

**Testimony of  
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President & Chief Executive Office  
Securities Industry and Financial Markets Association  
before the  
United States Senate Committee on Banking, Housing and Urban Affairs  
Subcommittee on Securities, Insurance and Investments**

**May 17, 2007**

**Hearing on:  
“Consolidation of NASD and the Regulatory Functions of NYSE:  
Working Towards Improved Regulation”**

**I. Introduction**

Mr. Chairman and members of the Subcommittee, I am Marc Lackritz, President and Chief Executive Officer of the Securities Industry and Financial Markets Association (“SIFMA”).<sup>1</sup> We commend you for holding this hearing and appreciate the opportunity to testify on the consolidation of the NASD and New York Stock Exchange (“NYSE”) regulatory functions into a single self-regulatory organization (“Single SRO”).

SIFMA supports the Single SRO because we believe it is a win-win situation for investors and market participants. A Single SRO will provide for more effective investor protection at the same time that it will ensure more efficient regulation for market participants. Importantly, the Single SRO will not diminish the quality or vigor of

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<sup>1</sup> The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers locally and globally through offices in New York, Washington D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA’s mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public’s trust in the industry and the markets. (More information about SIFMA is available at <http://www.sifma.org>.)

regulatory oversight of the markets. As such, we believe the Single SRO will be a significant step toward improving the global competitiveness of U.S. capital markets.

Nonetheless, we believe the Single SRO can be strengthened even more. A comprehensive SRO decision-making process, which includes expert practitioners, will ensure that regulation deals effectively with practical business considerations. In addition, the formation of a Single SRO provides an historic opportunity to reassess traditional regulatory approaches so that U.S. markets remain globally competitive. Achieving this goal, we believe, will require a more textured approach to regulation, a sound regulatory budget and continued SEC oversight.

## **II. SIFMA Supports the Single SRO**

SIFMA has long supported a more streamlined and effective approach to self-regulation.<sup>2</sup> Seven years ago, SIFMA produced a White Paper entitled “Reinventing Self-Regulation.”<sup>3</sup> The White Paper examined the purpose of self-regulation in light of major technological and competitive changes taking place in the securities industry, and considered the advantages and disadvantages of different models for regulation of the U.S. securities markets. The White Paper noted that despite having served us well for many decades, the self-regulatory system had two significant drawbacks: (1) conflicts of interest as a result of the SROs’ roles as both market operators and regulators, and (2) costs and regulatory inefficiencies resulting from duplication among multiple SROs.

Among the different models explored by the White Paper was a “hybrid” self-regulatory model, which – much like the Single SRO – would consolidate member firm regulation into a central entity while assigning each marketplace the regulation and enforcement of all aspects of trading, markets, and listing requirements. Following issuance of the White Paper, the SIFMA board endorsed the hybrid model. Since then,

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<sup>2</sup> In November 2006, the Securities Industry Association (“SIA”) merged with The Bond Market Association to form SIFMA. References to prior White Papers, comment letters, and testimony apply to positions taken by SIA, now SIFMA.

<sup>3</sup> Reinventing Self-Regulation, SIA White Paper (Jan. 5, 2000; updated on Oct. 14, 2003), available at <http://www.sifma.org/regulatory/structure/html/whitepaperfinal.html>.

we have testified before Congress a number of times on the need to improve and revamp our nation's self-regulatory structure.<sup>4</sup>

We are pleased that the NYSE-NASD regulatory consolidation will bring the hoped-for change in self-regulation to fruition.<sup>5</sup> With the Single SRO, there finally will be one centrally managed self-regulatory entity to oversee member firms. As envisioned, the Single SRO will become the largest private-sector regulator of our members and will have integrated technologies, a single set of rules for broker-dealer activities, one set of examiners and one examination strategy. Regulation of member firms will be more expert, effective and efficient – all of which serve to enhance oversight of U.S. securities firms, strengthen investor protection and increase the competitiveness of the U.S. capital markets.

