Testimony of

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Chairman Reed, Ranking Member Crapo and Members of the Subcommittee:

I am Steve Luparello, Vice Chairman of the Financial Industry Regulatory Authority, or FINRA. On behalf of FINRA, I would like to thank you for the opportunity to testify today.

FINRA

FINRA is the largest independent regulator for all securities firms doing business in the United States, and, through its comprehensive oversight programs, regulates 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 636,000 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 2010, FINRA brought 1,310 disciplinary actions, collected fines totaling $42.2 million and ordered the payment of almost $6.2 million in restitution to harmed investors. FINRA expelled 14 firms from the securities industry, barred 288 individuals and suspended 428 from association with FINRA-regulated firms. Last year, FINRA conducted approximately 2,600 cycle examinations and 7,300 cause examinations.

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

Protection of Retail Investors by the Federal Securities Laws

As a general matter, and depending upon the transaction, the federal securities laws provide the following types of protection to retail investors:

- **Antifraud Authority**—The federal securities laws prohibit various forms of fraud, including fraudulent, deceptive or manipulative practices in connection with the purchase or sale of a security. For example, Rule 10b-5 under the Securities Exchange Act of 1934 has been used successfully to combat a broad range of abusive practices, such as insider trading and market manipulation.

- **Disclosure**—For many transactions, the federal securities laws require disclosure about the issuer and the securities being sold. For example, the Securities Act of 1933 generally requires that publicly offered securities be sold through a prospectus that provides important information about the securities, the company's management and operations, and the risks of buying the securities.

- **Regulation of Intermediaries**—The federal securities laws regulate securities intermediaries. For example, the Securities Exchange Act of 1934 generally requires the registration of any firm or individual who is in the business of selling securities as agent or principal, and subjects retail brokers and dealers to FINRA's rigorous examinations and oversight. In general, a person who is offering investment advice must register with the SEC under the Investment Advisers Act of 1940 or with the states.

- **Qualification of Investors**—The level of regulation provided by the federal securities laws will often depend upon the sophistication or wealth of the investor. For example, Rule 506 of Regulation D provides a safe harbor from registration for securities sold to an unlimited number of "accredited investors," who meet certain thresholds of net worth or income, and up to 35 non-accredited investors. The rule also requires that any unaccredited investors to whom the securities are sold must have enough investment experience and knowledge to make an informed decision about the merits and risks of the investment.

- **Market Regulation**—The Securities Exchange Act of 1934 and the regulation of the stock exchanges and other market participants by the SEC and FINRA establish standards that are designed to protect the integrity of the public markets.

The federal securities laws are intended to achieve at least two objectives. First, they are designed to protect customers from abusive or fraudulent practices. Second, and equally important, they are intended to provide the investing public with confidence that market participants will treat customers fairly.

This testimony will address FINRA's regulation of intermediaries. From the perspective of a less sophisticated, retail investor, an intermediary can appear objective in its selection of securities to offer and reliable in its completion of the investor's securities transaction. Perhaps in recognition of this relationship, Rule 506 of Regulation D requires that each non-accredited investor, "either alone or with his purchaser representative(s)," have a specified degree of financial sophistication.

These assumptions by a retail investor about the professionalism of a securities intermediary necessitate that an intermediary be subject to adequate oversight by a securities regulator. In the course of our work, FINRA examines registered broker-dealers for compliance with the securities laws, SEC rules and our own rules. Of course, the particular requirements applicable to an intermediary should partly depend upon the nature of the intermediary's business. FINRA thus makes every effort to tailor its oversight according to the various business models within the broker-dealer industry.

In response to the Subcommittee's request, we are focusing the following discussion on the private placement and microcap markets. Given that the private placement market is a relevant analogy to a number of the capital-raising constructs currently under consideration, we believe our experience with that market and the issues and regulatory problems that we have found in that area may be particularly helpful to the Subcommittee.

