Securities Industry and
Financial Markets Association

Written Testimony

of

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Good afternoon, Chairwoman Velázquez, Ranking Member Graves and Members of the Committee. My name is John Moloney and I am President and Chief Executive Officer with Moloney Securities Company, Inc., located in Manchester, MO and Chairman of the Small Firms Committee[1] of the Securities Industry and Financial Markets Association[2] Thank you for the opportunity to testify before you on behalf of SIFMA on how changes to the financial regulatory system could affect small broker-dealers.

SIFMA and its small firm members applaud your efforts and the on-going leadership of the Small Business Committee to be the advocate of small businesses in Congress. Small businesses are the backbone of the U.S. economy and small broker-dealers are instrumental in serving individual investors and entrepreneurs in Main Street America. Small broker dealers, which comprise the overwhelming majority of SIFMA's membership, service niche markets and local communities, and help in job creation.

[1] In addition to serving as Chairman of the SIFMA Small Firms Committee, Mr. Moloney is a current member of the FINRA Membership Committee, past member of the FINRA Small Firms Advisory Board and FINRA Advisory Council, and past Chairman of the District Committee for FINRA District #4. He is also a past member of the Securities Industry/Regulatory Council on Continuing Education.

[2] SIFMA brings together the shared interests of more than 600 securities firms, banks, and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. SIFMA's members account for about 90% of the nation's municipal bond underwriting and trading activity by volume, which represented an estimated $5 trillion of municipal bonds in 2008. It has offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. More information may be found at our website: http://www.sifma.org.

As of August 2009, FINRA, the Financial Industry Regulatory Authority, reported that there are 4,797 registered broker-dealers.[3] Of these, it is estimated that some 4,600 are smaller broker-dealers defined by FINRA as having 150 registered persons, or fewer. That is the constituency I represent. My firm, Moloney Securities, is a general securities broker-dealer with 110 registered brokers and 20 support staff. We have three Offices of Supervisory Jurisdiction (OSJ) located in St. Louis, Kansas City and Denver, plus nineteen additional registered branches located in fourteen states. We are dually registered as a broker-dealer and as an investment adviser. Moloney Securities does not custody customer securities or cash. We clear customer transactions through two clearing firms. Our firm, like the overwhelming majority of broker-dealers, was not a TARP recipient.

As a threshold matter I wish to point out that the majority of the financial services reform proposals before Congress do not impact smaller firms like mine. Small firms are concerned that the changes contemplated for large, global, financial services firms could cause disparate effects on small firm operations. That being said, and because investor confidence in the markets is important to all firms regardless of size, I wish to echo the comments of SIFMA's President and CEO, Tim Ryan, when he testified before the House Financial Services Committee on October 21, 2008.[4] Tim testified that:

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[3] http://www.finra.org/Newsroom/Statistics/index.htm

[4] Testimony of T. Timothy Ryan, Jr. President and CEO of the Securities Industry and Financial markets Association before the U.S. House of Representatives Committee on Financial Services Hearing on the Future of Financial Regulation, October 21, 2008.

> "In our view, a sound regulatory regime must contain several key elements. First, it must be designed to minimize systemic risk to the financial system. Second, it must promote the safety and soundness of each regulated financial institution. Third, it must contain business conduct rules that promote fair dealing and investor protection. Fourth, it should be consistent from country to country. And finally, it is critical that the regulatory structure be as effective and efficient as possible. Regulation imposes meaningful costs on our financial system and over-regulation or inefficient regulation can diminish the competitiveness of markets vis-à-vis better regulated venues. Thus, well-crafted regulation—by which I mean regulation that achieves its goals and does so in a cost effective manner—is an important objective."

This last point is the key message that small broker-dealers wish to impart to Congress as it deliberates financial services reform. In short, well-crafted and thoughtful legislation is needed to avoid unintended consequences to firms that did not cause the current financial crisis. As I mentioned at the Committee on Small Business Regulatory Roundtable on June 16, 2009, Congress should consider including sunset provisions in financial services regulatory reform so that new legislation and regulations are reviewed to ensure that new rules are achieving the desired effect.

SIFMA supports strengthening consumer protection regulation as it relates to consumer credit products and lending practices. However, we are concerned that creating a new agency for these purposes might lead to wasteful and duplicative regulation while failing to deliver the hoped-for benefits due to the separation of consumer protection and prudential regulation.

