Financial Industry Regulatory Authority

A Letter from the Chairman & CEO

2009 Year in Review

What's Inside

Introduction

I am writing this letter to update you on FINRA's activities during the last year and provide you with our unaudited 2009 financial results while waiting for final audited results on our investments.

Enhancements to FINRA's Regulatory Program

For FINRA and all regulators, 2009 was a year to act on lessons learned from the financial crisis and revelations of fraud, and move ahead with new measures to strengthen investor protections and preserve the vitality of the financial markets. The necessary reform and regulatory restructuring of our financial system will take time. FINRA, however, recognizes that investors cannot be left exposed while we wait. We are committed to advancing investor protections and market integrity, and we strive to meet these objectives through enforcement and education. In this regard, FINRA implemented a number of valuable enhancements to our oversight capabilities throughout the year. These reforms—many of which are based on what FINRA learned from fraud schemes exposed in the last two years—enhance investor protections and contribute to greater investor confidence.

We created an Office of the Whistleblower in March to encourage individuals with firsthand knowledge of, or material information about, potentially fraudulent, illegal or unethical activity to come forward and share it with regulators. In October, we established the Office of Fraud Detection and Market Intelligence. This office provides a heightened and expedited review of 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.

FINRA also enhanced its 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've done include:

- gathering and analyzing more targeted information prior to each exam regarding a firm's ownership and affiliate relationships;
- examining the relationship between broker-dealers and/or their affiliates with feeder funds, or master funds that utilize feeder funds;
- enhancing the use of third-party verification of assets and reviewing for appropriate internal controls and segregation of duties where we identify apparent conflicts of interest; and
- verifying compliance with custody requirements when firms have a higher level of control over customer assets, such as when acting as both adviser and broker to customers.

In April 2009, FINRA's Board of Governors convened a special committee to conduct an internal review of FINRA's regulatory program as it related to the detection of fraud and Ponzi schemes. In October, the committee issued its report, which included three key findings: First, it recommended that FINRA institute a number of internal reforms to better safeguard investors and the broader financial system. Second, it called attention to the many regulatory challenges related to jurisdictional issues. Third, it highlighted the urgent need for financial regulatory reform that ensures comprehensive oversight, reduces jurisdictional confusion, streamlines enforcement and improves coordination and communication among all regulators.

In addition to the exam program changes listed above, we have since implemented significant policy and programmatic changes, as recommended by the committee, to further strengthen our regulatory programs.

We have centralized the receipt, analysis and distribution of referrals from 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's used across all regulatory operations. This operational enhancement means that serious matters are escalated and investigated more quickly. Quicker action means more investors escape harm.

Also in response to the committee's report, we have plans to expand FINRA's Regulatory Coordinator Program in both size and scope. As part of our enhancements to the program, Coordinators will spend more time focusing on the changing dynamics and business models of individual firms. Under this continuous surveillance model, Coordinators will be better equipped to assess the risks to investors, the markets and the firms themselves.

The same thinking applies to our examination program. It's our goal that one-size-fits-all regulation becomes a thing of the past. Using risk-based analysis, we are focused on understanding the composition of each firm's business as we walk in the door. We want our exam teams to be more focused on those areas at firms that pose a real risk to investors.

We also plan to pilot a thematic aspect to our examination program to obtain broad knowledge of specific high-risk topics across a number of brokerage firms.

FINRA is strengthening the use of third-party data to independently verify information received from firms. For example, we are verifying custody information with the Depository Trust and Clearing Corporation or other outside custodians, and customer account activity and balances directly with customers. This helps reduce the risk that inaccurate information provided by firms may affect the focus of examinations and conceal violations.

In the next few years, we expect to make even more changes to our exam program to be far more risk-based and far more informed with respect to the different types of firm business models.

Ongoing Enforcement of Rules and Regulations

Vigorous enforcement of rules and regulations is a cornerstone of FINRA's commitment to protecting investors. In 2009, FINRA took 993 disciplinary actions, barring 383 individuals, suspending 363 others and expelling 20 firms. We levied fines against firms and individuals totaling nearly $50 million. In addition, we ordered firms and individuals to return more than $8.2 million in restitution to investors.

In 2009, we conducted approximately 2,500 routine examinations and approximately 7,900 cause examinations in response to events such as customer complaints, terminations for cause and regulatory tips.

We reviewed 96,700 advertisements and sales communications from firms to investors.

Initiatives to Improve Surveillance

Our market surveillance work became more challenging and more important in 2009, due primarily to the pace of change in the trading environment, coupled with the ongoing fragmentation of the markets. During 2009, FINRA monitored an average of 2.25 billion quotes, orders and trades each day. And throughout the year, we focused on providing high-quality regulatory services to a number of markets, including The NASDAQ Stock Market, The NASDAQ Options Market, NASDAQ OMX Boston, NASDAQ OMX Philadelphia, the BATS Exchange and the International Securities Exchange.

