THE MATRYOSHKA DOLL PRINCIPLE: TRANSPARENT GOVERNANCE OBLIGATIONS OF FINRA REMAIN SAFELY NESTED WITHIN THE LAYERS OF EXISTING SECURITIES REGULATION

Brittany M. McIntosh

Abstract

This Article compares the U.S. Supreme Court's holding in *Free Enterprise Fund v. PCAOB* to the factors used in *Lebron v. National Railroad Passenger Corp.* when determining whether a corporation is part of the government (and consequently subject to government control and the President's removal powers). In *Free Enterprise*, the U.S. Supreme Court considered factors to determine whether or not an agency is a self-regulatory organization (an independent third party agency that is not subject to government control). Under the *Free Enterprise* test, the Court held that PCAOB was not an SRO (unlike the Financial Industry Regulatory Authority, Inc.) because PCAOB is "part of the government." Applying the *Free Enterprise* analysis and the *Lebron* test to FINRA, FINRA is considered to be an SRO and will remain safely nested like the tiniest matryoshka doll, away from direct governmental oversight. This Article discusses in-depth the *Free Enterprise* analysis, the *Lebron* test, and how FINRA does not pass the scrutiny of either test to be considered "part of the government." Therefore, FINRA will remain unchecked by the government, leaving FINRA free from scrutiny and without an obligation to be accountable to the public.

I. Introduction

In a 5–4 decision in June 2010, the U.S. Supreme Court determined that the dual requirements restricting the removal power of the U.S. President shielded the members of the Public Company Accounting Oversight Board ("PCAOB"), and was in contravention of constitutional powers vested in the President.[1] Specifically, the Court held that where the Securities and Exchange Commission ("SEC") regulations governing the PCAOB act to prevent the removal of PCAOB members except for good cause ("layer one") coupled with a restriction that an SEC Commissioner's removal by the President would be conditioned upon situations where a Commissioner's

1. *See* Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 130 S. Ct. 3138, 3147 (2010).

"inefficiency, neglect of duty, or malfeasance in office" have resulted in a lack of accountability to the President, ("layer two")[2] the separation of powers has been violated. While the *Free Enterprise* Court reasoned that the PCAOB is "not accountable to the President" and the President is "not responsible for the actions" of the PCAOB,[3] the Court concluded that "the President . . . must have some "power of removing those for whom he cannot continue to be responsible."[4] Therefore, the two enumerated levels of removal restrictions violated the President's constitutional duty to faithfully execute the laws.[5]

Because Congress modeled the PCAOB after the structure of a self-regulatory organization ("SRO"),[6] the holding in *Free Enterprise* arguably calls into question that very structure, specifically the SRO's unfettered powers of removal.[7] The *Free Enterprise* Court, in *dicta*, distinguished an SRO from the PCAOB using a test formulated in *Lebron v. National Railroad Passenger Corp.*, which examines whether a given entity is part of the federal government.[8] Utilizing the test, the *Free Enterprise* Court found that an SRO would not be considered a part of the government (i.e., under the control of government), because the SRO is not a "Government-created, Government-appointed entity, with expansive powers to govern an entire industry."[9]

Further, application of the *Lebron* test highlights what may be a contradiction to the U.S. Supreme Court holding in *Free Enterprise*[10] with regard to how courts applying *Lebron* would find governmental control over an entity, where, as in *Free Enterprise*, the Court had already equated removal power with the power of government to control such an entity,[11] not simply whether an entity meets the three prongs of the *Lebron* test. Applying the *Free Enterprise* analysis to the Financial Industry Regulatory Authority ("FINRA") or a similar organization, the *Lebron* test would not be satisfied, thus the problematic contradiction will persist. Therefore, FINRA will remain safely nested like the tiniest matryoshka doll, away from direct governmental oversight. Until the contradiction between the *Free Enterprise* analysis and the *Lebron* test can be reconciled by a subsequent holding or legislation, FINRA's dual layers of removal restrictions guarantee oversight of FINRA will remain unchecked, leaving FINRA free from scrutiny and without an obligation to be accountable to the public.

2. *See id.* at 3148.
3. *Id.* at 3148, 3153.
4. *Id.* at 3152 (citing Myers v. United States, 272 U.S. 52, 117 (1926)).
5. *See Free Enter. Fund*, 130 S. Ct. at 3147.
6. *See* Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 130 S. Ct. 3138, 3147 (2010).
7. *See id.*
8. *See id.* (citing Lebron v. Nat'l R.R. Passenger Corp., 513 U.S. 374, 397 (1995)).
9. *See Free Enterprise Fund*, 130 S. Ct. at 3147 (quoting Lebron v. Nat'l R.R. Passenger Corp., 513 U.S. 374, 397 (1995)). Lebron holds that when "the Government creates a corporation by special law, for the furtherance of governmental objectives, and retains for itself permanent authority to appoint a majority of the directors of that corporation, the corporation is part of the government for purposes of the First Amendment." *Lebron*, 513 U.S. at 397.
10. *See Free Enterprise Fund*, 130 S. Ct. at 3146.
11. *See* Edmond v. United States, 520 U.S. 651, 664 (1997) (removal is a powerful tool for control).

