Testimony of

Richard G. Ketchum
Chairman and CEO
Financial Industry Regulatory Authority

Before the Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services

U.S. House of Representatives

September 13, 2011

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

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.

FINRA

FINRA is the largest independent regulator for all securities firms doing business in the United States. FINRA provides the first line of oversight for broker-dealers, 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, 164,000 branch offices and 633,000 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 Securities and Exchange Commission (SEC), which approves all FINRA rules and has oversight authority over FINRA operations.

Evolution of Broker-Dealers and Investment Advisers

In recent years, increasing numbers of 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 may differ, the businesses have, in many ways, converged. While broker-dealers and investment advisers are regulated differently, the reality is—as the Rand Corporation said in a study completed for the SEC in 2008—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 an investment adviser representative.

In fact, there are approximately 2,500 firms that are dually registered as broker-dealers and investment advisers or are broker-dealers with one or more affiliated 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.

This means that firms offer customers a combination of brokerage and advisory services in a product menu, and that, in many cases, financial professionals offer commercially indistinguishable brokerage and investment advisory services to the same customer. This makes it highly unlikely that the 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 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.

Because broker-dealers and investment advisers operate under vastly different levels of oversight due to resource constraints of government regulators, firms offering similar services can arbitrage regulation by choosing a form of registration that offers the least regulatory oversight and minimizes the risk of enforcement if the firm engages in misconduct.

In Dodd-Frank, Congress authorized two studies related to the regulation of broker-dealers and investment advisers that were completed by the SEC in January. The first study examined the differences in the standards of care and other regulations for investment advisers and broker-dealers, and the second reviewed the SEC's frequency of investment adviser examinations and outlook for coverage going forward.

Standard of Care

In its study on Investment Advisers and Broker-Dealers, the SEC staff noted that "certain differences in the regulation of broker-dealers and advisers reflect differences, current, and historical, in their functions, while others may reflect differences in the regulatory regime, particularly when investment advisers and broker-dealers are engaging in the same or substantially similar activity." As an example of the latter, the staff found that the provision of personalized investment advice to retail customers was an area where differences in approach are no longer warranted and recommended establishing a uniform fiduciary standard for investment advisers and broker-dealers when providing investment advice to retail customers.

Among the benefits that a uniform fiduciary standard and disclosure requirements may offer, the study noted heightened investor protection and awareness, flexibility to accommodate different existing business models and fee structures, preservation of investor choice and the requirement "that investors receive investment advice that is given in their best interest, under a uniform standard, regardless of the regulatory label (broker-dealer or investment adviser) of the professional providing the advice."

FINRA has been clear in its view that the standard of care in both channels should be a fiduciary standard for the provision of personalized investment advice to retail customers.

We have found under the present broker-dealer regulatory regime that too often we and the SEC have been forced to respond 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.

The SEC's study reflects thoughtful analysis, but a number of questions and challenges remain that presumably would need to be addressed in any SEC rulemaking. FINRA believes that extending a fiduciary duty to all professionals providing individualized advice to retail customers should be done in a way that provides interpretative guidance as to the application of such a duty to the variety of broker-dealer business models that currently exist. FINRA has suggested in comments to the SEC that rules to implement such a standard should incorporate common law agency principles and require cogent, plain English disclosure of permissible conflicts at the time of account opening and, where appropriate, at the point of sale. This disclosure should describe clearly how the adviser or broker-dealer will manage those conflicts and prohibit conduct where conflicts are not consistent with acting in the best interest of the customer.

While disclosure alone is insufficient to address fiduciary issues, it is a critical cornerstone to make them work. We need to transition away from account statements that contain too much legalistic language, causing investors to simply ignore them.

It was for that reason that FINRA published a concept proposal late last year requesting comment on a proposed rule that would require firms, at or prior to commencing a business relationship with a retail customer, to provide a written statement that describes the types of accounts and services it provides. Under the proposal, firms would also be required to disclose the conflicts associated with such services.

