

September 7, 2017

Financial Services Capital Markets, Securities, and Investment Subcommittee: Oversight of the Financial Industry Regulatory Authority

The Financial Services Capital Markets, Securities, and Investment Subcommittee held a hearing today to review FINRA's agenda, structure, and initiatives, as well as its relationship with SEC; the Committee also seeks to better understand the "role that self-regulation plays in the U.S. capital markets." [Mr. Robert W. Cook](#), President and Chief Executive Officer of the Financial Industry Regulatory Authority, offered witness testimony.

Opening Statements

Chairman Bill Huizenga (R-MI) called the hearing to order, stating that FINRA is an independent organization authorized as self-regulating to oversee U.S. securities industries. FINRA's mission is to protect investors and promote market integrity; it drafts, implements, and enforces rules that oversee over 30,000 brokers. It also registers securities firms, operates trade reporting facilities, and administers the largest alternative forum designed to resolve securities-related disputes. FINRA plays an integral part in ensuring that capital markets are fair and efficient. However, FINRA has engaged in some "mission creep," transforming into what some call a "deputy SEC." The Committee last held a general oversight hearing in 2015, and since then Mr. Robert Cook has been appointed CEO. There have also been a number of substantive changes, including the FINRA 360 program. This program is multi-year and committed to continuous improvement by which Mr. Cook is participating in a "listening tour" to learn what FINRA is doing well and what it could do better. Another FINRA initiative is the trade reporting and compliance engine, or TRACE. TRACE provides regulators with regular transaction information in the U.S. securities market.

Rep. Brad Sherman (D-CA) noted that in 2016 alone, FINRA referred 785 matters to the SEC for possible enforcement, demonstrating quantitatively the important role they play. Sherman then noted that Wells Fargo employees were placed under incredible pressure, and some termination forms indicate that some employees were terminated for questioning accounts. He is pleased that FINRA has a system for going through these termination records, and he hopes that these employees will be treated appropriately. Sherman noted that FINRA retains monies collected in fines, collecting \$173.8 million last year. \$27.9 million of that was given to investors as restitution, leaving nearly \$150 million to spend on projects. Sherman hopes that there are not conflicts of interest present here.

Witness Testimony

Mr. Robert W. Cook of FINRA noted that FINRA plays an active role in the strength of U.S. capital markets, and is the first line of oversight for capital firms and individual brokers. The SEC has always closely supervised FINRA, but last fall enhanced its supervision by creating the FISIO office. FINRA welcomes this oversight, as it is central to the self-regulatory structure. Cook described his listening tour, intended to meet stakeholders and hear their questions. He has received important feedback, and has undertaken a range of new initiatives. One such initiative is the FINRA 360 program, a multi-year initiative designed to determine how FINRA can be more efficient and effective as a regulator. As such, FINRA has issued a request for comment to determine how to better engage with stakeholders and be

better as an SRO. As a result of the program, FINRA combined old enforcement teams into one unit, streamlining investigations and providing a more coordinated approach to oversight. Further, FINRA has engaged in outreach to better understand FinTech. Beyond FINRA 360, FINRA has worked to strengthen its core regulatory programs, stopping bad actors who put investors at risk. It has finalized a tailored set of rules for firms with a specific business model to support capital formation, and has launched a helpline to take calls and investigate investor issues. To date, FINRA has received 10,000 calls and as a result firms have voluntarily returned nearly \$4.7 million to investors. Cook described efforts to put holds on senior investor accounts when suspicion of financial abuse is present, an effort that is in line with the Senior Safe Act. Cook stated that FINRA must continue to innovate, and must work to recognize the diversity of members, including smaller broker-dealers.

General Questions

Chairman Bill Huizenga (R-MI) noted the decline in companies seeking to go public in recent years; he asked how FINRA can help make going public easier and more attractive for smaller business. Likewise, he wondered how to encourage other types of capital raising activities other than going public. Cook replied that FINRA has recently issued a request for comment on all rules related to capital raising to determine which rules should receive a fresh look. Also this year, FINRA has made operational a new ruleset for brokers engaged in capital raising to streamline and tailor the existing rules. Huizenga then asked what Congress can do to encourage IPOs. Cook replied that the decline in IPOs deserve focus, and we must ensure that we are thinking about whether regulations are appropriately calibrated. Those in the industry have suggested raising funding portals to enable more raising of money.

