The Agnostic Regulator – A Shift in Securities Regulatory Policy

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At the end of the '90s, Richard Grasso, then CEO of the New York Stock Exchange, made a statement that shocked the SEC. This turned out to be a catalyst for a whole series of changes in the way markets are regulated, not least at the NYSE.

At the time, the NYSE was considering whether or not to go public. Reacting to this proposal, the SEC suggested that the NYSE should divest its regulatory function from its business lines before selling shares to the public. Mr. Grasso vigorously rejected this notion. The investment bankers advising the NYSE had informed Mr. Grasso that most of the value of the NYSE was a function of its regulatory power over its members. Divesting this regulatory function would therefore severely reduce the franchise value of the NYSE.

The SEC was startled to discover that the regulatory power of the NYSE gave it a competitive advantage over other similar businesses. Traders, who deal with competition every minute of the day, would have thought this obvious.

To be fair, large NASDAQ market makers during the same period knew the competitive value of regulation. Firms made sure that District Committee memberships and director positions in the NASD were composed largely of market maker representatives or persons friendly to the market-making community. In the ultimate battle with SOES firms, the NASD was accused of using its regulatory power to discourage competition with the market makers. That also got the SEC's attention.

How things have changed. The NYSE and NASDAQ still retain some regulatory authority over listed issuers, and they are responsible for market supervision. But the regulation of broker-dealers has passed for the most part to FINRA, which is in many ways insulated from competitive market pressures. This has led to some subtle changes in regulatory policy.

One big change is that FINRA is agnostic as to venue. It doesn't matter whether a broker-dealer is executing on an exchange or in the over the counter markets. FINRA's regulatory scope encompasses all US trading venues. It is true that FINRA has spent a lot of time recently trying to merge the NYSE rules with the old NASD rules. But, the major impact of this regulatory shift, at least for now, is a lot more focus on the over the counter markets.

For many years, the over the counter markets were largely ignored by the NASD, FINRA's predecessor. There were relatively few rule changes. Firms operating in the over the counter market were examined infrequently and lightly. The NASD owned NASDAQ, which was its major source of revenues, and spent most of its time and attention dealing with the NASDAQ marketplace.

A quick look at the rules docket shows how much things have changed. In recent periods, rule changes have been proposed to extend limit order protection to over the counter trades. OATS is being extended to over the counter securities. Trade reporting, and the public dissemination of trade reports, will cover foreign securities traded in the over the counter markets. Proposals have been made to introduce access fees. Tick sizes are up for grabs.

The same regulatory attention is also being given to examination and enforcement priorities. In the past, firms that traded over the counter had never heard of Trading and Market Maker Surveillance (TMMS) audits, a prominent part of the NASDAQ compliance regime. Now, TMMS audits are commonplace on over the counter desks. This increased in audit focus is changing the way things are done. FINRA and the SEC are spending a lot more time prosecuting pump and dump schemes, and firms that were heavily involved in these frauds are quietly going out of business. Lots of firms are having to answer tough questions about the bona fides of Rule 504 offerings.

FINRA and the SEC have also convinced the Canadian authorities to do something about the British Columbia markets. New rules have been introduced in British Columbia, limiting the opportunities for cross border penetration of questionable issues. There have been some vigorous prosecutions. As a result, fewer frauds are being produced in Canada these days that find their way to the US over the counter markets.

It is safe to say that not everyone welcomes this change in regulatory focus. Smaller firms have complained vigorously about the time and expense involved in dealing with multiple, heavy-handed regulatory exams. Firms that rarely paid regulatory fines in the past are suddenly seeing their good record under attack. I have heard that District 10 meetings with small firms are loud and rancorous. Limit order protection has never been welcomed by the trading community. I personally believe that the introduction of access fees to this market would be a serious mistake.

On the other hand, regulatory attention is also good for the markets. Investors withdraw from markets where there is a risk they will be cheated. Chasing away frauds increases volumes. Increased volumes encourage innovation. Many of the regulatory changes adopted recently were long overdue.

I expect we will see more rule changes and regulatory attention in the future. So far, the regulatory emphasis has been to introduce changes into the over the counter markets that were adopted many years earlier by the listed exchanges. But, the over the counter markets have some unique characteristics. Future rules can be expected to take account of these differences. Among other things, I expect that FINRA will be taking a hard look at the firm quote rule and its application in a modern trading environment.

If history is any guide, this regulatory focus will improve the over the counter markets. They will become more efficient and investor friendly. The impact on the trading business is less clear. In many ways, the over the counter markets are the last refuge for the classic trader. The market was largely inefficient, giving the smart trader, and even the less gifted, an opportunity to profit. As the markets become increasingly efficient, past experience suggests that only the nimble will survive.