Testimony of

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Chairman Johnson, 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.

When a firm like MF Global fails, there is always value in reviewing the events leading to that failure and examining where rules and processes might be improved. I commend the Committee for having this hearing to do just that. Clearly the continued impact of MF Global's failure on customers who cannot access their funds is of great concern, and every possible step should be taken to restore those accounts as quickly as possible.

Like many other financial firms today, MF Global's operations included multiple business lines, engaging multiple regulatory schemes and crossing national boundaries. We and the other regulators here today will explain our roles in overseeing the various parts of the firm. We all share the goal of restoring funds to customers. While FINRA's role in that process is limited at this stage, we are committed to continuing to provide assistance wherever we can.

FINRA

FINRA is the largest independent regulator for all securities firms doing business in the United States, and, through its comprehensive regulatory oversight programs, regulates both the firms and professionals that sell securities in the United States and the U.S. securities markets. FINRA oversees approximately 4,500 brokerage firms, 163,000 branch offices and 630,000 registered securities representatives. FINRA touches virtually every aspect of the securities business—from registering industry participants to examining securities firms; writing rules and enforcing those rules and the federal securities laws; informing and educating the investing public; providing trade reporting and other industry utilities and administering the largest dispute resolution forum for investors and registered firms.

In 2011, FINRA brought 1,488 disciplinary actions, collected fines totaling more than $63 million and ordered the payment of almost $19 million in restitution to harmed investors. FINRA expelled 21 firms from the securities industry, barred 329 individuals and suspended 475 from association with FINRA-regulated firms. Last year, FINRA conducted approximately 2,400 cycle examinations and nearly 6,800 cause examinations.

One of our regulatory programs that is particularly relevant to today's hearing is our financial and operational surveillance. Through this program, FINRA reviews FOCUS (Financial and Operational Combined Uniform Single) reports that broker-dealers file on a monthly basis as required by the Securities and Exchange Commission (SEC). These reports detail a firm's financial and operational conditions and allow FINRA to closely monitor a firm's net capital position and profitability for signs of potential problems.

FINRA's activities are overseen by the SEC, which approves all FINRA rules and has oversight authority over FINRA operations.

Oversight of MF Global

Like many financial firms today that operate simultaneously in multiple channels, MF Global was not solely a broker-dealer, but also a futures commission merchant or FCM. As such, multiple government regulators and self-regulatory organizations (SROs), including FINRA, had a role in overseeing various parts of the firm's operations.

With respect to oversight of MF Global's financial and operational compliance, which is most relevant to today's hearing, FINRA shared oversight responsibilities with the Chicago Board Options Exchange (CBOE) and the SEC, especially in terms of the firm's compliance with the net capital rule. For broker-dealers that are members of multiple SROs, the SEC assigns a Designated Examining Authority, or DEA, to examine the firm's financial and operational programs, including the firm's compliance with the Commission's net capital and customer protection rules. For MF Global, that DEA was the CBOE. As such, CBOE conducted the regular examinations of the firm for capital compliance.

There are two primary SEC rules for which financial examinations evaluate compliance, the net capital and customer protection rules. The primary purpose of the SEC's net capital rule, 15c3-1, is to protect customers and creditors of a registered broker-dealer from monetary losses and delays that can occur if that broker-dealer fails. It requires firms to maintain sufficient liquid assets to satisfy customer and creditor claims. It accomplishes this by requiring brokerage firms to maintain net capital in excess of certain minimum amounts. A firm's net capital takes into account net worth, reduced by illiquid assets and various deductions to account for market and credit risk. This amount is measured against the minimum amount of net capital a firm is required to maintain, which depends on its size and business. The net capital rule is intended to provide an extra buffer of protection, beyond rules requiring segregation of customer funds, so that if a firm cannot continue business and needs to liquidate, resources will be available for them to do so.

The SEC's customer protection rule, 15c3-3, has two components, reserve formula computation and possession or control, and was designed to ensure the safety of customers' assets. The objective of the reserve formula computation is to protect the customer funds in the event the

broker-dealer becomes financially insolvent. Possession or control requires that the broker-dealer obtain prompt possession or control of customers' fully paid for and excess margin securities, ensure that customers' assets held by a broker-dealer are properly safeguarded against unauthorized use and separate firm and customer related business.

