**Testimony by**

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**Committee on Financial Services**

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Chairman Kanjorski, Ranking Member Garrett and Members of the Subcommittee:

I am Steve Luparello and I currently serve as Interim 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.

Unfortunately, we are all here today because the fraud that Bernard Madoff orchestrated has had tragic results for investors large and small who entrusted their money to him. Investors are disillusioned and angry, and are rightfully asking what happened to the system that was meant to protect them. It certainly appears that Madoff knew well the seams in that system that separated functional lines of regulation, and perhaps that knowledge assisted him in avoiding detection and defrauding so many unsuspecting individuals and institutions. By all accounts, it appears that Mr. Madoff engaged in deceptive and manipulative conduct for an extended period of time during which he defrauded the customers who invested with him and misled those who had the responsibility to regulate him.

Even so, Mr. Madoff's alleged fraud highlights how our current fragmented regulatory system can allow bad actors to engage in misconduct outside the view and reach of some regulators. It is undeniable that, in this instance, the system failed to protect investors. Investor protection is the core of FINRA's mission, and we share your commitment to identifying the regulatory gaps and weaknesses that allowed this fraud to go undetected, as well as potential changes to the regulatory framework that could prevent it from happening in the future.

## 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. Congress limited our authority to the enforcement of the Securities Exchange Act of 1934, the rules of the Municipal Securities Rulemaking Board and FINRA rules. Under our fragmented system, broker-dealers are regulated under the Securities Exchange Act and investment advisers are regulated under the Investment Advisers Act of 1940. FINRA is not authorized to enforce compliance with the Investment Advisers Act. Authority to enforce that Act is granted solely to the SEC and to the states.

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. All told, FINRA oversees approximately 5,000 brokerage firms, about 172,000 branch offices and almost 665,000 registered securities representatives.

FINRA has a robust examination program with dedicated resources, including more than 1,000 employees. In administering our exam program, FINRA conducts both routine and cause examinations. 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, and allows us to conduct our examinations more efficiently. We apply our risk-profile model according to the risks presented by each firm, and it is tailored according to the business that a particular firm conducts. Cause examinations are 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. 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 2,500 routine examinations and nearly 7,000 cause examinations.

FINRA brings disciplinary actions against broker-dealers and their employees that may result in sanctions, including fines, suspensions from the 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 instituted disciplinary action in 1,060 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 20 firms, barred 363 individuals from the industry and suspended 325 others.

**FINRA Oversight of Bernard L. Madoff Investment Securities' Broker-Dealer Operations**

Bernard Madoff's broker-dealer was registered with FINRA, and its predecessor organization, NASD, since 1960.

In its regulatory filings and FINRA examinations, the Madoff broker-dealer has consistently held itself out as a wholesale market-making firm; that means it was a firm that was in the business of executing, as a market maker, order flow that other broker-dealers directed to it for execution and otherwise trading securities for the risk of its own proprietary accounts. These relationships with other broker-dealers are treated under regulatory rules as counter-party rather than customer relationships. The Madoff broker-dealer consistently reported that 90 percent of its revenue was generated by market making and 10 percent by proprietary trading. The broker-dealer consistently represented to FINRA that it had no retail or institutional customer accounts, a position that would be consistent with the business model of a wholesale market-maker.

*Examinations*

During the last 20 years, FINRA (or its predecessor, NASD) conducted regular exams of Madoff's broker-dealer operations at least every other year. Madoff's broker-dealer was on a two-year examination cycle because it engaged in market making and was self-clearing. Based on this business model, our examinations tended to focus on areas such as the firm's financial and operational condition, supervisory system, supervisory and internal controls, AML compliance, internal communications and business continuity plans. In addition, in 1996 we began a separate market regulation exam program for broker-dealers, and we have conducted that exam of the Madoff broker-dealer on an annual basis since 1997. The Trading and Market Making Examination Program (TMMS) focuses on trading-related issues and is designed to complement FINRA's automated surveillance programs, as well as FINRA's examination programs for sales practice and financial and operational rules. TMMS exams focus on trade reporting, order handling and supervision.

