

**Testimony by**

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United States Senate**

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Chairman Dodd, Ranking Member Shelby and Members of the Committee:

I am Richard Ketchum, Chairman and CEO of the Financial Industry Regulatory Authority, or FINRA. On behalf of FINRA, I would like to thank you for the opportunity to testify today.

I commend you, Mr. Chairman, for holding today's hearing on the critically important topic of reforming our regulatory structure for financial services. As someone who has spent the great majority of my career as a regulator, dedicated to protecting investors and improving market integrity, I am deeply troubled by our system's recent failures.

The credit crisis and scandals of the last year have painfully demonstrated how the gaps in our current fragmented regulatory system can allow significant activity and misconduct to occur outside the view and reach of regulators. The fallout of this has been massive, and for many investors, tragic. Investor protection is the core of FINRA's mission, and we share your commitment to identifying existing regulatory gaps and weaknesses as well as changes to the regulatory framework that would close those gaps and improve the system for all investors.

**FINRA**

FINRA was created in 2007 through the consolidation of NASD and the member regulation, enforcement, and arbitration divisions of the New York Stock Exchange. With a staff of 2,800, FINRA regulates the practices of nearly 4,900 firms, about 174,000 branch offices and more than 650,000 registered securities representatives. As an independent regulatory organization, FINRA provides the first line of oversight for broker-dealers.

FINRA augments and deepens the reach of the federal securities laws with detailed and enforceable ethical rules and a host of comprehensive regulatory oversight programs. FINRA admits to and excludes from the industry both firms and individuals; adopts and enforces rules to protect investors and the financial markets; examines broker-dealers for compliance with its own rules as well as federal securities laws and rules of the Municipal Securities Rulemaking Board (MSRB); informs and educates the investing public; provides industry utilities and administers the largest dispute resolution forum for investors and registered firms. Significantly, FINRA is funded by regulatory fees – not taxpayer dollars. Yet FINRA’s Board of Governors is comprised of a majority of non-industry representatives. The uniquely balanced structure of our Board ensures a paramount focus on investor protection and the opportunity for input from a diverse variety of perspectives.

## **FINRA’s Core Investor Protection Programs**

### **► *Examinations***

FINRA has a robust and comprehensive examination program with dedicated resources of more than 1,000 employees. Routine examinations are conducted on a regular schedule that is established based on a risk-profile model. This risk-profile model is very important: It permits us to focus our resources on the sources of most likely harm to average investors. We apply our risk-profile model to each firm, and our exams are tailored accordingly. In performing its risk assessment, FINRA considers a firm’s business activities, methods of operation, types of products offered, compliance profile and financial condition, among other things.

During routine examinations, FINRA examines a firm’s books and records to determine if they are current and accurate. Sales practices are analyzed to determine whether the firm has dealt fairly with customers when making recommendations, executing orders and charging commissions or markups and markdowns. Anti-money laundering, business continuity plans, financial integrity and internal control programs are scrutinized.

In addition, FINRA conducts more narrow examinations based on information that we receive, including investor complaints, referrals generated by our market surveillance systems, terminations of brokerage employees for cause, arbitrations and referrals from other regulators. In 2008, FINRA conducted almost 2,500 routine examinations and nearly 6,500 targeted examinations.

### **► *Enforcement***

FINRA’s Enforcement Department is dedicated to vigorous and evenhanded enforcement of the federal securities laws and FINRA and MSRB rules. FINRA

brings disciplinary actions against firms and their employees that may result in sanctions ranging from cautionary actions for minor offenses to fines, suspensions from the business and, in egregious cases, expulsion from the industry. FINRA frequently requires firms to provide restitution to harmed investors and often imposes other conditions on a firm's business to prevent repeated wrongdoing.

