Self-Regulation in Today's Securities Markets

Outdated System or Work in Progress?

CFA Institute
Centre for Financial Market Integrity

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Executive Summary

Over the years, securities industry regulators around the globe have moved from a regulatory approach highly influenced by the U.S. model to a variety of approaches. Some have continued to recognize the benefits of a self-regulatory system, while others have moved toward a more government-centered approach. As markets become increasingly global and face demands for consolidation, regulators are addressing the growing need to engage in cooperative efforts to regulate across borders, raising issues that go beyond those in self-regulatory systems.

The U.S. Securities and Exchange Commission, in particular, has questioned the fairness and efficiency of U.S. securities industry self-regulation in light of market developments, new technologies, growing global competition, and additional factors that increase the conflicts inherent in a system of self-regulation. The SEC has called for public comment on a number of areas that would reform the current structure. Through this monograph, we seek to provide input into this process. We also comment generally on global convergence of securities markets and regulation, with broad recommendations on the challenges of integrating diverse global regulation.

Since enactment of the Securities Act of 1933 and Securities Exchange Act of 1934, the U.S. government has vested certain entities with self-regulatory power (self-regulatory organizations or SROs) and ceded oversight responsibility of them to the SEC. Under this U.S. system, broker-dealers, stock exchange members and listed firms, futures traders, and others are overseen or regulated, to some degree, by a variety of SROs, further securing the need for SROs and a defined self-regulatory function in the United States.

Although most countries around the world do not replicate the multiple SRO aspect of the U.S. system, many countries do provide a self-regulatory function within the financial exchanges (securities and futures) of their markets. The structure and responsibilities of these various self-regulation models have evolved over the decades. Particularly since 2000 and the notable increase in globalization of the world's capital markets, attention has turned to the challenges and efficiencies of differing regulatory frameworks. Thus, although not necessarily formalizing an SRO structure as done in the United States, some markets nonetheless incorporate a number of self-regulatory functions. Furthermore, we have found a number of commonalities in many regulatory systems regardless of the form—self-regulation or direct governmental regulation. It is in light of these recognitions that this monograph analyzes regulation in today's global marketplace.

This monograph seeks to address whether self-regulation is a viable method of regulation in today's climate. Given the current landscape, can self-regulation actually work? What conditions and structures will make self-regulation most effective? Moreover, in an era of consolidating securities markets, are there aspects of regulation, be they self-regulation or otherwise, that are applicable on a global basis? In exploring these issues, it is important to develop a working understanding of the genesis and evolution of self-regulation.

We begin in Chapter 1 with a historical overview of the evolution of self-regulation with its underpinnings in social systems. In discussing the overall viability of self-regulatory systems, we highlight the ongoing debate about the merits of self-regulation, much of which focuses on the efficiencies realized through such a system versus its inherent conflicts, including the consequential effects on investor protection. Proponents of self-regulation tout the efficiencies—both monetary and experiential—derived from a system that vests regulatory authority in SROs. Opponents cite the inherent conflicts of interest when a business must regulate the very members that fund it. The debate grows more complex with the demutualization of exchanges, transnational moves toward market consolidation, complex trading/technological advances, and the overall trend toward globalization of the securities markets.

Chapter 2 explores the underpinnings of the U.S. self-regulatory system, including threats to the system as it exists today and the current issues that must be addressed by SROs. This discussion provides examples of associations that fall along a continuum in terms of regulatory oversight.

Chapter 3 details aspects of the global experience with self-regulation. We note the movement by the United Kingdom toward a centralized form of regulation (from rules to principles) that still incorporates certain aspects of "soft" regulation. We discuss self-regulation in demutualized exchanges and the issues raised by opponents to demutualization as well as by the exchanges themselves. We investigate a number of similarities among regions in terms of market standards and regulatory concerns (commonalities). It is the prevalence of these commonalities that underlies our recommendation to consider the utility of a "global regulator" that would serve to rate compliance with these standards.

Chapter 4 identifies which attributes best define an effective regulatory system and which attributes are detrimental to regulatory success. In particular, certain traits, such as unresolved conflicts of interest, inadequate funding, and anti-competitive behavior, appear to undermine or doom the chance of regulatory success.

