

**Testimony of**

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**Before the Subcommittee on Capital Markets, Securities, and Investment**

**Financial Services Committee**

**U.S. House of Representatives**

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Chairman Huizenga, 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 operations and regulatory programs and about how we are fulfilling our mission of protecting investors and ensuring market integrity while facilitating vibrant capital markets.

Since the last time that FINRA testified before Congress at a general oversight hearing in 2015, there have been a number of significant changes at the organization. I joined FINRA as President and CEO in August 2016, and recently William H. Heyman, Vice Chairman and Chief Investment Officer of The Travelers Companies, Inc., was elected as Chairman of our Board of Governors. FINRA also has reached an important milestone this year—we are marking our tenth anniversary since FINRA was created from the merger of the National Association of Securities Dealers (NASD) and the regulatory arm of The New York Stock Exchange (NYSE).

Before outlining FINRA's activities and the steps we are taking to further enhance our organization, I would like to take this opportunity to recognize the Subcommittee's work to address the many complex and challenging issues of the securities industry and markets. Your recent hearings on equity and fixed income market structure, for example, have been instrumental in enriching the dialogue among policymakers and other stakeholders on how our capital markets can better serve investors and issuers.

FINRA plays a critical role in the continued strength of those markets as the first line of oversight for the thousands of broker-dealer firms and individual brokers in the United States. Our regulatory program has evolved with the industry for nearly 80 years, rising to meet the challenges of new markets, new products, and new business practices. In just the last several months, we have implemented trade reporting for U.S. Treasuries (the largest market in the world), continued to expand protections for senior investors,

enhanced our ability to pursue bad actors, requested comments on our entire set of capital formation rules, and launched a new initiative to address the latest developments in financial technology.

But the U.S. securities industry will never stop evolving, and neither can we. That is why earlier this year we commenced a program called FINRA360—a top-to-bottom review dedicated to making FINRA the most effective and efficient self-regulatory organization (SRO) that it can be. Drawing on input from inside and outside the organization, FINRA360 has already resulted in new investments in examiner training, new compliance tools for our member firms, and a newly consolidated enforcement program, among other improvements discussed below.

## **History of FINRA and SEC Oversight**

Strong, vibrant securities markets are central to the U.S. financial system. Companies and individuals around the world rely on these markets to finance growth, create jobs, and fund new ideas; to plan for the future; and to protect against unexpected market events. Trillions of dollars are raised by issuers and traded in the U.S. securities markets every year, and the ability of investors to access these markets depends on thousands of firms and hard-working brokers who serve their customers with diligence and integrity.

FINRA is the first line of oversight for a significant portion of the U.S. securities markets, complementing the work of the Securities and Exchange Commission (SEC) through our regulation of broker-dealer firms and individual brokers. FINRA is organized as a not-for-profit Delaware corporation, registered with the SEC as an SRO, and subject to comprehensive SEC oversight. Every brokerage firm and broker that sells securities to the public in the United States must be registered with FINRA. We do not regulate investment advisers, mutual funds, insurance companies, or banks.

As the SRO for more than 3,700 securities firms, nearly 160,000 branch offices, and over 630,000 individuals, FINRA plays an integral role in protecting the fundamental trust that investors and other market participants place in the U.S. financial system every day. In 2016, for example, we conducted more than 4,100 examinations to test that market participants were operating fairly and within established rules, and we brought more than 1,400 disciplinary actions where we found violations of those rules. In addition to our own enforcement measures, each year we refer hundreds of fraud and insider trading cases to the SEC and other agencies, leading to important actions that can prevent further harm to investors.

Working with securities exchanges, FINRA also conducts cross-market surveillance for approximately 99 percent of all trading in U.S.-listed equities markets and 65 percent of all trading in U.S.-listed options. In addition, FINRA is responsible for the surveillance of the unlisted equity market and fixed income instruments that trade in the over-the-counter (OTC) market. All told, in order to closely monitor trading activity across these markets, our surveillance systems process 37 billion market events a day on average

and generate billions of additional derived market events by standardizing trading activity across the markets.

FINRA also works to educate investors about the securities markets and give them the tools they need to invest knowledgeably and safely. More than 13 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 the information they need to better understand the markets and basic principles of investing.

These and other programs we operate—from comprehensive trade reporting to detailed public disclosure systems to licensing examinations—advance our mission by protecting investors and preserving market integrity. And they do so in many ways, from promoting compliance with applicable rules, to creating a level playing field for market participants, to stopping bad actors, to enhancing transparency and access to information.

SROs like FINRA and the securities exchanges have always been a cornerstone of the federal securities laws. Even before those laws were enacted, securities exchanges regulated their members. In 1934, Congress codified and strengthened the governance requirements that applied to the exchanges when it created the SEC. In 1938, Congress passed the Maloney Act, which extended the SRO model to broker-dealers that trade in the over-the-counter market. Congress stated then that reliance only upon direct regulation by the SEC “would involve a pronounced expansion of [the SEC’s] organization . . . [and] a large increase in the expenditure of public funds . . .”<sup>1</sup> One of FINRA’s predecessor organizations, the National Association of Securities Dealers (NASD), became a registered SRO as a result of the Maloney Act. In 1975, Congress again concluded that the SRO model “should be preserved and strengthened” as it amended the federal securities laws concerning the SEC’s oversight responsibilities.<sup>2</sup>

As an SRO, FINRA can involve its member firms more directly in its deliberations and thus benefit from their expertise on relevant matters, such as the different business models of those member firms and how they operate in practice, the complex and rapidly evolving securities markets in which they trade, and the wide range of investors they serve. Like other SROs, FINRA can use what it learns from its members to enrich our regulatory programs and develop solutions that are more practical, tailored, and effective than what could be developed without such input. FINRA also has flexibility to direct resources to large, multi-year technology development efforts that can improve the efficiency and effectiveness of regulatory programs. FINRA provides these benefits without any cost to taxpayers, since we are funded by fees assessed on regulated entities, among other sources.