In 2008, FINRA issued 200 formal complaints and 1,007 decisions were issued in formal disciplinary cases. FINRA collected over \$28 million in fines, either ordered or secured agreements in principle for restitution in excess of \$1.8 billion, expelled or suspended 19 firms, barred 363 individuals from the industry and suspended 321 others. Over the past decade, FINRA issued 12,158 decisions in formal disciplinary cases, expelled or suspended 208 firms and barred or suspended 7,496 individuals.

#### ► *Registration, Testing and Continuing Education*

Persons employed by a broker-dealer that engage in a securities business must register with FINRA. As part of the registration process, applicants must disclose their prior employment and disciplinary history, since certain prior conduct may prevent registration. FINRA also develops and administers qualification examinations that securities professionals must pass to demonstrate competence in the areas in which they will work. FINRA further administers a continuing education program that every registered person must satisfy. FINRA administers 28 qualifications exams to over 275,000 people every year, including examinations that support the MSRB, States and National Futures Association programs.

FINRA maintains the Central Registration Depository (CRD), the central licensing and registration system for the U.S. securities industry and its regulators. CRD contains the qualification, employment and disciplinary histories of firms and brokers, making it the world's largest and most sophisticated online registration and reporting system.

FINRA's BrokerCheck system makes publicly available, free of charge, certain information about firms and brokers, including disciplinary histories that can inform an investor's decision as to which firm or broker to use.

FINRA also developed, for the SEC, the Investment Adviser Registration Depository, a utility that allows federal- and state-regulated investment advisers to satisfy mandated licensing requirements. FINRA makes information about investment adviser firms publicly available.

Under contract with the Conference of State Bank Supervisors, FINRA also developed the Nationwide Mortgage Licensing System (NMLS). NMLS is a web-based system that allows state-licensed mortgage lenders, mortgage brokers

and loan officers to apply for, amend, update or renew licenses online for participating state agencies using a single set of uniform applications. Twenty-three states are currently participating in the NMLS system. Encouraged by the passage of the Housing and Economic Recovery Act of 2008, 10 additional states plan to participate in the system during 2009; 14 more have indicated plans to participate beginning in 2010.

#### ► *Advertising*

FINRA operates an extensive program to ensure that communications by firms to the public are not misleading. FINRA rules require that advertisements, Web sites, sales brochures and other communications present information in a fair and balanced manner. Some communications—those related to mutual funds, variable products and options, for example—must be filed with FINRA. In 2008, FINRA reviewed more than 99,000 pieces of communication and completed 476 investigations involving 2,378 separate communications.

#### ► *Investor Education*

Investor education is a critical component of investor protection and FINRA is uniquely positioned to provide valuable investor education primers and tools. FINRA sponsors numerous investor forums and outreach programs, and its Web site ([www.finra.org](http://www.finra.org)) is a rich source of such material, including investor alerts, unbiased primers on investing and interactive financial planning tools.

In addition to the investor education activities of FINRA itself, the FINRA Investor Education Foundation is the largest foundation in the United States dedicated to investor education. Its mission is to provide underserved Americans with the knowledge, skills and tools necessary for financial success throughout life. The Foundation awards grants to fund educational programs and research aimed at segments of the public who could benefit from additional resources. Since the FINRA Foundation's inception in December 2003, it has approved more than \$45 million in financial education and investor protection initiatives through a combination of grants and targeted projects. Many of those initiatives have focused on particularly vulnerable investors, such as seniors and military personnel and their families.

### **Gaps in the Current Regulatory System**

While regulators continue to look back and attempt to unravel the events and scandals of the past year, all of us must move ahead to aggressively revamp and modernize the regulatory framework. The failures that have rocked our financial system have laid bare the regulatory gaps that must be fixed if investors are to have the confidence to re-enter the markets. There are critical questions that should be considered as part of any new regulatory approach.

