

Testimony of

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

On behalf of the Financial Industry Regulatory Authority, or FINRA, I would like to thank you for the opportunity to testify today about FINRA's role in overseeing the municipal securities markets.

FINRA

Before I address municipal securities market oversight, I'd like to provide a brief overview of FINRA and its regulatory programs. FINRA plays an integral role in overseeing broker-dealers and the U.S. securities markets and regulating broker-dealer firms and brokers that sell securities in the United States. FINRA oversees nearly 4,000 brokerage firms and more than 600,000 registered brokers. FINRA supervises most aspects of the broker-dealer business—from registering individuals 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, broker-dealer firms and individual brokers.

This monitoring plays an important role in enabling us to detect and fight fraud. In addition to our own enforcement efforts, each year we refer hundreds of fraud and insider trading cases to the Securities and Exchange Commission (SEC) and other agencies. FINRA regularly shares information with other regulators, leading to important actions that can prevent further harm to investors.

FINRA, directly and through our regulatory service agreements with exchanges, monitors approximately 99 percent of all trading in U.S. listed equities markets and 70 percent of the options markets. In fact, FINRA's market surveillance systems process approximately 50 billion market events on average each day to closely monitor trading activity in equity, options and fixed income markets in the United States.

In addition, FINRA operates and regulates over-the-counter (OTC) market transparency facilities that provide the public and professionals with timely quote and trade information on publicly traded equity and debt securities. They are the primary source for regulatory data on these transactions, and provide FINRA-registered firms with tools to comply with reporting

obligations in secondary-market activity in fixed income and equity securities. In this role, we are continually evaluating and identifying areas where enhanced transparency can benefit investors and the markets.

Finally, FINRA believes that an essential component to investor protection is investor education. More than 10 years ago, FINRA established the FINRA Investor Education Foundation to support innovative research and educational projects aimed at improving the financial capability of all Americans. Together with the Foundation, FINRA is committed to providing investors with information and tools they need to better understand the markets and basic principles of investing—and to help them protect themselves from financial fraud. As part of this effort, FINRA offers dozens of free online resources about investing and avoiding fraud, including online calculators and investor alerts. FINRA's BrokerCheck® allows investors to research the professional backgrounds of current and former FINRA-registered brokerage firms and brokers.

Regulatory Oversight Framework for the Municipal Securities Markets

In the municipal securities market, pursuant to Sections 15A and 15B of the Securities Exchange Act of 1934 (Exchange Act), FINRA plays an instrumental role in examining for and enforcing compliance with the federal securities laws, SEC rules and regulations and the Municipal Securities Rulemaking Board (MSRB) rules by FINRA-regulated broker-dealers engaging in municipal securities transactions. In addition, since 2013, as a result of amendments to the Exchange Act by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) to require municipal advisors to register with the SEC and expand the MSRB's regulatory authority to municipal advisors, FINRA examines regulated firms' activities as registered municipal advisors and enforces compliance by such firms with the federal securities laws, SEC rules and regulations, and MSRB rules applicable to municipal advisors. Currently, there are approximately 1,440 municipal broker-dealers and municipal advisors that are FINRA members. In contrast, currently fewer than 30 municipal bank broker-dealers are overseen by the Federal Reserve, Office of the Comptroller of the Currency or the FDIC. A small number of these bank dealers are also municipal advisors.

The municipal securities market is overseen via a well-developed, collaborative relationship among: (1) the MSRB with its responsibility for adopting rules relating to the municipal securities market; (2) FINRA as the examination, surveillance and enforcement authority for its regulated firms; and (3) the SEC with its responsibilities for overseeing and approving the rules of FINRA and the MSRB. Effective coordination among these regulatory bodies is achieved through both leveraging of resources and collaborating on many financial, operational and business conduct topics, as well as with respect to implementing risk-based regulatory programs.

A memorandum of understanding (MoU) between FINRA and the MSRB sets out the terms of the relationship in a number of areas, including information and data sharing; referrals of potential rule violations from the MSRB to FINRA; types and frequency of meetings; confidentiality; fine sharing; MSRB assistance with rule interpretation and enforcement; and FINRA support of MSRB professional qualifications testing.