Among the key benefits of the Single SRO is the ability to focus resources on substantive investor protection by eliminating duplicative and inconsistent regulation among multiple SROs, as well as redundant SRO regulatory staff and infrastructure.<sup>6</sup> Under the current regulatory regime – and despite the SROs' best efforts to "harmonize" their rulemaking initiatives and coordinate their regulatory examinations – duplication can, and does, occur within the areas of rulemaking, data reporting, examinations, and enforcement actions.<sup>7</sup> Currently, the SROs and many firms expend significant time, resources and effort interpreting and applying different standards to their businesses,

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<sup>4</sup> See Testimony of Marc E. Lackritz before the United States Senate Committee on Banking, Housing and Urban Affairs, (Mar. 9, 2006); Testimony of Marc E. Lackritz before the United States House of Representatives Committee on Financial Services, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, (Nov. 17, 2005 and Oct. 16, 2003).

<sup>5</sup> See SIFMA Comment Letters in support of SRO Consolidation dated Dec. 12, 2006, and April 16, 2007.

<sup>6</sup> "Multiple SROs can result in duplicative and conflicting SRO rules, rule interpretations, and inspection regimes, as well as redundant SRO regulatory staff and infrastructure across SROs." SEC SRO Concept Release at 71264. The U.S. General Accounting Office has noted similar "inefficiencies associated with SRO rules and examinations." See GAO Report entitled "Securities Markets: Competition and Multiple Regulators Heighten Concerns about Self-Regulation," May 2002, GAO-02-362, available at <http://www.gao.gov/new.items/d02362.pdf>, at 1-2.

<sup>7</sup> We recently issued a report demonstrating that the cost of compliance for the securities industry has nearly doubled over the past three years. The Costs of Compliance in the U.S. Securities Industry, SIFMA Research Reports, Volume VII, No. 2 (Feb. 22, 2006), available at <http://archives2.sifma.org/research/pdf/RsrchRprtVol7-2.pdf>.

including different record-keeping, procedural and audit trail requirements for the same product or service. We believe a single rulebook for broker-dealer activities, along with one source of interpretations, compliance examinations and investigations, will more effectively focus existing resources on substantive investor protection at both the SRO level and the broker-dealer level.

### **III. Ensuring Investor Protection after the Regulatory Consolidation**

For this historic restructuring to reach its full potential, however, the Single SRO should engage in meaningful and regular interaction with all stakeholders throughout the rulemaking process. Developing a transparent and cost-effective regulatory structure – with investor protection at its core – will allow our regulatory system to be dynamic, informed and responsive to our rapidly evolving and highly complex financial markets.

#### **A. Expert Participation in the Self-Regulatory Process**

The success of today’s self-regulatory governance is directly related to member involvement in the process.<sup>8</sup> Self-policing by professionals who have the requisite working knowledge and expertise about both marketplace intricacies and the technical aspects of regulation creates a self-regulatory system with valuable checks and balances. Supplemented by government oversight, this tiered regulatory system can provide a greater level of investor protection than the government alone might be able to achieve. Indeed, without such member participation, an SRO loses its status as a private actor, and becomes little more than another arm of the government.<sup>9</sup> As such, SIFMA believes that

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<sup>8</sup> See generally S. Rep. No. 94-75, at 22 (1975) (accompanying S. 249, 94th Cong., 1st Sess. (1975)) (“In enacting the Exchange Act, Congress balanced the limitation and dangers of permitting the securities industry to regulate itself against ‘the sheer ineffectiveness of attempting to assure [regulation] directly through the government on a wide scale.’”); SEC Report of Special Study of Securities Markets, H.R. Doc. No. 88-95, Part 4 (1963) (“Special Study”).

<sup>9</sup> The securities industry self-regulatory structure is grounded in the New Deal of the 1930s. M. Parrish, *Securities Regulation and the New Deal* (1970). Broadly stated, the theory was that business people could establish “just and equitable principles” of trade without necessarily the same degree of formality as government standards, more akin to a business code of conduct. In contrast, were the new Single SRO to strip away the role of market participants, it would become more difficult to distinguish the Single SRO from any other governmental actor who would have to meet the more exacting standards required for state actors.

the active involvement of SRO members in the self-regulatory process of the Single SRO is integral to the continued success of our regulatory system.

