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"FIN RAH!" . . . A WELCOME CHANGE: WHY THE MERGER WAS NECESSARY TO PRESERVE U.S. MARKET INTEGRITY

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I. INTRODUCTION

In an age when news of a corporate merger seldom raises an eyebrow, it should come as no surprise that regulatory organizations would eventually follow suit. Corporate mergers are typically the result of efforts to increase the financial worth of the resultant company, in hopes of higher stock prices and, therefore, wealthier shareholders. However, the recent consolidation between the regulatory arm[1] of the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers ("NASD"), the two self-regulatory organizations ("SROs") chiefly responsible for oversight of the U.S. securities industry, is the by-product of a different type of sought reward: efficiency.[2]

For years, members of the industry criticized the duplicative efforts made by these two agencies and the discrepancies resulting from conflicting rules.[3] Under the former system, firms belonging to both agencies were "subject to dual—but not always consistent—rulebooks, examinations, investigations, sweeps and enforcement actions."[4] In an attempt to rid the regulatory oversight schema of such contradictory rules, these two organizations "unveiled . . . a plan to merge some of

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1. NYSE, Complaints & Inquiries, http://www.nyse.com/regulation/complaintsinquiries/1088808969148.html (last visited Jan. 24, 2008). Only certain areas of NYSE Regulation were affected by the consolidation. "Specifically, NYSE Regulation continues to be responsible for conducting market surveillance and enforcing rules and laws that relate to trading activity occurring on NYSE and NYSE Arca, as well as ensuring that companies listed on NYSE and NYSE Arca meet their financial and corporate governance listing standards." *Id.*

2. Consolidation of NASD and Regulatory Functions of the NYSE: Working Towards Improved Regulation: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs (May 17, 2007) (testimony of Mary L. Schapiro, Chairman and CEO of FINRA), *available at* http://www.finra.org/PressRoom/SpeechesTestimony/MaryL.Schapiro/P019169 [hereinafter Schapiro Testimony].

3. William H. Donaldson & Harvey L. Pitt, *Outdated and Inefficient*, WALL ST. J., Jan. 6, 2007, at A7.

4. *Id.*

their operations" in November 2006.[5] The final organization became known as the Financial Industry Regulatory Authority ("FINRA").[6]

As with any business deal affecting the overall economy, questions were raised concerning the potential impact on the public.[7] The overarching purpose of the merger was investor protection.[8] However, with optimism waning in the wake of the subprime mortgage debacle and the American economy dangling over the precipice of recession, some consumer advocates have questioned whether now is the best time to reduce the number of regulators looking out for their interests.[9] To the contrary, such issues prove that now is precisely the time to consolidate and streamline the regulatory system.

The consolidation not only serves to address the issues of duplication and inefficiency within the regulatory structure, but also the conflicts of interest that in recent years have resulted as both organizations focused on profit generation instead of on their obligations as supervisory organizations.[10] The NASD's role as creator and former owner of the NASDAQ and the NYSE's transition to a for-profit entity in 2006 caused some to question whether the two self-regulatory organizations could continue to regulate member firms in an impartial manner.[11] Their return to exclusive service as regulatory agencies, especially in this time of economic turmoil, reinforces the true regulatory mission of investor protection.

A. Sub-Prime Disaster

Recent headlines have drawn the world's attention to the subprime crisis that has infiltrated virtually every aspect of the financial sector.

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5. Randall Smith & Kara Scannell, *NASD, NYSE Agree to Merge Some Oversight–Supporters Foresee Streamlining In Market Regulation as Foes Fear Less Protection For Individuals*, WALL ST. J., Nov. 29, 2006, at C1.

6. FINRA, About the Financial Industry Regulatory Authority, http://www.finra.org/AboutFINRA/CorporateInformation/index.htm (last visited Apr. 30, 2008) [hereinafter About FINRA].

7. Carol E. Curtis, *Bumps Emerge on Road to Completion of SRO Merger*, SEC. INDUS. NEWS, June 11, 2007, *available at* 2007 WLNR 10863673 (Westlaw).

8. *See* Helen Kearney, *Regulation: The Burden and the Backlash*, ON WALL STREET, Feb. 1, 2008, *available at* 2008 WLNR 1930499 (Westlaw).

9. *Id.*

10. George R. Kramer & Alan E. Sorcher, *The Conflicting Roles of the New York Stock Exchange*, J. OF INV. COMPLIANCE, Dec. 22, 2006, at 54.

11. *Id.*

Although some sectors have been impacted more than others, the securities industry has surely been shaken.[12] Over the past few years, credit terms had become uncharacteristically flexible and home loans easily available, allowing anyone, including those with poor credit histories and with low incomes, to qualify for a home mortgage loan.[13] The easy access to credit appealed to individuals seeking the American dream of home ownership. Sadly, the dream turned into a nightmare as many, especially those with adjustable rate mortgages, found themselves unable to afford their mortgage payments and, subsequently, in default on their loans.[14] Since the interest rates on over 1.8 million subprime mortgages are scheduled to increase in 2008[15] and 2009, the number of foreclosures will almost certainly continue to rise, necessitating the financial industry to address the consequences of its investment participation in subprime mortgages.

The stock market fallout in 2000[16] led to the development of innovative yet highly speculative financial products, such as credit default swaps, collateralized debt obligations, and other financial vehicles backed by subprime mortgages.[17] These investment choices precipitated the venomous effects of the subprime mess on the brokerage industry.[18] A true domino effect, one by one the big Wall Street firms stepped forward with their massive subprime-related losses.[19] After releasing its 2007 third-quarter earnings, Citigroup announced that it would write down over $5 billion in losses, deeply cutting into the

12. Mark Gongloff, *Credit Woes Slam Stocks*, WALL ST. J., Nov. 26, 2007, *available at* http://online.wsj.com/article/SB119608282533903873.html.

13. Edmund L. Andrews, *Fed Shrugged as Subprime Crisis Spread*, INT'L HERALD TRIBUNE, Dec. 18, 2007, *available at* http://www.iht.com/articles/2007/12/18/business/18subprime.php.

14. Noelle Knox, *Record Foreclosures Hit Mortgage Lenders*, USA TODAY, Mar. 13, 2007, *available at* http://wwww.usatoday.com/money/economy/housing/2007-03-13-foreclosures_N.htm.

15. *Number of Foreclosures Soared in 2007*, MSNBC.com, Jan. 29, 2008, http://www.msnbc.msn.com/id/22893703.

16. Noelle Knox, *Mortgage Crisis: Home Loans Are Harder to Get*, USA TODAY, Aug. 6, 2007, *available at* http://www.usatoday.com/money/economy/housing/2007-08-05-mortgage-lenders_N.htm.

17. *Time to Brace for Impact*, INV. ADVISER, Dec. 17, 2007, *available at* 2007 WLNR 25785654 (Westlaw).

18. Shawn Tully, *Wall Street's Money Machine Breaks Down*, FORTUNE, Nov. 12, 2007, *available at* http://money.cnn.com/magazines/fortune/fortune_archive/2007/11/26/101232838/index.htm.

19. *Id.*

company's financials.[20] The amount of write-downs continued to rise, resulting in thousands of employee layoffs.[21] Merrill was also dealt a hard blow and is expected to write-down over $15 billion.[22] Others soon followed,[23] and the full extent of the damage is still to be determined.

The meltdown left many questioning why regulators did not prevent, or even foresee, the crisis, and wondering who dropped the ball.[24] Many blamed the regulators for failing to recognize the foreseeable credit issues that would arise from this type of securitization.[25] Some asked, "[Where was the NASD] when subprime funds were being dreamed up and then packaged and sold?"[26] While it is too late to undo the damage, the consolidation comes at a crucial point in our economy's history and can be a tool to analyze what went wrong and prevent a future disaster.

B. The Solution

The consolidation between the NYSE and NASD happened at the right time. Not even a year into its existence, FINRA already initiated a sweep to investigate firms and their marketing to customers of financial products tied to mortgages.[27] Because of its new structure, FINRA is

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20. Charles Gasparino, *Citigroup Plans New Round of 'Massive' Job Cuts*, CNBC.com, Nov. 26, 2007, http://www.cnbc.com/id/21974307/.

21. *Id*.

22. Julia Werdigier & Jenny Anderson, *Giant Write-Down is Seen for Merrill*, N.Y. TIMES, Jan. 11, 2008, *available at* http://www.nytimes.com/2008/01/11/business/11wall.html.

23. David Reilly & Karen Richardson, *For Financial Stocks, Is It Another False Bottom?*, WALL ST. J., Jan. 26, 2008, at C1, *available at* http://online.wsj.com/article/SB120044238607892763.html.

24. Paul Krugman, *Blindly into the Bubble*, N.Y. TIMES, Dec. 21, 2007, *available at* http://www.nytimes.com/2007/12/21/opinion/21krugman.html.

