

**Testimony of**

**Richard G. Ketchum  
Chairman and CEO  
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**Before the Subcommittee on Oversight and Investigations  
Committee on Financial Services**

**U.S. House of Representatives**

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Chairman Neugebauer, Ranking Member Capuano 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.

When a firm like MF Global fails, there is always value in reviewing the events leading to that failure and examining where rules and processes might be improved. I commend the Subcommittee for having this hearing to do just that. Clearly the continued impact of MF Global's failure on customers who cannot access their funds is of great concern, and every possible step should be taken to transfer and restore those accounts as quickly as possible.

Like many other financial firms today, MF Global's operations included multiple business lines, engaging multiple regulatory schemes and crossing national boundaries. We and the other regulators here today will explain our roles in overseeing the various parts of the firm. We all share the goal of restoring funds to customers. While FINRA's role in that process is limited at this stage, we are committed to continuing to provide assistance wherever we can.

**FINRA**

FINRA is the largest independent regulator for all securities firms doing business in the United States, 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, 163,000 branch offices and 636,000 registered securities representatives. FINRA touches virtually every aspect of the securities business—from registering industry participants to examining securities firms; writing rules and enforcing those rules and the federal securities laws; informing and educating the investing

public; providing trade reporting and other industry utilities and administering the largest dispute resolution forum for investors and registered firms.

In 2010, FINRA brought 1,310 disciplinary actions, collected fines totaling \$42.2 million and ordered the payment of almost \$6.2 million in restitution to harmed investors. FINRA expelled 14 firms from the securities industry, barred 288 individuals and suspended 428 from association with FINRA-regulated firms. Last year, FINRA conducted approximately 2,600 cycle examinations and 7,300 cause examinations.

One of our regulatory programs that is particularly relevant to today's hearing is our financial and operational surveillance. Through this program, FINRA reviews FOCUS (Financial and Operational Combined Uniform Single) reports that broker-dealers file on a monthly basis as required by the Securities and Exchange Commission (SEC). These reports detail a firm's financial and operational conditions and allow FINRA to closely monitor a firm's net capital position and profitability for signs of potential problems.

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

### **Oversight of MF Global**

Like many financial firms today that operate simultaneously in multiple channels, MF Global was not solely a broker-dealer, but also a futures commission merchant or FCM. As such, multiple government regulators and self-regulatory organizations (SROs), including FINRA, had a role in overseeing various parts of the firm's operations.

With respect to oversight of MF Global's financial and operational compliance, which is most relevant to today's hearing, FINRA shares oversight responsibilities with the Chicago Board Options Exchange (CBOE) and the SEC, especially in terms of the firm's compliance with the net capital rule. For broker-dealers that are members of multiple SROs, the SEC assigns a Designated Examining Authority, or DEA, to examine the firm's financial and operational programs, including the firm's compliance with the Commission's net capital and customer protection rules. For MF Global, that DEA is the CBOE. As such, CBOE conducted the regular examinations of the firm for capital compliance.

There are two primary SEC rules for which financial examinations evaluate compliance, the net capital and customer protection rules. The primary purpose of the SEC's net capital rule, 15c3-1, is to protect customers and creditors of a registered broker-dealer from monetary losses and delays that can occur if that broker-dealer fails. It requires firms to maintain sufficient liquid assets to satisfy customer and creditor claims. It accomplishes this by requiring brokerage firms to maintain net capital in excess of certain minimum amounts. A firm's net capital takes into account net worth, reduced by illiquid assets and various deductions to account for market and credit risk. This amount is measured against the minimum amount of net capital a firm is required to maintain, which depends on its size and business. The net capital rule is intended to provide an extra buffer of protection, beyond rules requiring segregation of customer funds, so that if a firm cannot continue business and needs to liquidate, resources will be available for them to do so.

The SEC's customer protection rule, 15c3-3, has two components, reserve formula computation and possession or control, and was designed to ensure the safety of customers' assets. The objective of the reserve formula computation is to protect the customer funds in the event the broker-dealer becomes financially insolvent. Possession or control requires that the broker-dealer obtain prompt possession or control of customers' fully paid for and excess margin securities, ensure that customers' assets held by a broker-dealer are properly safeguarded against unauthorized use and separate firm and customer related business.

