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CONSOLIDATION OF NASD AND THE REGULATORY FUNCTIONS OF THE NYSE: WORKING TOWARDS IMPROVED REGULATION

HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITIES AND INSURANCE AND INVESTMENT

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

ON THE OVERALL IMPACT AND OUTCOME OF THE CONSOLIDATION ON THE REGULATORY SCHEME INCLUDING BUT NOT LIMITED TO THE AREAS OF RULES, GOVERNANCE, ENFORCEMENT AND COMPLIANCE, ADVERTISING, ARBITRATION, FUNDING, AND THE POTENTIAL IMPACT ON INVESTORS

THURSDAY, MAY 17, 2007

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C O N T E N T S

THURSDAY, MAY 17, 2007

WITNESSES

CONSOLIDATION OF NASD AND THE REGULATORY FUNCTIONS OF THE NYSE: WORKING TOWARDS IMPROVED REGULATION

THURSDAY, MAY 17, 2007

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES, INSURANCE,
AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 2:30 p.m., in room SD–538, Dirksen Senate Office Building, Senator Jack Reed (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN JACK REED

Chairman REED. I will call the hearing to order now and welcome you all this afternoon. We are holding a hearing on the consolidation of the NASD and the regulatory functions of the New York Stock Exchange. This merger will result in a new single, self-regulatory organization for our capital markets, and I thank the witnesses for joining us this afternoon.

In this increasingly globalized financial services market, no institution can remain static. They must continually re-evaluate themselves to cope with dynamic and rapid change. In this context, this merger represented a very serious attempt to modernize and streamline operations of these SROs.

What cannot be lost is the continued need to keep our markets fair, transparent, and properly regulated. Indeed, in a world of increased competition, confidence in the integrity of our markets is essential to assuring their continued supremacy, and this merger needs to strengthen that confidence.

In creating this new entity, there is an opportunity to take stock of where we are now, and I further hope that this hearing is the beginning of a dialog on ways to improve the regulatory regime overall.

As Wall Street and Main Street intersect and millions of individuals invest in our capital markets through retirement plans and other tools, this is an issue that affects an overwhelming number of Americans. It is critical that the merger and the harmonization of the rule book results in better regulation of the industry and not a race to the bottom.

The globalization of markets across product lines as well as geographic boundaries through increasingly sophisticated trading in multiple markets and multiple currencies and other complex trans-

actions significantly raises the potential to obfuscate illegal activities and avoid timely detection. Daunting challenges arise from the rapid change that allows for a small group of individuals to exploit the system for gain, jeopardizing the whole market. As such, reducing the duplicative efforts of two regulators must result in the use of the single SRO's increased resources and capacity to preclude this behavior. The ability of regulators and regulations to both anticipate and adapt to change while helping investors understand new products and how they compare is essential. A more holistic approach to regulation will surely produce greater results for all stakeholders.

Finally, the role of the SEC in oversight capacity and working with this new regulatory entity is vital to its success. Balancing the authority of the SRO and the SEC cannot be overlooked, and I look forward to hearing from the SEC regarding the steps they have taken and will take in the future to provide adequate oversight of both this new regulatory body and the market as a whole.

The hearing this afternoon is an opportunity to understand the structure of the regulatory regime with this new entity and plans for moving forward to increase regulatory capacity both in member regulation and market surveillance. To this end, there are several key questions. What are the best regulatory models for SROs? How will the new SRO be better equipped to anticipate problems and ensure and enhance our markets' integrity and investor protections? How will the single new SRO be financed? And what is the role of the SEC in effectively overseeing this new regulatory body?

This transaction is an important sign of the growing integration of institutions and world capital markets. As activities of capital markets become more seamless, the way this merger is dealt with will shape the way we deal with challenges arising in the future.

We all look forward, again, to the testimony of our witnesses, but first I would like to recognize the Ranking Member, my colleague, Senator Allard. Senator.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Well, first, Mr. Chairman, I would like to thank you for holding this hearing today of the Subcommittee on Securities, Insurance, and Investment. I look forward to the opportunity of hearing about the consolidation of the NASD, or the National Association of Securities Dealers, and the regulatory functions in the NYSE.

The United States' securities markets represent the richest source of liquid capital in the world. Their sophisticated size and credibility are what attract investors from all over the world. Currently, the securities and financial markets in the United States are thriving, and investors are enjoying the longest bull run in over 80 years.

The Dow Jones Industrial Average has recorded 23 record closes since the start of the year, and the S&P 500 is 14 points below its record close it set in March of 2000. The Dow is no longer showing lingering effects of the 416-point drop it suffered on February 27th, and the U.S. economy is continuing to expand and is adding jobs. But as Securities and Exchange Commission Chairman Chris Cox noted yesterday before the Senate Financial Services Appropria-

tions Subcommittee, "Our savings are dependent on healthy"—he is talking about customers' savings—"are dependent on healthy, well-functioning markets." Prudent regulation has been the key to developing our capital markets. The SEC is obviously primary in that regulation; however, self-regulatory organizations also play an important regulatory role. Good regulations help foster fairness, transparency, and confidence in the marketplace. Yet we must also be cognizant of the burden of regulation. Too much regulation can be costly and inhibit innovation and stifle competition.

Because the SROs are also part of the industry, they can be helpful in finding a proper balance. As with all regulators, even SROs can be prone to bureaucracy, duplication, and excess cost. This seems to be the case for the NASD and the NYSE regulatory arm. Firms have to comply with two rule books, which are often different in rules or interpretation. Even those members who are not directly members of the NYSE also felt the effects if they did business with NYSE members.

The merger of the NASD and NYSE regulatory function has the potential to eliminate duplication, streamline regulations, and lower costs. The consolidation is not without its challenges, however. Small broker-dealers, in particular, are feeling vulnerable as these changes happen. As part of the NASD, they are living under a Senate model. Just as all States are equal in the Senate, all firms are equal at the NASD. So although the ten largest firms employ more than 25 percent of the registered representatives, they still have the same vote as the thousands of firms with less than ten employees.

The small firms, those with less than 150 registered representatives, will be able to vote for three members on the Board of Directors of the new consolidated regulator. This will shift things to a model much closer to the House of Representatives.

Now, having served in both the House and the Senate, as did our Subcommittee Chairman, I have an appreciation for both models. The House still addresses the needs of smaller or less populated States. Similarly, the new regulator can support small broker-dealers, but this will require deliberate effort on the part of the company, and I would strongly exhort them to maintain such a focus.

I firmly believe that the broker-dealers of all sizes can flourish under consolidated regulation. That is the bottom line.

I look forward to today's hearing as an opportunity to get more information on the merger. The merger is incredibly complex and will involve the integration of human capital, physical capital, rule books, procedures, information, technologies, and many other items. I think we can all agree that, should it receive the necessary approvals, it will not be completed quickly.

I am hopeful that you will keep in contact with this Subcommittee as the process moves forward. I know that the Chairman and I will be very interested in monitoring this merger. We have an outstanding line-up of witnesses, Mr. Chairman, and I appreciate their time and would like to welcome them. This hearing will be very helpful to the Subcommittee, and I look forward to their testimony.

Chairman REED. Thank you very much, Senator Allard.

Senator Tester, do you have an opening statement?

STATEMENT OF SENATOR JON TESTER

Senator TESTER. Yes, thank you, Mr. Chairman, and thank you for holding this hearing. I also want to thank the panels for being here today. I really appreciate their time, and I also appreciate the fact that anytime we have regulating agencies looking at ways to reduce duplication without risking consumer confidence, I think that is a good thing. And I want to applaud your efforts in this.

The Chairman's point about where the SEC plays an oversight of this SRO is critically important, and I look forward to hearing from you, Mr. Sirri, how that is going to happen, how you envision that unfolding, and once it is all done, how consumer protection can be achieved while still providing the kind of flexibility for the private sector to be able to run their business and do it well. This hearing is very important to me to be able to understand this proposal, find out what its implications are for investors and brokers and the dealers, also.

Finally, I would just like to say in the end hopefully somewhere in the panel's comments I would like to see what your vision for this SRO is over the long term, what you hope to accomplish, and how you see it operating over the long run.

With that, Mr. Chairman, once again I want to thank the panelists for being here, and it is a pleasure to be a part of the Subcommittee. Thank you.

Chairman REED. Thank you, Senator Tester.

Senator Bunning, do you have an opening statement?

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Very short. It is always good to meet the people who regulated me for 25 years.

Chairman REED. You wish baseball was here?

[Laughter.]

Senator BUNNING. No, no. Broker-dealer for 25 years, and the exams were horrible. I just want you to know that. The 8-hour exams for the principals were horrible exams to take.

It is not a very glamorous topic we are talking about today, but it is important to all investors, whether they know it or not. The last time the Banking Committee heard about the market regulation functions of the NASD and the New York Stock Exchange was before the merger was announced in November, so it is good to get an update today. I am interested to hear how the merger is going and what benefits investors, brokers, and companies are going to see. Duplication of regulations is rarely a good thing, whether it is done by the Government or whether it is done by the private sector. Whether regulations can be simplified without undermining quality, it should be done so that resources and people can be put to more useful purposes.

I am looking forward to hearing more about the deal. Thank you, Mr. Chairman.

Chairman REED. Thank you very much, Senator Bunning.

We have two panels, and let me now introduce our first panel. Mr. Erik Sirri is the Director of Market Regulation at the Securities and Exchange Commission. In this role, he is responsible at the Commission for the administration of all matters relating to the regulation of stock and option exchanges, national securities as-

sociations, brokers, dealers, and clearing agencies. Mr. Sirri is currently on leave from Babson College where he is a professor of finance. From 1996 to 1999, Mr. Sirri served as the chief economist of the Securities and Exchange Commission. Before joining the SEC, he was an assistant professor of finance at the Harvard Business School from 1989 to 1995. Mr. Sirri began his career—and this might be a very visionary start—receiving a B.S. in astronomy from the California Institute of Technology, and so he is someone who has a broad view of the world and the cosmos. He received an MBA from the University of California at Irvine, a Ph.D. in finance from the University of California at Los Angeles. Thank you very much, Mr. Sirri.

We are also joined by Mary Schapiro, Chairman and CEO of NASD, the world's largest private sector securities regulator. She joined NASD in 1996 as President of NASD Regulation and was named Vice Chairman in 2002. Before assuming her present duties, Ms. Schapiro was Chairman of the Federal Commodity Futures Trading Commission and, as Chairman, she participated in the President's Working Group on Financial Markets with the Secretary of the Treasury and the Chairman of the Federal Reserve Board and the SEC. Prior to assuming the CFTC chairmanship, Ms. Schapiro served 6 years as a Commissioner at the Securities and Exchange Commission. She is a graduate of Franklin & Marshall College in Lancaster, Pennsylvania, and earned a law degree with honors from George Washington University, and she was named the Financial Women's Association Public Sector Woman of the Year in 2000. Welcome.

Finally on this panel, Mr. Richard Ketchum has been Chief Executive Officer of New York Stock Exchange Regulation, Inc., since 2006. He is also a member of the New York Stock Exchange Regulation Board of Directors. Mr. Ketchum had served as the first chief regulatory officer of the New York Stock Exchange since March 8, 2004. From June 2003 to March 2004, Mr. Ketchum was General Counsel of the Corporate and Investment Bank of Citigroup, Inc. Previously, he spent 12 years at NASD and Nasdaq Stock Market, Inc., where he served as President of both organizations. Mr. Ketchum earned his J.D. from the New York University School of Law and a B.A. from Tufts University. Welcome, Mr. Ketchum.

Thank you all, and, Mr. Sirri, we will try to aim for 5 minutes, so you can summarize your testimony. Your written statements will be made part of the record, without objection. Mr. Sirri.

STATEMENT OF ERIK SIRRI, DIRECTOR, DIVISION OF MARKET REGULATION, SECURITIES AND EXCHANGE COMMISSION

Mr. SIRRI. Thank you very much. Chairman Reed, Ranking Member Allard, and Members of the Subcommittee, thank you for inviting me here today to testify about the proposal by the NASD and the New York Stock Exchange to consolidate their member firm regulatory functions into a single SRO. I believe the proposed consolidation represents a positive development in the regulation of our securities markets.

Although there are a number of SROs that perform various functions, only the NASD and the New York Stock Exchange are re-

sponsible for member firm regulation. Currently, the NASD and New York Stock Exchange together oversee more than 5,000 U.S. broker-dealers doing business with the public. About 170 of them are members of both organizations. As a result, there can be at times inefficient, duplicative, and potentially conflicting regulation of U.S. securities firms.

The proposed consolidation of the NASD and the NYSE member firm regulation functions into a single SRO is designed to help eliminate today's duplicative member rule books and the possibility of conflicting interpretation of these rules. At the same time, a single SRO structure would retain one of the fundamental precepts that has characterized the SRO model: that securities regulation works best when the front-line regulator is close to the markets.

As you know, this past November the NASD and the NYSE publicly announced their proposed consolidation. The combined SRO, which would be given a new name, would be responsible for all member firm regulation, arbitration, mediation, and other functions that are currently performed by the NASD. This consolidation would allow securities firms to operate under a uniform set of rules, replacing the overlapping jurisdiction and duplicative regulation that currently exists. Thus, all firms would deal with only one group of SRO examiners and one SRO enforcement staff for member firm regulation.

The NASD and the NYSE agreed to a governance structure for the combined SRO that reflects a blend of the current models. As the proposed governance structure requires amendments to the NASD's bylaws, these proposed bylaw changes are subject to the Commission's rule-filing process, which includes notice and comment as well as Commission action. We also expect to receive several additional filings from the NASD and the NYSE that are primarily technical in nature but, nonetheless, are critical to the closing of the proposed transaction.

On March 19th of this year, the NASD filed with the Commission the proposed changes to the NASD bylaws as approved by the NASD membership, and the Commission published these changes for public comment on March 26th. To date, the Commission has received 78 comment letters. Commenters supporting the proposed changes to the bylaws, including several securities firms, the SIFMA, the National Association of Independent Broker-Dealers, the Financial Services Institute, and the North American Securities Administrators Association, have generally agreed that the consolidation proposal would streamline regulation and simplify compliance with the uniform set of regulation.

Those commenters who urged the Commission not to approve the proposal, including a number of small NASD firms, the Commonwealth of Massachusetts, and the Center for Corporate Policy, generally argued that the proposed bylaw amendments would not protect investors or provide enough representation for industry members or smaller firms.

Currently, the SEC staff is reviewing all comments received and is in the process of preparing a recommendation to the Commission. I expect the staff will submit a recommendation to the Commission on the proposed NASD bylaw changes within the next few weeks.

I should note that the proposal currently before the Commission is to consider amendments to the NASD bylaws, which would be required to implement the governance changes necessary to establish the structure of the combined SRO. While these bylaw changes are a key component of the proposed consolidation, work would continue to be done after the closing of the consolidation, if approved, in order to integrate the member firm regulatory functions of the SROs. The combined SRO would need to complete the harmonization of member firm rules. Because there are a substantial number of rules that would need to be reconciled, the SRO is expected to have a transitional period during which the NASD and the NYSE member firm regulation rules would be retained within the combined SRO, with the NYSE rules applying to NYSE members and the NASD rules applying to its members.

During this transitional period, the combined SRO would continue to review and harmonize the duplicative NASD and NYSE rules governing member firm regulation and conflicting interpretation of those rules. It is my expectation that in developing a single rule set, the combined SRO intends to be sensitive to the needs and circumstances of firms of various sizes and business models.

I believe that the harmonized rules would help make self-regulation more effective and more efficient by allowing securities firms to operate under a uniform set of rules, replacing overlapping jurisdiction and duplicative regulation that currently exists for many firms. The harmonized rule book would be subject to Commission approval.

In addition to the proposed consolidation of the two rule books, the two separate regulatory staffs, and two different enforcement staffs, the proposal would consolidate the arbitration and mediation programs of the NASD and the NYSE, making arbitration subject to one set of rules. I believe that consolidating these two arbitration programs would reduce overhead significantly, thereby increasing efficiency, especially in light of the fact that the NASD currently is the arbitration forum for over 90 percent of securities arbitrations.

Finally, I should note that the proposed consolidation may very well have positive ancillary effects on investors and on the Commission's work. Following the consolidation, Commission staff would continue to conduct examinations of the combined SRO's regulatory, investigatory, and enforcement activities. However, instead of examining member firm regulation activities of two SROs, the Commission staff would be able to focus its efforts on ensuring that the single combined SRO effectively regulates member firms.

Investors, too, may benefit from the consolidation since the consolidated SRO would combine the strengths and the talents of the experienced enforcement and regulatory staffs from both SROs. As a result, the consolidated SRO staff would be able to more effectively focus their efforts in areas that are critical to investors, such as sales practices.

I am grateful for the opportunity to speak to you today about the self-regulatory system and about the update on the proposed consolidation of the NYSE and the NASD, and I am happy to take any questions.

Chairman REED. Thank you very much, Mr. Sirri.

Ms. Schapiro, please.

STATEMENT OF MARY SCHAPIRO, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, NASD

Ms. SCHAPIRO. Good afternoon, Chairman Reed, Ranking Member Allard, and distinguished Members of the Subcommittee. As a self-regulatory organization devoted to investor protection and market integrity, NASD is grateful for the invitation to testify on the historic regulatory consolidation of NASD and NYSE member regulation. I am especially pleased to be testifying on the panel today with my former SEC and NASD colleague, Rick Ketchum, and SEC Director of Market Regulation, Erik Sirri.

Never before have we witnessed so much change happening so quickly in the financial services industry. Consolidation, globalization, international mergers, and lightning-fast technology are leaving the landscape of the global capital markets forever altered.

As someone who has been a regulator for 25 years, I believe strong regulation, including the self-regulatory model, has always been a source of strength for our markets. But as the markets grow faster and the world grows smaller, if we expect to keep up with all the changes taking place around us, we need to bring regulation into the 21st century, making it more effective and more efficient.

Over the last several months, there have been three major reports warning that America risks losing its position as the world's financial capital. Whether you agree with these reports or not, they have raised important issues concerning the complexity of the regulatory structure and the competitiveness of U.S. markets and have spurred much discussion, as well they should.

NASD and the NYSE have chosen to lead and help shape a system of regulation that is better for investors and financial services firms of all sizes. Last November, we announced a plan to consolidate NASD and the member regulation operations of the NYSE into a combined organization which will be the sole private sector regulator for virtually all securities brokers and dealers in the United States. This consolidation is good for investors, U.S. markets, and the industry. It will bring about more focused regulation, able to meet the needs of today's investors as well as eliminate confusion and unnecessary duplication for firms. We believe more competent investors and more efficiently regulated firms will ultimately make U.S. markets stronger and more competitive.

Once the consolidated SRO is fully integrated, duplicative regulation and overlapping jurisdiction will become a thing of the past. Inconsistent approaches in rule interpretations and the potential for matters falling through the cracks between two separate regulators will be historical footnotes.

With the new SRO, there will be a single set of rules that can be adapted to firms in different sizes and business models. There will be one set of examiners and one enforcement staff. And the new SRO's board will host a diversity of representation. While there will be robust and diverse industry participation, the majority of the seats will be held by public Governors.

Today, as we await final approval from the SEC, we are focused on integrating 470 New York Stock Exchange and 2,500 NASD employees, merging technology platforms, and consolidating two rule

books, all the while continuing to be ever vigilant in enforcing our rules and overseeing our regulatory needs. With a staff of nearly 3,000 dedicated individuals and a budget approaching $800 million, the new SRO will be able to vigorously carry out its mission of protecting investors.

Though NASD will soon have a new name, one thing will not change: our dedication to investor protection and market integrity and our core responsibilities. These include member examination, advertising review, registration and testing, and enforcement, as well as our administration of the securities arbitration forum. It also includes our vigorous market surveillance that identifies and combats illegal trading, and I can assure you that technology and enforcement departments of the new SRO will remain ever vigilant against insider trading.

A critical component of investor education also includes a steadfast commitment to investor education. The NASD Investor Education Foundation, currently funded with $82 million, is the largest foundation in the U.S. dedicated to investor education. We are proud of our work in this area, and it will remain one of our top priorities.

Mr. Chairman, the financial services industry is fundamental to the success of our economy, our national security, and the well-being of our citizens. It has the means and the intellect to solve a wide range of social and economic problems and the potential to create secure financial futures for all Americans. The transformation taking place in capital markets both here at home and across the globe is here to stay. The only question is how regulators and the industry will evolve to meet the challenge.

NASD looks forward to working closely with Congress as it continues to review the changing regulatory landscape. Thank you again for giving us this opportunity to testify today.

Chairman REED. Thank you very much, Ms. Schapiro.

Mr. Ketchum.

STATEMENT OF RICHARD KETCHUM,
CHIEF EXECUTIVE OFFICER, NYSE REGULATION, INC.

Mr. KETCHUM. Thank you. Good afternoon, Chairman Reed, Ranking Member Allard, and distinguished Members of the Subcommittee. I want to thank the Subcommittee for providing this opportunity to address how the impending consolidation of the NYSE Regulation's member regulation functions and NASD will impact the securities industry and investors.

For decades, there have been multiple self-regulatory organizations, or SROs, to oversee the largest broker-dealers in the United States as well as other broker-dealers that have chosen to be members of both organizations. To protect investors and ensure confidence in our securities markets, the SROs were, in effect, deputized to work in the front lines of America's capital markets. Under the supervision of the SEC, New York Stock Exchange Regulation has played a significant role in the oversight of our Nation's largest brokerage firms and policing our markets.

Three years ago, I accepted an offer to serve as the New York Stock Exchange's first fully independent chief regulatory officer. The creation of my position was part of sweeping reforms that were

launched after the independence of regulation at the NYSE had been questioned.

Then, in April 2006, the merger of the New York Stock Exchange and Archipelago Exchange was completed, and the NYSE Group became a public company. To further ensure our independence, NYSE regulation was organized as a separate, not-for-profit corporation, wholly owned by the NYSE Group, but with its own majority independent board of directors, which I reported directly to.

I believe strongly in the value of self-regulation. In simplest terms, self-regulation offers the benefit of greater expertise in the capacity to leverage Government resources. But self-regulation must be efficient for the benefit of all parties, including the securities industry, capital markets, and investors.

In the past 3 years, working with NASD, we have achieved significant results in reducing duplicative regulation of brokerage firms that are members of both of our respective organizations. For more than a year, we have worked with the NASD, working particularly with the leadership of Mary Schapiro, and securities industry representatives on an ambitious program to harmonize our rules. But it became apparent that we could do even more.

That recognition led the New York Stock Exchange Regulation and the NASD to announce last November that we would combine our member-related regulatory functions into a new regulatory organization—the first major reform of the self-regulatory system in 73 years. Clearly, it is an idea whose time has come. I will serve and am pleased to serve as the Chairman of the Board of the new organization while also continuing on as the CEO of New York Stock Exchange Regulation, and as you know, Mary Schapiro, NASD's current Chairman and Chief Executive Officer, will run the new organization as CEO.

A word about Mary. I have had the privilege of working off and on with Mary Schapiro in numerous positions over a period of almost 25 years. She is a superb professional, enormously passionate about protecting investors, with tremendous leadership capabilities. I cannot imagine anyone more qualified to be the CEO of this new organization, nor anyone I will be more pleased to lead the board in helping to work with.

Approximately 470 of NYSE Regulation staff and member regulation, arbitration, risk assessment, and related enforcement units will join the new organization. Going forward, NYSE Regulation will be comprised of the Division of Market Surveillance, related enforcement staff, as well as our Division of Listed Company Compliance, ensuring that companies listed on the NYSE and NYSE-Arca meet their financial and corporate governance listing standards.

Our joint proposal with NASD is to create a single new self-regulatory organization that will be the private sector member regulator for all securities brokers and dealers that do business with the public in the United States. Under the strong oversight of the SEC, self-regulation will continue to play a vital role in the U.S. capital markets. Ultimately, there will be a single set of rules, one set of examiners, one set of interpretations, and one enforcement staff. The combined staff will have more time to ferret out wrongdoing when freed from the task of coordination or interpretation of

inconsistent rules. Firms will no longer be able to take advantage of subtle differences in rules and exploit different interpretations by the staff of the two SROs. This provides not only a direct benefit to the securities industry, but also directly to investors.

Importantly, NYSE Regulation will continue to play a vital role, both in overseeing the trading on NYSE markets and NYSE-listed securities and ensuring the regulatory integrity of our listing programs. These activities do not present the issue of regulatory duplication that we confront in member firm regulation. In addition, they are activities that are best performed within NYSE Regulation so that regulatory systems and processes can be developed and improved in real time and in close coordination with changes in the trading systems or rules or listing requirements.

I feel honored to have been part of the revitalized NYSE Regulation at a time of incredible change, but this new SRO for member firm regulation is an idea whose time has finally come. By combining the enormously talented staffs of NYSE Regulation and NASD, we will be able to meet the challenges of tomorrow.

Mr. Chairman, thank you for the opportunity to testify today.

Chairman REED. Thank you very much, Mr. Ketchum.

We will do 8-minute rounds of questioning, and we would be happy to entertain a second round if there are additional questions, and let me begin.

To both Ms. Schapiro and Mr. Ketchum, one of the obvious points of the merger is streamlining, combining rules and regulations, simplifying. All of that should result in cost savings and should accrue to the members and to the stability and the effectiveness of the market. But one other aspect, an overarching aspect, is: How will this improve the overall effectiveness of the organization? And, most particularly, how does it better protect investors? And I wonder if you might comment, Ms. Schapiro, and then Mr. Ketchum, on that point. This merger might be very appropriate when it comes to the savings to the industry and firms. We all collectively have to ensure it protects the consumers.

Ms. SCHAPIRO. I absolutely agree with you, Mr. Chairman. I think that one of the major ways that this approach really truly benefits investors is that it is an opportunity to leverage resources. To the extent—and I can give you a very specific example that both the New York Stock Exchange and NASD spend millions and millions of dollars a year developing technology to support our individual regulatory programs. Each of us has over 100 software applications that support regulation. Many of them do virtually the same thing. They just do them for two different SROs.

We can merger our technology platforms and save significant money there that can then be leveraged into other regulatory initiatives, training for our examiners and our enforcement staffs, or creating even more feature-rich technology to support the regulatory program.

So the ability to eliminate duplicative costs gives us the ability to leverage precious resources much more effectively in the interest of investor protection.

Chairman REED. Thank you.

Mr. Ketchum, your comments, please.

Mr. KETCHUM. Well, first, I entirely agree with Mary Schapiro. We live in a world of finite resources for everything, including regulation. Those resources should be focused as efficiently as they can be on investor protection and ensuring market integrity, and this merger, for exactly the reasons Mary indicated, does that.

I also want to assure you, Mr. Chairman, as you properly raise—and to some degree, questions have been raised in the variety of testimony submitted—that the focus in developing a single set of rules, we will be tremendously attentive ensuring that what we have is rules that are clear, can clearly be followed by brokerage firms. Clear rules that can clearly be followed consistently will result in better protection for investors. But we will be very careful to ensure that what we get continues to be the most effective supervisory environment and rules that protect investors that exist in the world. And I can say clearly that both from the standpoint of myself and Mary that nothing is more important to us than maintaining that level of investor protection.

Chairman REED. Thank you very much.

Mr. Sirri, both myself and Senator Tester in our statements basically raised an important question: the role of the SEC not just in terms of the preliminary steps of the merger, but for several years thereafter, supervising a new single SRO.

The first question: Do you have all the legislative authority that you need to deal with this merged SRO?

Mr. SIRRI. Yes, we believe we do. Our oversight of this process will come in a variety of ways. For example, as the two rule books come together, the new SRO will be required to file their new rules with the SEC. Those rules will be published for notice and comment. That means that the industry, investors, and other members of the public will be able to comment on those rules and that the Commission staff will evaluate those rules in coming to their opinion about how well those rule books are coming together.

Second, as that merged entity comes together and as it operates in the ensuing years, as you point out, the Commission has a staff in the Office of Compliance, Inspections, and Examinations whose job it is to evaluate the effectiveness of those rules, how well they are working, whether the staff of the new SRO is adhering to their new policies, their new rules.

That is something we will take very seriously. I will work with the director of that office, Laurie Richards, to make sure that, from a policy perspective, the policy issues are actually being examined effectively by that office.

Chairman REED. Mr. Sirri, part of it is not only the authority, which you indicate you feel comfortable with, but also the resources. Particularly as these organizations come together, I can imagine there will be some novel issues that arise, or at least issues that are not routine.

Do you have adequate resources now? And do you have the long-term commitment of the Commission to maintain those resources?

Mr. SIRRI. I think the pattern of resource use is going to be unusual. I think there will be a relatively high use of resources early on as we deal with the combined rule book and, as you point out, some novel issues.

I believe in the long run that, as Mary Schapiro and Rick Ketchum both said, the actual use of resources and the demand on resources will be actually less because of the more effectiveness—the greater efficiency and effectiveness of the combined single SRO.

So, yes, I do believe we do have the resources. It may take a little shuffling around and management, but I do not believe there is any shortfall.

Chairman REED. You indicated you have a certain degree of leverage, for want of a better term, when the rules are submitted, about the practices. Will you have the ability to look at the budgets of this combined entity and make a determination whether savings are, in fact, being reinvested into consumer protections in any way, shape, or form?

