**Testimony by**

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**Before the**
**Committee on Financial Services**

**U.S. House of Representatives**

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Chairman Frank, Ranking Member Bachus 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, with a particular focus on proposals to harmonize the regulation of broker-dealers and investment advisers and addressing the role of arbitration in the securities industry.

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 failures during the last two years. I strongly believe that we must act to pursue comprehensive reforms that will make the financial sector's regulatory architecture more robust, will help prevent a repeat of the kind of volatility we have recently witnessed and—most importantly—will strengthen investor protections.

In the wake of the events of the last two years, all of us involved in regulating the financial markets must take a hard and honest look at our programs and approaches, and search for ways to more effectively uncover misconduct and enhance investor protection. At FINRA, that process is well underway. Already this year, we have enhanced our routine examination programs and procedures for better detecting fraud. We have conducted training programs for examiners aimed at fraud detection. We have also instituted new procedures surrounding review of employer/employee arbitration matters. In March 2009, we established FINRA's Office of the Whistleblower to handle high-risk tips. FINRA has also just announced the establishment of a new Office of Fraud Detection and Market Intelligence. This new unit will provide a heightened review of incoming

allegations of serious frauds, a centralized point of contact internally and externally on fraud issues and consolidate recognized expertise in expedited fraud detection and investigation.

In addition to these efforts, in April 2009, the FINRA Board of Governors established a special committee to conduct a review of FINRA's examination program as it relates to the detection of fraud, specifically Ponzi schemes, including those operated by Bernard Madoff and allegedly perpetrated by R. Allen Stanford. The Special Review Committee, chaired by former U.S. Comptroller General Charles A. Bowsher and assisted by outside counsel, recently concluded its review and presented its findings to the FINRA Board.

Based on the independent review's findings, several key points are apparent. First, FINRA must institute a number of internal reforms to better safeguard investors and the broader financial system. Second, the report calls attention to the many regulatory challenges related to jurisdictional issues and product definitions. Finally, the review points to the urgent need for financial regulatory reform that ensures comprehensive oversight, reduces jurisdictional confusion, streamlines enforcement and improves coordination and communication among all regulators.

In response to the findings and recommendations of the special committee, FINRA is developing plans to implement additional changes to its programs, including: further enhancing fraud-detection measures across all aspects of our examination program; improving our technology systems to better support cross-organizational information sharing to support examinations; working with the SEC and other regulators to increase data sharing related to FINRA-regulated firms; and continuing to seek expanded jurisdiction that would close the regulatory gaps between broker-dealers and investment adviser firms.

The special committee's report provides an important roadmap for FINRA to become a more efficient regulator. I assure you and this Committee that I am fully committed to making the necessary changes to strengthen our programs and raise the level of protection for all investors. We look forward to continuing working closely with this Committee and the SEC as we implement these additional initiatives to make FINRA an even stronger and more efficient regulator.

**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. Federal law charges FINRA with the responsibility to examine broker-dealers for compliance with and enforce the Securities Exchange Act of 1934, the rules of the Municipal Securities Rulemaking Board

and FINRA rules. The SEC has oversight responsibility for FINRA and regularly examines FINRA's programs to ensure that we comply with our statutory responsibilities.

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 4,800 brokerage firms, about 173,000 branch offices and more than 646,000 registered securities representatives.

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. Significantly, FINRA is funded by regulatory fees – not taxpayer dollars. 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 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 Securities Exchange Act 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 filed over 1,000 enforcement actions. FINRA collected over $28 million in fines and the settlement of its auction-rate securities cases returned in excess of $1 billion to investors. FINRA 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, state regulators 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) 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 $46 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.

## The Need for Harmonizing Regulation of Broker-Dealers and Investment Advisers

In recent years, more retail investors have sought the advice of financial professionals to plan for their retirement, help them through the financial crisis,

prepare for their children's college education and meet their other financial goals. These investors have sought the advice of brokers and investment advisers. At one time, the investment adviser and broker-dealer businesses were distinct and separate but today, while the services offered in each channel differ, the businesses have, in many ways, converged. While broker-dealers and investment advisers have been regulated differently for years, today's reality is—as the Rand Institute said in a study completed for the SEC last year—that "trends in the financial service market since the early 1990s have blurred the boundaries between them." Many customers now hold investment adviser and brokerage accounts with the same firm and rely on the same financial professional who is registered as both a broker-dealer and as an investment adviser representative.