We cannot overstate the importance of regular interaction and cooperation between the Single SRO and its member firms. While independent rulemaking authority by the regulator is vital, equally important is an effective understanding of the practical implications and potential burdens rules may have on the firms to which they are applicable. SRO consultation with industry participants on the front-lines of market-place developments is crucial to obtaining that understanding and, when implemented properly, ultimately yields smarter, more effective regulation. Indeed, we are pleased that both the NASD and the NYSE have taken considerable strides to foster and strengthen effective working relationships with the industry over the past several years.

The NYSE, for example, has integrated the Compliance Advisory Group<sup>10</sup> – a vehicle that fosters a consistent regulator/industry dialogue on compliance and legal matters – into its efforts on identifying new areas of concern, interpretations and the rulemaking process.<sup>11</sup> Importantly, this dialogue identifies issues and concerns as proposed rules and interpretations are being considered at the inception of the rulemaking process. It has been our experience that the opportunity for meaningful dialogue at this phase of regulation maximizes the likelihood of frank feedback and contributes significantly to the comprehensiveness of the ultimate product. SIFMA fully supports this model of regulator/industry partnership and we strongly advocate its continuation in the Single SRO. We believe the governance structure as well as the ongoing interpretive and policy-setting process will benefit from the complete integration of market participants.

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<sup>10</sup> NASD has a similar structure with standing and advisory committees that also includes industry participants.

<sup>11</sup> Speech by Richard G. Ketchum, Chief Executive Officer of NYSE Regulation, Inc., Remarks before the SIFMA Compliance and Legal Conference, March 27, 2007.

## **B. Rationalizing Regulation**

Of heightened interest to our members is both the creation of the single rulebook for the consolidated entity and the regulatory philosophy that will undergird the rulebook. One approach is for the NASD and NYSE simply to “harmonize” their current rules to create a single reconciled rulebook that draws from both existing SROs’ rules and interpretations. Another approach is to pick and choose between the best of the existing SRO rules in what is at times described as the “band-aid” approach. For our members, however, neither approach is the best solution, notwithstanding the extraordinary effort of both the NASD and NYSE over the past year to seek regulatory harmonization.

Rather, and in light of the recent debate surrounding U.S. competitiveness within the global market, we believe the time is ripe to consider carefully the goals of SRO rulemaking as well as the best method for achieving those goals. In some cases, existing rules may remain the best approach to an issue. In other areas, however, a more “prudential” approach may be warranted. Such a prudential approach would establish “a clear set of standards with a more flexible implementation approach for meeting those standards. It means permitting regulated entities to meet their obligations in a more customized, as opposed to ‘one-size-fits-all,’ manner. It means more efficient regulation, not less effective regulation.”<sup>12</sup> We agree that such a textured approach protects investors while allowing firms the flexibility to compete, innovate and respond to changes in the global economy.

In this regard, and more specifically as relating to the construction of the single rulebook, the question is whether the Single SRO should adopt a “principle-based” vs. “rules-based” approach to regulation. While today’s SRO rule structure already relies in some measure on both principles and rules, the issue is one of approach: a principles-based approach to regulation involves a regulator moving away, where possible, from

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<sup>12</sup> Speech by SEC Commissioner Annette L. Nazareth, Remarks before the SIFMA Compliance and Legal Conference, March 26, 2007.

dictating in the first instance how a firm should reach a desired regulatory outcome. This does not remove the need for detailed rules, but suggests an approach where the analysis does not as a default begin with the creation of a rule, but considers first whether firms, supplemented by guidance as appropriate, could assume the responsibility to achieve those desired outcomes in the context of their business processes and existing supervisory obligations. We suggest that a paradigm whose foundation is more clearly based on principles and the achievement of outcomes tied to those principles may better serve investors, the markets and its constituent firms. This approach would allow firms to achieve regulatory objectives in ways that are tailored to their own businesses and that a rulemaking body might not have independently considered.