Through the comment process, we have gathered input from a variety of stakeholders about what may be the right combination of information to provide investors up front and how best to provide detail from a web-based standpoint.

In FINRA's view, harmonization of the standard of care is an important first step. However, just as critical is a consistent oversight regime to ensure investors are being properly protected. As the SEC's study noted, "to fully protect the interests of retail investors, the Commission should couple the fiduciary duty with effective oversight." The existence of a fiduciary standard alone is not a guarantee against misconduct. The risks to investors can be seen in the types of enforcement actions that have been taken against advisers. As we've seen all too often in the headlines, registered investment advisers have been implicated in Ponzi schemes. Other SEC actions involve a range of abusive behavior—such as trade recommendations that benefited the adviser over clients, misleading advertising, failure to disclose conflicts of interest, misappropriation of client funds, and inappropriate compensation and client referral arrangements. It is clear that compliance with the fiduciary standard must be regularly and vigorously examined and enforced to ensure the protection of investors.

SEC Study on Enhancing Investment Adviser Examinations

The SEC's study on investment adviser exams concludes that the agency "will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency." The study further acknowledges that new examination responsibilities provided to the agency under Dodd-Frank means that an increase in agency examination staff "is unlikely to keep pace with the growth of registered investment advisers."

In order to address the lack of oversight resources for investment advisers, the SEC's study recommends that Congress consider three possible approaches: 1) authorize the Commission to impose user fees on SEC-registered investment advisers to fund their examinations; 2) authorize one or more SROs to examine, subject to SEC oversight, all SEC-registered investment advisers; or 3) authorize FINRA to examine dual registrants for compliance with the Advisers Act.

The SEC oversees more than 11,000 investment advisers, but in 2010 conducted only 1,083 exams of those firms due to lack of resources. As such, the study notes, "the average registered adviser could expect to be examined less than once every 11 years."

While the SEC examines only about 9 percent of investment advisers each year, 55 percent of broker-dealers are examined each year by the SEC and FINRA. As the SEC's study states, "the Commission's and the Commodity Futures Trading Commission's experiences with SROs support the view that an SRO can augment government oversight programs through more frequent examinations."

The frequency of SEC investment adviser examinations has declined 50 percent since 2004. The study notes that while there may be a short-term percentage increase due to the number of advisers being shifted to state oversight, any potential increase "may be offset by the need to divert examination resources to fulfill new examination obligations that the Commission was given by the Dodd-Frank Act." The SEC study estimated that it would need to double the numbers of examiners to increase the frequency of examinations to even 20 percent.

In a statement issued at the time of the study's release, SEC Commissioner Elisse Walter noted that based on that calculation, the SEC would need to add more than 2,000 examiners to its advisory program to increase the SEC's examination frequency to FINRA's current average for broker-dealers. Commissioner Walter noted that in addition to the 50 percent decrease in the frequency of examinations since 2004, the number of examinations also decreased 30 percent over that time. The Commissioner attributes the decreases in part to the growth in the number of investment advisers (38.5 percent) and in assets under management (58.9 percent) during the same timeframe. Walter explains that while there may be a near-term decrease in the number of advisers subject to Commission oversight due to Dodd-Frank's shifting of some of that population to state regulation, there will be an immediate increase in assets under management "as larger and more complex entities enter the Commission's oversight." She notes that these advisers are "more likely to be assessed as higher-risk advisers, requiring more resources," and highlights the staff estimate that "due to the Dodd-Frank Act, the number of large and complex entities registered with the Commission will increase from 38 percent of all advisers to 58 percent."

FINRA believes the gap in investment adviser oversight is a significant void in the protection of advisory clients and should be addressed as quickly as possible. Providing the SEC authority to designate one or more SROs for investment advisers, subject to SEC oversight, is the most practical and efficient way to address this critical resource and investor protection issue. Chairman Bachus' draft legislation circulated for this hearing would establish that authority and set a framework of requirements for any entity that would be designated as an adviser SRO. These requirements would ensure that the oversight by any such SRO reflect the nature and diversity of the investment adviser industry. We believe the draft is a thoughtful approach to addressing the critical need for increased adviser regulation.

