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"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. <u>The "Independence" Level of the Board of Governors of the New SRO is Considerably Less Than Optimal</u>. 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, <u>The Conflicting Roles of the New York Stock Exchange</u>, 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 and Strengthened. 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, <u>to provide fair and adequate remedies for investors</u>, <u>to assure adequate procedural rights to investors in the nomination and election of directors and in other election contests</u>, 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 <u>Business Roundtable</u> 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. 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.