Over the course of preparing this monograph, we held individual meetings and forums in Washington, DC, London, Singapore, Melbourne, Sydney, and Hong Kong. In total, we met with nearly 70 regulators, exchange officials, market participants, and others to discuss the role of regulation and self-regulation in globally consolidating and demutualizing markets. With the increase in cross-border trading, accompanied by greater speed and highly sophisticated trading mechanisms, the various markets around the world are increasingly interconnected. The lack of integrated surveillance systems, disparate monitoring and enforcement regimes, and a wide range of transparency and disclosure requirements suggest a growing need for added investor awareness and system improvements.

Although regulation of the securities markets assumes varying forms and reflects a wide range of processes, the need for adequate investor protections is endemic to all successful systems. We approach this goal from two angles. First, we focus on traits that will strengthen self-regulatory systems where those are part of the regulatory structure by addressing the inherent conflicts. Second, we focus on a core set of standards generally applicable to most regulatory systems, regardless of jurisdiction or structure. We conclude by offering several suggestions for a global oversight framework of securities markets focused on efficiency and investor protection, summarized as follows:

- **Where self-regulation is practiced, establish an independent SRO body that is separate and distinct from exchange/market operations to oversee the regulation of the securities market.**
- **Eliminate dual or wasteful regulatory oversight conducted by multiple regulatory offices**. [For example, we support the creation of one regional or national entity with regulatory authority over all broker-dealers.]
- **Recognize a common framework for regulation, especially in keeping with International Organization of Securities Commissions (IOSCO) principles for securities regulation.**
- **Recognize an existing or new global organization that would rate each market in terms of compliance with this common framework.**

Introduction

Over the last few years, it has become apparent that the long-standing system of self-regulation in the United States has been slow to meet new and increasingly difficult challenges. In a late 2004 rule proposal, the U.S. Securities and Exchange Commission sought public input on a range of issues relating to self-regulatory organizations (SROs), including corporate governance reforms, disclosure, reporting, ownership, and voting requirements.[1] Perceived weaknesses in the SRO regulatory systems stemming from marketplace developments, increased competition, and the transformation of exchanges into for-profit entities (demutualization) raised a number of concerns about the integrity of the system and formed the bases for the proposed reforms.

A second 2004 concept release raised questions about the fairness and efficiency of the SRO system, noting inherent conflicts in numerous areas, the costs and inefficiencies of multiple SROs, the challenges of monitoring transactions across markets (intermarket surveillance), and issues of inadequate funding to meet system responsibilities.[2] It also noted the "failings or perceived failings" that threatened the public support of the SRO system. Through this release, the SEC asked for public input on various changes that would best address the problems identified in the current structure.

The CFA Institute Centre for Financial Market Integrity (CFA Centre) originally undertook this project to respond more fully to the issues raised by the SEC in these two releases. Our initial undertaking, therefore, was to provide a context within which to address the SRO structure and to make recommendations on how to revive this system, including a discussion of the characteristics needed to restore SROs to their original mandate.

Many of the issues threatening the viability of the SRO system are vastly different from those in play when it was first created. The current challenge is to reconcile these issues without sacrificing the beneficial attributes of the system—the efficiencies, expertise, flexibility—that have allowed it to succeed in the past. Through our study of self-regulation in general and as applicable to the U.S. securities markets in particular, we were able to identify characteristics that contribute to a stable and efficient system that also provides sufficient investor protections.

In order to provide a broader, more global context within which to address these issues, we went beyond the U.S. borders to address self-regulation in other markets. Our meetings in Europe, Asia, and Australia reminded us that the U.S. model of self-regulation is unique, although other markets may use aspects of self-regulation in their securities market regulation. Regardless of the form of regulation used, self- or otherwise, most markets share a number of similar concerns and goals. These "commonalities" not only reflect fundamentals that are important to markets and their regulators across borders but also raise the prospect of considering some type of global market standard-setter. This global body could "rate" market practices in light of these commonalities and thereby provide investors with benchmarks against which to weigh and select the markets in which they will participate.