Fewer than 20 FINRA-regulated broker-dealers have a DEA other than FINRA, but in those cases, we work closely and cooperatively with the DEA when questions or issues arise. Even when we are not the DEA for one of our regulated broker-dealers, FINRA monitors and analyzes the firm's FOCUS report filings and annual audited financial statements as part of our ongoing oversight of the firm. That was the case with MF Global.

While that monitoring focuses on a broad range of issues, it is particularly relevant to note that our financial surveillance team placed a heightened focus on exposure to European sovereign debt beginning in spring 2010. During April and May, our staff began surveying firms as to their positions in European sovereign debt as part of our ongoing monitoring of regulated firms.

In response to our outreach on this issue, MF Global indicated in late September 2010 that the firm did not have any such positions. We later learned that the firm began entering into transactions that carried European debt exposure prior to that inquiry. While the firm's response was consistent with GAAP accounting rules that repo-to-maturity (RTM) transactions are treated as a sale for accounting purposes, the lack of a complete response delayed us in detecting the firm's exposure.

MF Global's Exposure to European Sovereign Debt

In a routine review of MF Global's audited financial statements filed with FINRA on May 31, 2011, our staff raised questions about a footnote disclosure regarding the firm's RTM portfolio. RTMs are essentially transactions whereby the maturity date of a firm's bond position held in its inventory matches the maturity date of the repo. During the course of discussions with the firm, FINRA learned that a significant portion of that portfolio was collateralized by approximately $7.6 billion in European sovereign debt. According to U.S. GAAP, RTMs are afforded sale treatment and therefore not recognized on the balance sheet. Notwithstanding that accounting position, the firm remained subject to market and credit risk throughout the life of the repo.

Beginning in mid-June, FINRA had detailed discussions with the firm, in which CBOE also participated, regarding the proper treatment of the RTM portfolio and we asserted that not enough capital was reserved against the RTM. While the SEC has issued guidance clarifying that RTMs collateralized by U.S. Treasury debt do not require capital to be reserved, there is no such relief for RTMs collateralized by debt of non-U.S. governments. We researched whether the firm retained default risk on the positions, and concluded that it did. Our view was that while recording the RTMs as sales was consistent with GAAP, they should not be treated as such for purposes of the capital rule given the market and credit risk those positions carried. As a result, we asserted that capital needed to be reserved against the RTM.

FINRA and CBOE also had discussions with the SEC about our concerns that the firm was not holding capital against its RTM portfolio. The SEC agreed with our assertion that the firm should be holding capital against the positions. The firm fought this interpretation throughout the summer, appealing directly to the SEC, before eventually conceding in late August 2011.

The firm infused additional capital and filed an amended July FOCUS report on August 31 to report a $150 million capital deficiency in July. The firm also provided notification, pursuant to SEC Rule 17a-11, of its capital deficiency to the SEC, CBOE and FINRA as well as to the Commodity Futures Trading Commission (CFTC), pursuant to CFTC Rule 1.12. The net capital deficiency in the amended July FOCUS report was reported on the CFTC's website. In addition, on September 1, the firm amended its Form 10-Q filing with the SEC to identify the change in net capital treatment of the RTM portfolio.

In September, FINRA added MF Global to "alert reporting," a heightened monitoring process whereby we require firms to provide weekly information on net capital, inventory, profit and loss as well as reserve formula computations.

On October 19, the Intermarket Financial Surveillance Group (IFSG), which is comprised of securities and futures regulators and self-regulatory organizations, had its annual meeting. The IFSG was established in 1989 in order to enhance the coordination and monitoring efforts of both securities and commodities regulators. Through an information sharing agreement, SROs provide each other with financial surveillance data and related information on an as-needed basis. In addition, SRO representatives meet annually to discuss relevant capital and customer protection issues. Exposure to European sovereign debt was one of the topics at the October meeting and FINRA raised MF Global's positions during the discussions.

During the week of October 24, as MF Global's equity price declined and its credit rating was cut, FINRA increased the level of surveillance over the firm. We requested detailed information about the firm's balance sheet and liquidity; we received updates about the loss of lending counterparties and customers; and we spoke to clearing organizations about the margin required to settle trades. At the end of that week, FINRA was on site at the firm, with the SEC, as it became clear that MF Global was unlikely to continue to be a viable standalone business. Our primary goal was to gain an understanding of the custodial locations for customer securities and to work closely with potential acquirers in hopes of avoiding SIPC liquidation. As has been widely reported, the discrepancy discovered in the segregated funds on the futures side of the firm ended those discussions.