SIFMA believes the Consumer Financial Protection Agency (the "CFPA") could inadvertently encroach on the jurisdiction of the SEC and CFTC. The Administration's White Paper states that the CFPA would provide consumer protection in the financial products and services markets, "except for investment products and services already regulated by the SEC or CFTC." Treasury officials have reiterated in various public statements that the CFPA is not intended to supersede the broad investor protection mandate of the two agencies. Nevertheless, as proposed, the CFPA's jurisdiction would be broad and have uncertain boundaries, potentially overlapping with those of the SEC and CFTC. We believe the Act should provide a full exclusion for investment products and services regulated by the SEC or the CFTC. As currently drafted, it excludes only a narrow list of activities of some of the persons regulated by the SEC, such as broker-dealers and investment advisers. Arguably the SEC's authority over transparency and disclosure, including its exclusive ability to mandate issuer disclosure in proxy statements and annual reports, also would be called into question. To avoid overlapping jurisdiction, we urge Congress to exclude from the jurisdiction of the CFPA any securities activity and any person, product or other activity that is regulated by the SEC or the CFTC.

There are two additional features of financial services reform that do affect my firm and our registered brokers and I would like to address them now.

Harmonization of Broker-Dealer and Investment Adviser Regulation

SIFMA has long advocated the modernization and harmonization of the disparate regulatory regimes for brokers, dealers, investment advisers and other financial intermediaries.[5] When broker-dealers and investment advisers engage in the identical service of providing personalized investment advice about securities to individual investors, they should be held to the same standard of care. Conversely, when broker-dealers are not providing personalized securities investment advice to individual investors (such as, for example, when broker-dealers simply execute orders for customers, or engage in market-making, underwriting or providing cash sweep services), there is no cause for modifying the existing, extensive regulatory regime that governs broker-dealers. We therefore welcome Treasury's newly proposed legislation, the "Investor Protection Act of 2009," which appears to acknowledge these important distinctions, and which would give the SEC the authority to establish rules for a new, uniform, federal standard.

Individual investors deserve – and SIFMA strongly supports – a new federal fiduciary standard of care that supersedes and improves upon the existing fiduciary standards, which have been unevenly developed and applied over the years, and which are susceptible to multiple and differing definitions and interpretations under existing federal and state law. Whatever label, if any, the SEC applies to this new federal standard, we

[5] See, e.g., Testimony of T. Timothy Ryan, Jr. before the U.S. Senate Committee on Banking, Housing and Urban Affairs in the March 10,2009 hearing titled "Enhancing Investor Protection and the Regulation of the Securities Markets," available at http://www.sifma.org/legislative/testimony/pdf/Ryan-03-10-2009.pdf.

must ensure that it functions as a unitary and exclusive standard that is uniformly and even-handedly applied – at the federal level – to both investment advisers and broker-dealers when they provide personalized investment advice about securities to individual investors. Congress successfully followed a similar approach when it restructured federal - state securities regulation through the National Securities Markets Improvement Act of 1996.

The hallmark of a new federal standard should be putting investors' interests first. At the very outset of the customer relationship, the duties, obligations and expectations of the customer and the financial service provider must be communicated and documented in clear and concise language as opposed to excessively technical and legalistic jargon. Broker-dealers and investment advisers alike should seek to avoid conflicts of interest. If they cannot, then they must effectively manage conflicts through clear, unambiguous disclosure and, as appropriate, investor consent.

A new federal standard should also protect investors by respecting and preserving investor choice, which is part of putting clients first. This should include investor choice to select, contract for and receive any of the wide range of products and services offered by their financial services provider, and investor choice to define or modify relationships with their financial services provider based on the investor's preference. In light of the numerous, diverse and investor beneficial products and services offered by broker-dealers that differ from, and are far beyond, those offered by today's investment advisers, a new federal standard should also recognize and preserve product and service innovation and capital formation. Yet another way to support choice, innovation and service is to provide firms with appropriate relief from the SEC’s current prohibitions against principal trading, which in today’s liquid and transparent markets no longer make sense and have had the effect of foreclosing opportunities for investors to obtain more favorable pricing on transactions because of the requirement of transaction- by-transaction consent. A new federal standard thus must be sufficiently flexible to be adapted to the products, services and advice chosen by the investor, and applied only in the context of providing personalized investment advice about securities to individual investors.

We recognize the important role that States play in protecting investors, and so we believe that any new legislation should make it clear that the States may investigate or bring enforcement actions for fraud to the extent consistent with the new standard of care. Any new legislation, however, should make clear that subjecting a financial professional to the new federal standard does not create any presumption that the financial professional is providing investment advice or is a fiduciary for purposes of any other federal or state laws. This enables broker-dealers to continue to provide investors choice of investment products, particularly in IRAs.