Regulation 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. While we certainly recognize that there is an appropriate place for rules, we believe that there may be areas where a more principle-based approach is warranted.

In addition, and in connection with rule formulation, we would note that just as one size does not fit all broker-dealers, it also does not fit all market users. There is a world of difference between an individual investor seeking to invest his/her retirement savings and a multi-billion dollar hedge fund implementing a sophisticated trading strategy. Indeed, there is a similar difference between a high net worth individual managing substantial assets and retail market participants seeking to save for college. While all participants must be protected from fraud, we need a flexible regulatory structure that can differentiate between the various types of market participants when it comes to mandatory prophylactic rules and requirements.

Finally, as a part of this rules review, we also encourage the Single SRO to create a culture in which its surveillance, examinations and enforcement efforts take into account the different purposes of the rules, and address violations accordingly. The examination and enforcement program should not be used to set unwritten policies that the rules fail to articulate or contemplate, nor should it treat a books and records violation or operational glitches in the same manner as an act of fraud (e.g., insider trading). Both the examination and enforcement process should incorporate some sense of proportionality.

### **C. Funding the Regulator**

In a world of limited resources, the goal of any regulatory budget must be to ensure that each dollar is spent in the most effective manner. At the same time, fees for regulation should be apportioned to the industry on a fair and reasonable basis. Imposing regulatory fees that exceed the true costs of regulation acts as a tax on capital and imposes undue harm on the capital-raising system. We recommend that the consolidated regulator be required to define the costs necessary to meet its self-regulatory obligations, prepare and make public a budget to meet those obligations, and then fairly apportion those costs among members by making periodic filings with the Commission subject to public notice and comment as well as Commission approval.

Regulatory funding for the consolidated SRO should come from regulatory fees assessed on market participants; including broker-dealers, issuers and other constituents of the trading markets.<sup>13</sup> Trading markets will benefit significantly from regulatory oversight of broker-dealers and the various examination and continuing education programs. Such regulation and education initiatives foster market integrity and investor confidence. As markets will receive some of these benefits, SROs should likewise assume some of the associated regulatory and administrative costs.

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<sup>13</sup> On a related point, market data fees should fund only the collection and dissemination of market data – not regulatory costs. The SEC estimates that in 2003 market data fees provided 18 percent of the funding of the NYSE and NASD. SEC Concept Release Concerning Self-Regulation, 59 Fed. Reg. 71256, 71270 (Dec. 8, 2004).

#### **D. SEC Oversight and Increased Transparency Requirements**

One risk of the Single SRO is that it concentrates regulatory power and authority in one entity. Therefore, it will function effectively only if the SEC provides attentive oversight of its activities. Such oversight, paired with active member involvement, will act to prevent the consolidated regulator from becoming unresponsive with prohibitive cost structures. Most importantly, we look to the SEC to develop increased transparency requirements for the consolidated regulator, particularly concerning funding and budgetary issues. Making the regulator's operations transparent to both members and the investing public will place appropriate checks on the Single SRO and will enhance accountability to its constituents. Similarly, SEC oversight of the Single SRO will be necessary to identify and harmonize so-called "boundary" issues between conduct rules subject to the consolidated regulator's oversight, and market rules subject to the continued oversight of the various exchanges.<sup>14</sup>

#### **IV. Conclusion**

America's securities markets are strong and our robust regulatory system plays a crucial role in our markets' success. To retain that strength, we must be vigilant about removing unnecessary regulatory inefficiencies, particularly in light of increasing global competition. We are eager to work with Congress, the SEC, the SROs, and all other interested parties to ensure that our markets remain transparent, liquid, and dynamic, with unparalleled levels of investor protection.

Thank you.

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<sup>14</sup> For example, apparently the NYSE and the NASD currently may disagree regarding whether certain customer order handling rules are "marketplace" rules to be defined and interpreted by the individual markets or whether such rules are member firm rules to be defined and interpreted by the Single SRO. Such disagreements probably are inevitable, but demonstrate the need for vigorous SEC oversight.