

THE NATIONAL LAW JOURNAL

WWW.NLJ.COM

THE WEEKLY NEWSPAPER FOR THE LEGAL PROFESSION

MONDAY, MARCH 12, 2007

ALM

IN FOCUS

SECURITIES LAW

Tips for the newlywed regulators

NASD, NYSE merger is a good time to rethink regulatory oversight.

By Deborah G. Heilizer,
Clifford E. Kirsch
and Brian L. Rubin

SPECIAL TO THE NATIONAL LAW JOURNAL

THE MERGER OF NASD and the New York Stock Exchange will have far-reaching implications for the nearly 5,100 broker-dealers and 650,000 registered representatives who assist approximately 90 million Americans with investments, and for the attorneys who represent them. A new self-regulatory organization (NSRO) will consolidate examination, enforcement, arbitration and mediation operations of NASD (formerly the National Association of Securities Dealers) and the New York Stock Exchange (NYSE) into a new, as yet

Deborah G. Heilizer, Clifford E. Kirsch and Brian L. Rubin are partners at Sutherland Asbill & Brennan, Kirsch in the New York office, and Rubin and Heilizer in the Washington office. They are former staff members of the Securities and Exchange Commission. In addition, Kirsch and Heilizer previously served as in-house counsel to broker-dealers, and Rubin was a staff member of NASD.

unnamed private sector regulator for the majority of broker-dealers. The goals of the merger include eliminating duplicative regulation, making existing broker-dealer regulation more effective and reducing compliance costs to the industry.

Given that the NSRO is at a nascent stage, now is a good time to focus on how it can improve upon the performance of its predecessors. This article provides some modest proposals for the NSRO to consider as it begins to focus on how to operate more fairly and efficiently. (The merger also offers the opportunity for the new regulator to come up with a new and hip name, like Coordinator of the Securities Industry, or “CSI: Wall Street.”)

It might make sense to make settlements available online.

One area that the industry will watch closely is the new organization’s rule-making. Currently, rules become effective from a few weeks to several months after announcement of their promulgation. This ad hoc approach is problematic for many firms, which may be operating within a budget that has already been set for the year. As a result, firms may not have sufficient

unbudgeted resources to optimally revise procedures, enhance disclosures, deploy personnel or obtain advice regarding interpretation or implementation. They might need to shift resources from other areas that also require attention.

An alternative approach might be to make all or most new rules effective on Jan. 1 of the following year, after a reasonable notice period. This would enable firms to consider how best to implement new rules in conjunction with the required annual reviews under NASD rules 3012 and 3013, which include evaluation of legal and compliance issues. In addition, firms would more likely be able to identify adequate resources for implementation and supervision if they could properly budget for the increased costs that new rules impose.

Cost-benefit analysis historically has not been part of NASD’s or the NYSE’s rule-making process—in marked contrast to U.S. Securities and Exchange Commission (SEC) rule-making. Effective rule-making requires active analysis, which typically is included as a formal portion of the SEC’s rule filing. The public, including broker-dealers, investors and attorneys, are permitted to comment. Including such analysis and comments would give industry and investor participants the opportunity to suggest efficiencies in the often burdensome record-keeping associated with new rules—by, for example, integrating

required record-keeping or review with that required by other rules. Such an analysis would also afford the opportunity to consider the impact of proposed rules on each of the various types of broker-dealer models employed in the industry (i.e., independent, wirehouse, insurance-affiliated, etc.).

NASD and the NYSE have developed various tools intended to help investors and broker-dealers. Examples include the mutual fund cost calculator and certain central registration repository late-reporting statistics. The NSRO could develop more such tools with industry input. The development of these tools could be as much of a focus of the NSRO as are rule-making and enforcement.

Currently, there is no formal requirement for NASD or the NYSE to coordinate with state securities and insurance regulators. As a result, the regulators often overlap and at times are at odds with one another. A formal coordination program could be established—perhaps involving mandatory periodic meetings between NSRO and the North American Securities Administrators Association, or between NSRO district offices and the state regulators in their territory. That way, examination activities could be coordinated, consistent regulatory messages developed and common concerns appropriately addressed.

