



Testimony

of

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Housing and Urban Affairs**

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Hearing on Self-Regulatory Organizations

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Mr. Chairman and Members of the Committee: NASD is grateful for the invitation to testify regarding self-regulation in the securities industry. NASD commends the Committee's efforts in reviewing the self-regulatory system. As a regulatory organization devoted to investor protection and market integrity, NASD welcomes the Committee's focus on possible enhancements to the current regulatory system that could strengthen its operation and efficacy. As Congress considers the self-regulatory structure, we hope that insights derived from NASD's recent experiences may provide some helpful background.

NASD Experience

Founded in 1936, NASD is the world's pre-eminent private-sector securities regulator. In 1939, the Securities and Exchange Commission (SEC) approved NASD's registration as a national securities association under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934. We regulate every broker-dealer in the United States that conducts a securities business with the public—about 5,100 securities firms that operate more than 108,000 branch offices and employ about 664,000 registered representatives. We are the only private-sector regulator with industry-wide scope.

Our rules regulate every aspect of the brokerage business. Our market integrity and investor protection responsibilities include rule writing, compliance examinations, enforcement, professional training, licensing and registration, dispute resolution and investor education. NASD examines broker-dealers for compliance with NASD rules, MSRB rules and the federal securities laws, and we discipline those who fail to comply. Last year, NASD filed 1,399 new enforcement actions and barred or suspended 740 individuals from the securities industry. NASD has a nationwide staff of more than 2,400 with an operating budget of more than \$530 million and is overseen by a Board of Governors, more than half of whom are not in the securities industry.

During the last five years, NASD has been in the process of separating from The NASDAQ Stock Market, which in January of this year won SEC approval to become a national securities exchange. NASDAQ is now on an independent course under its own management and Board of Governors. NASD still monitors all trading on NASDAQ pursuant to a regulatory services agreement.

NASD also divested itself of the American Stock Exchange 15 months ago by selling it back to the AMEX membership. As with NASDAQ, NASD continues to monitor all activity on the AMEX pursuant to a regulatory services agreement.

When NASDAQ decided to become for-profit, shareholder-owned and publicly traded, the conflicts confronting NASD as a regulator increased significantly. The challenge for NASD was to create a corporate structure that would assure the public that commercial, financial and stock price considerations did not taint regulatory decisions. We chose complete structural separation between the NASDAQ Exchange and regulation—regulation in a completely separate self-regulatory organization (SRO), two

separate managements, two separate, non-overlapping boards, two separate balance sheets. This structural separation has allowed NASD to realign as a private-sector regulator with an exclusive focus on regulating the broker-dealer industry and, by contract, exchanges and markets.

Today, the New York Stock Exchange (NYSE) finds itself in a similar position with its merger with Archipelago and its conversion to a public company. To deal with these new conflicts, the NYSE has chosen to place regulation inside the shareholder-owned, for-profit holding company and to wall it off as a separate subsidiary with a different governance structure. Whether this approach provides the requisite assurance to the public that regulation will always be performed to protect them, not the shareholders, has been the subject of a great deal of healthy and needed debate in our industry. Interestingly, among competing for-profit exchanges in this country the NYSE proposes to be the only one that will have comprehensive regulatory authority over the firms that are or would be its customers.

Last year, the 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. The SEC also is examining and seeking comment on certain enhancements to the current SRO system and a number of regulatory approaches and legislative initiatives.

The SEC stated that the most controversial aspect of the current SRO system is the inherent conflicts of interest between an SRO's regulatory functions and its members, market operations, listed issuers and shareholders. Conflicts can result in poorly targeted and less extensive SRO rulemaking, and weak enforcement of SRO rules.

As we told the SEC in our response, one glaring inefficiency in today's regulatory scheme is the dual regulation of firms that are members of both the NYSE and NASD. Currently, these approximately 200 firms are faced with dual rulebooks; dual examinations, interpretations and enforcement; and dual fees. And, following the NYSE's current restructuring, the number of dually regulated firms may increase substantially, because NYSE has chosen to require that each firm that desires a trading license must submit not only to market, but also full member, regulation by the NYSE.

A solution that makes sense is a partnership between the NYSE and NASD to jointly handle the regulation of the firms that are members of both organizations. Under such a partnership, firms would be regulated according to one rulebook instead of two. They would pay one regulator instead of two, and they would have only one examination and enforcement staff to deal with, lowering their compliance costs. These savings could then be passed on to investors, while the regulation of these firms would be more coherent, effective and efficient.