We also hope that harmonization would involve a reaffirmation that pre-dispute arbitration clauses in advisory and brokerage contracts are valid. In the past, the SEC has prohibited the inclusion of such clauses in advisory contracts on the grounds that they may confuse clients by causing them to believe they have waived their rights under the federal securities laws, which would violate the anti-fraud provisions of the Investment

Advisers Act of 1940.[6] As I will describe in further detail, this opposition to arbitration clauses is at odds with federal policy, judicial precedent and empirical evidence.

Pre-dispute Arbitration Clauses

Treasury has proposed giving the SEC authority to prohibit pre-dispute arbitration clauses in broker-dealer and investment advisory account agreements with retail customers, if it studies such clauses and concludes that their use harms investors. Similarly, the CFPA, as proposed, would have authority to prohibit or limit the use of arbitration clauses in consumer contracts to the extent that the CFPA finds such prohibition or limitation to be in the public interest and for the protection of consumers.

Congress has maintained a policy in favor of arbitration since the passage of the Federal Arbitration Act. The basis for this policy has been that arbitration simultaneously promotes fairness and efficiency. The U.S. Supreme Court has expressly approved the use of pre-dispute arbitration clauses.

SIFMA supports the idea of conducting further study of securities arbitration and pre-dispute arbitration clauses. In fact, we conducted our own study of the matter in October 2007.[7] Based on empirical data, we confirmed that securities arbitration is faster and less expensive than litigation. Small investors benefit in particular, as arbitration allows them

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[6] McEldowney Financial Services, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 78,373 (Oct. 17, 1986).

[7] Available at http://www.sifma.org/regulatory/pdf/arbitration-white-paper.pdf.

to pursue claims that they could not afford to litigate or that would be dismissed in court. Moreover, the percentage of claimants who recover in securities arbitration – either by award or settlement – has remained constant in recent years and average inflation-adjusted recoveries have been increasing. In sum, we found that the securities arbitration system properly protects investors, in part because it is subject to public oversight, regulatory oversight by multiple independent regulators and procedural rules specifically designed to benefit investors.

Pre-dispute arbitration clauses are vital to the securities arbitration system.
In fact, it is our view that prohibiting such clauses would essentially be tantamount to doing away with securities arbitration. Research shows that parties rarely agree to arbitrate after a dispute arises. Rather, a variety of tactical considerations tend to drive parties to litigate. Claimants' counsel may prefer litigation to drive up costs and induce nuisance settlements, use a judicial forum to seek publicity or attract other clients, or shop for forums thought to have anti-business jury pools. Securities firms may favor litigation to take advantage of their greater financial resources to the detriment of the small investor by engaging in extensive discovery or filing numerous motions.

Accordingly, the result of a voluntary, post-dispute arbitration approach is likely to be that most disputes end up in lengthier, costlier litigation. This outcome would likely result in a complete denial of justice for individuals with smaller claims. This cannot be the intended result of Treasury's proposal. We urge Congress to consider these factors in its deliberation over Treasury's pre-dispute arbitration clause proposals. We also suggest that further study of this subject might be particularly instructive.

Disparate Impact of Regulation on Small Firms

There are a number of issues and concerns in the area of regulation of smaller firms that I would like to bring to the attention of the Committee. While each of and by themselves may not seem significant, it is the cumulative impact of these regulations that are making it more difficult for smaller broker-dealers to survive. Each of these rules constitute a "hit" to my firm's bottom line. For example, when I opened my firm in 1995, the cost of my clearing contract was $3,000 per quarter. That expense has gone up ten fold to $30,000 per quarter, and is largely attributed to the costs of compliance with regulation. In 1995, the member application fees to FINRA for my firm was $3,000. Today, if I were opening a new firm, the application fees alone would exceed $27,000. My point is that the barriers to entry in the brokerage industry have increased significantly. Couple that with the increased costs of compliance and it is easy to see why smaller firms are struggling to stay in business.

Costs of Compliance

In 2006, SIFMA released a study on the costs of compliance in the securities industry. [8] While the overall percent of revenue spent on compliance was less for small firms than for larger firms, out-of-pocket costs for such items as compliance, accounting and audit services were over four times higher than for larger firm categories. Capital expenditures

[8] http://www.sifma.org/research/surveys/pdf/CostofComplianceSurveyReport.pdf

for small firms, for example, sophisticated, systems, to meet manage or monitor ongoing compliance, was highest for smaller firms. The survey highlights that because smaller firms have fewer internal resources than larger firms, small firms must rely on outside services to meet their growing compliance burden.

