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# Report from SIFMA's 40<sup>th</sup> Annual Compliance and Legal Division Seminar: FINRA Officials Provide an Update on the NASD – NYSE Merger

## I. Introduction

On March 31, 2008, the Securities Industry and Financial Markets Association (“SIFMA”) opened its 40<sup>th</sup> annual Compliance and Legal Division Seminar with a general session (the “March 31 Session”) principally devoted to a discussion of the results of (to date) and next steps in relation to the merger of NASD with the member regulation of the New York Stock Exchange (the “Merger”). The Merger, which was approved by the U.S. Securities and Exchange Commission (the “SEC”) in July of 2007,<sup>1</sup> created the U.S. Financial Industry Regulatory Authority (“FINRA”), which now serves both as the principal regulator of the over-the-counter markets and as the largest regulator of business conduct in the U.S. securities industry. Virtually all U.S. broker-dealers (as measured both by number and size) are members of FINRA.

During the March 31 Session, a panel including Mary Schapiro, FINRA's Chief Executive Officer, and Richard Ketchum, FINRA's Non-Executive Chairman, as well as James Brigagliano of the SEC's Division of Trading and

Markets, discussed the effect of the Merger on the culture of the legacy NASD and NYSE groups, the benefits of the Merger, the ongoing project of rulebook consolidation, and the examination and enforcement activities of FINRA since the Merger.

The purpose of this client memorandum is to provide clients with a summary of the comments of the participants of the March 31 Session, and in particular to summarize the forward-looking comments of FINRA personnel. This client publication does not purport to be a complete discussion of the issues raised by the Merger, or of any specific issues described. For more information relating to any of the issues discussed in this client memorandum, please contact any of the Shearman & Sterling LLP attorneys listed on the last page of this client memorandum.

## II. Summary of the March 31 Session

### 2.1 Overview of the Integration of NASD and NYSE's Member Regulation Department

The March 31 Session commenced with Ms. Schapiro presenting an overview of the integration efforts relating to the Merger. Generally, she noted that:

- FINRA has seated a new Board of Directors that has commenced meetings, as well as commenced its duties as the principal oversight body for the post-Merger integration;

<sup>1</sup> On July 26, 2007, the SEC approved the merger of the regulatory operations of the New York Stock Exchange and the National Association of Securities Dealers, Inc. See “Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc.”, SEC Release 34-56145 (July 26, 2007), currently available at <http://sec.gov/rules/sro/nasd/2007/34-56145.pdf>. FINRA commenced operations on July 30, 2007. Information regarding the Merger is available at the FINRA Internet website: [www.finra.org](http://www.finra.org).

- FINRA's integration efforts with respect to its enforcement and examination functions has largely been completed, with FINRA now processing complaints and reviewing existing and prospective cases in coordinated processes;
- FINRA's consolidation of the legacy technology systems are on track for completion in mid-2009; and
- FINRA continues to work on the consolidation of the NASD and NYSE rulebooks, which task has become more challenging in the current environment.

## 2.2 Merging the Cultures of NASD and NYSE

Ms. Schapiro and Mr. Ketchum described the ongoing process — and philosophy — relating to merging the cultures of the predecessor regulators. Mr. Ketchum described that notwithstanding the shared mission of the predecessor regulators, the culture of the two entities was quite different, leading to differing viewpoints regarding moving the new regulator forward. Both Ms. Schapiro and Mr. Ketchum emphasized that FINRA's principal question in determining policy or procedure on any issue is, "what is the best way forward?" This highlights the desire of senior FINRA management not to be seen to be preferring or rejecting the methods of either predecessor. Mr. Ketchum noted that FINRA has, for example, continued and expanded the "coordinator"-based program that was the cornerstone of the relationship between NYSE-member firms and the NYSE's members regulation department.

## 2.3 Benefits of the Merger

Both FINRA and SEC representatives to the March 31 Session emphasized the efficiency benefits of the Merger. Mr. Ketchum particularly noted the efficiencies that are gained by having a single entity interpreting the relevant rules, and predicted that additional efficiencies will follow the rulebook harmonization. For his part, Mr. Brigagliano noted the benefit to SEC Staff of dealing with a single SRO in rulemaking activities.

## 2.4 Update on Rulebook Consolidation

Much of the substantive discussions in the March 31 Session centered around FINRA's ongoing effort to produce a single rulebook for the SRO, merging the NASD Manual with the applicable member regulation rules of the NYSE.

Ms. Schapiro noted that the general procedure by which rulebook consolidation will take place was set forth in a March 2008 Information Notice by FINRA.<sup>2</sup> Generally, FINRA currently operates on the basis of two sets of rules: NASD rules and rules incorporated from NYSE. The incorporated NYSE Rules apply only to members of FINRA that are also members of NYSE.