II. Case Analysis: *Free Enterprise Fund v. Public Company Accounting Oversight Board*

A. Constitutional Background

Article II Section 1 of the U.S. Constitution states "[t]he executive Power shall be vested in a President of the United States of America," and the President "shall take Care that the Laws be faithfully executed."[12] To faithfully execute the Laws, the Constitution implicitly provides for executive officers to "assist the supreme Magistrate in discharging the duties of his trust."[13] The *Free Enterprise* Court reiterated this principle, where Justice Roberts, speaking for the Court, noted: "the Constitution has been understood to empower the President to keep these officers accountable—by *removing* them from office, if necessary."[14] Importantly and without reexamining the issue, the *Free Enterprise* Court equated control with the removal power.[15]

Recognizing, however, that the President's removal power is not infinite,[16] the *Free Enterprise* Court touched on the already well-established separation of powers principles.[17] Citing the earlier Supreme Court case *Humphrey's Executor*, the Court in that case determined "that Congress can, under certain circumstances, create independent agencies run by principal officers appointed by the President, whom the President may not remove at will but only for good cause."[18] Specifically, the Court upheld a provision in the Federal Trade Commission ("FTC") Act, which permitted removal of a FTC commissioner by the President, but only for "inefficiency, neglect of duty, or malfeasance in office."[19] There, only one single level of restrictive removal power (the for-cause "layer one provision"), authorized by Congress over the agency commissioner, would not act to contravene the President's constitutional duties.[20] Accordingly, the *Free Enterprise* case examined where dual levels of restrictive removal powers butted up against well-established precedent upholding the constitutionality of a single level of restrictive removal power.[21]

B. Majority

Free Enterprise ultimately illustrates a novel issue: where two layers (as described above) of removal power with restriction are embedded in a statutory scheme, what is the effect on the separation of powers doctrine?[22]

---

12. U.S. CONS. Art. II, § 1, cl. 1; *see also id.* at § 3.
13. Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 130 S. Ct. 3138, 3146 (2010) (citing 30 WRITINGS OF GEORGE WASHINGTON 334 (J. Fitzpatrick ed. 1939) (emphasis added).
14. *Id.* (emphasis added).
15. *See Edmond*, 520 U.S. at 664.
16. *See* Humphrey's Ex'r v. United States, 295 U.S. 602, 620 (1935).
17. *See Id.*
18. *Free Enter. Fund*, 130 S. Ct. at 3146 (citing to *Humphrey's Ex'r*, 295 U.S. at 620).
19. *See Humphrey's Ex'r*, 295 U.S. at 620.
20. *See id.* at 632.
21. *See id.*; *see also* Morrison v. Olson, 487 U.S. 654, 660–61 (1988); United States v. Perkins, 116 U.S. 483, 485 (1886).
22. *See* Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 130 S. Ct. 3138, 3147 (2010).

The question addressed by the *Free Enterprise* Court was whether the President could be "restricted in his ability to remove a principal officer, who is in turn restricted in his ability to remove an inferior officer, even though that inferior officer determines the policy and enforces the laws of the United States?"[23] The five-justice majority ultimately held that dual layers of restrictive removal contravened the President's constitutional duties.[24]

At issue in *Free Enterprise* was the PCAOB, created under the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or the "Sarbanes-Oxley Act").[25] Sarbanes-Oxley regulations contain a series of heightened restrictions on the accounting industry enforced via the PCAOB, a nonprofit corporation.[26] The PCAOB governs "[e]very accounting firm—both foreign and domestic—that participates in auditing public companies under the securities laws."[27] Each accounting firm must annually register, pay fees, and comply with all PCAOB rules and regulations.[28] Additionally, the PCAOB enforces "securities laws, the [SEC's] rules, its own rules, and professional accounting standards."[29] Specifically, the PCAOB "promulgates auditing and ethics standards, performs routine inspections of all accounting firms, demands documents and testimony, and initiates formal investigations and disciplinary proceedings."[30] The PCAOB has the power to and "can issue severe sanctions in its disciplinary proceedings, up to and including the permanent revocation of a firm's registration, a permanent ban on a person's associating with any registered firm, and money penalties."[31] The broad swath of enforcement responsibilities afforded the PCAOB is indicative of the tremendous power the PCAOB may exercise over public company accountants and standards.[32]

Significantly, Congress structured the PCAOB model after private SROs[33] such as FINRA.[34] However, the *Free Enterprise* Court expressed that the PCAOB is fundamentally *unlike* an SRO because the PCAOB in fact, satisfies the test formulated in *Lebron v. National Railroad Passenger Corp.*[35] The *Lebron* test states that an entity is part of the government if it is a "Government-created, Government-appointed entity, with expansive powers to govern an entire industry."[36] Although the statute creating the PCAOB contained language stating that the PCAOB "shall not be an agency or establishment of the United States Government"[37] and the *Free Enterprise*

23. *Id.*
24. *Id.*
25. *See id.*
26. *See id.*
27. *Id.*
28. Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 130 S. Ct. 3138, 3147 (2010) (citing Sarbanes-Oxley Act of 2002, §§ 101(a), 102(a), (f), 103, 106(a)(1), 15 U.S.C. §§ 7211(a), 7212(a), (f), 7213, 7216(a)(1) (2006)).
29. *Id.* (citing Sarbanes-Oxley Act of 2002, §§ 105(b)(1), (c)(4), 15 U.S.C. §§ 7215(b)(1), (c)(4) (2006)).
30. *Id.* (citing Sarbanes-Oxley Act of 2002 §§ 103–105, 15 U.S.C. §§ 7213–7215 (2006 ed. and Supp. II)).
31. *Id.* (citing Sarbanes-Oxley Act of 2002 § 105(c)(4), 15 U.S.C. § 7215(c)(4) (2006)).
32. *See id.*
33. An SRO supervises and regulates the actions of its members, and is subject to oversight by the SEC. *See Definition of Self-Regulatory Organization–SRO*, INVESTOPEDIA, http://www.investopedia.com/terms/s/sro.asp#axzz1kF3u1cK2 (last visited Jan. 28, 2012).
34. *See* Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.,130 S. Ct. 3138, 3147 (2010).
35. *Id.* (quoting Lebron v. Nat'l R.R. Passenger Corp., 513 U.S. 374, 397 (1995)).
36. *Free Enter. Fund*, 130 S. Ct. at 3147.
37. Sarbanes-Oxley Act of 2002 § 101(b), 15 U.S.C. § 7211(b) (2006).