Rep. Stephen Lynch (D-MA) asked whether FINRA will investigate best execution and whether the conflict within the maker-taker rule is leading to suboptimal order routing by brokers. Cook replied that FINRA has done several things with regard to best execution, and has issued further guidance for firms and has reviewed firms' best execution practices. Cook anticipates doing more surveillance work to examine how firms quantify the benefits to customers of the routing decisions they are making. Lynch then noted that there have been several enforcement actions against broker dealers operating their own alternative trading systems, but have not brought cases focused on best execution. Cook noted that the cases were mainly focused on disclosures and how customer orders were handled; however, ATS and how they are run is a focus of FINRA and he hopes to bring more information in this area soon.

Rep. Bruce Poliquin (R-ME) focused on the Department of Labor's fiduciary regulations, imposing an unnecessary set of regulations on the financial community. Poliquin cited concern that these regulations are causing an exodus from the industry; he asked whether Cook has seen firms who are no longer providing advice to small savers and investors. Cook noted that he has heard concerns about fiduciary rule compliance during his listening tour. He favors a uniform standard, and agreed that a variety of rules can create confusion. Poliquin asked what FINRA does to ensure that members are treated fairly when it comes to conflicts of interest. Cook described disclosures, as well as an examination program to review account behavior. He emphasized that different regimes based on regulatory requirements precedes the fiduciary rule, and is the heart of the issue.

Rep. Brad Sherman (D-CA) asked whether Cook is considering extending the implementation date for Rule 2232, which requires dealers to begin reporting to retail customers the amount of mark up or mark down on most secondary transactions on corporate bonds. Cook replied that he is engaged closely with

industry representatives to understand implementation challenges. The rule is intended to give investors more information to help them make more informed decisions. FINRA has issued guidance, but is looking at whether more might be helpful. Sherman then asked how FINRA uses fine monies; Cook replied that these funds are used for capital initiatives, strategic initiatives, and investment in technology.

Rep. French Hill (R-AR) asked whether Cook considers himself as a private actor or a state actor with authority from the government in his job. Cook replies that FINRA is a combination created by Congress to facilitate regulation of the markets through active engagement in the industry in a way that ultimately serves investors. This balance is achieved through FINRA's structure, with a mix of regulatory and public representatives on the board. Given that FINRA does so much related to safety and soundness of our markets, Hill asked whether FINRA submits cost benefit analyses to the Committee or is subject to FOIA or other oversight structures, as do other public actors. Cook replied that no SROs are subject to some of these requirements, and wondered whether these ideas would help facilitate FINRA's SRO model or undermine it. However, he agreed that close oversight is important, and referenced the SEC's enhanced oversight that began recently. Hill asked whether the Commission should delay the implementation of the consolidated audit trail. Cook agreed that the issue of PII is significant, and we must ensure that appropriate protections are in place to safeguard this data.

Rep. David Scott (D-GA) discussed FINRA's toll-free number for seniors, and asked Cook to describe how it works. He expressed concern that we allow technology to get ahead of us, and wondered whether all toll lines are manned by people rather than automated services. Cook replied that he is aware of technological concerns, especially given the population in question. The lines are manned by real people who follow up with consumers to determine the nature of their issues and making referrals as necessary. Scott then turned to the fiduciary rule discussion, stating that he has urged Congress to come up with one uniform rule that could be applied; their failure to do so has led to the fragmentation that we see today. He asked Cook to walk us through the different varying standards that exist, and explain how this complication makes protection even more difficult. Cook stated that he also supports a uniform standard, and is willing to work with all relevant agencies to support this. Today, we have the ERISA fiduciary standard that covers qualified retirement accounts, the broker-dealer standard that involves FINRA oversight, and the investment-advisor fiduciary responsibility arising under securities laws. Cook added that he has seen many firms that want to promote a uniform standard; likewise, the SEC has opened a comment file to address this issue. There is an opportunity for the SEC and DOL to work together on this, and Cook expressed his willingness to aid as needed.

Rep. Randy Hultgren (R-IL) focused his questions on how FINRA promotes competition, and asked how Cook plans to work with broker dealers as they implement standards outlined in Rule 4210. Cook noted that there is an opportunity to provide more guidance to help firms with implementation. Hultgren asked how FINRA assesses its rules and rulebook to ensure that its regulation is not creating undue burden on broker dealers. Cook acknowledged consolidation in the industry, and noted that while there are many new entrants into the market, more broker dealers are leaving. He agreed that there is a need to tailor the rulebook and engage in careful economic analysis to take into account impacts on small firms. Hill asked what processes FINRA could adopt to look back at previous rules and determine whether economic analyses at the time were accurate. Cook agreed that retrospective reviews are helpful, and noted his continued interest in supporting this effort through the chief economist.