Fewer than 20 FINRA-regulated broker-dealers have a DEA other than FINRA, but in those cases, we work closely and cooperatively with the DEA when questions or issues arise. Even when we are not the DEA for one of our regulated broker-dealers, FINRA monitors and analyzes the firm's FOCUS report filings and annual audited financial statements as part of our ongoing oversight of the firm. That was the case with MF Global.

While that monitoring focuses on a broad range of issues, it is particularly relevant to note that our financial surveillance team placed a heightened focus on exposure to European sovereign debt beginning in spring 2010. During April and May, our staff began surveying firms as to their positions in European sovereign debt as part of our ongoing monitoring of regulated firms.

In response to our outreach on this issue, MF Global indicated in late September 2010 that the firm did not have any such positions. We later learned that the firm began entering into transactions that carried European debt exposure in mid-September 2010. While the firm's response was consistent with GAAP accounting rules that repo-to-maturity (RTM) transactions are treated as a sale for accounting purposes, the lack of a complete response delayed us in detecting the firm's exposure.

### **MF Global's Exposure to European Sovereign Debt**

In a routine review of MF Global's audited financial statements filed with FINRA on May 31 of this year, our staff raised questions about a footnote disclosure regarding the firm's RTM portfolio. RTMs are essentially transactions whereby the maturity date of a firm's bond position held in its inventory matches the maturity date of the repo. During the course of discussions with the firm, FINRA learned that a significant portion of that portfolio was collateralized by approximately \$7.6 billion in European sovereign debt. According to U.S. GAAP, RTMs are afforded sale treatment and therefore not recognized on the balance sheet. Notwithstanding that accounting position, the firm remained subject to market and credit risk throughout the life of the repo.

Beginning in mid-June, FINRA had detailed discussions with the firm, in which CBOE also participated, regarding the proper treatment of the RTM portfolio and we asserted that not enough capital was reserved against the RTM. While the SEC has issued guidance clarifying that RTMs collateralized by U.S. Treasury debt do not require capital to be reserved, there is no such relief for RTMs collateralized by debt of non-U.S. governments. We researched whether the firm retained default risk on the positions, and concluded that it did. Our view was that while recording the RTMs as sales was consistent with GAAP, they should not be treated as such for purposes of the capital rule given the market and credit risk those positions carried. As a result, we asserted that capital needed to be reserved against the RTM.

FINRA and CBOE also had discussions with the SEC about our concerns that the firm was not holding capital against its RTM portfolio. The SEC agreed with our assertion that the firm

should be holding capital against the positions. The firm fought this interpretation throughout the summer, appealing directly to the SEC, before eventually conceding in late August.

The firm infused additional capital and filed an amended July FOCUS report on August 31 to report a \$150 million capital deficiency in July. The firm also provided notification, pursuant to SEC Rule 17a-11, of its capital deficiency to the SEC, CBOE and FINRA as well as to the Commodity Futures Trading Commission (CFTC), pursuant to CFTC Rule 1.12. The net capital deficiency in the amended July FOCUS report was reported on the CFTC's website. In addition, on September 1, the firm amended its Form 10-Q filing with the SEC to identify the change in net capital treatment of the RTM portfolio.

In September, FINRA added MF Global to "alert reporting," a heightened monitoring process whereby we require firms to provide weekly information on net capital, inventory, profit and loss as well as reserve formula computations.

On October 19, the Intermarket Financial Surveillance Group (IFSG), which is comprised of securities and futures regulators and self-regulatory organizations, had its annual meeting. The IFSG was established in 1989 in order to enhance the coordination and monitoring efforts of both securities and commodities regulators. Through an information sharing agreement, SROs provide each other with financial surveillance data and related information on an as-needed basis. In addition, SRO representatives meet annually to discuss relevant capital and customer protection issues. Exposure to European sovereign debt was one of the topics at the October meeting and FINRA raised MF Global's positions during the discussions.