parties agreed that PCAOB members are "not Government officials for statutory purposes," the parties were able to agree that the PCAOB is "part of the Government" for constitutional purposes and thus will be subject to constitutional protections and vested powers of the other branches of government.[38] The PCAOB's structure consists of five members appointed by the SEC, each serving alternating five-year terms.[39] Under the existing structure, PCAOB members are "substantially insulated from the [SEC's] control"[40] because the regulations state that the SEC can *only* remove PCAOB members "for good cause shown."[41] In order to show good cause for removal, the SEC must determine that a PCAOB member either (i) wilfully violated any provision of [the Sarbanes–Oxley] Act, the rules of the Board, or the securities laws; (ii) has wilfully abused the authority of that member; or (iii) without reasonable justification or excuse, has failed to enforce compliance with any such provision or rule, or any professional standard by any registered public accounting firm or any associated person thereof.[42]

Further, the removal process of a PCAOB member requires an "on the record" determination "after notice and opportunity for a hearing," is afforded to the member.[43] The "[r]emoval of a [PCAOB] Board member requires a formal [SEC] Commission order and is subject to judicial review."[44] Thus, the Sarbanes-Oxley Act "not only protects [PCAOB] Board members from removal except for *good cause*, but withdraws from the President any decision on whether that good cause exists."[45] Because the decision rests solely with SEC Commissioners themselves, the *Free Enterprise* majority argued, the PCAOB as created is both "not accountable to the President and [conversely has] a President who is not responsible for the Board."[46]

The majority therefore held that two regulatory layers allowing removal are "contrary to [Article II-designated] vesting of the executive power in the President."[47] The majority further reasoned that because "[t]he President cannot 'take Care that the Laws be faithfully executed' if he cannot oversee the faithfulness of the officers who execute them," and moreover "the President cannot, [therefore], remove an officer who enjoys more than one level of good-cause protection, even if the President determines that the officer is neglecting his duties or discharging them improperly. That judgment is instead committed to another officer, who may or may not agree with the President's determination, and whom the President cannot remove simply because that officer disagrees with him."[48] This "limbo" status constructed by the regulatory structure thereby contravenes the President's "constitutional obligation to ensure the faithful execution of the laws."[49]

38. *Free Enter. Fund*, 130 S. Ct. at 3148 (citing *Lebron*, 513 U.S. at 397).
39. *Free Enter. Fund*, 130 S. Ct. at 3147.
40. *Id.* at 3148 (emphasis added).
41. Sarbanes-Oxley Act of 2002 § 101(e)(6), 15 U.S.C. § 7211(e)(6) (2006) (emphasis added).
42. Sarbanes-Oxley Act of 2002 § 107(d)(3), 15 U.S.C. § 7217(d)(3) (2006).
43. *Id.* at § 7217(d)(2).
44. Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 130 S. Ct. 3138, 3148 (2010).
45. *Id.* at 3153 (emphasis added).
46. *Id.*
47. *Id.* at 3154.
48. *Id.* (quoting Morrison v. Olson, 487 U.S. 654, 693 (1988)).
49. *Id.* at 3154.

The majority grounds their holding in the principle that a contradiction exists where the regulations, as structured, prevent the PCAOB from being accountable to the President, a concept that directly opposes the separation of powers principles embedded in the Constitution.[50] The majority maintains that the Framers of the Constitution wanted "those who are employed in the execution of the law [to] be in their proper situation, and the chain of dependence be preserved; the lowest officers, the middle grade, and the highest, will depend, as they ought, on the President, and the President on the community."[51]

In conclusion, the majority found that the two layers of restrictive removal ("for cause" and "intentional malfeasance") contravened the President's constitutional duty and severed the provision from the Sarbanes-Oxley Act, thereby permitting the *at will* removal of PCAOB members.[52]

C. Dissent

Converse to the majority, the four dissenters argued that the PCAOB, created under the Sarbanes-Oxley Act, does not "significantly" impede the President's constitutional power and to hold otherwise "disrupts severely the fair and efficient administration of the laws."[53] Associate Justice Breyer observed that the majority's rigid view and bright line approach to Congress' ability to limit the President's removal power deprives the government of flexibility.[54] The dissenting judges aspired to soften the seemingly inflexible underpinnings of the traditional constitutional separation of powers analysis and leave room for a more functional approach thereby permitting flexibility.[55] Furthermore, they argued that following precedent would actually better embody the concept of a "workable government."[56] The *Free Enterprise* dissenters did not rely on any specific text within the Constitution[57] and maintained that the Constitution's broad language allows for government expansion.[58] Specifically, the Supreme Court has previously held that:

> [the Constitution's] framework has been sufficiently flexible over the past two centuries to allow for enormous changes in the nature of government. The Federal Government undertakes activities today that would have been unimaginable to the Framers . . . Yet the powers conferred upon the Federal Government by the

