

**Testimony of**

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Committee on Financial Services**

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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.

Unfortunately, we are here today because of a massive fraud that has had tragic results for many investors. No regulator can feel good about its performance regarding Stanford. Notwithstanding the jurisdictional limits that confronted us, FINRA clearly could have done better and we deeply regret we did not. In the wake of Stanford, FINRA stepped back and took a hard look at our regulatory programs and approaches, and searched for ways to more effectively uncover misconduct, especially fraud, and enhance our programs to better protect investors.

In early 2009 the FINRA Board of Governors established a Special Review Committee to conduct a review of FINRA's examination program as it related to the detection of fraud and Ponzi schemes, including the one R. Allen Stanford is charged with perpetrating. The Special Review Committee, chaired by former U.S. Comptroller General Charles A. Bowsher, concluded its review in September 2009 and presented its full findings to Congress, the Securities and Exchange Commission (SEC) and the public. We are grateful to Chairman Bowsher and the other distinguished members of the Special Review Committee for the time and effort they dedicated to helping us identify areas where our regulatory programs could be enhanced.

The report made a number of important recommendations to FINRA staff focused on improving our regulatory procedures. First, the report identified a number of internal reforms designed to better safeguard investors and the broader financial system. Second, the report called attention to the many regulatory challenges related to jurisdictional issues and product definitions. Finally, the review pointed to the urgent need for reforms that ensure comprehensive oversight, reduce jurisdictional confusion, streamline enforcement and improve coordination and communication among all regulators.

FINRA staff moved swiftly to implement the recommendations in the report. FINRA has either fully implemented or is implementing all the recommendations that did not require action by the SEC or Congress.

First and foremost, we centralized fraud detection in a single unit, while focusing our examination program on finding fraud. FINRA created the Office of the Whistleblower in early 2009 and, later that year, built upon that model by establishing the Office of Fraud Detection and Market Intelligence (OFDMI). This office provides a heightened review of incoming allegations of serious frauds, functions as a centralized point of contact internally and externally on fraud issues and consolidates recognized expertise in expedited fraud detection and investigation. We have also enhanced our examination programs and procedures to improve our ability to identify conduct indicative of fraud and conducted training programs for examiners aimed at fraud detection. I will provide more detail on these efforts later in my testimony.

Each of the initiatives undertaken by FINRA contributes to our broader mission to protect investors by making sure the securities industry operates fairly and honestly, both in its dealings with individuals and through the operation of the systems and technologies that underpin today's markets.

## **FINRA**

FINRA is the largest independent regulator for all securities firms doing business in the United States. FINRA provides the first line of oversight for broker-dealers, and, through its comprehensive regulatory oversight programs, regulates both the firms and professionals that sell securities in the United States and the U.S. securities markets. FINRA oversees approximately 4,600 brokerage firms, 163,000 branch offices and 631,000 registered securities representatives. FINRA touches virtually every aspect of the securities business—from registering and educating 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, levied fines totaling \$41.1 million and ordered the payment of almost \$8 million in restitution to harmed investors. FINRA expelled 14 firms from the securities industry, barred 288 individuals and suspended 428 from association with FINRA-regulated firms. Last year, FINRA conducted approximately 2,600 cycle examinations and 7,300 cause examinations.

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

## **The Special Review Committee**

On April 13, 2009, the Board of Governors of FINRA established a Special Review Committee to review FINRA's examination program, with particular emphasis on the examinations of FINRA member firms associated with R. Allen Stanford and Bernard L. Madoff. The Special Committee included: former U.S. Comptroller General Charles A. Bowsher, who chaired the Committee; former Maryland Securities Commissioner Elynn L. Brown; former SEC

Commissioner Harvey J. Goldschmid; and, Joel Seligman, President of the University of Rochester.

The Board was particularly concerned with the significant harm to investors caused by Stanford and Madoff. Pursuant to a resolution approved by the Board, the Special Committee was asked to “recommend . . . changes in the examination program, where appropriate, to improve member oversight and FINRA’s fraud detection capability,” and to consider management’s “monitoring [of] compliance with examination program policies.” Today, per your request, I will focus on the Special Committee’s findings relating to Stanford.

The Special Committee reviewed relevant examination files from 2003 to 2009 of the principal firms associated with Stanford. Interviews were conducted with the examiners, supervisors and managers still employed by FINRA who were involved in the examinations. Numerous headquarters staff and senior management were interviewed as well to enable the Special Committee to develop factual findings and recommendations. In total, 60 interviews of FINRA staff were conducted.