The Private Placement Market

The private placement market is an essential source of capital for American business, particularly small firms. Regulation D under the Securities Act of 1933 provides the most important avenue for a company to privately issue shares. According to one estimate, in 2008 companies intended to issue approximately $609 billion of securities in Regulation D offerings.[1] While the private placement market is an important source of capital for many U.S. companies, the federal securities laws permit issuers to privately place their securities directly with qualified purchasers, without necessitating the protections of a regulated intermediary, and with limited or no disclosure about the company. In our oversight of broker-dealers that participate in Regulation D offerings, FINRA has uncovered fraud and sales practices abuses. Recently, for example, FINRA sanctioned a number of firms and individuals for providing private placement memoranda and sales material to investors that contained inaccurate statements or omitted information necessary to make informed investment decisions.

As a response to these problems, in 2010 FINRA issued guidance to firms concerning their participation in Regulation D offerings. The *Notice* reminded firms that FINRA's suitability rule requires that a broker-dealer conduct a "reasonable investigation" concerning recommended Regulation D offerings. The guidance also made clear that the requirement to conduct a reasonable investigation is a *duty* of a broker-dealer that arises from a long history of case law under the antifraud provisions, and under FINRA's just and equitable principles of trade. This duty requires the broker-dealer to understand the Regulation D securities and to take reasonable steps to ensure that the customer understands the risks and essential features of those securities.

In October, FINRA filed with the SEC proposed rule amendments to ensure that firms make basic disclosures about private placements that they recommend to their retail customers. This proposal, which is still pending at the SEC, would require firms to disclose the anticipated use of offering proceeds, the amount and type of offering expenses, and the amount and type of

[1] Office of the Inspector General, Securities and Exchange Commission, *Regulation D Exemption Process* 2 (March 31, 2009).

compensation to be paid. The proposed rule amendments also would require "notice" filings with FINRA of a broker-dealer's private placement activities.

Microcap Markets and Fraud

Microcap issuers are companies with low levels of capitalization. Often they are startups or shell companies whose stock is thinly traded in the over-the-counter market. Some may be private issuers whose shares became eligible for trading in the over-the-counter market. Others may have originally issued their shares through an exemption from registration, such as Regulation D, but have since become public companies through a reverse merger with a shell company or through other means.

Even the microcap issuers whose shares have been registered under the Securities Act of 1933 can present particular risks to retail investors. These companies may not be followed by independent financial analysts, their shares may be thinly traded, and the publicly available information about the company may not provide a sufficient basis to evaluate the company's claims about its business prospects.

During the last two years, FINRA has referred more than 500 matters involving potential microcap fraud to the SEC. For example, in one matter the SEC suspended trading in a purported power company and charged several of its executives with inflating the price of its stock by issuing a barrage of press releases touting the company, including claims that it was building a $10 billion nuclear power plant. In fact, the company, which went public through a reverse merger, had essentially no revenue or operations. The SEC also alleged that the company falsely claimed that its management had such confidence in the company that they had not sold any of its stock; records obtained by the SEC showed that two senior executives had secretly unloaded extensive stock holdings.

Fraudulent schemes in microcap stocks often seek to exploit well-publicized news events or trends. After the Japanese tsunami, FINRA warned investors about scams involving companies that claimed to offer products or services for detecting gamma rays or cleaning up nuclear waste. FINRA has also referred matters to the SEC involving stocks linked to China, the Gulf oil spill, gold and clean energy.

FINRA's Office of Fraud Detection and Market Intelligence

Many of the referrals noted above originate in FINRA's Office of Fraud Detection and Market Intelligence (OFDMI). OFDMI's mission is to ensure that allegations of serious fraud received by FINRA in the form of complaints, regulatory filings and other sources are subjected to a heightened review. OFDMI serves as a centralized point of contact on fraud issues, within FINRA and externally with other regulators and the public. The creation of OFDMI has expedited fraud detection and investigation, by pursuing matters as far as possible and by referring cases that fall outside of FINRA's scope to the appropriate authorities.

So far this year, OFDMI has referred more than 600 matters involving potential fraudulent or illegal conduct to the SEC or other federal law enforcement agencies for further investigation. In 2010, OFDMI made more than 550 referrals. These matters involved a wide range of issues, including insider trading, microcap fraud and Ponzi schemes.