25. *See, e.g.*, Jessica Dickler, *Senator Faults Regulators in Subprime Mess*, CNNMoney.com, Mar. 27, 2007, http://money.cnn.com/2007/03/26/real_estate/Dodd/index.htm (last visited Mar. 7, 2008); Dan Taylor, *As NASD/FINRA Fiddled, Credit Markets Burned*, INVESTMENTNEWS, Aug. 13, 2007, *available at* http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20070813/FREE/70813021/1006.

26. Taylor, *supra* note 25.

27. David Scheer & Jesse Westbrook, *Broker Probed by FINRA on Mortgage Security Sales, Person Says*, Bloomberg.com, Jan. 4, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=apNYRLoCVcUk&refer=home.

able to place more emphasis on this crisis and on investor protection.[28] With a two entity system, "multiple levels of regulation [made it] difficult to navigate and expose[d] consumers to gaps in protections."[29] A single non-profit regulatory structure allows for more centralized oversight of these areas and is better able to safeguard investors.[30] The NYSE and NASD previously acted as both market operators and regulators, which gave rise to potential conflicts and concerns.[31] The new regulatory organization is again directing its attention on investors.[32] FINRA is closely scrutinizing any areas where greater protection is required and taking further action regarding solicitation and product suitability for seniors.[33] It also uses a risk-based approach to identify and combat critical financial industry issues.[34] This is particularly necessary for the organizations entrusted with supervision over those engaged in the financial industry, since the markets are open to all participants, from the novice and inexperienced to the most sophisticated investor.

FINRA named investor protection as its primary goal and has already developed several programs to further its commitment to this objective.[35] Although investor protection was previously an objective of both SROs, their preoccupation with other market activities, such as merging with exchanges, steered their attention away from this purpose.[36] With U.S. capital markets serving as one of the leading and most powerful forces in the world, it is essential that investors have trust

28. *See* FINRA, Putting Investors First, http://www.finra.org/InvestorInformation/InvestorProtection/PuttingInvestorsFirst/index.htm (last visited Apr. 30, 2008).

29. Kearney, *supra* note 8.

30. Doug Schulman, Vice Chairman, NASD, Remarks at the Securities Traders Association (Jan. 26, 2007), http://www.finra.org/PressRoom/SpeechesTestimony/DouglasShulman/P018435 (last visited Apr. 30, 2008).

31. *Consolidation of NASD and Regulatory Functions of the NYSE: Working Towards Improved Regulation: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs* (May 17, 2007) (statement of Marc E. Lackritz, President, Securities Industry Association), *available at* http://www.sifma.org/legislative/testimony/pdf/lackritz5-17-07.pdf [hereinafter Lackritz Testimony].

32. Mary L. Schapiro, CEO, FINRA, Remarks at SIFMA Annual Meeting (Nov. 9, 2007), http://www.finra.org/PressRoom/SpeechesTestimony/MaryL.Schapiro/P037447 (last visited Apr. 30, 2008) [hereinafter Schapiro, Remarks at SIFMA].

33. Kearney, *supra* note 8.

34. Schapiro, Remarks at SIFMA, *supra* note 32.

35. *Id.*

36. *See generally* NYSE Euronext, Timeline, http://www.nyse.com/about/history/timeline_2000_Today_index.html (last visited Apr. 30, 2008).

and confidence in the system.[37] This requires constant transformation and adoption of innovative measures to keep up with the ever-changing environment.

C. The Merger

Aside from gaining recognition as the first exceptional change to the securities oversight structure in decades, this merger also drew great attention because of the parties involved. Regulatory organizations such as the former NASD are generally non-profit organizations and their main function is to effectively regulate their respective fields, not to generate income.[38] Therefore, merging of such organizations involved different motivation than typical mergers between for-profit companies. Whenever for-profit organizations seek to merge, management has a tendency to "envision new markets, more product lines and healthier balance sheets."[39] The transaction's main objective typically is to increase the bottom line.[40] Profit is so important that parties in these impending mergers might be subjected to undesirable tactics since different people and entities might not share the same perspectives on profit.[41]

Non-profits generally have less financial-related motivations to consolidate.[42] The most frequently cited benefits for merging non-profit organizations include "increased effect and reach," fewer redundancies in a specific area, "greater efficienc[y]," "stronger organization," and

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37. *See* Mary L. Schapiro, CEO, FINRA, Remarks at the Exchequer Club (June 20, 2007), http://www.finra.org/PressRoom/SpeechesTestimony/MaryL.Schapiro/P019306 (last visited Jan. 24, 2008).

38. Schulman, *supra* note 30.

39. Not-For-Profit Advisor, On the Verge of a Merge? What to Consider Before Proceeding, http://www.plantemoran.com/Industries/PublicSector/NotForProfit/Resources/Not+For+Profit+Advisor/2006+Winter/On+the+Verge+of+a+Merge+What+to+Consider+Before+Proceeding.htm (last visited Feb. 13, 2008) [hereinafter Not-For-Profit Advisor].

40. *Cf.* Judith R. Thoyer, *A New Look At Post-Merger Governance: The Dow Jones Acquisition*, PRACTISING LAW INSTITUTE, PLI Order No. 13964 657, 661 (2008) (discussing social issues involves in various transactions).

41. *See* Robert Guy Matthews, *Rio Tinto's Earnings Illustrate Why It's in Play*, WALL ST. J., Feb. 14, 2008, at A13. BHP Billiton submitted an unsolicited takeover offer for its rival RIO Tinto and RIO has been calling for rejection of the bid because, among other things, it undervalues the company.

42. Not-For-Profit Advisor, *supra* note 39.

"the continued ability to fulfill one's mission."[43] While FINRA's goal could be said to achieve all of these benefits, its foremost objectives are to protect investors and advance market integrity by increasing efficiency.[44] Two separate regulators essentially performing the same functions was inefficient. Other countries recognized the presence of multiple regulators as a shortcoming within their regulatory systems and are now consolidating, if they have not already successfully done so.[45]

On May 20, 1997, the U.K.'s Chancellor of the Exchequer, the principal Finance Minister of the British government, announced that it would merge "banking supervision and investment services regulation"[46] into what was then known as the Securities and Investment Board ("SIB"). SIB officially changed its name to the Financial Services Authority ("FSA") in October 1997[47] and continues to serve as a model of streamlined regulation.[48] This single organization is responsible for overseeing the banking, brokerage, and insurance industries[49] and employs principles-based regulation, which allows firms to decide how best to achieve their desired outcomes, rather than a rules-based regulation system like in the United States,[50] which instead focuses on the means.[51] Other countries followed the trend in regulatory consolidation, especially members of the European Union ("E.U.").[52]

The European Central Bank has cited two main motivations for consolidating supervisory functions within the E.U.[53] "First, they represent a response to the rapid developments in the financial sector,

43. *Id.*

44. FINRA, Putting Investors First, *supra* note 28.

45. Federal Financial Services Regulatory Consolidation, Overview, http://www.opencrs.cdt.org/document/RL33036/ (last visited Feb. 13, 2008).

46. History of the FSA, http://www.fsa.gov.uk/Pages/About/Who/History/index.shtml (last visited May 1, 2008).

47. *Id.*

48. Kearney, *supra* note 8.

49. FSA, FSA Sector Teams, http://www.fsa.gov.uk/Pages/About/Teams/index.shtml (last visited Apr. 30, 2008).

50. Roel C. Campos, Comm'r, SEC, Speech at the Luxembourg Fund Industry Association: Principles v. Rules (June 14, 2007), http://www.sec.gov/news/speech/2007/spch061407rcc.htm.

51. John Tiner, CEO, FSA, Speech at APCIMS Annual Conference (Oct. 13, 2006), http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1013_jt.shtml (last visited May 7, 2008).

52. European Central Bank, Developments in National Supervisory Structures, http://www.ecb.int/pub/pdf/other/supervisorystructureen.pdf (last visited Mar. 8, 2008).

53. *Id.*

also with a view to national peculiarities. Second, they aim at enhancing the effectiveness and efficiency of supervision."[54] Essentially, these countries have adopted the view that less is more when it comes to financial oversight.[55] While other countries and territories outside the E.U., like Hong Kong,[56] Dubai,[57] and Japan,[58] have also made attempts to consolidate their financial regulators,[59] the FSA's structure is frequently mentioned as the prototype to be emulated by regulatory bodies considering a merger.[60] The FSA's timely address of the subprime issues and shoddy lending practices within the U.K. in July 2007 further demonstrated its effectiveness in regulating the financial industry.[61] The U.K. was not impacted as severely as the U.S., with subprime lending accounting for only 10% of all homes in the country.[62] For such reasons, the NYSE and NASD worked cooperatively with the FSA during the consolidation process and FINRA continues to do so, especially to obtain guidance in its implementation of principles-based regulation.[63]

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54. *Id.*

55. *See generally id.* (discussing the developments in national supervisory structures of E.U. countries).