FINRA will now propose and seek the adoption of a new set of unified rules. As the SEC approves new FINRA rules, they will form the contents of a new (third) FINRA rulebook, and corresponding NASD and NYSE rules will be withdrawn. At the end of the process, FINRA will be left with a single rulebook.

Ms. Schapiro also noted that FINRA will propose a series of "core conduct" rules that are likely to form the basis of a principle-based element to FINRA regulation. Ms. Schapiro predicted that these core conduct rules would be proposed during the Spring of 2008. Ms. Schapiro noted, however, that both the content of the new FINRA rules (e.g., the degree to which NASD and/or NYSE rules would be changed) and the movement of the rulebook — and FINRA — towards "principle-based" regulation would be based in some measure on the kind of rule in question. In this regard, she pointed to guidance in the March Regulatory Notice relating to the kinds of rules that would more likely be adopted without substantiated change.<sup>3</sup> Ms. Schapiro

<sup>2</sup> See FINRA Information Notice, "Rulebook Consolidation Process" (March 12, 2008) (the "March Information Notice"). FINRA Information Notices are available at FINRA's Internet Website: [www.finra.org](http://www.finra.org).

<sup>3</sup> See the March Information Notice at Page 2 ("FINRA Staff is identifying those rules that do not lend themselves as well to this type of [principle-based or "tiered" regulatory] analysis and are candidates to be transferred into the Consolidated FINRA Rulebook without substantive modification. These rules include certain procedural and marketplace rules, which are prescriptive by necessity.").

cautioned that the “deep retail participation” in U.S. securities markets makes wholesale adoption of principle-based regulation unlikely.

In describing the unified rulebook project, the panelists in the March 31 Session also discussed the call by some within the industry for broad rule exemptions for institutional investors. Here, the panelists were notably cautious. Ms. Schapiro expressed reservations at the idea that traditional definitions of institutional status — based principally on the investable assets or assets under management of the particular entity — serve as appropriate basis for exemption from existing rules. Though she was clear that FINRA is considering institutional exemptions on a rule-by-rule basis, she was equally clear in her view that institutional exemptions from rules should be based on the sophistication, and not the size, of the investor. She suggested that the rulemaking project should focus on identifying those criteria that provide the best proxy for sophistication. While she noted that FINRA is considering a range of alternatives, she also noted that FINRA remains concerned about the nature and kind of underlying customers represented by the institutional investor.

## 2.5 Examination and Enforcement

The March 31 Session provided an update on the (post-Merger) examination and enforcement programs of FINRA.

With respect to the examination program, FINRA’s general viewpoint is that the post-Merger program, which has seen many firms placed on a new examination cycle, is designed to attempt to look at the risks posed by the business conducted at the firms, and to develop an examination plan for each firm, based on the risks posed by the firm’s business to the financial system and to the investors. Mr. Ketchum noted that members of exchanges are also subject to the various exchanges’ market surveillance and related examination programs. Mr. Ketchum noted his view that such examination focus on market risk issues and are not duplicative with FINRA’s efforts. With respect to the evolution of

FINRA’s enforcement program, both Ms. Schapiro and Mr. Ketchum described a desire to focus enforcement resources on market integrity issues, and to move away from traditional enforcement strategies where the circumstances of rule violations do not place investors or markets at risk. For her part, Ms. Schapiro noted that her interest is to see enforcement resources used to pursue those matters that strain market integrity or market quality. In particular, she highlighted fraud, insider trading, fraud against seniors, and complex products as areas that she felt were priorities for FINRA’s enforcement program. Both Ms. Schapiro and the SEC Staff representative, Mr. Brigagliano, were quick to point out that FINRA (and, for its part, the SEC) regularly decline to commence prospective enforcement actions on the basis of considerations such as those described above, and in particular where a firm has taken corrective action and where there has been no investor harm.

## III. Conclusion

The March 31 Session underscored the complexity of the current movement towards a unified self-regulatory authority for the U.S. securities industry. In addition to the program update described above, the panelists were asked to give their views around the impact of current market turmoil, the SEC’s mutual recognition program, and the Department of the Treasury’s proposals to restructure the entire system of financial markets regulation in the United States.<sup>4</sup> One consequence of the complex task being undertaken by FINRA is the existence of a complex transition period, during which firms must keep track not only of existing regulation, but also of the status of proposed regulation, and of the position(s) of FINRA’s examination staff relating to specific rules and practices.

<sup>4</sup> See the “Blueprint for a Modernized Regulatory Structure” (March 31, 2008), currently available at the Department of the Treasury’s Internet Website at: <http://www.treas.gov/offices/domestic-finance/regulatory-blueprint/>.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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