Through the Central Review Group unit, OFDMI has centralized the receipt, analysis and distribution of tips, complaints and referrals from the public and other regulators. In addition, OFDMI has implemented a comprehensive prioritization system that is used across all of FINRA's regulatory operations. This operational enhancement means that serious matters are escalated and investigated more quickly.

FINRA's Office of the Whistleblower, first established in March 2009, continues to receive and process, on an expedited basis, a significant amount of incoming information. As of November 2011, the office has received and triaged over 180 substantive calls to its hotline, and another 180 reviews were initiated from emails received via a dedicated email address. The office made 37 formal referrals to the SEC or other law enforcement agencies, and another 54 internal referrals. As a result, 12 registered representatives have been permanently barred from the securities industry, with an average of 135 days from the receipt of the matter to the imposition of the bar.

As of November 30, 2011, the Fraud Surveillance unit of OFDMI has referred 277 matters to the SEC this year. The referrals include matters involving issuer fraud, pump-and-dump schemes, market manipulation and account intrusions. During the same time period, OFDMI’s Insider Trading Surveillance unit made 285 insider trading referrals to the SEC, the highest in FINRA's history. The referrals included suspicious trading ahead of material news announcements by hedge funds, institutional investors, private equity funds and retail investors.

Beyond the establishment of OFDMI, FINRA also has enhanced its examination programs and procedures in a variety of ways intended to help us better detect conduct that could be indicative of fraud. Our examination teams are expected to focus most on those areas at firms that pose a real risk to investors. FINRA staff created an "Urgent" designation for those regulatory matters posing the greatest potential for substantial risk to the investing public. Urgent matters are expedited and then reviewed to make certain that the right level of resources and expertise are assigned to them, and to ensure there is coordination and information sharing across FINRA departments. We also have increased the number of staff in our district offices tasked with in-depth and ongoing understanding of specific firms, including increased real-time monitoring of business and financial changes occurring at a firm. This expansion has enhanced our staff's ability to evaluate available regulatory information and to target examinations based on that information.

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 our website 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.

Relative to the issues we are discussing today, FINRA has produced investor alerts that clearly explain the characteristics of the most commonly used securities frauds, including Ponzi and pyramid schemes, pump-and-dumps and offshore scams. For example, a range of investor alerts issued just this last year warned investors about:

- gold stock scams that mine investors' pocketbooks;
- fraudulent schemes exploiting the tsunami and nuclear crises in Japan; and
- pre-IPO scams purporting to offer access to shares of Facebook and other popular, well-known private companies.

Drawing on ground-breaking research supported by the FINRA Investor Education Foundation, we have delivered dozens of investor seminars that explore who is at risk, how to recognize the psychological persuasion tactics used by fraudsters to lure in their victims—tactics that are constant across a wide variety of frauds—and what simple, actionable steps investors can take to avoid investment scams. To reach an even wider audience, the FINRA Foundation produced an award-winning documentary, *Trick$ of the Trade: Outsmarting Investment Fraud*, which has aired more than 740 times on 170 public television stations in 30 states since September 2010.

A key theme of our investor protection initiatives is “Ask and Check.” We encourage investors to find out whether an investment professional is licensed—and to verify the information using FINRA’s BrokerCheck system. BrokerCheck allows investors to quickly access information about the disciplinary history, professional background, business practices and conduct of the brokerage firms and individual brokers with whom they invest. While dealing with a licensed professional isn't a guarantee against fraud, most investment scams tend to involve unlicensed professionals touting unregistered securities.

Conclusion

We appreciate the Subcommittee’s continued focus on improving access to capital for startups and small businesses while continuing to provide protections for investors. We hope that sharing our experiences in dealing with regulatory challenges in private offerings provides useful insight as the Subcommittee continues its evaluation of the many bills pending relative to this issue. As noted above, federal securities law and SRO rules provide protection for retail customers through five primary mechanisms—antifraud authority, disclosure, regulation of intermediaries, qualification of investors and market regulation. The legislative proposals currently under consideration attempt to build in some or all of these mechanisms in various ways. We would be happy to continue to work with the Subcommittee and its Members as you consider how best to balance the goals of providing new opportunities for building capital and protecting investors.

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