### **The Stanford Case**

Between 2003 and 2005, the National Association of Securities Dealers—FINRA’s predecessor entity—received information from at least five sources claiming that the Stanford CDs were a potential fraud. The most significant was a July 2005 five-page referral letter from the SEC’s Fort Worth office that explained in detail why the purported investment strategy of the offshore bank could not have produced the consistently high returns being paid by the CDs. According to this letter, “as of October 2004, [the Stanford firm’s] customers held approximately \$1.5 billion of CDs.” Despite the existence of this “red flag” and others described in the body of the Special Review Committee’s report, FINRA did not launch an investigation of whether the Stanford CD program was a fraud until January 2008.

FINRA missed a number of opportunities to investigate the Stanford firm’s role in the CD scheme. First, FINRA’s Dallas office staff curtailed a 2005 investigation prompted by the SEC referral letter because of a concern that the offshore CDs were not “securities” regulated under federal securities laws. Facts surrounding the decision not to pursue the fraud investigation indicated that certain of FINRA’s examination staff at the time were unsure of the full scope of the organization’s investigative authority, were reluctant to pursue investigations where jurisdictional questions arose and were not adequately trained to identify alternate bases of jurisdiction.

Second, FINRA procedures at the time did not set forth criteria for escalation of a matter to senior management or the use of specially trained investigators based on the gravity and substance of the fraud allegations. Additionally, the Dallas staff did not provide the SEC referral letter to FINRA senior management in Washington, D.C., until December 2008. As I will highlight later in my testimony, FINRA has since implemented a comprehensive prioritization system that ensures such matters will be immediately brought to the attention of senior staff and investigators.

Third, FINRA's Dallas staff did not adequately document communications with the SEC, or discussions within FINRA itself, regarding the CD program.

Finally, during this period, FINRA did not have a centralized database that gave examiners direct, electronic access to all relevant complaints and referrals associated with a firm. As a result, no single FINRA staff member was ever aware of all of the "red flags" related to the Stanford firm that are discussed in the report.

## **Recommendations**

Following its review, the Special Committee made a series of recommendations intended to enhance the effectiveness of FINRA's examination program by increasing its ability to detect fraud and improve its investor protection functions. The Special Committee's recommendations sought to achieve the following strategic objectives: (i) greater emphasis should be placed on the detection of fraud; (ii) potential fraud situations and other situations presenting serious potential risk to investors should be escalated promptly and properly; (iii) examination staff should be diligent in pursuing potentially serious issues, exercising an appropriate degree of skepticism; (iv) all FINRA operating units should closely coordinate and communicate in carrying out the examination program; and (v) FINRA should provide additional resources to strengthen its cause examination program.

The Special Committee recommended that FINRA's examination program be revamped to ensure that fraud detection and prevention are core elements. Allegations of the magnitude and gravity of those in the Stanford case should be given the highest priority, immediately escalated to FINRA senior management, and vigorously pursued by well-trained FINRA staff with all necessary investigative tools and techniques. In this connection, the Special Committee agreed with and supported the plan of FINRA senior management to create a dedicated fraud detection unit.

## **FINRA Response to the Recommendations of the Special Review Committee**

FINRA management and staff approached the Special Committee's recommendations with the utmost seriousness and immediately instituted a plan to implement each of its recommendations. As previously stated, FINRA has either fully implemented or is in the process of implementing all the recommendations that did not require action by the SEC or Congress.

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

As noted, one of the first initiatives FINRA undertook to implement the Special Committee's recommendations was the creation of the OFDMI in October 2009. This group houses the Central Review Group, Office of the Whistleblower and the Insider Trading and Fraud Surveillance teams, and is responsible for the centralized intake and triage of regulatory filings and investor complaints. This centralization enables an expedited regulatory response to high-level matters, including senior level review. OFDMI combines regulatory intelligence throughout

the organization and aggressively pursues matters as far as it is able and refers cases that fall outside of FINRA's scope to the appropriate authorities. In 2010, OFDMI referred more than 550 matters involving potential fraudulent or illegal conduct to the SEC or other federal law enforcement agencies for further investigation. These matters involved a wide range of issues, including insider trading, microcap fraud and Ponzi schemes.