This structure is very much in line with the hybrid SRO proposal that the SIA put forward a few years ago and has recently reiterated.

It is no secret that John Thain and I have had discussions about how a partnership between our two organizations could work. While it is too soon to know where these discussions will lead, my hope is that our two organizations can find a way to create a structure that best serves investors and solves some of these vexing problems.

To best protect the interest of investors, any new structure would have to solve the conflict inherent in both regulating and managing a for-profit exchange. The regulator will have rule writing and enforcement authority for sales practices, financial operations and transaction routing decisions. Thus, absent complete separation of a for-profit exchange and regulation of member conduct, there is the unavoidable inherent conflict that regulation of member conduct may be influenced by the commercial, financial and stock price impact of such regulation on the affiliated exchange.

That is the guiding principle for NASD as we move forward in any discussion about SRO consolidation. NASD has put forth to the NYSE several proposals concerning a possible partnership, but we cannot agree to any structure that would result in a loss of independence over rule writing, as well as examination, investigation and enforcement. As stated earlier, NASD has worked diligently for the last five years to become an independent, un-conflicted regulator that does not own or control markets. Any integrated structure with the NYSE must not cause us to give up that independence. That means NASD cannot give the NYSE control over our rule-making, interpretation function and examination decisions through a veto or any other mechanism.

A little history is important at this point. At the inception of the securities laws, Congress was deliberate in its design of a statutory scheme of self-regulation. It was recognized that it was impractical for government to provide the necessary resources to effectively regulate the securities industry and there was a legislative preference that the industry, as opposed to greater taxpayer-funded appropriations, pay for the task of necessary and increasingly extensive regulation. Congress understood that conflicts could arise in such a system of regulation, but, as the SEC's 1963 Special Study of Securities Markets noted in reflecting the intent of Congress in words and scheme, "regulation in the area of securities should, in short, be a cooperative effort, with the Government fostering maximum self-regulatory responsibility, overseeing its exercise, and standing ready to regulate directly where and as the circumstances require."

But the views of Congress were fashioned at a time when all self-regulatory bodies were not-for-profit, member-owned institutions, with a manageable degree of conflicts. The relatively recent advent of de-mutualized, shareholder-owned markets has significantly increased the degree of conflict by potentially putting at odds the interests of shareholders in maximizing profits with the interests of market participants in operating fair and orderly markets. This significantly increased conflict arising from the marriage of regulation and for-profit markets is unavoidable; it is a matter of corporate structure

even if it is not fueled by intent. In short, the commercial for-profit mandates of these SROs threaten to belie that "cooperative effort" between government and self-regulation, noted in the SEC's 1963 Special Study, when it comes to regulating member conduct. It is the recognition of this conflict that has led all major European exchanges, which have lead the way in converting to for-profit, shareholder-owned structures, to give up the regulation of the financial institutions that trade on their exchanges. Similarly, it is both the recognition of conflict and an effective response that are critical to ensuring the long-term integrity of the U.S. capital markets in international finance.

NASD is in a unique position among U.S. securities SROs. NASD has separated its regulatory operations from any interest in an exchange. NASD has fully divested itself of the American Stock Exchange, Inc., and with the SEC's recent approval of NASDAQ's application to become a registered national securities exchange, will complete the process of selling its remaining financial interest in NASDAQ before the end of the year.

We also have taken effective actions to address member conflict issues, implementing rigorous corporate structure changes to prevent undue influence of regulated firms over boards, key committees and staff. These actions reflect both structural and procedural changes to many of the core aspects of NASD operations and address the very conflicts of concern identified by the SEC in its review of self-regulation. With respect to funding, as noted earlier, virtually all broker-dealers are required to be NASD members. We have the authority to assess our members, as necessary, to fund our regulatory operations, and they cannot resign membership unless they give up doing securities business with the public. We do not face the same types of competitive pressures as other SROs to retain their members. NASD has members subject to regulation, not customers.

For these reasons, any partnership with the NYSE, and any resulting SRO structure, must preserve these attributes of independence in the SRO exercise of the regulatory mandate.

Rule Harmonization

In its February 7, 2006, response to comments filed with the SEC regarding its Archipelago merger, the NYSE suggests that rule harmonization with NASD will effectively address the conflicts between its for-profit exchange and its member regulatory function. But NASD believes harmonized rules amount to a topical treatment of some—but not all—symptoms of a more serious problem.