50. *See* Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 130 S. Ct. 3138, 3155 (2010).
51. *See id.* (quoting 1 ANNALS OF CONG. 463, 499 (1789) (J. Madison)).
52. *See Free Enter. Fund*, 130 S. Ct. at 3161 (emphasis added).
53. *Id.* at 3164–65.
54. *See id.*
55. *See id.* at 3170.
56. Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 130 S. Ct. 3138, 3167 (2010) (citing Youngstown Sheet & Tube Co. v. Sawyer, 343 U.S. 579, 635 (1932) (Jackson, J., concurring)); *see also* Morrison v. Olson, 487 U.S. 654, 689–90 (1988) (substance over form); Commodity Futures Trading Comm'n v. Schor, 478 U.S. 833, 854 (1986) (functional approach over rigid approach); Crowell v. Benson, 285 U.S. 22, 53 (1932) (substance over form).
57. *See Free Enter. Fund*, 130 S. Ct. at 3166 (noting that the U.S. Constitution is silent on removal power).
58. *See id.* at 3168 (citing New York v. United States, 505 U.S. 144, 157 (1992)).

> Constitution were phrased in language broad enough to allow for the expansion of the Federal Government's role.[59]

They found that the broad language of the Constitution allows for a workable government through the utilization of administrative agencies.[60] Consequently, the *Free Enterprise* dissenters contend that since a flexible government is set out in precedence, and an efficient Government is a flexible government, precedence commands a flexible and more functionalist view of the PCAOB.[61] Particularly, the dissenters relied on one previous decision, *Nixon v. Administrator of General Services*, that insisted "when 'determining whether [an] Act disrupts the proper balance between the coordinate branches, the proper inquiry focuses on the extent to which it prevents the Executive Branch from accomplishing its constitutionally assigned functions.'"[62] Accordingly, the dissent used a balancing approach and argued that the second layer of removal restrictions placed on the PCAOB members does not significantly affect the President's power.[63] They offered four examples to illustrate their approach:

> 1. The President and the Commission both want to keep a Board member in office. Neither layer is relevant.
> 2. The President and the Commission both want to dismiss a Board member. Layer Two stops them both from doing so without cause. The President's ability to remove the Commission [Layer One] is irrelevant, for he and the Commission are in agreement.
> 3. The President wants to dismiss a Board member, but the Commission wants to keep the member. Layer One allows the Commission to make that determination notwithstanding the President's contrary view. Layer Two is irrelevant because the Commission does not seek to remove the Board member.
> 4. The President wants to keep a Board member, but the Commission wants to dismiss the Board member. Here, Layer Two helps the President, for it hinders the Commission's ability to dismiss a Board member whom the President wants to keep in place.[64]

Utilizing the four scenarios portrayed above, the dissenters concluded that the removal of the second layer does not make the PCAOB any more accountable to the President.[65] Therefore, the dissenters would tolerate insignificant restrictions on the President's power, to yield flexibility.[66]

Further, the dissenters asserted that the Court should demonstrate judicial restraint and not question the removal restriction placed on the PCAOB.[67] The dissenters reasoned that the second layer does not significantly restrict the President and by leaving layer two in place, the Court would help

59. *New York*, 505 U.S. at 157.
60. *See id.*
61. *Free Enter. Fund*, 130 S. Ct. at 3164–65.
62. *See* Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 130 S. Ct. 3138, 3175 (2010) (citing 433 U.S. 425, 443 (1977)); *see also Morrison*, 487 U.S. at 691, 695 (upholding a significant impediment on the President's power by balancing the impediment versus function of the official in question).
63. *Free Enter. Fund*, 130 S. Ct. at 3171.
64. *Id.*
65. *See id.*
66. *See id.* at 3170.
67. *See id.*

to accomplish administrative flexibility.[68] The dissent added that the Court should defer to Congress because the Court holds an inferior understanding of the realities of administration.[69] In summation, the dissent's rationale in finding no flaw in the constitutionality of the application of the dual layers of restrictive removal was ultimately to bolster a mechanism to insulate the PCAOB from the political pressure surrounding the President, specifically that the Board members do not have political affiliations and are simply accounting experts trying to protect public company investors.[70]

III. The *Free Enterprise* Decision and FINRA

A. FINRA Origins

In 1936, the National Association of Securities Dealers, Inc. ("NASD") incorporated in the state of Delaware as a non-profit corporation.[71] In 1938, Congress amended the Securities and Exchange Act of 1934 (the "Exchange Act") to allow for the formation and registration of national securities associations, otherwise known as SROs.[72] After passage of the amendments, the NASD gained authorization from Congress as a national securities association in 1939.[73] In 2007, the NASD and NYSE Group, Inc. combined forces to create one entity—FINRA.[74]

B. FINRA Responsibilities

FINRA is responsible for the regulation and oversight of all securities firms that do business with the public, commonly known as broker-dealers.[75] Additionally, FINRA is in charge of the training and education of securities professionals, including the testing and licensing of registered representatives.[76] Further, FINRA inspects securities firms, establishes compliance rules, and enforces its rules in addition to the federal securities laws of the United States.[77] FINRA may also facilitate arbitration and mediation of complaints between

68. *See* Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 130 S. Ct. 3138, 3170 (2010).

69. *See id.* at 3169 (noting that the Sarbanes–Oxley Act passed by a vote of 423 to 3 in the House of Representatives and by a unanimous vote in the Senate).