One such case involved Joseph Mazella, the founder and President of the Great Atlantic Group, Inc., a Staten Island-based real estate and financial consulting company. Mr. Mazella was charged last month with securities fraud, wire fraud and money laundering arising out of his alleged operation of a \$12 million Ponzi scheme from 2007 to 2010. This action was a result of a referral from FINRA's OFDMI to the Federal Bureau of Investigation.

Another case involved a former registered representative named Kenneth Wayne McLeod. McLeod, a dually registered investment adviser and registered representative, conducted a 20-year, multimillion dollar Ponzi scheme through his advisory business that victimized mostly federal law enforcement agents. During 2010 this matter was identified by an analyst in FINRA's OFDMI during a routine review of a regulatory filing. It was then escalated to senior management and, because the fraud occurred through the firm's advisory business, was ultimately referred to the SEC for investigation and prosecution within about 30 days of discovery.

Through the Central Review Group unit, we have centralized the receipt, analysis and distribution of tips, complaints and referrals from the public and other regulators, and are now better able to manage and track these matters. In tandem with this change, we have implemented a more comprehensive prioritization system that is used across all regulatory operations. This operational enhancement means that serious matters are escalated and investigated more quickly.

FINRA's Office of the Whistleblower, first established in March 2009, continues to receive and process, on an expedited basis, a significant amount of incoming information. In 2010, it received and triaged over 170 substantive calls to its hotline, and another 220 reviews were initiated from emails received via a dedicated email address. The office made 28 formal referrals and permanently barred three registered representatives, with one investigation taking only 28 days from the receipt of the tip to the imposition of the bar.

The Fraud Surveillance unit of OFDMI referred 266 matters to the SEC in 2010. The referrals include matters involving issuer fraud, pump-and-dump schemes, market manipulation and account intrusions. The Insider Trading Surveillance unit made 259 insider trading referrals to the SEC in 2010, the highest in FINRA's history. The referrals included suspicious trading ahead of material news announcement by hedge funds, institutional investors, private equity funds and retail investors.

### **Examination Program Enhancements**

FINRA also enhanced its examination programs and procedures in a variety of ways intended to help us better detect conduct that could be indicative of fraud. It is our goal that exam teams focus most on those areas at firms that pose a real risk to investors. While not an exhaustive

list, I would like to highlight for you a number of the enhancements we have made to our examination program.

#### Focusing Resources on Highest-Priority Matters

An overarching theme of the Special Review Committee's report was the prioritization of regulatory resources. In response to those concerns, FINRA staff created an "Urgent" designation for those regulatory matters posing the greatest potential for substantial risk to the investing public. Urgent matters are expedited, and then reviewed to make certain that the right level of resources and expertise are assigned to them, as well as to ensure there is coordination and information sharing across departments at FINRA.

The Special Committee also identified that the lack of a formal mechanism for the escalation of policy issues created risk within the organization. FINRA issued a new policy designed to enhance the process for the escalation and documentation of complex legal and policy issues. This enhancement ensures that senior management is apprised of significant, complex and novel legal issues arising in the course of examinations and investigations; expediting the formulation of an organizational position on such issues; ensuring issues and decisions are appropriately documented by staff; and allowing regulatory staff access to these decisions through a company-wide, centralized searchable database.

#### Enhanced Expertise of Regulatory Staff

FINRA has increased the number of staff in its district offices who are tasked with in-depth and ongoing understanding of specific firms, including increased real-time monitoring of business and financial changes occurring at a firm. This expansion has enhanced our staff's ability to evaluate available regulatory information and to target examinations based on that information. We have added 35 new positions specifically dedicated to this surveillance function.

We have also redesigned an existing program to identify FINRA staff with expertise in specific subject matters who will lend their expertise to examinations, investigations and litigation, and assist with the training and development of staff. In addition, these individuals may be called upon to participate in the risk assessment process for individual firms with an active business in their area of expertise.

In addition, FINRA designed and conducted training for examination staff focused on fraud detection and established a framework for regulatory operations staff to complete continuing education instruction in selected topics. The continuing education requirement is part of the broader regulatory operations training program, and is intended to complement existing programs and serve as a mechanism by which we can ensure that staff is kept current on topics that are core to our regulatory programs and relevant in the current regulatory landscape.