The CFA Centre historically has supported self-regulation in lieu of government-imposed regulation. Our support for self-regulation, however, is tempered in situations where investor protections appear to be compromised. Through this monograph, we endeavor to provide an even-handed approach to addressing the problems and virtues of self-regulation for the securities markets. By supplying a meaningful framework within which to understand self-regulation, we hope to shape the debate concerning appropriate structures, highlight the areas in need of reform, and provide meaningful recommendations for shoring up the current SRO system.

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[1]See SEC *Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations; Disclosure and Regulatory Reporting by Self-Regulatory Organizations; Recordkeeping Requirements for Self-Regulatory Organizations; Ownership and Voting Limitations for Members of Self-Regulatory Organizations; Listing and Trading of Affiliated Securities by a Self-Regulatory Organization* (Release No. 34-50699; File No. S7-39-04).
[2]See SEC *Concept Release Concerning Self-Regulation* (Release No. 34-50700; File No. S7-40-04).

Self-regulation is one of the hallmarks of securities regulation in the United States. Although stock exchange self-regulation has been around for over 200 years, the formalizing of self-regulatory responsibilities for exchanges can be traced to the 1930s securities laws enacted in the United States. These laws not only laid the framework for self-regulation through the numerous exchanges but also imposed requirements on broker-dealers. As a result, the system of self-regulation in the U.S. securities markets has remained strong—reflecting legislative acceptance and deference to the system of free enterprise.

Over the last decade, the securities markets have encountered more rapid changes to structure, market participants, and regulation than at any other time in their history. These changes have challenged several of the underlying premises of self-regulation both in the United States and elsewhere in the world. Since the end of the technology bubble in 2001, market participants, exchanges, and government regulators around the world have begun undertaking reviews and implementing changes to their regulatory regimes. In particular, the following developments have directly affected the landscape of our global securities markets:

- The advent and use of electronic communications networks (ECNs), which provide improved opportunity for best execution regardless of the marketplace. ECNs create a serious competitive challenge to traditional marketplaces and thus raise new regulatory issues for the corresponding SROs.
- The demutualization of securities exchanges, which allows quicker reaction to market changes but also calls into question the relationships among the various parties, including listed firms, the regulator, the exchange, exchange members, and market participants in general (the investing public).
- The rise of global and cross-market trading strategies, which add new surveillance challenges for SROs with oversight and surveillance authority over only a single market.
- The variety of currently traded products that challenge the traditional regulatory structures that have been in place for decades.
- The consolidation of membership in some markets, which introduces the potential for conflicts of interest as some members gain market share and correspondingly greater influence over the self-regulatory process.
- The spate of enforcement actions brought by regulators outside of the SRO system against those regulated by the SROs casts doubt on the integrity of the current SRO regulatory process to adequately oversee and enforce the regulations in their markets.
- The increased occurrence of scandals (from analyst independence to accounting fraud), all affecting market confidence and raising questions about the efficacy of the current regulatory system to adequately remain abreast of market activities.

As a result of these changes, securities regulatory systems around the world are either in a state of flux or have already undergone significant changes. These developments signal a strong need to review, refine, and consider alternatives to the U.S. and global securities market regulatory systems that may better serve the changing marketplace.

History is a stark reminder of the importance of getting the regulatory equation correct. In the wake of the 1929 stock market crash, the value of all stocks on the New York Stock Exchange (NYSE) shrank by approximately 83 percent from almost $90 billion to less than $16 billion.[3] The 1933 Senate Banking Committee's Pecora hearings found that the markets were rife with fraudulent stock and bond sales, stock pools, insider trading, price manipulations, and other abuses.[4] These hearings resulted in the creation of the Securities Act of 1933 (1933 Act) and Securities Exchange Act of 1934 (1934 Act), which contained the implementing legislation for the SEC and our current self-regulatory system. Fraud and market bubbles have continued to occur since 1934, but widespread systemic abuses have been less dramatic and on a lesser scale than in 1929.[5]

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[3]Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance*, 3rd edition (New York: Aspen, 2003).
[4]Norman S. Poser, "The Origins of the Securities Laws," *Institutional Investor Advocate* (Fourth Quarter 2004).
[5]See Note 2, pp. 4–12.

