

The effects of the NYSE NASDAQ merger



For years, merger mania has swept through the country (and world, for that matter) under the perception that “bigger is better.” Financial institutions had long been prime participants; community bank was bought by regional bank which was gobbled up by national bank only to be merged into global bank. Likewise, certain investment firms followed similar transactional patterns. Managers and analysts touted the newly created cost efficiencies, synergies, and other business school buzzwords, and early investors often reaped the benefits of newfound profitability. Customers, on the other hand, did not always realize improved service as that personal touch from the tellers in the bank lobby, for example, often shifted to enhanced automation and an inability to talk to a live person whenever problems arose. (And that free toaster surely became a thing of the past.)

By Ron Brounes

So, in November 2006, when the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) announced their intent to merge their member regulatory, enforcement, and arbitration operations, more than a handful of skeptics emerged. Is bigger always better? Through this consolidation, the Financial Industry Regulatory Authority (FINRA) was created on June 30, 2007 and became the largest domestic non-governmental regulatory body overseeing the broker-dealer community.

FINRA maintains oversight authority over about 5,100 securities firms and over 650,000 registered representatives. Of its many responsibilities, the self-regulatory organization (SRO) engages in rulemaking, firm examinations, enforcement, arbitration, mediation, and general oversight of its member firms and their associated representatives. Of these member firms, less than 200 were previously required to be dually registered with both the NASD and NYSE. However, these entities produced the largest volume of business and generated the greatest revenue stream for the regulatory bodies.

"I must admit, when I first learned about the merger, I felt a certain degree of conflict," said Keith Roberts, Vice President and Chief Compliance Officer of USF Securities, the broker-dealer of US Fiduciary, Inc., a Houston, Texas-based wealth management firm, servicing the needs of independent registered reps and advisors. "Any time you can streamline regulation and end some duplicity of NASD and NYSE rules and regs, that should be a good thing," Roberts adds. "However, from a small broker-dealer perspective, the initial reaction was 'geez, the big Wall Street boys won another round.' What is going to happen now when rule-making comes about, relative to the needs of smaller firms?"

A History Lesson

Major Wall Street firms had long been lobbying the regulators about inconsistencies and inefficiencies in the prior system. The largest broker-dealers were required to be dual registered and objected to

