

Testimony of
Daniel M. Sibears
Executive Vice President, Member Regulation Programs
Financial Industry Regulatory Authority

Before the
Committee on Banking, Housing, and Urban Affairs

United States Senate

August 17, 2009

Mr. Chairman and Members of the Committee:

I am Dan Sibears and I currently serve as Executive Vice President, Member Regulation Programs for the Financial Industry Regulatory Authority, or FINRA[®]. On behalf of FINRA, I would like to thank you for the opportunity to testify today.

Unfortunately, we are here today because of allegations of a massive fraud that has had tragic results for many investors. The Stanford investigation has demonstrated again that there are bad actors determined to engage in misconduct outside the view and reach of some regulators, and that they are willing to design their businesses to take advantage of gaps in regulatory oversight or jurisdiction.

Investor protection is the core of FINRA's mission, and we share your commitment to identifying regulatory weaknesses, gaps and constraints that provide opportunities to those who would harm investors, as well as potential changes to the regulatory framework that could improve the structure and scope of financial regulation.

FINRA

FINRA is the largest non-governmental regulator for securities brokerage firms doing business in the United States. Congress mandated the creation of FINRA's predecessor, NASD, in 1938, granting it authority to examine for compliance with and enforce the Securities Exchange Act of 1934, the rules of the Municipal Securities Rulemaking Board and FINRA rules.

FINRA, with a staff of 2,800, provides the first line of oversight for broker-dealers. FINRA registers and educates industry participants, examines broker-dealers and writes rules that those broker-dealers must follow; enforces those rules and

the federal securities laws; and informs and educates the investing public. FINRA oversees nearly 4,900 brokerage firms, about 174,000 branch offices and over 650,000 registered securities representatives.

FINRA has a robust regulatory program with more than 1,000 employees dedicated to its examination responsibilities. In administering our exam program, FINRA conducts both routine and cause examinations. In 2008, FINRA conducted over 2,500 routine examinations. Routine examinations are conducted on a regular schedule; firms are identified and prioritized for inspection based on a quantitative and qualitative risk-assessment process that takes into account, among other things, the size of the firm, certain financial condition risks, the regulatory action history and employment history of individuals registered with the firm, along with any customer complaints about the firm or its registered individuals. This risk-based approach helps us to focus our examination resources on the sources of most likely harm to investors.

In addition to our routine examination program, FINRA conducts more narrowly focused examinations based on information that we receive, including investor complaints, whistleblower tips, referrals generated by our market surveillance systems, terminations of brokerage employees for cause, arbitrations and referrals from other regulators. FINRA consults with the SEC and state regulators about examination priorities and frequently conducts special “sweep” examinations with respect to issues of particular concern. In 2008, FINRA conducted over 6,500 of these targeted cause examinations.

FINRA brings disciplinary actions against broker-dealers and their employees that may result in sanctions, including fines, suspensions from the securities business and, in egregious cases, expulsion from the industry. FINRA frequently requires broker-dealers to provide restitution to harmed investors and often imposes other conditions on a firm’s business to prevent repeated wrongdoing. In 2008, FINRA issued over 1,000 decisions in formal disciplinary cases. FINRA collected over \$28 million in fines, either ordered or secured agreements in principle for restitution in excess of \$1 billion, expelled or suspended 19 firms, barred 363 individuals from the industry and suspended 321 other individuals.

FINRA also makes background information and disciplinary histories of broker-dealers available to the public free of charge through our BrokerCheck[®] system. FINRA requires all brokers to register, pass qualification exams and satisfy continuing education requirements. To capture and record that information, we maintain the largest and most sophisticated online registration and reporting system in the world—known as the Central Registration Depository[®]. Using that data, our BrokerCheck system allows investors to check the backgrounds of firms and brokers online at www.finra.org/brokercheck or by calling a toll-free hotline number, (800) 289-9999. In 2008, members of the public used this service to conduct 11.6 million reviews of broker or firm records.

FINRA Oversight of Stanford Broker-Dealer Operations

Stanford Group Company registered with FINRA and its predecessor, NASD, in 1995. For the last 10 years, the Stanford broker-dealer was subject to regular exams of its operations every other year.

Disciplinary Actions Related to Stanford

In the course of FINRA's routine and cause exams, the Stanford broker-dealer was subject to both formal and informal discipline. The formal disciplinary actions involve:

- censure and a \$20,000 fine in April 2007 for violations related to customer funds, supervisory procedures and net capital deficiency;
- censure and a \$10,000 fine in November 2007 related to sales literature for certificates of deposit (CDs) (this matter is discussed in more detail below);
- censure and a \$10,000 fine in July 2008 for violations of municipal trade reporting requirements; and
- censure and a \$30,000 fine in November 2008 for violations of research report and analyst rules.

FINRA's formal disciplinary actions are publicly disclosed through monthly announcements as well as through information included in its publicly available database, BrokerCheck, described above. Copies of an actual document of a disciplinary action are available to the public by request. Investors can also obtain information regarding complaints filed against a broker from BrokerCheck, which includes information about, and the disciplinary record of, any FINRA-registered broker or brokerage firm.