Then, as now, the dramatic evolution of financial markets demands attention. In 1929, floor-based "trading clubs" led the stock exchanges. Given the technological advances and their effects on securities trading, the securities markets of the 21st century may well revolve around ECNs or other technology not yet developed.

To keep abreast of enormous technical changes such as these, market and exchange regulation will require a forward-looking regulator not hindered by conflicts of interest. Such a regulator must be focused on identifying inefficiencies and continually refining oversight and enforcement capabilities that match technological advances. Such a forward-looking perspective is one of the greatest challenges any self-regulatory system faces.

We first provide an overview of the history of self-regulation. Second, we discuss the U.S. experience with self-regulation, including the challenges of maintaining this system. Third, we address the lack of any one global form of regulation, noting the regulatory experiences of other countries. Fourth, we explore the attributes of successful and unsuccessful self-regulatory frameworks. We conclude our discussion by noting the commonalities of regulation shared by all forms—be they self-regulatory or otherwise—in framing four recommendations for regulatory systems.

Chapter 1. History of Self-Regulation

In a broad sense, the concept of self-regulation dates back to the medieval guilds, which had their origins in religious fraternities. Over time, these religious fraternities evolved into associations of the professional and merchant classes with certain privileges and powers granted them by the town authorities. In return, guild members "owed obedience to the town authorities who had granted to them their privileges and powers."[6] Because of the position bestowed upon them in the community, the guilds developed rules and regulations not only to protect their members but also to establish standards of workmanship.

What Do We Mean by "Self-Regulation"?

From the time of the guilds, the concept of "self-regulation" as a means of guiding or enforcing social behavior has established itself in a range of professions and social thought, including law, medicine, education, private business and institutions, accreditation bodies, consumer goods, ISO (International Organization for Standardization) classification standards,[7] and even ship classification organizations. With such a long history and broad range of self-regulated industries and professions, it is not surprising that there is no single definition of self-regulation. In fact, over time, self-regulation has assumed different forms, met different objectives, and faced a range of challenges to its perceived success, depending on the industry, the market, and social conditions of the time.

When defining self-regulation, some focus on the term "Self" as referring to any collective grouping that does not include the State.[8] This approach relies heavily on the members of any such group acting voluntarily, but collectively, for a common purpose and to avoid outside intervention. Under the assumption that government and other industry parties agree to the concept of self-regulation, we suggest the following general definition: a system that encourages ("regulates") certain social behaviors by a collective (the "Self") in order to avoid direct State intervention ("regulation"). This definition assumes a bottom-up approach, through which the Self (stakeholders or participants) initiates behavior-modifying activities (as opposed to top-down government imposition) for the benefit of the regulated community,[9] as well as its consumers (customers).

This broad definition envisions the assumption by participants in the system of the duty to create and adopt common guidelines to govern their collective behavior.[10] Although such a system can take many forms, including voluntary agreements, codes of conduct, charters, guidelines, and harmonized standards, self-regulation "must be consistent with Community law, represent added value for the general interest, [and] meet the criteria of transparency . . . and representation of the parties involved."[11] Simply put, *the overarching purpose of any self-regulatory group is to keep industry interests aligned with the public interest so as to avoid government intervention and the possibility of more-restrictive regulation.*

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[6]Lalor, John, ed., *Cyclopædia of Political Science, Political Economy, and the Political History of the United States by the Best American and European Writer*s (New York: Maynard, Merrill, and Company, 1899): www.econlib.org/library/YPDBooks/Lalor/llCy519.html.

[7]ISO (International Organization for Standardization) is a global network of non-governmental organizations of national standards bodies in 149 countries around the world (one standards body per country). ISO members identify what International Standards are required by business, government, and society; develops them in partnership with the sectors that will put them to use; adopts them by transparent procedures based on national input; and delivers them to be implemented worldwide.

[8]Joseph A. Cannataci and Jeanne Pia Mifsud Bonnici, "Can Self-Regulation Satisfy the Transnational Requisite of Successful Internet Regulation?" 17th BILETA Annual Conference, Free University, Amsterdam (5–6 April 2002): www.bileta.ac.uk/pages/Conference%20Papers.aspx.