56. *See* The Securities and Futures Commission Homepage, http://www.sfc.hk/sfc/html/EN/ (last visited May 1, 2008).

57. Dubai Financial Services Authority, http://www.dfsa.ae/dfsa/about+us/who_we_are/ (last visited Feb. 13, 2008).

58. *See* Financial Services Agency Organization, http://www.fsa.go.jp/en/about/about01_menu.html (last visited Feb. 13, 2008) (showing the consolidated structure of the Japanese Financial Services Agency).

59. Steve Zwick, *Rube Goldberg's Regulatory Legacy*, FUTURES CHI., Feb. 1, 2008, *available at* 2008 WLNR 2248865 (Westlaw).

60. Jeremy Grant, *US Looks to London for Regulatory Model*, FIN. TIMES ASIA, Dec. 14, 2007, at 6, *available at* 2007 WLNR 24641743 (Westlaw).

61. Jennifer Hughes & Jane Croft, *FSA in Subprime Crackdown*, FIN. TIMES LONDON, July 5, 2007, at 17.

62. Patrick Collinson, *Subprime Lender Becomes First British Victim of Credit Crunch*, GUARDIAN, Sept. 11, 2007, *available at* http://www.guardian.co.uk/business/2007/sep/11/money.mortgages.

63. Schapiro, Remarks at SIFMA, *supra* note 32.

II. PRE-CONSOLIDATION

The NYSE and the NASD have long been recognized as two of the leading SROs in the United States.[64] Both were instrumental in ensuring that the firms they regulate[65] comply with the multitude of securities industry rules and regulations.[66] While the two served similar purposes as regulators, each had a very distinct history and origin as an SRO. In order to truly appreciate the magnitude of the recent consolidation, it is essential to understand their background and establishment as regulatory agencies.

A. The New York Stock Exchange

Before passage of the federal securities laws[67] and the founding of the Securities and Exchange Commission ("SEC"), the NYSE had long served as one of the principal exchanges for trading in securities.[68] The NYSE originated in 1792.[69] For over a century, the NYSE, as well as the other existing exchanges at the time, remained an unregulated entity, governed only by its floor members and plagued with market manipulation.[70] Some cite the lack of regulation of the securities industry as one of the reasons why the economic crisis, spurred primarily by fraudulent activity,[71] culminated and crippled the American

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64. Both were established as SROs after the Maloney Act was passed in 1968. 15 U.S.C. § 78o-3 (1968).

65. About FINRA, *supra* note 6. There are over 5,000 brokerage firms being regulated by these entities. *Id.*

66. In addition to complying with the Securities Act of 1933 and the Securities Exchange Act of 1934, members of the securities industry must also comply with rules created by the SROs. *See generally Self-Regulatory Organizations: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs* (Mar. 9, 2006) (statement of Robert Glauber, Chairman, NASD), http://www.finra.org/PressRoom/SpeechesTestimony/RobertR.Glauber/P016123 (Mar. 9, 2006) [hereinafter Glauber Testimony].

67. *See* Securities Act of 1933, 15 U.S.C. § 77a; Securities Exchange Act of 1934, 15 U.S.C. § 78a. Both were enacted during a time of economic turmoil following the Stock Market Crash of 1929.

68. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 73 (3d ed. 2003).

69. *See* History of the NYSE, http://www.nyse.com/about/history/1089312755484.html (last visited Jan. 24, 2008).

70. SELIGMAN, *supra* note 68, at 48.

71. *See id.*

economy with the stock market crash in 1929.[72] This disaster caused a national crisis as millions of people lost their life savings.[73] This called for reform and close scrutiny of financial practices, since investors lost confidence in the American economy.[74] In order to prevent another such catastrophe and to restore trust in the markets, Congress began probing into the potential causes of the crash.[75]

From 1932 to 1934, the Senate Banking and Currency Committee conducted an "investigation of stock exchange practices, usually called the Pecora Hearings, in recognition of the decisive role played by the committee's counsel, Ferdinand Pecora."[76] The investigation revealed an abundance of corruption and supervisory deficiencies.[77] One area of focus concerned the NYSE's listing procedures, specifically its approval process and due diligence when registering a company's stock.[78] Enforcement of its listing requirements became unmanageable and virtually nonexistent with the increase in new stock applications between 1926 and 1929,[79] leading to the listing of worthless securities.[80] Frank Altschul, chairman of the NYSE's Committee on Stock List, stated at the Pecora Hearings "that the NYSE ceased making any independent investigation of an application for the listing of additional stock by a firm whose stock was previously listed unless there appeared

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72. In addition to lax or nonexistent regulation of the stock market, there was a proliferation of mischief and unscrupulous activity in other areas of the financial sector. *Id.* Accounting principles were lenient during this time since firms were free to employ whatever accounting methods they wanted, resulting in companies overstating their worth in their financial statements and misrepresenting themselves to the investing public. *Id.*

73. DAVID M. KENNEDY, THE AMERICAN PEOPLE IN THE GREAT DEPRESSION: FREEDOM FROM FEAR, PART ONE 163 (9th ed. 1999).

74. ROBERT S. MCELVAINE, THE GREAT DEPRESSION: AMERICA 1929-1941, at 48 (Three Rivers Press N.Y. 1993).

75. SELIGMAN, *supra* note 68, at 2.

76. *Id.* at 1.

77. *Cf. id.* at 2 (discussing the fact that the conclusions of the Pecora hearings were intended "to diminish . . . faith in the nation's financial institutions").

78. *See id.* at 47.

79. *Id.* at 47 (stating that new stock applications rose from 300 to over 750 between 1926 and 1929).

80. *Id.* In 1929, the NYSE had allowed Krueger and Toll Company to list "a thirty-year debenture, reserving the right to substitute new pledged securities for those listed as collateral on the application." *Id.* The company later "replaced the French debentures serving as collateral with less valuable Yugoslavian debentures." *Id.*

patently suspicious matter in the listing application."[81] Pecora successfully identified an instance where the NYSE failed to investigate even when there was such a suspect matter.[82]

Specialist trading was also closely scrutinized. Specialists are responsible for maintaining a fair and orderly market in a specific security by "acting as brokers' brokers who [execute] purchase or sell orders when the market price reache[s] [a] stipulated price . . . ."[83] Allegations "were made repeatedly" throughout the hearings accusing specialists of using "their pivotal position to orchestrate pool operations or exploit[ing] their knowledge of the specialist books in trading for their own accounts."[84] The NYSE's lack of oversight in these areas was later used as leverage to gain approval for restructuring of the organization's board.[85] Conclusion of the hearings led to the creation of the SEC in 1934 and manifold industry regulations in an attempt to restore investor confidence in the U.S. markets.[86] Even with the newly created SEC, the market came close to suffering another crash between 1937 and 1938.[87] Many condemned the government's efforts and cited them as the cause of the recession that ensued shortly after the passage of the federal securities laws.[88]

SEC Chairman, William O. Douglas, in advocating the Act, attributed the economic downturn to the NYSE's regulatory deficiencies[89] and prevailing conflicts of interest.[90] Douglas feared repercussions stemming from the brokerage firms' outcries, such as hindrance from future securities legislation and repeal of some of the SEC's powers.[91] Douglas called for complete revamping of the NYSE's

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81. *Id.*
82. *Id.*
83. *Id.* at 335.
84. *Id.* at 74. Evidence was discovered between May 3 and July 24, 1933, uncovering a scheme involving Russell Brown, a specialist on the NYSE, who also happened to be chairman of the board of American Commercial Alcohol. He and several other individuals organized a pool operation, driving up American Commercial's stock price from $20 to almost $90. *Id.* at 88.
85. *Id.*
86. *See id.* at 99.
87. *See id.* at 160-61.
88. *See generally id.*
89. *Id.* at 162. Prior to becoming the SEC Chairman, William O. Douglas had been a Yale Law Professor who opposed the Securities Act. *Id.* at 71.
90. *Id.* at 162-63.
91. *Id.* at 162.

board to include a salaried, independent (non-industry) chair[92] and to focus on representing the interests of the public. The existing structure consisted of "floor traders and specialists who dominated New York Stock Exchange governance."[93] Douglas believed that independence of board management would help eliminate the conflicts that had proliferated throughout the industry,[94] mainly involving member trading.[95] Douglas suspected that members' short sale trading had precipitated the extreme decline in the markets in 1937.[96] On March 17, 1938, on the heels of former NYSE President Richard Whitney's expulsion from the industry for embezzlement,[97] revisions to the Exchange's constitution were adopted.[98] Douglas resigned from the SEC in 1939 after President Franklin D. Roosevelt selected him to serve as a Supreme Court Justice.[99]

