Statement of Stephen Luparello
Vice Chairman, Financial Industry Regulatory Authority
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Chairmen Schapiro and Gensler and Commissioners, I am Steve Luparello, Vice Chairman of the Financial Industry Regulatory Authority, or FINRA. As a long-ago alum of both agencies, it is a true pleasure to have the opportunity to be here today.

FINRA is the primary securities self-regulatory organization for U.S. firms conducting a securities business with the public. We regulate over 4,800 firms, 600,000 registered representatives, and 173,000 branch offices. We brought approximately 1,100 disciplinary actions in 2008, and are on pace to exceed that this year. Of our 4,800 firms, approximately 230 are dually registered as futures commission merchants.

Across our financial regulatory system, the fragmented approach to overseeing financial institutions and intermediaries that has developed over the years creates challenges, gaps and a compelling need for effective coordination among regulators. This is clearly evident in the oversight of securities and futures, especially as certain products and features of those markets converge and impact each other in increasingly significant ways.

Despite the differences in the underlying statutes, the agencies and self-regulatory organizations historically have found ways to work together through both formalized mechanisms and outreach on particular issues and areas of concern, and intermediaries have found ways to address overlapping and sometimes inconsistent regulatory schemes. That said, certain inefficiencies will always exist in such a bifurcated structure.

Regulatory Cooperation

From the SRO perspective, I'd like to note the strong working relationship between FINRA and the primary futures SRO, the National Futures Association. We have a history of effective collaboration in terms of both identifying issues that could affect investors and minimizing some of the burdens associated with separate regulatory schemes.

FINRA staff meets regularly with its counterparts from NFA in formalized industry-wide groups, such as the Intermarket Financial Surveillance Group, where representatives from the agencies and SROs discuss financial oversight, rule developments and exam priorities. This type of coordination helps promote consistent rules and allows SROs to target their exams to avoid redundancies.

The IFSG has also proven very helpful in times of crisis, such as in the Refco and Lehman bankruptcies, helping to foster an orderly winding down of positions.

FINRA and NFA also collaborate on an ad hoc basis to discuss new issues, products, or trends we are seeing in our respective jurisdictions that may impact the other or highlight a need for coordination. We've jointly developed training materials, discussed examination approaches, and shared proposed rulemaking. In addition, FINRA has regulatory agreements with NFA to exchange information regarding firms that are subject to regulation by both.

FINRA regularly makes referrals to NFA or the CFTC when it receives information related to activity outside its jurisdiction. There were about two dozen such instances last year, and there have been approximately 20 so far this year.

Foreign Exchange

A timely example of both the risks inherent in fragmented regulation and the benefits of functioning cooperative relationships involved the recent increase in the number of firms actively marketing retail foreign currency trading. Retail forex, especially in its current form, which includes opaque pricing, high leverage, and non-transparent activity, is an area ripe for fraud and customer harm. By way of background, retail forex business traditionally was not conducted out of broker-dealers. However, in 2008, Congress, at NFA's request, increased capital requirements for FCMs that conduct an off-exchange retail forex business, creating the possibility of a significant migration of forex business to FINRA-registered broker-dealers.

In no small part thanks to a series of meetings between NFA and FINRA staff, FINRA has been able to stay in front of this issue. In November 2008, we issued Regulatory Notice 08-66, reminding broker-dealers that a number of our rules, including our rule requiring adherence to just and equitable principles of trade, our communications with the public rules, and our membership rules, applied to their activity in this area.

In June of this year, we proposed changes to our margin rules relative to the product. Those changes, still pending, would require a customer to post a substantial amount of the notional value of its forex position. In this instance, FINRA's rulemaking took a different approach than that of the NFA – focusing on leverage instead of capital requirements. In fact, that difference in approach was motivated at least in part by our status as a securities self-regulatory organization and our jurisdiction; using our margin rules in part to further our sales practice mission, given our imperfect reach over non-securities product sales conducted by broker-dealers, including the limitations on our suitability rules.