Mr. SIRRI. Well, as you know, we take our mission of investor protection very, very seriously. From the budgeting perspective, the main way we look at these issues is not so much by looking at costs at the SRO, but by looking at the fees that they file. There is a standard for fees that has to do with an equitable allocation of reasonable dues, fees, and other charges. That is something that we evaluate as a staff. So when the new SRO, for example, asks for a change in fees, as they may, then we would notice those, put those up for public comment, and evaluate those fee changes in light of the needs and the specific circumstances.

Chairman REED. Thank you.

Mr. Ketchum, one of the points that you raised in your testimony was the fact that this is a consolidation of most functions, except you maintain market surveillance of the stock exchange, although the new combined SRO will, as I understand the transaction, maintain member regulation. Is that accurate? And so the question I think is, obviously—and you suggested, at least alluded to it—is why this residual separateness in terms of regulation.

Mr. KETCHUM. Well, not surprisingly, market integrity is absolutely critical to the New York Stock Exchange. The exchange, although it is a swiftly changing marketplace, remains a hybrid and a *sui generis* marketplace as to how it operates. The proper application and interpretation of its rules, effective market surveillance to ensure absolute investor confidence with respect to trading that occurs at the exchange, is a critical part of what the exchange has offered historically and cares greatly about today. And it is the area of market surveillance and the ability to use the knowledge that I think our staff uniquely has with respect to that market, the ability to participate in the development of technology, to ensure that the proper rule compliance is considered as that technology is developed from a trading standpoint, all that is very important in the exchange, and those are all reasons why we feel that while it is time to combine member regulation and ensure a single entity and operating it with respect to markets, both the New York Stock Exchange and the wide range of competing markets in the United States, it makes sense for market surveillance to still reside with those marketplaces.

Chairman REED. Thank you very much.

Senator Allard.

Senator ALLARD. Mr. Chairman, thank you.

In my opening statement, I mentioned the small brokers and dealers and the fact that they are concerned about the merger. I wonder if you could share with the Committee here how you plan on taking them into account as you plan the merger. And how do you plan to address their needs in the rule book? And then, finally, how are you going to do this without creating basically two systems? And maybe Ms. Schapiro as well as Mr. Ketchum can both talk about that.

Ms. SCHAPIRO. I would be pleased to start, because most of the small firms are NASD members and are not current New York Stock Exchange members, so we have a long history of working closely with smaller broker-dealers. I would like to mention just a few things in that regard.

For example, we have a small firm advisory board that advises the staff and the NASD board on issues that are of importance to small firms so that we can understand that while the regulatory burden has clearly ramped up over the last several years and creates unique burdens on smaller firms, exactly what those burdens are and how we can help ameliorate them without compromising basic investor protections.

Earlier this year, or late last year after I became CEO, I created an Office of Member Relations, which is staffed with people, including a former CEO of a small broker-dealer, to reach out to small firms, to travel to their offices, talk to them about their issues, bring their concerns and issues back to the NASD so that we can try to address them as proactively as possible.

We are going through a process now where, with the assistance of a small firm task force, we are reviewing all NASD rules that are going through the harmonization process with New York to have sort of a small firm lens applied to those rules and to understand where exemptions might be appropriate for small firms or other less burdensome ways to implement rules would be appropriate.

Then, finally, two other points I would make. We have produced many tools and compliance programs to assist small firms in meeting their regulatory obligations, so that in the area of anti-money laundering, for example, where a small firm is really hard pressed to go out and hire a consultant to develop a money-laundering prevention program, we have developed a plan and a template for them to use and to provide a basic structure for them. And we have done that in a number of different areas. We host many educational programs, including webcasts and podcasts on regulatory issues geared toward a small firm audience.

And then the last thing I would say is that we have explicitly in recent months taken into account when we are levying sanctions against a small firm for rule violations, we have required the adjudicators of those violations to take into account a firm's size and revenues when assessing a fine so that we do not put small firms out of business with big fines where those are not appropriate.

As we go forward, we will remain incredibly focused on small firm issues. I very much am of the belief that investors need a choice in the kind of financial intermediary they go to, and in many communities across this country, having a small firm there and someone you can talk to face to face is very important. And our

goal is to maintain that wide diversity of business size in our financial community.

Senator ALLARD. Now, I think you also talked in your testimony about the savings mentioned in tens of millions of dollars. Can you be more specific in how those savings are achieved?

Ms. SCHAPIRO. I would be happy to. Clearly, for the firms that are dually regulated, that are members of both New York and NASD, there will be many in-house, so to speak, savings from not having to keep up with two sets of rules, two sets of examinations, and so forth. I really could not quantify those savings.

I believe a large amount of the savings for the consolidated SRO will come from the combination of the technologies that I spoke about earlier. We each are supporting over 100 applications to support regulatory programs. The number of applications the joint SRO will need—it may not be 100, but it is certainly not going to be over 200, and so by being able to retire some applications and invest going forward in a single set I think will amount to cost savings.

There will also be some attrition in staff, we would expect, over the years, and right-sizing.

Senator ALLARD. I suspect probably the most sensitive issue is the issue of fees, and give us some idea of how you are going to apply fees to a smaller operation versus a bigger operation.

Ms. SCHAPIRO. I would be happy to talk about that, and as Erik Sirri pointed out, fees are filed with the SEC.

As part of the consolidation agreement and in order that all firms can share in the financial benefits and synergies that we think the consolidation will realize, we actually intend to grant a moratorium—not a moratorium, but a reduction in the gross income assessment, which is the primary fee that is paid by firms to the NASD of $1,200 a year.

What that means is that for the next 5 years, about 2,800 small broker-dealers will pay no annual membership fee to the NASD for their services. When we do fee filings and when we review them on a periodic basis, we do it with great sensitivity to the burden that they create for small firms.

Senator ALLARD. Yesterday, the Senate Appropriations Subcommittee on Financial Services and General Government held a hearing with Chairman Cox. At that hearing I asked him about the budgetary implications of the merger. He indicated that he believed the agency had requested a sufficient budget to oversee the merger.

He also took that opportunity to say that he believed the consolidation of the regulatory functions of NASD and NYSE will make it easier to track fraud across markets. And he continued on to note, "We will be much more efficient in tracking down fraud."

As Chairman Cox described, it can be difficult to stop fraud when the sheriff has to stop at the border, and this merger will help eliminate that border. Do you agree with his assessment that the merger will help eliminate fraud? Maybe I would have the panel in general speak about that.

Mr. KETCHUM. I think the Chairman is absolutely right. Anytime you can have a single examination team focused on ensuring that nothing drops between the cracks, you increase the ability to detect and identify fraud by using your resources more efficiently. And I

think this merger, as Mary indicated earlier, puts together a range of knowledge and expertise as well as allowing us to identify the most effective technology systems used by both self-regulatory organizations.

So by eliminating risk that things fall between the cracks, providing a more efficient environment where we can spend more of our time, more of our examiners' time looking and identifying where there may be securities law violations, we do place ourselves in the better position to identify serious wrongdoing, and I think that is clearly one of the most important things about the merger.

Ms. SCHAPIRO. I agree completely with Rick. I think that whenever we can take a fragmented regulatory approach and fragmented data and consolidate it and bring it together and have a better view of the marketplace as a whole, we will be much more effective with respect to catching fraud.

Senator ALLARD. Mr. Sirri, anything you want to add?

Mr. SIRRI. Yes. I would just like to say I agree as well. Chairman Cox in another setting has observed that today a lot of fraud occurs outside the United States—the perpetrators are situated outside the United States, but, in fact, the occurrence is inside the States, making it difficult to catch. And I think that simple example carries over within the United States.

Senator ALLARD. You will have to repeat that statement.

Mr. SIRRI. Sure.

Senator ALLARD. Fraud occurs outside the United States, but the victims are inside the United States? Is that what you were saying?

Mr. SIRRI. Exactly. And the point of the Chairman's statement——

Senator ALLARD. That is easy to believe.

Mr. SIRRI [continuing]. When he made it was that we as a Nation have a hard time getting our arms around those people in a rapid way. And I think that same point carries over here. Individuals who engage in fraud do not often restrict themselves to just exchange-traded markets or just the over-the-counter market or just the options market. Often they will engage in a transaction or a series of transactions that encompass all those markets. One of the benefits of this consolidation is that a single regulator, this new SRO, will have oversight over listed markets, exchanges, over-the-counter markets, broker-to-broker transactions, as well as, say, options markets. All of that will be under one roof.

In addition, not only is that oversight under one roof, but all that information is under one roof. Oftentimes you could see a transaction here or a transaction there. You cannot hook them together. By having that all in one place, you can put the pieces of the puzzle together, making it more likely that you uncover that fraud.

Senator ALLARD. I see my time has expired, Mr. Chairman. Thank you.

Chairman REED. Thank you very much, Senator Allard.

Senator Tester.

Senator TESTER. Yes, thank you, Mr. Chairman.

Mr. Ketchum talked about dozens of SROs. Mr. Sirri—or Mr. Ketchum, it does not matter—are NASD and New York Stock Exchange the last two standing, or are there other SROs out there?

Mr. SIRRI. No, there are other SROs out there. Most exchanges are SROs. Other entities such as clearing agencies are also SROs, the Municipal Securities Rulemaking Board.

Senator TESTER. Is there overlap with those with these two, also?

Mr. SIRRI. The key distinction here is that the combination of these SROs involve member firm regulation.

Senator TESTER. OK. Can you give me an idea how much overlap—Ms. Schapiro or Mr. Ketchum, how much overlap currently exists between the two SROs?

Mr. KETCHUM. Well, perhaps I can start and Mary can add in. The exchange has approximately 400 members; 170 of those members are both members of the New York Stock Exchange and the NASD. Those are, as a generalization, the largest firms in the United States, and they account for well over 90 percent of the total securities accounts, for example.

So of the total activity, there is a very significant amount of the total activity in the securities market which we are both looking at from the standpoint of sales practice violations and the like. So while we do our best to harmonize, there is a significant overlap.

Senator TESTER. OK. Ms. Schapiro, you talked about transition, but I did not catch how long. How long do you anticipate this transition to take?

Ms. SCHAPIRO. Well, we talk about transition in the context of the initial board of directors for the new organization will be in place for 3 years, and Rick as Chairman of the board, yet still chief regulatory officer in the New York Stock Exchange will be in that role for 3 years. After the initial board elections and the 3-year period expires, the organization will obviously be fully functioning and go through a normal governance election process.

We think the combination of the rule books will take some time, because it is a careful process and we want to make sure we get it right. That will take, I would guess, about 18 months for us, optimistically, to conclude.

Senator TESTER. Can that go on during the 3-year period or are you talking over and above the 3-year period?

Ms. SCHAPIRO. Oh, no. Someone should call us up here and take us to task if by the time the 3-year period is over we have not concluded a dual rule book.

Senator TESTER. OK. Mr. Sirri, do you have input into the bylaw rewrites?

Mr. SIRRI. The bylaws were up for a proxy vote. They were noticed and commented, and then they will be approved by the Commission. So the Commission itself has a say in the approval of those bylaws.

Senator TESTER. OK. Thank you.

Ms. Schapiro, I think it was Mr. Sirri that pointed out that generally folks thought this was a good idea, but some of the small firms, as Senator Allard pointed out, had some problems with it, as well as the Commonwealth of Massachusetts. With the education you are doing and with the reduction in fees and elimination of fees in a lot of cases, what is really the rub here?

Ms. SCHAPIRO. We have worked very hard to structure a consolidation and a governance system that we think will serve firms of all sizes, and particularly serves well small firms. The primary

complaint that we have heard—and I should say that we went out across the country. We met with firms in 28 cities to explain the transaction, to receive their questions. We were available during the entire voting period to explain it to them and to work with them.

The primary concerns have been the governance structure. Small firms currently only have one seat dedicated to them on the NASD board, but they broadly elected the entire board. All firms elected the entire board.

The new structure dedicates three seats to small firms, but they only vote for the small firm representatives. Large firms will vote for three large firm representatives. Intermediate size firms will vote for their representative.

Senator TESTER. Do you think it is a valid concern?

Ms. SCHAPIRO. I understand the concern, but I think we have worked very hard to structure an extremely fair governance model.

Senator TESTER. OK. And any of you three can answer this, but it is directed at Ms. Schapiro. What is the downside of doing this?

Ms. SCHAPIRO. The downside of doing the consolidation?

Senator TESTER. Yes.

Ms. SCHAPIRO. I have to be very honest. As I said, I have been a regulator for 25 years in the commodity side of financial markets, the securities side at the SEC, the CFTC, and the NASD, and I have seen every model of regulation, I think, that exists, and I do not see a downside. With strong SEC oversight and very committed and expert staffs, I really only see upside.

Senator TESTER. Mr. Ketchum, do you see it the same way?

Mr. KETCHUM. I do not see a downside. I see challenges, which I am fully confident that Mary and her staff will be up to. This is putting together—this is a significant integration that needs to ensure that we do truly put together the best of both organizations and that we really develop a single rule book that both addresses burdens, ensures protection of investors, and recognizes where there are different firms and different situations from the standpoint of small and large firms. Those are challenges; this organization will be up to them.

Senator TESTER. OK. Mr. Sirri?

Mr. SIRRI. This is a question that is out for comment for us and that the Commission will be developing an opinion over time.

Senator TESTER. OK. The last question, and I want to thank you folks for your concise answers. I really, really appreciate that. The question, I guess, is directed to Mr. Sirri. When Mr. Reed asked you about if you had the authority, you said yes. Then he asked if you had adequate resources in the short term, and you said yes. And then you potentially made the error—and it is not, by the way—of saying that long term this may require less work. Do you see, long term, a cost savings here? And what would you anticipate on a percentage basis that cost savings might be?

Mr. SIRRI. Well, hopefully it was not a mistake. I was serious——

Senator TESTER. No. I agree, and I appreciate that. I appreciate your candor.

Mr. SIRRI. I think that is the sense in which there is real efficiency here. I want to say I can always make good use of those resources for the benefit of investors, though.

But, that said, I think those savings are going to come from a reduction in—really an efficiency in the way we use our people to oversee this group, this set of activities. For example, when it comes to inspections, we had to inspect before two different SROs, which would each engage in the same set of functions. Now there will be one, and one team.

Senator TESTER. So it will ultimately be a savings on a couple different levels—the SRO level and your level.

Mr. SIRRI. We are hopeful. If things work well, that is what I would anticipate.

Senator TESTER. OK. And I assume this is self-funded. I assume the SEC is self-funded through—not through taxpayer dollars.

Mr. SIRRI. No, we are not a self-funded organization.

Senator TESTER. All right. Well, I appreciate efficiency for sure. I guess I fibbed. One last question. You do not have to spend a lot of time on this, but it is always interesting to me, in the worldwide economy that we live in, how you deal with regulation on worldwide transactions. And if there is fraud that deals with somebody in another country of a company in your organization, is that let go and you only apply it to U.S. citizens, U.S. companies? Or how is that handled?

Ms. SCHAPIRO. For NASD and as I recall from my SEC experience, it is dealt with through cooperative efforts with the foreign regulators, wherever either the fraudulent conduct took place or the person who perpetrated the fraud is resident. And that is why it is so important for regulators to have basic understanding of each other's regulatory regimes and close working relationships around the world.

Senator TESTER. Thank you very much. I appreciate the panel today. Thank you.

Chairman REED. Thank you very much, Senator Tester.

Senator Bunning.

Senator BUNNING. Thank you.

Mr. Sirri, is there anything about this merger that has not been resolved that causes you concern?

Mr. SIRRI. Well, as I said, right now we have—the proxy and the rules are out for comment, so we are collecting comment. So it probably would not be appropriate for me to comment right now as a staff member, but in the coming weeks, we hope to come to a conclusion as a Commission and make some statement on that.

Senator BUNNING. When is the comment period over?

Mr. SIRRI. The comment period has already concluded. There have been almost 80 letters that have been received. We are evaluating those letters now and coming to the conclusion.

Senator BUNNING. The comment period is over, and then how long do you have?

Mr. SIRRI. My anticipation is that we would come to a conclusion in about a month. As a staff, we would make a recommendation up to the Commission in about a month.

Senator BUNNING. I have looked at the numbers of people involved in the NASD: 5,100 brokerage firms, 663,000 registered representatives. That is the NASD. And the New York Stock Exchange has—let me read this. Four hundred New York Stock Exchange broker-dealer firms have been registered by the SEC, and approxi-

mately 180 of those are both NASD members and New York Stock Exchange members. Is that accurate?

It seems to me that the small, the little broker-dealer—and I am talking about the guy out in Richmond, Kentucky, that has a two-office shop or a two-person shop that is a member of the NASD presently is going to have a devil of a time understanding what the heck you are doing in New York. Ms. Schapiro?

Ms. SCHAPIRO. I would love to respond. You know, NASD has been around for almost 70 years.

Senator BUNNING. Yes.

Ms. SCHAPIRO. And during that period of time, we have learned and worked closely with many, many small firms around the country because, as you correctly point out, many of our members are, in fact, small firms. We have to work with the largest financial institutions in the world on one end of the spectrum and a couple of thousand very small broker-dealers who may have less than ten employees.

Senator BUNNING. My big concern is fitting that into one playbook.

Ms. SCHAPIRO. I actually believe that the playbook—it will be easier to have a tiered regulatory structure when we have one rule book in place rather than two potentially dueling rule books. And we have made a commitment and actually have already begun to effectuate the commitment of ensuring that rules that impact small broker-dealers disproportionately—particularly rules that do not go to core investor protections—we will find a way to make them fit the smaller firm business model. We do not believe in one-size-fits-all regulation. I guess that is the distinct way——

Senator BUNNING. That is my big concern.

Ms. SCHAPIRO. We have understood that for a very long time, and we clearly understand that in this new environment. We have a small firm advisory board that works closely with the staff to advise us on issues that impact small firms. We have a small firm rules impact task force—again, made up of the CEOs of small firms—that help us look at every rule and understand how we might change it to make it less impactful to small firms while not diminishing the investor protection that is at the core of the rule.

Senator BUNNING. Well, let us put it this way: I lived through this from the early 1960's through the mid-1980's. There were so many mergers and acquisitions going on in the big firms, and the medium and regional firms were all eaten up by the—I mean, most of them were eaten up by the larger and more affluent firms, and instead of having a Cincinnati-based firm, you would have a Cincinnati-based firm that was connected to a New York Stock Exchange firm. And the same thing—we used to have offices of—I worked for a company that had offices in two cities—Cleveland and Cincinnati. That is it. And they were members of the New York Stock Exchange. They did not have a floor trader, but they used somebody to trade for them on the floor. And I am concerned about those kinds of firms, particularly if they do not deal in equities much, if they are a specialty firm that deals in municipal bonds, for instance.

Ms. SCHAPIRO. And we have many firms that are specialized in municipal bonds. You know, it is a very fair point.

I should add that we have 14 offices around the country. We are actually based here in Washington, and, of course, the New York Stock Exchange is based in New York. But we have 14 offices around the country, and the major reason for that is so that we could be close to the firms throughout the country and be able to work with them, do the examinations, work with them on preventive compliance programs, be closer to the customers as well. And that basic structure will not change. We will maintain a nationwide presence so that small firms have a face at the NASD or at the new SRO that they can always associate with and talk to in the form of our district office directors and our district staff.

Senator BUNNING. I can see UBS Warburg having a compliance officer and someone who is in charge of making sure that we are complying with your book. But I have a devil of a time understanding how a firm that has five broker-dealers and two offices has the same type of a compliance officer that would be as good and make sure that all the regulations that the NASD and/or the New York Stock Exchange, if they have a connection with the New York Stock Exchange, would comply and have that person on the site every day making sure that you as a broker-dealer are complying and so that your customers are not getting the short stick.

Ms. SCHAPIRO. Well, you are right. Many of the smallest broker-dealers do not have the resources to have a dedicated full-time compliance officer onsite in their offices. They are still responsible for ensuring that they have compliance with the rules, and sometimes it is the CEO who takes on that responsibility or the office manager. But we also work with those firms to try to give them some of the tools to help them stay in compliance, whether it is trade reporting or books and records or supervisory controls. We really work with firms, our theory being that if they can get it right in the firm, if they can take care of their compliance and regulatory obligations, at the end of the day the customers will be best served by that.

Senator BUNNING. You know, those same firms could be in a selling group. They could be in a group that underwrites. And I worry about the ability of them to control the leakage so that we do not have insider traders and we do not have small firms that have the same knowledge that UBS does or someone like that, and the information is going out just to two people.

Ms. SCHAPIRO. Well, with respect to insider trading—and Rick can speak to this as well—both NASD and New York have very sophisticated surveillance technologies that can actually detect very small amounts of insider trading. And over the years, we have each made several hundred referrals a year.

Senator BUNNING. Well, we have missed some, haven't we?

Ms. SCHAPIRO. Oh, without a doubt. Without a doubt. There is no system that catches everything. But insider trading is one of those areas where technology has really benefited the program.

Senator BUNNING. But, see, the least bit of insider trading and the least bit of leakage like that, public confidence in the markets is damaged constantly from that.

Ms. SCHAPIRO. I would agree with that, and it is one reason that this consolidation will actually benefit the regulatory structure——

Senator BUNNING. So you think you can do it better with fewer people?

Ms. SCHAPIRO. I do not know that we will be doing it better with fewer people. We will be doing it better with less money spent on duplicative technologies.

Senator BUNNING. I understand that part.

Ms. SCHAPIRO. And overlapping. I think we can do it better with people who are expert, where we bring different expert people together——

Senator BUNNING. Are you going to be able to do the same amount of going around and making sure that your 14 offices are able to——

Ms. SCHAPIRO. Oh, yes. Our examination program out in the field will not change. We will continue to go into every broker-dealer on a periodic basis, as we do now and as the SEC closely over——

Senator BUNNING. Yes, they used to come and sit in our offices. I remember very clearly.

Ms. SCHAPIRO. That program will not change with this. What will change is those 170 or so firms that now host examiners from both New York and NASD will get one.

Senator BUNNING. Yes, will get one. But will they get a good, thorough exam? That is what I——

Ms. SCHAPIRO. Yes.

Senator BUNNING. OK. Thank you very much, Mr. Chairman.

Chairman REED. Thank you, Senator Bunning.

I have two questions, and then I will recognize Senator Allard. Much has been made and Mr. Sirri referred to the comments about the governance, and the comments seemed to be coming from the industry. But there is the issue here of the independence of the proposed board. In effect, the majority of the members will be either elected by the industry or be the Chair and the CEO and the non-executive chairman.

Professor Coffee notes in his testimony that the New York Stock Exchange requires all of its directors to be independent, an entirely independent board.

So, Mr. Ketchum and Ms. Schapiro, your comments on the independence of the board, and then I would like Mr. Sirri to comment and see if there are concerns that he has with respect to the proposed board.

Mr. KETCHUM. Well, thank you, Mr. Chairman. Let me start, since I do have the experience of having worked for numerous years at the NASD and now have been involved in the creation of the requirements of the New York Stock Exchange as a fully public board.

I think that the requirement that no member of the board of the New York Stock Exchange, and certainly of New York Stock Exchange Regulation, should have any affiliation with a brokerage firm. Given the unique issues of the exchange operating as a for-profit corporation and taking on, as it is required by statute, serious regulatory responsibilities, both from the standpoint of enforcing rules and also just operating a marketplace that is absolutely critical to investors going forward justifies a standard of having a fully public board. That does not mean that the exchange both from the business side and from my side and the regulation side does

not work very closely with the industry and ensure that they have an advisory role to make sure that our regulations and the way we design systems are sensitive to their needs. We do and we should.

I would say my experience from working at the NASD and my experience of what I expect in this new board is that this balance will work. I do not think that Marc Lackritz, whom you will hear in the next panel, or other people in the industry will have much trouble distinguishing Mary and myself from industry representatives, as they count, as to what majority of the board is. I think the majority of the board is truly representative of the public, and certainly from our standpoint, we view ourselves as our representation is for good governance and to protect investors.

I do believe there is, with respect to an organization that is separate from a marketplace, a benefit in having direct participation of the industry on the board as long as that participation is not a control position. It allows the industry to be able to identify issues from a regulatory standpoint. It often allows the industry members to be able to cut through excuses or suggestions that, because of their expertise, they are more able to cut through.

So I believe the design as it exists that both represents firms of all sizes and ensures that they all have a voice, but absolutely make sure that this board is independent from a decisionmaking standpoint and the majority of persons do have as their sole responsibility the public and statutory responsibility of the new SRO, it will give you exactly the type of oversight and self-regulation that Congress appropriately should expect.

Chairman REED. Ms. Schapiro, do you have a comment?

Ms. SCHAPIRO. I really agree completely with what Rick said. I think what we have is a hybrid governance structure—the old NASD such and the old New York Stock Exchange Regulation structure—and we really combined it to create something that will have diverse and robust industry participation but will not be in control. There will be a majority of public directors.

Between us, I think Rick and I have somewhere north of 50 years of regulatory experience, so I would agree that few people would characterize us as "industry" or "non-public" members of this board.

Chairman REED. Mr. Sirri, do you have a comment?

Mr. SIRRI. Just let me make two points.

First, I have known Mary and Rick for a long time, and I have a great deal of confidence in their work and their ability to be serious about this. In our role as an overseer of the SROs, we intend to take these issues very seriously and, as I said, are monitoring even now what is going on.

I want to make one specific comment, though. The nature of this board is one in which it is tiered and there are small, medium, and large firms with separate representation. I think that is at the heart of your question. I want to point out that is not the first time something like this was done. In a slightly different circumstance, for the ISC, one of our options exchanges, the board structure was set not with an eye toward firm size but with an eye toward the nature of the firm and the nature of their business. There were various kinds of brokers that brought business to that exchange, and so the board was tiered where there was separate representa-

tion from each category or type of broker on that exchange that were members, the non-public members.

But the point is that this approach they have taken, which I think is reasonable, is not the first time it has been done. The balance that was struck is one of representation and closeness to the industry where you are balancing off what I think you are citing as potential for lack of independence.

Chairman REED. A final question. I will direct it at Mr. Sirri, but Ms. Schapiro and Mr. Ketchum might want to comment. The description you had of the process of SEC in some respects could be interpreted as somewhat passive; i.e., the rules are presented to you, comments are made, and you will talk to people and sort of negotiate.

But there are probably areas where proactively and together you might be able to forge better rules; rather than waiting to be told, you might have some suggestions. One area is arbitration, which always seems to be an area of debate, issue of fairness, issue of representation. Here you have, as you point out, 90 percent of the arbitration is already done by NASD, but there was always that other option, et cetera.

I am just wondering. With that case, but a more general way, are there areas that you want to see rule improvements made and that you are going to work proactively with the merged organization?

Mr. SIRRI. Well, I think there is a distinction here. One is the literal process we go through, which is one in which an SRO files a rule with us, and we generally put it out for notice and comment, and then it is approved. That probably should not—and I take your point. You should not infer, however, that we are passive in that. In fact, I am sure Mary will have a view on whether we have always been passive over time, and probably some folks in the audience, too.

I think we have a fairly activist, an appropriately activist view of our role. We are encouraging when we think it is appropriate to be encouraging of certain changes. That said, there is a process that is in place with filing, notice, and comment.

But, no, I do not think as a group we are shy as a staff about indicating our preferences, but in the end, it is up to the SRO to make that rule filing.

Chairman REED. Ms. Schapiro. Mr. Ketchum.

Ms. SCHAPIRO. The only thing I would add is that arbitration is probably a great example of an area where, as we bring the two rule books together, we will work very closely with the Commission to address issues that are becoming more prominent as the days go on.

Chairman REED. Mr. Ketchum.

Mr. KETCHUM. I would agree with that and would agree with Erik's characterization of the SEC's relationship not being passive. Exhausting, perhaps, but definitely not passive.

Self-regulation truly is a partnership with the SEC. On good days we get along; other days maybe we do not. But on all days, we have a tremendous respect and the SEC has great commitment to ensure that the rules and the enforcement of those rules are done right. The great thing about moving to this single rule book for all persons involved, both industry and investors, is the chance

to dust off and take a hard look at our regulatory structure and ask how it can be better, and that is a process that I expect should involve not only these two great organizations, also the SEC and also the key constituents, both industry and investor, that exist with respect to our marketplaces.

Chairman REED. Thank you very much.

Senator Allard.

Senator ALLARD. I will just make a point. If you follow the testimony in the Appropriations Committee with Chairman Cox of the SEC, I would emphasize the importance of the PART program, which is basically setting measurable goals and objectives and following through to measure performance. And so I am one who will follow that closely, so as you go through this reorganization, you expect some follow-up from me in that regard.

My question to you—and this is the only question I had, Mr. Chairman. Mr. Sirri, you had mentioned that you had some 80 comments or so that you received in your office, and as a result, because of that, you did not feel it appropriate to make any comments at this point in time. But the board members have made comments and indicated their strong support.

Is that appropriate for them to do that before you have reviewed those comments?

Mr. SIRRI. I am not sure there is any issue with the board members making comments. I think my comment was strictly for ourselves. As a staff we cannot—I am not sure——

Senator ALLARD. Their minds are already made up, and so are the—the fog, I am sure, that comes across some people's minds, if they have already made up their mind, why in the world are we submitting comments?

Mr. SIRRI. Well, I think broadly they have been very supportive of this transaction. The differences, as I understand what the board members have said, have been on some of the details of it. The board members, as I have listened to and read about what they have said, have been very broadly supportive. Maybe Mary would have something to say about whether it is appropriate or not.

Ms. SCHAPIRO. For the Commission to speak to these issues?

