Testimony of

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

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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.