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<sup>1</sup> S. Rep. No. 1455, 75<sup>th</sup> Cong., 3d Sess. I.B.4. (1938); H.R. Rep. No. 2307, 75<sup>th</sup> Cong., 3d Sess. I.B.4. (1938) (duplicate text quoted in both reports).

<sup>2</sup> S. Rep. No. 94-75, 94<sup>th</sup> Cong., 1<sup>st</sup> Sess. 7, II (1975).

A critical feature of the SRO model is oversight by the SEC of all aspects of an SRO's regulatory operations. Under the federal securities laws, FINRA is subject to comprehensive SEC oversight with respect to our rulemaking, examinations, enforcement activities, and other programs. For example, the SEC:

- approves or disapproves FINRA rulemakings after seeking public comment on FINRA proposals through notice in the Federal Register;
- can abrogate, add to, and delete FINRA rules as it deems necessary or appropriate in furtherance of the purposes of the Securities Exchange Act of 1934;
- 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 SEC; and
- inspects FINRA regulatory programs regularly to ensure that FINRA is fulfilling its regulatory responsibilities and to mandate corrective action as needed.

While the SEC has always supervised FINRA, in October 2016, the SEC's Office of Compliance Inspections and Examinations (OCIE) launched the FINRA and Securities Industry Oversight (FSIO) office to further enhance its program. FSIO is composed of approximately 45 staff members whose primary responsibility is the oversight of FINRA. This oversight includes comprehensive reviews of FINRA operations through inspections and examinations. Since January 2016, OCIE and now FSIO have initiated 24 inspections of FINRA programs. In addition to these programmatic and thematic inspections, they have initiated 39 targeted reviews of FINRA examination files. FSIO also holds regular monitoring meetings with senior management from FINRA offices, and receives extensive reports and documentation from FINRA on an ongoing basis.

We welcome this oversight by the SEC as we believe it not only helps us further our investor protection and market integrity mission, but also provides valuable independent perspectives on our operations. This oversight also helps to maintain and update as appropriate the self-regulatory model for FINRA as envisioned by Congress in the Maloney Act.

FINRA has a Board of Governors (Board) composed of a majority of public governors, along with industry representatives from various sectors of the business. The Board and its various committees (which include Audit, Finance, Regulatory Policy, and other key committees) play an active role in reviewing any significant initiatives at FINRA as well as the day-to-day operations of the organization. This structure, together with extensive SEC oversight, ensures that FINRA acts in the public interest while being informed by a strong understanding of broker-dealer operations and market developments.

FINRA currently has 16 standing advisory committees, 15 ad hoc committees, and 11 district committees, reflecting subject-matter expertise from the broker-dealer industry while also incorporating other perspectives, such as those of academics and investor advocates. FINRA staff generally discusses regulatory initiatives, industry issues, and

significant rule proposals with relevant committees early in the rulemaking process. This approach typically includes discussion of the reasons for proposing the rule change, the committees' views on any potential advantages or disadvantages of the rule change, the practical consequences of the rule change, and possible alternatives to the rule change that might achieve the same objectives.

FINRA also seeks to engage its member firms, investors, and other stakeholders through a variety of other formal and informal mechanisms, including the rulemaking comment process, member surveys, investor education forums, roundtables, and continuing education programs.

## **FINRA360**

As I noted above, this summer marks an important milestone in FINRA's history as it has now been ten years since FINRA was created from the merger of the NASD and the regulatory arm of the NYSE. During this past decade, FINRA successfully integrated these two complex regulatory programs and subsequently made many substantial enhancements to its operations to adapt to changes in its membership and the markets.

Since joining FINRA, I have been focused on listening to investors, firms, and other stakeholders, reflecting our commitment to be the best-informed, most effective SRO we can be. I intend to keep up this listening tour throughout my time at FINRA. It has been inspiring to hear many express their interest in helping FINRA be a successful SRO. But the feedback—particularly the potential opportunities for improvement that have been identified—also has underscored the timeliness of stepping back and engaging in a top-to-bottom review.

FINRA360 is a multi-year exercise focused on creating an organization that is committed to continuous improvement.<sup>3</sup> It provides a framework for processing the internal and external feedback we continue to receive, engaging in a thoughtful analysis to determine whether there are opportunities for improvement, and making changes that will produce a more effective, more efficient FINRA. Now is an opportune time for FINRA to review how our operations are—or are not—meeting the current challenges facing the organization, and to make any changes required. As a new CEO of a ten-year-old organization, with the benefit of fresh eyes, and with the support and oversight of our Board, I am working with senior management to look at how things are done and identify ways to do them better.

With FINRA360, there are several broad principles that are being used to guide our work. Most importantly, we must remain focused on how to best fulfill our core mission—promoting investor protection and market integrity while facilitating vibrant capital markets. Potential changes must be evaluated based on the extent to which they will advance these goals.

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<sup>3</sup> See: [www.finra.org/about/finra360](http://www.finra.org/about/finra360)

In addition, our thinking should consistently reflect our identity as an SRO. FINRA stands at a unique intersection of regulation and industry: our mission is investor protection and market integrity, and our task is to work with our members and other stakeholders to cultivate and deploy a deep expertise in the securities industry and enable regulation that is more effective—and more efficient—than would otherwise be possible if the government acted alone. We must continue to be mindful of the potential benefits of self-regulation and consider how best to deliver those benefits. And we must be thoughtful about what types of actions or policy decisions are more appropriately left to the government rather than SROs.

FINRA360 will take time—a comprehensive and thoughtful review of our entire organization requires no less. But we are not waiting until all of the work is complete before we implement any changes, some of which are already underway. More than a set of specific proposals, FINRA360 provides a process for carefully considered—but ambitious—changes and improvements throughout FINRA, as reflected in the varied initiatives described below.

### *Enforcement Restructuring*

Since its creation, FINRA has maintained two distinct enforcement teams within the organization—one handling disciplinary actions related to trading-based matters found through our market surveillance and examination programs, and the other handling cases referred from other regulatory oversight divisions within FINRA. On the listening tour and in other forums, I heard that stakeholders can experience these units as two different regulators. Our internal analysis also identified this structure as a potential area for improvement to address duplicative operations and sometimes different approaches to managing our enforcement activities.