Senator ALLARD. Yes.

Ms. SCHAPIRO. I thought you might not have understood exactly the question, but it is appropriate for the Commission, I think, to speak—not on the specific rules that are pending before them until it is the appropriate time to make decisions after the staff recommendation and the comments have been summarized and absorbed. But it is certainly not inappropriate to speak in support of the transaction in the sense of a streamlining of the regulatory effort. The Commission actually spoke to this issue in some proposed rulemaking, and a concept, or at least it did several years ago, on the structure of self-regulatory organizations. I believe it spoke to it to some extent in the Arca order.

So it has been a view I think shared by many members of the SEC over a long period of time that rationalizing the regulatory structure would be a benefit to U.S. markets and U.S. investors.

Senator ALLARD. OK. So you are comfortable that nobody has put themselves in a position where they cannot objectively look at any

evaluation that comes out of those comments because of public statements.

Ms. SCHAPIRO. I certainly do not think so, but I am not the judge, really.

Mr. SIRRI. Yes, I apologize. I misunderstood your question. I was interpreting you as commenting on the NASD board.

Senator ALLARD. Well, any board out there, I guess.

Mr. SIRRI. I do not think there is any problem with that. The Commission maintains an open mind. They evaluate comments as they come in. There has been an ongoing dialog about SRO structure for some time. It began with a concept released by the Commission. The SIFMA submitted a white paper. So there has been an active dialog for a period of time, and so I think those are just comments in the spirit of that ongoing dialog.

Senator ALLARD. Very good.

Thank you, Mr. Chairman.

Chairman REED. Thank you, Senator Allard.

Thank you for your excellent testimony. Let me remind you that Members of the Committee may have questions in writing which we would submit to you and ask you to respond as promptly as you could.

Let me call forward the second panel, and also we are expecting a vote in about 15 or 20 minutes, so I think this will give us an opportunity to get the testimony of the second panel, and then we might have to recess for a moment while we vote. But we will return for questions. But let me thank the first panel for their excellent testimony.

Well, let me thank the second panel for joining us today. Thank you very much, gentlemen. I will introduce the panel now, recognize you for opening statements, and then we will wait on the timing of the vote to see if we go right into questions.

First let me introduce Mr. John Coffee. Mr. Coffee is the Adolf A. Berle Professor of Law at Columbia University and Director of its Center on Corporate Governance. He is a fellow of the American Academy of Arts and Sciences and has been repeatedly listed by the National Law Journal as among its 100 most influential lawyers in America. He is an international authority in terms of securities and has testified before Congress. He worked closely with this Committee with the drafting of Sarbanes-Oxley. We thank you for your work, particularly Title V. Professor Coffee has been a member of the Legal Advisory Board to the New York Stock Exchange, the Legal Advisory Board to the NASD, the Market Regulation Committee of the NASD, and the Economic Advisory Board to Nasdaq. So it is quite an impressive and extensive participation. Before entering his teaching career, he practiced corporate law as an associate with the small firm of Cravath, Swain & Moore in New York City, and he is a graduate of Yale Law School and Amherst College. Thank you, Professor Coffee, for joining us today.

Mr. Marc Lackritz is President and CEO of the Securities Industry and Financial Markets Association, the trade association formed in 2006 by the merger of the Securities Industry Association and the Bond Market Association. He was President of SIA for 14 years and was its Executive President and head of the Washington office for 2 years prior to that. Before joining SIA, Mr.

Lackritz was Executive Vice President and head of the Washington office of the Public Securities Association, later renamed the Bond Market Association. He has extensive experience on Capitol Hill and was previously a partner at the Washington-based law firm of Wald, Harkrader & Ross, specializing in litigation, lobbying, and trade regulation. He received his J.D. from Harvard University Law School, a master's degree in economics at Oxford, and a bachelor's degree in public policy from Princeton University. Thank you, Mr. Lackritz.

Mr. Joseph Borg is the Director for the Alabama Securities Commission and President of the North American Securities Administrators Association, the NASAA, an international securities regulatory association. His prior positions at NASAA include membership on the board of directors, Chair of the enforcement section, and treasurer. Mr. Borg is also a delegate to the Intergovernmental Expert Group for the United Nations Commission on International Trade Law to prepare a study on international fraud and the criminal misuse and falsification of identity. He has testified before various committees of Congress and in various areas, and we thank you for joining us today, Mr. Borg.

Let me begin with Mr. Borg, then Mr. Lackritz, then Professor Coffee. Mr. Borg.

STATEMENT OF JOSEPH BORG, PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Mr. BORG. Thank you, Chairman Reed. On behalf of NASAA, I appreciate the opportunity to testify on the merger, and I plan to focus my comments on the element of this hearing's title, that is, working toward improved regulation.

Today, 100 million Main Street Americans buy and sell securities locally through their State-licensed brokers, but as a whole, the financial service industry itself has become increasingly more global in scope. A merger of certain self-regulatory functions does make sense. We hear a great deal about regulatory efficiency, including the recent three capital markets reports. But we must remember that efficiency at the expense of effective regulation is not in our national interest. Our markets will remain strong if our shareholders and investors are confident that, in cooperation with Federal and State regulators, their brokers and the capital markets will be adequately policed by the new SRO.

Scaling back a system of regulation that has vigorously protected U.S. investors for decades could have profound and costly consequences. So while streamlining current rules and regulatory structures may create some savings and efficiency, the needs of investors must come first. With one less regulator dealing with the public, State securities regulators urge the new SRO to demonstrate that any rule changes they propose will protect investors from fraudulent and manipulative acts and practices.

In review of the NYSE's harmonization proposal, we have concerns that the new rules will favor the interests of member firms over the adoption of provisions that protect investors. My written testimony contains several examples which, taken as a whole, appear to reflect a trend to weaken certain rule provisions. This is of great concern to us. Rules harmonization must offer the greatest

investor protection, not the least. This new SRO must be tough and effective and willing to make hard decisions that, in all likelihood, will not be popular with its members. In the past, the NASD has been under great pressure not to embrace some initiatives that serve investors' interests when its members raised objections.

For example, the NASD received pressure when it proposed revisions to its public disclosure system that reveals the disciplinary history of stockbrokers. Initially, its proposal to the SEC included the enhanced disclosure of certain disciplinary history on BrokerCheck. Various NASD members opposed the disclosure of this information. Subsequently, the NASD amended its proposal and removed the enhanced disclosure that the industry found objectionable. The entire disciplinary history is available from State regulators, and it is an essential tool for investors when deciding who they are going to trust with their life savings. The NASD should match State regulators and make the complete history publicly available.

On another subject, NASAA has been at the forefront of trying to make certain the securities arbitration system is fair and transparent to all. The NASD and NYSE dispute resolution forums, although similar, have different rules, procedures, and administrative practices. The new SRO will be the exclusive arbitration forum. That raises the stakes for getting it right.

As long as arbitration panels include a mandatory industry representative of the securities industry and include public arbitrators who maintain significant ties to the industry, the arbitration process will be both perceptively and fundamentally unfair to investors. NASAA urges the removal of the mandatory industry arbitrators from the process and for public arbitrators to have no ties with the industry. This change will bring greater fairness to securities arbitration and instill greater confidence in retail investors that their complaints will be heard in a fair and unbiased forum.

State securities regulators often hear directly from investors, and it is important to allow NASAA to be an official observer at the National Arbitration and Mediation Committee, called the NAMC. These meetings is where it occurs that the new SRO will address arbitration rules and procedures.

The merger of the two SROs will impact State securities regulation, and there must be consultation between the entities involved and NASAA before relevant rule proposals and notice to members are announced.

As referenced in my written statement, there have been instances of proposed rulemaking by NASD that would significantly affect State regulation done without consultation. We believe advanced discussion will generate further efficiencies and streamlining in the development of the new SRO rules.

Currently, the SROs each have surveillance and enforcement programs. Consolidation may result in a less effective enforcement regime if not handled carefully. The following questions must be addressed if the merger is to serve the public's need for strong enforcement:

Will the new entity embrace an aggressive enforcement philosophy that protects the public as effectively as possible from abuses in the securities markets, both in the short and long term?

Will the new entity allocate sufficient monetary and staff resources to ensure that its unified enforcement program is at least as robust as the two current programs that the NASD and NYSE currently operate?

And will the new entity work cooperatively with State securities regulators on enforcement matters?

In conclusion, a strong and effective regulatory structure requires preserving the authority of State securities regulators, it requires a strong SEC, and it requires a tough SRO for efficient compliance. It takes all three working in equal partnership to maintain investor confidence in the world's deepest and most transparent markets.

I believe investors deserve a regulatory system that commands and deploys the resources, expertise, and philosophy necessary to vigorously enforce securities laws and maintain fair and transparent capital markets. State securities regulators are committed to working with Congress, the SEC, and the new SRO to ensure that our Nation's investors continue to prosper in a regulatory environment that provides the strongest of investor protections.

Thank you, Mr. Chairman.

Chairman REED. Thank you very much, Mr. Borg. Thank you.

Mr. Lackritz, please.

STATEMENT OF MARC LACKRITZ, PRESIDENT, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

Mr. LACKRITZ. Thank you, Mr. Chairman. First of all, thank you very much for convening this hearing, and thank you also for the opportunity to testify on the consolidation of the two SROs. We have been strong supporters of this over the years, and we are very pleased that this has come to fruition and pleased that the Committee is taking an active interest in this subject.

We have supported the single SRO because we believe it is a win-win situation for both investors and market participants. A single SRO will provide for far more effective investor protection; at the same time it will ensure more efficient regulation for market participants. It will also improve the quality and vigor of regulatory oversight of the markets rather than diminish it, as some of the critics have suggested.

As such, we believe the single SRO will be a significant step forward toward improving the global competitiveness of our U.S. capital markets as well. Nevertheless, we believe that the single SRO can be strengthened even more. A comprehensive SRO decision-making process which includes expert practitioners will ensure that regulation deals effectively with practical business considerations. In addition, the formation of a single SRO provides a historic opportunity to reassess traditional regulatory approaches so that the U.S. markets remain globally competitive. Achieving this goal we believe will require a more textured approach to regulation, a sound regulatory budget, and continued SEC oversight.

We have long supported a more streamlined and effective approach to self-regulation and are very pleased, as I mentioned before, that this regulatory consolidation will bring the hoped-for change in self-regulation to fruition.

With the single SRO, there will finally be one centrally managed self-regulatory entity to oversee member firms. As envisioned, it will become the largest private sector regulator of our members and will have integrated technologies, a single set of rules for broker-dealer members, one set of examiners, and one examination strategy. It will also more effectively focus existing resources on substantive investor protection at both the SRO level and the broker-dealer level.

For this historic restructuring to reach its full potential, the single SRO should engage in meaningful and regular interaction with all stakeholders throughout the rulemaking process. Consultation with industry participants on the front lines of the marketplace is critical to developing an understanding of the practical implications and the potential burdens that rules may have on the firms to which they are applicable. This model of regulator-industry partnership yields smarter, more effective regulation. It also allows our regulatory system to be dynamic, informed, and responsive to our rapidly evolving and highly complex financial markets.

Of particular interest to our members is the regulatory philosophy that will undergird the single rule book. The question is whether the single SRO should adopt a principles-based versus a rules-based approach to regulation. A principles-based approach to regulation involves a regulator moving away, where possible, from prescribing how a firm should reach a desired regulatory outcome. This approach considers first whether firms supplemented by guidance, as appropriate, could assume the responsibility to achieve the desired outcomes in the context of their business processes and existing supervisory obligations. We suggest that a paradigm whose foundation is more clearly based on principles and the achievement of outcomes tied to those principles may better serve investors and its constituent firms.

As part of this rules review, we also encourage the single SRO to create a culture in which its surveillance, examinations, and enforcement efforts take into account the different purposes of the rules and address violations accordingly. The examination and enforcement process should incorporate some sense of proportionality. In a world of limited resources, the goal of any regulatory budget must be to ensure that each dollar is spent in the most effective manner. At the same time, fees for regulation should be apportioned to the industry on a fair and reasonable basis. We recommend that the consolidated regulator be required to define the costs necessary to meet its self-regulatory obligations, prepare and make public a budget to meet those obligations, and then fairly apportion those costs among members by making periodic filings with the Commission subject to public notice and comment as well as Commission approval. Regulatory funding for the consolidated SRO should come from regulatory fees assessed on market participants, including broker-dealers, issuers, and other constituents of the trading markets.

One risk of the single SRO is that it concentrates regulatory power and authority in one entity. Therefore, it will function effectively only if the SEC provides attentive oversight of its activities. We look to the SEC to develop increased transparency requirements for the consolidated regulator, particularly concerning fund-

ing and budgetary issues. Making the regulator's operations transparent to both members and the investing public will place appropriate checks on the single SRO and will enhance accountability to its constituents.

Our securities markets are strong, and our robust regulatory system plays a critical role in our markets' success. To retain that strength, we must remain vigilant about removing unnecessary regulatory inefficiencies, particularly in light of increasing global competition. We are here to work with you, Mr. Chairman, the Congress, the SEC, the SROs, and all other interested parties to ensure that our markets remain transparent, liquid, and dynamic, with unparalleled levels of investor protection.

Thank you very much.

Chairman REED. Thank you very much, Mr. Lackritz.

They have just called the vote. Professor Coffee, the timing is pretty good because your testimony, we will take it now, and if you will indulge me, I will recess for a moment, vote, and come back, and we will have the rare opportunity of questioning three experts alone.

Professor Coffee.

STATEMENT OF JOHN COFFEE, ADOLF A. BERLE PROFESSOR OF LAW, COLUMBIA LAW SCHOOL

Mr. COFFEE. I will be as brief——

Chairman REED. No, no. Take 5 minutes, at least.

Mr. COFFEE. My basic message is that the idea of a sole consolidated regulator is an idea whose time has come. It is efficient. There will be economies. There will be a stronger regulator.

Chairman REED. Can I ask you to bring the microphone up closer?

Mr. COFFEE. I think there are numerous efficiencies, and I think this idea of consolidation is inevitable. But there is one remaining question, and that is the effect of this consolidation on investor protection. I think here the outcomes are uncertain, and I think that these problems can be corrected with some fairly modest tinkering that does not jeopardize the idea of a merger of these two regulators.

My concern is simply that this new consolidated SRO is vulnerable to industry domination because 10 of its originally 23 and ultimately 22 members will come from the industry. This is in sharp contrast to what has been done recently across the board of exchange regulation.

You have already heard the example I will give you of the New York Stock Exchange which has an entirely independent board. Now, notice, the New York Stock Exchange is a business. We are talking about this new regulator which is essentially going to be a quasi-judicial body. What it is going to do is bring prosecutions, hear cases, hear appeals. That is essentially a judicial or prosecutorial kind of role, and historically the standards of independence, integrity, lack of conflict of interest have always been higher for judicial officers than they have been for corporate directors or businessmen generally. So I am suggesting the specialized nature of this body requires a higher rather than lower standard of independence and protection from industry domination.

I fully recognize that the statute says that on the board of an SRO there has to be fair representation being given to the industry. The SEC has historically said that that level of fair representation is satisfied by 20-percent representation. Here we are talking about 10 out of 22. That is effectively 40 to 45 percent. I think giving representation but at a smaller level, a smaller percentage, would do more to protect the interests of investors, and I want to give you some examples.

I am going to be met with the argument, I know, that there will be 11 public Governors as opposed to 10 industry directors. I think there are three things to say in response to that.

One is that the standards are wholly unspecified as to what these public Governors have to be, what level of independence they have to have. They may come from the public, but they could have all kinds of conflict of interest, and we are not told that they even have to meet the level of independence that a New York Stock Exchange director has to meet.

Next, they will be initially appointed by the boards of the New York Stock Exchange and the boards of the NASD. Frankly, I think these will be fine, excellent, competent people, but they are not going to be industry activists, enforcers, people who have a specialized interest in the world of enforcement. I think they are going to be reasonable business people, but, again, they will be not organized, not cohesive, and they will have to face ten Governors coming from the industry, who will be elected by constituencies, very small constituencies, that will want loyal agents protecting their interests. And I think they have some interests, they need to be protected, and they will be against a somewhat diffuse, disorganized group of ten public Governors, who will necessarily have divergent perspectives because they are not a unified force.

Now, what are my specific concerns? Again, I am not suggesting that somehow the industry Governors will intervene to stop prosecutions or to reduce penalties. I am suggesting it will be subtler kind of influence. Let me give you two examples.

One is our system of securities arbitration. There are many today who believe, including myself, that this system is somewhat ineffectual, somewhat cumbersome. As you may be aware, Senators Leahy and Feingold have recently written the SEC asking that securities arbitration no longer be made mandatory by the industry. I frankly do not see that happening. Even if it did happen, we would still need to reform absolutely because the average investor must rely on it and cannot find an attorney that he can afford to hire in most securities disputes.

That is a world where I cannot believe that the current system of arbitration will be reformed if we have something like 45 percent of the directors coming from the industry. The No. 1 problem today in securities arbitration is the presence of one industry representative on every panel. Gretchen Morgenson of *The New York Times* wrote just 2 weeks ago that having that industry representative on the panel is the equivalent of having a police officer on every jury hearing a police brutality case. It does affect the dynamics. It may well be the other two override and outvote that industry member, but they may compromise on the penalty or the damages and give a lesser sanction.

This is an area where I think some serious attention has to be given to securities arbitration because we are now consolidating two systems into one, and I do not think in this process we are going to get significant reform with the level of industry control over the process. That is example one, securities arbitration, where I think the industry will have too much influence.

Example two is the harmonization of the two rule books. We all understand that harmonization is a good idea and we want it to happen, but the two rule books differ, and in some areas one rule book gives more protection to investors than the other. Anytime you harmonize, you can level up or you can level down. Given the domination of industry members and the diffuse nature of the public Governors, I think there is a significant danger that the rule book will be leveled down rather than leveled up.

There are really significant differences, such things as old as the "know your customer" rule of these two bodies, and if we want the stronger one, I think we need to have some SEC oversight.

So, in substance, I am suggesting to you that this merger should be encouraged, but it would work better if we reduced the level of industry representation from ten Governors to something like five Governors, and I think that both this Committee and the SEC has to exercise very close oversight over the harmonization of these rules, and I would submit also that this Committee should ask the SEC to conduct a long, overdue study of the efficacy of securities arbitration. Can it be made better? Is it fundamentally fair? We cannot expect that the industry itself is going to change something that will be very costly to the industry if it is significantly reformed.

Thank you.

Chairman REED. Thank you very much, Mr. Coffee. And if you would grant me the opportunity to go vote, which is part of my job, we will recess for approximately 10 minutes, no more, and I hope less. And I will return, and I look forward to an opportunity to ask you questions. Thank you for your testimony.

We stand in recess for approximately 10 minutes.

[Recess.]

Chairman REED. The hearing will resume, and again, thank you, gentlemen, for your excellent testimony. I think you have raised many issues—in fact, common themes I think in all the testimony. But let me begin with one that Mr. Borg raised and that also I think was echoed by both Mr. Lackritz and Mr. Coffee.

We understand there is a savings in terms of streamlining efficiencies, but when you go from two regulators to one regulator, you lose what some people call "regulatory competition," where regulators will see things that the other does not, and there will be a sharing of information.

So if you want to elaborate on this notion, Mr. Borg, and elaborate further, Mr. Lackritz, then Mr. Coffee.

Mr. BORG. Thank you, Mr. Chairman. With regard to combining regulators, you can streamline and you can add resources and whatnot, but, you know, two eyes are usually better than one. The old example of two folks watch a car accident; they see things, one does not. Streamlining makes sense, especially if you are at the 20,000-foot level, but from an investor on Main Street, somebody

has got to take care of that investor. We are afraid, to some extent, that by raising the bar to 20,000 feet, or whatever level it is going to be, there is going to be less look-see at the lower level.

Now, we have looked at the testimony from Mary Schapiro and Rick Ketchum, and they seem to indicate that that is not going to happen. Our concern is, OK, let's make sure we understand what these problems are and make sure that there is a way to fix it. We are not against the consolidation. We think it has merit. And like Professor Coffee said, it has just some concerns we have got to work out.

With regard to the fees and structures that we heard, I heard a little inconsistency, I thought, a little earlier in that there will be a reduction in costs and yet they are going to reduce fees. Nowhere did I hear but let's put it toward investor protection and make sure we maintain or heighten that ability. So I am a little concerned about that, and it is in our written testimony.

Other areas about putting two regulators together, again, has to do with big organizations have a tendency to go in one direction. There is a format, there is a process, and sometimes when you have multiple regulators, you come at it from different directions. When we work with the SEC—or the NASD, for that matter—we bring a different sort of focus than they do. My office is not as technically savvy as market surveillance in New York, but I understand investors and how the frauds work on the ground probably better than most.

So we lose a little bit of that. That is why our testimony is geared that as this process goes forward, there has got to be terrific and great amount of interaction between NASAA members and the new SRO as they form the rules. Let us make sure we are covering all the bases. We can help them do that, and I think that is the important factor here.

Chairman REED. I would presume that as these rules are promulgated for notice and comment that your organization would participate very actively. Is that fair?

Mr. BORG. We will, but we think it is more efficient if we act in concert with them on the front end before they propose the rules. Then we have got to go through the process of responding to the rules. Then they have got to pull them back and start all over.

It makes sense that if NASAA is on the front end of any new SRO rules that come out, we can avoid having to miss a few things because we look at it from a different perspective. There is an example of that in our written material specifically to that point.

Chairman REED. Thank you.

Mr. Lackritz, your comments on this notion of regulatory competition, you know, going from two to one, and one set of eyes rather than two.

Mr. LACKRITZ. Sure. One person's competition is somebody else's duplication, and I think here we should be focusing on effectiveness, not necessarily whether it is competition or not.

Multiple pairs of eyes miss lots of things. Single pairs of eyes that are well trained, well qualified, highly professional, and have some experience and history in the process are actually much more effective, I would think, longer term.

If you look from the standpoint of how many different layers of regulation securities firms are subject to, it is extraordinary. We have not only the SEC and we have self-regulatory organizations; we have State regulators as well. And so by eliminating one extra duplicate layer of self-regulation, what you are going to do with the single SRO is to improve the quality of the examination. You are going to improve the examination strategy and the technology that goes into it. And we think actually that will improve the quality of investor protection. It will not diminish it whatsoever.

So we think it becomes a question of duplication rather than competition.

Chairman REED. And this goes, I think, to the point you made in your testimony about that these savings have to be reinvested in investor protections in a public fashion. Is that a fair point that you made in your——

Mr. LACKRITZ. Well, we think——

Chairman REED. Somebody's statement, I should say.

Mr. LACKRITZ. We think, first of all, that there is some significant savings, which are good for investors as well as good for the industry, and as they go through this process—they have already identified a big chunk of that, I think. It is shown in the governing bylaws, the proxy statement. And as it goes forward, I think it is important to make sure that the SEC stays involved to assure that there is no diminution in investor protection.

Chairman REED. Professor Coffee, the same question, and sort of the flip side of regulatory competition between regulators with two sets of eyes as regulatory arbitrage or someone——

Mr. COFFEE. This is a unique moment because I agree with my colleague Mr. Lackritz here. I do not think this is the normal kind of regulatory competition where two is better than one. The New York Stock Exchange does have a residual conflict of interest. If it continued to run New York Stock Exchange Regulation, it would often be regulating and overseeing its competitors, and that is an unhealthy set of circumstances. Thus, it is desirable that its regulatory enforcement arm gets moved into a more independent body. The NASD, having sold off its interest in Nasdaq, has no conflict, and I think we improve the caliber and at least the perceived integrity of the process.

Next, I also agree with the point that there is not going to be just one regulator. There are going to be three levels of regulation. There is going to be the SEC, which never steps aside. In a big fraud, it is always there first. Then there is going to be this coordinated SRO. Then there are going to be the States, sometimes 50 of them. That is multiple layers of regulation that still remain, so I do not think we are going to have a monopolistic situation here at all.

Chairman REED. One of the issues I want to ask all of you, but start with you, Professor Coffee, because you raised it in your testimony, is the issue of independence. It is independence not only in terms of, as you suggest, the subtle ways in which the Board might operate, but also NASD itself has a large portfolio of over $2 billion in assets. They have to make arrangements to have that independently regulated. So can you comment on independence from several different perspectives?

Mr. COFFEE. Yes. I would look at what happened when the New York Stock Exchange set up NYSE Regulation, and there at the last moment, at the same last moment we are now at, the SEC intervened and changed the balance slightly to make sure there was more of a public influence and that the New York Stock Exchange had less control over the directors of New York Stock Exchange Regulation.

So I still think this merger can go forward without any major hitch, but I think there can be an adjustment, reducing the level of the industry representatives from the current 45 to a more realistic 25 percent or so, without this fundamentally impairing the merger. If you do that, then I think this process of integrating and harmonizing the rule book will get done by a board that has a little bit more concern for investor interest and a little bit less obsession with the costs of regulation. I agree the costs have to get considered, but I think that an organized group of ten members of a board will make almost any CEO somewhat more cautious.

I have great respect for Mary Schapiro, but I know that when our Founding Fathers drafted the Constitution—and we are now drafting a Constitution for our market system—they had to look beyond George Washington. They knew he was great, but they had to see that there were future Presidents that might not be quite as perfect, and there could be future heads of this new coordinated regulator that might be less able or less committed than Mary Schapiro, and we have to think about that. Therefore, I want to make sure our Board is a little bit more independent than they proposed.

Chairman REED. Thank you very much.

Mr. Lackritz, this issue of independence, and then Mr. Borg, because I think it is an important one.

Mr. LACKRITZ. Yes. First of all, Mr. Chairman, I think it is a good question. This negotiation was a very carefully negotiated deal between the NASD and the New York Stock Exchange. It required the approval of our firms. I should mention that our small firms committee endorsed this, our regional firms committee endorsed this, and our board aggressively endorsed this. That meant that there had to be some representation from the industry that was part of the self of self-regulation. Our concern in this process is to assure that there is business expertise, background, and understanding of what the business is about infused in this process.

And so from the standpoint of the different constituency representations, that was very carefully negotiated in an effort to assure that the industry could support moving away from the previous structure. And so we think it is an important component of the current structure. Clearly, ten people out of 23 are not going to dominate or control. They do not have the votes. The two other members, as Rick Ketchum mentioned in the earlier panel, we would hardly perceive of as being industry representatives. They both have been regulators for 25 years in their careers, and I think they bring a balanced perspective of both industry understanding and regulatory perspective that really does help to promote the public interest.

So we think this balance is a very good balance because it provides a majority of the members coming from the public, ten mem-

bers from the industry. They cannot dominate that other group. They come from different constituencies within the industry that sometimes have different perspectives. And that was a very fundamental part of actually getting this deal done in the first place.

Chairman REED. One other follow-up, Mr. Lackritz, and I think it takes off on a comment that Professor Coffee made. The term "independent" or "public director" is not particularly defined. Do you think in the process of this merger going forward that definition would help this issue of independence, that clearly the individuals do not have any direct influence with respect to member firms that they might regulate?

Mr. LACKRITZ. Well, you know, I actually take a bit of umbrage at the notion that there is a zero sum game here and on the one hand are investors and on the other hand is an avaricious industry that somehow it is a zero sum game. It is obviously not in our interest for firms, individuals, or representatives to commit bad acts. We want to get bad actors out of this business. Trust in our markets and trust in our profession is the top goal of our association, and I think it is the top goal of our industry and our industry leadership as well.

So I would sort of reject the notion that it is a zero sum game, that you are either an investor's advocate or you are an industry shill, because I do not think that is accurate.

Chairman REED. I do not think that is accurate either, but again—and this might go to the point of what works now with people that you know very well and respect extremely—Ms. Schapiro and Mr. Ketchum—and I think that respect is shared by everyone that I have spoken to.

Mr. LACKRITZ. Yes.

Chairman REED. Over time those change, but also I think, you know, maybe a clearer definition of the criteria for these directors might help resolve this issue, or at least this debate, and not such——

Mr. LACKRITZ. Sure. Absolutely. I think that having a clear definition so that there are clear expectations certainly is helpful. And from the standpoint of what "public" means, that obviously is a fairly broad term, and so getting more definition around that probably is a helpful thing.

Chairman REED. Mr. Borg, your comments?

Mr. BORG. Thank you, Mr. Chairman. If the purpose of the new SRO is investor protection, protection of the markets—investors are the bedrock of the entire capital market of the U.S.—I think Professor Coffee's comments with regard to concerns about board makeup is correct and right on point.

With regard to the public Governors of the new board, undefined as it is, it is hard for us to make a determination whether it would be fair or not. Is this going to be CEOs of the major firms who have an interest in stock options and things of that nature? Or is this going to be members of the 100 million investing public who have maybe something to say about this? Or is it going to be folks who have experience in enforcement? Who are these public Governors?

I think that is what Professor Coffee was getting to, and I think that is the concern we share. And, therefore, we pretty much join in Professor Coffee's concerns.

Chairman REED. Thank you very much.

There is another issue that was raised in the first panel, and I think I would like your advice and opinion also. That is, is there sufficient legislative authority for this new model of regulation, a single SRO? Are there things that we should be doing? Ultimately, I think the results of this Committee's deliberations are suggesting if necessary—it may not be, but if necessary, legislative changes would be appropriate.

Professor Coffee, let me start with you and then go down. Any suggestions?

