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Client Alert

NASD and NYSE Member Regulatory Operations to Merge

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On November 28, 2006, the National Association of Securities Dealers (NASD) and NYSE Group, Inc. (NYSE Group) announced the signing of a letter of intent to consolidate their member regulatory operations into a new self-regulatory organization (SRO). The plan is being hailed by securities professionals as a positive development, which, if completed, will streamline and enhance consistency of regulatory efforts, eliminate conflicts under the current scheme of overlapping regulation, and result in regulatory cost savings for member firms.

For years, members of the securities industry have had to grapple with overlapping and sometimes different rule requirements, joint and sometimes overlapping regulatory examinations, and joint and overlapping investigations of the same or similar matters. Although regulators, in recent years, have stepped up their efforts to coordinate with a view towards eliminating duplication, these efforts have not always proved successful. The consolidation of NYSE and NASD regulatory functions should be a significant step towards achieving efficiencies and cost reductions.

Currently, NASD regulates the more than 5,100 securities firms in the United States (including roughly 116,000 branch offices and more than 650,000 registered representatives). Approximately 200 of these firms, which are estimated to collectively hold 84% of all public customer accounts, are also subject to regulatory oversight by the New York Stock Exchange (NYSE), through NYSE Regulation, Inc. (NYSE Regulation) The merger plan would eliminate this dual regulatory scheme and create for the first time a single SRO solely responsible for the following activities, among others:

- all member regulation and enforcement;
- member compliance examinations;
- rule writing;

- market regulation currently conducted by NASD by contract for NASDAQ, the American Stock Exchange, the International Securities Exchange, and the Chicago Climate Exchange;
- dispute resolution;
- training, testing, licensing, and registration of representatives;
- investor education; and
- industry utilities such as the Alternative Display Facility, the OTC Bulletin Board, and trade reporting facilities.

NYSE Regulation alone will continue to be responsible for market surveillance and listed company compliance for the securities exchanges operated by the NYSE Group: NYSE and NYSE Arca.

The relevant boards have already approved a non-binding letter of intent contemplating the merger plan. The transaction is still subject to completion of binding agreements, NASD member votes on certain amendments to the NASD by-laws, and review and approval of the merger plan by the Securities and Exchange Commission (SEC) after public comment. However, assuming the transaction closes – and SEC Chairman Cox has strongly endorsed the plan in principle – the new yet-to-be-named SRO will begin operations in the second quarter of 2007 and have offices in New York City and Washington, DC, with 18 district and dispute resolution offices located nationwide.

The new SRO's CEO will be current NASD Chairman and CEO Mary L. Schapiro and its non-executive Chairman will be current NYSE Regulation CEO Richard G. Ketchum. A 23-member Board of Governors for the new SRO will also be created, comprised of:

- Ms. Schapiro and Mr. Ketchum;
- Eleven governors appointed from outside the securities industry (five each by the current NYSE and NASD Boards, and one jointly); and
- Ten governors from inside the securities industry as follows:
  - Three elected by small firms (1-150 registered representatives), with an initial slate to be nominated by NASD;
  - One elected by medium-sized firms (151-499 registered representatives), with an initial person nominated jointly by NASD and NYSE;
  - Three elected by large firms (500 or more registered representatives), with an initial slate nominated by NYSE;
  - an NYSE-appointed floor member;
  - an NASD-appointed representative of independent dealers/insurance affiliated broker-dealers; and
  - an investment company representative jointly appointed by NASD and NYSE.

The interim Board of Governors will serve for a three year transitional period. Notably, the NYSE does not currently have industry representation on its own Board so the composition of the Board of Governors for the new SRO is closer to the NASD governance model. Another new feature is that the structure guarantees representation on the Board of Governors for each size-type of securities firm.

Additional information about the merger plan is expected to be released shortly, and the NASD has created a special section on its website entitled "Regulatory Consolidation" which will carry further news and information about the merger plan[1]. In the coming weeks, the NASD will also be having special meetings with its members across the country to discuss the merger.

What Does This Mean for Member Firms?

The announced consolidation means that the days of dual oversight by NASD and NYSE Regulation of approximately 200 securities firms and their registered representatives may soon be over. It will be huge effort to consolidate and homogenize the staffs, rules, operations, and procedures of the two SROs, but upon completion, we expect that regulated firms should realize cost savings. Indeed, the NASD already plans to make a one-time payment of $35,000 to all member firms and reduce member firms' annual NASD dues by $1,200 for the next five years, in anticipation of further cost savings resulting from creation of the new SRO.

Time will tell what legacy practices of NASD and NYSE Regulation the new SRO adopts, but having one set of rules will be a definite improvement over two. As aptly stated by Ms. Schapiro in announcing the plan: "When the new organization is in place and fully integrated, there will be one set of rules, one set of examiners, and one enforcement staff. Duplicative and inconsistent regulation and overlapping jurisdiction will become a thing of the past." One thing is for certain, however: the ultimate array of consolidated "New-SRO" rules that emerge will require securities professionals and their advisors to adapt to a new regulatory regime. It is unclear at this point whether any transitional period, under which NASD/NYSE dual regulation would persist, is contemplated.

Live Link

NASD Regulatory Consolidation

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[1] See *www.nasd.com/RegulatoryConsolidation/index.htm*.