#### Enhanced Use of Third-Party and Other Information

FINRA has enhanced its use of third-party and other external information to inform our regulatory programs. We have established procedures for third-party verification of firm-provided information, particularly as it relates to customer assets. FINRA passed a rule to ensure that it can independently verify assets maintained by a FINRA-regulated firm at a non-FINRA-regulated institution. The rule provides that a FINRA-regulated firm may not custody assets at a non-FINRA-regulated institution that fails promptly to provide FINRA with written

verification of assets. We are also working with third parties to test available data sources that may be incorporated into our programs.

FINRA also now requires high-risk firms to submit financial data on a more frequent basis. As part of our effort to obtain more timely regulatory information, FINRA now requires all firms assessed as high risk to submit financial data, including income statements, on a monthly, as opposed to a quarterly, basis.

In addition, in 2009, FINRA instituted a process to review all employer-employee related statements of claim filed with FINRA Dispute Resolution, in addition to customer-related statements of claim that FINRA had previously reviewed and continues to review. FINRA then expanded that process to include review of all amended claims and additional claims related to arbitration matters. These include counter claims, cross claims, answers to employer-employee related matters and third-party claims.

#### Multi-Year Technology Enhancement Plan

A number of the initiatives FINRA is undertaking to strengthen its programs and make them more investigative are technology-based. One of those initiatives was the development of an enterprise search tool, which allows FINRA staff to access internal regulatory intelligence by conducting searches for information and documents regarding firms, individuals, products or other significant regulatory topics from across FINRA's regulatory areas.

Longer term, we are in the midst of an initiative that will overhaul existing applications and tools used to conduct examinations and reviews by FINRA regulatory staff. The project will create a new integrated examination platform, and introduce new and expanded tools and services that will provide FINRA regulatory staff greater capability and flexibility to collect, access and share data, information and regulatory intelligence across the organization.

#### Coordination With the SEC

In addition to the initiatives listed above, FINRA has increased communication and coordination with the SEC relative to our respective programs. FINRA and SEC staffs meet routinely to share details about strategic design and tactical delivery of information to our respective regulatory programs. FINRA and the SEC also meet periodically to discuss risk assessment, including models to measure characteristics of risk of broker-dealers, branch offices and registered representatives.

#### Risk-Focused and Risk-Defined Exams

FINRA continues to reshape its exam program, and I would like to highlight a few of the ways we will be transforming our program in the months ahead. In late 2010 we created a new Office of Risk to begin the process of strengthening our ability to identify high-risk firms, branch offices, brokers, activities and products through broader data collection and more comprehensive analysis. FINRA will require more information to help us better understand firms' business models, including information about business activities, product mix and customer base. This information will be used to better understand the risks that exist for individual firms and to tailor regulatory responses to those risks.

## **Investor Education**

FINRA believes that investor education is a critical component of investor protection and FINRA is uniquely positioned to provide valuable investor education primers and tools. FINRA sponsors numerous investor forums and outreach programs, and our website is a rich source of such material, including investor alerts, unbiased primers on investing and interactive financial planning tools. In addition to the investor education activities of FINRA itself, the FINRA Investor Education Foundation is the largest foundation in the United States dedicated to investor education.

Relative to the issues we are discussing today, FINRA has produced investor alerts and conducted seminars across the country that clearly explain the characteristics of the most commonly used securities frauds, including Ponzi and pyramid schemes, pump-and-dumps and offshore scams. Drawing on ground-breaking research supported by the FINRA Investor Education Foundation, the seminars expose the psychological persuasion tactics used by fraudsters to lure in their victims—tactics that are constant across a wide variety of frauds. The FINRA Foundation's award-winning documentary, *Trick\$ of the Trade: Outsmarting Investment Fraud*, has aired on more than 95 public television stations in 24 states to date.

## **Conclusion**

The Special Review Committee's report and recommendations provided an important roadmap for FINRA to become a more effective regulator, especially in terms of enhancing our ability to quickly identify and investigate conduct that could indicate fraud or other serious customer harm. In implementing the Special Committee's recommendations, FINRA has strengthened and increased the scope of its regulation, changing the way it deploys resources to monitor and examine securities firms.

I assure this Subcommittee that I am fully committed to continue making the necessary changes to strengthen our programs and raise the level of protection for all investors. We look forward to continuing to work closely with this Subcommittee and the SEC as we move forward with initiatives to make FINRA an even more effective regulator.

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