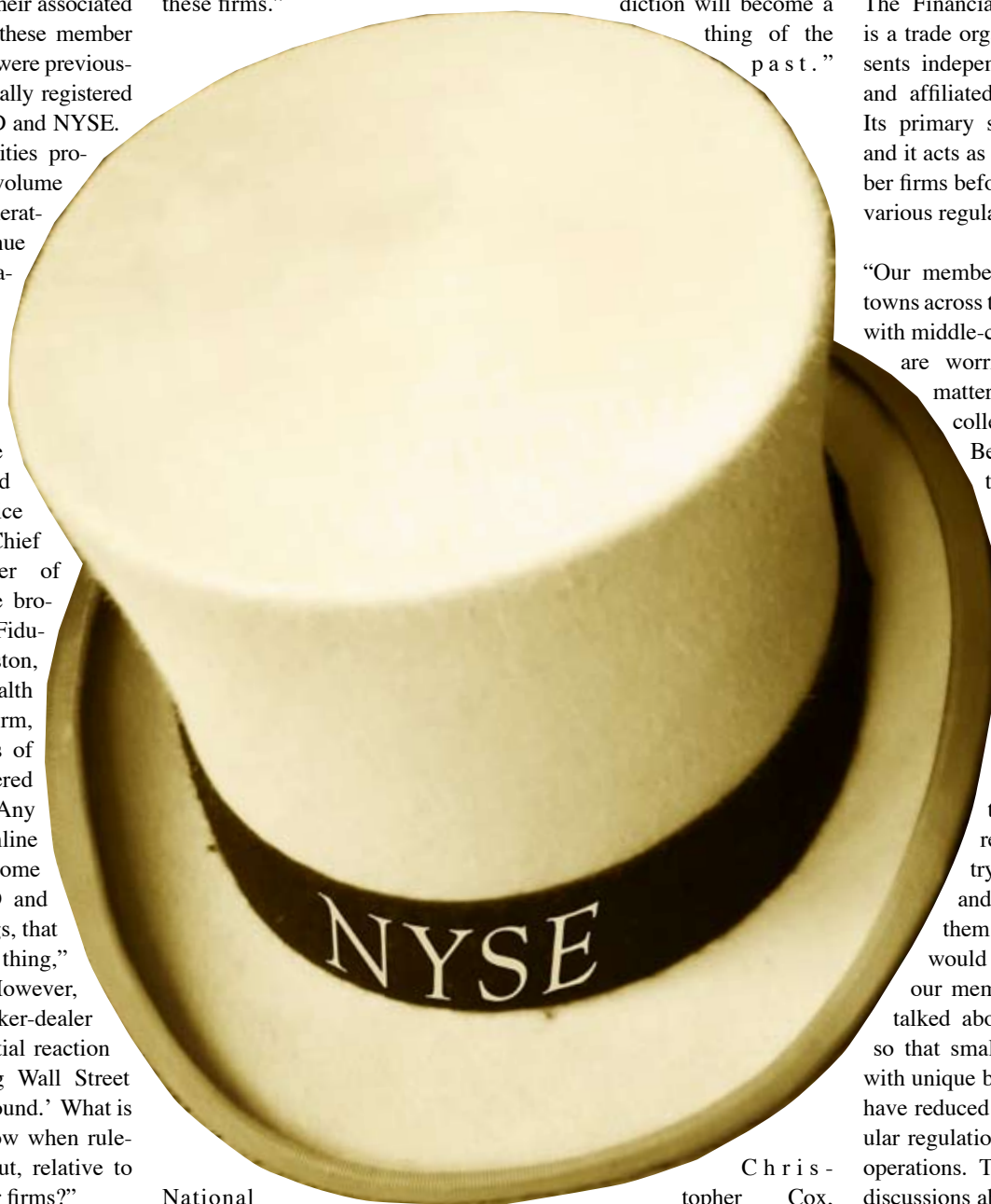
the oversight by both the NASD and NYSE regulatory bodies. Marc Horin, President of National Compliance Consultants, Inc. explained the dilemma.

"The NYSE had its own regulatory arm and firms that ran off-floor brokerage operations were required to be members," Horin said. "On the other hand, if a firm dealt with the public and marketed over-the-counter securities, it must be registered with the NASD. Back in the way-back machine of the 70's, a firm that was a member of multiple self-regulatory organizations (SROs) may have had all of them show up at the same time, or worse, one right after the other. The NYSE may conduct its review and right on its heel, comes the NASD and then the CBOE (Chicago Board of Options Exchange). It became quite a regulatory burden for these firms."

broker-dealers and investment advisor clients.

"While the Securities and Exchange Commission (SEC) had a mechanism in place to allow one SRO to lay off certain parts of regulatory exams to another SRO, the general thought among the large broker-dealers was that too much duplication between the regulatory bodies existed," Horin said. "The concept behind the merger and creation of FINRA was to get rid of this overlap and do things more efficiently."

In the immediate aftermath of the proposed merger announcement, the early talk from the regulatory execs confirmed this sentiment. According to Mary L. Schapiro, former NASD chairman and chief executive, who now heads FINRA, "Duplicative and inconsistent regulation and overlapping jurisdiction will become a thing of the past."



National Compliance Consultants was founded in 1987 as a consulting firm that helps broker-dealers and investment advisory firms meet ongoing compliance needs. Essentially, it serves as an outsourced compliance department for small and mid-sized

Christopher Cox, chairman of the SEC, praised the move as "a definitive first step toward a historic change that will simplify and strengthen the current self-regulatory structure in the United States." Richard G. Ketchum, former chief executive at the NYSE's regulatory arm,

called the proposal "the first major reform after more than 70 years of the creation of the self-regulatory system."