Mr. COFFEE. I cannot say that there is clearly inadequate authority. What I can say is that there is this very cloudy decision in the D.C. Circuit, the Business Roundtable case, that cut back on the New York Stock Exchange authority to adopt a rule, a one-share/one-vote rule, because it interfered with State corporate governance. I think there are areas where the rules of the SRO will affect things like proxy contests, director nominations, or broker votes. Broker votes is a very important part in its regulation of industry members.

There will be arguments made by many law firms in this city that anything that the SRO does that differs at all with State law invades the province of State law. Maybe the courts will agree, maybe they will not, but you would forestall future litigation and future uncertainty if you added some clarifying words, making it clear that there was the full power to create investor remedies, to have control over arbitration, and to otherwise structure a system that did achieve the purposes of self-regulation.

Chairman REED. Thank you.

Mr. Lackritz, your comments?

Mr. LACKRITZ. Yes, Mr. Chairman. I think we do not believe at this point that you need additional legislative authority in this area. You have oversight authority of the SEC. The SEC has direct oversight authority of the SRO and the consolidation. So from that perspective, we think you have ample authority and would urge you to stay involved in the oversight of this process to assure that the public interest is well served here.

Chairman REED. Mr. Borg?

Mr. BORG. As the first panel mentioned, this is a new model; it is a new hybrid. It is going to be a moving target.

The initial impression seemed to be that things are in place to make it work if the criticisms and the comments that have been aired today are taken seriously. I think what we are going to find is that there may be some unforeseeable issues that may require in the future another look-see. And I would just say let us keep an open mind on that issue and let us see what may be needed down the road, because if it is a new model and it is a new car that needs to be tested, you never know when you have to make a tweak to the power steering or the brakes. So we will just have to see how it goes.

From NASAA's point of view, that is what we intend to do, is to make sure that we keep an eye on things and bring to the attention of yourself and those appropriately to let them know when we see something that may be going awry. The key is let us make sure we are all involved, and that would include Mr. Lackritz at SIFMA,

NASAA, you know, our good friends, like Professor Coffee, who have great knowledge in this area. And let us make sure we are all in the dialog together up front.

Chairman REED. Well, thank you very much. I think that is a good point at which to conclude the hearing.

I want to thank you all for excellent testimony and your insights into a very important process. One area that we did not get a chance really to go into in detail is that in this globalized market, this could be a template for a lot of other not only national approaches, but perhaps even international approaches of self-regulation and dealing with a global securities market.

I would for the record indicate that some of my colleagues might have written questions that they might submit to you. I would ask you to respond in a very appropriate time to these requests. And I appreciate your time and your patience, and thank you very much.

The hearing is adjourned.

[Whereupon, at 4:42 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

TESTIMONY
OF

ERIK R. SIRRI, DIRECTOR
DIVISION OF MARKET REGULATION
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
THE CONSOLIDATION OF NASD WITH THE MEMBER FIRM REGULATORY FUNCTIONS OF THE NYSE

BEFORE THE SUBCOMMITTEE ON
SECURITIES, INSURANCE, AND INVESTMENT

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

MAY 17, 2007

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Testimony of

Erik R. Sirri
Director, Division of Market Regulation
U.S. Securities and Exchange Commission

Concerning the Consolidation of NASD with the Member Firm Regulatory Functions of the NYSE: Working Towards Improved Regulation

Before the Subcommittee on Securities, Insurance, and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs

May 17, 2007

Chairman Reed, Ranking Member Allard, and Members of the Subcommittee:

Thank you for inviting me to testify today about the proposal by the NASD and the New York Stock Exchange to consolidate their member firm regulatory functions into a single self-regulatory organization, or SRO. I believe that the proposed consolidation represents a positive development in the regulation of our securities markets.

Although there are a number of SROs that perform various functions, only the NASD and the NYSE are responsible for member firm regulation. Currently, the NASD and the NYSE together oversee the activities of more than 5,000 U.S. broker-dealers doing business with the public, approximately 170 of which are members of both organizations. As a result, there can at times be inefficient, duplicative, and potentially conflicting regulation of U.S. securities firms. The proposed consolidation of NASD and NYSE member firm regulatory functions into a single SRO is designed to help eliminate today's duplicate member rulebooks, and the possibility of conflicting interpretations of those rules. At the same time, a single SRO structure would retain one of the fundamental precepts that has characterized the SRO model: that securities regulation works best when the front-line regulator is close to the markets.

Securities industry self-regulation has a long tradition in the United States. In its earliest years, the nascent U.S. securities industry was subject to self-imposed codes of dealings and state laws. As the NYSE and other exchanges developed, they assumed responsibility for supervising their members' activities, and trading conventions became formalized as exchange rules.

Federal regulation of the exchanges followed as a result of several significant events, including the stock market crash of 1929 and the failure on the part of the NYSE to respond adequately to incidents of market manipulation. In enacting provisions governing national securities exchanges and associations during the 1930s, Congress concluded that self-regulation of both the exchange markets and the over-the-counter market was a mutually beneficial balance between government and securities industry interests. Thus, the securities industry continued to be supervised by an organization familiar with its operations, and the SROs in turn were overseen by the SEC. In addition, the federal government benefited by being able to use its resources more efficiently through an oversight role. The exchanges continued to develop their own standards relating to just and equitable principles of trade, membership requirements, and business conduct.

In recent years, a number of significant – and interrelated – competitive, technological, and regulatory developments have transformed our nation's securities markets. U.S. exchanges have faced increased competition from electronic communications networks (ECNs) and other alternative trading systems, as well as from foreign markets. As a result, there have been significant shifts in market share away from the primary markets. At the same time, most U.S. securities exchanges have evolved from their historical status as member-owned organizations to become for-profit entities. The competition by exchanges for market share and the conversion of exchanges to publicly-traded, for-profit companies has heightened concerns regarding the

conflicts inherent in the existing self-regulatory system. In addition, concerns have been raised about the costs inherent in a system of regulation where members of multiple exchanges have multiple regulators.

Over the years, the Commission has examined the self-regulatory system and the extent to which SROs have successfully fulfilled their statutory obligations. In addition, Congress periodically has reassessed the self-regulatory system and made legislative changes as necessary to strengthen the system. The securities industry too has considered the self-regulatory system. In January 2000, the Securities Industry Association (now known as SIFMA), through its publication of a white paper entitled "Reinventing Self-Regulation," urged the Commission to review the self-regulatory system with a view toward simplifying the current structure with its multiple regulators.

The Commission in December 2004 published a Concept Release Concerning Self-Regulation that explored the continuing efficacy of the existing self-regulatory model and discussed possible alternatives to that model. The alternatives discussed ranged from strengthening the existing self-regulatory model, to the "Hybrid" model in which a single market-neutral SRO would assume responsibility for all member firm regulation but each market would remain responsible for regulating its own market, to direct regulation by the Commission.

In addition, the Commission over the years has taken a number of steps to reduce the burdens and inefficiencies of multiple member SROs. For example, the Commission is authorized to name a single SRO as the designated examining authority – the DEA – to examine common members for compliance with the financial responsibility requirements imposed by the Exchange Act, the Commission, or SRO rules. When an SRO has been named by the Commission as a common member's DEA, all other SROs to which the common member

belongs are relieved of the responsibility to examine the firm for compliance with applicable financial responsibility rules.

More recently, in connection with the Commission's approval of the merger between the NYSE and Archipelago in February 2006, the NYSE undertook to work with NASD and industry representatives to eliminate inconsistent rules and duplicative examinations and to reduce regulatory burdens. In February 2007, the NYSE filed with the Commission a proposal that seeks to harmonize NYSE rules that are inconsistent with comparable NASD rules, as well as a report on those conflicting rules that were not proposed to be reconciled.

Moreover, to reduce burdens on those firms that are members of both SROs, the NASD and NYSE have sought to coordinate their oversight and examination efforts. NASD and NYSE hold quarterly planning meetings to coordinate schedules for routine examinations and have worked to coordinate their examination programs generally. For example, the NASD and NYSE, along with the Commission, developed a shared database on branch office examinations as a means to strengthen coordination and reduce the possibility of overlap in examinations of broker-dealers' branch offices.

Building upon the rule harmonization effort I just described, high-level representatives of the NASD and NYSE began meeting last year to discuss ways to improve the self-regulatory system. These meetings culminated in a decision to consolidate the NASD and NYSE member firm regulatory operations into one SRO that would be the sole U.S. provider of member firm regulation for securities firms that do business with the public.

On November 28, 2006, the NASD and NYSE publicly announced their proposed consolidation. The combined SRO, which would be given a new name, would be responsible for all member firm regulation, arbitration and mediation, and other functions currently performed

by the NASD. This consolidation, in essence, would be a market-based determination to implement the Hybrid model of self-regulation. It would allow securities firms to operate under a uniform set of rules, replacing the overlapping jurisdiction and duplicative regulation that currently exists. Thus, all firms would deal with only one group of SRO examiners and one SRO enforcement staff for member firm regulation.

The NASD and NYSE agreed to a governance structure for the combined SRO that reflects a blend of their current models. The combined SRO would have a 23-member Board of Governors. Eleven of the 23 Governors would be non-industry public Governors. There also would be industry representation on the board in the form of three industry Governors elected by small broker-dealer firms, one industry Governor elected by mid-size broker-dealer firms, three industry Governors elected by large firms, and three appointed industry Governors. The CEO of NASD and, during a three year transitional period, the CEO of NYSE Regulation, also would be Governors.

As the proposed governance structure requires amendments to the NASD's By-Laws, NASD delivered a proxy statement to its members in December 2006 and held a special meeting of its members on January 19, 2007. At the special meeting, NASD members approved the proposed By-Law changes, with 64 percent of NASD member firms that voted supporting the transaction. These proposed By-Law changes are subject to the Commission's rule filing process, which includes notice and comment, as well as Commission action. We also expect to receive several additional filings from the NASD and NYSE that are primarily technical in nature but nonetheless are critical to the closing of the proposed consolidation. For example, the NASD must incorporate various NYSE member rules into its rulebook until the task of developing a single rulebook is completed. As part of this process, NYSE members that belong

only to the NYSE would be required to become members of the combined SRO so that the combined SRO would have jurisdiction over them.

On March 19, 2007, the NASD filed with the Commission the proposed changes to the NASD By-Laws, as approved by the NASD membership, and the Commission published these changes for public comment on March 26, 2007. To date, the Commission has received approximately 78 comment letters from 72 commenters on the proposal. Commenters supporting the proposed changes to the By-Laws – including several securities firms, SIFMA, the National Association of Independent Broker/Dealers, the Financial Services Institute, and the North American Securities Administrators Association – generally agreed that the consolidation proposal would streamline regulation and simplify compliance with a uniform set of regulations. Those commenters urging the Commission not to approve the proposal – including a number of small NASD member firms, the Commonwealth of Massachusetts, and the Center for Corporate Policy – generally argued that the proposed By-Law amendments would not protect investors or provide enough representation for industry members or smaller member firms. Currently, SEC staff is reviewing all the comments received and is in the process of preparing a recommendation to the Commission. I expect that the staff will submit a recommendation to the Commission on the proposed NASD By-Law changes within the next few weeks.

I should note that the proposal currently before the Commission is to consider the amendments to the NASD By-Laws, which would be required to implement the governance changes necessary to establish the structure of the combined SRO. While these By-Law changes are a key component of the proposed consolidation, work would continue to be done after the closing of the consolidation, if approved, in order to fully integrate the member firm regulatory functions of these two SROs.

The combined SRO would need to complete the harmonization of the member firm rules. Although some work was undertaken as part of the NYSE's harmonization project that I discussed earlier, there are a substantial number of member rules that would need to be reconciled. In this regard, the SROs expect to have a transitional period, during which both NASD and NYSE member firm regulation rules would be retained within the combined SRO, with NYSE rules applying to NYSE members and NASD rules applying to NASD members. During this transitional period, the combined SRO would continue to review and harmonize the duplicative NASD and NYSE rules governing member firm regulation and conflicting interpretations of those rules. It is my expectation that, in developing a single rule set, the combined SRO intends to be sensitive to the needs and circumstances of firms of varying sizes and business models. I believe that the harmonized rules would help make self-regulation more effective and efficient by allowing securities firms to operate under a uniform set of rules, replacing the overlapping jurisdiction and duplicative regulation that currently exists for many securities firms. The harmonized rulebook would be subject to Commission approval.

In addition to the proposed consolidation of two rulebooks, two separate regulatory staffs, and two different enforcement systems, the proposal would consolidate the arbitration and mediation programs of the NASD and NYSE, making arbitrations subject to one set of rules. I believe that consolidating these two arbitration programs would reduce overhead significantly, thereby increasing efficiency, especially in light of the fact that the NASD currently is the arbitration forum for over 90% of securities arbitrations.

Finally, I should note that the proposed consolidation may very well have positive ancillary effects on investors and on the Commission's work. Following the consolidation, Commission staff would continue to conduct examinations of the combined SRO's regulatory,

investigatory, and enforcement activities. However, instead of examining the member regulation activities of two SROs, Commission staff would be able to focus its resources on ensuring that the single, combined SRO effectively regulates member firms. Investors, too, may benefit from the consolidation, since the consolidated SRO would combine the strengths of the talented and experienced enforcement and regulatory staff from both the NASD and the NYSE. As a result, the consolidated SRO's staff could be able to more effectively focus their efforts in areas that are critical to investors, such as sales practices.

I am grateful for the opportunity to provide you with an overview of the self-regulatory system and an update on the proposed consolidation of the NASD's and NYSE's member firm regulatory operations. I am happy to take any questions you may have.

Testimony
of
Mary L. Schapiro
Chairman and CEO

Before the
Committee on Banking, Housing
and Urban Affairs
United States Senate

Securities, Insurance and
Investment Subcommittee

Hearing on Consolidation of NASD and
the Regulatory Functions of the NYSE:
Working Towards Improved Regulation

May 17, 2007

Good afternoon, Chairman Reed, Ranking Member Allard and distinguished Members of the Subcommittee. NASD is grateful for the invitation to testify regarding the regulatory consolidation of NASD and NYSE Member Regulation.

As a self-regulatory organization (SRO) devoted to investor protection and market integrity, NASD welcomes the Committee's focus on this development and we look forward to discussing this historic change to the self-regulatory system.

It is our strong belief that this consolidation will serve to strengthen the regulation of the securities industry at a time when we are witnessing unprecedented changes taking place in global markets every day.

NASD

Founded in 1936, NASD is the world's largest private-sector securities regulator. We regulate practically every securities broker-dealer in the United States—more than 5,000 securities firms operating over 171,000 branch offices and employing about 663,000 registered representatives. We are the only private-sector regulator with industry-wide scope.

From oversight to education, we touch virtually every aspect of the securities industry. We oversee and regulate trading in equities, corporate bonds and options. And we provide education and qualification examinations to industry professionals while supporting securities firms in their compliance activities.

NASD licenses individuals and admits firms to the industry, writes rules to govern their behavior, examines them for regulatory compliance and disciplines those who fail to comply. Our member regulation function is comprehensive in its oversight of securities firms. It includes not only conducting financial and operational reviews of firms, but also examines the manner in which securities firms interact with their customers. When firms or individuals fail to comply with our rules or the federal securities laws and rules, we may impose a range of sanctions from censures to removal from the industry with the purpose of the remediation of conduct. Last year, NASD filed 1,206 enforcement actions and barred or suspended 746 individuals from the securities industry.

We also operate the largest securities dispute resolution forum, processing over 4,600 arbitrations and nearly 1,000 mediations in 2006. And, both directly and through the NASD Investor Education Foundation, NASD plays a major role in the education of those who invest their personal savings in this nation's securities markets.

NASD also operates, as part of its statutory mandate, a number of transparency services designed to bring information to the marketplace. These services include the Trade Reporting and Compliance Engine (TRACE), which provides investors accurate and timely trading information on the corporate debt market, the Alternative Display

Facility (ADF), the Over-the-Counter Bulletin Board (OTCBB) and a number of Trade Reporting Facilities (TRFs) operated jointly with registered U.S. exchanges.

With a staff of nearly 2,500 and an annual budget of nearly $700 million, NASD is a world leader in capital markets regulation.

Historical Background

As this Committee has witnessed during the last six years, NASD and The NASDAQ Stock Market underwent a long process of separation that was finally completed in 2006 when NASDAQ received regulatory approval as a national securities exchange. While NASD continues to monitor trading on NASDAQ pursuant to a regulatory services agreement, the market is operated under its own, separate management and Board of Directors. NASD is now in a unique position among U.S. securities SROs, operating as a private-sector regulator with an exclusive focus on regulating the broker-dealer industry and, by contract, exchanges and markets.

With respect to funding, every securities firm in the United States doing business with the public is required to be an NASD member. We have the authority to assess our members, as necessary, to fund our regulatory operations, and they cannot resign membership without also giving up the right to sell securities to the public.

Background on NASD/NYSE Member Regulation Consolidation

In 2000, as increased competition and technological, legislative and regulatory changes swept across the capital markets, the securities industry began a focused discussion about the benefits and disadvantages of the current self-regulatory structure. In a white paper evaluating regulatory options, the Securities Industry Association supported the consolidation of the broker-dealer regulatory functions of securities firms regulated by both NASD and NYSE into a single "hybrid" regulator.

In 2004, the Securities and Exchange Commission (SEC) published a concept release examining the current SRO system and sought public comment on a range of issues, including: (1) the inherent conflicts of interest between an SRO's regulatory obligations and the interests of its members, its market operations, its listed issuers and, in the case of a demutualized SRO, its shareholders; (2) the costs and inefficiencies of the multiple SRO model; (3) the challenges of surveillance across markets by multiple SROs; and (4) how SROs generate revenue and fund regulatory operations.

As NASD told the SEC in our response to the concept release, the one glaring inefficiency in today's regulatory scheme is the dual regulation of firms that are members of both the New York Stock Exchange and NASD. Currently, these roughly 170 firms are faced with dual rulebooks, dual examinations, interpretations and enforcement, and multiple fees.

Serious discussions between NASD and the NYSE about consolidating the member regulation and related enforcement functions of NYSE with NASD began last summer. In November 2006, NASD and NYSE Regulation announced at a press conference with SEC Chairman Christopher Cox that both organizations had signed a letter of intent to consolidate their member regulation operations into a combined organization that would be the sole private-sector regulator for all securities brokers and dealers doing business with the public in the United States.

In December, the NASD Board of Governors approved By-Law amendments to implement required governance changes for the consolidation to take place. The By-Law amendments then had to be voted on and approved by the full membership of NASD before taking effect. In January 2007 the By-Law changes were overwhelmingly approved by the securities industry.

In March, NASD filed the amended By-Laws with the SEC. The SEC comment period closed April 16, and we have filed a response to the comments received. We have received two other regulatory clearances necessary for the transaction to be completed—from the Justice Department and the Internal Revenue Service. Although one securities firm filed a purported class action lawsuit to stop the consolidation, the suit has been dismissed by the court.

We anticipate the transaction will close in the second quarter of this year, sometime in June. We are hard at work bringing these two outstanding organizations together in an effort to bring investor protection and market integrity into the 21st Century.

A New SRO for a New Century

Today, globalization, international mergers, lightning-fast technology and a dizzying array of new products are leaving the landscape of the markets forever altered.

In the last several months, there have been three major reports warning that America risks losing its position as the world's financial capital. These reports have raised important issues concerning the future competitiveness of U.S. markets and have spurred much discussion—as well they should.

As someone who has been a regulator for 25 years, I believe strong regulation makes for strong markets. It gives investors confidence. And investor confidence in well-regulated U.S. markets has always been our source of strength. It has distinguished our markets from others for years.

The changes we are witnessing in today's capital markets are unprecedented. As the markets grow faster and the world grows smaller, if we expect to keep up with all of the changes taking place around us, we need to bring regulation into the 21st Century. That means streamlining regulation—making it less burdensome, more efficient and more effective.

When the consolidated SRO is in place and fully integrated, there will be a single set of rules adapted to firms of different sizes and business models. There will be one set of examiners and one enforcement staff. Duplicative regulation and overlapping jurisdiction will become a thing of the past. Inconsistent approaches and rule interpretations, and the potential for matters falling through the cracks between two separate regulators, will be historical footnotes.

The new SRO will be responsible for all member examination, enforcement, arbitration and mediation functions, registration and testing, as well as all other current NASD responsibilities, including market regulation by contract for The NASDAQ Stock Market, the American Stock Exchange, the International Securities Exchange and the Chicago Climate Exchange. NYSE Regulation will continue to oversee the NYSE market through its market surveillance division, related enforcement functions and listed company compliance.

The new SRO's governance structure will ensure a broad diversity of representation on the new Board. A 23-person Board of Governors will oversee the new SRO's activities with 11 seats held by Public Governors. Large firms, consisting of 500 or more registered persons, and small firms, consisting of 150 registered persons or fewer, will each be guaranteed three elected seats on the new SRO Board. Medium-sized firms with 151-499 registered persons, NYSE floor members, independent dealer/insurance affiliated firms, and investment company affiliates will each be guaranteed one seat on the new organization's Board. As CEO of the new organization, I will also serve on the Board. Richard Ketchum will serve as the non-executive Chairman of the Board.

Upon closing of the transaction, each NASD member firm will receive a one-time payment of $35,000 in recognition of anticipated cost savings that will result from the implementation of the plan.

Staff members from both NASD and NYSE Regulation have been working around the clock to integrate the two organizations and ensure that the new SRO will be even more robust in its ability to carry out our core functions of enforcement, member regulation, arbitration and investor protection and education.

Regulatory Program Integration

I am committed to ensuring that when we begin operating as one company on Day One, the SRO will not miss a beat in fulfilling our regulatory duties to protect investors and ensure market integrity. The regulatory mission of the new SRO will not be compromised, even for a day.

We are focused on integrating 470 new NYSE employees, merging technology platforms, consolidating the two rulebooks, maintaining strict adherence to a fair and just arbitration process, all while continuing to be ever-vigilant in enforcing our rules and

overseeing our regulatory beats. There is a tremendous amount of talent and experience in NASD and NYSE that will be leveraged in the new SRO.

On the technology front, NASD has a portfolio of over 130 different applications with various technology platforms to complete its day-to-day work. NYSE utilizes over 100 production applications. Right now, staff is working to bring these technologies together in order to create one robust portfolio. In this way we will achieve maximum efficiencies in an area that is increasingly critical to market operation and regulation.

Perhaps the most critical step we will take to bring more efficiency to our regulatory efforts as part of this consolidation is the creation of a single rulebook for the industry. Currently, we are building on work done last year to look at harmonizing rules between NASD and the NYSE. In 2006, a series of industry committees was convened to assist in the detailed work required to bring the two rulebooks into line. These committees reviewed a wide range of rules, including all rules in the NASD and NYSE manuals covering sales practices, supervision, financial and operational obligations, registration, and qualification and continuing education requirements.

In certain ways the two existing rulebooks complement one another. While NASD has an expertise in the sales practices used in selling products including mutual funds and variable annuities, NYSE Regulation excels in the financial and operational arenas. These complementary sections of the rulebooks can, in large measure, be moved wholesale into the new succeeding rulebook. Of course this does not mean that the smaller broker-dealers will be burdened by rules that are inapplicable to the scope or nature of their business for the ease of consolidating rulebooks; rather, we will be careful in calibrating the rules to have application to the appropriate firms.

We envision the new rulebook to be a compilation, drawing on the strengths of both rule sets. We will also attempt to take a tiered approach to accommodate firms of different sizes and business models. I want to stress that does not translate into different levels of investor protections. While the new rule book will not be in place Day One, our goal is to have it together as soon as possible.

Enforcement of our rules is one of the most important responsibilities we have. A strong and effective enforcement program ensures investor protection and market integrity. In this complex marketplace, it is critically important to create a streamlined and efficient enforcement program. With that in mind, we are working to combine the NYSE Regulation and NASD Enforcement Departments into a fully integrated, single enforcement unit.

There is much that is similar about these two separate enforcement departments. Both share strong and dedicated staffs that are passionate about their mission. As we create a single, unified department we are focusing on a number of areas, including reviewing the timeliness of investigations; incorporating state-of-the-art technology in the review and prosecution of cases; ensuring consistency in charging

decisions and sanction recommendations; and eliminating multiple reviews of the same or similar conduct.

In the area of Member Regulation, we are conducting a review and analysis of the member firm oversight functions in both organizations including personnel, processes and technologies. The two key programs we are focusing on are examinations and financial surveillance.

Here we will build on the complementary strength of the two existing organizations. The transitioning NYSE staff brings a wealth of knowledge in the areas of financial and operational risk, especially for the most diverse and complex financial services firms.

NASD staff, with its broad range of existing firms and responsibilities, has expertise in the sale and trading of a wide variety of financial products.

The combination of these two programs, while not without its complexities, will result in a single exam program that will oversee firms and the industry more effectively and efficiently.

Finally, ensuring that investors have a fair forum to address grievances is fundamental to market integrity. Harmonizing the arbitration and mediation rules of the NASD and NYSE dispute resolution programs is a top priority.

Using the recently-approved NASD Code of Arbitration Procedure as our base, we have already begun the process of comparing the new NASD rules with the existing NYSE rules, and aim to develop a harmonized set of rules that reflect the best of both arbitration and mediation programs.

Benefits of Self-Regulation

When the integration is complete, I believe this new organization, with a more effective, streamlined approach to regulation, will allow us to realize fully all of the benefits of self-regulation. I believe the self-regulatory model has many important benefits for investors and the markets and is uniquely capable of protecting investors.

First, private-sector regulators are able to tap industry expertise to make certain that rules are practical, workable and effective. Also, industry participants often are in the best position to identify potential problems, thus enabling regulators to stay ahead of the curve.

Second, private funding is a critical advantage to the self-regulatory model. Hundreds of millions of dollars can be and are spent by SROs on examination, enforcement, surveillance and technology at no cost to the U.S. Treasury. In a self-regulatory system, the industry—not the taxpayers—pays for regulation.

Third, unlike governmental laws and rules, self-regulatory standards can extend beyond the legal to the ethical. Perhaps the best example is our rule requiring industry participants to act "in accord with high standards of commercial honor and just and equitable principles of trade."

In light of the rapid changes in our markets, it is appropriate for Congress to continually review the efficacy of the evolving model of securities regulation. I am confident that, once fully integrated, the new organization will be able to leverage these benefits on a larger scale and continue to help keep America's markets safe for investors.

Though NASD will soon have a new name, one thing will not change: our commitment and dedication to investor protection and market integrity. Given the continuous transformations taking place in the global economy today, we believe this new regulatory model will be better suited to protecting investors and ensuring market integrity in today's fast-paced capital markets.

Thank you for giving NASD and NYSE the opportunity to testify on this important topic, and for your timely review of the securities industry's self-regulatory structure. NASD looks forward to working closely with Congress as it continues to review the changing regulatory landscape.

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Testimony

New York Stock Exchange, Inc. 11 Wall Street New York, NY 10005 www.nyse.com

NYSE

Richard G. Ketchum

Chief Executive Officer
NYSE Regulation, Inc.

On
"Consolidation of NASD and the Regulatory Functions
of the NYSE: Working Towards Improved Regulation"

Subcommittee on Securities, Insurance
and Investment

Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, DC

May 17, 2007

I. Introduction

Chairman Reed, Senator Allard, and distinguished Members of the Subcommittee, I am Richard G. Ketchum, Chief Executive Officer of NYSE Regulation. NYSE Regulation, Inc., is a not-for-profit subsidiary of NYSE Euronext, dedicated to strengthening market integrity and investor protection.

I want to thank the Subcommittee for providing this opportunity to address how the impending consolidation of NYSE Regulation's member regulation functions and NASD will impact the securities industry and investors.

For decades there have been multiple self-regulatory organizations ("SROs") with the responsibility to oversee the largest broker-dealers in the United States. To protect investors and ensure confidence in our securities markets, the SROs were, in effect, deputized to work on the front lines of America's capital markets under the supervision of the U.S. Securities and Exchange Commission (SEC). The SROs' mandate is to ensure that there is a fair and level playing field for all investors.

NYSE Regulation has played a significant role in the oversight of our nation's largest brokerage firms. Our 400 member firms maintain 98 million customer accounts, or 84 percent of the total public customer accounts handled by broker-dealers, with total assets of over $5 trillion. They operate from 20,000 branch offices around the world and employ 197,000 registered personnel. NYSE Regulation has served a vital role in policing this market.

Our Market Surveillance division monitors trading activities on the Floor and trading "upstairs" by member firms. The division also investigates trading abuses, including insider trading and market manipulation. Using sophisticated technology and

pattern recognition systems, the staff detects and investigates activity that may violate NYSE rules or federal securities laws, and recommends cases for prosecution to the NYSE Regulation Enforcement division or the SEC, depending upon jurisdiction.

Our Member Firm Regulation (MFR) division protects investors through regular and for-cause on-site examinations of NYSE member firms. These examinations are designed to review each firm's financial integrity, operational stability, timeliness and accuracy of books and records, compliance with customer protection rules, and sales practice compliance programs. MFR establishes guidelines to identify firms approaching financial or operational difficulties and to anticipate the erosion of capital due to losses, potential capital withdrawals, and changes to regulatory capital requirements.

NYSE Enforcement investigates and prosecutes violators of NYSE rules and the federal securities laws. Enforcement cases stem from a variety of sources, including referrals from NYSE Member Firm Regulation and NYSE Market Surveillance, as well as investor complaints made directly to the NYSE, required filings by member firms, and referrals from the SEC.