Benefits and Oversight of SROs

Self-regulation in the securities industry has a long and effective history, and both Congress and the SEC have periodically examined and reaffirmed its critical role. In designing the statutory scheme of securities regulation in the 1930s, Congress envisioned that most of the day-to-day responsibilities for market and broker-dealer oversight would be performed by independent regulatory organizations under the SEC's direct supervision.

In the oversight regime for broker-dealers, FINRA supplements the work of the SEC in terms of front-line regulation. Among the functions FINRA provides to that regime are: 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. SROs for investment advisers could provide similar benefits to augment government oversight of that industry.

Self-regulatory organizations provide these benefits without significant additional cost to taxpayers, since they are typically funded by fees assessed on regulated entities. Self-regulatory organizations also have more flexibility than their government counterparts to devote and direct resources to large, multiyear technology development efforts that can support a variety of regulatory programs, including those focused on examinations, enforcement, market transparency and licensing qualifications.

One of the most important factors in self-regulation in the U.S. securities markets is that Congress mandated that the SEC conduct ongoing oversight of all self-regulatory organizations it oversees, such as FINRA. The SEC's authority in this regard is wide-ranging. For example, the SEC:

- approves all FINRA rulemaking and seeks public comment on FINRA proposals through notice in the *Federal Register*;
- can add, delete or amend FINRA rules as it deems necessary or appropriate;
- hears appeals of FINRA disciplinary actions, which also may be appealed to the federal courts;
- requires FINRA to keep records and file reports with the Commission, and records are subject at any time to Commission inspection;
- inspects FINRA regulatory programs to ensure that it is fulfilling its regulatory responsibilities and to mandate corrective action as needed;
- may conduct special inspections at any time for any reason;
- can impose limitations on FINRA's operations if it finds deficiencies justifying such action;
- may compel FINRA to act if it determines that FINRA is failing to provide adequate protection to investors; and,
- may suspend or revoke FINRA's registration under the Exchange Act and remove from office or censure any FINRA officer or director.

FINRA believes that any SRO for investment advisers should be subject to the same type of oversight. In this connection, we note that the discussion draft appropriately incorporates similar SEC oversight provisions.

Structuring an SRO Approach to Enhancing Investment Adviser Oversight

The SEC study states that "one or more investment adviser SROs would provide scalable resources that could supplement the Commission's oversight program for investment advisers. An SRO, like OCIE if it had additional resources, could use those resources to conduct earlier examinations of newly-registered investment advisers and more frequent examinations of other registered investment advisers." The SEC also correctly identifies several issues that would need to be addressed if an SRO approach is implemented for investment adviser oversight.

The first relates to the designation standards for SRO applicants and the scope of advisers required to be members of an SRO. If Congress were to grant the SEC authority to designate SROs to augment the oversight of investment advisers, FINRA's view is that all SRO applicants should be subject to designation requirements similar to those set forth for registered securities associations, modified as appropriate to meet the unique circumstances of the investment adviser industry. These standards include, among other things, assuring fair representation of the public interest and the adviser industry in the selection of any SRO's governing body; ensuring that any SRO's rules are designed to prevent fraud and protect investors, consistent with existing law, and do not impose burdens on advisers that are not necessary or appropriate; ensuring that any SRO provides for periodic examinations of members and their associated persons; and providing for equitable allocation of fees. The discussion draft of legislation circulated for this hearing establishes specific criteria for SROs in this manner. While the draft reflects the approach taken for national securities associations in the Exchange Act, it suggests a slightly modified approach for adviser SROs to reflect the industry it would regulate.

Requiring investment advisers to be a member of at least one SRO, as is required of broker-dealers, is highlighted in the SEC study as a key to the success of an SRO approach. However, the study notes that exclusions may be appropriate. It states: “For example, advisers to registered investment companies that are subject to examination under the 1940 Act could be excluded. Or specific exclusions could be provided for investment advisers to private funds (such as hedge funds) or advisers that do not have retail clients.” FINRA believes that the focus of any adviser SRO should appropriately be on retail-facing business. As such, FINRA supports the approach taken by the discussion draft that would exempt certain advisers from SRO regulation, such as advisers that primarily serve mutual funds and other qualified institutional buyers.