In fact, there are approximately 4,500 firms that are dually registered as broker-dealers and investment advisers or have affiliated broker-dealers and investment advisers. Beyond that, a vast majority of registered investment adviser representatives also offer brokerage services. Approximately 88 percent of all registered advisory representatives are also registered representatives of a broker-dealer. Most of these representatives are employed by a firm that is dually registered.

In reality, this means that firms offer customers a combination of brokerage and advisory services in a product menu, and that many financial professionals offer brokerage and investment advisory services that involve, in many cases, commercially indistinguishable investment services to the same customer, which in turn makes it highly unlikely that that customer can distinguish between those services and the differing obligations and protections that are present in advisory and brokerage channels.

Despite this convergence in services, the federal regulation of investment advisers and broker-dealers remains quite different. The two industries are subject to different standards of conduct and different levels of oversight and enforcement. In light of the rising investor interest in seeking the advice of professionals, one would expect the convergence of the investment advisory and brokerage businesses to continue and even accelerate. This overlap in services has important implications for policy makers and regulators.

Broker-dealers and investment advisers face two standards of conduct and vastly different levels of oversight due to resource constraints at the federal level. The current system allows firms offering similar services to arbitrage oversight by choosing a form of registration that offers the least regulatory burden and minimizes the risk of enforcement should the firm engage in misconduct. This type of fragmented regulatory oversight provides opportunities to those who would cynically game the system to do so at great harm to investors.

The need to harmonize the regulation of broker-dealers and investment advisers to enhance investor protection is clear. FINRA believes that in order to truly harmonize regulation of these providers, two steps are necessary. The first is establishing a consistent fiduciary standard for investment advisers and broker-dealers providing investment advice. The second is harmonizing the oversight and enforcement of that standard and the other rules relevant to each channel to better ensure that participants in that industry actually comply with those obligations.

Consistent Fiduciary Standard

The Administration's white paper on regulatory reform noted that investment advisers and broker-dealers are regulated under different statutory and regulatory frameworks, even though the services they provide often are virtually identical from a retail investor's perspective. The Administration has further proposed legislative language that would authorize the SEC to write rules harmonizing the standard of care for the two channels. FINRA stands in agreement with numerous interested parties that the standard of care in both channels should be a fiduciary standard for the provision of advice.

The Administration's proposed legislation would accomplish this objective by giving the SEC broad rulemaking authority to require a fiduciary duty for any broker, dealer or investment adviser who gives individual investment advice about securities. This provision would provide a practical framework that will allow the SEC to fine-tune the application of a fiduciary standard to better protect investors. Commission rulemaking can provide much-needed guidance on what a fiduciary standard requires in specific circumstances, and the duties and obligations that flow from the application of the standard.

Too often regulators must act issue by issue, or violation by violation, rather than addressing problems more broadly and prospectively. A fiduciary standard would establish a benchmark for the regulator and the regulated, to help ensure that brokers and investment advisers have consistent obligations through each step of their financial advice, and that the first question they must ask is not whether a product is acceptable but whether it is in the best interests of the customer.

In FINRA's view, harmonization of the standard of care is an important first step. However, given the number of recently revealed frauds perpetrated by investment advisers bound by the fiduciary standard, it is clear that the existence of the fiduciary standard of care alone is not a guarantee against misconduct. Compliance with that standard must be regularly and vigorously examined and enforced to ensure the protection of investors.

Oversight Examinations and Enforcement

The SEC oversees more than 11,000 investment advisers, but in 2007 conducted fewer than 1,500 exams of those firms due to lack of resources. As SEC Chairman Schapiro said earlier this year, given the vast number of investment adviser registrants, in some cases, a decade could pass without an examination.

FINRA believes that Congress should authorize the SEC to designate one or more independent regulatory organizations to augment the SEC's efforts in overseeing investment advisers to better protect investors regardless of how their financial professional is registered. Any such independent regulatory organization for investment advisers should structure oversight programs that are tailored to fit the services investment advisers provide and their role in the market. This type of structure has worked well in the broker-dealer channel, with FINRA working alongside, and overseen by, the SEC.