Through our Listed Company Compliance division, NYSE Regulation ensures that companies listed on NYSE and on NYSE Arca meet their financial and corporate governance listing standards. To maintain the quality of our list, listed companies are required to meet original listing criteria and maintain continued listing standards that, on the NYSE, are among the highest of any market in the world.

Arbitration at the Exchange dates back to 1817 and has served as an effective alternative forum to the courts. Our Arbitration Unit's effectiveness is based on the facts that it is efficient, convenient, quicker, and less expensive than legal proceedings.

II. Recent Changes

Three years ago, I accepted an offer to serve as the New York Stock Exchange's first fully independent chief regulatory officer. The creation of my position was part of sweeping corporate governance reforms that were launched after the independence of regulation at the NYSE had been severely questioned. A new structure was created that explicitly separated market operations from regulation, strengthened the independence of regulatory decision-making, and established a governance structure in which the chief regulatory officer reported not to the New York Stock Exchange's chief executive officer—as previously had been the case—but rather directly to the Regulatory Oversight Committee of the NYSE's board of directors.

New regulatory management was recruited. Our investment in technology was increased to efficiently improve oversight of the activity of member firms and trading on the Floor of the Exchange. We began leveraging technology to assist us in performing risk-based examinations of our member firms in both sales practice and financial and operational areas. Enforcement actions grew in size and sophistication. A Risk Assessment Unit was created to enhance the protection of the investing public and increase NYSE Regulation's effectiveness by identifying and responding to emerging trends or practices that may compromise investor protection.

While the new governance structure of NYSE Regulation worked well, new developments required further steps. In April 2006, the merger of the New York Stock Exchange and the Archipelago Exchange was completed and the NYSE Group became a public company. As a public company with a fundamental responsibility to maximize shareholder value, it became important to further formalize the organizational separation

that had been created between the market and regulation and provide for full legal separation. As a result, NYSE Regulation was organized as a separate not-for-profit corporation, wholly owned by the NYSE Group but with its own majority independent board of directors.

While we successfully addressed conflict concerns, our experience demonstrated that if self-regulation is to maintain its central role in the increasingly complex financial industry, we also needed to eliminate needless duplication from our rules, our examination programs, as well as in our enforcement investigations.

I believe strongly in the value of self-regulation. In simplest terms, self-regulation offers the benefit of greater expertise, the capacity to leverage government resources, and the ability to impose ethical standards that would be inappropriately compelled by a governmental entity. But self-regulation must be carried out efficiently for the benefit of all involved parties—including the securities industry, capital markets, and investors. This, of course, includes eliminating inconsistent or duplicative rules that impose unfounded financial burdens.

In the past three years, working with NASD, we have achieved significant results in reducing regulatory duplication of brokerage firms that are members of both of our respective organizations. A Memorandum of Understanding with NASD assured firms that if they requested a joint oversight exam, rather than separate visitations, they would get it. Moreover, we began coordinating sweeps or targeted examinations with NASD and the SEC.

For more than a year, we have worked with NASD and representatives of the securities industry on an ambitious program to harmonize our rules. We have identified

unjustifiable differences between NYSE and NASD rules and interpretations, proposed a program of revisions. I am pleased to report that we have made very substantial progress in this initiative.

III. Regulatory Merger

But soon it became apparent that we could do even more. That recognition led the New York Stock Exchange and NASD to announce last November that we would combine our member-related regulatory functions into a new regulatory organization—the first major reform of the self-regulatory system in 73 years. Clearly, it is an idea whose time has come.

I will serve as chairman of the board of the new organization, while also continuing on as chief executive officer of NYSE Regulation. Mary Schapiro, NASD's current chairman and chief executive officer, will run the new organization as CEO. I look forward to working with Mary, who I have known for more than 25 years. She is a strong regulator and a great professional.

The new SRO will operate from Washington D.C., New York City, and district offices throughout the US. Approximately 470 of NYSE Regulation staff in member regulation, arbitration, risk assessment, and related enforcement units will join the new organization.

Going forward, NYSE Regulation will be focused on areas where its unique market expertise is critical to effective regulatory oversight. Specifically, we will continue to be responsible for conducting market surveillance and routine disciplinary actions, as well as ensuring that companies listed on NYSE and NYSE Arca meet their financial and corporate governance listing standards.

IV. Benefits of the Merger

Our joint proposal with NASD is to create a single, new self-regulatory organization that will be the private-sector member regulator for all securities brokers and dealers that do business with the public in the United States. Under the strong oversight of the SEC, self-regulation will continue to play a vital role in the U.S. capital markets. Ultimately, there will be a single set of rules, most likely tiered for firms of different sizes. There will be one set of examiners and one enforcement staff.

The goal for both organizations is to reduce burdens on firms that have received multiple visits by different sets of examiners, while increasing the ability to protect investors by using exam resources in the most efficient and effective way. The resulting efficiencies should allow the firms to be more efficient, and to be able to serve their customers at lower cost.

The combined staff will have more time to ferret out wrongdoing when freed from the task of coordination or interpretation of inconsistent rules. Regulatory arbitrage will also be a thing of the past. Firms will no longer be able to take advantage of subtle differences in rules and exploit different interpretations by the staff of the two SROs. This will be a direct benefit to investors.

In February 2007, we filed with the SEC a report detailing the results of our Rule Harmonization project. If approved by the Commission, the rule proposals will substantially conform NYSE rules to those of NASD. In certain instances, the industry committees that were part of the process recommended that NASD adopt the NYSE rule. In other instances, we have chosen the best of both regulators' rules and expect the dialogue to continue as the new organization works toward a single rulebook.

In the interim, the new SRO will adopt all existing NYSE rules applicable to NYSE member firms. We are encouraged that the SEC has indicated that they will fast track certain proposed amendments to our rules that in all likelihood eliminate different standards on day one of the merger.

While these are important steps, the new, combined regulator will have as one of its highest priorities the creation of a single rulebook. As chairman of the new organization, I look forward to seeing this project through to its conclusion.

As for the merger, in addition to uniting rulebooks, NYSE Regulation and NASD are working closely together in several Integration Teams. One such team is combining the examination programs of both SROs. The goal is to have one integrated Financial/Operational and Sales Practice Program for 2008. Much progress has been made, proof of the commitment by both SROs to the ideals behind the consolidation. At the same time, both SROs are working together to complete their respective examinations for 2007 by working together to avoid any regulatory duplication.

Importantly, NYSE Regulation will continue to play a vital role, both in overseeing the trading on the NYSE markets and in NYSE-listed securities, and in assuring the regulatory integrity of our listing programs. These activities do not present the issue of regulatory duplication that we confront in member firm regulation. In addition, they are activities that are best performed by NYSE Regulation, so that regulatory systems and processes can be developed and improved in real time and in close coordination with changes in the trading systems or rules or listing requirements. Our ability to effectively regulate these important activities is significantly enhanced by

our continuing to do these activities in the independent, yet connected, entity that is NYSE Regulation.

V. Conclusion

I feel honored to have been a part of the revitalized NYSE Regulation at a time of incredible change. But this new self-regulatory organization for member firm regulation is an idea whose time has come. U.S. investors will continue to have a regulator that has the resources and skills to keep pace with an increasingly complex, global and changing securities industry. Our member firms deserve the most efficient regulatory structure possible based on a single rulebook and one consolidated examination and enforcement program. By combining the enormously talented staffs of NYSE Regulation and NASD, we will be able to meet the challenges of tomorrow.

TESTIMONY OF JOSEPH P. BORG

Director, Alabama Securities Commission

And

President of the
North American Securities Administrators Association, Inc.

Before the

United States Senate

Committee on Banking, Housing, and Urban Affairs

Subcommittee on Securities, Insurance and Investment

"Consolidation of NASD and the Regulatory Functions of the NYSE:
Working Towards Improved Regulation"

May 17, 2007

Chairman Reed, Ranking Member Allard and Members of the Subcommittee,

I'm Joe Borg, Director of the Alabama Securities Commission and President of the North American Securities Administrators Association, better known as NASAA.[1] I appreciate the opportunity to testify on the merger of NASD and New York Stock Exchange Regulation, and plan to focus on the "working towards *improved* regulation" element of this hearing's title.

States Have Protected Main Street Investors for Nearly 100 Years

Let me begin with a brief overview of state securities regulation, which actually predates the creation of the Securities and Exchange Commission (SEC) and NASD by almost two decades.

State securities regulators have protected Main Street investors from fraud for nearly 100 years. The role of state securities regulators has become increasingly important as over 100 million Americans now rely on the securities markets to prepare for their financial futures, such as a secure and dignified retirement or sending their children to college. Securities markets are global but securities are sold locally by professionals who are licensed in states where they conduct business.

In addition to licensing, state securities regulators are responsible for registering some securities offerings, examining broker-dealers and investment advisers, providing investor education, and most importantly, enforcing our states' securities laws.

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, the U.S. Virgin Islands, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

Similar to the securities administrators in your states, the Alabama Securities Commission prosecutes companies and individuals who commit crimes against investors, and brings civil actions for injunctions, restitution and penalties against companies and individuals who commit securities fraud. Another of our responsibilities is to order administrative actions to discipline brokers who engage in violations of rules and regulations, (for example, by selling unsuitable investments, and charging excessive fees).

Investor Concerns with the Consolidated SRO

Keeping in mind that Americans buy and sell securities locally, as a whole, the financial services industry has become increasingly more global in scope. A merger of certain self-regulatory functions makes sense. NASAA does not oppose consolidation, as long as the consolidation does not weaken investor protection. We hear a great deal about regulatory efficiency, but we must remember that efficiency at the expense of effective regulation is not in our national interest. Our markets will remain strong if our shareholders and investors are confident that, in cooperation with federal and state regulators, their brokers and the capital markets will be adequately policed by the new self-regulatory organization created by the merger of NASD and NYSE Regulation, referred to herein as "the Consolidated SRO." To date, the state-federal-industry regulatory relationship has a proven record of serving investors well, and, through the public comment process, we will be carefully monitoring the Consolidated SRO since this merger will result in one less regulator overseeing securities firms that deal with the public.

Investor protection is a fundamental mandate of the state and federal securities laws. State securities regulators urge the SEC and Congress to require the NASD and NYSE Regulation demonstrate that any rule changes they propose will protect investors and the public interest, promote just and equitable principles of trade, and prevent fraudulent and manipulative acts and practices. While "streamlining" current rules and regulatory structures by amendments to existing rules may create some savings and efficiencies, the needs of investors must come first. Permit me to provide a few illustrations where investor protection could be weakened under the structure of the Consolidated SRO.

NASD/NYSE Rule Harmonization

NASAA endorses the goal of harmonizing the rules applicable to the industry and minimizing overlap to the extent that harmonization does not compromise investor protection standards. Our preliminary review of the NYSE's proposal on the harmonization of its rules with those of the NASD raises concerns about the prospect that the rule harmonization project will favor the interests of member firms of the newly Consolidated SRO over the adoption of provisions that protect investors. For instance, as explained in the proposed rule filing on the NYSE's website[2] the following rules will be amended to facilitate harmonization with less stringent NASD requirements.

a) **Supervisor Registration.** Currently, NYSE Rule 342.13(a) requires three years of creditable experience as a stockbroker or three years of equivalent experience before a representative can be registered as a supervisor. This rule is proposed to be eliminated and replaced by the provisions of NASD Rule

[2] See, http://apps.nyse.com/commdata/pub19b4.nsf/docs/03089F7D7251E2AC8525728F00740F67/$FILE/NYSE-2007-22%20Omnibus%20SRO%20.

1014(a)(10)(D) which requires only one year of direct experience or two years of related experience before a representative seeks registration as a supervisor.

b) **Registered Representative Training.** The NYSE Rule 345 requires a four-month training period for registered representatives. NASD rules have no similar requirement, and the proposal calls for eliminating the training period. It seems only logical to insist on a minimum four-month training to help ensure that registered representatives understand the complicated financial products they are selling.

c) **Customer Complaints**. NYSE Rules require that customer complaints, both oral and written, be reported to the Exchange. The NASD rules do not require the reporting of oral complaints. The new rule proposed to be implemented eliminates the requirement that oral complaints be reported. Rather, members must simply acknowledge and respond to all complaints, and records of such acknowledgment and responses must be maintained by its members.

d) **Office Space Sharing Arrangements**. NYSE Rule 343 prohibits members from jointly occupying an office with another broker-dealer or investment adviser or any other person who conducts a securities business with the public without prior approval of the Exchange. Such approval is granted if there are sufficient safeguards in place, such as signage, to prevent customer confusion. There is no analogue within the NASD rules. The proposed rule amendment would eliminate the approval requirement and place the burden on the member to take the necessary steps to eliminate customer confusion.

Each of these instances, taken alone, may not be a cause for concern. Taken as a whole, however, the examples listed above appear to reflect a trend to weaken certain rule provisions designed to foster diligent supervision, to the detriment of investors. Again, while NASAA understands the need to minimize the discordance in the rules of NYSE and NASD, such an undertaking should not be done at the cost of investor protection. Insuring that stockbrokers and their supervisors are sufficiently trained and knowledgeable; that all complaints are reported; and that investors understand with whom they are dealing are matters of significant investor protection and should be preserved. In short, as the rules are harmonized, the provisions offering the greatest investor protection should be adopted, not those offering the least investor protection.

Aggressive Self-Regulation – The Need for Greater Disclosure

This new SRO must be a tough and effective regulator willing to make hard decisions that may not be popular with its members. In the past, the NASD has not always been willing to embrace initiatives that serve investors' interest if its members raise objections. For instance, several years ago the NASD proposed various revisions to its public disclosure system that reveals the disciplinary history of stockbrokers. This program, commonly known as BrokerCheck, can be accessed through NASD's website. Initially, NASD's proposal included the disclosure of certain disciplinary history that, at the time, was not being disclosed on BrokerCheck. In comment letters filed with the SEC, various NASD members and particularly the Securities Industry Association (now the Securities Industry and Financial Markets Association) opposed the disclosure of this information. Subsequently, the NASD amended its proposal and removed or amended many of the disclosure provisions that the SIA found objectionable. This disciplinary

history, which is available in its totality to investors from state regulators, is an essential tool for investors when deciding whom they should trust with their life savings and NASD should make the information publicly available.

Similarly, various NASD members have opposed NASAA's attempts to amend registration forms used by stockbrokers to capture instances where a stockbroker's actions have been the basis of a customer complaint and arbitration proceeding. Specifically, where a stockbroker is not explicitly named as a party in a dispute or complaint by a customer, the NASD has taken the position that the stockbroker or his firm does not need to disclose the dispute, **even if it results in an award from an arbitration panel or a settlement.** NASAA is concerned that state securities regulators, who license stockbrokers, and the general public are missing critical information that otherwise would be disclosed. NASAA's attempts to amend the forms to add a question to remedy this problem have been opposed by representatives of NASD member firms, and the NASD has been reluctant to aggressively address this issue. This is a significant problem that has been reported in the press, but more importantly, reflects a reluctance by NASD to arm investors with the information they need to choose the right stockbroker and regulate for the public benefit.[3]

Arbitration

A substantial majority of broker-dealers presently include in their customer agreements, a pre-dispute arbitration provision that forces public investors to submit all disputes that they may have with the firm and/or its associated persons to mandatory arbitration. NASAA has been at the forefront of trying to make certain the securities

[3] *See*, "Broker's Pasts Can Still Be Covered Up," Wall Street Journal, April 7, 2005 and "Industry Report Cards For Stockbrokers Questioned," Naples Daily News, March 13, 2005.

arbitration system is fair and transparent to all. The NASD and NYSE dispute resolution forums each have different rules, procedures, and administrative practices, all of which can have a significant procedural impact on an arbitration proceeding. The consolidation of NASD and NYSE will eliminate one arbitration forum for the resolution of disputes between public customers and the securities industry, which raises the stakes for getting it right.

NASAA believes that investors should be given a choice of forums; however, where there is no choice but arbitration through a program administered by the Consolidated SRO, then this one forum must at least be independent and fair to investors. As long as arbitration panels include a mandatory industry representative of the securities industry and include public arbitrators who maintain significant ties to the industry, the arbitration process will be both perceptively and fundamentally unfair to investors. NASAA urges the removal of mandatory industry arbitrators from the arbitration process, and for public arbitrators to have no ties to the industry. This change will bring greater fairness to securities arbitration and instill greater confidence in retail investors that their complaints will be heard in a fair and unbiased forum.

We are also concerned with the trend in NASD arbitrations that permit securities firms to make dispositive motions, such as motions to dismiss, in arbitration hearings. These motions are questionable because they tend to increase the legal costs and complexities for customers, and when such motions are granted by arbitrators, customers lose any chance for recovery before they've even presented their evidence and with no possibility for appeal.

NYSE arbitration rules do not have a provision for motions to dismiss and the NYSE has not permitted such outright dismissals. We recommend the NYSE's practice of not allowing motions to dismiss be incorporated into the code of arbitration for the Consolidated SRO.

Another innovative rule proposal by the NYSE would greatly expand the number of cases that would potentially be decided by a single (public) arbitrator, as opposed to three arbitrators, thereby reducing the amount of fees and related expenses that a public investor would be forced to incur to have his or her dispute resolved.

Having a truly independent dispute resolution forum that promotes the interests of the public investor is one of NASAA's greatest concerns of the consolidation. Additional questions to be explored include:

a) whether there is sufficient disclosure of potential conflicts of interest by panel members;
b) whether the arbitrators receive adequate training and if explanations of awards are sufficient;
c) if the system is fast and economical for investors;
d) whether the entire arbitration process should be optional, not mandatory, for investors; and
e) whether greater transparency such as allowing state securities regulators to attend arbitration hearings in their jurisdictions would improve the process. At present, state securities regulators are denied attendance at these hearings.

State securities regulators often hear directly from investors, and it is important to allow NASAA to be an official observer at the National Arbitration and Mediation Committee meetings where the Consolidated SRO will address arbitration rules and procedures.

Coordination with State Securities Regulators

To the extent that the merger between the NASD and NYSE-R will impact state securities regulation, there must be consultation between the entities involved and state regulators before relevant rule proposals and Notices to Members are announced. Failure to consider the impact of the merger on state laws and regulations is evidenced by the NASD's release of Notice to Members 07-12 earlier this year. This notice, without any advance discussion with state regulators, proposed the elimination of the term, "Office of Supervisory Jurisdiction (OSJ)," and changes to the definition and registration of branch offices. This proposal was particularly troublesome in light of the fact that NASAA, NASD, and NYSE worked together to establish a branch office registration program and promulgated a form to facilitate the registration of these offices. Furthermore, several states that require branch office registration either adopted, or were in the midst of adopting, a proposed uniform definition of branch office. While we understood the purpose of the proposed change was to simplify the current supervisory office classification and harmonize the different provisions of NASD and NYSE rules, NASAA felt the proposal complicated the registration process and served to hamper efforts to revise other forms used for regulatory purposes by both the SROs and the states.

Since the proposed modification would impact state registration requirements, NASAA submitted a comment letter opposing the proposed change and offering an alternative solution. It is our belief that once NASD reviews the alternative proposal suggested by NASAA and others (including representatives of the broker-dealer community) that NASD will abandon the approach announced in Notice to Members 07-

12. While we are hopeful that the NASD will reconsider its proposal, we can't help but believe NASD's stated intent could have been easily achieved had NASD consulted with NASAA prior to the Notice to Members being released for public comment.

Will the Merger Have a Negative Impact on Enforcement?

Currently, NASD and New York Stock Exchange each have surveillance and enforcement programs that are designed to detect and punish a wide variety of fraudulent conduct and other abuses by broker-dealers and registered representatives. The merger raises the very serious concern that consolidation of these programs may result in a less effective enforcement regime and therefore less protection for the investing public.

We believe several key questions must be addressed if the merger is to serve the public's ever-present need for strong enforcement of the securities laws.

Philosophy: Will the new entity embrace an aggressive enforcement philosophy that protects the public as effectively as possible from abuses in the securities markets? Self-regulatory organizations have always been subject to concerns that they are inherently conflicted and therefore incapable of aggressively policing their own members. In some measure, those concerns have been addressed through organizational changes designed to ensure that the enforcement arms of the SROs operate independently of other business units. In addition to these structural arrangements, a strong and demonstrable commitment to enforcement by the leadership of the new entity is essential. To weaken enforcement undermines our capital markets through the diminution of investor and issuer confidence.

Resources and Expertise: Will the new entity allocate sufficient monetary and staff resources to ensure that its unified enforcement program is at least as robust as the

two current programs that NASD and NYSE currently operate? The merger of two organizations always entails a process of streamlining operations and enhancing efficiency. As noted above, that is one potential benefit of the merger. At the same time, however, this very process can result in the commitment of fewer overall resources to the task at hand – in this context, enforcement.

Operational Effectiveness During and After the Merger: Will the new entity take steps to ensure that enforcement priorities do not suffer, both in the short term and the long term, as the merger process unfolds and takes effect? Steps must be taken to ensure that the larger, more centralized organization, will nevertheless maintain an aggressive and nimble enforcement program.

Cooperation with the States: Will the new entity work cooperatively with state securities regulators on enforcement matters? Cooperation among enforcement authorities is one of the cornerstones of an effective and efficient regulatory system that offers maximum protection to investors. The SROs and the states have had some success working together. NYSE, for example, has been a true partner with our member in New Jersey on a number of major investigations and enforcement actions. However, there is room for improvement in the area of enforcement cooperation, and the merger represents an opportunity to forge even better relations between state securities regulators and SRO enforcement authorities. Taking advantage of this opportunity and enhancing the level of enforcement cooperation with the states should be high priorities of the new entity.

Capital Markets Competitiveness

It is significant to note that the merger of NASD and NYSE-R comes at a time when some on Wall Street and certain business interests in Washington are calling for the weakening of our current regulatory framework in an attempt to do away with laws and regulations that require accountability and punish wrongdoing. This recent clamor for "reform" is based on the false notion that our capital markets are losing their competitive edge in relation to other world markets. With record profits on Wall Street and the echoes of Enron still reverberating, scaling back a system of regulation that has vigorously protected U.S. investors for decades could have profound and costly consequences.

Those who would seek to eliminate or reduce state authority are focusing on a new, more subtle methodology – the research study – such as the Committee on Capital Markets Regulation's Interim Report, the McKinsey Report, and the report of the Commission on the Regulation of U.S. Capital Markets in the 21st Century, sponsored by the U.S. Chamber of Commerce. These reports share a common recommendation that we need to move away from our current set of rules and regulations and move towards a "principles based" approach to securities regulation. While the concept of principles based regulation may be appealing, it's still necessary to have clarity for regulated entities, and finding that balance will be a challenge going forward.

NASAA supports a strong and effective regulatory structure for capital markets and that requires preserving the authority of state securities regulators, the local cops on the securities beat. It also requires a strong Securities and Exchange Commission to

properly implement laws, and it requires a strong SRO for efficient compliance. It takes all three of us working in equal partnership to maintain investor confidence in the world's deepest and most transparent markets.

Conclusion

I believe investors deserve a regulatory system that commands and deploys the resources, expertise, and philosophy necessary to vigorously enforce securities laws and maintain fair and transparent capital markets. State securities regulators are committed to working with Congress, the SEC and the new entity created by the merger of NASD and NYSE-R to ensure that our nation's investors continue to prosper in a regulatory environment that provides the strongest investor protections.

Testimony of
Marc E. Lackritz
President & Chief Executive Office
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before the
United States Senate Committee on Banking, Housing and Urban Affairs
Subcommittee on Securities, Insurance and Investments

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Hearing on:
"Consolidation of NASD and the Regulatory Functions of NYSE:
Working Towards Improved Regulation"

I. Introduction

Mr. Chairman and members of the Subcommittee, I am Marc Lackritz, President and Chief Executive Officer of the Securities Industry and Financial Markets Association ("SIFMA").[1] We commend you for holding this hearing and appreciate the opportunity to testify on the consolidation of the NASD and New York Stock Exchange ("NYSE") regulatory functions into a single self-regulatory organization ("Single SRO").

SIFMA supports the Single SRO because we believe it is a win-win situation for investors and market participants. A Single SRO will provide for more effective investor protection at the same time that it will ensure more efficient regulation for market participants. Importantly, the Single SRO will not diminish the quality or vigor of

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers locally and globally through 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. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at http://www.sifma.org.)

regulatory oversight of the markets. As such, we believe the Single SRO will be a significant step toward improving the global competitiveness of U.S. capital markets.

Nonetheless, we believe the Single SRO can be strengthened even more. A comprehensive SRO decision-making process, which includes expert practitioners, will ensure that regulation deals effectively with practical business considerations. In addition, the formation of a Single SRO provides an historic opportunity to reassess traditional regulatory approaches so that U.S. markets remain globally competitive. Achieving this goal, we believe, will require a more textured approach to regulation, a sound regulatory budget and continued SEC oversight.

II. SIFMA Supports the Single SRO

SIFMA has long supported a more streamlined and effective approach to self-regulation.[2] Seven years ago, SIFMA produced a White Paper entitled "Reinventing Self-Regulation."[3] The White Paper examined the purpose of self-regulation in light of major technological and competitive changes taking place in the securities industry, and considered the advantages and disadvantages of different models for regulation of the U.S. securities markets. The White Paper noted that despite having served us well for many decades, the self-regulatory system had two significant drawbacks: (1) conflicts of interest as a result of the SROs' roles as both market operators and regulators, and (2) costs and regulatory inefficiencies resulting from duplication among multiple SROs.

Among the different models explored by the White Paper was a "hybrid" self-regulatory model, which – much like the Single SRO – would consolidate member firm regulation into a central entity while assigning each marketplace the regulation and enforcement of all aspects of trading, markets, and listing requirements. Following issuance of the White Paper, the SIFMA board endorsed the hybrid model. Since then,

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[2] In November 2006, the Securities Industry Association ("SIA") merged with The Bond Market Association to form SIFMA. References to prior White Papers, comment letters, and testimony apply to positions taken by SIA, now SIFMA.

[3] Reinventing Self-Regulation, SIA White Paper (Jan. 5, 2000; updated on Oct. 14, 2003), available at http://www.sifma.org/regulatory/structure/html/whitepaperfinal.html.

we have testified before Congress a number of times on the need to improve and revamp our nation's self-regulatory structure.[4]

We are pleased that the NYSE-NASD regulatory consolidation will bring the hoped-for change in self-regulation to fruition.[5] With the Single SRO, there finally will be one centrally managed self-regulatory entity to oversee member firms. As envisioned, the Single SRO will become the largest private-sector regulator of our members and will have integrated technologies, a single set of rules for broker-dealer activities, one set of examiners and one examination strategy. Regulation of member firms will be more expert, effective and efficient – all of which serve to enhance oversight of U.S. securities firms, strengthen investor protection and increase the competitiveness of the U.S. capital markets.

Among the key benefits of the Single SRO is the ability to focus resources on substantive investor protection by eliminating duplicative and inconsistent regulation among multiple SROs, as well as redundant SRO regulatory staff and infrastructure.[6] Under the current regulatory regime – and despite the SROs' best efforts to "harmonize" their rulemaking initiatives and coordinate their regulatory examinations – duplication can, and does, occur within the areas of rulemaking, data reporting, examinations, and enforcement actions.[7] Currently, the SROs and many firms expend significant time, resources and effort interpreting and applying different standards to their businesses,

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[4] See Testimony of Marc E. Lackritz before the United States Senate Committee on Banking, Housing and Urban Affairs, (Mar. 9, 2006); Testimony of Marc E. Lackritz before the United States House of Representatives Committee on Financial Services, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, (Nov. 17, 2005 and Oct. 16, 2003).

[5] See SIFMA Comment Letters in support of SRO Consolidation dated Dec. 12, 2006, and April 16, 2007.

[6] "Multiple SROs can result in duplicative and conflicting SRO rules, rule interpretations, and inspection regimes, as well as redundant SRO regulatory staff and infrastructure across SROs." SEC SRO Concept Release at 71264. The U.S. General Accounting Office has noted similar "inefficiencies associated with SRO rules and examinations." See GAO Report entitled "Securities Markets: Competition and Multiple Regulators Heighten Concerns about Self-Regulation," May 2002, GAO-02-362, available at http://www.gao .gov/new.items/d02362.pdf, at 1-2.

[7] We recently issued a report demonstrating that the cost of compliance for the securities industry has nearly doubled over the past three years. The Costs of Compliance in the U.S. Securities Industry, SIFMA Research Reports, Volume VII, No. 2 (Feb. 22, 2006), available at http://archives2.sifma.org/research/pdf/RsrchRprtVol7-2.pdf.

including different record-keeping, procedural and audit trail requirements for the same product or service. We believe a single rulebook for broker-dealer activities, along with one source of interpretations, compliance examinations and investigations, will more effectively focus existing resources on substantive investor protection at both the SRO level and the broker-dealer level.

III. Ensuring Investor Protection after the Regulatory Consolidation

For this historic restructuring to reach its full potential, however, the Single SRO should engage in meaningful and regular interaction with all stakeholders throughout the rulemaking process. Developing a transparent and cost-effective regulatory structure – with investor protection at its core – will allow our regulatory system to be dynamic, informed and responsive to our rapidly evolving and highly complex financial markets.