First, what protections should be provided to investors? Our current system of financial regulation leads to an environment where investors are left without consistent and effective protections when dealing with financial professionals. Investors deserve a system where they can be confident they will receive certain basic protections regardless of what product they buy or what license their financial professional holds. At the very least, our system should provide investors with the following protections:

- every person who provides financial advice and sells a financial product should be tested, qualified and licensed;
- the advertising for financial products and services should be subject to requirements that it is not misleading;
- every product marketed to a particular investor is appropriate for recommendation to that investor; and
- there should be full and comprehensive disclosure for the services and products being marketed.

Unfortunately, not all financial products come with these important attributes or protections.

Second, what products, activities and services should be regulated, and how? There are a number of gaps across our system, both in terms of similar products and services being regulated quite differently. Where we can identify these regulatory gaps that compromise investor protection and pose risk to the financial system, they should be thoughtfully filled.

One example is hedge funds. Hedge funds play a significant role in the financial system, but they are an unregulated part of it. The absence of transparency about hedge funds and their investment positions is a concern. First, as we have seen from the recent redemptions by fund investors and the de-leveraging of funds in response, they have significant ability to directionally move markets. Secondly, such funds are significant traders of over-the-counter derivative products that are unregulated and system regulation requires an understanding of these positions by regulators. Finally, although these funds are generally marketed only to investors deemed sophisticated, public pension funds, endowments and other fiduciary-type funds have exposure to hedge funds and absent some level of regulation, we cannot gain comfort that only investors with the appropriate risk tolerances and sophistication are invested in these unregulated vehicles.

Apart from their use by any class of investor or type of fund, over-the-counter (OTC) derivatives need much greater regulatory consideration. As trading in the credit default swap market has demonstrated, derivative trading can have tremendous impact on the pricing of the underlying security or index. The lack of transparency and the potential impacts these products can have on regulated

markets and the broader financial system is cause for concern. Some of these products allow substantial leverage that directly interacts with and impacts equity and debt markets. For instance, positions in OTC derivatives can impact the viability of broker-dealers through freezing their funding even when positions in those products are booked in other parts of the holding company. In addition, many OTC derivatives encounter great counterparty settlement risk because they do not clear through an established centralized clearing system that greatly reduces the risk of default in the settlement of contractual obligations. FINRA is pleased to have filed a proposed margining structure with the Securities and Exchange Commission that would enable its regulated firms that are members of the Chicago Mercantile Exchange to settle credit default swaps through that exchange's newly developed central clearing system for those products.

Finally, I'd like to highlight the regulatory gap that, in our view, is among the most glaring examples of what needs to be addressed in the current system—the disparity between oversight regimes for broker-dealers and investment advisers. The lack of a comprehensive, investor-level examination program for investment advisers impacts the level of protection for every member of the public that entrusts funds to an adviser.

In fact, the Madoff Ponzi scheme highlighted what can happen when a regulator like FINRA has only free reign to see one side of a business. Fragmented regulation provides opportunities to those who would cynically game the system to do so at great harm to investors.

So what can be done to try to prevent this from happening in the future? The regulatory regime for investment advisers should be expanded to include an additional component of oversight by an independent regulatory organization, similar to that which exists for broker-dealers.

The SEC and state securities regulators play vital roles in overseeing both broker-dealers and investment advisers, and they should continue to do so. But it's clear that dedicating more resources to regular and vigorous examination and day-to-day oversight of investment advisers could improve investor protection for their customers, just as it has for customers of broker-dealers.

As the SEC has noted, the population of registered investment advisers has increased by more than 30 percent since 2005. Investment advisers now number 11,300—more than twice the number of broker-dealers. While the SEC has attempted to use risk assessment to focus its resources on the areas of greatest risk, the fact remains that the number and frequency of exams relative to the population of investment advisers has dwindled. Consider the contrast: FINRA oversees nearly 4,900 broker-dealer firms and conducts approximately 2,500 regular exams each year. The SEC oversees more than 11,000 investment advisers, but in 2007 conducted fewer than 1,500 exams of

those firms. The SEC has said recently that in some cases, a decade could pass without an examination of an investment adviser firm.