In July, after careful consideration, we announced our plan to combine our enforcement programs and named a new Director of Enforcement, bringing together these teams. In addition, the Director now reports directly to me and also sits on FINRA's Management Committee. We believe these changes will result in a more effective and efficient enforcement function that will enable us to vigorously and fairly enforce applicable rules.

### *Engagement and Transparency*

Another example is engagement. In all of our initiatives and programs, FINRA cannot be a successful SRO without meaningful interaction with member firms, investors, and other stakeholders. It is essential that we engage in ways that are conducive to promoting our shared interest in well-informed regulation, strong compliance, and vibrant capital markets.

That is why we issued a Special Notice on Engagement earlier this year to better understand how our existing mechanisms for soliciting input from members, investors

and the public—and there are many—work and how they can be improved.<sup>4</sup> Improving these mechanisms in turn will help us better collect and consider feedback on the many other areas that we are reviewing under FINRA360. The comment period for this Notice recently ended, and we are reviewing the comments received, which are publicly available on our website.

## **Other Recent FINRA Initiatives**

Our initiatives over the last year demonstrate both the breadth of FINRA's regulatory program and how we are seeking to meet the challenges of the ever-evolving marketplace and needs of investors.

### *Transparency for Treasury Market Regulators*

On July 10, FINRA, working closely with Treasury, the Federal Reserve, and the SEC, launched an initiative for FINRA member firms to report transactions, post-trade, in U.S. Treasury securities to FINRA's Trade Reporting and Compliance Engine, known as TRACE.<sup>5</sup> This initiative provides regulators, for the first time, with regular transaction information for this important market. I understand that the successful launch of TRACE for Treasuries was featured at your fixed income market structure hearing on July 14.

By leveraging the existing TRACE system for the regulatory reporting of U.S. Treasury securities, FINRA was able to accomplish this critical regulatory objective for the largest segment of the fixed income market in an efficient and cost-effective manner. According to industry figures, there is just under \$40 trillion outstanding in fixed income debt in the U.S. as of the first quarter of 2017, compared with roughly \$30 trillion in U.S. equity market capitalization. U.S. Treasury securities account for more than a third of the fixed income markets, with a little less than \$14 trillion outstanding. Securitized products are the next largest segment, with a little more than \$10 trillion outstanding.

Expanding TRACE to cover Treasury securities and making this information available to regulators required substantial technology and market expertise, extensive collaboration with and effort by our broker-dealer members, and no taxpayer funding—a good example of the potential benefits that an SRO can bring to our regulatory structure.

Although expanding TRACE reporting for Treasury securities by FINRA members was an integral first step, additional steps are being considered to increase insight into the Treasury cash market. In October 2016, the Federal Reserve Board announced its intent to collect data from banks for secondary market transactions in U.S. Treasury securities in a manner that would complement the work of the SEC in approving FINRA's collection of these transactions from broker-dealers.

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<sup>4</sup> See: *Special Notice: FINRA Requests Comment on Potential Enhancements to Certain Engagement Programs*. [www.finra.org/industry/special-notice-032117](http://www.finra.org/industry/special-notice-032117)

<sup>5</sup> See: *Regulatory Notice 16-39 (SEC Approves Rule Change to Require Reporting of Transactions in U.S. Treasury Securities to the Trade Reporting and Compliance Engine (TRACE))*. <http://www.finra.org/industry/notices/16-39>

## *Protections for Senior Investors*

Another successful recent initiative has been FINRA's Securities Helpline for Seniors. The Helpline was launched in April 2015 so that senior investors, or individuals caring for a senior investor, can call to raise concerns about issues with brokerage accounts and investments.<sup>6</sup> As we have passed the two-year anniversary of the Helpline, we have fielded more than 10,000 calls from all 50 states and from individuals ranging in age from 17 to 102 years old—the average age of callers is 70 years old. The FINRA staff has referred over 820 matters to state, federal, and foreign regulators, and made more than 146 referrals to Adult Protective Services in 16 states.

In one example, a 92-year-old woman contacted the Helpline because a registered representative traded 368 times in her four separate accounts without authorization. FINRA investigated the allegations and barred the registered representative. Upon further review of the activity, the firm offered to resolve the customer's complaint and also offered a settlement to another senior couple who experienced the same mistreatment by the representative.

Helpline calls cover a variety of financial services-related products, including variable annuities, mutual funds, and real estate investment trusts. Callers have inquired about how to review an investment account statement and access investor tools and resources (such as FINRA's BrokerCheck<sup>®</sup>), requested assistance with lost securities, and raised concerns of potential unsuitable recommendations, fraud, or illegal activity involving brokerage accounts and investments, as well as abuse and exploitation of seniors by persons outside of the securities industry. Many firms have taken the initiative to establish designated points of contact to work with Helpline staff to streamline the process of resolving investor issues, and we are grateful to our members for this type of collaboration on such an important issue.

To date, the Helpline has returned approximately \$4.7 million to customers due to firms proactively investigating issues raised to them by the Helpline and making customers whole when appropriate. To further support these efforts, FINRA finalized a rule earlier this year to allow broker-dealers to delay a disbursement of funds or securities if the broker-dealer suspects suspicious activity in a senior's account, subject to specified conditions. This type of pause allows the broker-dealer and FINRA to look closer at the situation to determine if there is misconduct. The rule has been approved by the SEC and will go into effect early next year.

FINRA also supports this Committee's work on the SeniorSafe Act. As our experience with the Helpline has demonstrated, there is a need for this important bill, which will help allow broker-dealers and other financial services representatives to report activity that appears suspicious and may endanger seniors and their investments. We also believe that FINRA should be added as a "covered agency" under the bill so that there is no gap

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<sup>6</sup> See: <http://www.finra.org/investors/highlights/finra-securities-helpline-seniors>



in the ability of broker-dealers to communicate with regulators. We look forward to continuing to work with Congress on this legislation.