For example, for several years, small, non-public securities firms had received an exemption from the Sarbanes-Oxley requirement that a broker-dealer's financial audit be conducted by a registered public accounting firm under rules promulgated by the Public Company Accounting Oversight Board (PCAOB). This PCAOB small firm exemption expired in 2008. Now, SIFMA Small Firms Committee members report that their financial audit fees have increased significantly. While we understand and support the need for an effective audit regime to protect investors, maintain confidence in the markets, and prohibit fraud, many smaller firms in rural communities have had difficulties finding an accounting firm in their area that is willing to register under PCAOB. The scarcity of local PCAOB audit services further drives up the costs for local companies that have to seek out a PCAOB auditor outside of their communities. The average increase in financial audit fees reported to me is from $6,500 up to $8,000, with some small firms paying up to $30,000 for a PCAOB audit.

Earlier this year, the Securities Investor Protection Corporation (SIPC) increased their annual assessment to broker-dealers from $150 per year to one-quarter of one percent of gross revenue effective April 2009.[9] For one of my colleagues on the Small Firms

[9] http://www.sipc.org/media/release02Mar09.cfm

Committee, their SIPC assessment jumped from $150 to $40,000. This dramatic increase was not anticipated, impacted all firms, and for a smaller firm, can be devastating.

Recently, FINRA's Board of Governors voted to double the Personnel Assessment for registered persons and alter the formula for calculating its Gross Income Assessment. [10] In an economy where small firms are fighting to survive, FINRA has elected to impose additional fees to their member firms. Although these increases are now available for public comment through the SEC, FINRA did not request member comment on these additional levies.

Finally, the Municipal Securities Rulemaking Board (MSRB) also increased its annual fees. Many small firms execute a small number of municipal transactions every year. These firms maintain membership in the MSRB because they want to provide full service to their customers. But increased fees, coupled with the additional supervisory responsibilities placed on firms by FINRA for municipal securities compliance, are causing some firms to reconsider their municipal bond activity. The result is fewer firms serving municipal bond investors.

Presently, FINRA has proposed to the SEC to eliminate the Anti-Money Laundering (AML) Third Party Exemption for small firms.[11] Like the proposed FINRA assessment increases, FINRA did not put this proposal out for comment to FINRA members, but rather sent it to the SEC directly. Small firms already feel the burden of complying with

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[10] http://www.sec.gov/rules/sro/finra/2009/34-60624.pdf

[11] http://www.sec.gov/rules/sro/finra.shtml

AML through the implementation of internal policies, procedures, supervisory tasks, and the utilization of scarce human resources in maintaining compliance with AML rules that our clearing firms comply with as well. Now, FINRA proposes that small firms be required to hire a third-party to test our AML procedures. Again, we have talked to many small firms and consultants who will provide these third-party services. For example, we expect that our AML audit will increase from between $2,500 to $4,000.

In addition, the SEC is proposing to ban placement agents in representing investment advisors, private equity, and other private investments to public pension funds.[12] This ban would have devastating effects on small firms that do not have the internal resources to hire marketing and fundraising staff on a full time basis and would place small broker-dealers at a competitive disadvantage compared to larger firms. Small firms would be forced to exit this business, or sacrifice other scare resources to continue this important service for public pension funds and the private equity investment management sector.

Taken together, the issues that I have outlined have created the perception among smaller firms of a "piling-on" by regulators that is pinching already narrow margins and the ability of firms to serve customers. The more that small firms spend on assessments and audit fees, the less small firms can spend on compliance enhancements, training and client service.

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[12] http://www.sec.gov/rules/proposed/2009/ia-2910.pdf

My final comment relates to the Regulatory Flexibility Act,[13] or RegFlex. In accordance with RegFlex, federal agencies are required to include an Initial Regulatory Flexibility Analysis (IRFA) as part of the rule proposal process. SIFMA wishes to express its support for the Small Business Committee's initiative to correct deficiencies in RegFlex that will help ensure that small businesses are not overly burdened by regulations. We endorse your efforts to eliminate outdated regulations, ensure that agencies do not ignore the requirements of RegFlex, and compel agencies to consider foreseeable economic impacts of rules on small business.

Thank you, Madam Chairwoman and Ranking Member Graves, for allowing me to present SIFMA's views. We hope to continue our dialog on financial services regulatory reform and stand ready to assist this Committee with any of these matters.

[13] 5 U.S.C. 603