There are several reasons why harmonization of rules is a less-than-ideal substitute for the hybrid model of self-regulation. First, harmonization does not resolve the inescapable conflict where an SRO both operates a trading market and regulates that market's participants, which in some instances may be competitors of that market. Under the hybrid model of self-regulation, the SRO responsible for member regulation would have no incentive to promulgate rules that either drive business to a particular market

center or otherwise protect the SRO's commercial interests; the NYSE model is unavoidably embedded with these conflicts because of its shareholder-owned, publicly-held, for-profit structure, and the answer does not lie in making the rulebooks of a conflicted SRO and a non-conflicted SRO look alike.

Second, while harmonization would result in substantially similar rulebooks, it would not eliminate all duplicative costs and efforts associated with having two organizations, rather than one, write, administer and enforce those rules. Third, harmonization at the level of the SRO rulebook will inevitably not be sustainable as divergence will necessarily occur at the level of interpretation, examination and enforcement. Common sense dictates that more effective, efficient and evenhanded rules would result from a single rulemaking entity than from an arranged marriage of two distinct entities with differing institutional histories.

Benefits of Self-Regulation

Clearly, in light of developments at the SROs, it is appropriate to consider the future of the self-regulatory model. The evolving model of securities regulation has proven effective through nearly 70 years of regulatory experience. Both Congress and the SEC have periodically examined the role of self-regulation in the securities industry, and while each has taken steps when needed to remedy shortcomings, the concept of self-regulation has been repeatedly reaffirmed and strengthened.

The self-regulatory model has many important benefits to investors and the markets. Self-regulation can and does extend past enforcing just legal standards to adopting and enforcing ethical standards (i.e., just and equitable principles of trade). Government regulation is well suited for policing civil or criminal offenses, but less so for ethical lapses, which, while not necessarily illegal, may be unfair or hinder the functioning of a free and open market. Self-regulation is uniquely capable of protecting investors from those sorts of transgressions.

Private funding is another critical advantage to the self-regulatory model. Millions of dollars can be 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 by NASD. Regulators operating in the private sector are also better positioned to move quickly to address regulatory issues because, among other things, they are not subject to spending restrictions of the federal government, and are better able to develop large-scale systems for important regulatory matters like market surveillance, broker registration and trade reporting.

Moreover, private-sector regulators are able to tap industry expertise in ways not readily available to the government and to use this expertise to better protect investors and ensure market integrity. Among other things, this expertise helps 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.

Need for Separation of Market and Regulator

This is not to say that self-regulation is free from conflicts. NASD's evolution into its current corporate structure and separation from NASDAQ illustrates the conflicts that exist when an entity both owns and regulates a market, and how NASD resolved those conflicts.

In the mid-1990s, NASD faced a conflict that fundamentally altered its existence. The SEC found NASD to be negligent in how it regulated its member firms and their trading on NASDAQ. This finding called into question NASD's corporate structure and whether it was appropriate for managing both the regulation of more than 5,000 firms and their half-million securities professionals, and the operation of a trillion-dollar securities market with its own myriad purposes.

In November 1994, the NASD Board of Governors appointed an independent committee to review NASD's corporate governance structure and recommend changes that would enable NASD to better meet its regulatory and business obligations, including oversight of The NASDAQ Stock Market. In September 1995, the committee recommended the establishment of two distinct subsidiaries: one to perform NASD's regulatory functions and the other to run NASDAQ. The committee recommended that each subsidiary have a separate Board of Directors and that NASD remain as the non-profit parent corporation overseeing the operations of both subsidiaries.

Based on those recommendations, NASD formed two subsidiaries—NASD Regulation and NASDAQ. And, just as importantly, NASD implemented a new corporate governance structure that ensured a majority of NASD's Board of Governors would be from outside the securities industry. In 2000, NASD created another subsidiary for its mediation and arbitration functions, NASD Dispute Resolution.

In 2000, when NASDAQ decided to become a shareholder-owned, publicly-traded exchange, NASD determined that the existing structure that placed regulatory activities in a subsidiary no longer afforded sufficient protection for investors. Operating an exchange to maximize profits for shareholders and simultaneously managing regulatory activities to fully protect investors could not be conducted under the same corporate structure without unmanageable conflicts, in our view. We therefore restructured NASDAQ and NASD as two wholly separate companies with separate managements, separate funding sources and separate, non-overlapping boards. The governance separation is complete; economic separation is near completion with the recent action by the SEC to designate NASDAQ an exchange and the sale of NASD's remaining minority share ownership in NASDAQ, which we are committed to doing by the end of this year.

Conclusion

Thank you for giving us 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 with Congress as it continues to review the changing regulatory landscape.