In terms of the governance structure of potential investment adviser SROs, FINRA believes that public representatives should form a majority of any governing body, and members of the investment advisory industry should be allocated a number of the remaining seats to ensure adequate industry representation. The discussion draft sets out criteria for IA SRO governance in a way that should ensure the independence of any SRO while allowing for representatives of various parts of the adviser industry to be represented on the board of any such organization.

Another significant issue to address is the scope of authority of any investment adviser SRO. The SEC study explains that Congress could provide for an SRO with broad or more limited authority, and notes that one option would be to “grant an SRO limited examination authority over investment advisers, while maintaining the Commission as the sole holder of authority to develop regulatory policy under the Advisers Act. Such an SRO also could have limited rulemaking authority to address matters collateral to the exercise of examination authority (such as authority to require maintenance of records).”

In FINRA’s view, the primary regulatory structure for advisers should remain the fiduciary standard incorporated in the Advisers Act and related SEC rulemaking and interpretations. Adviser SROs should have limited rulemaking authority, although the extent of that limited authority should be a matter for Congress and the SEC to determine. Commission approval and oversight of any rule proposals, including SEC public notice and comment, would ensure that any such SRO rules are appropriate for the adviser industry and consistent with the Investment Advisers Act. Any adviser SRO should have authority to examine for, and enforce compliance with, the Investment Advisers Act, the rules under that Act and the SRO’s own rules.

The discussion draft addresses this issue in very specific ways. It establishes a high standard for SEC approval of SRO rules in the adviser area and a requirement for consultation with the SEC in developing an examination program for investments advisers. We support this approach.

Before concluding, I want to be very clear—if FINRA becomes an SRO for investment advisers, we would implement regulatory oversight that is tailored to the particular characteristics of the investment adviser business. FINRA would establish a separate entity with separate board and committee governance to oversee any adviser work, and would plan to hire additional staff with expertise and leadership in the adviser area. That said, given our experience operating a nationwide program for examinations and our ability to leverage existing technology and staff resources to support a similar program for investment advisers, we believe we are uniquely positioned to serve as at least part of the solution to this pressing problem. In addition, FINRA’s current programs would be enhanced and investors be better protected if we had the authority to examine the full operations of dually registered firms, where currently we can only see the broker-dealer side of what is typically a fully integrated business.

Conclusion

The SEC and state securities regulators play vital roles in overseeing both broker-dealers and investment advisers, and they should continue to do so. Investor protection demands, however, that more resources are dedicated to regular and vigorous examination and day-to-day oversight of investment advisers. Under SEC oversight and subject to the type of detailed requirements that govern current SROs, investment adviser SROs can help the SEC fill an untenable gap in the protection of investment advisory clients.

FINRA is committed to working closely with other regulators and this Committee as you consider how best to address the lack of examination resources for investment advisers.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
Richard G. Ketchum	Financial Industry Regulatory Authority

3. Business Address and telephone number:

[redacted]

4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☑ No	☑ Yes ☐ No

6. If you answered yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

In July 2001, NASD Regulation, a predecessor organization to FINRA, entered into a contract with the SEC to build and operate the Investment Adviser Registration Depository (IARD). The IARD is the central system used by the SEC and the states to register/license investment adviser firms and individual investment adviser representatives. The original contract, with a value of $3.2 million, was for a term of 5 years with three annual renewal periods. The original term of the contract expired in 2006 and one year renewal periods were executed in 2006, 2007 and 2008. The continuing contract became effective on July 23, 2009 for a term of one year with an option for four annual renewals. A one year renewal was effected in 2010. The IARD system is fully funded by fees paid by system users.

7. Signature:

Please attach a copy of this form to your written testimony.