70. *See id.* at 3174 (noting that the PCAOB is not appropriated money from Congress evinces Congress' recognition for the need to insulate the PCAOB from political pressure).

71. *Entity Details of Financial Industry Regulatory Authority, Inc.*, DEL. SEC'Y OF STATE, https://delecorp.delaware.gov/tin/controller (last visited Jan. 28, 2012).

72. *See* The Maloney Act of 1938, ch. 677, 52 Stat. 1070 (1938) (codified at Exchange Act § 15A, 15 U.S.C. § 78o-3 (1988)) (generally known as § 15A of the Securities Exchange Act of 1934).

73. *In re* Application by National Association of Securities Dealers, Inc., for Registration as a National Securities Association, Exchange Act Release No. 34,2211, 5 S.E.C. 627 (promulgated Aug. 7,1939).

74. Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory, Exchange Act Release No. 34,56145, 91 S.E.C. Docket 517 (July 26, 2007), *available at* http://www.sec.gov/rules/sro/nasd/2007/34-56145.pdf.

75. *See About FINRA*, FINRA, http://www.finra.org/AboutFINRA/ (last visited Nov. 4, 2011).

76. *See id.*

77. *See id.*

investors (customers) and broker dealers.[78] Finally, FINRA monitors securities trading on the U.S. stock markets.[79]

C. FINRA Framework

A Board of Governors controls FINRA.[80] The FINRA bylaws state that the Board of Governors must consist of FINRA's Chief Executive Officer, the Chief Executive Officer of NYSE Regulation, eleven Public Governors, and ten Industry Governors.[81]

The registered FINRA companies (i.e., "broker-dealers") elect seven of the ten industry Governors.[82] The three additional Industry Governors round out diversity on the Board and include a Governor associated with a floor member of the New York Stock Exchange, one Governor associated with an independent financial planning registered firm or an affiliate of an insurance company, and one Governor associated with an affiliated Investment Company.[83] The Board of Governors appoints these three Industry Governors from candidates chosen by the Nominating Committee.[84]

Further, the Board of Governors appoints FINRA's eleven Public Governors from candidate recommendations via the Nominating Committee.[85] The Nominating Committee is comprised of certain members from the Board of Governors and is annually appointed by the remaining Board of Governors.[86] Finally, the SEC can *only* remove a Governor on the Board after appropriate notice, opportunity for a hearing, and for cause.[87]

D. Is FINRA Exempt From the *Free Enterprise* Decision?

1. Is FINRA a Part of the Federal Government?

As mentioned above, the *Free Enterprise* majority specifically points out that an SRO is not part of the government because an SRO does not meet the elements of the *Lebron v. National Railroad Passenger Corp.* test.[88] In *Lebron*, the Court held that the test for whether a corporation is part of the government is if the "Government creates a corporation by special law, for the furtherance of governmental objectives, and retains for itself permanent

78. *See id.*
79. *See id.*
80. *See* The Maloney Act of 1938, ch. 677, 52 Stat. 1070 (1938) (codified at Exchange Act § 15A, 15 U.S.C. § 78o-3 (1988)).
81. *By-Laws of the Corporation Article VII*, FINRA, http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=4598 (last visited Nov. 4, 2011).
82. *See id.* at Article I(z), Article I(dd), Article I(xx) (defining Small Firm Governor, Mid-Size Firm Governor, and Large-Firm Governor), and Article VII, Section 4(a).
83. *See* The Maloney Act of 1938, ch. 677, 52 Stat. 1070 (1938) (codified at Exchange Act § 15A, 15 U.S.C. § 78o-3 (1988)).
84. *See id.*
85. *See FINRA By-Laws*, *supra* note 81, art. VII, § 9.
86. *See id.*
87. *See id.*
88. *See* Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 130 S. Ct. 3138, 3147 (2010).

authority to appoint a majority of the directors of that corporation."[89] Under a *Lebron* analysis, FINRA would not be a part of the Government.

The *Lebron* test is comprised of the following three elements: "the entity must be created by the Government, must be appointed by the Government, and must possess powers to govern an industry."[90]

The first *Lebron* element arguably is not satisfied under an initial reading of the language "Government created by special law"[91] because a federal statute did not create FINRA; instead it is a corporation authorized as a national securities association under the Exchange Act.[92] Merriam-Webster defines "create" as "to bring into existence."[93] Although the government did not expressly create FINRA by statute,[94] Congress ultimately recognized FINRA as a national securities association,[95] indicating that the government played a part in bringing FINRA into complete existence.[96] For FINRA to satisfy *Lebron* element one, the element of "Government created by special law" would have to be expanded from statutorily created entities, to also include statutorily authorized entities.

FINRA satisfies the second element under *Lebron*, "the furtherance of governmental objectives."[97] The SEC and FINRA's shared mission is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[98] FINRA, *inter alia*, registers and educates securities industry participants, examines securities firms, writes rules, enforces rules and the federal securities laws, informs and educates investors, and provides arbitration for investors and registered broker-dealers.[99] According to the SEC's website, the SEC's power includes, *inter alia*, "the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation's securities self-regulatory organizations (SROs)," like FINRA.[100] Clearly, FINRA's aims advance U.S. governmental objectives because they are substantially similar to the objectives expounded by the SEC.

At first blush, the third and final element under *Lebron*, the government's "authority to appoint a majority of [the entity's] directors," is not satisfied by FINRA because[101] the federal government has no active part

89. Lebron v. Nat'l R.R. Passenger Corp., 513 U.S. 374, 399 (1995).

90. *Id.* at 397 (holding that "the Government creates a corporation by special law, for the furtherance of governmental objectives, and retains for itself permanent authority to appoint a majority of the directors of that corporation, the corporation is part of the Government for purposes of the First Amendment").