In 1970, Congress enacted the Securities Investors Protection Act ("SIPA"), "creating the Securities Investor Protection Corporation ("SIPC") to administer a fund providing $50,000 of insurance protection to each customer of virtually all broker-dealers registered with the SEC."[100] SIPA vested the SEC with the authority to: (1) compel SROs to implement any particular alterations or modifications to its rules, practices or procedures related to the regularity and scope of its investigations and examinations of its member firms; (2) require that SROs supply the SIPC and/or the SEC with any reports or records concerning the financial state of specific SRO members; and (3) require that an SRO inspect a member company's financial state.[101] The NYSE's Board of Governors asked the then former NYSE chairman, William McChesney Martin, Jr., "to prepare a comprehensive study of

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92. *Id.* at 161.
93. *Id*. at 86.
94. *See id.* at 163.
95. *Id.*
96. *Id.* at 162 (focusing specifically on the declines between September 7 and October 25, 1937).
97. *Id.* at 173. Richard Whitney was NYSE President from 1930-1935. *Id*.
98. *Id.* William McChesney Martin, Jr. was appointed President of the NYSE, serving in that role until 1940. *Id*. at 235.
99. ROBERT SOBEL, A HISTORY OF THE NEW YORK STOCK EXCHANGE 1935-1975, at 62-63 (1975).
100. SELIGMAN, *supra* note 68, at 465.
101. *Id.*

the New York Stock Exchange's constitution, rules, and procedures,"[102] which later became known as the Martin Report.[103]

The Martin Report recommended reorganization of the NYSE to recognize "its public nature and the respective interests of the public, the companies listed on the exchange, and the members of the securities industry involved."[104] As a result, the NYSE restructured its board such that it was "balanced between securities firms and issuer, institutional investor, and public representatives."[105] Additionally, it created a nominating committee completely independent of both NYSE members and the NYSE board and gave the committee the responsibility of selecting new candidates for the board.[106] The NYSE also "became a non-profit, non-dividend paying corporation, owned by its members."[107]

In December 2003, the SEC approved the NYSE's proposed rule change to amend its constitution and again reorganize its governance.[108] The most significant change was a decrease in the number of board representatives and complete independence from management of the NYSE.[109] Up to this point, the NYSE's board had been comprised of up to 24 members.[110] The approved governance structure in 2003 reduced it to "between 6 and 12 members."[111]

The next few years marked some extraordinary changes in NYSE history.[112] The merger of the NYSE and Archipelago Holdings Inc., operator of an electronic communications network, officially ended the

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102. *Id.* at 469.

103. *Id.*

104. *See* Concerning Improving the Governance of the New York Stock Exchange: Before the S. Comm. on Banking, Housing and Urban Affairs (Nov. 20, 2003) (statement of William H. Donaldson, Chairman, SEC), *available at* http://www.sec.gov/news/testimony/ts112003whd.htm (last visited Apr. 30, 2008).

105. *Id.*

106. *Id.*

107. *Id.*

108. Order Approving Proposed Rule Change Relating to the Amendment and Restatement of the Constitution of the Exchange to Reform the Governance and Management Architecture of the Exchange, Exchange Act Release No. 34-48946, File No. SR-NYSE-2003-34 (Dec. 17, 2003), *available at* http://sec.gov/rules/sro/34-48946.htm.

109. *Id*.

110. *Id.*

111. *Id*.

112. *See generally* SELIGMAN, *supra* note 68 (discussing the transformation of Wall Street and the financial industry).

NYSE sale of seats on December 30, 2005.[113] This was a significant change to the NYSE's membership structure. The result was the "NYSE Group, Inc., a for-profit, publicly-owned company."[114] Rather than taking the initial public offering route and offering new shares, the NYSE became a public company by virtue of its merger with Archipelago.[115] The public could now own a piece of one of the major U.S. securities exchanges. In 2007, the NYSE merged with Euronext, the pan-European exchange running "stock exchanges in Paris, Amsterdam, Brussels and Portugal, as well as a derivatives exchange in London."[116] This merger resulted in the "first trans-Atlantic stock exchange[,]"[117] "offer[ing a] diverse array of financial products and services."[118] Already known as "the world's largest and most liquid cash equities exchange,"[119] the NYSE now gained an even greater presence in the markets. It was at this juncture that the organization was ready to engage in the most noteworthy merger in securities industry history—consolidation with the NASD.

1. The National Association of Securities Dealers

In 1938, Congress passed the Maloney Act,[120] amending the Securities and Exchange Act of 1934.[121] The Maloney Act "established the concept of a registered national securities association or SRO,"[122]

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113. NYSE Euronext Timeline, *supra* note 36.

114. *Id.*

115. Jerry Knight, *Stock Markets on the Open Market: Exchanges Go Public, Generate Windfalls*, WASH. POST, Feb. 20, 2006, at D1.

116. Mark Stein, *From Top of the Corporate World to Appeals Court*, N.Y. TIMES, May 27, 2006, at C2.

117. *Id.*

118. Press Release, NYSE, Shares of NYSE Euronext Begin Trading, Marking the Beginning of the First Truly Global Financial Marketplace (Apr. 4, 2007), http://www.nyse.com/press/1175665133200.html (last visited Jan. 24, 2008). "NYSE Euronext [brings] together six cash equities exchanges in five countries and six derivatives exchanges [and now serves as] a world leader for listings, trading in cash equities, equity and interest rate derivatives, bonds and the distribution of market data." *Id*.

119. *Id*.

120. *See* Maloney Act of 1938, 15 U.S.C. § 78o-3 (1938).

121. Joshua E. Levine, *The New Financial Industry Regulatory Authority*, N.Y.L.J., Aug. 16, 2007, at 4.

122. *Id.*

which would "regulate the activities of their member broker-dealers."[123] The SEC would keep watch over SROs, which included the NYSE, and the SROs would now be required "to implement the federal securities laws as well as their own rules."[124]

In addition to heightening SRO standards, the NASD was established [125] to police over-the-counter ("OTC") trading. Knowing that it could not effectively oversee the area of OTC trading, the SEC had granted the NASD extensive oversight and power, establishing it as a quasi-governmental body and giving it disciplinary authority over these firms.[126] Firms were enticed to join mainly due to the economic incentives that came with being subject to such regulations. "Broker-dealers who were members of [the] NASD were charged a 'wholesale' price when they purchased or sold securities from other NASD members; non-NASD members had to pay the same price as the public."[127]

The agency's tremendous growth called for new regulatory practices.[128] In 1956, the NASD established qualification exams for those wishing to engage in securities business,[129] a requirement aimed at protecting investors and ensuring that its member representatives were

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123. Order Approving Proposed Rule Change, Exchange Act Release No. 17371, 45 FR 83707 (LEXIS) n.44 (Dec. 19, 1980).

124. Annette L. Nazaretch, Comm'r, SEC, Remarks at the ALI-ABA Course of Study, Broker Dealer Regulation (Jan. 11, 2007), *available at* http://www.sec.gov/news/speech/2007/spch011107aln.htm.

125. It is important to note that a predecessor existed prior to establishment of the NASD, formed by the Code Committee under the National Recovery Act of 1933. *See* History of the NASD, http://www.people.hbs.edu/aperold/resource/ISR/Teaching%20Note/AKS%20-%20History%20of%20the%20NASD.doc (last visited May 1, 2008). The NRA was declared unconstitutional and

> the question of whether the Investment Bankers Code Committee should be continued on a voluntary basis was submitted to a vote of Code members. Ninety percent of those who voted agreed to join and finance such an organization. The Code Committee thus became the Investment bankers Conference Committee, its function to be one of discussion and conference with federal agencies looking toward the establishment of an organization to preserve and formalize the values of the code. Within a year, a successor organization known as the Investment Bankers Conference, Inc., was established to proceed more formally towards the objective of a legal entity empowered to administer rules promoting 'high standards of commercial honor.'

Id.

126. *Id.* at 189.

127. *See* SELIGMAN, *supra* note 68, at 188.

128. History of the NASD, *supra* note 125.

129. *Id.*

knowledgeable and fit to advise the public. Because the NASD saw a surge in customers ill-served "by brokers who were often inept,"[130] the NASD made its exams more difficult.[131] After four years of consultation with the SEC, the NASD ordered the construction of "a national electronic data-processing and communications system to provide instantaneous over-the-counter price quotations from over-the-counter market-makers."[132] The National Association of Securities Dealers Automated Quotations ("NASDAQ") system went into effect in 1971.[133] Automation revolutionized the OTC market.[134] While serving only as a quotation system at its inception, by the end of its first year in existence, it had expanded to also gather and distribute volume data.[135]

The NASD's regulatory duties continued to rise from 1975 to 2001, prompting the organization to return to its original roots as exclusively a self-regulatory organization. To help accomplish this goal, in 2000 the NASD decided to spin off NASDAQ.[136] From its inception in 1937, the NASD grew to become one of the most influential and authoritative regulatory bodies in the U.S.[137] The NASD's decision to merge with the NYSE in 2007 further cemented its prominence in the securities industry.