FINRA's Municipal Securities Coordination

FINRA coordinates closely with the SEC and MSRB in the oversight of municipal securities professionals. To this end, FINRA dedicates specialized staff that act as a central point of

contact with the SEC and the MSRB regarding the regulation of municipal securities broker-dealers and municipal advisors that are FINRA-regulated firms.

As part of this coordination, FINRA requests interpretive guidance from the MSRB regarding its rules and provides information to the MSRB about FINRA's municipal securities market examinations and enforcement actions. This sharing of information with the MSRB enables the MSRB to provide assistance to FINRA with its examination and enforcement actions and to evaluate the ongoing effectiveness of the MSRB's rules. FINRA also participates in formal, periodic meetings with the MSRB and SEC, including bi-monthly meetings with the MSRB and semi-annual meetings with the SEC and MSRB as required by the Exchange Act. In addition, we also participate in informal, monthly meetings with the SEC and MSRB to discuss timely issues arising from current municipal broker-dealer and municipal advisor examinations.

Examinations and Surveillance

Within the last five years, amendments to MSRB Rule G-16 have allowed FINRA to shift from mandatory two-year cycle examinations of municipal broker-dealers to a risk-based approach that better ensures the allocation of resources to the protection of investors and market integrity. While the smallest municipal broker-dealers may now be examined once every four years, FINRA visits the largest, most complex municipal broker-dealers annually. That's because a firm's business and risk profile—meaning transaction volume, product type, business model, customer profile and other risk factors—determine how frequently we examine firms and on what we focus during those examinations.

FINRA and the MSRB collaborate on municipal securities regulatory priorities each year leveraging, among other things, regulatory intelligence gathered from current year examinations, new rules, rule interpretations and emerging issues. FINRA then performs a quantitative and qualitative risk assessment of each municipal broker-dealer and municipal advisor. The assessments include analyzing relevant data about each firm—much of which is obtained from the MSRB under our MoU—such as transaction data, underwriting filings, revenue, news and disciplinary history to determine each firm's examination frequency and inspection scope.

FINRA conducts, on average, about 500 municipal broker-dealer and 60 municipal advisor on-site examinations per year. In recognition of the unique characteristics of the municipal market, FINRA operates specialized municipal examination teams assigned to examinations of the largest, most complex and highest risk municipal broker-dealers and municipal advisors. Separately, FINRA also reviews firms' financial and operational conditions for compliance with, among other things, SEC net capital and customer protection regulations. These examinations incorporate municipal securities as well, including reviews of municipal short positions, inventory valuations, haircuts and other financial prudential regulations.

In addition to periodic examinations, FINRA also conducts ongoing monitoring of regulated firms. We review a variety of information, including monthly balance sheets and income statements, position data and relevant news. We also meet periodically with firms that exhibit a large footprint in the municipal securities space outside of the routine examination cycle.

Market Regulation

FINRA's fixed income surveillance program for municipal securities, like FINRA's other market regulation programs, uses a risk-based approach, focusing on firms that demonstrate a pattern and practice of non-compliance for customer protection and transaction reporting reviews. FINRA receives municipal security transaction information reported to the MSRB's Real-time Transaction Reporting System (RTRS) and currently conducts surveillance based on 18 distinct patterns for municipal securities.

Once alerted to the existence of a potentially problematic pattern, FINRA applies certain thresholds to identify instances where further investigation is warranted. FINRA's selection thresholds for customer protection and transaction reporting alerts are designed to take into consideration the absolute number of violations, compliance rates, impact to the municipal securities market, and the potential harm to investors, among other factors. FINRA's alert review for potentially manipulative behavior is designed to identify conduct that may impact the integrity of the municipal securities market and bring provable actions that will effectively deter future misconduct.

Disciplinary Actions

In response to violations of MSRB rules, FINRA takes both formal and informal actions to enforce these rules. For formal matters, FINRA has action and settlement options such as Minor Rule Violation letters; Acceptance, Waiver and Consents; Formal Complaints; and suspensions, bars and monetary sanctions. FINRA can also caution firms in writing for less significant violations.