### *Technology-Driven Innovation in Regulation*

Technology is vital to FINRA's ability to achieve our mission of investor protection and market integrity. To build a complete, holistic picture of market trading in the United States, our market surveillance systems process 37 billion market events a day on average and generate billions of additional derived market events by standardizing trading activity across the markets. FINRA's investments in technology have vastly improved our regulatory operations and reduced our operating costs over time.

In addition, FINRA is a pioneer in the use of cloud technology which has had significant benefits for our operations and improving our ability to surveil the markets and conduct examinations. For example, the flexibility to use virtual servers depending on need means that queries that used to take hours can now be completed in minutes or seconds. Prior to our move to the cloud, it was not unusual for a FINRA analyst to set a query running that could take hours to complete depending upon its size. In the cloud, and with improved surveillance tools, in some cases a response to a query that previously took 60 minutes has been reduced to a sub-second response time.

FINRA's use of cloud technology has enabled our staff to generate more leads from the data, process more information, and supply a greater regulatory presence to the trading markets. These advances in technology allow us to aggregate data from across multiple trading venues and see trading patterns we were not able to see before in order to better protect investors. We also have begun exploring machine learning to enhance our surveillance for suspicious trading patterns. Machine learning offers the potential to provide our analysts with powerful new capabilities to sift through mountains of data to discern signs of sophisticated efforts to violate the rules and harm investors. We also are using advanced text analytics to automatically read, summarize and categorize large quantities of incoming data, automatically linking it to information we already have.

In addition, cloud technology has improved FINRA's capabilities with respect to data security and resilience. Because data is widely dispersed and encrypted in storage and in transit, it can be more secure than it would be under some traditional approaches.

Finally, FINRA's use of cloud technology has reduced operating costs. Because we only pay for what we use and we no longer need to maintain our own infrastructure, we can achieve significant savings in data storage and usage.

### *Innovation Outreach Initiative*

FINRA is also continuing to actively consider how our rules and programs interact with technology innovations in the broader industry. Over the past few years, FINRA has engaged in active dialogue with market participants to assess the impact of FinTech-related business models and tools on investors as well as broker-dealer

operations. We have an internal advisory committee that serves as a forum to identify and prioritize FinTech topics that impact the securities industry and to coordinate appropriate regulatory approaches with key stakeholders, including other regulators. FINRA has issued reports on Distributed Ledger Technology and Digital Investment Advice, as well as Investor Alerts on virtual currencies, automated investment tools, and crowdfunding.<sup>7</sup> And we have been closely monitoring other emerging areas at the intersection of new technology and financial services, such as online capital raising, compliance-related technology (RegTech), artificial intelligence, and social media sentiment investing.

In order to further develop these efforts, we recently launched the FINRA Innovation Outreach Initiative which will engage with those in the securities industry seeking to develop or use new financial technology applications and other innovations.<sup>8</sup> This initiative will help FINRA better understand these innovations and how we can foster a collaborative environment for productive interactions with firms operating in this space. It may also allow us to identify areas where we could adapt our regulatory approach to take into account evolving business models and risks.

### **Broker-Dealer Oversight**

All of these recent initiatives are examples of how FINRA has worked to enhance our core regulatory programs and ensure they are working in the most effective and efficient manner. Through these programs, FINRA provides oversight of broker-dealer operations and the securities markets in order to protect investors and maintain market integrity. We also bring enforcement actions where there are violations, develop and refine rules that further our mission, and educate investors on the opportunities and risks they may face.

#### *Examinations*

FINRA has a comprehensive examination program and regularly examines all broker-dealers who are our members to determine compliance with FINRA's rules and those of the SEC and the Municipal Securities Rulemaking Board (MSRB). During a routine examination, FINRA examines core areas of a firm's business as well as aspects of the firm that present heightened regulatory risk. Specifically, for an examination, FINRA may review a firm's books and records to see if they are current and accurate; analyze sales practices to determine whether the firm has dealt fairly with customers when making recommendations, executing orders, and charging commissions or markups and markdowns; and scrutinize a firm's anti-money laundering program, business continuity plans, and financial integrity and internal control programs. Firms also may be subject to a rigorous review for compliance with financial and operational requirements, including how they handle customer funds and securities.

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<sup>7</sup> See: [http://www.finra.org/sites/default/files/FINRA\\_Blockchain\\_Report.pdf](http://www.finra.org/sites/default/files/FINRA_Blockchain_Report.pdf)

<sup>8</sup> See: <http://www.finra.org/newsroom/2017/finra-launches-innovation-outreach-initiative>

In 2016, FINRA conducted nearly 1,400 routine cycle examinations and over 900 branch office examinations in our oversight of member firms. We also conducted over 2,500 cause examinations, which are targeted exams that may be initiated due to complaints, tips, referrals or other specific issues.

In January 2017, FINRA issued its annual Regulatory and Examination Priorities Letter.<sup>9</sup> In the letter, FINRA identified specific areas of concern that are a focus of examinations this year including high-risk brokers, the treatment of senior investors, sales practices for complex and long-term products, the management of liquidity and other financial risks, programs to mitigate cybersecurity risks, and firms' testing of their internal supervisory controls. FINRA uses a variety of methods to better identify risk and decide where, how, and with what intensity to apply our resources. We continue to enhance the exam process by applying this risk-based approach to both the frequency of exams and the areas where our examiners focus.

### *Compliance Tools and Resources*

FINRA also focuses on identifying better ways to help firms comply with rules. In fact, a common request from the listening tour and other interactions with our members—especially smaller firms—is that we provide more tools to assist firms in achieving compliance.

For example, we recently launched a new Compliance Calendar and Vendor Directory, which are both designed to help industry participants fulfill their compliance responsibilities. The Compliance Calendar is a way for firms to keep track of not just upcoming filing requirements and other significant deadlines, but also educational opportunities. The Compliance Vendor Directory is designed to help firms more easily locate compliance-related vendors, such as compliance consultants, cybersecurity experts, and exam prep resources.

Another initiative to aid compliance is the Cross-Market Surveillance Report Card, which we launched last year. Although firms generally review trades for manipulation, abusive traders can be very good at concealing their activity by trading across multiple firms, markets, and products. These new report cards do not reflect conclusions that violations have occurred. Rather, they indicate potential problems that a firm should review.