III. PROBLEMS WITH DUAL REGULATION

While the concept of multiple regulators might in theory seem ideal, in practice it created many unnecessary complexities. Complying with two SROs' rules led to some trying issues for the securities industry.[138] The greatest challenges resulted from the conflicting rules and high costs of compliance.[139] Responsible for independently promulgating rules for their member firms, these agencies were under no obligation to consult with each other when developing their rules,

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130. SOBEL, *supra* note 99, at 248.
131. *Id.*
132. SELIGMAN, s*upra* note 68, at 353.
133. *Id.* at 490.
134. *See id.*
135. History of NASD, *supra* note 125.
136. *Id.*
137. *Id.*
138. *See* Stephen L. Carlson & Frank A. Fernandez, *The Costs of Compliance in the U.S. Securities Industry*, 7 SIA RESEARCH REPORTS 1 (2006), *available at* http://archives2.sifma.org/research/pdf/RsrchRprtVol7-2.pdf.
139. *Id.*

resulting in frequent overlap.[140] These difficulties were identified as the principal reasons for the consolidation.[141] While only firms dually regulated were affected, they comprised some of the largest firms in the securities business.[142] Of the nearly 5,100 brokerage firms in the U.S., approximately 200 were subject to dual regulation[143] and consisted of the largest securities firms in the country.[144] Therefore, the detrimental effects were substantial enough to warrant change.

Perhaps the greatest impetus for the merger was the need to end duplication. As successfully demonstrated by the FSA, a centralized regulatory source is the optimal structure to address such issues.[145] As provided by FINRA's CEO, Mary Schapiro,[146] having two, separate SROs resulted in "a duplicative, sometimes conflicting system that [made] inefficient use of resources, and as such, [could be] detrimental to the ultimate goal of investor protection."[147] Independently, the NYSE and the NASD oversaw more than 5,000 "securities firms doing business with the public in the United States."[148] Marc E. Lackritz, President of SIFMA, testified before Congress in 2006 and voiced the association's concerns regarding multiple SROs, mainly citing

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140. *Id.*

141. Notice of Filing of 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., Exchange Act Release No. 34-55495, File No. SR-NASD-2007-023 (Mar. 20, 2007), *available at* http://www.sec.gov/rules/sro/nasd/2007/34-55495.pdf [hereinafter Notice of Filing Proposed Rule Change].

142. Carrie Johnson, *SEC Approves One Watchdog For Brokers Big and Small*, WASH. POST, July 27, 2007, at D2.

143. Glauber Testimony, *supra* note 66.

144. *See* Fortune 500 List of Largest Securities Firms, http://money.cnn.com/magazines/fortune/fortune500/2007/performers/companies/profits/index.html (last visited Apr. 30, 2008).

145. *See generally* FINANCIAL SERVICE AUTHORITY, PRINCIPLES-BASED REGULATION: FOCUSING ON THE OUTCOMES THAT MATTER (2007), *available at* http://www.fsa.gov.uk/pubs/other/principles.pdf (discussing principles based regulation in the U.K.).

146. Notice of Filing Proposed Rule Change, *supra* note 141.

147. *Id.*

148. NYSE Group, Inc., Quarterly Report (Form 8-K), ex. 99.2 (Nov. 24, 2006), *available at* http://www.secinfo.com/drDX9.v1b2.b.htm#1stPage.

duplication and disorganization.[149] This sentiment was consistently echoed by members of the industry.

Those organizations subject to dual regulation "expend[ed] significant time, resources and effort interpreting and applying different standards to their businesses, including different recordkeeping, procedural and audit trail requirements for the same product or service."[150] Broker-dealers belonging to both agencies were subject to not only two separate, but also sometimes inconsistent, sets of rules. Even where the agencies had identical rules on a particular issue, each SRO in some instances interpreted the rules differently.[151] Many securities firms often raised their dissatisfaction over such incongruity within the regulatory system.[152] Moreover, these inconsistencies opened the door for regulatory arbitrage, leading not only to inefficiency and high costs for firms, but also creating the risk of firms taking advantage of the system and providing a disservice to the investing public.[153] Such issues led to the proposal and subsequent approval of the merger.

In addition to efficiency and consistency, the consolidation also reduced the excessive costs associated with complying with two sets of rules. Much criticism of the previous structure "center[ed] around the cost of compliance . . . . According to one report by SIFMA, securities firms spent $23.2 billion on compliance in 2004 and an estimated $25.5 billion in 2005."[154] Some of these costs could be attributed to firms having to build intricate surveillance systems, training staff and developing efficient processes to ensure fulfillment of their regulatory

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149. *A Review of Self Regulatory Organizations in the Securities Market: Hearing Before S. Comm. on Banking, Housing and Urban Affairs* (Mar. 9, 2006) (statement of Marc E. Lackritz, President, Securities Industry Association), *available at* http://www.sifma.org/legislative/testimony/archives/Lackritz3-9-06.html.

150. *Supporting and Improving SRO Consolidation*, SEC. INDUS. NEWS, June 11, 2007, *available at* 2007 WLNR 10863703 (Westlaw).

151. *See* Reinventing Self-Regulation, Sec. Indus. Assoc., White Paper, Jan. 5, 2000, updated Oct. 14, 2003, *available at* http://www.sifma.org/legislative/testimony/pdf_archives/reinventingselfreg.html.

152. *Id.*

153. Mary L. Schapiro, Remarks at the Distinguished Speaker Series at Georgetown University McDonough School of Business (Sept. 26, 2007), http://www.finra.org/PressRoom/SpeechesTestimony/MaryL.Schapiro/P037079 (last visited May 1, 2008).

154. Simon Butler, *NASD Chief Mary L. Schapiro is Gearing Up for the Challenges Posed by the Consolidation with NYSE Regulation*, ON WALL ST., June 1, 2007, *available at* 2007 WLNR 10205905 (Westlaw).

obligations.[155] FINRA expects the consolidation to result in lower costs and fees to these firms.[156] Financial relief is expected since there will be one less SRO regulating the industry. This is certainly a welcome benefit as financial firms continue to suffer economically from the subprime crisis.[157]

IV. THE CONSOLIDATION

While truly a significant occasion in the history of the securities industry, the consolidation emerged out of several recent events. In a 1999 speech concerning market structure at Columbia University, then SEC Chairman Arthur Levitt spoke about the frustrations of dual regulation.[158] He "raised concerns as to whether for-profit, shareholder-owned exchanges qualitatively increased the conflicts of interest inherent in this structure so as to warrant a separation of member regulation from market regulation, with member regulation ideally put in a single SRO for all members."[159] This was subsequently referred to as the "'hybrid' model of self-regulation."[160] After this speech came a SIFMA White Paper, which analyzed several alternate SRO models and ultimately embraced the hybrid model.[161] These events laid the groundwork for the consolidation.

In conformity with the requirements of the Securities and Exchange Act of 1934, the NASD filed its proposed rule change with the SEC on March 19, 2007.[162] The submitted notice outlined several key changes to the NASD's by-laws that would accommodate the merger, including changes to its new governance structure.[163] On March 26, 2007, the

155. *See* Carlson & Fernandez, *supra* note 138, at 6.

156. Notice of Filing Proposed Rule Change, *supra* note 141.

157. Lingling Wei & Randall Smith, *Wall Street Gears for Its New Pain*, WALL ST. J., Mar. 3, 2008, at C1, *available at* http://online.wsj.com/article/SB120450569895406511.html.

158. Levine, *supra* note 121.

159. *Id.*

160. *Id.*

161. Levine, *supra* note 121. SIFMA White Papers explore a variety of securities industry topics. Recent issues can be found on SIFMA's website at http://www.sifma.org/regulatory/white-papers.shtml.

162. *See* Notice of Filing Proposed Rule Change, *supra* note 141; NASD Release 2007-023, http://www.finra.org/RulesRegulation/RuleFilings/2007RuleFilings/P018845 (last visited Jan. 24, 2008).

163. *See* Notice of Filing Proposed Rule Change, *supra* note 141.

proposed rule change was published and commentary solicited from the public.[164] Over 70 comment letters from industry firms, consumer advocates and investors voicing their opinions towards the merger and assisting the SEC in its approval decision were received.[165]

A. Comment Letters

1. Opposition

Smaller firms mainly voiced opposition to the consolidation because they believed their interests were not being considered.[166] The three main areas of concern were: the by-law changes, the one-time payment to firms, and the arbitration forum.