2007 Censure and Fine Related to Sales Literature for Certificates of Deposit

The disciplinary action most relevant to today's hearing is the censure and \$10,000 fine FINRA levied against Stanford's broker-dealer in November 2007 for violations regarding sales literature the firm used in connection with CDs issued by an affiliate bank.

FINRA's predecessor, NASD, conducted an examination of Stanford's broker-dealer in 2005 as the result of a letter from the SEC following its examination of the firm. The examination focused on disclosures in sales and marketing materials used for CDs issued by its offshore affiliate bank. FINRA focused its investigation on the marketing and sales materials because of concerns we had about our ability to investigate the products themselves, which were issued by the non-FINRA-registered offshore bank.

The advertising action brought in 2007 cited a number of deficiencies in the brochures the broker-dealer used to promote the CDs, including the failure to disclose that the CDs were not issued by a U.S. bank and were not FDIC-insured; that the affiliation between the broker-dealer and the issuing bank could create a conflict of interest; that the issuing bank was not subject to U.S.

regulation; and that a CD purchase transaction was not protected by U.S. securities or banking laws.

Regulatory Tips, Complaints and Arbitrations Alleging Misconduct by Stanford

FINRA has received and reviewed nine complaints and seven regulatory tips related to the Stanford broker-dealer since 2001. FINRA reviews every customer complaint and regulatory tip it receives. Matters determined to warrant further investigation are routed to the appropriate FINRA office based upon areas of responsibility and expertise, including Enforcement, Office of the Whistleblower, Market Regulation, Advertising Regulation and Member Regulation's district offices. Referrals may be made to federal and state regulators when a complaint or regulatory tip concerns persons and activities outside of FINRA's jurisdiction, or when cooperative regulatory efforts have been agreed upon to avoid regulatory duplication.

The first regulatory tip FINRA received related to the CDs was in September 2003. That tip was received by both FINRA and the SEC, and FINRA deferred this tip to the SEC. In addition, FINRA regulatory staff received an arbitration panel referral in November 2003. In that case, a former Stanford employee made a variety of allegations, including some related to the firm's sales of offshore CDs. The information contained in the arbitration referral was reviewed in connection with the 2003 routine examination of Stanford's brokerage operations. In both instances, FINRA was limited in its review as it could not, despite repeated attempts by both FINRA and the SEC, compel the necessary evidence from the foreign bank affiliate of the broker-dealer.

An employer-employee arbitration filing with FINRA Dispute Resolution in 2003 resulted in a counterclaim by a Stanford employee that included allegations related to Stanford's offshore bank affiliate. This counterclaim was not referred to or reviewed by FINRA investigative staff. Prior to 2009, FINRA's investigative staff reviewed statements of claim filed with FINRA Dispute Resolution that involved customers, but not those that involved employment disputes. This was based on an assessment that customer claims were most likely to evidence misconduct leading to investor harm. As of March of this year, FINRA has changed its procedures, and now investigative staff reviews all statements of claim filed with Dispute Resolution, as discussed in further detail below. Again, however, even if this claim had been reviewed by FINRA's regulatory staff, our lack of effective reach into the foreign bank affiliate would have served as a barrier to investigating the allegations.

2009 Branch Exams

In conjunction with other Stanford matters, in January 2009, FINRA conducted an unannounced examination of six branch offices of the Stanford broker-dealer. FINRA notified the SEC of these examinations and, in response to its request, FINRA referred the matters to the SEC. The SEC's ongoing investigation of the firm led to the complaint filed in federal court on February 17, 2009.

FINRA Responses to Recent Frauds

FINRA's role and mission as a regulator requires us to be mindful of changes in markets, market structure and products in designing our examinations and regulatory programs. We also adapt our programs based on information we learn through implementing those programs, discussions with other regulators or from the lessons learned when there are breakdowns in the regulatory system.

In the wake of recent events, we reviewed our programs to determine whether there were any changes we could make to those programs, within the scope of our authority, to enhance our ability to identify red flags that may indicate fraud or other customer harm. A few of the resulting initiatives are outlined below:

Enhancing Exam Procedures

FINRA has designed several new elements for its examination program that are focused on the review of certain high-risk areas and brokerage responsibilities regarding dual broker-dealer and investment advisory accounts for the purpose of fraud detection. These examination elements supplement existing routine examination procedures. Among the procedures FINRA added to its examination programs are the following:

Ownership and Affiliate Background and Apparent Conflicts of Interest

This review expands pre-examination information gathering with regard to a firm's ownership and affiliate relationships and identifies potential concerns and conflicts of interest. The procedures include verification of information obtained, investigation into any potential conflicts of interest, and reconciliation of any discrepancies noted between information reported to FINRA and certain publicly available information.

Feeder Funds

The purpose of this examination element is to examine the relationship between broker-dealers and/or their affiliates with feeder funds, or master funds that use feeder funds, with respect to the potential for fraudulent activity. Examiners focus on identifying where problematic conflict of interests exist, assessing the extent and adequacy of due diligence conducted, the adequacy of offering documents and disclosures, the appropriateness of recommendations to customers investing in feeder funds or master funds using feeder funds, and, to the extent practicable, evaluating the legitimacy of the investment strategy of the master funds using feeder funds.