Firms can use this information to upgrade internal controls and address any problematic areas. And there is evidence that this approach works. In April 2017—about a year after FINRA began issuing the cross-market report cards on layering—we saw an 82 percent decline in layering exceptions. We plan to expand the program to include an additional type of cross-market surveillance alert by the end of the year with a type of alert schedule to be added in the first half of 2018.

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<sup>9</sup> See: <http://www.finra.org/sites/default/files/2017-regulatory-and-examination-priorities-letter.pdf>

Another new compliance tool that we have committed to providing is an exam findings report. Firms can get an individual report after any FINRA exam of their own firm. But we have often heard that it would be useful to learn more about what FINRA is seeing through its examination programs more broadly. So, later this year, we will provide firms with a new report that will summarize key examination findings from across our programs, enabling them to use this information to strengthen their own control environment and address any potential deficiencies before their next exam.

### *Office of Fraud Detection and Market Intelligence*

The Office of Fraud Detection and Market Intelligence (OFDMI), created in 2009, centralizes FINRA's review of allegations of serious fraud and significant investor harm, and serves as a central point of contact, both internally and externally, on fraud-related issues. OFDMI reviews regulatory intelligence from numerous sources, including tips, complaints and regulatory filings, to identify and expedite review of matters involving potential fraud or other serious misconduct. OFDMI's whistleblower unit offers a telephone hotline and dedicated email box for individuals to report evidence of potentially illegal or unethical activity which is evaluated carefully and escalated for further investigation.

In addition, OFDMI conducts robust cross-market surveillance for potential insider trading and fraud OFDMI also coordinates with Enforcement and other FINRA departments to aggressively pursue matters under FINRA's jurisdiction, and refers matters involving potential fraud and misconduct that are outside of FINRA's jurisdiction to the SEC or other regulators or law enforcement agencies for further investigation. Last year, OFDMI referred 785 matters to the SEC and other regulators. And through OFDMI's high risk broker program, to date we have barred approximately 300 registered representatives from the industry.

### *Stopping Bad Actors*

One of FINRA's most important functions is to protect investors of every age from bad actors—those who seek to evade regulatory requirements and harm investors for their own personal gain. This area is a significant focus for us. A special working group of our Board and a committee of senior staff have been working to further augment our long-standing regulatory programs focused on bad actors. I recently summarized our efforts in a speech at Georgetown University,<sup>10</sup> and bad actors were at the top of FINRA's exam priorities letter this year.

Given how challenging it can be to identify brokers prone to abuse customers, and how important it is to do everything we can to prevent them from harming investors in the last few years FINRA has initiated more targeted efforts to better identify and supervise those firms and individual brokers who may pose the greatest risk of harm to investors—or “high-risk” firms and brokers. In addition, FINRA recently established a dedicated unit focused on monitoring and examining these high-risk brokers. A key

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<sup>10</sup> See: <http://www.finra.org/newsroom/speeches/061217-protecting-investors-bad-actors>

objective of this targeted program is to ensure we are using a risk-based methodology to allocate our finite monitoring and examination resources in ways that will best protect investors.

This heightened scrutiny has had an impact. Of the firms assessed as highest risk in the last five years, more than 40 percent are no longer in the business, in many cases because of regulatory action. In other cases, close scrutiny by our examination team has caused firms to take steps to address our concerns, such as by making changes or improvements in personnel, operations, and the quality of their supervisory controls.

It is important to be clear about the challenges and limitations inherent in identifying high-risk firms and brokers. Care is required both in how we conduct the assessment and in what we do with it. FINRA does not possess a crystal ball—our assessment of brokers for oversight purposes does not always identify brokers who will cause problems in the future. In addition, the risk profile of firms and brokers will change over time. We must continually seek to update our assessments and improve our approach based on practical experience, additional information, and new analytical techniques.

Earlier this year, FINRA's Board also approved several new initiatives to further enhance our oversight of high-risk brokers. Among them is a proposed rule amendment to require brokerage firms to adopt heightened supervisory procedures for individuals while a disciplinary case is pending appeal. We also will issue a Regulatory Notice to reinforce and clarify firms' existing supervisory obligations concerning any high-risk brokers they may employ. The Board also approved several other related measures, such as a change to our sanction guidelines to enable adjudicators to consider more severe sanctions when a respondent's history includes a pattern of damaging past misconduct. This is an area of continued focus by FINRA's Board and management and we anticipate a number of additional steps in the coming months.

### *Registration and BrokerCheck*

FINRA operates and maintains the central licensing and registration system for the U.S. securities industry and its regulators. The Central Registration Depository, CRD<sup>®</sup>, developed in concept by FINRA and the North American Securities Administrators Association (NASAA), was introduced in 1981 and established a framework of uniform registration forms, one-stop form filing and fee collection, and a single regulatory database and registration processing system to meet the requirements of all participating securities regulators. CRD automates and supports the registration, qualification, disclosure and continuing education rules and regulations of FINRA, other SROs, the SEC and state regulators. Policies governing CRD are jointly established by FINRA and NASAA under SEC oversight.

FINRA's BrokerCheck<sup>®</sup> system makes available to the general public registration, licensing and disciplinary information on nearly 1.3 million current and former securities brokers and about 21,000 firms currently or formerly registered with FINRA or a national

securities exchange.<sup>11</sup> Implemented by FINRA in 1988, BrokerCheck allows investors to check the professional background, business practices and conduct of securities firms and investment professionals, thereby helping investors make informed choices about the individuals and firms with which they conduct business.

## **Market Oversight**

FINRA oversees and regulates its member firms' trading across the securities markets, as well as the OTC markets for equities, corporate and municipal debt instruments, and other fixed income instruments. FINRA also conducts examinations of market making and trading firms to assess compliance with FINRA trading rules and the federal securities laws.

As noted in FINRA's 2017 Regulatory and Examination Priorities Letter<sup>12</sup>, areas of focus for this year include potentially abusive trading algorithms, cross-market and cross-product manipulation, order routing practices, best execution and disclosure and market access controls.