A. Expert Participation in the Self-Regulatory Process

The success of today's self-regulatory governance is directly related to member involvement in the process.[8] Self-policing by professionals who have the requisite working knowledge and expertise about both marketplace intricacies and the technical aspects of regulation creates a self-regulatory system with valuable checks and balances. Supplemented by government oversight, this tiered regulatory system can provide a greater level of investor protection than the government alone might be able to achieve. Indeed, without such member participation, an SRO loses its status as a private actor, and becomes little more than another arm of the government.[9] As such, SIFMA believes that

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[8] See generally S. Rep. No. 94-75, at 22 (1975) (accompanying S. 249, 94th Cong., 1st Sess. (1975)) ("In enacting the Exchange Act, Congress balanced the limitation and dangers of permitting the securities industry to regulate itself against 'the sheer ineffectiveness of attempting to assure [regulation] directly through the government on a wide scale.'"); SEC Report of Special Study of Securities Markets, H.R. Doc. No. 88-95, Part 4 (1963) ("Special Study").

[9] The securities industry self-regulatory structure is grounded in the New Deal of the 1930s. M. Parrish, Securities Regulation and the New Deal (1970). Broadly stated, the theory was that business people could establish "just and equitable principles" of trade without necessarily the same degree of formality as government standards, more akin to a business code of conduct. In contrast, were the new Single SRO to strip away the role of market participants, it would become more difficult to distinguish the Single SRO from any other governmental actor who would have to meet the more exacting standards required for state actors.

the active involvement of SRO members in the self-regulatory process of the Single SRO is integral to the continued success of our regulatory system.

We cannot overstate the importance of regular interaction and cooperation between the Single SRO and its member firms. While independent rulemaking authority by the regulator is vital, equally important is an effective understanding of the practical implications and potential burdens rules may have on the firms to which they are applicable. SRO consultation with industry participants on the front-lines of market-place developments is crucial to obtaining that understanding and, when implemented properly, ultimately yields smarter, more effective regulation. Indeed, we are pleased that both the NASD and the NYSE have taken considerable strides to foster and strengthen effective working relationships with the industry over the past several years.

The NYSE, for example, has integrated the Compliance Advisory Group[10] – a vehicle that fosters a consistent regulator/industry dialogue on compliance and legal matters – into its efforts on identifying new areas of concern, interpretations and the rulemaking process.[11] Importantly, this dialogue identifies issues and concerns as proposed rules and interpretations are being considered at the inception of the rulemaking process. It has been our experience that the opportunity for meaningful dialogue at this phase of regulation maximizes the likelihood of frank feedback and contributes significantly to the comprehensiveness of the ultimate product. SIFMA fully supports this model of regulator/industry partnership and we strongly advocate its continuation in the Single SRO. We believe the governance structure as well as the ongoing interpretive and policy-setting process will benefit from the complete integration of market participants.

[10] NASD has a similar structure with standing and advisory committees that also includes industry participants.

[11] Speech by Richard G. Ketchum, Chief Executive Officer of NYSE Regulation, Inc., Remarks before the SIFMA Compliance and Legal Conference, March 27, 2007.

B. Rationalizing Regulation

Of heightened interest to our members is both the creation of the single rulebook for the consolidated entity and the regulatory philosophy that will undergird the rulebook. One approach is for the NASD and NYSE simply to "harmonize" their current rules to create a single reconciled rulebook that draws from both existing SROs' rules and interpretations. Another approach is to pick and choose between the best of the existing SRO rules in what is at times described as the "band-aid" approach. For our members, however, neither approach is the best solution, notwithstanding the extraordinary effort of both the NASD and NYSE over the past year to seek regulatory harmonization.

Rather, and in light of the recent debate surrounding U.S. competitiveness within the global market, we believe the time is ripe to consider carefully the goals of SRO rulemaking as well as the best method for achieving those goals. In some cases, existing rules may remain the best approach to an issue. In other areas, however, a more "prudential" approach may be warranted. Such a prudential approach would establish "a clear set of standards with a more flexible implementation approach for meeting those standards. It means permitting regulated entities to meet their obligations in a more customized, as opposed to 'one-size-fits-all,' manner. It means more efficient regulation, not less effective regulation."[12] We agree that such a textured approach protects investors while allowing firms the flexibility to compete, innovate and respond to changes in the global economy.

In this regard, and more specifically as relating to the construction of the single rulebook, the question is whether the Single SRO should adopt a "principle-based" vs. "rules-based" approach to regulation. While today's SRO rule structure already relies in some measure on both principles and rules, the issue is one of approach: a principles-based approach to regulation involves a regulator moving away, where possible, from

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[12] Speech by SEC Commissioner Annette L. Nazareth, Remarks before the SIFMA Compliance and Legal Conference, March 26, 2007.

dictating in the first instance how a firm should reach a desired regulatory outcome. This does not remove the need for detailed rules, but suggests an approach where the analysis does not as a default begin with the creation of a rule, but considers first whether firms, supplemented by guidance as appropriate, could assume the responsibility to achieve those desired outcomes in the context of their business processes and existing supervisory obligations. We suggest that a paradigm whose foundation is more clearly based on principles and the achievement of outcomes tied to those principles may better serve investors, the markets and its constituent firms. This approach would allow firms to achieve regulatory objectives in ways that are tailored to their own businesses and that a rulemaking body might not have independently considered.

Regulation by principles and by rules is best described as a continuum of regulatory options. At one end of the continuum a regulator articulates principles and leaves a firm to determine wholly how to achieve the outcome called for in the principle; at the other end of the continuum the regulator dictates through a prescriptive rule how the outcome must be achieved. Within the continuum are various types of guidance that a regulator could promulgate to assist a firm in achieving outcomes. While we certainly recognize that there is an appropriate place for rules, we believe that there may be areas where a more principle-based approach is warranted.

In addition, and in connection with rule formulation, we would note that just as one size does not fit all broker-dealers, it also does not fit all market users. There is a world of difference between an individual investor seeking to invest his/her retirement savings and a multi-billion dollar hedge fund implementing a sophisticated trading strategy. Indeed, there is a similar difference between a high net worth individual managing substantial assets and retail market participants seeking to save for college. While all participants must be protected from fraud, we need a flexible regulatory structure that can differentiate between the various types of market participants when it comes to mandatory prophylactic rules and requirements.

Finally, as a part of this rules review, we also encourage the Single SRO to create a culture in which its surveillance, examinations and enforcement efforts take into account the different purposes of the rules, and address violations accordingly. The examination and enforcement program should not be used to set unwritten policies that the rules fail to articulate or contemplate, nor should it treat a books and records violation or operational glitches in the same manner as an act of fraud (e.g., insider trading). Both the examination and enforcement process should incorporate some sense of proportionality.

C. Funding the Regulator

In a world of limited resources, the goal of any regulatory budget must be to ensure that each dollar is spent in the most effective manner. At the same time, fees for regulation should be apportioned to the industry on a fair and reasonable basis. Imposing regulatory fees that exceed the true costs of regulation acts as a tax on capital and imposes undue harm on the capital-raising system. We recommend that the consolidated regulator be required to define the costs necessary to meet its self-regulatory obligations, prepare and make public a budget to meet those obligations, and then fairly apportion those costs among members by making periodic filings with the Commission subject to public notice and comment as well as Commission approval.

Regulatory funding for the consolidated SRO should come from regulatory fees assessed on market participants; including broker-dealers, issuers and other constituents of the trading markets.[13] Trading markets will benefit significantly from regulatory oversight of broker-dealers and the various examination and continuing education programs. Such regulation and education initiatives foster market integrity and investor confidence. As markets will receive some of these benefits, SROs should likewise assume some of the associated regulatory and administrative costs.

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[13] On a related point, market data fees should fund only the collection and dissemination of market data – not regulatory costs. The SEC estimates that in 2003 market data fees provided 18 percent of the funding of the NYSE and NASD. SEC Concept Release Concerning Self-Regulation, 59 Fed. Reg. 71256, 71270 (Dec. 8, 2004).

D. SEC Oversight and Increased Transparency Requirements

One risk of the Single SRO is that it concentrates regulatory power and authority in one entity. Therefore, it will function effectively only if the SEC provides attentive oversight of its activities. Such oversight, paired with active member involvement, will act to prevent the consolidated regulator from becoming unresponsive with prohibitive cost structures. Most importantly, we look to the SEC to develop increased transparency requirements for the consolidated regulator, particularly concerning funding and budgetary issues. Making the regulator's operations transparent to both members and the investing public will place appropriate checks on the Single SRO and will enhance accountability to its constituents. Similarly, SEC oversight of the Single SRO will be necessary to identify and harmonize so-called "boundary" issues between conduct rules subject to the consolidated regulator's oversight, and market rules subject to the continued oversight of the various exchanges.[14]

IV. Conclusion

America's securities markets are strong and our robust regulatory system plays a crucial role in our markets' success. To retain that strength, we must be vigilant about removing unnecessary regulatory inefficiencies, particularly in light of increasing global competition. We are eager to work with Congress, the SEC, the SROs, and all other interested parties to ensure that our markets remain transparent, liquid, and dynamic, with unparalleled levels of investor protection.

Thank you.

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[14] For example, apparently the NYSE and the NASD currently may disagree regarding whether certain customer order handling rules are "marketplace" rules to be defined and interpreted by the individual markets or whether such rules are member firm rules to be defined and interpreted by the Single SRO. Such disagreements probably are inevitable, but demonstrate the need for vigorous SEC oversight.

Testimony of Professor John C. Coffee, Jr.

Adolf A. Berle Professor of Law
Columbia University Law School

Before the Senate Subcommittee on Securities, Insurance and
Investment of the Senate Banking Committee
On May 17, 2007

"CONSOLIDATION OF NASD AND THE REGULATORY FUNCTIONS OF THE NYSE: Working Towards Improved Regulation"

Chairman Reed and Fellow Senators:

I am pleased and honored to be invited to testify here today and will get to the point without delay.

The impending merger or "regulatory consolidation" of the regulatory arms of NASD and NYSE Group makes excellent sense on a variety of levels: It should result in:

(1) increased efficiency and cost savings by eliminating duplicatory examinations and potentially inconsistent rules;[1]

(2) reduced conflicts of interest, which are inherent in a for-profit exchange having even indirect influence over its regulatory subsidiary;

(3) more effective enforcement through the creation of a single regulator.

The virtues of this consolidation are real; in addition, the persons leading the new body—both Mary Schapiro, as CEO, and Rick Ketchum, as the Non-Executive Chairman—are among the most able and sophisticated in the industry and have proven capabilities as regulators.

So what's not to like? At the possible risk of sounding like a malcontent, I must express several reservations about the design of the new consolidated regulator. It is not my contention that the merger should be rejected or even deferred, but that the goal of "improved regulation" that is noted in the title for these hearings requires that attention be given to the problems discussed below. To this point, the SEC has not formally commented on the impending consolidation. When it does, it should be asked to address the following points:

[1] At present, some 170 U.S.-based broker-dealers doing business with the public are regulated by both NASD and NYSE Regulation. See SEC Exch. Release No. 34-55495 (March 20, 2007), 2007 SEC LEXIS at *3. These firms will be the primary beneficiaries of the cost savings.

1. The consolidation does not go far enough. According to the joint statement released by NASD and the NYSE Group ("NASD/NYSE Regulatory Consolidation Overview"), NYSE Regulation, Inc., will continue to "oversee market surveillance and listed company compliance at the New York Stock Exchange." This retention of "market surveillance" authority by the NYSE Group leaves open some possibility for regulatory arbitrage.

As the Government Accountability Office has noted:

> "Heightened competitive pressures have generated concern that an SRO might abuse its regulatory authority—for example by imposing rules or disciplinary actions that are unfair to the competitors it regulates."[2]

The SEC's 2004 Concept Release on Self-Regulation voiced a similar concern that competitive pressures might encourage regulatory staff "to permit market activity that attracts order flow to their market ... [or] ... to abuse their SRO status by over-regulating members that operate markets that compete with the SRO's own market for order flow."[3]

Under the proposed consolidation, the new SRO would not assume control of the Market Surveillance division of the NYSE. In its November 2005 Registration Statement relating to its merger with Archipelago Holdings Inc., the NYSE Group described the activities of the Market Surveillance division as being "responsible for monitoring trading activities on the NYSE floor and trading by member organizations of NYSE-listed securities. The Market Surveillance division ... checks for abusive or manipulative trading practices and insider trading."[4] As so described, significant enforcement authority

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[2] See "Securities Markets: Competition and Multiple Regulators Heighten Concerns About Self-Regulation," General Accounting Office, May 2002 (GAO-02-362) at pp. 1-2.
[3] See Securities and Exchange Commission, "Concept Release Concerning Self-Regulation," 69 Fed. Register 71256 at 71262-63 (December 8, 2004).
[4] See Amendment No. 3 to Form S-4, Registration Statement Under the Securities Act of 1933, NYSE Group, Inc. (November 3, 2005) (Registration No. 333-126780) at p. 262.

remains in this division, and it could be used to discipline those NYSE members who are also competitors. I do not predict that this will happen, but only observe that it could (and that both the GAO and the SEC have previously expressed concern about this possibility). This possibility would be alleviated if the NYSE Group would assure this Committee that any violations detected by the Market Surveillance Group would be turned over to the new SRO for possible prosecution and would not be enforced directly by it or NYSE Regulation, Inc.

The NYSE Group will also retain authority over the stock listing function. This is understandable. Any exchange should be able to set its own listing standards. But in late 2005, in the middle of a hotly contested takeover battle for Sovereign Bank, the NYSE seemingly abandoned its long-standing rule that no more than 20% of a listed company's voting shares could be issued without a shareholder vote. Instead, it ruled that this requirement only applied to newly issued shares and not to treasury shares. Institutional shareholders revolted and appealed to the SEC to invalidate this interpretation because they recognized that under it an issuer could buy 30% (or more) of its stock in the open market and then re-issue it to a favored bidder—without shareholder approval.[5] To many, this looked suspiciously like an exchange bowing to pressure in the middle of a takeover fight. The SEC took no action, but NYSE Regulation, Inc. officials have suggested that they would seek to amend this critical rule prospectively to eliminate the "treasury share exemption," as it created a major loophole approximately the size of the Washington Square Arch. I would thus suggest that the Committee obtain clarification of whether the

[5] See "CalPERs Opposes Deal by Sovereign Bancorp," Wall St. Journal, January 21, 2006, Section B, p. 3. The Council of Institutional Investors similarly protested.

NYSE Group is in fact amending its listing rules to restore this important protection for shareholders.

2. The "Independence" Level of the Board of Governors of the New SRO is Considerably Less Than Optimal. The current proposal envisions a 23 member "interim" Board of Governors to oversee the new SRO for a three-year transitional period. Of these 23 members, only a minority (eleven) will be "public" members. Alone, a 23 member board is unwieldy and far larger than the contemporary board of most public corporations (which today averages between ten and eleven directors). When NYSE Regulation Inc. was first proposed by the NYSE Group, its board was to consist of nine directors, but could have been reduced later to as few as three directors. A majority of the board of NYSE Regulation were required to be both (1) not members of the NYSE Group board, and (2) "independent" of the NYSE Group under the NYSE's reasonably rigorous independence policy.

Even this proposal encounter stiff resistance from the (then) Securities Industry Association (the "SIA"; today, the "SIFMA"), which argued that the NYSE Group could still dominate NYSE Regulation through its control of NYSE Regulation's parent, New York Stock Exchange LLC.[6] The SEC also criticized the proposed structure of NYSE Regulation and appears to have forced some marginal, last minute changes in the level of control that its parent held over it.[7]

In contrast, consider the current plan for the new SRO. Of its 23 person, only eleven members will be appointed from outside the securities industry (five to be chosen by the NASD Board and five by the NYSE Board with the eleventh to be chosen by both

[6] See George Kramer and Alan Sorcher, The Conflicting Roles of the New York Stock Exchange, 7 J. of Investment Compliance 51 (Dec. 2006).
[7] See SEC Exch. Release No. 34-53382 (Feb. 27, 2006) at pp. 8-10.

organizations). Where formerly a majority of the NYSE Regulation Inc. board had to be "independent" of the NYSE, this is no longer the case with respect to the new SRO. Even with respect to these eleven "Public Governors," the only promise in the joint statement is that they would "be appointed from outside the securities industry," not that they would satisfy the same independence standards that the NYSE mandates for directors of a publicly held corporation. Thus, persons affiliated with law or consulting firms serving the securities industry might populate even these minority positions.

Correspondingly, ten "industry" representatives would be appointed to the 23 member board from various "tiered" segments of the industry. With the SRO's CEO and Chairman, they would outnumber the "Public Governors." This contrasts sharply with past practice. For example, the SEC's approval order for the PHLX exchange noted that PHLX had provided 5 seats on its 22 member board for its parent.[8] In the case of Nasdaq, no board seats on the Exchange's board were reserved for its for-profit parent.[9]

Although I recognize that there is a statutory requirement in the Securities Exchange Act that industry members be given "fair representation" on SRO boards,[10] the SEC has previously found that this requirement can be satisfied by a structure that assigned as little as 20% of the regulatory board's seats to industry representatives.[11]

More generally, the NYSE Group requires that all members of its board (other than its CEO) must satisfy requirements for independence from management, member organizations, and listed companies. This is exemplary. But if the NYSE itself mandates

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[8] See SEC Exch. Release No. 34-49098 at 26-28 (10 additional seats were open to industry members).
[9] See SEC Exch. Release No. 34-53128 at 13-16 (January 13, 2006).
[10] See Section 15A(b)(4) of the Securities Exchange Act of 1934. Similarly, Section 6(b)(3) of the Securities Exchange Act of 1934 imposes a similar standard for exchange boards. Neither provision literally applies to the board of a subsidiary (except to the arguable extent that "fair representation" must also be given in the "administration of its affairs"), and neither specifies any quantitative test.
[11] See SEC Exch. Release No. 34-49718 (May 17, 2004).

an entirely independent board, why should minority independent representation be acceptable for the new SRO that is to regulate the securities industry. Given its more public and quasi-judicial responsibilities as a regulator, it would seem that a higher level of independence should be required in its case. More, not less, independence is appropriate in the case of the key industry regulator, which has no business-oriented responsibilities.

Nor is the level of independence a formal, abstract issue with little "real world" implications. For example, the new SRO created by this consolidation will become the exclusive provider and overseer of securities arbitration. Today, the standard broker-dealer contract with the retail customer mandates an exclusive arbitration remedy, and resort to courts is precluded. It is thus in the industry's collective interest to maintain securities arbitration as a costly, time-consuming remedy that yields only modest returns to the investor. That thumbnail description, even if possibly incomplete in some respects, still accurately describes the overall securities arbitration system that we have today. It is unlikely to change under an SRO as dominated by the industry as the one presented to you today.

Put simply, even though the SRO's CEO and Chairman could join with the eleven Public Governors to outvote the industry representatives, this is not likely to happen very often. The Public Governors do not constitute a cohesive, united body; each may have his or her own views (also, they will be initially chosen by the NASD and the NYSE, neither of which is looking for activists). In contrast, the industry representatives are elected by constituents to represent their interests, and a liberalized arbitration remedy is contrary to

those interests. A CEO who ignores the desires of a strong and unified faction of his or her board is likely to encounter serious opposition and faces an uncertain future.

3. The Contemporary Securities Arbitration System is Ineffective and One-Sided. The contemporary securities arbitration system was sharply criticized earlier this month by New York Times columnist Gretchen Morgenson,[12] who was also reporting recent criticisms made by Senators Patrick Leahy and Russell Feingold, of the Senate Judiciary Committee. Even if she (or they) may have overstated some of their criticisms,[13] they are correct about the following points:

(1) discovery is far less available than in a federal court proceeding;

(2) the three member arbitration panel is inherently unbalanced in light of the mandatory presence of one industry representative—as Ms. Morgenson wrote, this is "akin to having a police officer on a jury hearing a police brutality case";[14]

(3) the process is often slow with multiple delays and adjournments (possibly because the arbitrators have more important matters to attend to);

(4) no class remedy is available, even in cases where the same factual issues may be present in hundreds of cases;

(5) panel members not infrequently have hidden conflicts;[15] and

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[12] Gretchen Morgenson, "Dear SEC: Reconsider Arbitration," New York Times, May 6, 2007 at Section 3, pg. 1.

[13] I do not question the integrity or competence of the neutral arbitrators in securities arbitration; nor do I deny that the process sometimes works well.

[14] See Morgenson, supra note 12, at 1.

[15] The California Judicial Council recently sought to impose higher standards on the arbitrators in NASD securities arbitration, but its attempt to require broader disclosure was found to be preempted by the Securities Exchange Act. See Credit Suisse First Boston Corp. v. Grunwald, 400 F.3d 1119 (9th Cir. 2005).

(6) the investor has no practical choice, because the industry will not open a retail account unless the investors agrees to a mandatory arbitration clause—arguably, a "contract of adhesion."

Despite these problems, I doubt that our current securities arbitration system will be dumped (as she and the two Senators have urged),[16] but it can and should be reformed. However, I see little chance of such reforms coming from an SRO with only a minority of public members.

4. The SEC's Oversight Powers Over SROs Need to Be Broadened, Strengthened And More Effectively Exercised. In Business Roundtable v. SEC,[17] the Court of Appeals for the D.C. Circuit narrowly interpreted the SEC's authority over the exchanges and other SROs under Section 19(c) of the Securities Exchange Act.[18] Although that Section on its face broadly authorizes the Commission to amend, add to, delete or abrogate the rules of a self-regulatory organization, the D.C. Circuit found that the SEC had exceeded its authority in adopting a rule (Rule 19c-4) that mandated a "one-share, one vote" rule for exchange-listed securities. Such a rule, the D.C. Circuit said, invaded the authority of the states to allocate substantive power among shareholders and between shareholders and managers.

Although the subject of shareholder voting power is not currently controversial, the Commission's authority under Section 19(c) over exchanges and SROs remains uncertain in light of that decision. For example, exchange rules regulate important issues

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[16] The Supreme Court has, of course, upheld mandatory pre-dispute arbitration clauses. See Shearson/Am. Express Inc. v. McMahon, 482 U.S. 220 (1987). Of course, Congress can overrule the Court on this statutory issue, but I consider that unlikely. In any event, even if mandatory arbitration were overturned, the existing arbitration system still needs to be reformed because it is the only alternative for many investors who cannot afford litigation in court.

[17] 905 F.2d 406 (D.C. Cir. 1990).

[18] See 15 U.S.C. § 78s(c).

such as the voting of proxies by brokers and the independence level of directors. Arguably, these could also be see as invading the province of the states to regulate substantive corporate governance. It thus might be desirable to add additional language to Section 19(c). For example, it would not harm (and some good) to revise the first sentence of Section 19(c) as follows:

> "(c) The Commission, by rule, may abrogate, add to, and delete from (hereinafter in this subsection collectively referred to as "amend") the rules of a self-regulatory organization (other than a registered clearing agency) as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization, to provide fair and adequate remedies for investors, to assure adequate procedural rights to investors in the nomination and election of directors and in other election contests, to conform its rules to requirements of this title and the rules and requirements thereunder applicable to such organizations, or otherwise in furtherance of the purposes of this title, in the following manner: ...."

This language would not disturb the fundamental result of the Business Roundtable decision that state law controlled the substantive allocation of power among shareholders, but it would curb the overuse of that decision to prevent the Commission from adopting procedural rules or reforms in remedies.

Even if legislation is feasible, it is only part of the broader answer. Given the potentially dominant role that industry representatives will play on the board of the new SRO, greater SEC and Congressional oversight seems desirable. Both the SEC and this Committee should be informed as to the SRO's planning, priorities and internal policies. Prior SEC review of the SRO's budget would also make sense, and this already seems to be the practice in the case of the Public Company Accounting Oversight Board ("PCAOB"). Greater transparency also seems necessary, including with respect to compensation of senior executives. Over the next year or so, the new SRO will face the major task of integrating the rule books of the two former SROs. Much could be

simplified (and some pruning of old rules would be desirable). In particular, the new SRO, even if not legally required to do so, should conduct a cost/benefit analysis of its rules. Merely the fact that a rule has been on the books of either body for the last thirty years (or more) does not mean that it continues to be desirable or efficient in the new era of the Internet. Finally, the new SRO should be asked to conduct periodic self-studies. It (and possibly the SEC also) should examine whether securities arbitration is working in the investor's interest and report publicly on what reforms are feasible and why they have not been implemented.

CONCLUSION

The new SRO appears subject as a practical matter to an industry veto of any reforms that might better protect investors. Securities arbitration is only a case in point, but it is an important example. Were the ratio of Public Governors to industry representatives raised to, say, 2:1, my concerns would be alleviated. Clearly, the time has come for a unified single SRO regulator. But it should be an "independent" one.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM ERIK SIRRI

Q.1. Chairman Cox said on November 28, 2006 that the combination of the NASD and NYSE Regulation "done properly . . . could make our self-regulatory system more efficient and more robust from an investor protection standpoint."

Mr. Mark Lackritz's testimony stated that the combined regulator "will function effectively only if the SEC provides attentive oversight of its activities." SIFMA also called for "the SEC to develop increased transparency requirements for the consolidated regulator, particularly concerning funding and budgetary issues." Professor John Coffee's testimony stated that "greater SEC . . . oversight seems desirable" and the SEC "should be informed as to the SRO's planning, priorities, and internal policies."

A. Will the SEC staff formally review in advance the proposed budgets of the combined SRO with a view to assessing regulatory priorities, how monies are allocated to different functions, compensation levels, and other matters on a periodic basis?

B. What benefits could inure to the Commission, to investors and to others from such oversight?

A.1. SROs that are national securities exchanges and national securities associations are required to supplement their registration forms by annually filing financial information with the Commission. The combined SRO would be required to file, as NASD does currently, an annual consolidated supplement to the NASD's registration as a national securities association. This supplement must contain annual financial statements for the preceding year, including the balance sheet and an income and expense statement. Commission staff currently reviews the financial information that SROs file each year as a supplement to their registration forms.

SROs are not required to submit their proposed budgets to the Commission and, as a result, Commission staff does not review the proposed budgets of SROs. However, as part of the Commission's exercise of oversight responsibility over SROs, Commission staff periodically meets with SROs and at that time discusses the SROs' plans and priorities. During such meetings with a SRO, Commission staff may inquire about the adequacy of the resources devoted to the SRO's regulatory programs and the SRO's capacity to carry out the purposes of the Exchange Act. I expect that Commission staff would hold similar meetings with the combined SRO, if the proposed By-Law changes are approved by the Commission.

Benefits may inure to the Commission, to investors, and to others as a result of the Commission's oversight of a combined SRO. Investors may benefit to the extent that Commission resources that have been used to examine the two SROs can be redeployed to address other areas of concern. Member firms may benefit because of the increased efficiencies, and lower regulatory compliance costs, of a single member SRO. The Commission may benefit because, instead of conducting separate inspections of the NASD's and NYSE's examination, enforcement and surveillance programs, the Commission staff would be able to focus its resources on ensuring that the

single, combined SRO effectively regulates member firms. This, I believe, is a more efficient use of the Commission's resources.

Q.2. Professor John Coffee testified that "Greater transparency also seems necessary, including with respect to compensation of senior executives." Transparency in executive compensation has been a significant regulatory focus recently of the SEC, with its new rules that require registrants to provide more extensive annual disclosure of executive compensation.

While a self-regulatory organization is not a public company, do you feel it would be appropriate for the combined self-regulatory organization to publicly disclose executive compensation for the benefit of its members and investors?

A.2. There currently is no requirement that SROs disclose the compensation of their senior executives, unless they happen to be public companies. However, several SROs (*e.g.,* NYSE, Nasdaq, and ISE) are subsidiaries of holding companies that are public companies or are tax-exempt organizations (*e.g.,* NASD), and therefore the compensation of the highest paid executives of the holding company or tax exempt organization would be publicly available. Transparency by the combined SRO regarding executive compensation could foster good governance, and broad dissemination of this information could benefit investors.

Q.3. The SEC performs an analysis of the competitiveness impact of its proposed rules pursuant to Section 23(a)(2) of the Exchange Act. Professor John Coffee in his testimony recommended that "the new SRO, even if not legally required to do so, should conduct a cost/benefit analysis of its rules."

What would you see as the benefits and costs of requiring the new self-regulatory organization to perform a cost-benefit or competitiveness analysis of its proposed rules?

A.3. SROs currently are required to provide a statement on any burden on competition a proposed SRO rule may impose when the SRO files a proposed rule change with the Commission. Specifically, when filing a proposed rule change with the Commission, a SRO is required to state whether the proposed rule change will have an impact on competition and, if so, (i) state whether the proposed rule change will impose any burden on competition or whether it will relieve any burden on, or otherwise promote, competition and (ii) specify the particular categories of persons and kinds of businesses on which any burden will be imposed and the ways in which the proposed rule change will affect them. The SRO also must explain why any burden on competition is necessary or appropriate in furtherance of the purposes of the Exchange Act.

In addition, any proposed rule change by the combined SRO must provide a statement on the statutory basis for the proposal, which must be sufficient to support a finding that the proposed rule change is consistent with the Exchange Act and the rules and regulations thereunder applicable to the SRO. Furthermore, Section 3(f) of the Exchange Act requires the Commission, in reviewing an SRO's proposed rule change, to consider whether its action will promote efficiency, competition, and capital formation. I believe that these requirements are appropriate.

