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NYSE Returns To the Regulatory Beat

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New York is a two regulator town again. At least that's the case when it comes out to self-regulation in the securities industry.

On Jan. 4, 2016, the New York Stock Exchange (NYSE)—now owned by Intercontinental Exchange—reassumed some of the regulatory responsibilities it yielded to the Financial Industry Regulatory Authority (FINRA), starting in 2007 when the NYSE and National Association of Securities Dealers (NASD) merged their self-regulatory functions.¹ The goal then was to address inefficiencies and overlap that often resulted from the concurrent oversight by these two self-regulatory organizations (SROs).

This article will set forth a brief history of securities industry self-regulation and then discuss the events leading to the creation of FINRA, the NYSE's related ceding of its regulatory functions, and its subsequent decision to return to self-regulation, before concluding with an overview of how NYSE will operate its reconstituted regulatory program.

The Origins of Self-Regulation

Securities industry SROs date back to the 1930s, when Congress passed a series of broad acts designed to avoid a repeat of the 1929 Stock Market Crash. Included among this legislation was the Securities and Exchange Act of 1934 (the Exchange Act), which, among other significant measures, set forth national exchange registration requirements.² Under these requirements, a prospective exchange must file with the SEC its "rules of the exchange"³ designed to allow the exchange to regulate the conduct of its members so as to protect investors and the public interest.⁴ In effect, this requirement resulted in national exchanges, such as NYSE, functioning as SROs. In 1938, Congress passed

the Maloney Act, which amended the Exchange Act and established registered national securities association SROs. Certain provisions of the Maloney Act required broker-dealers to register with either a national securities exchange or a "registered securities association."⁵ Accordingly, in 1939, the NASD was founded to serve as the SRO responsible for monitoring the conduct of member brokerage firms and exchange markets.

Over the next 60 years, self-regulation took hold and then dramatically expanded to the point where the financial firms subject to self-regulation, not to mention government oversight, became well-positioned to make the case that they were unfairly burdened by an overbroad and inefficient regulatory regime. By the turn of the century, both the NASD and NYSE, who shared many common members, had evolved into active and omnipresent regulatory forces on Wall Street.⁶

Regulatory Consolidation

The push by both the Clinton and Bush II administrations to deregulate the nation's financial markets and banking systems fueled the industry's desire to lessen its self-regulatory burdens. The brokerage industry began to agitate for some type of consolidation so that firms would not have to answer to multiple overseers and be subject to dual rule regimes. In her May 2007 testimony before the Senate banking subcommittee, then NASD CEO Mary Schapiro stated, "[p]erhaps the most critical step we will take to bring more efficiency to our regulatory efforts as part of this consolidation is the creation of a single rulebook for the industry."⁷ Her testimony took place in the context of joint

planning by the NYSE and NASD to merge their regulatory operations into a single organization (the 2007 Allocation). The SEC approved this plan on July 26, 2007, and four days later, FINRA opened its doors for business, or, more accurately, regulation.⁸

Under the 2007 Allocation, FINRA assumed the examination, enforcement, and surveillance responsibilities for members common to both organizations (Common Members) with regard to a set of "Common Rules" set forth in the plan.⁹ NYSE reserved some of its oversight authority, including (1) examinations of Common Member conduct covered by NYSE Rules not part of the Common Rules and/or federal laws or regulations; (2) surveillance, investigation, and enforcement



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with respect to (a) conduct relating to trading on or through NYSE systems or facilities, (b) conduct otherwise covered by NYSE-only Rules, or (c) whether conduct under (2)(a) or (2)(b) constituted a violation of federal laws or regulations.¹⁰

In June 2010, NYSE ceded its residual market surveillance and enforcement duties to FINRA under a "Regulatory Services Agreement" (RSA).¹¹ Consequently, FINRA took on the responsibility to monitor NYSE member conduct under NYSE rules, investigate and enforce violations of NYSE rules, and conduct disciplinary proceedings arising out of such enforcement actions.¹² At the time, the SEC noted that the evolution and increasing fragmentation of the securities markets called for effective cross-market, cross-product oversight. NYSE Euronext's CFO, Michael Geltzeiler, stated that the move marked a step towards the optimal structure of a single market surveiller.¹³ Between the 2007 Allocation and the 2010 RSA, NYSE gave FINRA essentially all member regulatory functions previously performed by NYSE Regulation (NYSE-ER) including all disciplinary proceedings relating to NYSE-specific rules and non-FINRA members.¹⁴ The RSA was drafted to expire on Dec. 31, 2015.¹⁵