[9]This has been defined as the "possibility for economic operators, the social partners, non-governmental organization or associations to adopt amongst themselves and for themselves common guidelines." See Anna Jassem, "An Introduction to Co-Regulation and Self-Regulation in the EU," EPHA Briefing for Members (February 2005).

[10]Ibid.

[11]Ibid, p. 2.

In designing a self-regulatory system for any industry and evaluating its benefit over government intervention, policy makers must define the objectives, focus on the social policy implications, balance the costs, and weigh the risks to the public and its individuals of any failures in the system. In essence, the design for self-regulation is often self-originating and self-driven.

Some question the worth of any regulatory system that relies upon self-monitoring and regulation by member participants. Yet, various groups, governments, entities, and industries around the world have embraced self-regulation throughout the ages as an efficient and cost-effective alternative to formal government regulation. Most recognize that self-regulation benefits from the SRO's knowledge of and familiarity with the marketplace, but the price of that knowledge is the potential for conflicts of interest. It is from this recognition that we seek to define the traits of a successful self-regulatory system.

The Viability of Self-Regulation

However defined, any form of self-regulation has its own set of conflicts that require special balancing in light of the challenges the system faces. Thus, whether self-regulation is seen as a total avoidance of or as a complement to outside intervention, most agree that self-regulation on a stand-alone basis is not a panacea and that tensions and conflicts will continue to exist. The debate over self-regulation, therefore, often focuses on maintaining the appropriate balance among all affected factions. Such a balance must nurture the positive aspects of self-regulation while not giving the self-regulated members so much discretion that they will, if left unchecked, ultimately corrupt the system by favoring their own interests over the public good.

The balancing of the costs and benefits of self- versus government regulation is difficult. As with any system, participants will differ as to what is achievable, reasonable, and in their best interests and the interests of the public. Maintaining an appropriate balance requires avoiding certain pitfalls that threaten the safeguarding of the public's interests and the general integrity of the system, including:

- Intervention favoring larger (more influential) participants at the expense of smaller (less influential) participants;
- Systems that are inadequate for detecting violations and enforcing SRO regulations;
- The co-opting of the reputational benefits of the SRO by unscrupulous practitioners who do not subscribe to the standards of the SRO and who do not disclose their lack of compliance;
- The rise of anti-competitive or collusive practices at the expense of customers;
- Greater ineffectiveness or even "regulatory arbitrage," in which regulators compete to attract participants through a lowering of regulatory standards; and
- The risk and confusion to consumers when similar products/services are regulated under different standards.

Proponents of self-regulation expound the benefits of a system that places the responsibility for crafting and enforcing regulations in the very hands of those to be regulated. They believe that such a system is philosophically in keeping with the principles of free market enterprise. This group notes the efficiency of allowing the participants, who are the industry experts, to craft rules that more realistically reflect the issues of the industry, thereby reducing the regulatory burden on market participants. Given the speed with which the global markets move, supporters of self-regulation also cite the benefits of a system whose flexibility allows it to respond to market developments quickly, fostering innovation. They also note the advantages of a system that is basically self-funding, relieving the government of a financial burden.

As Adam Smith pointed out long ago, the vested self-interest of participants in a capitalist system allows the invisible hand to work.[12] He notes that, "after following their natural

[12]Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, 5th edition, (London: Methuen and Co., 1904).

instincts to trade with each other, individuals will just as naturally begin to attempt to devise mutually acceptable rules of behavior."[13]

Howard Davies, former head of the United Kingdom's Financial Services Authority (FSA), recognizes the "substitutional" aspect of regulation. He believes social preferences determine whether regulation is ultimately governmental or self.[14] The relationship between the self-regulated and the government can be complex and change over time. Some argue that self-regulation is only one form along a continuum and should be able to co-exist with other methods of regulation.[15] As part of a regulatory continuum, consumers may consider markets that are self-regulated to pose less risk than unregulated ones; concomitantly, members of a self-regulatory organization are often perceived as being self-motivated to strive for the highest standards in order to maintain their economic benefits.[16] And many countries and professions have adopted just this approach.