Each SRO has taken aggressive steps to limit customer harm in this area and we have appreciated the willingness of NFA to share with us some of their lessons-learned. Nonetheless, this is a useful example of how our current regulatory system creates the potential for gaps or arbitrage that can be exploited as participants move almost effortlessly from one statutory scheme to another.

Efforts to Minimize Duplication in Rulemaking

In terms of the SRO rulemaking process, we strive to avoid adopting overlapping rules wherever appropriate. As an example, our recent rule on Member Private Offerings expressly excluded offerings of commodity pools, as NFA has developed a comprehensive filing and disclosure regime for such offerings.

Our rules also recognize the role of futures for hedging purposes. Recent amendments to FINRA's options position limits create a delta hedging exception that specifically contemplates that approved proprietary pricing models may include futures as a basis of an effective options hedge.

Margin

While the cooperation I've mentioned certainly has had benefits, many of the challenges in regulating the increasingly interrelated securities and futures businesses are borne of differences compelled by statute. SIPC versus the segregated funds regime is a significant one, and the progress in achieving full resolution on portfolio margining has been difficult.

The SEC's portfolio margining pilot program was expanded in 2007, and corresponding SRO rules were adjusted. FINRA's portfolio margin rules were written to allow customers to base their margin charges on risk-based calculations that incorporate securities, futures and OTC derivatives. Our rules stand ready to allow portfolio margining for a single account holding securities and futures if the issues presented by the differences between SIPA and the segregated funds regime are resolved.

The differing margin regimes also complicated efforts earlier this year by market participants pursuing efforts to move clearing of credit default swaps onto centralized clearing facilities. These efforts were impeded in part because transactions effected by broker-dealers would not, absent specific rulemaking, be subject to the same margin levels as those effected by FCMs or IBs. The willingness of a clearinghouse to assume responsibility for both sides of a CDS transaction is predicated on each counterparty having sufficient margin or performance bond. Earlier this year, FINRA launched a pilot program establishing margin requirements for firms effecting transactions in CDS contracts that are cleared through a central counterparty clearing service to ensure that transactions effected by broker-dealers are subject to margin requirements equal to or greater than those of the clearing facility.

Need for Derivatives Transparency

Another significant challenge presented by the current bifurcated system of regulating securities and derivatives is overseeing these markets, which are increasingly connected. As you noted again last week, Chairman Schapiro, and we agree, it is clear that regulators need increased access to data across cash and derivatives markets to conduct more meaningful surveillance.

The review of trading activity across cash markets and futures markets generally has not been integrated. Where there has been a need to share information, either on a product-specific basis, or to assist in reviews and investigations, most notably with insider trading and frontrunning, there always has been very good cooperation between the cash and futures markets. As members of the Intermarket Surveillance Group, U.S. cash and futures markets are obligated to share information with each other for regulatory purposes.

Ad hoc approaches to market oversight will become increasingly inadequate in light of new trading patterns. While there has yet to be a proven case of manipulation based on an allegation that swaps trading moved the market in the related equity, there can be no doubt that such a fact pattern is possible. With the increasing standardization in OTC derivatives, as well as the clearer linkage between the derivatives and cash markets, it is obvious that audit trails of different quality or restricted to certain types of products will no longer reveal the full picture of trading activity that affects the marketplace, and will interfere with our ability to combat illegal activity.

Conclusion

In any environment with separate agencies and separate SROs, there will be the potential for gaps in oversight. As we explore ways to harmonize regulation, we need to keep our focus on those gaps and be conscious of where others may be created by changes in the marketplace or in regulation.

No regulator can predict every eventuality, and our best efforts to achieve harmonization will not create a perfect system. These points underscore the need to continue to fostering cooperation among regulators. Increasing information available to regulators and increasing communication between regulators can only serve to assist in this process and in the implementation of our missions.

Other participants today will cite examples of how the dual regimes interfere with, or layer costs onto, the products and services that they offer to their customers. These are legitimate issues, and worthy of your attention, and we strive to ensure that any costs we impose do not unnecessarily contribute to those layers or costs. But our primary focus has been, and will continue to be, ensuring that we

have the tools, knowledge, and information required to promote investor protection.

Thank you again for the opportunity to be here. I'd be happy to answer any questions.