Commentary: FINRA's NYSE Reg Takeover -- The End of an Era?

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It was announced a month ago, on May 4, 2010, and was greeted without much fanfare: The New York Stock Exchange will delegate to FINRA responsibility for performing market surveillance and enforcement over trading on the New York Stock Exchange.

To comply with the niceties of the Securities Exchange of 1934, the NYSE will retain responsibility for making sure that FINRA is doing its job. Lawyers will prepare appropriate procedures to demonstrate that this oversight function is being carried out properly. But, I very much doubt that anyone believes this will amount to anything more than window dressing. The NYSE's oversight role will be mainly perfunctory.

FINRA already provides market surveillance functions for NASDAQ, BATS and ISE. With the NYSE under its wing, it can't be long before FINRA also supervises Chicago and the Midwest, as well as anyone else that registers as an equities exchange in the future.

After all of the changes that have taken place over the last decade, this latest transition seems anti-climactic. Not much will change. About 225 NYSE employees will either transfer to FINRA, or join the millions now on the unemployment line. But, trading will go on much as it has since Reg NMS was implemented – automated, cheap and fast. Those who are regulated, for the most part software programmers and systems mechanics, are unlikely to notice that a different regulator is now running the ship.

Nonetheless, this is a sea change that removes the assumptions about market structure that are the founding principles of the Exchange Act.

In the late 1990s, the NYSE's management realized that substantial investments in technology would be required to modernize the exchange to respond to the growing competitive threat by NASDAQ and alternative off-exchange trading systems. At the time, the NYSE was a mutual organization, owned by its members. There's a lot to be said for mutuals, but it is very difficult for them to raise a significant amount of capital. So, the NYSE hired some prominent investment bankers to provide advice about ways to access the capital markets, which meant demutualizing and issuing securities to the public.

For the NYSE, going public presented significantly more complex issues than would confront the typical widget manufacturer, or even the typical mutual savings bank. For one thing, no one had ever taken an exchange public before. More importantly, the NYSE is regulated by the SEC as a national securities exchange, and the SEC had one big problem with the idea.

The NYSE is a self-regulatory organization, which means it creates and enforces rules of its members. The SEC was concerned that as a public company, the NYSE would tend to cover up rule violations of its members, rather than acting as a zealous enforcer of the securities laws. So, the SEC suggested that the NYSE come up with a plan to divest its regulatory functions. The NYSE's response horrified the Commission, even its more pro-business and conservative members.

Richard Grasso, the NYSE's CEO at the time, told the SEC that its investment bankers believed most of the value of the NYSE was vested in its power to regulate its members. This power enabled the NYSE to maintain its exclusive franchise. The SEC's request to divest its regulatory functions would therefore deprive the NYSE of most of the value of its franchise and make it difficult to offer securities to the public at an acceptable price.

Regulation's nature is to restrain competition, generally by creating a favored status for those that are regulated. Lawyers, for example, have an exclusive franchise to practice law in every one of the 50 states, and this means that non-lawyers cannot compete with them for business.

The NYSE and other exchanges are regulated entities, which means they enjoy some competitive advantage over non-exchanges. But, they are also regulators. This means that they can improve their market power by exercising control over their regulated members. Since an increase in market power is associated with greater profits, it follows that a publicly owned regulator can use its regulatory power to increase its profits. Indeed, it can be argued that it owes a fiduciary duty to its shareholders to increase profits through anti-competitive use of market regulation.

Of course, the use of regulatory power to stifle competition is not in the public interest. The practice inevitably results in higher costs without any corresponding public benefit. Richard Grasso's candid conversation with the SEC provoked a serious examination of the NYSE's behavior as a regulator. It is fair to say that the SEC was not pleased with what it saw, and the result was a series of market structure regulations intended to deprive the NYSE of its monopoly power over equity markets.

On the other hand, regulation is also expensive. If the NYSE as a public company cannot use market regulation to increase its profits, then its self-regulatory powers are a costly burden, rather than a revenue-enhancing benefit. In that case, an exchange would owe its shareholders a duty to divest its costly regulatory function, if possible.

It is no coincidence that the NYSE's share of trading in its own listed securities has fallen to 11%. To compete on a level playing field with NASDAQ, BATS and other fleet footed competitors, the NYSE needs to be free of the dead weight of market regulation. The May 4th announcement reflects the final transformation of the NYSE's business model and its capitulation to market forces.

This raises the question about the meaning of "exchange" status. The "national securities exchange" created by Securities Exchange Act of 1934 is first and foremost a self-regulatory organization with rules to govern the conduct of its members. In the absence of this self-regulatory function, what is it that sets an exchange apart from an alternative trading system?

The concept of "national securities exchange" is a cornerstone of the Exchange Act. Removing it would reduce the grand regulatory edifice to rubble. But, the fact is that the commercial realities of modern equity markets have already done the job. The only sensible thing to do is to haul away what can be salvaged and junk the rest.

The Exchange Act must be thoroughly revised. Postponing the project will only increase the pain and suffering involved in the process.

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