There are differences in the current rules and standards that apply to broker-dealers and investment advisers, reflective of some of the differences that exist in the services provided by each class of professionals. And while the two channels have converged over the years, there remain some differences that need to be taken into account when enhancing oversight and exams to make that oversight fit the activity and services in each.

Broker-dealers are subject to a very detailed set of rules established and enforced by FINRA that pertain to safety of customer cash and assets, advertising, sales practices, limitations on compensation, financial responsibility, and trading practices. FINRA ensures firms are following the rules with a comprehensive examination and enforcement regime.

Investment advisers are subject to provisions of the Investment Advisers Act of 1940 that pertain to registration, disclosure, record-keeping, custody and compensation. Importantly, investment advisers are also subject to a fiduciary standard with regard to their clients. In designing a more regular oversight and examination program for investment advisers, these rules and standards should be taken into account.

Simply put, FINRA believes that the kind of additional protections provided to investors through its model are essential. Does that mean FINRA should be given that role for investment advisers? That question ultimately must be answered by Congress and the SEC, but FINRA is uniquely positioned from a regulatory standpoint to build an oversight program for investment advisers quickly and efficiently. We have a strong track record in our examination and enforcement oversight, as well as in our other core programs. Certainly in the registration area, with regard to investment advisers and mortgage brokers, we have two success stories of adapting our infrastructure to meet needs in areas beyond the realm of broker-dealers.

In FINRA's view, the best oversight system for investment advisers would be one that is tailored to fit their services and role in the market, starting with the requirements that are currently in place for advisory activity. Simply exporting in wholesale fashion the broker-dealer rulebook or current governance would not make sense. That said, as I noted earlier, where applicable, we do believe that enhanced regulatory consistency is in the best interest of investors, especially in the four areas I mentioned—licensing, advertising, sales practice and disclosure.

We believe that regular and frequent exams are a vital component of effective oversight of financial professionals, and that the absence of FINRA-type oversight of the investment adviser industry leaves investors without that critical component of protection. In our view, it simply makes no sense to deprive

investment adviser customers of the same level of oversight that broker-dealer customers receive. And quite simply, as we learned from the Madoff scandal, it would not make sense for two, separate independent regulatory bodies to oversee investment advisers and broker-dealers, especially when they exist in the same legal entity. Again, there would be no single regulator with a complete picture of the business.

One of the primary issues raised about investor protection differences between the broker-dealer and investment adviser channels is the difference between the fiduciary standard for investment advisers and the rule requirements, including suitability, for broker-dealers. As this the process moves forward, this is the kind of issue that should and will be on the table as we all look at how best to reform our regulatory system and strengthen investor protections. In keeping with our view there should be increased consistency in investor protections across financial services, we believe it makes sense to look at the protections provided in various channels and choose the best of each.

We stand ready to work with Congress and the SEC in exploring whether a properly designed fiduciary standard could be applied to broker-dealers' selling activities, and if there are problems raised, make a strong effort to resolve those problems.

## **Conclusion**

It has become painfully clear that the current regulatory structure is weakened by gaps and inconsistencies that should be remedied.

The individual investor is the most important player in the financial markets, and unfortunately, our system has not sufficiently protected these individuals. We need to earn back the confidence of those investors by closing the gaps in our current system and strengthening oversight.

As I have stated, FINRA believes that one of the most important gaps to close in terms of investor protection is the disparity in oversight between broker-dealers and investment advisers. The addition of a comprehensive and regular oversight program with more frequent exams and strong enforcement would enhance protections provided to all customers of investment advisers.

More broadly, investors deserve a consistent level of protection no matter which financial professionals or products they choose. Creating a system of consistent standards and vigorous oversight of financial professionals—no matter which license they hold—would enhance investor protection and help restore trust in our markets.

FINRA is committed to working with other regulators and this Committee as you consider how best to restructure the U.S. financial regulatory system.