensome additional layer of regulation.

TOPICS

FINANCIAL SERVICES 70

END NOTES

1. "FINRA Board of Governors," Financial Industry Regulatory Authority. Accessed April 28, 2015. Available at: <http://www.finra.org/about/finra-board-governors>.
2. "2013 FINRA Year in Review and Annual Financial Report," Financial Industry Regulatory Authority, 2013. Accessed April 27, 2015. Available at: <http://www.finra.org/about/annual-reports-financials>.
3. "2013 FINRA Year in Review and Annual Financial Report," Financial Industry Regulatory Authority, 2013. Accessed April 27, 2015. Available at: <http://www.finra.org/about/annual-reports-financials>.
4. "Reshaping the Financial Regulatory System," Report, The Volcker Alliance, April 20, 2015. Accessed April 27, 2015. Available at: <https://volckeralliance.org/resources/reshaping-financial-regulatory-system>.
5. Hester Peirce, "The Financial Industry Regulatory Authority: Not Self-Regulation after All," Report, Mercatus Center, George Mason University, January 6, 2015. Accessed April 27, 2015. Available at: <http://mercatus.org/publication/financial-industry-regulatory-authority-finra-not-self-regulation-after-all>.
6. "2013 FINRA Year in Review and Annual Financial Report," Financial Industry Regulatory Authority, 2013. Accessed April 27, 2015. Available at: <http://www.finra.org/about/annual-reports-financials>.
7. Jean Eaglesham and Rob Barry, "Regulator Deletes Red Flags From Brokers' Records, Says Study," *The Wall Street Journal*, March 6, 2014. Accessed April 27, 2015. Available at: <http://www.wsj.com/news/articles/SB10001424052702304554004579423270046013550>.
8. Jean Eaglesham and Rob Barry, "Regulator Deletes Red Flags From Brokers' Records, Says Study," *The Wall Street Journal*, March 6, 2014. Accessed April 27, 2015. Available at: <http://www.wsj.com/news/articles/SB10001424052702304554004579423270046013550>.