In 2011, the NYSE annexed its last regulatory function when it transferred responsibility for investigating insider trading occurring on the NYSE to FINRA.¹⁶ Since this transfer, FINRA has essentially been the only self-regulator on the industry beat. However, FINRA learned in the fall of 2014 that this distinction was only temporary.

The NYSE Comeback

On Oct. 6, 2014, NYSE announced that NYSE-ER would be taking back market surveillance, investigation, and enforcement duties from FINRA upon the expiration of the RSAs.¹⁷ NYSE-ER's reclaimed authority encompasses the enforcement of rules that specifically govern the markets operated by ICE, the New York Stock Exchange, NYSE Arca, and NYSE MKT (the NYSE Exchanges).¹⁸

NYSE-ER has identified two primary drivers for its return to regulation: (1) taking direct responsibility for monitoring activity on the NYSE Exchanges, and (2) early detection of potentially violative behavior and prompt disposition of such instances.¹⁹ NYSE-ER CEO Mary Brienza stated that NYSE-ER's expertise and proximity to the markets being regulated will enable more effective surveillance and rule enforcement.²⁰ In connection with its resumption of regulatory duties, NYSE has created an entirely new Enforcement Department, consisting of attorneys, examiners, paralegals, and investigators. Overseeing the department as NYSE-ER's Head of Enforcement is Adam Wasserman, formerly of Dechert LLP, where he was a senior member of the firm's white-collar and securities litigation group.²¹ Going forward, regulatory inquiries concerning conduct primarily occurring on the NYSE markets will be initiated by NYSE-ER,²² who will investigate and prosecute matters arising from surveillance to final disposition.²³

The New Regulatory Landscape

NYSE-ER's new regulatory program is substantially similar to the old one. As before, NYSE-ER will pursue disciplinary action through the dual

processes of settlements and formal complaints. Settlements and the issuance of complaints will require authorization from NYSE's Disciplinary Action Committee (DAC), as they did prior to the 2007 merger.²⁴ The DAC, which will replace the function now served by FINRA's Office of Disciplinary Affairs, will be chaired by NYSE's Chief Regulatory Officer and two senior NYSE-ER staff appointees whose responsibilities do not include investigating and prosecuting disciplinary matters.²⁵ One notable departure from the NYSE's pre-merger operation is that now NYSE-ER will litigate formal actions before FINRA's Office of Hearing Officers,²⁶ as the expected volume of disciplinary actions does not warrant the creation of a stable of hearing officers and support staff. Hearings will take place before panels chaired by a FINRA Hearing Officer, who will be joined by two additional panelists.²⁷ However, the appeals process is the same. Panel decisions may be appealed to the NYSE Board of Directors or a committee acting on their behalf.²⁸ From there, the appeals route parallels the one in place with respect to FINRA disciplinary actions, where the first level of review is the SEC and then the appropriate U.S. Court of Appeals.²⁹

Under the new regime, FINRA will still be responsible for overseeing investigations and

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prosecutions whose subject matter fall outside the RSA. These matters include compliance with the Common Rules allocated to it through the 2007 and 2011 SEC Orders, which means insider trading occurring on the NYSE markets will remain within FINRA's purview. In these cases, FINRA staff will be required to seek settlement and complaint authorization from the DAC. FINRA will also continue to perform cross-market surveillance and investigation, as well as the registration, testing, and examinations of NYSE broker-dealers.³⁰

