



[Newsroom](#) > [Speeches](#) > [Richard G. Ketchum](#)

Rick Ketchum
Chairman and CEO, FINRA

Securities Industry and Financial Markets Association (SIFMA) Annual Meeting
New York, NY

October 27, 2009

As prepared for delivery

Thank you for that introduction, and thank you all for coming. As all of you know, we are at an important moment in the debate over financial regulation and the future profile of financial markets in the United States, and throughout the world. So I am pleased to have this opportunity to share some of my thoughts about where we've been and where we can hopefully go.

It was about this time last year that a memorable description of the volatility that was unfolding in the markets appeared in *The Wall Street Journal*. The paper observed that,

The U.S. financial system resembles a patient in intensive care. The body is trying to fight off a disease that is spreading, and as it does so, the body convulses, settles for a time and then convulses again. The illness seems to be overwhelming the self-healing tendencies of markets. The doctors in charge are resorting to ever-more invasive treatment, and are now experimenting with remedies that have never before been applied.

Today, to extend the metaphor, the patient is healthier, and seems to have been stabilized, but is certainly not ready for a clean bill of health. There's been a strong recovery in the equity markets, but some sectors, such as the securitization market, are still on life support. Similarly, unemployment numbers are still rising—and approaching double digits.

The last two years have been a deeply unsettling period. For countless individuals, it has meant a plunge in their investment portfolios and their savings. It has also fostered a severe erosion of confidence in the entire financial system—and one of the great challenges ahead for everyone associated with the financial-services industry is working to win back that confidence.

That process is underway, with much-needed discussion and debate about the underlying causes of the financial turmoil, and how we can reduce the likelihood of it being repeated. It needs to be emphasized that we collectively as securities industry leaders and securities regulators have a solemn responsibility here—we must push ourselves honestly to ask what lessons we have learned and resolve to chart a specific and concrete path forward that focuses fundamentally on investors.

It would be presumptuous of me to retrace the ground covered by so many analyzing what went wrong before and during the market implosion. It's more important to evaluate where we are today in a world where in a very real way everything has changed for your firms and the industry. From capital and liquidity demands to frozen credit and asset-backed markets to risk management and market volatility, fundamental assumptions and strategies have been trashed or, at least, subject to complete rethinking. Moreover, the implications of increased government entanglement and, for a number of you, the shift to a bank holding company—with all the organizational complications and regulatory oversight changes that entails—have fundamentally changed the way you conduct your business.

Yet in other ways, the warning yellow flashing signs of regulatory danger remain the same; the industry continues to operate in a complex environment replete with conflicts that need to be controlled and properly disclosed. The inexorable quarterly earnings pressures—as well as the need to respond to customers' demands for strategies that work in this unstable economic environment—continue to push the industry to redesign and offer an explosion of proprietary structured products and variable annuities as well as a menagerie of exchange traded funds.

Simultaneously, regulators have had to rethink how they can do their job better and properly assimilate the lessons of regulatory failure exposed by the financial implosion.

In that spirit, I would like to explore some of the new paradigms we're seeing emerge—both in regulation and in the industry's business practices and how we must respond.

Regulatory Shift

I'd like to suggest we start by focusing on regulation, and regulators. One of the fundamental challenges facing any financial regulator is trying to keep pace with the dynamism and change that defines financial markets. The challenge is particularly acute right now, given the paradigm shift that's underway. While the immediate task is to reform the regulatory architecture to address the many vulnerabilities in the financial system and help restore investor confidence, part of the long-term objective must be to create an architecture in which regulations can evolve to adapt to the inevitability of changed circumstances in the financial sector. If we simply look backward, we will be, in some sense, "fighting the last war." The real test will be whether the regulatory system can evolve along with the financial system and help to prevent the excesses that are destined to develop.

One specific area for regulatory modernization is the regulation of broker-dealers and investment advisers. FINRA whole-heartedly embraces the Administration's goal of harmonizing regulation of these two sectors. For while they are distinct entities, the everyday reality is, as the Rand Institute said in a study last year, that "trends in the financial service market since the early 1990s have blurred the boundaries between them."

