Demutualization and Self-regulation: The Evolution of FINRA in the US

October 22, 2008

Jeanne Balcom
Financial Industry Regulatory Authority (FINRA)

FINRA™
Financial Industry Regulatory Authority

Financial Industry Regulatory Authority (FINRA) Today

- Formed through the merger of NASD and NYSE
- Private sector, member-funded, non-profit regulator with a professional staff of over 3000
- Jurisdiction over 5000 firms and 650,000 registered representatives
- Registers firms and individuals, writes rules governing their behavior, conducts inspections and investigations, and carries out enforcement actions
- Conducts market surveillance of the over-the-counter corporate bond and equities markets
- Surveils through Regulatory Service Agreements: NASDAQ (PHLX, BSE), AMEX, International Securities Exchange, and the Chicago Climate Exchange.

Financial Industry Regulatory Authority (FINRA) Today

Corporate Governance

- Board consists of a majority of ***non-industry*** directors
- ***Staff*** and not the industry committees decide which cases to move forward and professional hearing officers hear the cases
- Member committees serve only as ***advisors*** with respect to the rulemaking process
- All key committees are ***balanced*** (non-industry members equal or exceed industry members)

History of NASD as an SRO

1929 – Stock Market Crash.

1934 – Securities Exchange Act created the SEC, and established the exchanges, such as NYSE, as SROS.

1938/9 – Securities Exchange Act amendment establishes a national securities association as SROS for the over-the-counter market. NASD becomes the only registered national securities association.

1971 – NASD established NASDAQ – for NASD Automated Quotation System – as a wholly- owned subsidiary

1987 – NASDAQ becomes a stock market

History of NASD as an SRO

As NASD becomes the owner, operator and regulator of a market and potential conflicts of interest began to surface.

***Turning point for NASD*:**

- 1996 - SEC issued a highly critical public report citing failures to properly oversee its members and the NASDAQ Stock Market. Report cited a breakdown in bringing enforcement actions against large market participants, due, in the SEC's view, to:
  - Large members making up a substantial proportion of NASD's board
  - Members extensive influence over the disciplinary process due to their strong representation on committees that decided which cases to bring forward

History of NASD as an SRO

- **The SEC 21(a) Report led to many important reforms, most significantly, the separation of regulation from operations, to minimize conflicts of interest:**
  - The NASD Board of Governors and all key committees became ***balanced*** – the number of public and non-industry governors equaled or exceeded the number of industry governors.
  - NASD Regulation, Inc., became ***a separate subsidiary***
  - NASD Regulation staff became autonomous and independent from the members (e.g. NASD was given sole discretion as to what matters to investigate and prosecute).
  - Professional hearing officers were hired to become independent adjudicators, comparable to judges.
  - NASD also modified its order handling rules and agreed to spend $100 million over a five-year period to improve its market surveillance operations.

NASDAQ and Demutualization

When NASDAQ decided to become a public, for-profit entity, this posed new challenges for self regulation.

The solution, primarily driven by NASDAQ, was for NASD to sell NASDAQ, and therefore end its status as an owner and operator of markets.

- Late nineties, NASDAQ moves to become a for-profit entity
- 2000 – NASDAQ decided to go public; NASD began selling its interest in NASDAQ.
- 2002 - NASD and NASDAQ became operationally separate; NASD had sold most of its interest in NASDAQ.
- 2006 - The SEC approved NASDAQ as an Exchange.
- 2006 - NASD completed sale of NASDAQ.

NASD becomes a private sector regulator that was no longer an owner and operator of markets.

NYSE and Demutualization

March 2006 – NYSE and ArcaEx merge and the NYSE Group becomes a for-profit, publicly-owned and demutualized company

In the wake of the NYSE/Arca merger, SEC approved corporate governance changes aimed at further separating regulation from operations

- Establishment of NYSE Regulation as a ***not-for-profit subsidiary***
- Stipulation that a majority of Board Members on NYSE Regulation's Board are not also on NYSE Group Board (due to a previous reform all NYSE board members must also be independent from NYSE Group and its subsidiaries)
- Requirement that the Chief Regulatory Officer reports only to NYSE Regulation Board

June 2006 – NYSE announces its merger with Euronext and NASD/NYSE Regulation commence merger discussions

July 2007 – NASD/NYSE Merger finalized and FINRA becomes operational

FINRA Confronts Financial Crisis in its First Year

- FINRA management and staff have spent many nights and weekends on-site at major firms to monitoring their financial and capital condition and to make sure that all customer assets in affected firms were protected
- FINRA has also been actively working with the SEC, the Federal Reserve, and overseas regulators to monitor financial health of these firms and if necessary facilitate the transfer of customer accounts
- As part of this heightened monitoring, FINRA instituted weekly reporting of inventories of key products (CDS, ARS, CDOs, and other Structured Products)
- Heightened focus on liquidity, margin accounts, and firm’s risk management models (i.e. monitoring backtesting exceptions)
- Conducting heightened surveillance aimed at detecting the circulation of harmful or misleading rumors
- Monitoring firm compliance with short sales bans
- Prosecuting crisis-related violations (i.e. suitability in sales of auction rate securities)
- Putting out a number of investor alerts and regulatory notices

Conclusion

SRO structures must continue to evolve as markets change

- FINRA is committed to maintaining the “self” in self-regulation
- It seems clear that in the U.S. the trend toward separation of the regulation and operation of markets will continue
- This trend may also lead to further consolidation of the self regulatory entities in the U.S. in the future

