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Can Fraud Be Immunized by Giving the Defrauder Certain Governmental Powers Over the Victims?

by Hans Bader on October 26, 2011

Can a private organization that has been delegated some government regulatory powers claim absolute government immunity against lawsuits when it engages in fraud against those it regulates — even when the fraud is at most distantly related to its regulatory functions? Amazingly enough, an appeals court said yes — a ruling that conflicted with another appeals court's ruling — and the Supreme Court is now being asked to reverse that decision.

The Competitive Enterprise Institute joined Cato Institute in filing an *amicus* brief asking the Supreme Court to review that disturbing ruling shielding wrongdoing. The brief, which cites constitutional safeguards and separation-of-powers principles, can be found here. The case is *Standard Investment Chartered* v. *National Association of Securities Dealers* (NASD). NASD converted into an entity called FINRA after deceiving regulated members about the terms of the conversion. (FINRA's CEO was shortly thereafter appointed by President Obama to head the federal Securities and Exchange Commission.) Cato Institute's Ilya Shapiro describes the significance of the case here.

Forbes has an interesting article on the case by Edward Siedle. As he puts it:

Should FINRA, the brokerage industry's self- regulatory organization, have absolute immunity from lawsuits—even when FINRA issues a false and misleading proxy statement to its membership? As a former SEC attorney and owner of a FINRA-member brokerage for more than 20 years, in 2008 I thought the answer to this question was pretty simple. Almost four years later, I'm still waiting to learn whether FINRA is accountable to anyone.

Back in 2008 I was well aware that the degree of control FINRA had over the investing public was both remarkable and disturbing. . . .self-regulation of the brokerage industry involves an inherent and insurmountable conflict of interest. . . Investors pay a heavy price for conflict ridden self-regulation. . .[NASD boasted that] "The NASD has

successfully resisted many proposals inimical to the best interests of . . . its members." Very revealing—no pretense of concern for the nation's investors in that boastful line.

Despite this unique history of largely unchecked power over investors, as a former securities regulator I figured there were limits to how far this maniacal monster could go. I was confident that if FINRA, an organization responsible under the law with regulating the truth and adequacy of statements by members of the brokerage industry, lied about the terms of a financial transaction, FINRA, like anyone else, would be held liable.

In 2008, my brokerage firm, Benchmark Financial Services, Inc. filed a class action lawsuit against FINRA on behalf of all FINRA-member firms alleging that FINRA had issued a false and misleading proxy statement to its members in connection with the merger of the NASD and NYSE. Also named as a defendant in the suit was its then Chairman and CEO, Mary Schapiro—the current Chairperson of the Securities and Exchange Commission. . .. The lawsuit focuses chiefly on the truth of statements made about a $35,000 payment that was made by the NASD to induce its members – firms such as Benchmark – to vote in favor of the merger of the NASD and NYSE. The merger closed in July 2007 leading to the creation of FINRA. . .. [NASD falsely] stated in the proxy statement that the tax code and the Internal Revenue Service had imposed a $35,000 ceiling on the payment to NASD members in connection with the merger. Through the course of the litigation, I learned that a much higher payment to NASD member firms was not only possible but feasible. In actuality, the NASD did not even receive an IRS ruling with respect to the payment until months after the proxy statement was issued to NASD members. Documents that the NASD subsequently filed with the SEC made it clear that the NASD's mantra that the tax code imposed a $35,000 limit on the payments to NASD members was simply untrue. The IRS did not issue a private letter ruling to the NASD concerning the payment to members until March 13, 2007, nearly four months after the proxy was issued and nearly two months after the voting had closed. OK—so NASD fabricated the claim that the IRS limited the payment to a maximum of $35,000 . . .. Here's the killer: The IRS private letter ruling . . . did not provide any specific limitation on the payment to NASD members. Instead it provided a range of permissible payments that would not affect the self-regulatory organization's tax exempt status.

Meanwhile, "The NASD at the time was sitting on over a $1 billion pool of cash that constituted NASD 'Members Equity.'" This money was never paid out to NASD's members, or investors. Instead, it was hoarded partly for the benefit of FINRA's new managers, whose inept oversight many believe played a role in the 2008 financial crisis. Later, "FINRA paid Mary Schapiro almost $9 million upon her departure to the SEC—about the same as Goldman Sachs CEO Lloyd Blankfein made in that year." Mary Schapiro was President Obama's pick to head the Securities and Exchange Commission.

FINRA and NASD failed investors and the American public in the years leading up to the financial crisis. As the Cato/CEI amicus brief notes (pp. 11-12):

The cases of Bernard Madoff and Stanford Financial provide evidence of this lax enforcement; in-house reports addressed FINRA's responsibilities in each. . . Further evaluation of the Stanford CD scheme, however, revealed that FINRA missed key points of factual analysis and communication that would have unearthed fraud earlier and prevented substantial losses. . .Another gross failure of regulation is apparent from the auction-rate securities breakdown of 2008. Several major banks misrepresented auction-rate securities to customers as liquid assets without disclosing the risks involved. Jill E. Fisch, Top Cop or Regulatory Flop? The SEC at 75, 95 Va. L. Rev. 785, 801-02 (2009). When the market demand dropped significantly, many investors were unable to sell their ARSs. FINRA has been criticized for failing to prevent or at least soften this collapse. Danielle Brian, POGO Letter to Congress Calling for Increased Oversight of Financial Self-Regulators, Project on Government Oversight, available at http://www.pogo.org/pogo-files/letters/financial-oversight/er-fra-20100223-2.html. . .FINRA turned a blind eye to the questionable advertising practices of these banks, despite its knowledge of the potential pitfalls of ARSs. . .FINRA referred to its ARSs explicitly as non-cash assets on its annual reports for the duration of holding, exhibiting its understanding of the non-liquid nature of ARSs. Id. FINRA divested itself of all ARS investments in 2007 without any warning to consumers.

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