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## **FINRA and Whistleblowers**

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**CRIMINAL JUSTICE**

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### **FINRA AND WHISTLEBLOWERS**

#### ***Introduction***

As most of you know, in 2007, the National Association of Securities Dealers, Inc. (NASD) amended its by-laws and changed its name to the Financial Industry Regulatory Authority (FINRA). FINRA has also taken over the regulatory duties of the New York Stock Exchange (NYSE) wholly owned subsidiary, NYSE Regulation, Inc.. FINRA is not a governmental agency but works closely with the Securities Exchange Commission (SEC). However, just like the NASD and NYSE Regulation, Inc., FINRA has the potential for making referrals for regulatory action and criminal prosecution.

In this month's *Criminal Justice* column, we will review the history of self-regulation in the securities industry culminating in the 2007 revamping of the FINRA organization. We will then look at the new Office of Whistleblower just created by FINRA and its implication for the prosecution of federal criminal violations arising out of the securities industry.

## *Foxes Guarding the Chicken Coop*

After the stock market crash of 1929, the federal government enacted the Securities Act of 1933 and the Securities Exchange Act of 1934. The idea was to avoid another crash and to do so by imposing strict regulations upon the stock traders and the securities industry. Like a lot of regulatory programs, once the industry to be regulated saw the handwriting on the wall, the industry itself sought to control the regulatory process.

The 1934 Act created the U.S. Securities Exchange Commission (SEC), an institution of the federal government. Five Commissioners are appointed to enforce the federal securities laws. They now have a staff of over 3500 people, have headquarters in Washington, D.C. and offices in 16 other cities. The SEC investigates wrongdoing and can take civil enforcement actions in the federal courts. They can also refer matters for prosecution to the Federal Bureau of Investigation (FBI), to the Department of Justice and to the offices of the United States Attorneys.

But the 1934 Act, as further amended in 1939, also gave the securities industry an opportunity to create what were designated “self-regulatory organizations.” Interestingly, only one major organization was formed to do this, the National Association of Securities Dealers, Inc. (NASD). Although the NASD was a private corporation, it took on quasi governmental powers and, by statute, can make referrals to and work closely with the SEC to regulate the securities industry. The NASD issued licenses to brokers, employed enforcement officers and lawyers and even had internal administrative tribunals to adjudicate disputes and enforcement actions against individuals and businesses who held licenses.

In 2007, FINRA took over the role of the NASD and merged the regulatory functions of the NYSE into one private agency. It was touted as a bigger, better and more streamlined organization that would be better able to compile one Rulebook and to provide more modern regulation of the securities industry. It is still not a governmental organization but has the same quasi-governmental powers based on its statutory grant and on its relationship with the SEC. Besides licensing and rule-making, it is supposed to be the first line of defense for investors against fraud and misconduct among securities brokers. Its officers and directors are, for the most part, active or retired members of the big securities firms, banks or related

entities. They are the brokers regulating the brokers for the protection of the investors.

Self-regulation can be a good thing, of course, but it can also be utilized as a way to deflect real regulation. It cannot go without notice that FINRA was up and running for a year before the 2008 financial crisis. That crisis was precipitated in large part by sharp practices on the part of the securities industry. FINRA dropped the ball. They failed to regulate the big firms and the fraudulent Bernie Madoff and Allen Stanford operations went undetected.

The SEC itself has been criticized for being too easy on the biggest organizations. One researcher recently evaluated this phenomenon in light of the theory that the Commissioners are less likely to commence enforcement actions or make criminal referrals regarding the biggest firms because that is where former Commissioners often find employment after serving. FINRA, as a private company, makes no pretense otherwise. But the SEC and FINRA are inseparable. The former CEO of FINRA, Mary Shapiro, who presided over the lack of oversight of Madoff and Stanford, has now been appointed the Chairman of the SEC.

In the wake of Madoff and Stanford, as well as the general disaster in the securities industry in 2008-09, a Special Review Committee (the “Special Committee”) was appointed by the Board of Governors of FINRA. In addition to investigating the failure to detect Madoff and Stanford, the Special Committee determined that there are more systemic problems with the organization.

### ***Whistleblowers***

There is skepticism about the ability of FINRA or the SEC to independently regulate the industry that they purport to oversee. There is also concern that the vast bureaucratic resources of these organizations are likely to be reinvigorated sufficiently to make a difference. More than one commentator has remarked that current reforms may be no more than rearranging the deck chairs on the Titanic.

In one step toward reform, FINRA has created a new Office of the Whistleblower through which, individuals with material information about potentially illegal or unethical activity can submit their information in a way that should get to the appropriate staff people. They will evaluate the information and take necessary action including referring any whistleblower tips that fall outside FINRA's jurisdiction to regulatory or law enforcement agencies.

On the face of it, this seems like a good idea. Certainly if tips about Allen Stanford or Bernie Madoff had been followed up on, those schemes might have been stopped before they harmed so many people. Of course, there is a question about how this will really work. FINRA, and the NASD before it, always had a protocol to accept tips and complaints from investors and other members of the community. It is hard to see how a new email address and phone number for "whistleblower tips" will change the staff response from what it has been to complaints coming into their regular e-mail address and phone number.

Even if there is a means to focus staff attention on legitimate whistleblower tips, is this the way to conduct the kind of regulation that the securities industry requires? FINRA should be regulating, investigating, verifying the information from the actual players, particularly the largest players, in the industry. There is something desperate in the thought that a major announced change in FINRA operations is the creation of an Office of the Whistleblower.

But the bigger problem from a criminal law standpoint is the fact that whistleblowers as a source of information are problematic. First, there is no guarantee that whistleblowers will assist in detecting the problems in the securities industries with the biggest players and with the bigger schemes. There may be an undue focus on complaints about individual brokers and individual transactions rather than the types of systemic problems that led to the current recession. Hence, there are likely to be more prosecutions of individuals and smaller organizations rather than the larger companies or higher up individuals who make policy.

Second, whistleblowers often have their own agendas. They can be unreliable reporters in order to advance their own interests. They can suffer from the same weaknesses as informants in other kinds of criminal cases. Many studies, including those of the California Commission on the Fair Administration of Justice, have determined that reliance on informants is dangerous in criminal cases and can lead to wrongful convictions.

### ***Conclusion***

FINRA is under pressure to make significant changes in light of the current financial disaster. Criminal prosecutions are always a good way to deflect attention from institutional failures. FINRA is likely to make more referrals to the SEC and to the FBI

and United States Attorneys for prosecution of people and companies. The new Office of the Whistleblower makes it more likely that we will see increased activity at the local level. Unfortunately, the whistleblower/informant procedure is likely to result in criminal investigations and prosecutions of individuals and smaller companies which may not be guilty while allowing untoward practices to continue at a larger level.