Indeed, as you are aware, most investors cannot distinguish between the investment advisory service they

receive and their brokerage service. But broker-dealers and investment advisers are regulated differently and held to different standards.

As you know, the Administration has proposed that the SEC write rules establishing consistent fiduciary standards of care for investment advisers and brokers providing investment advice. FINRA stands in agreement with numerous interested parties, including SIFMA, that the standard of care in both channels should be a fiduciary standard for the provision of advice.

As we look for ways to achieve harmonization, we should start with a commitment that the standard is "business model neutral" and focus on the basic shift that each recommendation must be in the "best interest of the customer." While I believe all present business models can thrive in a properly designed customer-facing fiduciary standard, there also should be no question that this will involve real change. There is an important cultural change from shifting the question from is a product "suitable" or "ok" to is it "in the best interests of the customer." While it will be up to the SEC to design the precise parameters of the standard, it's worth taking a moment to discuss what you as senior management should be focusing on now.

First, disclosure: there is no question that the quality of account opening disclosure has steadily improved over the years. But the process has been painful, involving lengthy debates and often enforcement actions as conflict by conflict has been identified and resulted in improper selling practices. The anticipation of a common fiduciary standard provides an important opportunity for firms to revisit their current account opening disclosure to ensure that its discussion of potential conflicts is clear, complete and in plain English.

Similarly, this is an opportunity to rethink your training of dual-hatted financial advisers as well as their point-of-sale disclosure to ensure that your customers understand any conflicts that may impact the recommendation as well as the worst case risks of the product and any alternative investments they might consider. The risk that an investment may not be "in the best interests of the customer" can only be increased if he or she doesn't fully understand each of these facts. Of course it may be in the interest of the client to have access to IPO's, fixed income offerings that the firm trades as a dealer or structured products—but only if the risks and conflicts raised by these products are clearly understood.

In addition to establishing a consistent fiduciary standard, we also need to harmonize the oversight and enforcement of that standard and the other rules relevant to each channel, to better ensure that participants in that industry comply with those obligations. Harmonization of the standard of care is an important first step. However, given the number of recently revealed frauds perpetrated by investment advisers bound by the fiduciary standard, it is clear that the existence of the fiduciary standard of care alone is not a guarantee against misconduct. Compliance with that standard must be regularly and vigorously examined and enforced to ensure the protection of investors.

Especially today, when so many firms and individuals are dually registered as both broker-dealers and investment advisers, or have affiliated businesses that work closely together, it is vital that both sides of those businesses be examined on a regular basis so that regulators can see the full picture of both sides of the business.

Fraud Detection

Just as regulation needs to adapt to new circumstances, so do regulators. One way we are doing that at FINRA is to focus on making our examinations, as well as our regulatory programs, more effective in identifying and fighting fraud.

Already this year, we have enhanced our examination programs, procedures and training in a variety of ways intended to help us better detect conduct that could be indicative of fraud. A few examples of what we're doing include:

- Gathering more information—prior to each exam—regarding a firm's ownership and affiliate relationships.
- Identifying indications of problematic behavior concerning the opening of investment advisory accounts at a broker-dealer.
- Examining the relationship between broker-dealers and/or their affiliates with feeder funds, or master funds that utilize feeder funds.
- Identifying potentially fraudulent activity by examining for material misstatements in financial reporting, unusual money movement, and apparent red flags involving a firm's auditor and off balance sheet items.

Of course, these types of procedures and inquiries have been part of the FINRA examination program for some time. Our enhancements are based on what we have learned from the many recently exposed frauds—including many that involve non-registered entities. For this latter group, we are not looking to extend our jurisdiction, but we are more focused on relationships that broker-dealers have with affiliated and other third parties so that we can assess the impact on the broker-dealer and thus on investor protection.

In addition, back in March, we established an Office of the Whistleblower to handle high-risk tips. And earlier this month, we announced the creation of FINRA's Office of Fraud Detection and Market Intelligence. This new office provides a heightened review of incoming allegations of serious frauds, a centralized point of contact internally and externally on fraud issues and consolidates recognized expertise in expedited fraud detection and investigation.