Another Voice Heard From

While David Bellaire, General Counsel and Director of Government Affairs for the Financial Services Institute, acknowledges that the decision to modernize, reform, and streamline the regulatory scheme would have greater impact on the large Wall Street firms, he understands the concerns of the independent broker-dealers. "While the merger would provide new efficiencies and give FINRA greater leverage in discussions and negotiations with the SEC about rulemaking proposals, independent firms were worried about unintended consequences that may arise when the rulebooks merged."

The Financial Services Institute is a trade organization that represents independent broker-dealers and affiliated financial advisors. Its primary service is advocacy and it acts as a voice for its member firms before Congress and the various regulatory bodies.

"Our members operate in small towns across the country and work with middle-class Americans who are worried about personal matters like retirement and college education," said Bellaire. "While we think it is important to streamline regulations, our members turned to us to look out for their best interests."

Bellaire points out that he was pleased with the initial contact from the regulatory bodies. "They reached out to industry groups for input and feedback to help them make decisions that would be well-accepted by our members," he said. "We talked about tiering the rules so that smaller firms and those with unique business models may have reduced burdens of a particular regulation to better suit their operations. There were a lot of discussions about a more sensible rulemaking approach and taking a fresh look at what we can do to improve the current system."

John Cooney, Chief Compliance Officer of Essex National Securities, believed Mary Schapiro when she said the combined regu-

latory entity could achieve cost efficiency and other benefits. "If you listened to people who objected to the merger, they were concerned that the small firms would not be adequately represented," said Cooney. "Some thought they were not given enough time to consider the merger and there wasn't enough clarity in the cost savings for member firms."

Cooney said that in response to these objections, he received multiple communications explaining the FINRA positions regarding the merger and addressing the concerns. "We were given assurances that there would be considerations both in design and application of rules as they pertain to the size and model of member firms," said Cooney. Essex is an independent broker-dealer which provides support services to financial institutions and currently serves about 400 registered reps.

Every Vote Counts

USF's Roberts claimed that representation on the FINRA board was a primary reason for early dissent among the smaller firms. "I must admit, there was quite a bit of consternation among the NASD member firms, especially those that were active with the small firm advisory board. Would we lose our voice when going up against the big wirehouse type firms?" Like Bellaire and Cooney, he admits that FINRA made reasonable efforts to ensure that the voices of the smaller firms would continue to be heard.

National Compliance Consultant's, Horin, explained why the change in board makeup raised more than a few eyebrows. "In the past, every firm had a vote for each board member," said Horin. "The smaller membership had the same voice as the larger firms when it came to the elections. Now, the members no longer have a say in electing all board members because the voting is based on firm size: three members representing small firms (150 reps), one member representing mid-sized firms, and three members representing large firms." Horin adds that 14 other board members are appointed by FINRA, including 11 outside directors.

"The small firms were concerned that they would not be represented in as effective a manner as before," Horin said. "Even if they voted in a bloc, they would still be in the minority and no longer have much authority to make things happen." Bellaire points out that one of the

appointed board seats is reserved for an independent broker-dealer representative and FINRA has reached out to his organization for input on this appointment. "In fact, the immediate past chairman of our board, John Simmers, is the current independent broker-dealer representative on FINRA's Board of Governors," said Bellaire. "John is also the CEO of ING Advisors Network, a group of four independent broker-dealer firms."

Bellaire also believes that the creation of a small firm advisory board was another crucial move and the group would maintain a very important role within FINRA, helping to ensure that the voice of the smaller and independent broker-dealers would still be heard.

Despite some of the initial concerns, the proposed merger passed a majority of the membership and FINRA became a reality in June 2007. Horin remembers that the regulators placed one final carrot in front of the members heading into the vote. "Due to the economies of scale that would be created, each member firm was to be allocated a certain dollar amount that represented the expected cost savings," said Horin. "While some members questioned the calculation of the number and even believed it should have been larger, ultimately, a flat \$35,000 was distributed to each firm."

The Early Results Are In...

