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Newly Merged SRO Points Toward Principles

BY CAROL E. CURTIS

Already in its early days, new self-regulatory organization (SRO) Finra—the Financial Industry Regulatory Authority—is taking U.S. broker-dealer oversight in a new direction. Its approach is to focus increasingly on outcomes rather than prescriptive rules, and to consider a firm's size and business model in determining how it will be regulated.



Mary Schapiro

Finra was formed from a merger of NASD and the member-firm regulatory functions of NYSE Regulation that was announced Nov. 28, approved by the Securities and Exchange Commission on July 26, and became effective July 30. The consolidated non-government regulator for broker-dealers oversees over 5,100 securities firms and 660,000 registered representatives. Its 3,000 employees operate from Washington, D.C. and 15 district offices. Finra's responsibilities include rulemaking, examinations, enforcement, arbitration and mediation, in addition to the former NASD's market regulation of the Nasdaq Stock Market, American Stock Exchange, International Securities Exchange and Chicago Climate Exchange.

"The creation of Finra is the most significant modernization of the self-regulatory regime in decades," said Mary Schapiro, who headed NASD and is the new body's CEO. "With our common purpose of investor protection, Finra will be greater than the sum of its parts," added NYSE Regulation CEO Richard Ketchum, chairman of Finra's board of governors.

Besides Schapiro and Ketchum, the leadership team and their responsibilities include senior EVP Stephen Luparello, member regulation, enforcement and market regulation; vice chairman Doug Shulman, strategy and planning, market transparency, testing and continuing education, registration and disclosure, technology and member relations; senior EVP Elisse Walter, investment company regulation, investor education, corporate finance, emerging issues, advertising regulation

and member education; Linda Fienberg, president of dispute resolution and chief hearing officer; and EVP Susan Merrill, head of the office of enforcement.

Member regulation will consist of two departments led by EVPs Grace Vogel, heading risk oversight and operational regulation, and Robert Errico, sales practice regulation.

The more principles-based approach promises to be a significant departure from past SRO practice. Influenced by methods recently adopted and articulated by the U.K.'s Financial Services Authority, many of the new Finra rules will put the onus on regulated firms to decide how desired outcomes will be reached, rather than depending on checklist-type procedures for compliance.

An early example of how this will work was a joint NASD-NYSE release on e-mail retention in June. It sets out guidelines for policies and for supervising their implementation. Although the release indicates that the use of outside e-mail platforms concerns regulators, it does not prohibit such platforms; instead, there are suggestions on how to manage them.

How Size Matters

The multi-tiered aspect of firm oversight is another departure for Finra. "We will tier regulation to firm size and business model," explained vice chairman Shulman at a gathering of accountants in May (*Securities Industry News*, May 12). Shulman also said that while exam cycles will be unchanged for the time being, over time Finra will move to a risk-based exam program similar to the one recently implemented at the SEC. Firms will be ranked according to their risk profile in determining how often they are examined.

Although the securities industry has supported principles-based regulation, there are signs of unease as Finra gets off the ground. "Our clients are compliance professionals. They do not want principles-based regulation," says Nicole Lefort, head of compliance services at Complinet, a London-based provider of compliance intelligence to financial services firms. Complinet's clients include the 20 largest financial services companies in the world.

The new approach "will be a significant industry shift in that most broker-dealers want to maximize

profit," says Lefort. "But clear rules are helpful for compliance professionals. If the compliance professional can no longer use the rule to instruct the broker-dealer about what to do, it will increase tension."

Lefort also has reservations about the tiered approach and how firms will be categorized. "The fear is about what is going to change, how it will change, and how [customers] will keep up to date with that," she says.

Paul Johns, chief marketing officer of Complinet, wonders how the e-communications guidelines will play out. That is "one area where people are erring on the side of caution," he says. "I am talking to firms that don't delete anything, ever."

On the Same Page

Now that it is operational, Finra will be focusing on the creation of a single rulebook, replacing its predecessors' two. Even though it is likely to take more than a year for harmonization to be complete, regulators have been taking steps to issue rules in areas that include supervisor registration, registered rep training and office-space sharing arrangements.

Among other things, oral complaints will no longer have to be reported, and under the proposed arbitration system, many more cases could be decided by a single arbitrator, rather than three. Some critics have charged that such proposals could be to the detriment of investor protection. But Ketchum counters that Finra "will create more effective and efficient supervision of an increasingly complex, global securities industry."

Lefort doesn't see these intentions toward change bringing an overwhelming shift. In the case of oral complaints, for example, she says that as a practical matter, firms will still want to handle them: "There will be no mass move to ignore oral complaints," she predicts.

What's more, Lefort doesn't see compliance getting any easier for her clients. "The downside is that it will be harder for compliance professionals," she says. "Compliance has a seat at the table now. I would like to think that the idea of a principles-based rules system is that you get to the underlying idea of risk, and doing the right thing. But if there are not clear rules, you wonder how far the line is going to get pushed." ■