### *Cross-Market Surveillance*

FINRA has a responsibility to oversee and regulate OTC trading of exchange-listed and non-exchange-listed securities, as well as trading in corporate and municipal debt instruments and other fixed income instruments. FINRA also conducts examinations of market making and trading firms to assess compliance with FINRA trading rules and the federal securities laws.

In addition, FINRA provides surveillance and other regulatory services to U.S. equity and options exchanges. FINRA has regulatory service agreements in place with 19 exchanges that operate 26 equity and options markets. As a result, working with the exchanges, FINRA's cross-market surveillance systems canvass over 99 percent of the listed-equity market and approximately 65 percent of the listed-options market.

In order to protect investors and market integrity, it is important that FINRA be able to conduct surveillance of activity across securities markets. While there is vigorous competition across equity and options markets which has benefitted investors and market participants, a by-product of this competition is more market fragmentation, which in turn raises concerns about abusive trading algorithms like layering and spoofing that purposefully spread activity across markets in an effort to avoid detection. FINRA has found that approximately 65 percent of its surveillance alerts involve activity from more than one market and that approximately 50 percent of its alerts involve activity from more than one broker-dealer. In addition, for many of our cross-market surveillance patterns all of the alerts involve more than one market. In fact, based on market activity we have seen while conducting investigations, FINRA recently enhanced one of its equity cross-market surveillance patterns to detect potential trading abuses

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<sup>11</sup> See: <https://brokercheck.finra.org/>

<sup>12</sup> See: <http://www.finra.org/sites/default/files/2017-regulatory-and-examination-priorities-letter.pdf>

involving up to six different broker-dealers.

The Consolidated Audit Trail (CAT), mandated by the SEC, will consolidate today's audit trails and combine them into one uniform audit trail in an effort to promote more comprehensive market surveillance. As CAT data will be available to all SEC-regulated SROs and the SEC, it will be very important that, working under the leadership of the SEC, FINRA and other SROs strive to avoid both gaps that may raise risks for investors and unnecessary duplication that would be inefficient and costly to the industry. The SROs can work together to develop a regulatory environment that leverages the respective regulatory expertise of each SRO and creates a comprehensive and effective regulatory program for today's complex markets, ensuring that markets are fair and orderly and that investors are protected.

#### *Dark Pool Volume Transparency Initiative*

With well over 30 percent of total national market system (NMS) volume now being executed off of U.S. exchanges and with nearly half of that volume being executed by so called "dark pool" automated trading systems (ATS), FINRA, in consultation with the SEC, recognized the need for greater transparency regarding OTC trading venues. To that end, in June 2014, FINRA began posting weekly on its website reported volume and trade count information for all ATSs. Market participants, investors, regulators and academics are now able to see with unprecedented granularity volume information and trends regarding dark pool trading and trading on other ATSs on a security-by-security basis.

In April 2016, FINRA expanded this transparency initiative by publishing the remaining half of equity trading volume executed OTC by all firms on a security-by-security basis (*i.e.*, non-ATS volume executed by wholesale market makers, firms that internalize order flow, block positioners, and other types of trading). This provides greater transparency to the marketplace with respect to the full range of trading activity that is currently taking place off of U.S. exchanges. In addition, FINRA further expanded transparency for OTC volume by publishing detailed ATS block trading volume information in October 2016.

#### **Enforcement**

One of FINRA's key functions is the enforcement of FINRA rules, MSRB rules, and federal securities laws and rules. FINRA may initiate investigations from various sources, including examination findings, filings made with FINRA, customer complaints, calls to the Senior Helpline, anonymous tips, surveillance reports, referrals from other regulators or other FINRA departments, and press reports. FINRA's Department of Enforcement consists of more than 300 staff members, largely experienced attorneys and investigators. For example, many of our attorneys have a broad range of experience as former federal and state prosecutors, and partners and senior attorneys at major law firms. Our investigators include former FBI agents and former industry professionals such as former traders, investment bankers, and compliance officers.

Enforcement team members investigate potential violations of FINRA rules and federal securities laws by requesting documents and testimony from registered entities. They may also work with harmed customers to collect evidence of wrongdoing in order to bring disciplinary action against their brokers. After Enforcement determines that it has evidence of a rule violation, it brings a disciplinary action to sanction the individual or firm that committed the infraction. In 2016 alone, we brought 1,434 disciplinary actions. Most of these cases settle, but when no settlement can be reached, Enforcement litigates its claims against the respondent in FINRA's disciplinary forum. Respondents have the right to appeal adverse decisions to the SEC.

Some of Enforcement's most important actions involve individual brokers who have harmed investors and in some cases posed a risk to the broader marketplace. In 2016, we barred 517 individuals for egregious violations of the securities laws and FINRA rules, such as fraud and conversion. In addition, we imposed 727 suspensions on individuals for violations that were less egregious but still serious, such as recommending unsuitable securities, falsifying customer signatures, or failing to make required disclosures. This year through July, Enforcement has barred 288 registered representatives for egregious misconduct, including 25 brokers that were designated as high risk brokers by OFDMI.

We also suspended or expelled 50 firms from the industry in 2016. These cases concerned a wide range of trading and sales practice issues. FINRA permanently expelled firms from the industry for egregious violations such as fraud, conversion, and failure to provide FINRA the information it requested to investigate potential misconduct.

FINRA also sanctioned firms by assessing fines where firms had violated the securities laws or rules; for example, in 2016 FINRA imposed significant fines for misconduct such as firms' failure to implement systems to monitor trading for suspicious transactions; failure to supervise registered representatives who recommended certain types of variable annuities, ETFs, and other complex products; failure to maintain records in a format that could not be altered; and failure to review the quality of the trade executions provided to customers.

Equally important, in the last two years (not including 2017), we have ordered some \$123 million in restitution to harmed investors. FINRA ordered \$27.9 million in restitution to customers in 2016, in line with the 5-year range of restitution, which has varied from a low of \$9.5 million in 2013 to a high of \$96.2 million in 2015. For example, FINRA has taken action against firms that failed to ensure that customers such as charitable organizations and retirement accounts were getting the sales discounts they were entitled to—we have ordered more than \$75 million in restitution to those customers over the past several years.