91. *Id.*

92. *See Entity Details*, *supra* note 71.

93. *Create*, MERRIAM-WEBSTER ONLINE DICTIONARY, http://www.merriam-webster.com/dictionary/create (last visited Nov. 4, 2011).

94. *See Entity Details*, *supra* note 71; *see also* Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151, 159 (2008) (discussing that FINRA, formerly known as the National Association of Securities Dealers, Inc., was incorporated in Delaware in 1936).

95. *See* Karmel, *supra* note 94.

96. *See id.* at 157.

97. Lebron v. Nat'l R.R. Passenger Corp., 513 U.S. 374, 399 (1995).

98. *What We Do*, SEC, http://www.sec.gov/about/whatwedo.shtml, (last visited Nov. 4, 2011).

99. *See In re* Application by National Association of Securities Dealers, Inc., for Registration as a National Securities Association, Exchange Act Release No. 34,2211, 5 S.E.C. 627 (promulgated Aug. 7,1939).

100. *See* Karmel, *supra* note 94, at 157.

101. *Lebron*, 513 U.S. at 399.

in the appointment of the FINRA Board of Governors.[102] However, the SEC has ultimate approval power over any change in FINRA's bylaws.[103] Therefore, the government (the SEC) must approve the rules outlining the appointment of the Board of Governors and the appointment of the Nominating Committee thereby satisfying the third element of *Lebron*.[104]

Traditionally, the Supreme Court has equated removal power with the power to control,[105] but the *Lebron* analysis seems to indicate that *appointment* power may also serve as an element indicating federal government control.[106] This discrepancy is in need of clarification. Implied in the third element of *Lebron* is the concept that the power to control stems from the power to appoint.[107] However, the Supreme Court's *Free Enterprise* decision held that control is removal power without reference to any other elements that would signify control.[108] By implication, a viable argument exists that the ultimate test for who controls an entity lies in the answer to who holds the power to destroy the same entity. Accordingly, because the SEC retains the power to remove FINRA's Board of Governors and the federal government retains no power to destroy FINRA, the *Free Enterprise* holding would support the conclusion that the SEC is in control.[109] Because of the seeming inconsistency in the *Free Enterprise* holding and the tenets of the *Lebron* test, for FINRA to satisfy element three of *Lebron*, the element would have to be expanded to include removal power, or the Supreme Court would need to recognize and give considerable weight to the fact that the SEC has final approval over the appointment guidelines of the FINRA Board of Governors suggesting the requisite level of governmental control.

To conclude, the *Lebron* analysis as applied to FINRA, FINRA would not have existed as an SRO without the approval of Congress.[110] Furthermore, the appointment procedures of FINRA's Board of Governors as outlined in FINRA's By-Laws would not have existed without the SEC's approval.[111] Although the above analysis is not narrowly tailored to the holding in *Lebron*, the preceding discussion may be viable arguments to expand the *Lebron* holding.

2. Would the Removal Process of FINRA's Board of Governors Contravene the President's Constitutional Power?

Assuming that an expansion of element three of the *Lebron* holding is persuasive and arguments that FINRA is part of the Government are

102. *See* The Maloney Act of 1938, ch. 677, 52 Stat. 1070 (1938) (codified at Exchange Act § 15A, 15 U.S.C. § 78o-3 (1988)) (generally known as § 15A of the Securities Exchange Act of 1934).

103. *See By-Laws of the Corporation*, art. XI, § 1, FINRA, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4661 (last visited Jan. 28, 2011); *see also* Karmel, *supra* note 94, at 157.

104. See FINRA By-Laws, art. XI, § 1.

105. *See* Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 130 S. Ct. 3138, 3162 (2010) (citing Edmond v. United States, 520 U.S. 651, 664 (1997)).

106. *See* Lebron v. Nat'l R.R. Passenger Corp., 513 U.S. 374, 399 (1995).

107. *See id.*

108. *See Free Enter. Fund*, 130 S. Ct. at 3162 (citing *Edmond*, 520 U.S. at 664).

109. See FINRA By-Laws, art. IX.

110. *See* Securities and Exchange Act § 19(h)(4), 15 U.S.C. § 78s(h)(4) (2006).

111. *See Lebron*, 513 U.S. at 399.

convincing, the next step in the analysis would be to determine whether or not the removal of FINRA's Board of Governors violates the separation of powers doctrine, similar to the PCAOB conundrum in *Free Enterprise*. Under the *Free Enterprise* analysis, FINRA's dual layered removal process contravenes the President's constitutional obligation to faithfully execute the laws.