Enforcement

In the enforcement arena, the NSRO might consider the burdens imposed on the industry by its production requests. Responding to these requests can be burdensome, particularly when the request calls for data not found in existing books and records of the firm or requires extensive analysis. For example, regulators often require that firms “slice and dice” data and create electronic files, dictating the particular format of the response and the categories of information to be included. Responding to such requests often proves costly to member firms, both in time and money, as firms may need to retain specialists and commandeer resources to retrieve the data and create the requested database. If a second regulator begins a

similar inquiry, firms may be required to repeat these costs so that they can respond to slightly different requests. The NSRO could encourage its staff to consider using information that has already been compiled or that might be available in a slightly different form.

Regulatory staff has begun to pose interrogatory-type questions, sometimes requesting information that spans years and significant corporate events, such as mergers and divestitures. The purpose of such questions and their relationship to the investigation often seem murky at best. Answering these questions may be difficult if not impossible, and may require attorneys to perform extensive (and costly) and burdensome reviews. Such requests raise jurisdictional questions about the regulators’ ability to require firms to create information rather than provide existing books and records.

Finally, some regulated firms view as unfair the production certifications that include attestations of the reach and results of a search. Setting aside the question of whether the NSRO can or should demand such certifications, at the very least it should be conscious of the burdens associated with such requests and should consider those burdens when evaluating the timeliness and adequacy of a firm’s production. It also might reformulate the production representations that it requires so that firms no longer are required to attest to the impossible.

Confidentiality

Currently, confidential documents and information produced to the SEC may be protected from public disclosure under the Freedom of Information Act. In contrast, requests for confidential treatment of the same information by NASD or the NYSE often are met either with silence or refusal. The NSRO might consider creating a process to inform the producing firm or individual if the NSRO decides to share that information with others or receives a subpoena or request for the information from federal or state regulators (or others). That way, an objection can be filed or appropriate protection for the information sought.

Another area of concern involves the way regulators bring formal proceedings. In general, if the staff intends to recommend the institution of an enforcement action, the staff issues a so-called Wells notice to the proposed respondent. The firm or individual then has an opportunity through a Wells submission to challenge the basis for the staff’s proposed charges. At that point, if the parties do not settle, the Wells submission, along with the staff’s conclusions, is submitted to the body that authorizes the complaint. That body (for example, NASD’s Office of Disciplinary Affairs) then reviews both sets of papers and decides whether to issue a complaint.

Recently, it seems to have become more common for NASD or NYSE staff to issue a Wells notice prior to the conclusion of the investigation, as a device to flush out the proposed respondents’ legal or factual theories, or to obtain a quick settlement. If the Wells notice does not produce a settlement, the staff then continues the investigation—or threatens to do so—in an apparent attempt to force the other side to capitulate. Regulated firms and individuals argue that investigations should not be conducted as a way to force a settlement or test novel legal theories. This practice, they say, distorts the process, misuses resources and ignores real-world implications, which may include amending forms U4 and U5 or making a public disclosure about the matter. The NSRO should carefully consider these issues and guide its staff regarding the proper timing and purpose of Wells notices.

Credit for cooperation

The SEC was the first securities regulator to formally announce a specific policy of rewarding cooperation with its oversight responsibilities. In the October 2001 Seaboard Report, the SEC identified four broad measures of a company’s cooperation, including self-reporting of misconduct when it is discovered and remediation. In addition, the Seaboard Report sets forth 13 specific criteria the SEC will consider in determining whether to give credit for a company’s cooperation. See SEC release nos. 34-44969 and AAER-1470 (Oct. 23,

2001), available at www.sec.gov/litigation/investreport/34-44969.htm.

In September 2005, the NYSE published an information memo that outlined how members could earn “credit for extraordinary cooperation.” Information memo 05-65 (Sept. 14, 2005), available at <http://apps.nyse.com/commdata/Pub-InfoMemos.nsf/AllPublishedInfoMemos-NyseCom/>. The NYSE listed eight factors that the exchange will consider in determining whether to reward credit for cooperation and four forms of credit that might be awarded.