Consider the following:

- There are nearly 5,000 broker-dealer firms registered with the SEC, and between the SEC and FINRA, approximately 55 percent of those firms are examined on an annual basis. By contrast, there are over 11,000 investment adviser firms registered with the SEC, and the agency expects only 9 percent to be examined in fiscal years 2009 and 2010.

- By authorizing an independent regulatory organization for investment advisers, like that which exists for broker-dealers, the SEC could leverage the manpower and resources of a private-sector entity to get more boots on the ground, dramatically increasing the frequency of examinations and resources devoted to enforcement.

- Dedicating more resources to regular and vigorous examination and day-to-day oversight of investment advisers would improve investor protection, just as it has for customers of broker-dealers.

- By authorizing an independent regulatory organization to carry out these functions, the increased manpower and enhanced investor protection would come at no cost to the taxpayer.

In the oversight regime for broker-dealers, FINRA supplements the work of the SEC in terms of front-line regulation and supervision. As outlined in more detail earlier in my testimony, among the functions FINRA provides to that regime are: adopting rules and standards beyond statutory requirements, particularly with regard to professional conduct; conducting examinations to ensure compliance with applicable laws and rules; undertaking enforcement and disciplinary proceedings with respect to regulated firms, including barring firms and

individuals from the industry; administering registration and disciplinary databases to provide critical information to regulators and the public; and implementing continuing education and training programs.

All of these functions provided by FINRA are closely overseen by the SEC, with all rules and fees approved by the SEC. And, as previously mentioned, FINRA's Board is comprised of a majority of non-industry representatives.

Authorizing an independent regulatory organization for investment advisers would bring these significant functions and benefits to the oversight regime for investment advisers and enhance protections for customers who invest through an adviser.

**Arbitration**

FINRA operates the largest securities arbitration forum in the United States to assist in the resolution of monetary and business disputes involving investors, securities firms and individual brokers.

FINRA's nationwide arbitration and mediation program has 72 hearing locations – at least one in every state. We believe our forum provides efficient resolution of disputes in an impartial forum that is less costly and faster than traditional litigation. FINRA-registered firms pay for most arbitration costs and FINRA waives fees for individuals experiencing financial hardship.

Our arbitration program is subject to rigorous oversight by the SEC, which regularly examines the program and must approve any changes to its rules. Proposed rules are publicly disseminated by FINRA and the SEC and published in the *Federal Register* for public comment.

It is important to note that FINRA can, and does, suspend brokers from doing business if they fail to pay an award or a settlement.

FINRA maintains a roster of 6,300 arbitrators, a group that is separated into two categories – public and non-public. The public arbitrators are from outside the securities industry, while the non-public have – currently or in the past – some affiliation with broker-dealers. FINRA conducts a comprehensive pre-approval background check on all arbitrator applicants and provides training and continuing education. Arbitrators are selected to hear disputes by the parties involved and during this process both sides of the dispute review arbitrators' previous decisions.

Depending on the circumstances of the case, disputes are heard by either a panel of three arbitrators (two public and one non-public), or by a single public arbitrator. Nearly all – 98 percent – of three-arbitrator decisions are unanimous. All awards are made public on FINRA's Web site. The award provides the names

of the parties, the arbitrators, allegations, date and location of hearing and the arbitrators' rulings, which are generally final and binding for the parties. Overall, the average turnaround time for cases is approximately one year.

FINRA rules do not require investors to arbitrate disputes with their brokerage firm; however, we do require the firms to arbitrate if the investor chooses arbitration over litigation. Similarly, the rules do not require firms to include a pre-dispute arbitration section in customer agreement. This is a matter of contract between firms and their customers. To protect investors, however, we do require firms to clearly and conspicuously state the nature and implications of the pre-dispute arbitration agreement.

The Administration has proposed as part of its regulatory reform plan that Congress authorize the SEC to restrict or prohibit mandatory arbitration agreements. FINRA has long maintained that a determination about whether mandatory arbitration agreements should be allowable is a decision best made by Congress and the SEC. Our view is that Congressional or SEC action is necessary in light of Supreme Court precedent that upholds the ability of firms to contract in this way with customers. As such, we do not object to the Administration's proposal.