The office is also one element of our larger effort to change the regulatory culture with respect to detecting fraud. We are placing renewed importance on attracting staff who bring a range of skills and experiences. In addition to fraud detection, they need to have forensic capabilities, knowledge of the technology used to facilitate securities manipulation and insider trading, and a background that equips them to ask the right questions. And as they chase down leads and deal with peripheral issues, they need to be able to maintain a laser-like focus on the end goal.

Industry Shift

Just as regulation and regulators need to adapt to the new climate, so does the financial industry. It's clear that firms need to rethink a number of long-established business practices, and focus on complying not only with the letter of the laws, but also the spirit underpinning them, and do this through a fiduciary lens. Let me touch on a few areas, starting with conflicts of interest.

While the profile of the financial sector has been transformed over the past two years, conflicts remain—and they demand greater disclosure. Failing to disclose conflicts frequently results in exposure of conflicts. And that brings even greater scrutiny from the press, the public and regulators; it heightens reputational risk, and it contributes to an erosion of investor confidence. More fundamentally, disclosure is the right thing to do—customers should know when a firm's interests may not be aligned with their interests.

While disclosure improvements are important, it is equally critical to review your conflict identification process. In a fiduciary world, the regular examination of conflict of interest becomes even more fundamental. Institutions should make reviewing their conflicts a part of their standard operating procedure. It is not enough to do a conflict review once every few years and put it in a drawer. It should be a continuous, evolving process that's just as real-time as the changes in a firm's business and the financial products it manufactures and sells. This process is important today and crucial to meeting the new fiduciary disclosure and compliance expectations. Finally, it sends an important message to your employees that enhancing shareholder value is important but that, long term, that will only be accomplished by always placing the customer first.

Products and Sales Practices

Next, I'd like to turn to how financial services firms should think about the products they offer and the sales practices they utilize.

In recent years, business practices have evolved to a point where for some firms products and services were being offered not on the basis of whether they were in the best interest of the customer, but whether they met a minimum standard of acceptability. We've seen this with a variety of structured products, in which there was no change in the business model despite a dramatic change in the business climate.

As I mentioned earlier, while firms have made some real progress in the new products process over the last few years—through the incorporation of compliance earlier in the product creation process—too often the analysis ends when the product is pushed out for the first time. Today, firms typically maintain product review committees, to review what the firm is selling, how popular and profitable their products are, and to explore additional products that could potentially be offered. Having a formal committee pass judgment on financial products is a good step, but more is needed.

Like the reviews of conflicts of interest, product committees need to be institutionalized. And the committees need to broaden their focus to look at not just whether a product is acceptable, but also how products have evolved, who they have been sold to, whether they have become riskier over time, and whether they continue to serve the needs of investors. That requires an in-depth understanding of the components of the products. It also demands a sophisticated analysis of which external forces could influence their behavior, and how. This kind of front-end analysis will help to prevent problems that can culminate in enforcement actions and civil litigation. Most importantly, it will help prevent harm to the investing public.

The recent experience with auction rate securities highlights the need to understand the risk-reward quotient of products. That understanding must extend from the product originator to any firm marketing the product. Product review cannot be a static process and firms must understand when market forces render a change in the risks of a product at the earliest reasonable time.

As firms develop new products, I hope they will redouble their efforts to focus on whether and how the product will serve their customers. This is more important now than ever, given the aging of the population and the changes to the U.S. retirement system that have shifted the burden of risk from large institutions to individual investors.

As baby boomers, once again, create a secular explosion—this time with the number of persons verging on retirement—I am continually troubled by products and practices that prey on seniors, who are among the most vulnerable to questionable products and practices. The explosion in the number of retirees makes this an area where the industry can both provide tremendous benefit and yet also be exposed to new levels of compliance risk. FINRA has devoted significant time and resources to educating seniors on financial issues and how to avoid frauds and scams. And we've also devoted significant resources to enforcing high standards on firms that deal with seniors.