FINRA has successfully prosecuted a number of important municipal securities cases—with invaluable assistance from the MSRB. The MSRB has given FINRA access to data and information that better positions us to address a wide range of novel, problematic conduct. As an example, the MSRB's support enabled us to quickly link two firms—Cantone Research Inc. and Lawson Financial—through their shared association with Christopher Brogdon, an individual who had been barred from the securities industry decades earlier. Through our ability to connect MSRB and FINRA information, we were able to bring fraud charges against both firms and their owners for failing to disclose to investors material information known to them about bond issues they underwrote, including the likelihood that the obligors would be unable to repay the debt. We also made referrals to other authorities regarding conduct beyond FINRA's jurisdiction. It is unlikely that FINRA would have been able to so quickly connect these firms and discover the extent of their misconduct without such a collaborative relationship with the MSRB.

Regulatory Policy Coordination

FINRA works closely with the SEC and MSRB to develop regulation for the fixed income markets that is consistent yet calibrated to reflect the unique regulatory needs of each marketplace. In particular, FINRA's work with the SEC and MSRB has focused on initiatives designed to enhance transparency and promote better execution quality in the fixed income markets. These initiatives are tied together by a common thread—strengthening investor protection with a data-driven approach that accounts for recent, current and anticipated developments in fixed income market structure. FINRA's work with the MSRB in these areas has also been informed by SEC efforts in recent years. Transparency and execution quality

were key subjects in the SEC's 2012 Report on the Municipal Securities Market, and they were again highlighted in recommendations made by Chair White in her 2014 speech on the fixed income markets more broadly.

One of these initiatives involves proposals that FINRA and the MSRB recently filed with the SEC to require that additional pricing information be provided to customers on their trade confirmations in corporate and agency debt and municipal securities. As FINRA and the MSRB state in the respective proposals, putting additional pricing information in the hands of customers will better enable them to evaluate the cost and quality of the services firms provide and encourage communications between firms and their customers about their fixed income transactions. As part of our coordination efforts, FINRA and the MSRB also jointly conducted investor testing to evaluate the potential benefits of the proposed disclosure. FINRA looks forward to evaluating the comments it receives on the proposal and continuing its coordination with the MSRB on any interpretive issues raised in connection with the proposals.

Similarly, in recognition of the significant changes that have occurred in the fixed income market, FINRA consulted with the MSRB as each organization published guidance on firms' best execution obligations relating to transactions in fixed income securities. FINRA's guidance for non-municipal debt securities, among other things, reiterated firms' overall best execution obligations and emphasized the importance of evaluating the accessibility of electronic systems and how such systems can provide benefits to firms' customer order flow to ensure customers receive the best prices reasonably available.

Educational Efforts

Joint Regulatory Training

FINRA operates several educational programs to further train regulatory staff working on municipal securities matters, including hosting municipal securities training events, co-hosting joint training seminars with the MSRB and SEC for FINRA and SEC examiners, and developing in-depth written examination content on municipal securities and their regulatory framework for examiners.

Guidance for Firms

As is true for many issues, FINRA issues Regulatory Notices and guidance to assist firms with their compliance efforts. For municipal securities issues, FINRA and the MSRB sometimes issue joint notices.

In addition, FINRA analyzes data obtained from the MSRB to create industry compliance reports and tools that address concerns arising from FINRA examinations, such as the timeliness of underwriting filings, disclosures of material information, sales of bonds below the minimum denomination and underwriter due diligence. These reports are created on a monthly basis and are available to firms as well as to examiners.

FINRA conducts a biennial fixed income conference, and co-hosts a biennial joint SEC-FINRA-MSRB Municipal Advisor Compliance Outreach Conference. These events are live and webcast to allow nationwide participation.

Guidance for Investors

FINRA, the SEC and the MSRB all provide investor education materials, information and alerts relative to investing in municipal securities. Recent FINRA alerts have covered topics including important considerations for municipal bond investors, bond liquidity and duration, and the impact of interest rate changes on bond portfolios.

Conclusion

FINRA appreciates this opportunity to discuss its role in the oversight of the municipal securities market with the subcommittee. FINRA remains committed to working closely with other regulators, this subcommittee and the full committee as we continue to work toward our dual mission of protecting investors and safeguarding market integrity.