Q.4. The North American Securities Administrators Association in its testimony warned that "efficiency at the expense of effective regulation is not in our national interest" and asked that the SEC "to require the NASD and NYSE Regulation [to] demonstrate that any rule changes they propose will protect investors and the public interest, promote just and equitable principles of trade, and prevent manipulative acts and practices."

How would you respond to the merits of this request?

A.4. The Exchange Act requires that the rules of a SRO be designed, among other things, to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, to protect investors and the public interest. In this regard, the Commission adopted rules that require that an SRO's filing relating to proposed rule changes be sufficiently detailed and specific to support a finding by the Commission that the proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to the SRO.

I agree with the statement that "efficiency at the expense of effective regulation is not in our national interest." NASD and NYSE Regulation have publicly stated that the proposed regulatory merger would make self-regulation more effective and efficient, while also reducing the risk that fraud occurring in multiple markets would fall between the regulatory cracks. A number of commenters believe that these benefits would help strengthen investor protection and market integrity. Commission staff currently is evaluating the proposed consolidation so I cannot comment on how the Commission will act. However, I can assure you that the Commission takes seriously its mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.

Q.5. The North American Securities Administrators Association in a letter dated February 12, 2007 to SEC Chairman Cox, said, "arbitration panels must be unquestionably neutral. As long as arbitration panels remain comprised of a mandatory industry representative and public arbitrator who maintain significant ties to industry, the process is fundamentally unfair to investors."

NASAA recommended in its testimony "the removal of mandatory industry arbitrators from the arbitration process and for public arbitrators to have no ties to the industry. This change will bring greater fairness to securities arbitration and instill greater confidence in retail investors that their complaints will be heard in a fair and unbiased forum."

How has the Commission responded to NASAA and its concerns expressed in the February letter? How do you plan to address the concerns raised by NASAA about arbitration?

A.5. The Commission is considering NASAA's letter to Chairman Cox, along with the other comments it received, as it considers whether to approve NASD's changes to its by-laws. By way of background, currently, both NASD and NYSE arbitration panels include one "non-public" and two "public" arbitrators, one of which serves as the panel chair. Smaller cases are heard by a single public arbitrator in both forums, although the thresholds for what con-

stitutes a small case differ. NASD has stated that it is working with NYSE to harmonize their definitions of "public" and "non-public" arbitrators. Any resulting proposed rule changes would be filed with the Commission and subject to public comment at that time.

Q.6. William Glavin, Secretary of the Commonwealth of Massachusetts, in a letter published in the Wall Street Journal on December 11, 2006, called for an examination of "Whether the boards of directors of self-regulatory organizations (like the NASD and the stock exchanges) adequately represent small investors."

How would you respond to Secretary Galvin's concerns? Will the combined self-regulatory organization's board adequately represent small investors, even though no board member is specifically designated to be drawn from or represent this group?

A.6. The "fair representation" provision of the Exchange Act requires that an SRO's board include one or more representatives of issuers and investors. This statutory provision, however, does not require that a representative of small investors be on an SRO's board. Under NASD's proposed By-Law changes, eleven of the 23 Governors of the combined SRO would be required to be Public Governors. Because no Public Governor could have a material relationship with a broker or dealer or other SRO, NASD has stated that these Public Governors would fulfill the role of representing investors and issuers.

Q.7. Professor Coffee in his testimony discussed concerns about the board structure of the combined regulator. He observed that "Public Governors" would not be required to "satisfy the same independence standards that the NYSE mandates for directors of a publicly held corporation. Thus, persons affiliated with law or consulting firms serving the securities industry might populate even these minority positions."

A. Please comment on Professor Coffee's observation about "Public Governors."
B. What standards will the SEC employ in reviewing the proposed composition of the Board of the combined regulator?

A.7. The proposed board structure of the combined SRO is not dissimilar to the governance structures approved by the Commission for other SROs. Specifically, the combined SRO's proposed definition of Public Governor is comparable to the definition of Public Governor or Independent Director contained in the governing documents of other SROs. In addition, the definition proposed for the combined SRO is substantially the same as the definition of Public Director that is in the NASD's current By-Laws, in that the definition of a Public Governor would preclude such a Governor from having a material relationship with a broker-dealer or an SRO. In other words, significant relationships, monetary or otherwise, would be precluded.

In terms of the NYSE's definition of Independent Director, NYSE has a more detailed independence policy than other SROs. However, the Commission has not required every SRO to adopt the NYSE's approach, which is modeled on the governance standards that NYSE has in place for its own listed issuers. I expect that there may be less concern about conflicts of interest for the pro-

posed combined SRO, which would be a not-for-profit regulator, unlike other SROs that operate markets, such as the NYSE.

Because the proposed By-Law changes are pending before the Commission, I hesitate to offer views that may in any way prejudge the Commission's action on this important matter.

However, I can say that, in reviewing the proposed composition of the combined SRO's board, the Commission is required to consider whether the changes are consistent with the statutory requirements set forth in the Exchange Act, particularly the fair representation requirements of Section 15A(b)(4). This statutory provision requires that the rules of a national securities association assure the fair representation of its members in the selection of its directors and administration of its affairs, and provide that one or more directors will represent issuers and investors and not be associated with a member of the exchange, broker, or dealer. The Commission also is required to consider whether the combined SRO would be so organized and have the capacity to carry out the purposes of the Exchange Act and to enforce compliance by its members and persons associated with its members with the provisions of the Exchange Act, including those provisions relating to investor protection and the prevention of fraudulent and manipulative acts and practices.

Q.8. The combination of the self-regulatory organizations will result in the NYSE rules and NASD rules being transformed into, as you testified, one "uniform set of rules." The North American Securities Administrators Association in its testimony raised concerns "that harmonization does not compromise investor protection standards." NASAA raised a concern that "the rule harmonization project will favor the interests of members firms of the newly Consolidated SRO over the adoption of provisions that protect investors." NASAA cited several instances in which it said the New York Stock Exchange has a stronger investor protection rule than the NASD but is proposing that its "rules will be amended to facilitate harmonization with less stringent NASD requirements."

Columbia University Law Professor John Coffee in oral testimony pointed out that "in some areas one rule book gives more protection to investors than the other. Anytime you harmonize, you can level up or you can level down. Given the domination of industry members and the diffuse nature of the public governors, I think there is a significant danger that the rule book will be leveled down rather than leveled up. There are really significant differences, such things as old as the 'know your customer' rule of these two bodies, and if we want the stronger one, I think we need to have some SEC oversight."

A. How would you respond to NASAA's concerns?
B. How would you respond to Professor Coffee's concerns?
C. In connection with the harmonization of rules, what standards would govern the Commission staff analysis and the recommendations that the staff would make to the Commission regarding self-regulatory organization rule proposals that would reduce the protections that some investors currently receive?

A.8. When the Commission considers proposed rule changes by SROs, I believe that it is crucial that investor protection standards not be compromised. Because no harmonized rules have yet been submitted for Commission consideration with respect to the combined SRO, I am unable to speak about specific rules. I expect that it may take the combined SRO approximately one year to complete the harmonization process. I can assure you, however, that, as with all SRO rule changes, the Commission will carefully review the proposed harmonized rules when they are filed, including ascertaining how they compare to current NASD and NYSE rules. The Commission also will consider comments received from interested persons.

The Commission's analysis of the harmonized rules will be governed by the requirements set forth in the Exchange Act. These requirements provide that an SRO's rules be designed, among other things, to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, to protect investors and the public interest.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM ERIK SIRRI

Q.1. The SEC and others have noted that some rules cannot be easily categorized as either a member or market rule. What challenges do NASD and NYSE Regulation face in separating member and market rules? How might such challenges hamper their ability to effectively regulate members and markets separately?

A.1. I agree that some rules cannot easily be categorized as either a "member rule" or a "market rule." For example, rules relating to order handling have components that are related to member firm regulation and components that are related to market surveillance. Similarly, in connection with investigations of trading rule violations (a market surveillance function), SROs may examine the quality of supervision by the member firm (a member firm regulation function).

During the process of categorizing rules as "member rules" or "market rules," the NASD and the NYSE may face difficult judgment calls. However, I do not believe that there are any insurmountable challenges. Indeed, my understanding is that the NASD and the NYSE have completed a review of the NYSE's rules to determine which rules should be "member rules" and which should be "market rules." The Commission will review the NASD's filing that identifies the "member rules," including the judgment calls made by the NASD and the NYSE.

If the Commission approves the NASD's filing that identifies the member firm conduct rules, it will be clear as to which SRO will have oversight responsibility for a particular rule because such rules will be clearly enumerated in the combined SRO's rules. Thus, I do not believe that the NASD's and NYSE Regulation's ability to effectively regulate members and markets will be hampered.

Q.2. In its concept release on self-regulation, SEC identified several ways in which the current SRO structure could be modified but recognized that each has its advantages and disadvantages.

What do you view are the principal advantages and disadvantages of the proposed regulatory merger in terms of both regulatory efficiency and effectiveness?

How will you measure efficiencies gained and the SRO's effectiveness in ensuring proper regulatory oversight?

What are the principal factors the SEC is weighing in deciding whether to approve the NASD by-law changes required for the merger? Furthermore, what factors will be considered for reviewing and approving a single rule book while ensuring market competitiveness and strong investor protections?

A.2. The principal advantages of the proposed regulatory consolidation include the elimination of today's duplicate member rulebooks and the possibility of conflicting interpretations of those rules. The consolidation also would result in firms dealing with only one group of examiners and one enforcement staff for member firm regulation. In addition, consolidation could reduce the risk that fraud occurring in multiple markets could fall between the regulatory cracks. All of this could reduce unnecessary regulatory costs while, at the same time, increasing regulatory effectiveness.

I believe that the principal disadvantages of the consolidation would be temporary. During the initial transition period, there could be some increased costs and use of resources as the combined SRO works to harmonize the NASD and NYSE member firm rules. There also could be an adjustment period as the combined SRO integrates the staffs.

As to the combined SRO's overall regulatory effectiveness, the Commission would monitor closely whether the combined SRO is effectively carrying out its regulatory oversight responsibilities under the Exchange Act. In this regard, the Commission would continue to conduct examinations of the combined SRO's regulatory, investigatory, and enforcement activities.

In reviewing the proposed harmonized rules, when received, the Commission would consider whether they are consistent with Section 15A(b)(6) of the Exchange Act, which requires such rules to be designed, among other things, to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, to protect investors and the public interest.

In reviewing the NASD's proposed By-Law changes, the Commission must consider whether they are consistent with the requirements of Section 15A(b)(6) of the Exchange Act described above, as well as consider the effects of the proposed By-Law changes on efficiency, competition, and capital formation. In addition, the Commission will be required to consider whether the changes are consistent with other Exchange Act provisions, particularly the fair representation requirements of Section 15A(b)(4). This statutory provision requires that the rules of a national securities association assure the fair representation of its members in the selection of its directors and administration of its affairs, and provide that one or more directors will represent issuers and investors and not be asso-

ciated with a member of the exchange, broker, or dealer. The Commission also will be required to consider whether the combined SRO would be so organized and have the capacity to carry out the purposes of the Exchange Act and to enforce compliance by its members and persons associated with its members with the provisions of the Exchange Act, as set forth in Section 15A(b)(2) of the Exchange Act.

Q.3. In your testimony, you discuss arbitration merely in terms of increased efficiency and do not address many of the concerns regarding fairness and effectiveness that have been raised by stakeholders. Will the Commission address these concerns as they consider the by-laws of the new SRO?

A.3. The Commission will take into account all of the comments it received on NASD's proposed changes to its by-laws, as well as NASD's response to the comments. Section 19(b)(2) of the Exchange Act requires the Commission to approve a self-regulatory organization rule change if it finds the rule change is consistent with the requirements of the Act. Section 15A(b)(6) of the Act requires the rules of a national securities association to be designed, among other things, to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

Q.4. It is my understanding that the NASD/NYSE regulatory consolidation will fully harmonize the "two rule books" of the NASD and NYSE. North American Securities Administrators Association President Borg raised significant concerns on this front in his testimony. Mr. Borg gives four examples of proposed rule changes—related to supervisor registration, registered representative training, customer complaints, and office space sharing arrangements—where taken as a whole "appear to reflect a trend to weaken certain rule provisions designed to foster diligent supervision, to the detriment of investors." How will you address concerns about investor protections while harmonizing the rule books? Will investors have a meaningful opportunity to participate in this process to ensure that the harmonized rule book serves their needs?

A.4. As the governmental agency responsible for protecting investors under the federal securities laws, the Commission would give great weight to the impact of the harmonized rules on investors. When considering the rules, the Commission is required to consider the Exchange Act's requirement that an SRO's rules must, among other things, be designed to prevent fraudulent and manipulative acts and practices and to protect investors and the public interest.

Investors would have a meaningful opportunity to participate in the rule filing process. NASD would be required to submit the proposed harmonized rules to the Commission for consideration subject to Section 19(b)(2) of the Exchange Act. The Commission would then publish the proposed changes for public notice and comment. During the comment period, any interested investors as well as other persons would be able to submit comment letters for Commission consideration. As with any proposed SRO rule change, the Commission would consider the views and comments expressed by all interested persons.

Q.5. There has been a lot of discussion in recent years regarding giving shareholders greater access to the proxy statements companies produce. But companies are concerned that it is not always transparent as to who is voting the shares, or even who the shareholders are—such that they could identify and communicate with them. What should the regulators be doing to determine who actually owns shares and who is voting them?

A.5. In May 2007 the Commission held a series of roundtables seeking input from a variety of industry participants and investor groups, including issuers, institutional investor groups, broker-dealers, clearing agencies, transfer agents, and private-sector proxy processors. As the roundtables made clear, processing proxies and votes for investors who hold in street name involves numerous complex legal, regulatory, and operational issues. For example, the rights and obligations of stock ownership differ between record owners and beneficial owners under state and federal law. Moreover, the manner in which the U.S. trading and clearing systems operate creates a number of challenges in determining the allocation of voting entitlements. The Commission is currently considering the comments of market participants to determine the appropriate regulatory response and whether any such actions may be implemented in part or whole in order to affect the 2008 proxy season.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM MARY SCHAPIRO

Q.1. The State securities regulators have an important role in protecting investors, as has been shown many times in the past decade's securities frauds. The North American Securities Administrators Association in its testimony stated "To the extent that the merger between the NASD and NYSE–R will impact state securities regulation, there must be consultation between the entities involved and state regulators before relevant rule proposals and Notices to Members are announced."

Will the operating procedures for the combined regulator require that there be such consultation with State regulators? Why or why not?

A.1. NASD has historically engaged in a comprehensive and robust dialogue with state and other regulators about rule proposals, as well as other regulatory and investor protection initiatives. FINRA intends to continue those efforts.

Toward that end, FINRA (as NASD) coordinated with state regulators to form working groups to address specific areas of concern (e.g., the Variable Annuity Group and the Book and Records Task Force). Moreover, FINRA, state regulators, and representatives of NASAA have certain standing committees (*e.g.*, the CRD Steering Committee and the Licensing and Registration Council) that meet on a regular basis. These meetings provide opportunities to discuss rule proposals and their potential impact on state regulators. In addition, all of FINRA's proposed rules are published for notice and comment from interested parties.

Finally, NASD established in 2001, the office of State Liaison to provide states (and NASAA) with a dedicated resource. In conjunc-

tion with the existing forums described above, FINRA's State Liaison will continue to work closely with state regulators to address current issues and developments, including any potential impacts of FINRA rules on state regulation. In sum, FINRA will continue these longstanding communication and coordination efforts with state and other regulators.

Q.2.a. Columbia University Law Professor John Coffee in his testimony discussed concerns that have been raised about the board structure of the combined regulator. He said that "Public Governors" would not be required to "satisfy the same independence standards that the NYSE mandates for directors of a publicly held corporation. Thus, persons affiliated with law or consulting firms serving the securities industry might populate even these minority positions."

Please explain in detail the standards of independence for a Public Governor in the combined regulator.

A.2.a. FINRA rules have prohibitions against persons with material affiliations to the securities industry from serving as "Public Governors." Specifically, any individual who (1) is or has served during the prior year as an officer, director (other than as an independent director), employee or controlling person of a broker or dealer, (2) has a consulting or employment relationship with or provides professional services to a self regulatory organization ("SRO") registered under the Securities Exchange Act of 1934 (the "Act"), or has had any such relationship or provided any such services at any time within the prior year, or (3) has a material business relationship with a broker or dealer or an SRO registered under the Act (other than serving as a public director of an SRO) is prohibited from serving as a "Public Governor" of FINRA. The definition of "controlling person" further restricts individuals who possess, directly or indirectly, the power to direct or cause the direction of the management and policies of a broker or dealer, whether through the ownership of voting stock, by contract or otherwise from serving as a "Public Governor." Individuals who own 20 percent or more of the outstanding voting stock of a broker or dealer likewise will be restricted from serving as a "Public Governor."

For purposes of evaluating whether a "Public Governor" has a "material business relationship" with a broker or dealer or an SRO, the term "material business relationship" will be defined as a "relationship, whether compensatory or otherwise, that reasonably could affect the independent judgment or decision making of the director." In evaluating whether a Board candidate has a material business relationship with a broker or dealer or an SRO, the Office of the Corporate Secretary and the Nominating Committee (aka the Nominating and Governance Committee) will consider various factors, which capture the types of professional and business relationships that may be considered to be material and pose significant conflicts of interests, including, but not limited to:

1. Employment or service as an officer, director, board committee member, or general partner with a Covered Entity [1]
2. Whether the Board candidate and/or the candidate's firm or partnership provided consulting or professional services to a Covered Entity or the director, officer or employee of a Covered Entity and the amount of fees collected from such services
3. Whether the Board candidate ever has appeared as an expert witness or consultant in an SRO hearing or SRO arbitration proceeding on behalf of any party, other than him- or herself or the registered firm with which the candidate is associated
4. Whether the Board candidate ever had any other type of business relationship with or received any other types of payments or benefits from a Covered Entity including, for example, but not limited to, benefits under a tax-qualified retirement plan, pensions, deferred compensation for prior or continued service, non-discretionary compensation, insurance benefits, post-employment office-space and/or administrative support, or other benefits
5. Whether the Board candidate possesses, directly or indirectly, the power to direct or cause the direction of the management and policies of a Covered Entity, through the ownership of voting stock, by contract or otherwise
6. Whether the Board candidate has a stock or another ownership interest in a Covered Entity
7. Whether the Board candidate's investment portfolio is concentrated in the securities industry
8. Whether the Board candidate has made or accepted any loan or any other form of indebtedness to a Covered Entity
9. Whether the Board candidate has an immediate family member with and employment or investment relationship with a Covered Entity

Each of these factors has been incorporated in the form of a question in the Board of Governors' questionnaire, which is the means by which FINRA collects information that is necessary for a determination of the prospective committee member's classification as an "Industry Governor" or "Public Governor."

Q.2.b. Is Professor Coffee's comment accurate, that it would be permissible for "Public Governors" to include "persons affiliated with law or consulting firms serving the securities industry"?

A.2.b. Under most circumstances, attorneys, consultants or other professionals whose practice area or expertise involves the securities industry would be prohibited from serving as a "Public Governor," based simply on the definitions of "Industry Governor" and "Public Governor." First, any individual who currently has, or had during the previous year, a consulting or employment relationship with or currently provides, or provided during the previous year, professional services to an SRO may not serve as a "Public Governor." This restriction is all-inclusive regardless of the amount of work performed for, time dedicated to, or fees charged to the SRO.

[1] For purposes of the assessment, the term "Covered Entity" shall include any SRO, broker-dealer, insurance company, investment company, investment adviser, or an affiliate of any such entity.

Although this restriction allows any individual who provided legal, consulting or other professional services to an SRO more than a year ago to serve as a "Public Governor," the minimum one-year look-back period removes the individual from any direct or immediate ties to the industry.

Second, although the By-Laws expressly prohibit persons affiliated with law or consulting firms who work with or on behalf of SROs from serving as a "Public Governor," it does not expressly prohibit such persons if they provide similar services to a broker or dealer. However, any lawyer or consultant who provides professional services to brokers or dealers will be prevented from serving as a "Public Governor" if such services amount to a "material business relationship." This will restrict a large number of individuals with the appropriate experience and knowledge of the securities industry from serving on the Board in the capacity as a "Public Governor."

Q.2.c. If this observation is accurate, do you feel that individual investors would have concerns about the composition of the Board and, if so, how would you respond to these concerns.

A.2.c. FINRA does not believe Professor Coffee's observation is accurate for several reasons. First, as explained above, most "persons affiliated with law or consulting firms serving the securities industry" will be ineligible to serve as a "Public Governor."

Second, Professor Coffee inaccurately described the "Public Governors" as "minority positions." FINRA's By-Laws expressly provide that the number of "Public Governors" must exceed the number of "Industry Governors."

Third, "Public Governors" historically have represented a cross-section of representatives with varied backgrounds, including the public sector, and academia. The "Public Governors" of FINRA will continue to bring wide-ranging experiences to the Board and will continue, in their public capacity, to represent the needs of investors, industry and the marketplace with an independent point of view.

Q.3. William Galvin, Secretary of the Commonwealth of Massachusetts, in a letter published in *The Wall Street Journal* on December 11, 2006, called for an examination of "Whether the boards of directors of self-regulatory organizations (like the NASD and the stock exchanges) adequately represent small investors."

How would you respond to Secretary Galvin's concern? Is the resulting organization's board designed to adequately represent small investors, since no board member is specifically designated to be drawn from or to represent the concerns of this group?

A.3. We believe the FINRA's board is more than adequately designed to represent small investors and that the interests of all investors will be well represented in the new organization. To begin, FINRA's By-Laws expressly provide that the number of "Public Governors" must exceed the number of "Industry Governors." As described above in response to Question Number 2, the Board's eleven "Public Governors" will not include anyone who (1) is or has served during the prior year as an officer, director (other than as an independent director), employee or controlling person of a broker or dealer, (2) has a consulting or employment relationship

with or provides professional services to an SRO, or has had any such relationship or provided any such services at any time within the prior year, or (3) has a material business relationship with a broker or dealer or an SRO registered under the Act (other than serving as a public director of an SRO). Those serving as Public Governors share FINRA's commitment to investor protection. Among others, FINRA's inaugural Board of Governors includes a former SEC Commissioner, a former state securities commissioner, two university presidents, a former Comptroller General of the U.S., and an expert in individual investor rights.

Under strong leadership selected by the Board, FINRA will fulfill its mission of investor protection and market integrity through surveillance, rulemaking, and working directly with the industry to ensure that members comply with regulations, ensuring investor choice, offering investor education tools. With nearly 3,000 staff, FINRA will be committed to providing more effective protection for the tens of millions of people who invest for their future in the U.S. capital markets.

Furthermore, FINRA will continue NASD's longstanding commitment to investor protection and education, which is the most effective way to protect investors and ease their interaction with the marketplace. Over the past decade, NASD has taken a number of steps to reach as many investors as possible with education and tools to inform their investment decision-making. These have included developing and publishing Investor Alerts, brochures and online resource guides on such critical topics as mutual fund class shares, retirement accounts, college savings plans, and bond investing. FINRA holds investor forums around the country to directly reach investors and answer their questions. FINRA also offers multiple tools on its web site that can help investors manage their money with confidence, including mutual fund fee and expense calculators. Online tools such as BrokerCheck allow investors to search a database to find out their broker's qualifications and determine whether any regulator has ever taken disciplinary action against the broker.

FINRA regularly examines all firms to determine compliance with the rules of the SEC, FINRA, the Department of Treasury and the Municipal Securities Rulemaking Board (MSRB). Examinations are conducted by FINRA's 15 District Offices, with oversight from its offices in Washington, DC, and New York City. Sales practices are analyzed to determine whether the firm has dealt fairly with customers when making recommendations, executing orders and charging commissions or markups and markdowns; and anti-money laundering, business continuity plans, financial integrity and internal control programs are scrutinized. In addition to routine examinations, FINRA conducts thousands of investigations each year stemming from investor complaints, terminations of registered persons for cause, financial problems, arbitrations, referrals from other regulators and FINRA surveillance system alerts.

FINRA's disciplinary procedures promote investor protection and market integrity by providing a process to appropriately sanction firms or associated persons who violate FINRA rules (currently NASD Rules and incorporated NYSE Rules, for dual members), the federal securities laws, or other regulations. These procedures pro-

vide for progressive discipline for repeat offenders and can result, for those who have been found to have engaged in the most serious forms of misconduct and harm to investors, in expulsion from the industry. Where feasible, FINRA orders violators to make restitution to customers identified as having been harmed by their actions. Over the past decade, FINRA has filed over 14,000 disciplinary actions, and expelled close to 200 firms from the industry. We have barred over 4,900 individuals and suspended another 3,600 from the industry.

Finally, NASD established its Investor Education Foundation in 2003. Now renamed the FINRA Investor Education Foundation, it currently is funded with $82 million, making it the largest foundation in the U.S. dedicated to investor education. The Foundation's mission is to provide investors with high quality, easily accessible information and tools to better understand the markets and the basic principles of saving and investing. As demonstrated by all these programs, FINRA and the thousands of people who work for the organization will continue to maintain a fierce commitment to protecting the interests of the individual investing community.

Q.4.a. Some have raised questions about advertisements by broker-dealers. For example, some have said that advertisements for registered representative sometimes suggest that they have a fiduciary relationship with their clients.

How would the NASD respond to such concerns?

A.4.a. FINRA's advertising rules prohibit any misrepresentation by a broker-dealer of its regulatory responsibilities. In addition, all communications with the public must provide a sound basis for evaluating the facts with regard to the broker-dealer's services. Of course, any determination of whether a violation of the advertising rules has occurred depends upon the facts and circumstances surrounding the sales piece at issue, including the context in which it is used and the accuracy of its representations.

Q.4.b. Please describe the role of the NASD in overseeing member advertisements.

A.4.b. FINRA's advertising rules require that any communication with the public by a broker-dealer comply with high standards. Every communication must be fair, balanced and not misleading, and must comply with the specific requirements of the FINRA, SEC, MSRB and SIPC advertising rules. Some types of sales material must be filed with FINRA's Advertising Regulation Department. Most of the sales material that is subject to the filing requirement consists of variable product and mutual fund sales material produced or used by broker-dealers. The Department reviews over 93,000 pieces of sales material every year to determine whether they meet the standards of our advertising rules. We require that members correct any material that violates our rules. Material that is not filed is subject to review by our District Office staff through the examination process. In addition, FINRA conducts periodic sweeps to identify practices and violations not found through the filing program or examination process. Depending upon the severity of the violations, we may pursue disciplinary action through our Department of Enforcement.

Q.5. The North American Securities Administrator Association and Professor Coffee cited several concerns about the arbitration process in their testimony.

A. The North American Securities Administrators Association testified that as "long arbitration panels include a mandatory industry representative of the securities industry and include public arbitrators who maintain significant ties to the industry, the arbitration process will be perceptively and fundamentally unfair to investors." How would you respond to NASAA's observation? What would be the costs and benefits of adopting NASAA's suggestion: "the removal of mandatory industry arbitrators from the arbitration process, and for public arbitrators to have no ties to the industry"?

B. A recent column published in The New York Times, "When Winning Feels a Lot Like Losing," discussed concerns about an arbitration and said: "One explanation for why awards may not reflect the facts of the cases . . . is arbitrators, who are often retired, want to be chosen to serve on future panels. Those known for giving big awards to plaintiffs are more likely to be stricken by brokerage firms from lists of potential arbitrators."

Do you feel this is a significant problem in the arbitration process? If so, what is the NASD doing to address it?

A.5. FINRA's arbitration program and rules are consistent with landmark United States Supreme Court decisions, are highly regulated and investor friendly. Our program is regulated by the SEC, which must approve any rule changes or fee increases and which inspects our program on a regular basis. FINRA serves the arbitration claims on industry parties; arbitrations are held in the location where the investor lived when the event occurred that gave rise to the arbitration; FINRA has hearing locations in all 50 states, Puerto Rico and London; and FINRA suspends from the business any industry parties that do not pay arbitration awards within 30 days. Whether or not an arbitrator is classified as public or non-public, all arbitrators serving in FINRA's arbitration forum are expected to be fair and neutral. Arbitrators do not represent a part or interest in the arbitration matter to which they are assigned. All arbitrators—public and non-public—execute an oath when they accept appointment to an arbitration, and swear to serve in an impartial manner, in accordance with the FINRA Code of Arbitration Procedure and the AAA/ABA Code of Ethics for Arbitrators. All arbitrators—public and non-public—must disclose any business or personal relationships they have with any of the parties, their counsel and representatives, or their witnesses.

We would like to provide some background on the current composition of arbitration panels. (This discussion relates to NASD arbitration rules, which apply to new cases filed after the consolidation.) The NASD Code of Arbitration Procedure classifies arbitrators as either public or on-public. Under both NASD and NYSE Regulation current arbitration rules, customer arbitrations are decided either by a single public arbitrator or by a panel of three arbitrators, two of whom are public and one of whom is non-public. Under the revised rules, non-public arbitrators are not necessarily

from the industry; they could be persons who derive some income from the industry. For example, an attorney who represents investors 80% of the time but also represents industry clients 20% of the time would be a non-public arbitrator. Many non-public arbitrators have, however, worked in the industry at some point.