NASD, on the other hand, has not established a formal policy. The only formal statements NASD has made on this issue are four general pronouncements contained in the sanction guidelines. NASD sanction guidelines at 6-7 (2005), available at www.nasd.com/web/groups/enforcement/documents/enforcement/nasdw_011038.pdf.

Moreover, only on rare occasion has NASD expressly applied these factors to give credit for extraordinary cooperation. The NSRO might consider adopting clear guidance regarding when it will—and when it won’t—award credit for extraordinary cooperation, while leaving intact the attorney-client privilege. Such pronouncements would help broker-dealers, law firms and regulators know what is expected and what the rewards will be.

Regulation by enforcement

In recent years, a trend has emerged that has caused concern in the field: Securities regulators are using enforcement actions to make new rules and/or dramatically change the scope and interpretation of existing rules. There are several recent examples in which a securities regulator identifies an industry practice that it deems to be problematic. Rather than issuing guidance or amending existing rules to clarify its views about the practice, the regulator initiates a “sweep” investigation of numerous firms and ultimately brings enforcement proceedings against several firms. The ensuing settlements establish, in effect, new standards of conduct. An example of this scenario involves the sale

of mutual fund Class B shares. While the mechanics and costs of Class B shares have not changed much during the past decade, due to enforcement actions a de facto rule has been established setting forth a limit of \$50,000 worth of B shares to any one client. See NASD press release, Dec. 19, 2005, available at www.nasd.com/PressRoom/NewsReleases/2005NewsReleases/NASDW_015753 (sanctioning several firms for alleged improper sales of Class B shares of mutual funds and ordering remediation if investors purchased Class B shares totaling \$50,000 or more); NASD press release, March 23, 2005, available at www.nasd.com/PressRoom/NewsReleases/2005NewsReleases/NASDW_013648 (same).

Another example arises in NASD’s use of Rule 2110, which requires “high standards of commercial honor and just and equitable principles of trade.” If NASD doesn’t like certain conduct but no rule specifically prohibits that behavior, it often brings actions based on this nebulous standard. Recently, for example, a registered representative agreed to pay a fine of \$2.25 million for violating Rule 2110 in connection with market timing. His conduct, however, had nothing to do with his broker-dealer activities. Rather, NASD sanctioned him for the conduct of his hedge fund, even though NASD has no jurisdiction over hedge funds. See NASD press release, dated Oct. 25, 2006, available at www.nasd.com/PressRoom/NewsReleases/2006NewsReleases/NASDW_-017689.

Members of the industry find this trend troublesome for many reasons, most notably because rule-making through enforcement circumvents the required notice-and-comment procedures required for rule-making. It is inefficient and slow, requiring the regulators and firms to expend significant resources during the investigation, settlement and post-settlement phases. Moreover, settlements generally provide far less guidance to the industry than would an industry notice or rule. In light of the foregoing, the NSRO, when confronted by a troublesome industry practice, could either adopt a rule or issue guidance about the practice. Enforcement actions could therefore be

brought only if firms fail to comply with the rule or industry notice a reasonable time after publication.

It also might make sense to make all settlements available online. Currently, when the NYSE settles a matter prior to litigation, it is done through a stipulation and consent; NASD settles cases through a letter of acceptance, waiver and consent (AWC). Typically, the NYSE makes its settlements available at www.nyse.com. In contrast, one must personally contact NASD, often pay a fee and then wait days or weeks before receiving a copy of an AWC.

This process is hard to understand in today’s Web-based world—especially given the importance of settlements, which often are used as informal precedent. In addition, quickly posting AWCs would assist member firms and their attorneys in keeping current with the regulators’ expectations.

Rarely does a regulatory agency have the chance to re-evaluate its rules, processes and procedures without being impeded by the tired old refrain: “That’s the way we do things.” The proposed merger presents a unique opportunity for the NSRO to keep what works and discard the rest. As part of its evaluative process, the NSRO should sit down with its constituents, particularly broker-dealers and registered representatives (and the attorneys who represent them), to come up with new and more effective approaches to securities regulation.