The first area of concern was the by-law change. Most of the comments received opposing adoption of the by-law changes suggested that the new by-laws would not protect investors and would not give small brokerage firms adequate representation.[167] Many of the smaller firms already felt that the industry favored the larger companies and that they were at a disadvantage, especially regarding the cost of compliance with regulatory provisions.[168] In response to this concern, the NASD provided that this new organization would better protect investors because it would streamline securities firm regulation and take action ensuring that individuals advising the public were well-trained and that the products recommended were suitable for their clients.[169]

FINRA also believes that the new governance structure affords small brokerage firms greater input and representation.[170] One benefit is that they will now have three seats on the FINRA board, instead of the

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164. Notice of Filing of 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., 76 Fed. Reg. 14149 (Mar. 26, 2007), *available at* http://www.finra.org/web/groups/rules_regs/documents/rule_filing/p018866.pdf.

165. *See e.g.*, Comments on NASD Rulemaking, http://sec.gov/comments/sr-nasd-2007-023/nasd2007023.shtml (last visited May 1, 2008).

166. *See e.g.*, *id.* (noting the concerns, questions and comments different affected groups had about the consolidation).

167. *Id.*

168. Letter from Bonnie K. Wachtel to SEC (Apr. 16, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-56.pdf.

169. Schapiro, Remarks at SIFMA, *supra* note 32.

170. Butler, *supra* note 154.

one seat they had on the NASD board.[171] Small firms will also be the only ones allowed to select their representatives.[172] Additionally, "the small firm advisory board will be 50% elected instead of solely appointed by the NASD."[173] This board will determine which exemptions might be appropriate for these companies[174] and will serve as the voice of the smaller firms, ensuring "that issues of particular interest and concern to small firms are effectively communicated to and considered by the FINRA Board of Governors."[175]

The second area of concern was the $35,000 payment. In anticipation of the cost savings to firms as a result of the consolidation, FINRA gave each member firm a one-time $35,000 payment.[176] Several commentators felt that the amount was inadequate and that more could have been offered.[177] In response, the NASD explained that as a tax-exempt 501(c)(6) corporation, it is not permitted to pay out any form of dividends because doing so would result in forfeiture of this status.[178] The NASD consulted with the Internal Revenue Service prior to announcing the expected disbursement amount,[179] who granted approval because the payment represented the projected cash flows for each firm as a result of the consolidation.[180] More specifically, it did not constitute a tax code violation because the payment is solely based upon the cost efficiencies that the consolidation is expected to yield.[181]

The third area of concern was the selection of arbitration for the merged entity's dispute resolution forum. The critics that cited the

171. *Id*. Having more seats on the board allows small firms greater input in regulatory changes or proposals that may affect them.

172. *Id*.

173. *Id*. Previously, the advisory board from small firms was solely appointed by the NASD. *Id*.

174. Donna Block, *Regulatory Consolidation Raises Concerns*, N.Y.L.J., May 24, 2007, at 5.

175. FINRA, FINRA Small Firm Advisory Board, http://www.finra.org/Resources/InformationforSmallFirms/p010702 (last visited Jan. 24, 2008).

176. NYSE Group Inc., *supra* note 149.

177. Comments on NASD Rulemaking, *supra* note 167.

178. *See* Response Letter from T. Grant Callery, NASD, to Nancy Morris, Sec'y, SEC (July 16, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-85.pdf.

179. *See* Notice of Filing Proposed Rule Change, *supra* note 141, n.6.

180. *See* Response Letter from Mario J. Verdolini, Jr., Davis Polk & Wardwell, to Nancy Morris, Sec'y, SEC (July 16, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-87.pdf.

181. *Id.*

arbitration forum[182] as a point of conflict took issue with the composition of the arbitration panels, the costs to customers and dispositive motions.[183] Integration of the two forums is still in progress and the comments concerning the panels and dispositive motions will be taken into consideration.[184] One critic claimed that a share of the cost savings from the consolidation should have been used to reduce customer fees for use of the new arbitration forum.[185] In its response, the NASD provided that the resulting lower costs for administration of the forum impacted the firms, not the investors.[186] Firms are the ones that bear the expenses associated with the forum because they are the ones that have to pay for "staff salaries and benefits, arbitrator training and travel, long-term leased space, computer systems, supplies, and equipment."[187] Users of the forum, on the other hand, are only responsible for paying fees associated with administration of their own personal claims.[188] Therefore, it is justified that the cost savings be spread to the firms and not to individual investors.

2. Support

Many voiced the end of duplication, inefficiency and exorbitant costs as the basis for their support for the merger,[189] regarding the

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182. *See* Letter from Public Members of Securities Industry Conference on Arbitration to Christopher Cox, Chairman, SEC (Jan. 12, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-10.pdf; Letter from Les Greenberg to SEC (Apr. 11, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-19.pdf; Letter from Kathryn L. Lundgren to SEC (Apr. 16, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-67.pdf; Letter from Steven B. Caruso, President, Public Investors Arbitration Bar Association to SEC (Apr. 16, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-65.pdf; Letter from William F. Galvin, Sec'y of the Commonwealth, Mass. Sec. Div., Commonwealth of Massachusetts to SEC (Apr. 18, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-73.pdf.

183. Response Letter from Linda D. Fienberg, President, Dispute Resolution, NASD, to Nancy Morris, Sec'y, SEC (May 29, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-81.pdf.

184. *Id.*

185. *Id.*

186. *Id.*

187. *Id.*

188. *Id.*

189. The following comment letters all support consolidation. *See* Letter from Joan Hinchman, Nat'l Ass'n of Compliance Prof'ls, Inc. to Nancy Morris, Sec'y, SEC (Apr.

change as a positive move for the industry. One supporter felt that the merger would allow "business owners and representatives [to] spend more time focusing on their customers rather than [on] a myriad of inconsistent rules from multiple regulators that are not based on the type of business or service that [they] provide."[190] Supporters of the merger also called for expedited approval.[191] Such sentiments support FINRA's belief that its new configuration will provide greater protection for

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26, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-77.pdf; Letter from Michael J. Mungenast, CEO, ProEquities to Nancy Morris, Sec'y, SEC (Apr. 23, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-56.pdf; Letter from Joseph P. Borg, President, N. Am. Sec. Admin. Ass'n, Inc. to Nancy Morris, Sec'y, SEC (Apr. 17, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-74.pdf; Letter from William R. Pictor, President, Trubee, Collins & Co., Inc., to Nancy Morris, Sec'y, SEC (Apr. 16, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-72.pdf; Letter from M. LaRae Bakerink, CEO, WBB Securities, Inc. to Christopher Cox, Chairman, SEC (Apr. 16, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-71.pdf; Letter from Walter S. Robertson, III, President & CEO, Scott & Stringfellow Inc. to Nancy Morris, Sec'y, SEC (Apr. 16, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-70.pdf; Letter from Dale E. Brown, CEO, Fin. Serv. Inst. To Nancy Morris, Sec'y, SEC (Apr. 16, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-56.pdf; Letter from Mark S. Casady, Chairman and CEO, LPL Fin. Serv. to Nancy Morris, Sec'y, SEC (Apr. 16, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-63.pdf; William A. Johnstone, President and CEO, D.A. Davidson & Co. to Nancy Morris, Sec'y, SEC (Apr. 16, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-62.pdf; Letter from William C. Alsover, Chairman, Centennial Sec. Co. to Nancy Morris, Sec'y, SEC (Apr. 16, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-61.pdf; Letter from Lisa Roth, President Nat'l Ass'n of Indep. Broker-Dealers to Nancy Morris, Sec'y, SEC (Apr. 16, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-58.pdf; Letter from Deborah Castiglioni, CEO, Cutter & Co. Inc. to Nancy Morris, Sec'y, SEC (Apr. 16, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-567pdf; Letter from David W. Stringer, President, Prospera Fin. Serv. Inc. to Nancy Morris, Sec'y, SEC (Apr. 16, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-55.pdf; Letter from Ira D. Hammerman, Managing Dir., SIFMA to Nancy Morris, Sec'y, SEC (Apr. 16, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-54.pdf; Letter from Albert Kramer, President, Kramer Sec. Corp. to Nancy Morris, Sec'y, SEC (Apr. 16, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-51.pdf; Letter from E. John Moloney, President and CEO, Moloney Sec. Co., Inc. to Nancy Morris, Sec'y, SEC (Apr. 15, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-45.pdf; Letter from Sennett Kirk, Kirk Sec. Corp. to SEC (Apr. 12, 2007), http://sec.gov/comments/sr-nasd-2007-023/nasd2007023-27.pdf.