Rep. Jim Himes (D-CT) noted that there have been around 1000 IPOs since the passage of the JOBS Act; the median spread for pre-jobs act was 7.00%. Post, JOBS Act, the median spread is the same. The mean has changed from 6.94% to 6.96%. Given this consistency, Himes noted that Cook's analysis of this offers two competing explanations: that there is collusive pricing behavior, or that "flat pricing of gross spreads can represent an efficient contractual solution for issuers and underwriters by reducing the dimensionality of the contract and that it simplifies negotiations between the issuer and the underwriter." Himes asked for an explanation of this and how it could be consistent with 7% gross spreads. Cook deferred to FINRA's economists to determine whether there has been enough time to evaluate the JOBS Act's effects. He believes that in order to fully follow up on this, he needs access to all the relevant parties. Himes agreed, but noted that the JOBS Act was intended to lower the cost of IPOs, and it's unclear whether that has occurred.

Rep. Tom Emmer (R-MN) followed up on FINRA 360, asking how many comments FINRA received on the issue of self-improvement. Cook did not recall the exact number, but noted that the comment file and the listening tour have both yielded numerous suggestions (both positive and negative) on how to improve operations. Issues around transparency and disclosure are included in comments received, and Cook plans to go to the board to discuss how to implement changes. Emmer asked for more transparency on how decisions are being made and what FINRA's money is being used for. He noted that the SRO model used to look different, but now looks like a government agency that uses a heavy hand to extract fines.

Rep. Greg Meeks (D-NY) noted that the 2015 dispute resolution task force recommend that FINRA gather race and gender information to determine whether its mediators and arbitrators were making meaningful change. Cook noted that the recommendation is one he supports, and in adopting the recommendations, has engaged a consultant to understand the diversity of the arbitrator roster. Further FINRA has enhanced recruitment tools and done more marketing on social media.

Rep. Warren Davidson (R-OH) returned to the consolidated audit trail, and asked if it is still on track. Cook noted that FINRA is not implementing this; it has been contracted to a private company with a consortium of exchanges. Asked how to evaluate whether the consolidated audit trail is working, Cook replied that rolling out a new system engenders a lot of work. We need to ensure that data reporting coming in is of sufficient quality prior to letting go of the old system; that being said, the goal is to shed the old system.

Rep. Trey Hollingsworth (R-IN) asked what the feedback has been with regard to FinTech so far. Cook noted that they had an internal committee to review FinTech, and has recognized the need for FINRA to "ramp up" its efforts in this area. He is very interested in RegTech, as well as understanding how technology can help in setting up new firms. The goal is to help understand how FINRA can participate in discussions around investor protection concerns, ideally to understand whether FINRA rules are getting in the way of new developments. Cook added that all regulators are interested in this area; FINRA is trying to have a dialogue with other actors to learn what others are doing and how to adapt it to their context.

Rep. Ann Wagner (R-MO) reminded the Committee that she is not a fan of the fiduciary rule. FINRA's mission is to safeguard the investing public against fraud and bad practices; she asked whether DOL consulted with FINRA when crafting their rule. Cook replied that FINRA provided technical advice to offer their understanding of the brokerage model and how DOL proposals might interact with FINRA

rules. Wagner asked whether DOL did or did not consult substantively with FINRA, and Cook replied that FINRA offered comments, which DOL took under consideration. When asked whether it is best that SEC take the lead on this issue, Cook replied that a uniform standard would be best. Should the SEC move forward with its own rule, Wagner asked what role Cook expects FINRA would take. Cook replied that he would appreciate the opportunity to offer technical advice, and depending on the proposal, may have to look at reforming some of FINRA's own rules.

Ranking Member Carolyn Maloney (D-NY) discussed the TRACE for Treasury program, by which FINRA collects information on transactions in Treasury securities, which will be made available to the regulators. There is a debate around whether Treasury transactions should be reported publicly as well. Some participants felt this would harm the markets via high speed trading, while others thought that increased transparency would enhance market quality and bring in more investors. She asked for Cook's take on the issue. Cook replied, saying that TRACE for Treasury is very new, just initiated in July. We must ensure that all relevant parties are reporting into the system. Before we think about reporting some trades and not others, we must ensure that the full scope of reporting is sufficiently covered. Turning to cybersecurity, Maloney noted that this is one of FINRA's priorities this year. Maloney asked whether firms have adequate programs in place to mitigate cybersecurity risks, or whether this is an area that we must continue to shore up. Cook answered that this must be an area of continued focus, given that cyber threats are always evolving. There is an opportunity to look across the financial services agencies to look at what standards should be applied.

Subcommittee Chairman Bill Huizenga (R-MI) thanked Mr. Cook for his testimony and adjourned the hearing.