Conclusion

The most pressing question presented by the NYSE's return to self-regulation is whether it represents a resumption of the pre-FINRA state of affairs wherein brokerage firms were subject to regulatory overlap and the associated burdens and costs. As currently constituted, the new dual self-regulatory scheme is a far cry from the one that preceded FINRA's creation in 2007. For one, the NYSE regulatory operation is substantially smaller than its pre-consolidation predecessor. Second, NYSE-ER's regulatory mandate is precisely drawn. Instead of being an omnibus enforcement entity, NYSE-ER has taken on a series of discrete missions directly tied to the distinct character of

the individual exchanges that comprise the NYSE. Third, the new regime incorporates explicit coordination and interdependence between NYSE-ER and FINRA, reflected, for example, by NYSE-ER's utilization of FINRA's Hearing Officers and the requirement that FINRA staff seek complaint and settlement authorization from the NYSE DAC for certain types of cases. Only time will tell if two's a crowd, but these differences, combined with the NYSE's effective management of its comeback, has, at least for the time being, allayed securities industry anxiety about having to serve two regulatory masters.

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1. FINRA is actually headquartered in Rockville, Md., but maintains a significant presence in New York, where most of its executive and Enforcement staff is located.

2. See Concept Release Concerning Self-Regulation, 69 Fed. Reg. 71,256 (Dec. 8, 2004).

3. 15 U.S.C. §78f(a).

4. 15 U.S.C. §78f(b)(5).

5. 15 U.S.C. §78o(b).

6. Central to the evolution of the securities industry self-regulation was the regulation of the regulators themselves, which Congress granted to the SEC. The Exchange Act gave the SEC power to bring a civil enforcement action against an SRO for not adequately regulating its members. Periodically, the SEC has used this authority when it found that the NYSE or NASD did not adequately discharge their oversight responsibilities. In 1975, Congress amended the Exchange Act to allow the SEC to initiate as well as approve SRO rule-making and take on a more expansive role in SRO enforcement and discipline. See Robert S. Karmel, "Securities Regulation: the Future of Self-Regulatory Organizations," NYLJ, June 18, 2009.

7. Schapiro became CEO of FINRA and then served as Chairperson of the SEC from 2009 to 2012.

8. Program for Allocation of Regulatory Responsibilities Pursuant to Rule 17d-2, 72 Fed. Reg. 42,146 (Aug. 1, 2007).

9. *Id.*

10. *Id.* at 42,148.

11. Proposed Rule Change to References in NYSE LLC Rules, 75 Fed. Reg. 36,729 (June 28, 2010).

12. *Id.*

13. Jacob Bunge & Suzanne Barlyn, "Finra to Regulate NYSE Equities, Options Markets," WALL ST. J. (May 5, 2010), <http://www.wsj.com/articles/SB10001424052748703866704575224020545962244>.

14. Proposed Rule Change to References in Exchange Rules, 72 Fed. Reg. at 36,729. NYSE Regulation, a subsidiary of NYSE, performs and oversees NYSE, NYSE Arca, and NYSE MKT (i.e., NYSE's U.S. securities exchanges) SRO responsibilities and functions, through a combination of intercompany delegation agreements and regulatory services agreements. Regulation: NYSE Regulation, INTERCONTINENTAL EXCH., <https://www.nyse.com/regulation> (last visited Nov. 18, 2015).

15. Press Release, Intercontinental Exch., NYSE Regulation to Perform Market Surveillance Investigation and Enforcement Program for NYSE Group Exchanges (Oct. 6, 2014).

16. Notice of Filing and Order Approving and Declaring Effective an Amendment to the Plan for the Allocation of Regulatory Responsibilities, 76 Fed. Reg. 4,948 (Jan. 27, 2011).

17. See Press Release, Intercontinental Exch., *supra* note 15.

18. Memorandum from NYSE Regulation to NYSE Markets (Nov. 4, 2015), available at <https://www.nyse.com/publicdocs/nyse/markets/nyse/rule-interpretations/2015/NYSE-15-6.pdf> (Information Memo #1).

19. *Id.*

20. See Press Release, Intercontinental Exch., *supra* note 15.

21. *Id.*

22. See Information Memo #1, *supra* note 18.

23. See *id.*; Memorandum from NYSE Regulation to NYSE Markets (Nov. 23, 2015), available at <https://www.nyse.com/publicdocs/nyse/markets/nyse/rule-interpretations/2015/NYSE%2015-8.pdf> (Information Memo #3).

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.*

28. *Id.*

29. *Id.*

30. See Press Release, Intercontinental Exch., *supra* note 15.