Financial Statement and Filings Analysis

This examination enhancement seeks to identify potentially fraudulent activity by examining for material misstatements in financial reporting, unusual money movement between the firm and control persons or entities, and apparent red flags involving the firm's auditor and off balance sheet items. The examination element directs examiners to review

financial documents for plausibility and reasonableness, and to ensure that financial information is properly disclosed and that control relationships related to financial reporting are not conflicting.

While these new procedures are intended to enhance our ability to detect misconduct that could indicate fraud, they will not expand the scope of FINRA's jurisdiction. Stanford's operations included a broker-dealer, an investment adviser and offshore bank, allowing it to conduct a good portion of its business outside FINRA's jurisdictional limits.

Reviewing Rules

FINRA has filed a rule proposal with the SEC that would make records of final regulatory actions against brokers permanently available to the public through its BrokerCheck system. Under current rules, a broker's record generally becomes unavailable to the public two years after he or she leaves the industry. Individuals previously barred by FINRA or other regulators have been involved in several recent frauds, and this proposal enhances the information available to investors about the disciplinary history of financial professionals.

FINRA is reviewing its rules to identify areas where potential changes could assist us in detecting misconduct that could be indicative of fraud, and to ensure that we are maximizing our reach within the scope of our authority. Among the other potential rule changes we are considering are possible enhancements to FINRA processes for registering new firms and gathering information when a firm makes changes to its structure or business model.

Reviews of Employer/Employee Arbitration Matters and Post Filings

As mentioned above, to expand the regulatory review of arbitration matters, in March 2009 FINRA instituted a process to review all employer-employee related statements of claim filed with FINRA Dispute Resolution in addition to customer-related statements of claim that FINRA had previously and still regularly reviews. Through July 2009, FINRA had conducted approximately 1,250 reviews of employer-employee related statements of claim dating back to January 1, 2008. In addition, in April 2009, we instituted a process to review all amended claims and additional claims related to arbitration matters. These filings include counter claims, cross claims, answers to employer-employee related matters and third-party claims. Through July 2009 we had reviewed approximately 400 such filings.

Office of the Whistleblower

In March of this year, FINRA announced the creation of its Office of the Whistleblower to expedite the review of high-risk tips by FINRA senior staff and ensure a rapid response for tips believed to have merit. FINRA established this new office to encourage individuals with first-hand knowledge of, or material information about, potentially illegal or unethical activity to come forward and share it with regulators. To facilitate the submission of whistleblower information, FINRA established a toll-free phone number—(866) 96-FINRA—and posted a dedicated Web page—www.finra.org/whistleblower—where individuals may

email information to FINRA. Credible whistleblower tips are reviewed and investigated on an expedited basis. Matters that fall outside FINRA's jurisdiction are referred to the appropriate regulatory or law enforcement agency. This new initiative does not replace FINRA's longstanding processes for handling the thousands of regulatory tips and customer complaints it receives each year.

Since its inception, FINRA's Office of the Whistleblower has received over 100 email and telephone tips. To date, the Office of the Whistleblower has completed investigations that have resulted in 15 referrals to the SEC, other SROs or other regulators, as well as a number of ongoing FINRA investigations. These referrals contain evidence of potential securities fraud, including Ponzi-type schemes, boiler-room activity and affinity schemes. As is often true with referred matters, additional investigative work on matters outside FINRA's authority will be required of regulators receiving these referrals. Four matters referred to the SEC have already resulted in publicly disclosed regulatory actions.

Conclusion

Recent frauds, including Stanford, and the financial crisis of the last two years have made it painfully clear that the current regulatory structure is weakened by gaps, inconsistencies and, at times, jurisdictional limitations that should be remedied. In the Stanford case, while FINRA examined Stanford's broker-dealer, it did not examine the investment adviser, nor did it have the clear ability to compel information from Stanford's foreign bank affiliate. Such limitations are frustrating in practice and in the aftermath of this kind of fraud, no regulator can be happy with the status quo.

Individual investors are the most important players in the financial markets, and we need to earn back the confidence of those investors by closing the gaps in our current U.S. regulatory system and strengthening oversight of all financial firms and professionals regardless of how they are registered. As FINRA's CEO, Rick Ketchum, testified before this committee earlier this year, we believe 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. Between the SEC and self-regulatory organizations, more than half of the approximately 4,900 registered broker-dealer firms are examined each year. By contrast, the SEC projects that fewer than 10 percent of the more than 11,000 registered investment adviser firms will be examined during fiscal years 2009 and 2010. The authorization of an independent regulatory organization for investment advisers would augment the SEC's ability to oversee those financial firms with more frequent exams and expanded enforcement resources would enhance protections provided to all customers of investment advisers.

As we have learned over the last two years, a system of fragmented regulation provides opportunities to those who would cynically game the system to do so at great harm to investors. FINRA is committed to working with other regulators and this Committee as you consider how best to restructure the U.S. financial regulatory system.