We continue to seek a more complete picture of market activity and, to that end, are working to develop a comprehensive surveillance platform that views trading across multiple markets and financial products. In May 2010, we announced an agreement with NYSE Euronext to perform the market surveillance and enforcement functions currently conducted by NYSE Regulation. This is a critical step in improving how regulators monitor market activity. Under the agreement, which became effective June 14, FINRA assumed the regulatory functions for NYSE Euronext's equities and options markets operating in the United States—the New York Stock Exchange, NYSE Arca and NYSE Amex. As a result, FINRA is now responsible for aggregating and regulating approximately 80 percent of U.S. equity trading.

This is significant progress toward our goal of addressing the realities of today's trading environment, which is characterized by rapid changes and increasingly fragmented markets. Such a fragmented trading environment creates real challenges for regulators. While some of this fragmentation is the natural byproduct of technological progress, it has nonetheless eroded the ability of regulators to obtain a complete picture of market activity.

Our agreement with NYSE Euronext will help change this. It will allow FINRA to capture and analyze additional data that can help us detect problematic trading activity across multiple markets and financial products. This more holistic, unified approach to regulating trading goes a long way toward strengthening our ability to protect investors—and has multiple benefits for the markets.

In addition, this agreement will allow us to move closer to a single order audit trail platform. We believe strongly in the value of a single set of eyes looking at all equity market activity. And while the consolidation of FINRA's and NYSE's surveillance systems is a great first step, far more needs to be done. Regulators do not currently have a consistent convention in place to identify a market participant across different markets and no easy way to determine which desk within a firm is responsible for a trade. Current audit trails also are limited in their ability to identify trading activity that results from direct market access and specific trading strategies.

For these reasons, we are pleased that on May 26, 2010, the SEC proposed a new rule that would require FINRA and the exchanges to act jointly to create a consolidated order and transaction audit trail. FINRA agrees and believes there should be consistent granular and uniform aggregation of order, trade and quote information across all equity and options markets. Done properly, such an effort can be both cost-effective and improve dramatically the regulation of the markets. While a consolidated audit trail would not eliminate all the challenges of analyzing the data from a market freefall like we saw on May 6 of this year, it would make the process significantly more efficient and effective.

Expansion of Transparency Initiatives

Bringing greater transparency to the financial system has always been one of our top priorities, as it advances our mission of protecting investors and enhancing market integrity.

In 2009, we took a number of important steps to improve market transparency. In September, the SEC approved an expansion of FINRA's Trade Reporting and Compliance Engine (TRACE) to include debt issued by federal government agencies, government corporations and government-sponsored enterprises (GSEs), as well as primary market transactions in new issues. This expansion, which took effect March 1, 2010, helps investors to better monitor their executions by putting timely and accurate sales and pricing information in their hands. It also gives regulators more information about this segment of the bond market, and enhances our ability to detect unfair pricing and other misconduct.

FINRA has also proposed, and the SEC recently approved, expanding TRACE to cover asset-backed securities (ABS). The reporting of ABS transactions to FINRA, which is scheduled to become effective in early 2011, would provide us with trade prices, volume and other information, thus enhancing our ability to supervise the market. However, with more than 1.2 million CUSIPs, we recognize that the breadth and complexity of these products are far greater than that of the instruments currently included in TRACE. We will not immediately disseminate the data we gather, but will study the information closely to determine the most effective way to bring transparency to the trading of these products.

In addition to the changes to TRACE, last year we also expanded our BrokerCheck system to provide additional information to investors who are considering whether to conduct business with a particular securities broker or firm. This free online service allows investors to see the employment, qualifications and disciplinary history of nearly 850,000 current or former brokers. The expansion makes records of final regulatory actions against brokers permanently available to the public, regardless of whether they continue to be employed in the securities industry.

FINRA Financial Results

Last year, FINRA's financial results were affected by market instability and the continuing effects of the recession. Although the equity markets showed signs of stabilizing, the year remained a challenging one for the economy and markets overall. As a result, in 2009 FINRA's revenues declined 6 percent versus 2008 to $755 million, mainly due to a decrease in Gross Income Assessment fees. These fees, which trail industry revenues by one year, were consistent with the declines in revenue seen among firms in 2008.

In response to these challenging economic conditions, we reduced our expenses by 9 percent—a decrease of nearly $90 million. We achieved this primarily through reductions in compensation and benefits related to a voluntary retirement program offered in 2008, as well as decreases in professional and contract services for technology-related initiatives and other variable costs, including travel.

Despite revenue declines and cost reductions taken in 2009, we maintained the effectiveness of our operations and strengthened many of our regulatory programs—without compromising our regulatory responsibilities or our mission to protect investors.