Annuities are a particular concern when seniors are involved, because they are complex investments designed for the long-term investor. They are not suitable for meeting short-term goals because of substantial penalties if one withdraws money early. Therefore, the product, in many cases, is not suitable for older investors who may need access to their money in the short-term. FINRA has brought a number of cases in the last two years against firms who have moved elderly investors into variable annuities inappropriately.

Our concern about the marketing and sale of variable annuities to seniors led FINRA to adopt a new rule, Rule 2821, which details specific sales practice standards and supervisory requirements. Beyond this, however, is the fact that the product is continually changing. The guarantees that became critical in the last year are being revised to control underwriters' risk. That provides you with the challenge to ensure that your financial advisers and their customers understand how the product works, how much it costs and what alternatives should be considered.

Another area where there is a need for firms to live up to the fiduciary standard is life settlements. Life settlement products have grown in popularity in recent years, and there's some evidence that they are being aggressively marketed without giving investors the information they need to make an informed decision.

At one time, the owner of a life insurance policy who no longer wanted or could not afford it had two options: to let the policy lapse or surrender it to the issuer for its cash surrender value. The emergence of a secondary market for existing life insurance policies provides a third alternative: to sell the policy to a third party for less than the net death benefit, but more than the cash surrender value. Such transactions are typically referred to as life settlements.

While life settlements can be a valuable source of liquidity for people who would otherwise surrender their policies or allow them to lapse, they can have high transaction costs and unintended consequences. Individual policyholders have also said that determining a fair price can be very difficult. Given the complexity of these

products, and the sensitivity connected to any product linked to end-of-life issues, firms need to make extra efforts to ensure that they are serving the long-term needs of both their customers and associated family members.

FINRA can implement and enforce high standards, and we have done so, but the larger point is that there needs to be a shift in the way some firms approach their development of new products and the way they market these products to the public. Your integrity and commitment to good business practices should be the first line of defense in investor protection, and I urge you to view your responsibilities in a true fiduciary spirit.

Technology Change

Similarly, how can firms evolve the way they communicate with customers while still meeting regulatory requirements and without sacrificing the protection of the very audience they are trying to reach? We continue to witness the advent of technologies that will challenge your ability to ensure compliance with regulatory requirements. The social networking phenomenon is one such innovation. Social networking sites such as Facebook or LinkedIn provide new ways to connect, inform and interact with customers. They also raise new regulatory challenges. For example, as currently designed they may not allow you to archive and maintain the communications on your own books and records.

Many registered representatives, particularly younger ones, want to use social networking sites to communicate with friends and potential customers. As currently constructed, these sites would not permit you to easily supervise these communications. For that reason, most firms prohibit their employees from using these sites for their business. Nevertheless, interest in these sites will not go unabated. Overcoming many of these challenges will require technology solutions. In fact, we are aware of new technologies that may soon enable firms to archive employee communications in order to comply with supervision and recordkeeping requirements.

FINRA is trying to do its part. We have formed a Social Networking Task Force comprised of industry participants to explore how regulation can embrace technological advancements in ways that improve the flow of information between firms and their customers—without compromising investor protection.

Market Structure Shift

Let me turn now to changes in the markets and what that means for regulators and the industry alike. We talk constantly and aspirationally about anticipating issues, about seeing structural changes as they happen and responding, before the crisis, scandal, or meltdown forces us to respond. Unfortunately, as both regulators and as an industry, our record needs to get much better. But I would like to discuss one such opportunity, and it concerns the rapidly changing world of equity market structure.

The story in the equities markets is a good one. Despite the turmoil of the past year, the markets structurally came through relatively unscathed, despite both historic market volatility and unprecedented regulatory volatility, mostly in the area of short selling.

Yet all is not as stable as it appears, and there are impediments to regulatory effectiveness that are not terribly well understood and potentially damaging to the integrity of the markets. I'm not specifically speaking about the hot topics in the equities world of high frequency trading and dark pools, although I'm delighted that the SEC is focused closely on these issues. My interest is in the fragmentation we see in the markets, and the increasing number of genuine liquidity centers, and what these do to the ability of regulators to oversee the markets.