190. Letter from M. LaRae Bakerink, *supra* note 189.

191. *Id.*

investors. FINRA commenced its operations under the approval of the SEC in July 2007.[192]

B. Governance Structure

One of the most talked about changes is FINRA's new governance structure.[193] Mary Schapiro, formerly CEO and Chairwoman of the NASD, serves as FINRA's CEO and Richard Ketchum, formerly head of NYSE Regulation, Inc., serves as Chairman of FINRA's interim board.[194] The interim board of governors consists of twenty-three members for a transitional period of three years and is structured as follows:

- The CEO and Non-Executive Chairman will serve on the interim Board of Governors.
- Eleven Governors will be appointed from outside the securities industry.
    - The current NASD Board and NYSE Boards each will appoint five Public Governors.
    - One Public Governor will be appointed jointly by both organizations.
- Ten Governors will be from inside the securities industry.
    - Three representatives (nominated by NASD) to be elected by small firms (1-150 registered representatives); small firms may also present their own slate of nominees.
    - One representative (jointly nominated) to be elected by medium-sized firms (151-499 registered representatives); medium-sized firms may also present their own slate of nominees. Three representatives (nominated by NYSE)

192. *See* Press Release, SEC, SEC Gives Regulatory Approval for NASD and NYSE Consolidation (July 26, 2007), *available at* http://sec.gov/news/press/2007/2007-151.htm. FINRA was originally named the Securities Industry Regulatory Authority ("SIRA"). Smith & Scannell, *supra* note 5. After receiving public objection concerning the proposed name because of its similarity to an Arabic word, "commonly spelled Sirah, which refers to the biographies of the Prophet Muhammad," it was changed to the Financial Industry Regulatory Authority. Susanne Craig, *Deals & Dealmakers: For the NASD, Goodbye, SIRA – Kay-Syrah Sira – Street's Securities Cop Renames Itself After Flap; A Muslim Connection*, WALL ST. J., July 13, 2007, at C2.

193. Comment on NASD Rulemaking, *supra* note 165.

194. FINRA, FINRA Board of Governors, http://www.finra.org/AboutFINRA/CorporateInformation/FINRALeadership/FINRABoardofGovernors/index.htm (last visited Jan. 24, 2008).

to be elected by large firms (500 or more registered representatives); large firms may also present their own slate of nominees.

- Three represstentatives will fill the remaining three seats, including an NYSE-appointed floor member, an NASD-appointed representative of independent dealers/insurance affiliated broker-dealers and a jointly appointed representative of investment companies.[195]

Merging of the two SROs resulted in a "streamlined [organization] . . . better suited to [deal with] the complexity and competitiveness of today's global capital markets."[196] In recent years, many companies, even those eligible to list their securities in the U.S., have opted to list abroad, naming a fragmented regulatory infrastructure as a leading reason.[197] It was, therefore, only a matter of time before a consolidation would be necessary to promote confidence in the U.S. economic system. FINRA is responsible for policing nearly every facet of the securities industry, from individual registration, examination and training to rule writing, rule enforcement and examination of firms.[198] In addition to carrying out its own regulatory responsibilities, FINRA "also performs market regulation under contract for The NASDAQ Stock Market, the American Stock Exchange, the International Securities Exchange and the Chicago Climate Exchange."[199] Staffed with over 3,000 employees,[200] it is hoped that the organization is well-equipped to handle the industry challenges that will arise in the future and prevent future market disasters.

195. NYSE Group Inc., *supra* note 149.

196. About FINRA, *supra* note 6 (quoting Mary L. Schapiro, CEO, FINRA).

197. *See* Liz Moyer, *Too Many Regulators for Wall Street?*, FORBES.COM, Nov. 9, 2006, *available at* http://www.forbes.com/2006/11/09/sia-wall-street-boca-biz-cx_lm_1109sia.html.

198. *See* About FINRA, *supra* note 6.

199. *Id.*

200. *Id.*

V. BENEFITS AND EFFECTS

A. The Investing Public

Subprime-related arbitrations and lawsuits have already begun and the number will surely increase as more investors advance investment complaints.[201] FINRA will provide the principal forum for securities arbitration and mediation claims involving member firms.[202] Prior to consolidation, the NASD had "operat[ed] the largest securities dispute resolution forum, processing over 4,600 arbitrations and nearly 1,000 mediations in 2006"[203] alone. It continually made efforts to streamline its arbitration and mediation processes and in 2007 revised its Code of Arbitration Procedure, making it a less onerous process for users.[204]

Among its new customer-friendly features, the revised code is organized in a logical sequence,[205] provides a comprehensive definitions section, and uses "plain English" explanations throughout.[206] FINRA is currently working on eliminating discrepancies and inconsistencies to develop uniform arbitration and mediation procedures that take into account the beneficial features of its predecessors.[207]

In addition to paying close attention to issues related to subprime mortgage-backed products,[208] FINRA will also look into suitability issues and marketing of certain products to particular populations of

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201. *See* Lori Pizzani, *Morgan Keegan Lawsuits, Arb Claims Could be Tip of Subprime Iceberg*, MONEY MGMT. EXECUTIVE, Jan. 14, 2008, *available at* http://www.mmexecutive.com/issues/2008_2/90216-1.html.

202. *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, Exchange Act Release No. 34-56145, File No. SR-NASD-2007-023, at 2-3 (July 26, 2007), *available at* http://sec.gov/rules/sro/nasd/2007/34-56145.pdf.

203. Schapiro Testimony, *supra* note 2.

204. *See* NASD, Code of Arbitration Procedure for Customer Disputes (Apr. 16, 2007), http://www.finra.org/web/groups/rules_regs/documents/rule_filing/p018365.pdf.

205. Proposed Rule Change by NASD, File No. SR-NASD-2003-158, at 6 (Oct. 15, 2003), http://www.nasd.com/web/groups/rules_regs/documents/rule_filing/nasdw_009310.pdf.

206. *Id.* at 32. "In 1998, the SEC launched an initiative to encourage issuers and self-regulatory organizations ("SROs") to use "plain English" in disclosure documents and other materials used by investors." *Id.*

207. *See* Levine, *supra* note 121.

208. *See id*.

investors such as seniors.[209] Earlier this year, FINRA initiated two regulatory sweeps aimed at ensuring that firms are utilizing suitable sales practice methods in dealing with seniors and with those nearing retirement.[210] Of concern are professional designations being used by registered representatives, implying expertise in areas such as retirement planning, when the registered representative did not undergo adequate training or does not possess specific knowledge in these areas.[211] FINRA is committed to tackling such issues and currently has approximately seventy open investigations relating to seniors.[212] Marketing tactics are also under close scrutiny, especially the use of "free lunch" investment seminars.[213] In more than half of the free investment seminar investigations conducted by several regulators, including the SEC and FINRA, they found that the "sales materials—including the invitations and advertisements for the events—contained claims that appeared to be exaggerated, misleading or otherwise unwarranted [a]nd [that] 12 [%] of the seminars appeared to involve fraud, ranging from unfounded projections of returns to sales of fictitious products."[214]

FINRA plans to do better by constantly surveying the market.[215] FINRA will analyze investors' experiences with the latest products,[216] identify potential regulatory issues and act expeditiously to prevent investor harm or immediately rectify any harm that has already occurred.[217] Recent issues surrounding the subprime mortgage crisis

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209. *See* Press Release, FINRA, FINRA Announces Major Regulatory Sweeps at Seniors Summit (Sept. 10, 2007), http://www.finra.org/PressRoom/NewsReleases/2007 NewsReleases/P036809.

210. *Id.*

211. *Id.*

212. Press Release, FINRA, supra note 209.

213. *See generally* FINRA Investor Alert, "Free Lunch" Investment Seminars–Avoiding the Heartburn of a Hard Sell, (Sept. 10, 2007), http://www.finra.org/Investor Information/InvestorAlerts/FraudsandScams/FreeLunchInvestmentSeminars-Avoiding theHeartburnofaHardSell/index.htm (discussing the negative aspects of free investment seminars).

214. *Id.*

215. Mary L. Schapiro, CEO, FINRA, Remarks at FINRA Fall Securities Conference (Oct. 11, 2007), http://www.finra.org/PressRoom/SpeechesTestimony/Mary L.Schapiro/P037180 [Schapiro, Remarks at FINRA Conference].

216. *Id.* To accomplish this, FINRA implemented the "Ahead of the Curve Program." *Id.*

217. *Id.*

require regulators to take a proactive approach. FINRA will continue to remain abreast of the regulatory controversies plaguing the industry and will look closely at how they will affect investors.[218]

B. The Securities Industry

The most grueling and complex challenge for FINRA will be synchronization of the NYSE's and NASD's rulebooks.[219] "Member conduct rules in particular are being held up to significant scrutiny and detailed analysis and [FINRA is] fully committed to seeking broad input on the approaches [it] will recommend."[220] FINRA identified five principles to uphold while integrating the rulebooks.[221] The first entails meticulous review of each former SRO's rules to determine which, if any, is the better and more effective rule or whether a new rule should be created.[222] Second, FINRA will also tailor each rule to the specific firm[223] taking into account the diversity in member size, business model or type of customer.[224] Third, FINRA will determine whether rules can be categorized in a "conceptual manner," in hopes of giving firms more insight into the rationale behind the regulation.[225] The fourth and fifth principles entail development of clearer rules and implementation of a "principles-based approach" wherever possible.[226]

Synchronization has commenced, and already has received criticism from the public.[227] SIFMA recently raised some concerns regarding the coordination of these rules, warning that it could instead lead to triplication.[228] At the heart of that assertion lays the current method of submitting rule changes.[229] The process still seems disjointed according to SIFMA, which urges the SEC to suspend approval of the

218. *Id.*
219. *Id.*
220. *Id.*
221. Schapiro, Remarks at SIFMA, *supra* note 32.
222. *Id.*
223. *Id.*
224. *Id.*
225. *Id.*
226. *Id.*
227. *See generally Harmonization Rule Could Lead to Triplication*, WALL ST. LETTER, Sept. 3, 2007, *available at* 2007 WLNR 19675359 (Westlaw) (discussing the need for a consolidated rulebook).
228. *Id.*
229. *See id.*

rule changes[230] if FINRA "is unlikely to incorporate changes relating to the common rules into its rulebook."[231] Despite such commentary, FINRA has been actively submitting new rule changes[232] in furtherance of its harmonization efforts.

