



**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 21<sup>st</sup> 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 21<sup>st</sup> 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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