The first layer of removal power regards the removal of SEC Commissioners. Such removal is not express in statute, still, the *Free Enterprise* majority assumes, and both parties stipulated, that the removal power is for cause, specifically, "inefficiency, neglect of duty, or malfeasance in office."[112] As mentioned above, the dissent questioned such assumption and provided a thorough opposing argument, which centered around an analysis of the historical context and incorporated Congress' intent to create the SEC.[113] The dissent warned that the majority should be wary when assuming a "for cause" provision in order to strike down another statute because based on Congress' intent (i.e., the President's removal power of the SEC Commissioners could very well be at will and not for cause.)[114] If SEC Commissioners are removable at will, there remains only one layer of restrictive removal protecting the PCAOB. Thus, the President's constitutional duty is not usurped because one layer of restrictive removal has firm precedence as being found constitutional.[115] Because the SEC cannot remove a FINRA Governor unless the Governor has willfully violated the statute, abused his or her authority, or "failed to enforce compliance without a reasonable justification or excuse, the process to remove FINRA Governors would be, arguably, very strict under the *Free Enterprise* analysis."[116]

Therefore, the SEC's "for cause" removal, layered on top of FINRA's "for cause removal," would violate the separation of powers doctrine, presumably for the same reasons as the majority cited regarding the PCAOB in *Free Enterprise*—the dual layer scheme indicates control, thus violating implicit constitutional powers. Further, in light of the *Free Enterprise* dissent's historical argument regarding whether the SEC Commissioners are removable for cause or at will,[117] it would be crucial for such question to be researched and clarified to avoid confusion and miscategorization of entities going forward. However, does the contention that FINRA is not government-created and the government does not appoint the FINRA Governors save the removal process from the stamp of unconstitutionality under the *Free Enterprise* decision? The answer is yes until the Supreme Court chooses, if ever, to re-evaluate *Lebron*. Moreover, it is undeniable that five justices in the *Free Enterprise* majority emphatically stated that an SRO is not "Government created or Government appointed.[118] Nevertheless, the Court concedes that

112. Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 130 S. Ct. 3138, 3144, 3183 (2010).
113. *See id.* at 3170.
114. *Id.* at 3182.
115. *See* Humphrey's Ex'r v. United States, 295 U.S. 602, 620 (1935). However, regardless of the removal of the SEC Commissioners, the dissent concluded that two layers of restrictive removal power are constitutional because the second layer does not significantly restrict the President's power and provides for a flexible government. *Id.*
116. *Id.*
117. *See* Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 130 S. Ct. 3138, 3170 (2010).
118. *See id.*

Congress designed the PCAOB after the SRO model and SRO statutes. Therefore, logically, if the PCAOB is part of the government and the PCAOB was designed using the SRO model, there is a strong argument in favor of designating any SRO as part and parcel of the federal government.

IV. Expansion of *Lebron v. National Railroad Passenger Corp.* to Include FINRA

A moralistic argument in favor of an expansion of the *Lebron* case can be found in the massive economic and regulatory fallout following the last several years of global economic downturn. FINRA and the SEC have both suffered image and trustworthiness attacks after the lack of adequate securities regulation unveiled by the loss of investors' finances and trust in such well-publicized cases as the Bernie Madoff and R. Allen Stanford fraud-scandals. These scandals illustrate what some critics refer to as "both the broadest and deepest criticism of FINRA: that FINRA has an inherent conflict-of-interest because it is controlled by brokers, while also regulating brokers, thus rendering FINRA an ineffective regulator."[119] FINRA oversees the securities industry, but FINRA is comprised of the leaders profiting from and driving the very same securities industry, which begs the obvious question: is self-regulation the best practice for securities regulation?[120] Arguments against self-regulation include that FINRA is an ineffective regulator because it tends to serve and protect "brokers' interests, rather than the public's interest."[121] One major critic disavowing self-regulation, the non-governmental watchdog known as the Project on Government Oversight, ("POGO")[122] found FINRA to be failing at its regulation of broker-dealers, subsequently suggesting that all securities regulations should be "under the umbrella of the government, with no independent regulator."[123]

However, there are advantages of classifying FINRA as part of the federal government. First, historically the securities regulation field has been criticized for its lack of transparency.[124] An egregious example of such lack of diversity and transparency within the regulatory field involved the appointment of Bernard "Bernie" Madoff's (currently incarcerated for felony

119. Manuel P. Asensio & Daniel Rodriguez, *Securities Regulatory Reform: Addressing FINRA's Inherent Conflict and Moral Hazard*, ALLIANCE FOR ECON. STABILITY, 7 (Jan. 4, 2010), *available at* www.asensio.com/FINRAReportweb.pdf (citing Richard Lindsey, *. . . But Beware of 'Moral Hazards'*, WALL ST. J., Sept. 5, 1995, at A18).

120. Page Perry, LLC, *Concerns Grow Over SRO Bill For Advisors*, INV. FRAUD LAWYER BLOG (Dec. 14, 2011), http://www.investmentfraudlawyerblog.com/2011/12/concerns_grow_over_sro_bill_fo.html.

121. Asensio & Rodriguez, *supra* note 119, at 9.

122. *About Us*, PROJECT ON GOV'T OVERSIGHT, http://www.pogo.org/about/about-us-history.html (last visited Nov. 15, 2012). The Project on Government Oversight is a "nonpartisan independent watchdog" based in Washington, DC and funded by foundation grants and individuals. *Id.*

123. Shahien Nasiripour, *Watchdog Group Warns Congress About Wall Street Oversight*, HUFFINGTON POST, http://www.huffingtonpost.com/2010/02/23/watchdog-group-warns-cong_n_473399.html (last updated Apr. 25, 2010).