1. Principles-Based Regulation

Members of the U.S. financial industry have kept a vigilant eye on the principles-based approach to regulation employed abroad. This method of regulation is touted as one of high effectiveness and efficiency and has been in use by the United Kingdom since 2001.[233] This form of oversight focuses on outcomes by setting standards as to the types of actions and behaviors expected from firms, rather than focusing on the particular rules.[234] As explained by SIFMA,

> [R]egulation by principles and by rules is best described as a continuum of regulatory options. At one end of the continuum a regulator articulates principles and leaves a firm to determine wholly how to achieve the outcome called for in the principle; at the other end of the continuum the regulator dictates through a prescriptive rule how the outcome must be achieved. Within the continuum are various types of guidance that a regulator could promulgate to assist a firm in achieving outcomes.[235]

Some critics of principles-based oversight argue that such regulation only works in wholesale markets and that retail markets require rules-based oversight.[236] FINRA has provided that it will use a combination of the two to ensure that the most efficient method of regulation is employed.[237] The diversification within the securities

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230. *Id.*

231. *Id.*

232. *See, e.g.*, Proposed Rule Change by FINRA, File No. SR-2007-008 (Aug. 30, 2007), *available at* http://www.finra.org/web/groups/rules_regs/documents/rule_filing/p036662.pdf.

233. *See generally The Seventh Annual A.A. Sommer, Jr. Lecture On Corporate, Securities and Financial Law: "The U.K. FSA: Nobody Does It Better?"*, 12 FORDHAM J. CORP. & FIN. L. 259 (2007).

234. *See id.* at 270.

235. Lackritz, Testimony, *supra* note 31.

236. *See The Rules of the Game*, ECONOMIST, Sept. 15, 2007, *available at* 2007 WLNR 18026488 (Westlaw).

237. Schapiro, Remarks at SIFMA, *supra* note 32.

realm requires FINRA to utilize the most advantageous processes, including those that are principles-based, wherever possible.[238]

2. Single Exam Program

Developing a single examination program poses another multifaceted challenge for FINRA.[239] Broker-dealers belonging to multiple SROs are subject to periodic audits by these organizations to identify any regulatory deficiencies.[240] As a single entity, FINRA will provide its members with one examination program.[241] It will require bringing together two diverse examination teams, training them on the new technological platforms, and hopefully creating a synergetic and symbiotic relationship between them.[242] The organization hopes to fully integrate its examination program by 2008, but recognizes the obstacles that such an endeavor may present.[243] Among them, the highest hurdle may be identifying, extracting and retaining the strengths of each program while establishing one unified approach.

FINRA will employ a more risk-based methodology in its investigations,[244] advancing its commitment of considering each firm's unique needs while developing its examination program. This will require looking at both the financial company's areas of deficiency as well as the issues plaguing the existent regulatory landscape. FINRA's surveillance of certain firms will also be heightened.[245] FINRA will work with each firm to address regulatory concerns regarding their product offerings and any related market issues.[246]

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238. *Id*.
239. *See* Schapiro Testimony, s*upra* note 2.
240. *See* Maloney Act, *supra* note 120.
241. Schapiro, Remarks at FINRA Conference, *supra* note 219.
242. *See* Schapiro Testimony, s*upra* note 2.
243. *See* Schapiro, Remarks at FINRA Conference, *supra* note 215.
244. Mary L. Schapiro, Chairman and CEO, NASD, Remarks at the U.S. Chamber of Commerce First Annual Capital Markets Summit: Securing America's Competitiveness (Mar. 14, 2007), http://www.finra.org/PressRoom/SpeechesTestimony/MaryL.Schapiro/P018816.
245. *See id.*
246. *See id.*

3. *"Firm Gateway" System*

FINRA is also introducing several new tools and programs for the industry. One of FINRA's newest technological innovations is the Firm Gateway System, providing member firms easy access to regulatory forms, filings, notices of upcoming rule changes, and other useful resources.[247] This portal will allow firms to submit their FINRA electronic forms online, expediting the submission process.[248] The system will also reduce the need for multiple passwords to log into different programs by providing easy access to other applications.[249] After complete implementation, the system "will be available to about 25,000 firm users—mostly compliance personnel at FINRA-regulated broker-dealers."[250]

4. *Small Firm Emergency Partner Program*

FINRA is also taking steps to assist small firms with business continuity planning.[251] Recent tragic events such as hurricane Katrina as well as business interruptions like mass black-outs have been detrimental to businesses, requiring that organizations be equipped to continue operations in case of such disasters.[252] Large companies have the resources for such back-up capabilities, but many small firms do not. To deal with such issues, FINRA has developed the "Small Firm Emergency Partner Program."[253] This voluntary program will match a firm with another "pre-established partner firm unaffected by the event to step in temporarily and assist [the firm's] customers regarding liquidating transactions."[254] At the contracting firm's discretion, "they can expand their agreement to include limited categories of purchases, such as money market funds."[255] This new program further

247. *See* FINRA Firm Gateway System, http://www.finra.org/web/groups/reg_systems/documents/regulatory_systems/p036867.pdf (last visited Jan. 24, 2008).
248. Schapiro, Remarks at FINRA Conference, *supra* note 215.
249. *Id.*
250. *Id.*
251. *See, e.g.*, FINRA, Small Firm Emergency Partner Program: Overview and Guide, http://www.finra.org/web/groups/rules_regs/documents/rules_regs/p037162.pdf (last visited Jan. 24, 2008).
252. *Id.*
253. *See* Schapiro, Remarks at FINRA Conference, *supra* note 215.
254. FINRA, Small Firm Emergency Partner Program, *supra* note 251.
255. *Id.*

demonstrates FINRA's commitment to the industry's smaller companies.

VI. CONCLUSION

Financial companies, especially those having experienced some type of merger or acquisition, are fully aware of the complexities and intricacies involved in such transactions.[256] The process can be very gradual and, as some organizations can attest, never truly accomplished.[257] The FINRA merger "required bringing together two workforces, two complete sets of technologies, two cultures and two funding mechanisms."[258] FINRA has been forthcoming in informing the public that the process is complex and that it is working to have full harmonization as quickly as possible.[259]

Synchronization of the rules is perhaps the greatest challenge faced by this new organization and it is safe to say that failure of this initiative will render the merger a disappointment in the eyes of many. Therefore, it is imperative that FINRA is given support to allow them to get it right. As the first considerable change in the regulatory system in decades, it is expected that many will voice their opposition and criticism. Many are resistant to change, and some comments will simply be tenuous. Others, however, will be warranted, especially worries concerning the expediency of rule harmonization and choosing those most suitable to ensure efficient regulation. Certainly, it would not be in the best interest of the industry or the public to employ lax or subpar regulations.

Adequate oversight of the financial industry is necessary to build investor confidence. As we continue to feel the effects of the subprime mortgage crisis and worries of a recession pervade the industry,[260] it is crucial that the public maintain some level of confidence in the financial markets. FINRA is dedicated to investor protection, and the merger

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256. *See generally* R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS § 9.9 MERGER AGREEMENT (Aspen Law & Business 2002) (1998) (stating the Delaware law regarding merger agreements).

257. *See Why Do So Many Mergers Fail?*, KNOWLEDGE@WHARTON, Mar. 30, 2005, http://knowledge.wharton.upenn.edu/articlepdf/1137.pdf?CFID=50312265&CFTOKEN=26349611&jsessionid=a83051919f32372c2458.

258. Schapiro, Remarks at FINRA Conference, *supra* note 215.

259. Schapiro, Remarks at SIFMA, *supra* note 32.

260. *See Recession Fears Hit Stocks*, WALL ST. J., Mar. 11, 2008, *available at* http://online.wsj.com/article/SB120518660320825319.html.

came at just the right time. The move to consolidate fostered an obligation to the public and to the industry, helping to restore and promote a robust U.S. market economy and to preserve market integrity at a time when both U.S. market wealth and integrity have been shaken.