FINRA rules require any broker-dealer, including wholesale market makers such as Madoff, to comply with best execution and order-protection requirements for customer orders routed there by other broker-dealers, even though the executing broker-dealer does not have the direct customer relationship. The firm was also required to comply with recordkeeping and trade reporting requirements. The anti-fraud provisions of the federal securities laws and FINRA rules applied to the Madoff broker-dealer's trading with other broker-dealer counterparties.

In the course of FINRA's broker-dealer exams, we found no evidence of the fraud that Bernard Madoff carried out through its investment advisory business. While there have been some reports that victims of the fraud received statements from the Madoff broker-dealer, our examinations did not reveal the existence of customer relationships that the broker-dealer would have had in

providing execution or custody of advisory assets, and they did not reveal that the Madoff broker-dealer in fact held client assets other than in a small number of inactive employee accounts. Also, FINRA did not receive customer complaints that might have alerted us to the existence of the alleged accounts.

It is worth noting that in 2006, when the SEC examined Madoff's advisory business, the only violation that it apparently found was the firm's failure to register. Our subsequent examination of the firm in 2007 was tailored to its wholesale market making operations, which resided in the broker-dealer.

*Disciplinary Actions Related to Madoff*

As discussed previously, the Madoff broker-dealer was subject to oversight by FINRA through, among other things, routine and cause examinations as well as more trading-focused exams. In addition, their trading was subject to oversight by our Market Regulation department. As a result, over the past ten years, the Madoff broker-dealer was subject to both formal and informal (non-public) discipline, including:

- censure and a $7,000 fine in July 2005 for limit-order display violations;
- censure and an $8,500 fine in February 2007 for limit-order display and Manning violations;
- censure and a $25,000 fine in August 2008 for violations relating to blue sheets; and
- 14 Cautionary Letters for technical trading and/or reporting violations.

*Complaints Related to Madoff*

FINRA has received and investigated 19 complaints against the Madoff broker-dealer since 1999. The complaints generally related to trade execution quality issues; none related to the investment advisory issues involved in the allegations against Bernard Madoff.

FINRA did not receive any whistleblower complaints alleging either frontrunning or Ponzi schemes at the Madoff money management business, nor did the SEC share the tip it received or alert FINRA to any concern that it may have had with the firm.

**Issues Raised by the Madoff Fraud**

Custody and Feeder Funds

FINRA's role as a regulator requires us to be mindful of changes in the markets, market structure and new products in designing our examinations and the focus of our regulatory programs. We also adapt our programs to information that we learn through implementing those programs, conversations with other market regulators or from the experiences of other regulators when there is a significant breakdown in the regulatory scheme as is the case in the Madoff situation.

Since learning of Mr. Madoff's arrest, FINRA has launched two broad reviews—one involving custody issues in joint broker-dealer/investment advisers and the other involving the role of broker-dealers as feeders or finders to money managers such as Madoff.

On the latter issue, FINRA launched an investigation to review the type of activity evident in the Madoff incident, in which finders or feeder funds referred business to a money manager or investment adviser. We are reviewing broker-dealers whose registered representatives may have referred clients to Madoff's advisory business. However, many of these finders and feeders are registered as investment advisers, not as broker-dealers, again compromising FINRA's reach in this important area.

Need for Greater Information Sharing and Oversight of Dual Registrants

Since the SEC has broad jurisdiction to examine both the broker-dealer and investment adviser lines of business, we would propose a more formalized information sharing process between the SEC and FINRA to identify potential problems with dually registered firms. This could include notifications of when the Commission requires an existing broker-dealer to register as an investment adviser, as well as sharing statements or representations made to the SEC by an investment adviser that may be pertinent to an exam of the broker-dealer.