Both NASD and NYSE Regulation—now FINRA—have taken significant steps to ensure that public arbitrators do not have ties to the industry. Working with investor representatives, arbitrators and the securities industry, we amended the arbitration rules—after publication in the Federal Register, public comments and SEC approval—to eliminate from the pool of public arbitrators those with any ties to the securities industry. Individuals employed at a company that controls, is controlled by, or is under common control with, a securities firm are not eligible nor are spouses and immediate family members of such individuals allowed to serve as public arbitrators. This prevents individuals with even indirect ties to the securities industry from serving as public arbitrators in the FINRA forum. In order to enforce this rule, FINRA requires arbitrators to disclose relevant information about their education, employment history and any potential conflicts of interest.

It is helpful to have at least one arbitrator on a three-person panel (three-person panels are used in larger cases—those with damages claims over $50,000) who is knowledgeable about industry practices. Knowledge about industry rules and procedures, documentation practices, and other regulatory requirements prevents counsel from having to educate each arbitrator about these issues. This expedites hearings, saving time and costs for the parties. Our forum handles increasingly complex issues, such as variable annuities, breakpoints, and mutual fund switching. Industry knowledge about rules and procedures in this area helps hold firms and individuals accountable. If a party prefers to introduce expert witnesses to inform the panel on a particular issue, however, then of course the party may do so.

We understand from our discussions with arbitrators that they work together to uphold their oath to decide each case fairly and to render a just award. Deliberations are collaborative efforts to analyze evidence and testimony, not adversarial debates between the public and non-public arbitrators. A review of the awards database provided free of charge on the FINRA Web site will show that an overwhelming percentage of all awards are unanimous.

We note also that other systems involving technical matters often have one arbitrator who is from the field in question, such as arbitration systems used in state medical malpractice, attorney malpractice, residential real estate, and construction.

We have no indication that arbitrators are issuing small awards or attempting to curry favor with one side in order to assure future appointments. Because of the time commitment necessary to serve as an arbitrator, many of our arbitrators are retired; however, others are working full-time or part-time and do not rely on arbitrator honorarium as an important source of income. Currently, an arbitrator receives an honorarium of $400 for an eight-hour day of hearings, with $75 extra for the chairperson.

In addition, it is important to note that both the claimants' bar (largely through the Public Investors Arbitration Bar Association,

or PIABA) and the defense bar (largely through the Securities Industry and Financial Markets Association, or SIFMA) are well organized. We understand that they both maintain historical information on arbitrators, which they share with their colleagues through email lists, member-only Web sites, seminars, or other sources. Other investors may be represented by one of the several securities arbitration clinics operated by law schools. Thus, it is in the best interests of arbitrators to act in a fair and judicious manner. Also, FINRA maintains a free, online awards database that parties and counsel may search for prior awards by the arbitrators on the lists of proposed arbitrators that FINRA sends to them on each case. In researching their arbitrators, parties and counsel also must be aware that only about a quarter of arbitration cases go to an award. Significantly more arbitration matters are resolved by settlements, which generally are confidential but almost certainly include compensation to the investor, in that experienced industry attorneys tend to settle the strongest cases filed against them by investors.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM MARY SCHAPIRO

Q.1. In a March 8, 2005, letter commenting on an SEC concept release on self-regulation, NYSE opposed a proposal to consolidate member regulation under a single SRO, stating that the existing SRO structure, "preserves one of the key advantages of a competitive regulatory structure, namely multiple watchdogs reviewing trading activity." Is it still a concern? What internal mechanisms or external factors will serve to prevent this potential unintended consequence?

A.1. As indicated in our 2005 comment letter in response to the SEC Concept Release, NASD did not share the NYSE view on consolidation of member regulation. Our view then as now was that the benefits of consolidation in terms of regulatory effectiveness, elimination of regulatory fragmentation and efficiency more than offset the elimination of an additional overseer. Importantly, the consolidation in fact combines all the complementary abilities and resources of both NYSE Regulation and NASD, while seeking to eliminate inconsistent regulatory requirements, and redundant infrastructures and technology applications.

Member and market regulation had always been spread among the various competing self-regulatory organizations and the result was redundant, or sometimes competing, regulation, with firms having to ferret through the minor and major distinctions by each SRO and build a compliance program around those distinctions.

But then came the opportunity that accompanied the change in the business structure of exchanges. When the non-profit exchange model gave way under competitive pressures to public ownership of markets, the opportunity to support a change in self regulation in the interests of elimination of conflicts and efficiency was presented.

Q.2.a. According to the NASD, it will make a one-time payment of $35,000 to its members once the merger is approved in anticipation to cost savings achieved by the new SRO. NASD also will reduce

each firm's annual dues by $1,200 each year for five years and pay NYSE Group $103 million. At the same time, NASD announced that it does not plan to close any of its offices or lay off any of its staff as a result of the consolidation.

What additional revenues will the new SRO receive from taking over NYSE Regulation's Member regulation, and how does NASD expect to achieve its anticipated cost savings?

A.2.a. The revenue streams that accompany the regulatory expenses of NYSE are similar to revenue streams at NASD. Regulatory Fees such as Gross Income Assessment, Personnel Assessments, and Branch Office Fees fund the Member Regulation functions. These revenues have effectively allowed NYSE Regulation's member regulation to operate on a break-even basis.

The anticipated costs savings are expected to be achieved through the retirement of duplicative technology platforms, the ability to leverage existing back office functions.

Q.2.b. How did NASD calculate the $35,000 payment, and why isn't NASD waiting to first achieve cost savings before making such a payment to its members?

A.2.b. The $35,000 payment represents the incremental value derived from this transaction and NASD wanted to ensure that the whole industry was able to share in these savings, not just the dually regulated firms. These savings were based upon an independent valuation. NASD was confident in its ability to meet these savings and therefore determined to pass them onto its members up-front so all members can begin realizing the benefits immediately.

Q.2.c. What, if any, special funding sources or powers will the new SRO have if regulatory fees prove insufficient for a given year if its anticipated cost savings are not realized?

A.2.c. FINRA does not have special funding powers; however, the core regulatory revenue stream (Gross Income Assessment—"GIA") is based on the industry's prior year revenue performance. That said, FINRA can use quarterly FOCUS filings to project future regulatory revenues and in the event that industry revenues declined significantly, FINRA would adjust the GIA rates to ensure adequate funding of the regulatory program.

Q.3. NASD has a $2 billion plus investment portfolio. Given that members of NASD's Finance Committee—an advisory committee that provides investment recommendation to the board—include money managers for large, well known financial firms, what safeguards and protections are in place to ensure that NASD remains independent and free of conflicts? With the merger of the two SROs, what, if any, changes are expected to be made in the future to NASD's investment process?

A.3. The FINRA Investments Office (formerly the NASD Investments Office) is charged with sourcing and managing investments. The Investments Office is composed entirely of FINRA staff which makes all investment recommendations. Some of these recommendations are subject to Investment Committee approval, as dictated by the Investment Policy Statement. Duties and responsibilities for members of the Investment Committee and Invest-

ments Office staff are reflected in the Investment Policy Statement. The Investment Committee's duties and responsibilities are also reflected in the Charter of the Investment Committee. This process remains the same as it was prior to the merger of the two SROs.

FINRA subscribes to high standards of ethics and professional conduct, consistent with its mission of investor protection and market integrity, and requires annual certification by all FINRA staff of compliance with the FINRA Code of Conduct. FINRA similarly holds its investment managers and investment consultants to the highest ethical business practices.

FINRA may retain investment managers, custodians, brokers, or other advisors, provided that members of the Investment Committee fully disclose if they are an employee or contractor of the firm and recuse themselves from discussion and voting. FINRA may retain investment managers in which a member of the Investment Committee is also invested, provided that the member makes full disclosure of the member's interest.

Q.4. There have been reports of many concerns raised about the arbitration process involving arbiters' conflicts of interest, failure of brokers to provide documents, unfairness to investors, and so on. *The New York Times* and witnesses who appeared on our second panel have highlighted these deficiencies in the arbitration process. With the merger of the two SROs what changes should be made to enhance the arbitration process?

A.4.

Arbitrator Neutrality and Conflict of Interest

FINRA provides to both sides in arbitration disputes identical lists of proposed arbitrators, along with detailed reports on each arbitrator's background. We also provide a list of cases in which each arbitrator has issued a final decision, or award. Parties may also find a record of past awards online and free of charge on FINRA's website.

Arbitrators work on a case-by-case basis as independent contractors. They must apply with FINRA to be arbitrators, and we verify through an independent vendor their education, licenses, employment and disciplinary history. Prior to serving on panels, arbitrators are required to take training courses and pass related exams.

In each case to which they are appointed, arbitrators take a written oath to remain neutral. Arbitrators are further required to complete an Arbitrator Disclosure Checklist, as well as to make decisions on the facts and merits of the cases they hear. FINRA constantly monitors arbitrators to ensure they meet necessary standards. If an arbitrator fails to meet those standards, he or she is removed from FINRA's roster of eligible arbitrators.

Impact of the NASD–NYSE Regulatory Consolidation

There was a steady migration by investors to NASD's arbitration forum before the consolidation was proposed; the result is that, prior to the merger, NASD already administered over 94 percent of the investor-broker disputes filed every year. Also, over the past decade, the SEC has approved the consolidation of arbitration programs at several SROs with NASD with no adverse effects.

FINRA's dispute resolution program is subject to extensive regulatory oversight and must operate in a fair manner. As noted above, the SEC must approve all arbitration and mediation rules. FINRA must file with the SEC proposed changes to the rules, as well as significant changes to our processes. After publication in the Federal Register, there follows an extensive period for comments by the public, and FINRA must address the issues raised by the commenters. We often amend rule filings in response to comments from the public. SEC's Office of Compliance Inspections and Examinations (OCIE) conducts periodic inspections of our dispute resolution program. The GAO also conducts reviews of our program from time to time.

The consolidation of the NASD and NYSE dispute resolution forums continues to serve the interests of the investing public. The combined entity continues to be subject to full SEC oversight and inspections, and its rules subject to approval by the Commission as at present. The economics of scale will make it more efficient to recruit, train, and maintain a unified roster of neutrals; there will be better coordination on disciplinary referrals arising out of arbitrations, and on suspending or terminating firms for non-payment of awards; and the single set of rules will reduce confusion for investors.

Q.5. It is my understanding that the NASD/NYSE regulatory consolidation will fully harmonize the "two rule books" of the NASD and NYSE. North American Securities Administrators Association President Borg raised significant concerns on this front in his testimony. Mr. Borg gives four examples of proposed rule changes—related to supervisor registration, registered representative training, customer complains, and office space sharing arrangements—where taken as a whole "appear to reflect a trend to weaken certain rule provisions designed to foster diligent supervision, to the detriment of investors." How will you address concerns about investor protections while harmonizing the rule book? Will investors have a meaningful opportunity to participate in this process to ensure that the harmonized rule book serves their needs?

A.5. The rule harmonization effort, which will now be concluded in the rule consolidation process, will do nothing to undermine investor protection. To the contrary, a coordinated and harmonized system of member conduct regulation should allow firms to more efficiently meet their regulatory requirements and thereby move them towards a more perfect execution of their responsibilities. NASD and the NYSE have consistently emphasized the primacy of registered representative and supervisory education as well as supervision as core concepts of its regulatory scheme. As recently as its joint guidance on Electronic Communications, both SROs emphasized education and supervision as a bulwark towards avoiding the failure to comply with firm conduct requirements. Neither harmonization nor consolidation will undermine investor protection and all new rules of the combined SRO, FINRA, that materially change the rules of either SRO will be filed with the SEC and subject to public comment by all members of the public.

Q.6.a. In your speech before the Chamber of Commerce you talked about regulatory agencies having "overlapping jurisdiction" and the

need to deploy regulatory resources thoughtfully. In addressing the issue about limited regulatory resources, a number of agencies have revised their examination procedures to take a risk focused regulatory approach.

What changes have the SROs made recently to ensure limited resources are deployed in the high risk areas?

A.6.a. Prior to becoming FINRA, NASD had a long evolutionary history in terms of assessing risk as an important driver into the decision of where to apply its resources. There is a tremendous amount of diversity in the securities industry. The business lines are far-ranging, from making markets in over-the-counter securities, to real estate syndication, to retail sales of equities, mutual funds and fixed income products. Firm structures include partnerships, sole proprietors, corporations, subsidiaries of holding companies, independent contractors, and other models. While some firms operate from a single location, others do business throughout the world, managing trillions of dollars in customer assets from dozens of domestic and foreign venues.

As a result of this diversity across the industry, the examination program has evolved to meet the demands of the increasing complexity in products and trading systems, the growing use of sophisticated technology by firms, the new requirements introduced by Congress, the SEC and SROs, and the shifting mix of business activities and models. Further, as a result of the merger with NYSE Regulation's member regulatory program, the examination program at FINRA has expanded its scope of responsibilities, most notably in the area of financial and operational regulation of large firms.

We have launched specific initiatives to design and implement a more risk-based approach to our work. An initial step in this direction was the enhancement of our approaches and the development of risk models to assess sales practice and financial risks based on the footprint, or impact, of firms regulated by FINRA. The ability to assess risk and impact allows us to focus our limited regulatory resources on those firms that present the most risk, those firms that represent a significant part of overall industry activity, and those areas that reflect our current regulatory priorities. This new approach allows us to better hone our sales practice risk focus and conduct more frequent and thorough financial and operational examinations.

A significant number of firms are examined annually. From an impact perspective, this group of firms includes the largest broker-dealers with significant retail, investment banking operations, or highly complex financial operations, as well as all firms that clear or carry for themselves or other firms. From a risk perspective, this group of firms includes broker-dealers with a history of sales practice problems and may present other significant risks to investors. The firms with the highest risk earn a special, specifically-tailored examination during the current year. Moreover, we will refresh our risk view of regulated firms periodically throughout the year to make certain that resources are properly allocated. Among the remaining firms, riskier firms and higher impact firms are placed on a two-year examination cycle. Firms that appear less risky and are smaller in scale of operations will default to a four-year cycle. We

are developing offsite approaches to enhance the monitoring of these four-year cycle firms in the intervening years.

While we tailor the scope of our cycle examinations, there are certain priority areas that our examination staff reviews during every examination, when applicable. These priority areas include items such as Anti-Money Laundering and Protection of Customer Information.

Sweep examinations are another method of performing a focused review of emerging regulatory issues. Rather than directly incorporate these reviews into our on-site examinations, we have used sweeps to inform our thinking on current issues. As sweeps have progressed, we have enhanced our examination techniques to make the job more efficient for our staff and less intrusive for firms. In this regard, we have successfully experimented with on-line surveys, questionnaires, and self-assessments to collect and analyze data. This approach leverages our regulatory resources and permits us to conduct a global assessment of potentially systemic problems.

Q.6.b. Also, what changes do you expect to make to the new SRO to ensure that regulatory resources are deployed appropriately?

A.6.b. FINRA will continue to have a risk-based examination program. FINRA staff is currently engaged in a process of developing the framework for our risk based examination program for 2008 and beyond. While cycle examinations will continue to exist, much as they do today, we will look to further develop our approach to be sure that higher risk member firms and activities are subject to more frequent examinations.

We are also leveraging the synergies between legacy strategic NASD risk-based initiatives and strategic NYSE Member Firm Regulation initiatives. The successful integration of these concepts will blend advanced analytics with additional and rich data for better quality risk identification.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM RICHARD KETCHUM

Q.1. The State securities regulators have an important role in protecting investors, as has been shown many times in the past decade's securities frauds. The North American Securities Administrators Association in its testimony stated "To the extent that the merger between the NASD and NYSE–R will impact state securities regulation, there must be consultation between the entities involved and state regulators before relevant rule proposals and Notices to Members are announced."

Will the operating procedures for the combined regulator require that there be such consultation with State regulators? Why or why not?

A.1. Both NYSE Regulation and the NASD have been committed to a close working relationship with NASAA, and we have every expectation that the staff of FINRA will continue that commitment. We are confident that the rule harmonization proposals that are put forth by FINRA will reflect a careful weighing of the relative merits of the existing rules, with absolute commitment to ensuring that the new rules effectively protect investors and the integrity of

the market. To the extent anyone, whether a state regulator, a representative of the industry or of the public, has a concern with any proposal, it can be raised in the public comment period, and will be considered and weighed in the balance by the SEC, as the final arbiter of whether a rule proposal is consistent with the statute and the public interest.

Q.2.a. Professor Coffee in his testimony discussed concerns that have been raised about the board structure of the combined regulator. He said that "Public Governors" would not be required to "satisfy the same independence standards that the NYSE mandates for directors of a publicly held corporation. Thus, persons affiliated with law or consulting firms serving the securities industry might populate even these minority positions."

Please describe the standards of independence for the directors of a NYSE-listed company and the reasons the Exchange has adopted such standards.

A.2.a. The Exchange's listing standards (Section 303A of the NYSE Listed Company Manual) require generally that listed companies have a majority independent board. To be independent a director must be determined by the company's board to have no "material business relationship" with the company, and the rules also note that the focus in this regard is on independence from the company's management. This basic test is supplemented by a series of "bright line" standards, which specify certain relationships that preclude independence. To paraphrase, these are specified business relationships with the company, the company's independent auditor, or another company with specified relationships with the listed company. (See section 303A.02(b)(i) through (v).)

The Exchange adopted these standards in the 2002–2003 timeframe to shore up investor confidence in the wake of the Enron and Worldcom scandals. The purpose was to provide confidence that listed companies had appropriately independent boards in place to safeguard the interests of investors who owned stock in the listed companies. These standards represented an evolution in historical NYSE standards that already required at least a certain number of independent directors on the board and that required an audit committee composed entirely of independent directors.

Q.2.b. Please compare the standards of independence for the directors of a NYSE-listed company with the standards of independence for a Public Governor in the combined regulator.

A.2.b. The basic standard is the same as our general independence requirement for listed companies, in that it precludes having a material business relationship with FINRA. The FINRA policy adds the requirement that the public governor not have a business relationship with a broker dealer or any other SRO.

Q.2.c. and Q.2.d.

C. Do you agree with Professor Coffee's statement that it would be permissible for Public Governors to include "persons affiliated with law or consulting firms serving the securities industry"?

D. If this observation is accurate, and persons affiliated with law or consulting firms serving the securities industry are seated

as Public Governors of the board of the combined regulators, do you feel that individual investors may have concerns about the composition of the Board and, if so, how would you respond to these concerns?

A.2.c. and A.2.d.

The following is an answer to both of the above questions. The FINRA standard would not preclude a person from public governor status simply because they are with a law or consulting firm that spent part of its time serving the securities industry. Rather, such an affiliation would be considered in determining whether the individual had a material business relationship with a broker-dealer. We believe this to be an appropriate standard for an organization such as FINRA. FINRA requires public governors who are knowledgeable regarding the financial services business and the needs of investors. Law firms and consulting firms garner their expertise by serving all parts of the business spectrum. Clearly individuals have to be evaluated individually, and we believe that the FINRA standard will allow that to happen.

Q.3.a. and Q.3.b.

The combination of the self-regulatory organizations will result in the NYSE rules and NASD rules being transformed into one uniform set of rules. The North American Securities Administrators Association in its testimony raised concerns "that harmonization does not compromise investor protection standards." NASAA raised a concern that "the rule harmonization project will favor the interests of member firms of the newly Consolidated SRO over the adoption of provisions that protect investors." NASAA cited several instances in which it said the New York Stock Exchange has a stronger investor protection rule than the NASD but is proposing that its "rules will be amended to facilitate harmonization with less stringent NASD requirements."

Columbia University Law Professor John Coffee in oral testimony pointed out that "in some areas one rule book gives more protection to investors than the other. Anytime you harmonize, you can level up or you can level down. Given the domination of industry members and the diffuse nature of the public governors, I think there is a significant danger that the rule book will be leveled down rather than leveled up. There are really significant differences, such things as old as the 'know your customer' rule of these two bodies, and if we want the stronger one, I think we need to have some SEC oversight."

A. How do you respond to these concerns that the combined regulator will have rules that are the weaker of the current NYSE or NASD rules to the detriment of investors?
B. How will the combined regulator address the perception that it is reducing the protections that are currently afforded for the benefit of some investors as it proceeds with rule harmonization?

A.3.a. and A.3.b.

The following is an answer to both of the above questions. As a registered national securities association, FINRA is required to have rules that, among other requirements, prevent fraudulent and manipulative acts and practices, promote just and equitable prin-

ciples of trade, and in general, protect investors and the public interest. The SEC will have to be satisfied that FINRA's proposed rule changes satisfy these requirements, and the SEC will reach such conclusion only after public notice and opportunity for comment. The entire process is one that should satisfy the public that FINRA has made appropriate choices as it promotes efficient regulation through the rule harmonization project.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM RICHARD KETCHUM

Q.1. In a March 8, 2005, letter commenting on an SEC concept release on self-regulation, NYSE wrote, "because member firm regulation and market surveillance functions frequently intertwine, it would substantially degrade the quality of both functions to split them into two or more SROs." The letter went on to reference the implementation of Regulation SHO in this context, saying, "because the short sale restrictions involved aspects of both member firm and market regulation, the situation required a degree of fluid and ongoing collaboration between employees of the NYSE's member firm regulation and market surveillance divisions that would have been difficult to achieve if the two groups had been located within separate regulatory entities."

Will the quality of member firm regulation and/or market surveillance be degraded as a result of their separation? What changed your position on this matter?

What steps is NYSE Regulation taking to ensure that market surveillance not only remains robust, but continues to improve, given the evolving nature of our capital markets?

A.1. The following is an answer to both of the above questions. NYSE Regulation did indeed have the concern expressed in the March 8, 2005 comment letter, and we focused on structuring the transaction with the NASD in a way that addressed that concern.

In negotiating and planning with the NASD and the SEC for the structure of the new combined regulator—FINRA—we were very attentive to the need to ensure good communication and cooperation between FINRA and NYSE Regulation. Important in this regard are several elements—(1) the three year transition with an integrated board at FINRA comprised of appointees from both NYSE and NASD, (2) providing for senior NYSE staff to have senior positions in FINRA, and (3) the time and attention we have paid and will continue to pay to integrating NYSE staff and procedures with those of FINRA. These are all part and parcel of ensuring that NYSE Regulation and FINRA remain committed to and capable of efficient and effective cooperation so as to provide continued high quality regulation for the industry and investors.

Q.2. In a March 8, 2005, letter commenting on an SEC concept release on self-regulation, NYSE opposed a proposal to consolidate member regulation under a single SRO, stating that the existing SRO structure, "preserves one of the key advantages of a competitive regulatory structure, namely multiple watchdogs reviewing trading activity."

Is this still a concern? What internal mechanisms or external factors will serve to prevent this potential unintended consequence?

A.2. As indicated above, the opinion expressed in the March 8th letter about the importance of keeping surveillance of our market at the NYSE led to our decision to structure the consolidation with FINRA in a way that kept the market surveillance function at NYSE Regulation. In fact, we have been working with the NASD and the other securities self-regulatory organizations, with the knowledge and cooperation of the SEC staff, to rationalize and optimize the way our industry surveils for insider trading in listed securities—further evidence of NYSE's continued commitment to the support and improvement of the market surveillance function.

Q.3. There have been reports of many concerns raised about the arbitration process involving arbiters' conflicts of interest, failure of brokers to provide documents, unfairness to investors, and so on. *The New York Times* and witnesses who appeared on our second panel have highlighted these deficiencies in the arbitration process. With the merger of the two SROs, what changes should be made to enhance the arbitration process?

A.3. Over many years, the investors who are users of securities industry arbitration have shown a clear preference for the NASD program, to where it now comprises over 90% of all arbitrations nationwide. It will be up to FINRA, the industry and the SEC to decide the future fate of securities industry arbitration, including whatever evolutionary changes are shown to be appropriate as time goes on.

Q.4. It is my understanding that the NASD/NYSE regulatory consolidation will fully harmonize the "two rule books" of the NASD and NYSE. North American Securities Administrators Association President Borg raised significant concerns on this front in his testimony. Mr. Borg gives four examples of proposed rule changes—related to supervisor registration, registered representative training, customer complaints, and office space sharing arrangements—where taken as a whole "appear to reflect a trend to weaken certain rule provisions designed to foster diligent supervision, to the detriment of investors." How will you address concerns about investor protections while harmonizing the rule books? Will investors have a meaningful opportunity to participate in this process to ensure that the harmonized rule book serves their needs?

A.4. The proposed changes in the harmonization filings were made only after a lengthy and careful examination allowed us to be satisfied that they did not degrade investor protection. As a general matter, we have proposed to eliminate what we found to be overly prescriptive regulations that imposed excessive burdens and delay, while retaining key requirements necessary to protect investors. In place of specific prescriptions we have provided that it will be each member firm's responsibility to develop policies and procedures to effectively comply with the rules. FINRA examiners will still have to be satisfied that the firms have taken the appropriate measures to comply and are not compromising the protection of investors.

We are likewise confident that the additional rule harmonization proposals that are put forth by FINRA will reflect a careful weighing of the relative merits of the existing rules of NYSE and NASD. Nonetheless, to the extent anyone, whether a state regulator, a representative of the industry or of the public, has a concern about

a proposal, whether one already filed by NYSE or one that is filed in the future by FINRA, that concern can be raised in the public comment period, and it will be considered and weighed in the balance by the SEC, as the final arbiter of whether a rule proposal is consistent with the statute and the public interest.

303A.02 Independence Tests

In order to tighten the definition of "independent director" for purposes of these standards:

(a) No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must identify which directors are independent and disclose the basis for that determination.

Commentary: It is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company (references to "company" would include any parent or subsidiary in a consolidated group with the company). Accordingly, it is best that boards making "independence" determinations broadly consider all relevant facts and circumstances. In particular, when assessing the materiality of a director's relationship with the listed company, the board should consider the issue not merely from the standpoint of the director, but also from that of persons or organizations with which the director has an affiliation. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. However, as the concern is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding.

The identity of the independent directors and the basis for a board determination that a relationship is not material must be disclosed in the listed company's annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC. In this regard, a board may adopt and disclose categorical standards to assist it in making determinations of independence and may make a general disclosure if a director meets these standards. Any determination of independence for a director who does not meet these standards must be specifically explained. A company must disclose any standard it adopts. It may then make the general statement that the independent directors meet the standards set by the board without detailing particular aspects of the immaterial relationships between individual directors and the company. In the event that a director with a business or other relationship that does not fit within the disclosed standards is determined to be independent, a board must disclose the basis for its determination in the manner described above. This approach provides investors with an adequate means of assessing the quality of a board's independence and its independence determinations while avoiding excessive disclosure of immaterial relationships.

(b) In addition, a director is not independent if:

(i) The director is, or has been within the last three years, an employee of the listed company, or an immediate family member is, or has been within the last three years, an executive officer ,[1] of the listed company.

Commentary: Employment as an interim Chairman or CEO or other executive officer shall not disqualify a director from being considered independent following that employment.

(ii) The director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than $100,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service).

Commentary: Compensation received by a director for former service as an interim Chairman or CEO or other executive officer need not be considered in determining independence under this test. Compensation received by an immediate family member for service as an employee of the listed company (other than an

executive officer) need not be considered in determining independence under this test.

(iii) (A) The director or an immediate family member is a current partner of a firm that is the company's internal or external auditor; (B) the director is a current employee of such a firm; (C) the director has an immediate family member who is a current employee of such a firm and who participates in the firm's audit, assurance or tax compliance (but not tax planning) practice; or (D) the director or an immediate family member was within the last three years (but is no longer) a partner or employee of such a firm and personally worked on the listed company's audit within that time.

(iv) The director or an immediate family member is, or has been within the last three years, employed as an executive officer of another company where any of the listed company's present executive officers at the same time serves or served on that company's compensation committee.

(v) The director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues.

Commentary: In applying the test in Section 303A.02(b)(v), both the payments and the consolidated gross revenues to be measured shall be those reported in the last completed fiscal year. The look-back provision for this test applies solely to the financial relationship between the listed company and the director or immediate family member's current employer; a listed company need not consider former employment of the director or immediate family member.

Contributions to tax exempt organizations shall not be considered "payments" for purposes of Section 303A.02(b)(v), provided however that a listed company shall disclose in its annual proxy statement, or if the listed company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC, any such contributions made by the listed company to any tax exempt organization in which any independent director serves as an executive officer if, within the preceding three years, contributions in any single fiscal year from the listed company to the organization exceeded the greater of $1 million, or 2% of such tax exempt organization's consolidated gross revenues. Listed company boards are reminded of their obligations to consider the materiality of any such relationship in accordance with Section 303A.02(a) above.

General Commentary to Section 303A.02(b): An "immediate family member" includes a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than domestic employees) who shares such person's home. When applying the look-back provisions in Section 303A.02(b), listed companies need not consider individuals who are no longer immediate family members as a result of legal separation or divorce, or those who have died or become incapacitated.

In addition, references to the "company" would include any parent or subsidiary in a consolidated group with the company.

[1]For purposes of Section 303A, the term "executive officer" has the same meaning specified for the term "officer" in Rule 16a-1(f) under the Securities Exchange Act of 1934.

Transition Rule. Each of the above standards contains a three-year "look-back" provision. In order to facilitate a smooth transition to the new independence standards, the Exchange will phase in the "look-back" provisions by applying only a one-year look-back for the first year after adoption of these new standards. The three-year look-backs provided for in Section 303A.02(b) will begin to apply only from and after November 4, 2004.

As an example, until November 3, 2004, a listed company need look back only one year when testing compensation under Section 303A.02(b)(ii). Beginning November 4, 2004, however, the listed company would need to look back the full three years provided in Section 303A.02(b)(ii).