FINRA will continue to pursue vigorously those cases that involve harm to investors and work to remove the individuals who engage in this conduct from the industry whenever appropriate.



## Rulemaking

FINRA's rulemaking process is a key point of engagement and is intended to ensure that our regulatory program is calibrated to achieve its objectives efficiently, without undue burdens on legitimate business activities. This open process makes for better rulemaking. In addition to the advisory committee consultations described above, our rulemaking process typically includes multiple opportunities for any interested parties to comment. FINRA itself provides forums for comment when it is considering a rule proposal, and all FINRA proposed rule changes must be filed with, and with limited exceptions, approved by the SEC. The SEC review process includes its own, separate opportunity for comments. FINRA rule proposals frequently are revised throughout this review process.

We also must carefully assess the impact of our rulemakings for potential impacts on stakeholders, including investors and the firms we supervise. FINRA's Office of the Chief Economist conducts an economic impact analysis on all significant rulemakings, which evaluates the proposal against the identified problem. The analysis reviews relative costs and benefits, potential impacts on FINRA member firms, and the regulatory alternatives that were considered. Particular attention is paid to the potential impact on smaller firms. The analysis can be quantitative and qualitative and is informed by consultation with the public and FINRA's advisory committees, including FINRA's Economic Advisory Committee, which is composed of leading experts from the academic and industry research communities.

### *Capital Formation and Rule Modernization*

As we take a fresh look at our operations, we also are looking at our rulebook to identify opportunities for improvement and to ensure that we are appropriately accounting for changes in the regulatory environment and market practices. Earlier this year, for example, we issued a formal request for comment on all of our rules, operations, and administrative processes related to capital-raising and how they might impact capital formation.<sup>13</sup>

A vibrant capital-raising process supports both large and small businesses, creates jobs, strengthens the economy and serves the interests of investors. Broker-dealers perform an important role in capital raising, but the process is evolving and it is essential that our supervision also evolves where appropriate to ensure that important investor protections are preserved without needlessly interfering with capital formation. There have been significant developments recently in the mechanisms companies use to raise capital through securities offerings, including new rules and regulations regarding crowdfunding, exempt offerings under Regulation A, and private offerings under Regulation D.

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<sup>13</sup> See: *Regulatory Notice 17-14 (FINRA Requests Comment on FINRA Rules Impacting Capital Formation)*. <http://www.finra.org/industry/notices/17-14>

FINRA has taken a number of steps in recent years to modernize its regulation of members' participation in capital-raising activities. For instance, FINRA recently created the Capital Acquisition Broker (CAB) rule set, which allows members engaged in a limited range of corporate-financing activities—such as advising companies and private equity funds on capital raising and corporate restructuring—to elect to be governed by a targeted set of rules<sup>14</sup>. In response to crowdfunding provisions of the JOBS Act, FINRA created the Funding Portal rules, which are a set of streamlined rules that are tailored to the limited scope of activities in which funding portals are permitted to engage under the JOBS Act and the SEC's Regulation Crowdfunding.<sup>15</sup>

In addition, in the last few years FINRA amended its rule<sup>16</sup> covering new issue allocations and distributions to create an important exception to facilitate firm compliance when allocating shares of a new issue to the accounts of unaffiliated private funds. FINRA also consolidated a number of rules regarding the sale of securities in fixed price offerings, creating a simplified rule that removed numerous outdated and redundant requirements, while at the same time maintaining core protections for investors and for the integrity of such offerings.

We have also sought to update our rules on broker registration to reflect feedback about how those rules have operated over time as markets and firms have changed. Recently, the SEC approved our proposed rule change that will make it easier for an individual with no prior securities industry experience—whether an investor, a recent college graduate, or a professional seeking a second career—to take a general knowledge exam as an important first step to entering the industry. The rule change also modernizes our registration rules in other respects, and it reflects yet another effort to revisit our existing rules and determine how best to modernize them in a way that will both preserve important investor protections and reduce unnecessary burdens.

### *Retrospective Rule Review*

Reviewing our rules and how we implement them is part of the FINRA360 goal of continual self-improvement. Changes in the industry and markets can affect whether a rule continues to achieve its original objective as well as the burdens it imposes on firms or investors. Regular rule reviews can help us understand whether rules can be made more effective and less burdensome, and also identify gaps and areas where investor protections can be strengthened.

In 2014, FINRA commenced a retrospective rule review process,<sup>17</sup> whereby FINRA regularly looks back at significant rulemakings to make our rules more efficient without

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<sup>14</sup> See: *Regulatory Notice 16-37 (SEC Approves FINRA's Capital Acquisition Broker (CAB) Rules)*.  
<http://www.finra.org/industry/notices/16-37>

<sup>15</sup> See: *Regulatory Notice 16-06 (SEC Approval of FINRA Funding Portal Rules and Related Forms)*.  
<http://www.finra.org/industry/notices/16-06>

<sup>16</sup> See: *Regulatory Notice 13-43 (SEC Approves a Limited Exception From FINRA Rule 5131(b) to Permit Firms to Rely Upon a Written Representation From Certain Unaffiliated Private Funds)*.  
<http://www.finra.org/industry/notices/13-43>

<sup>17</sup> See: <http://www.finra.org/newsroom/2014/finra-launches-retrospective-rule-review>

diminishing investor protections. Based on these reviews, FINRA takes steps to maintain or improve the effectiveness of the rules while minimizing any negative economic impacts. The reviews consider not only the substance of the rules, but also FINRA's administration of them, and the review process also incorporates extensive engagement with the industry, investors, and other stakeholders.

These retrospective reviews can result in significant changes. For example, as part of the review of the rule set regarding communications of FINRA members with the public, we established a new public communications advisory committee, issued additional guidance, and obtained SEC approval of rule amendments to streamline or eliminate some filing and disclosure requirements.