Disparate Regulatory Oversight of Broker-Dealers and Investment Advisers

The Madoff affair illustrates how our fractured regulatory system can fail to protect investors. FINRA regulates broker-dealers, but not investment advisers, even though they provide services that are virtually indistinguishable to the average consumer. FINRA's authority, as noted above, does not extend to writing rules for, examining for or enforcing compliance with the Investment Advisers Act of 1940. That authority was granted to the SEC and the states. The limits of FINRA's jurisdiction have been recognized by the SEC, the Treasury Department in last year's Blueprint for Financial Markets, and by the investment adviser industry, which has always opposed the idea of FINRA or a FINRA-like organization to examine and enforce rules for registered advisers.

For years, FINRA has argued for regulatory reform, so that consumers can be protected no matter what type of financial professional they hire. NASD issued public statements as far back as the late 1980s on this subject. We've submitted public comments to the SEC and Treasury on this disparity. In 2008, FINRA's former CEO, Mary Schapiro, personally raised these issues with then-SEC Chairman Cox.

The absence of FINRA-type oversight of the investment adviser industry leaves their customers without an important layer of protection inherent in a vigorous examination and enforcement program and the imposition of specific rules and requirements. It simply makes no sense to deprive investment adviser customers of the same level of oversight that broker-dealer customers receive.

Broker-dealer regulation is subject to a very detailed set of rules established and enforced by FINRA that pertain to the conduct of advertising, customer account conduct and selling practices, limitations on compensation, financial responsibility, trading practices and reporting to FINRA of various statistical information used in the examination and enforcement practice. The investment advisory business is not subject to this level of regulation—even though many advisory services are virtually indistinguishable from the services of a broker-dealer.

According to the SEC, the population of registered investment advisers has increased by more than 40 percent in recent years. (In 2001, there were 7,400 advisers; there were almost 11,000 as of March 2008.) As the SEC's Director of the Office of Compliance Inspections and Examinations stated last year, during this increase in the adviser population, "our examiner staffing levels have not increased. Given this fact, we came to the conclusion that our limited resources would best be used in examining those firms and issues that have the greatest potential to pose harm to investors."[1] 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.

Need for Consistent Investor Protection Across Financial Services Channels

The type of investor protection gap inherent in the disparate treatment of broker-dealers and investment advisers is not isolated to that area. Unfortunately, our current fragmented system of financial regulation—where no single regulator has the full picture—leads to an environment where systemic and other risks may be left unchecked or go unnoticed, and investors are left without consistent and effective protections when dealing with financial professionals. Further, some products and services are completely outside the U.S. regulatory system.

FINRA believes that it should be simpler for investors to know exactly what product they're buying, the legal protections they are entitled to and the qualifications of the person selling it. We believe that the solution to this problem is through greater regulatory harmonization—creating a regulatory system that gives retail investors the same protections and rights no matter what product they buy. At the very least, investors should be able to enter into any transaction knowing that:

- every person selling a financial product is tested, qualified and licensed;
- the product's advertising is not misleading;
- every product sold is appropriate for them; and

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[1] "Focus Areas in SEC Examinations of Investment Advisers: The Top 10," Lori A. Richards, Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, to the IA Compliance Best Practices Summit 2008, IA Week and the Investment Adviser Association (March 20, 2008).

- there is full, comprehensive disclosure for all products being sold.

Unfortunately, not all financial products come with these simple guarantees or protections.

Establishing consistency among these four areas of investor protection would be a key first step in harmonizing the financial regulatory system. And equally as important in order to be effective, strong oversight and enforcement programs must accompany these investor protection obligations.

**Conclusion**

As I stated at the outset, what has happened to Madoff's investors is tragic. Investigations are ongoing and more information, no doubt, will emerge to assist all of us in analyzing exactly how this alleged fraud was executed. But some facts are already clear: the structure of our current regulatory structure keeps some activities out of the sight of some regulators, and those gaps and inconsistencies leave investors without the protections they believe they are receiving.

When Americans are being asked to take on more of the responsibility to manage their own retirement funds and to save and invest for college tuition and mortgage down payments, they need a forward-thinking regulatory system to help them meet this growing responsibility. The individual investor is the most important player in the financial markets. Unfortunately, our system has not always sufficiently protected these individuals.

A point made earlier, but one which bears repeating, is that 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 Subcommittee as you consider how best to restructure the U.S. financial regulatory system.