124. *See* Complaint at n. 4, Amerivet Sec., Inc. v. FINRA, 2009 WL 7418040 (D.C. Super. Aug. 10, 2009.) (No. 09CV05767); *see also* Barry James Dyke, *You Must Be Kidding: Mary Shapiro a Sheriff on Wall Street*, ECON. WARRIOR (May 27, 2010. 9:36 AM), http://economicwarrior.org/2010/05/27/you-must-be-kidding-mary-shapiro-a-sheriff-on-wall-street-what-are-the-editors-at-time-magazine-smoking/.

securities fraud)[125] to the regulatory body that reviews FINRA's disciplinary action.[126] Concurrently, Madoff's brother and niece both held positions at FINRA.[127] The multiple familial connections certainly raise scrutiny and question how any official, charged with the security and protection of strangers, could effectively regulate their own family.[128]

Despite past conflicts of interest, a lack of transparency still plagues FINRA because many of FINRA's executive leaders hail from the very same broker-dealers it is responsible for regulating.[129] Thus, the most compelling argument in favor of classifying FINRA as an SRO is to ensure the agency is regulated directly by the federal government.[130] Direct federal government oversight authority will bolster public trust in FINRA, where FINRA will become less likely to be perceived as making its own rules or satisfying the interests of insiders ahead of the public.[131]

V. Conclusion

In addition to seeking clarity and uniformity in court precedent, there are good public policy reasons to implement an overhaul of the securities regulators, including increasing transparency and accountability of all regulators to all investors. However, unless the *Lebron* test is expanded, neither the *Lebron* nor the *Free Enterprise* holdings will reach FINRA. In order to reach FINRA as well as other such organizations, the Supreme Court should expand *Lebron*'s test in two ways. First, element one can easily be expanded to include government-approved entities, given that Congress

125. *See* Patricia Hurtado, *Peter Madoff, Brother of Bernard Will Plead Guilty,* BLOOMBERG NEWS (June 26, 2012. 9:01 PM), http://www.bloomberg.com/news/2012-06-27/peter-madoff-brother-of-bernard-will-plead-guilty-u-s-says.html.

126. *See* Complaint at n. 4, Amerivet Securities, Inc., 2009 WL 7418040.

127. *See id.*; *see also* Asensio & Rodriguez, *supra* note 119, at 9.

128. Similar conflicts of interest also existed between FINRA and Stanford Financial Group. Anna Driver, *Stanford Workers Had Ties to Regulator FINRA*, REUTERS (Feb. 24, 2009, 5:08 PM), http://www.reuters.com/article/idUSTRE51N5RO20090224 (discussing that a compliance officer at Stanford Financial, Lena Stinson, held a position on FINRA's membership committee and Stanford Group Holding's Chief Operation Officer, Frederick Fram, held a position on FINRA's continuing education committee).

129. *See* Danielle Brian*, POGO Letter to Congress Calling For Increased Oversight of Financial Self-Regulators,* PROJECT ON GOV'T OVERSIGHT (Feb. 23, 2010), http://www.pogo.org/pogo-files/letters/financial-oversight/er-fra-20100223-2.html (mentioning that the "cozy relationships" between FINRA and the securities industry is a serious conflict of interest). The Project on Government Oversight (POGO) is a nonpartisan independent watchdog that investigates corruption and other misconduct in order to achieve a more effective, accountable, open, and ethical federal government. *See id.* POGO observed that the current FINRA Chief Executive Officer, Richard Ketchum, "is a former General Counsel for the Corporate and Investment Bank at Citigroup, Inc. Robert Errico, FINRA's Executive Vice President for Member Regulation, is a former Senior Vice President for Capitals Market Oversight at Charles Schwab & Co., and a former General Counsel for Schwab Capital Markets L.P. Susan Merrill, FINRA's Executive Vice President and Chief of Enforcement, is a former partner at Davis Polk & Wardwell, which represents some of the largest financial institutions in the world. And on FINRA's Board of Governors, many of the members that are supposed to represent the public's interest have close ties to the securities industry." *See id.* However, Robert Errico and Susan Merrill have since stepped down from their positions, possibly because of the POGO findings. *See FINRA Executives*, FIN. INDUS. REGULATORY AUTH., http://www.finra.org/AboutFINRA/Leadership/P019457 (last visited Jan. 21, 2011).

130. Furthermore, the fees from the broker-dealers fund FINRA; therefore, the brokerage firms provide FINRA's executive compensation. Hence, FINRA's regulation of the broker-dealers provides a deterrent for the FINRA executives to "bite the hand that feeds them." Therefore, FINRA executives have a financial incentive to place broker-dealers' interest in front of the public's. *See* Page Perry, LLC, *supra* note 120.

131. *Id.*

already approves whether an entity becomes a national securities association. Second, element two should be expanded to include organizations where government has the power to remove directors of the entity, instead of the current model which allows only for the government appointment of directors. If the courts would instead interpret the power of removal to be on equal footing with the power to control an entity, the federal government, through the SEC, would then be deemed in control over FINRA (or like organizations) regardless of who has actually appointed the entity's Board of Governors. An expansion of the *Lebron* test would force transparency and accountability to investors (or other public beneficiaries) on the part of organizations like FINRA.

The watchdog organization POGO has identified FINRA's lack of transparency or accountability to be a telltale sign highlighting the Court and/or the legislature's need to act, describing the organization as follows: "[i]n light of FINRA's abysmal track record" and because "[o]ur economy is too important to be left in the hands of the very financial industry that brought us to the brink of collapse,"[132] we advocate for a change. Therefore, if the above policy reasons would be persuasive to the Supreme Court, reinterpretation of *Lebron* allowing for the recategorization of FINRA as an SRO would accomplish the desirable effect of fortifying both the public and investors' faith alike in the legitimacy of securities regulation thereby decreasing the opportunity for catastrophic failures in oversight that might lead to future economic disruption or missteps.

132. Brian, *supra* note 129 (POGO Letter to Congress).