Most recently, we launched a new review of our rules regarding outside business activities and private securities transactions, an area where we have received considerable feedback from our members and other stakeholders. It had been some time since we issued guidance on these rules, and we continue to look for public feedback on their operation.

## **Dispute Resolution**

FINRA administers a dispute resolution forum for investors and brokerage firms and their registered employees. FINRA's Dispute Resolution program provides investors and markets with a fair, efficient and economical alternative to court actions, which are sometimes cost-prohibitive for investors with small claims. FINRA offers both mediation and arbitration services.

Since 2011, FINRA's program has provided investors the opportunity to select arbitration panels composed exclusively of public arbitrators. The all-public panel option ensures that no investor will have an arbitrator affiliated with the securities industry unless he or she voluntarily chooses one. In addition, several recent rule amendments have narrowed the definition of a public arbitrator, including by establishing a bright line test that prevents anyone who has ever worked in the financial industry from serving as a public arbitrator.

FINRA's program has several other features that distinguish it from other private arbitration forums. FINRA's program charges significantly lower arbitration fees to investors than other forums, uses an investor-friendly discovery guide, and offers 71 hearing locations, including at least one in every state. Our Motion to Dismiss Rule ensures that investors in arbitration have a full opportunity to argue their case by limiting motions made prior to the investor resting his or her case, and provides for sanctions for frivolous motions and abusive motion practices. FINRA has the authority to suspend firms and registered representatives that fail to pay arbitration awards or agreed-upon settlements.

In July 2014, FINRA formed a Task Force to consider possible enhancements to its program to improve the effectiveness, transparency, impartiality and efficiency of

FINRA's dispute resolution forum for all participants.<sup>18</sup> In December 2015, the FINRA Dispute Resolution Task Force (Task Force) issued its Final Report relating to its review of FINRA's dispute resolution forum, which included 51 recommendations. FINRA has already taken action on the majority of the recommendations. FINRA continues to work with the National Arbitration and Mediation Committee (NAMC), a FINRA advisory committee, to evaluate ways to implement recommendations not yet addressed, and is considering additional steps to further enhance the forum's operations and transparency in response to the recommendations.

## **FINRA Foundation and Investor Education**

In 2003, FINRA established the FINRA Investor Education Foundation,<sup>19</sup> which aims to provide underserved Americans with the knowledge, skills and tools necessary for financial success throughout life. The FINRA Foundation accomplishes its mission through educational programs and research that help consumers achieve their financial goals in a complex and dynamic world.

### *Investor Protection Campaign*

The FINRA Foundation's research-based Investor Protection Campaign (IPC) aims to help investors recognize that anyone with savings could be a target for those who would commit fraud. The IPC identifies the common persuasion techniques fraudsters use and encourages all investors to ask questions and check information. In collaboration with the AARP Foundation, the Association of Retired Americans, the Council of Better Business Bureaus, the National Center for Victims of Crime, the National Telemarketing Victim Call Center, the National White Collar Crime Center, state and federal securities regulators and many others, the FINRA Foundation alerts investors to the red flags of investment fraud—including the persuasion tactics fraudsters use—and empowers people to become fraud fighters.

A sampling of recent IPC accomplishments includes the following:

- From 2012–2017, the campaign has enabled more than 908,000 vulnerable investors to be counseled by FINRA Foundation-supported fraud fighter call centers.
- More than 2,100 law enforcement professionals and victim advocates have been trained by the Foundation to detect, prevent and respond to financial fraud.
- FINRA Foundation staff collaborated with researchers from the U.S. Department of Justice (DOJ) and the Stanford University Center on Longevity to prepare a financial fraud supplement to the National Crime Victimization Survey. DOJ anticipates 79,000 responses to the supplement in 2017.

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<sup>18</sup> See: <http://www.finra.org/newsroom/2014/finra-announces-arbitration-task-force>

<sup>19</sup> See: <https://www.finrafoundation.org/>

## *Investor Education*

Investor education is a potent form of investor protection, and FINRA's Office of Investor Education<sup>20</sup> engages with the public through a wide array of retail investor education initiatives that provide free, unbiased information and tools to help people protect themselves and better understand the markets and basic principles of investing. For example, FINRA develops and maintains interactive tools and calculators like the Fund Analyzer and Required Minimum Distribution Calculator; publishes alerts, articles and newsletters through the Investors section of FINRA's website; syndicates relevant information on topics of interest for investors through FINRA's Alert Investor blog; and creates and disseminates podcasts, infographics and videos on personal finance and investing topics such as choosing a financial professional, understanding complex investment products, dealing with the financial impact of job loss and more.

FINRA organizes or participates in dozens of investor education events each year, reaching thousands of retail investors. In addition, FINRA prints and distributes more than half a million pieces of educational material—all at no cost to the individual investors, financial educators and coaches, librarians, teachers, industry professionals and others who request them.

The FINRA Foundation's National Financial Capability Study, for example, benchmarks and tracks over time key indicators of financial capability—both nationally and state-by-state—and evaluates how these indicators vary with underlying demographic, behavioral, attitudinal and financial literacy characteristics. Separately, the FINRA Foundation supports the work of academics and other researchers who explore investor behavior.

The FINRA Foundation's projects range from helping investors spot, avoid and handle the aftermath of financial fraud to fostering the financial readiness of military families to advancing workplace financial capability programs for America's low-income workers. The FINRA Foundation also trains financial educators and equips grass-roots organizations, including a nationwide network of reference librarians, to help families in diverse circumstances.

Since its inception, the FINRA Foundation has dedicated more than \$108 million to financial capability and fraud prevention initiatives. Much of this work has been accomplished in partnership with organizations that share a deep commitment to the Foundation's mission.

## **Conclusion**

FINRA is in the middle of a process of self-assessment and organizational improvement that will result in potentially transformational change. However, as we continue this exciting exercise, we will remain firmly focused on our core mission of protecting investors and market integrity while promoting vibrant capital markets. I look forward to

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<sup>20</sup> See: <http://www.finra.org/investors>

working with Congress, other regulators, market participants, and the public to further these important goals.