As we discussed in last year's annual report, we also transitioned FINRA's investment portfolio to a more conservative asset allocation model. I am pleased to report that the rebound in broader market performance led to gains in our investment portfolio in 2009 versus the losses sustained in 2008.

Continued Investor Education Efforts

At FINRA, we have long believed that education is the best form of investor protection. In December 2009, the FINRA Investor Education Foundation released the results of The National Financial Capability Survey, conducted in partnership with the U.S. Department of the Treasury and the President's Advisory Council on Financial Literacy. The results of the National Survey, the first of three linked surveys to be released as part of the National Financial Capability Study, give us rich and complex data on how Americans save, borrow and plan for their financial future. At the same time, they underscore the urgent need for financial education in this country.

The FINRA Foundation's focus on investor education complements FINRA's work to combat investment fraud, particularly given the recent surge in fraudulent activity that preys on vulnerable groups, such as seniors.

In 2009, we expanded our senior investor protection program to five states: Colorado, Florida, North Carolina, Vermont and Washington.

Additionally, the Foundation continued its efforts to help military families manage their money. Working with the Pentagon's Financial Readiness Campaign, the Foundation delivers free, unbiased tools and training to servicemembers, their spouses and military financial educators. Since the launch of the military financial education program in 2006 and through the end of 2009, we have conducted over 90 forums, reaching more than 22,000 members of the military community.

In addition, throughout the year, the Foundation expanded its reach at the grassroots level and made more than $3 million in grants through grant programs with the American Library Association and United Way. Our grant programs in partnership with the American Library Association help local libraries provide free, unbiased financial education resources to library users across America. And together with United Way, we are helping community-based organizations provide effective and unbiased financial education to low- and middle-income Americans.

Regulatory Reform

In 2009, the Obama administration and Congress considered comprehensive measures intended to reform and modernize financial regulation.

At this moment, it remains unclear whether Congress will direct the SEC to impose a fiduciary standard for broker-dealers, or whether it will require the agency to study the issue. But even if such a standard is not immediately imposed, FINRA and the industry cannot stand back as if we have learned nothing from recent history. FINRA believes one of the most important issues pertaining to regulatory reform is the elimination—or substantial reduction—of the unequal consumer protections across business lines. We believe that anyone selling securities or providing advice, whether an investment adviser or broker-dealer, should only make recommendations that are in the best interest of the customer.

We support a fiduciary standard for broker-dealers who provide personalized advice and believe the SEC is the correct agency to ensure that the standard is both effective and properly reflects the diverse business models and complex organizations that characterize the broker-dealer industry. However, a consistent fiduciary standard is not a guarantee against misconduct. We believe a fiduciary standard of care must be accompanied by a comprehensive examination program. This is especially important 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. Both sides of those businesses must be examined on a regular basis to ensure that regulators see the full picture in order to better protect investors.

The Road Ahead

The market volatility of the past few years, coupled with the disclosures of fraud, has challenged financial regulators to strengthen the focus on investor protection. At FINRA, we are determined to meet our mandate through effective oversight, enforcement and education, while also working to keep pace with the dynamic change at the heart of the securities industry. As we go forward, we will continue to work with the administration, Congress and our fellow regulators to protect investors—and ensure that financial markets can continue to serve as a healthy engine of growth and opportunity in the United States and throughout the world.

Financial Summary

Please note that this is an unaudited report of FINRA's 2009 financial results. The final FINRA 2009 Financial Report will be issued in September 2010 after all audited financial statements for FINRA's investments have been received.

Key Results
(in millions)

Years Ended December 31,

	2009 Unaudited	2008 Actual	2007 Pro forma (Unaudited)[1]	2007 Actual[2]
Net revenues	**$ 755.6**	$ 804.5	$ 808.0	$ 724.7
Total expenses	**(876.7)**	(965.4)	(903.8)	(812.2)
Interest and dividend income	**32.0**	56.6	77.2	77.2
Special payment to firms in connection with the consolidation of NASD and the member regulation operations of NYSE	-	-	(178.3)	(178.3)
Net investment gains (losses)[3]	**37.3**	(479.2)	113.8	113.8
Equity earnings (losses) from other investments	**83.7**	(144.9)	42.1	42.1
Other	**13.8**	32.1	5.7	5.7
Net income (loss)	**$ 45.7**	$ (696.3)	$ (35.3)	$ (27.0)

1 *2007 Pro forma (unaudited) amounts reflect an estimated full year of NYSE member regulation operations to provide comparable year-over-year revenues and expenses for the years ended December 31, 2009, 2008 and 2007.*

2 *2007 Actual amounts reflect NYSE member regulation operations from July 30 through December 31, 2007.*

3 *Amounts are net of impairments of $44.8 million, $308.6 million and $2.1 million for 2009, 2008 and 2007.*

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