MF Global Bankruptcy and Liquidation Proceeding

On October 31, 2011, MF Global Holdings, Ltd. and MF Global, Inc. filed for bankruptcy and entered into SIPC liquidation. Since that time, FINRA has provided assistance as requested by the SEC and the trustee.

On November 4, 2011, FINRA assisted the trustee in alerting broker-dealer firms via email that the trustee was accepting proposals for the transfer of approximately 450 customer securities accounts of MF Global to another member of SIPC.

We have also assisted the trustee by providing information about other broker-dealers to which MF Global securities customer accounts may be transferred.

Increased Regulatory Coordination and New Rulemaking Efforts to Better Protect Customers and Their Funds

Both prior to and since the failure of MF Global, FINRA has worked to identify changes that can be made to better protect customers and their funds, through both our own rulemaking process, and also in terms of our coordination with our regulatory counterparts. I will highlight a few of the efforts that FINRA has been involved in over the past several months.

First, FINRA and the Chicago Mercantile Exchange have established regular coordination calls so that our respective staffs can share information about the approximately 50 firms that are both broker-dealers and futures commission merchants, and therefore are subject to the oversight of both entities. Through these calls, our staffs will have regular opportunities to discuss routine oversight issues as well as to highlight for one another any concerns or situations that warrant heightened monitoring. The goal for these calls is to enhance coordination between our organizations and ensure that each is aware of issues identified by the other, as early as possible. In addition, FINRA is currently in discussions with the CFTC regarding possible information sharing arrangements that could further enhance oversight of dual broker-dealer/futures commission merchant firms.

Another example of enhanced coordination among regulators is a series of "supervisory colleges" that we initiated last fall. Based on the model that international regulators have used in overseeing large global banking institutions, we hosted an in-depth briefing on select non-bank investment firms and invited staff from both domestic and international regulators of securities and futures to participate. During the event, regulators were able to exchange information and engage in a dialogue with the firms' senior executive management—and each other—to gain a more comprehensive understanding of each institution's business strategy, legal and regulatory structure, corporate governance, and risk drivers. We plan to host a second such event in June and have expanded the list of regulators and SROs included in the event.

In addition to coordinating with other regulators, FINRA has continued its work on two rulemaking efforts that are aimed at enhancing financial surveillance and expediting the return of customer funds and securities in the event of liquidation.

In late February, FINRA implemented a new rule that requires FINRA-regulated firms to file additional financial or operational schedules or reports as we deem necessary to supplement the FOCUS report. The rule provides FINRA with the framework to request more specific information that we determine is necessary or appropriate for the protection of investors or in the public interest. Under this rule, the SEC has approved the adoption of one such report—the Supplemental Statement of Income—which enables FINRA to capture more granular detail about a firm's revenue and expenses, including a breakdown of commission revenues by product, a breakdown of principal trading gains and losses by security type as well as detailed components of fee and interest revenues among other things.

Also pursuant to this rule, last week, the FINRA Board approved a proposal to adopt a second supplemental FOCUS report to capture information that is not otherwise reported on certain firms' balance sheets. If approved by the SEC, all carrying and clearing firms would be required to file this information with FINRA on a quarterly basis. Captured in this report would be, among other data, gross exposures in financing transactions, such as reverse repos, repos, repos to maturity and other transactions that are otherwise netted under GAAP. This additional information will permit FINRA to more effectively assess on an ongoing basis the potential

impact that off-balance sheet activities may have on such firms' net capital, leverage and liquidity, and their ability to fulfill their customer protection obligations.

FINRA has also proposed a new rule that would expedite the liquidation of a firm and most importantly, the transfer of customer assets, should a firm need to cease operations. FINRA is currently reviewing comments submitted on this proposal and will make adjustments as warranted before submitting a final proposal to the SEC for review.

Conclusion

FINRA will continue to work with our fellow regulators and Congress as the liquidation process for MF Global proceeds, and as we implement the measures identified to date which could improve oversight of similar firms and coordination between regulators. We share your commitment to reviewing the events involved in the firm's collapse, relevant rules and coordination with other regulators to continue to identify potential policy or procedural adjustments that may be warranted.

We realize that it is critical to continually evaluate the customer protection regime to ensure that it is designed as well as it can be to ensure prompt restoration of customer funds in the event of a firm collapse. To that end, we would be glad to participate in a broader review, in coordination with the SEC, CFTC, self-regulatory organizations and others to provide an overall assessment of where current rules and processes may need enhancements.

Again, I appreciate the opportunity to testify today. I would be happy to answer any questions you may have.