Fast forwarding to today, the transition process is still ongoing and many questions have yet to be answered. FINRA's CEO Schapiro circulated a progress report in mid-February in which she updated the membership about the ongoing integration and rulemaking consolidation efforts. According to her correspondence, "The transformation of FINRA's enforcement department is now complete, with the two operations fully integrated." With regard to the FINRA rulebook, Schapiro stated, "Rather than simply choosing a legacy NASD or NYSE rule, we have set out to identify rules where a more principles-based or tiered approach—which could consider a firm's size or business model—would be appropriate. We are also identifying rules that may be obsolete or duplicative of SEC requirements. We remain committed to modernizing our rulebook in ways that ensure investor protection, yet reduce unnecessary burden on firms."

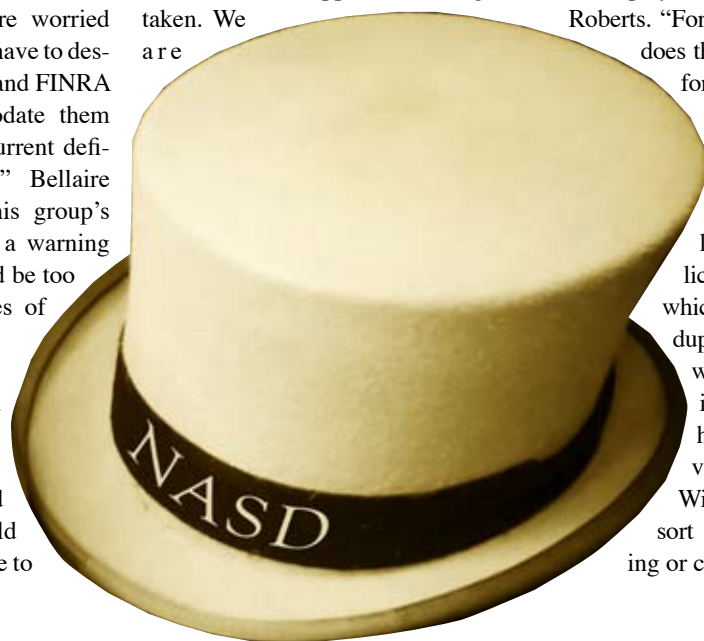
Bellaire sees some early positive signs regarding rulemaking and

the fact that FINRA is looking at various regs to see if they have outlived their purpose. However, he also admitted that one of the initial proposals brought him and his group some early cause for concern.

"Shortly after the merger went through, FINRA proposed a rule that would have changed the way OSJs (Office of Supervisory Jurisdiction) operate," said Bellaire. "The larger firms were worried about how they would have to designate offices as OSJs and FINRA appeared to accommodate them by throwing out the current definition of these offices." Bellaire noted that some of his group's members took this as a warning sign that FINRA would be too sensitive to the desires of the big firms.

"Our members have a lot of time, energy, and money invested in the current structure and we believed this would be a relatively tiny issue to

Bellaire said the Financial Services Institute is watching developments along the enforcement line as well. "We are particularly pleased that the Disciplinary Advisory Committee was brought over to FINRA from the NYSE to help promote uniformity in its enforcement efforts," he said. "This group of senior execs reviews enforcement actions, settlements, and cases to ensure they are comfortable with the approaches being taken. We are



Roberts. "For example, what does the merger mean for the various registration categories? Many professionals have a collection of these licenses, some of which are inherently duplicative." What will they do for individuals who hold Series 24 vs. Series 10? Will there be some sort of grandfathering or consolidation?

“Trade groups and consultants may be working behind the scenes on transition issues, but for some broker-dealers it's business as usual.”

the large broker-dealers," he said. "Financial Services Institute was very vigilant in this circumstance and worked with FINRA so that they understood the implications. Ultimately they withdrew the rule proposal and created an exemption for larger firms. While we were pleased with the results, this served as a wake-up call for us to stay involved and make sure our members are well represented."

Horin and his team at National Compliance Consultants still have concerns about FINRA's enforcement role and whether the larger regulatory body may become more overbearing on the smaller broker-dealers.

