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And

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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.