During the week of October 24, as MF Global's equity price declined and its credit rating was cut, FINRA increased the level of surveillance over the firm. We requested detailed information about the firm's balance sheet and liquidity; we received updates about the loss of lending counterparties and customers; and we spoke to clearing organizations about the margin required to settle trades. At the end of that week, FINRA was on site at the firm, with the SEC, as it became clear that MF Global was unlikely to continue to be a viable standalone business. Our primary goal was to gain an understanding of the custodial locations for customer securities and to work closely with potential acquirers in hopes of avoiding SIPC liquidation. As has been widely reported, the discrepancy discovered in the segregated funds on the futures side of the firm ended those discussions.

### **MF Global Bankruptcy and Liquidation Proceeding**

On October 31, 2011, MF Global Holdings, Ltd. and MF Global, Inc. filed for bankruptcy and entered into SIPC liquidation. Since that time, FINRA has provided assistance as requested by the SEC and the trustee.

On November 4, 2011, FINRA assisted the trustee in alerting broker-dealer firms via email that the trustee was accepting proposals for the transfer of approximately 450 customer securities accounts of MF Global to another member of SIPC.

We have also assisted the trustee by providing information about other broker-dealers to which MF Global securities customer accounts may be transferred.

## **Proposed Rules to Enhance Financial Surveillance and Expedite the Return of Customer Funds and Securities in the Event of Liquidation**

While FINRA believes that financial oversight rules of the SEC, combined with SIPC, create a good structure for protecting customer funds, firm failures provide opportunities for review and analysis of where improvements may be warranted. FINRA has proposed two rules that we believe would assist us in our work to monitor the financial status of firms. One of the proposals, approved by FINRA's Board in September of this year, would expedite the liquidation of a firm and most importantly, the transfer of customer assets. This rule is focused on enabling a more orderly resolution when a firm must cease operations. Specifically, it would require firms to contractually require their clearing banks and custodians to continue providing transaction feeds to the firm after the commencement of liquidation avoiding the recent reconciliation problems experienced by MF Global in its final days of business.

The rule would require the clearing agencies and custodians to provide read-only access to the firm's records to the regulators and SIPC, with the goal of providing a more timely transfer of customer assets. The rule would also require carrying or clearing firms regulated by FINRA to maintain and keep current certain records in a central location to facilitate a more rapid and orderly transfer of customer accounts to another broker-dealer as well as a more orderly liquidation in the event the firm can no longer continue to operate.

The other proposed rule, approved by FINRA's Board in July 2010, would require that FINRA-regulated firms file additional financial or operational schedules or reports as we deem necessary to supplement the FOCUS report. The rule would provide FINRA with the framework to request more specific information regarding, among other things, the generation of revenues and allocation of expenses by business segment or product line, the sources of trading gains and losses, the types and amounts of fees earned and the nature and extent of participation in securities offerings. As part of the rule filing, we have proposed a supplemental statement of income to the FOCUS reports, in order to capture more granular detail of a firm's revenue and expense information.

We are also working to develop an off balance sheet schedule, which could highlight exposures to regulators on a more timely basis.

We believe these proposals would enhance our ability to closely oversee the financial operations of firms we regulate and to more quickly and efficiently assist in transfers or liquidations when firms must close their doors.

### **Conclusion**

FINRA will continue to work with our fellow regulators and Congress as the liquidation process for MF Global proceeds. We share your commitment to reviewing the events involved in the firm's collapse, relevant rules and coordination with other regulators to identify the lessons learned and potential policy or procedural adjustments that may be warranted.


We realize that it is critical to continually evaluate the customer protection regime to ensure that it is designed as well as it can be to ensure prompt restoration of customer funds in the event of a firm collapse. To that end, we would be glad to participate in a broader review, in coordination with the SEC, CFTC, self-regulatory organizations and others to provide an overall assessment of where current rules and processes may need enhancements.

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

**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.

<b>1. Name:</b>  Richard G. Ketchum	<b>2. Organization or organizations you are representing:</b>  Financial Industry Regulatory Authority
<b>3. Business Address and telephone number:</b>  <div style="background-color: black; width: 100%; height: 40px;"></div>	
<b>4. Have <u>you</u> 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?</b>  <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	<b>5. Have any of the <u>organizations you are representing</u> 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?</b>  <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
<b>6. If you answered <u>yes</u> 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.</b>  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.	
<b>7. Signature:</b>  	

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