"We are curious to see if FINRA feels the purpose of enforcement is to remediate or to punish," said Horin. "Does the larger organization take the easy way out and use a large mallet or does it look at the overall effect on the customer, the marketplace, the investing public? Is it better to enforce a rather draconian fining structure or might they consider the degree and level of the offense before punishing?"

hopeful that this group will result in a reduction in the 'rulemaking by enforcement' approach which has never been a fair way to conduct business."

Following the Rules

From a continuity standpoint, FINRA is still deciding which regulations will be kept and which will be modified. According to Bellaire, rulebook integration is a one year process and should take place throughout calendar year 2008. "We have been told by FINRA that they will engage in ongoing dialogue about rulemaking and integration of the rulebook," said Bellaire. "We have met with FINRA folks who are directly involved in the integration process and they have welcomed our input thus far. Our members expect us to remain vigilant with regard to integrating the rulebook."

Horin is closely watching the rulemaking process as well. "Some current rules apply only to former NYSE members and not NASD," said Horin. "We are hoping to see some type of differentiation based on size and the type of business

conducted by the firms. There is precedent through the SEC of certain rules that apply to some members and not to others."

While the trade groups and consultants may be working behind the scenes on certain transition issues, for many of the broker-dealers themselves, it has been business as usual. "Since the creation of FINRA, we are still waiting to see how it all plays out," said USF's

Roberts. "For example, what does the merger mean for the various registration categories? Many professionals have a collection of these licenses, some of which are inherently duplicative." What will they do for individuals who hold Series 24 vs. Series 10? Will there be some sort of grandfathering or consolidation?

Essex's Cooney has not seen much difference in his firm's daily operations since the merger. "We are following the same rules and operating procedures, dealing with the same people at FINRA who were previously at NASD," said Cooney. At this point, we are not feeling much of an impact. In fact, the administrative aspects have been the biggest burden thus far. We have had to change all of our letterhead (from NASD to FINRA) and Internet links. We understand that the bulk of the changes will come when rule harmonization is completed and we still have a ways to go with that."

An Apple a Day

FINRA has made education of members and investors among its primary missions and formed the FINRA Investor Education Foundation to promote innovative research and educational projects. The Foundation continues the prior work of the NASD Investor Education Foundation and provides tools for investors to better understand the markets and the basic principles of saving

and investing. Of particular note, FINRA is attempting to reach out to those tens of millions of Americans who plan to retire over the next 20 years with trillions of dollars in retirement assets.

"The NASD had been moving in that direction (education) even before the merger, though from my perspective it was at a glacier pace," said USF's Roberts. "I have seen evidence that the pace has picked up since the merger, though I am not sure if that is just an interesting coincidence or the efforts of the NASD have finally started paying off. Recently, FINRA partnered with the SEC, state securities administrators, and AARP to focus on the needs of seniors and sale of financial products to seniors."

Horin points out that the NASD had been increasing its educational opportunities for the past decade. "They came out with a compliance boot camp and a certification in conjunction with the Wharton School of Business," said Horin. "FINRA is continuing what the NASD was moving toward in terms of protecting the investing public. Given the huge number of baby boomers, some third-party service companies and independent marketing firms were offering what appeared to be bogus credentials and certifications for professionals calling on this growing market. FINRA realizes that many seniors have been ripe for the picking and is educating both their examiners and the member firms to be mindful of brokers who target them."

The Jury is Still Out

While FINRA attempts to find those cost efficiencies and synergies between its predecessor organizations, many concerned parties are closely monitoring its every move to ensure that the voice of the independent broker-dealer will be heard loud and clear. The ink on the merger is barely dry and only time will tell whether "bigger is better" from a regulatory standpoint. ■

Ron Brounes, CPA, is a technical financial writer and president of Brounes & Associates (www.ronbrounes.com), a Houston, Texas-based consulting firm that provides writing, communications, and educational services for financial services professionals.

He can be reached at ron@ronbrounes.com.