The decline of the primary market concept, where there was a single price discovery market whose on-site regulator saw 90-plus percent of the trading activity, has obviously become a reality. In its place are now two or three or maybe four regulators, all looking at an incomplete picture of the market and knowing full well that this fractured approach does not work. This is especially true given how easy it is for market participants to move volume on a second-by-second basis between venues.

Structural developments in other ways serve to cloud the audit trail. Order information is inconsistent and incomplete—overwhelming in some contexts and non-existent in others. While FINRA serves as the trade repository and regulator of dark pool activity, it's not always clear what activity emanates from the pool versus what emanates from unrelated desks throughout the sponsoring firm. And data quality varies across the exchanges, with no clear set of reporting requirements. It is also becoming easier to hide the identity of the actual participant in a trade in the trade report, further frustrating our efforts. It often takes days, not minutes, to understand who traded and where, and that is not the standard we want for a well-regulated and modern market.

Audit trails used to be relatively straightforward, analytically if not technologically. The information the market needed for the tape and for clearing was exactly the information the regulator needed for surveillance. But that dynamic doesn't work so well in the current environment. I think we need to look at the data we get versus the data we need, and find cost effective ways to close that gap.

At a minimum, all the data needs to be consolidated, with a single set of eyes looking at the market holistically. We've taken that first step by consolidating the surveillance for insider trading based on listed market. But there is much more to be done in the areas of frontrunning, manipulation, abusive short selling, and just having a better understanding of who is moving the markets and why.

The consolidated data pool likewise should be surveilled by a unified single regulator. A single regulator that can bring the best technology, the best people, and a unified set of rules needs to be empowered. Today, there are multiple regulators attempting to respond in a timely way to market changes, using scarce resources to try to simultaneously develop similar systems and processes. A stronger, single regulator would be equipped to meet market surveillance objectives more effectively, and with less expense, than multiple regulators.

What I'm proposing is somewhat daunting, because it is simultaneously a significant undertaking and a baby step. I say it's a significant undertaking because I have been around long enough to know that any attempt to change the routine flow of market information without overburdening the market itself is a challenge. I also appreciate, as the former regulator of multiple markets at NYSE Regulation, and the current regulator of multiple markets at FINRA, that combining regulatory databases is much easier said than done.

But it's also a baby step because consolidation is already assumed to be the norm, and prior to market fragmentation it more or less was the norm. While there's been some progress on consolidated surveillance, there are still a number of steps that need to be taken to give us a more complete picture of the markets, starting with the more difficult step of integrating listed options. After that, we need to capture information from the credit default swap market that is 100 percent opaque right now. After the events of last fall, nobody can say that swap spreads and underlying equity prices are never linked, but at this point it is very hard to see and even harder to prove.

Finally, we need more information on the entities that move markets—the high-frequency traders and hedge funds that are not registered. Right now, we are looking through a translucent veil, and only seeing the registered firms, and that gives us an incomplete—if not inaccurate—picture of the markets.

In short, there is a lot of work ahead, but not a lot of time.

Conclusion

Having spent most of my professional life working in financial-market regulation, I've seen the commitment to a strong culture of compliance ebb and flow—often in correlation with market movements. And while there's been progress, one of the lessons of the past two years is that there is still work to do—as there always will be. As Thomas Jefferson once said, "the price of liberty is eternal vigilance."

The regulatory reforms pending before Congress can help to wring some excesses out of the system, and prevent abuses. And SIFMA can continue to play a constructive role in this process. But we should remember that regulation, while critically important, is not going to prevent every instance of fraud or deception. What's most important of all is for market participants—from senior executives to individual investors—to possess a commitment to ethics, integrity and professional responsibility.

A marketplace defined by a high level of trust and confidence will be one where capital can flow efficiently to those who use it wisely and productively. And that trust and confidence will, in the long run, help to deliver the greatest economic dividends of all.

Thank you for listening. I'd be happy to take your questions.