Recent Rule Changes

FINRA has focused its efforts on running the most efficient and effective program we can. In that regard, we have made several significant changes to our rules recently that I'd like to highlight for the Committee.

First, we raised the dollar threshold for cases that are heard by a single public arbitrator from $50,000 to $100,000, thereby doubling the number of cases decided in this manner – to one-third of all cases. This change alone greatly streamlines the dispute resolution process and cuts costs and time for thousands of investors in hundreds of cases.

Also, at the end of last year, we enacted strict limitations on motions to dismiss arbitration cases. The new rule was put in place after we heard investor concerns about abusive filing of these motions. FINRA received complaints that some firms were filing dispositive motions routinely and repetitively, causing increased costs for retail investors forced to defend against these motions. So we set substantial curbs around the practice, including penalties for motions to dismiss filed in bad faith. From the February effective date of the rule to September 1, 2009, dispositive motions filed in FINRA's forum decreased by 85 percent compared to the same time period last year.

Finally, in response to the collapse of the auction rate securities market, FINRA created a special arbitration procedure for claims of consequential damages

involving auction rate securities filed by customers of firms that entered into regulatory settlements with FINRA, the SEC or state securities regulators. Use of this special procedure is at the investor's sole option and investors also have the option of bringing a case under standard arbitration rules or in any other forum where they may have the right to seek redress.

Non-Public Arbitrator/Public Arbitrator Pilot Program

One year ago today, we launched a two-year Public Arbitrator Pilot Program where a portion of new cases is heard by three public arbitrators, instead of the usual panel of two public and one non-public arbitrator.

We created the pilot program primarily in response to criticism regarding the presence of an arbitrator with securities-industry experience on panels hearing investor claims. Financial markets and products, and the operation of brokerages, can result in disputes with many complexities. While some believe that an individual with relevant experience can serve as a useful guide through complicated disagreements, others believe the presence of a currently or formerly affiliated individual creates a perception of unfairness.

We have deployed pilot programs in the past to gain useful feedback on our operations, and more importantly, to map out a clear path to improvement. We crafted this pilot program to gauge sentiment among all the different constituencies in arbitration. The findings of the pilot program will guide any changes in our policies going forward.

Here is what we are looking at in the pilot program:

- As we test the concept of three-public-arbitrator hearing panels, we are analyzing the percentage of investors who opt into the pilot and the percentage of investors in the pilot program who actually choose an all-public panel. We will also compare the results of pilot and non-pilot cases, including the percentage of cases that settle before award and how quickly they settle, the length of hearings, and the use of expert witnesses. FINRA is also surveying participants for their feedback.

- The pilot program was structured so that even if investors enroll, they still have the choice to select a non-public arbitrator. I should also add that participation in the pilot is purely the choice of the investor. Firms have no control over that choice.

- One notable takeaway at the pilot’s midpoint is that half of the investors who are eligible to opt into the public arbitrator pilot are declining to do so, and slightly more than 50 percent of those entering the pilot are choosing to have a non-public arbitrator on their panel.

Yesterday, we announced an expansion of the pilot program. I am pleased to report that, for its second year, the number of eligible cases will increase to over 400 and the program will expand from 11 to 14 FINRA-registered firms.

Law School Clinics, FINRA Foundation Support

In addition to operating the dispute resolution forum, FINRA also works with law schools around the country to provide legal assistance to individuals filing arbitration claims. In May 2009, the FINRA Investor Education Foundation announced an Investor Advocacy Clinic Grant Program to provide start-up funding for investor advocacy clinics at law schools in the United States.

We continuously work to make FINRA's arbitration forum a fair and efficient place for investors to resolve disputes with their brokers. As with our other programs, we will continue to seek ways to enhance our investor service and protection.

## SEC Funding

Before I conclude, let me very briefly touch on the issue of self-funding for the SEC. FINRA's view is that that any mechanism that could provide more resources and predictability to the SEC in support of its critical mission should be explored. Especially now, we should evaluate every potential tool available to increase our ability to examine market participants and enforce the laws and rules that apply to them.

## Conclusion

It has become painfully clear that the current fragmented 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 for financial professionals—no matter which license they hold—would enhance investor protection and help restore trust in our markets.

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