Opponents of a self-regulatory system, on the other hand, dismiss the long-term viability of self-regulation and believe that it is incapable of truly divesting itself of self-interests in favor of the public's good.[17] This group believes that the conflicts inherent in having the regulated regulate themselves doom this system as ultimately impractical at best and grossly self-serving at worst.

These opponents cite a range of developments that threaten to undermine the system. The financial services industry, in particular, exemplifies an industry in transition. Over the last decade, the securities markets have become electronic, the internet has transformed the availability of data and methods of trading, and low-cost global transfers of funds have brought about changes that are straining the capacity of our current self-regulatory system to monitor itself. Increased competition for listings, exchange business (e.g., order flow), the disproportionate power of a consolidating base of large, influential participants, and the limited sources of regulatory funding have all increased the strains on SROs as they seek to adequately police and enforce current rules, as well as design new ones. Globalization of the financial markets puts additional strains on the system. As proof of developing fractures along the fault line, critics note the spate of government-induced litigation and enforcement cases involving members of established SROs who have been charged with violating fundamental rules of practice on which the SRO system is based.

Central to any self-regulatory structure is the degree to which governmental authorities cede primary responsibility to the self-regulating entity. Government deferment can take various forms:

- An initial "hands-off, wait and see" approach while the government assesses the success of the entity's ability to regulate itself;
- A pre-emptor to direct government intervention[18] by voluntary establishment of self-regulation (possibly with the threat of government intervention if the industry does not establish adequate regulatory standards); or
- Assumption of the role of ultimate guardian of the rights of citizens through an oversight authority where the SRO is the "frontline" regulator and the government reviews its actions on a periodic basis.

What are the threshold requirements for a self-regulatory system to avoid government intervention? On a basic level, these requirements include the ability to make or influence policy, initiate or implement regulations, enforce the rules and regulations they promulgate, and adjudicate against offenders (i.e., deciding whether a violation has occurred and

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[13]See Edwin West, "An Interview with Adam Smith" (June 1994): www.adamsmith.org/smith/interview.htm.
[14]Howard Davies, "Regulation and Politics: The Need for a New Dialogue," David Hume Lecture Series, Scotland (27 September 2004).
[15]Darren Sinclair, "Self-Regulation versus Command and Control? Beyond False Dichotomies," *Law & Policy*, vol. 19, no. 4 (1997).
[16]Ibid.
[17]See Note 8.
[18]Ibid.

imposing an appropriate penalty), as well as the ability to create and maintain adequate disclosure and transparency.[19]

The ability of entities to self-govern without the specter of an outside enforcer is highly dependent on the situation. Throughout the ages, self-regulation has taken many forms—from guilds to highly sophisticated forms of financial regulation. They have achieved varying degrees of success and engendered varying amounts of skepticism.

All of these issues raise certain basic questions about the concept of self-regulation, in general, and about the continuation of the current SRO system, in particular: What are the objectives and underpinnings of self-regulation? Does self-regulation really work? Does it have meaning in a time of global harmonization of financial markets? Is it a viable option in today's securities markets in light of domestic changes and international concerns? If so, does the current system contain all the elements that make it most effective—both in terms of industry needs and investor protections? If not, is a reconfiguration in order?

As noted in this monograph, many industries and countries have gone, or are going, through similar analyses. For example, internet participants are vigorously debating the efficacy of self-regulation versus direct government regulation. In a sense, financial regulation presents challenges similar to internet regulation. The internet exists outside of the defined space of national borders, with users freely "crossing" between nations; financial activities, too, increasingly are transpiring across multiple borders. Investors are less bound by nationality than by investing activities or often by multiple investing activities.[20] Therein lies one of the primary challenges facing financial self-regulation in the future.

Costs and Benefits of Self-Regulation

An essential component of both successful and unsuccessful self-regulation is an analysis of the costs and benefits of that regulation. As a nascent self-regulatory system first develops, participants who will be regulated must believe that the self-regulatory costs to them of compliance will be less than government-mandated regulations.

Central to any self-regulatory system is the presumption that the government will defer active involvement until such time as the self-regulatory body reveals itself unable to effectively regulate. Government deference to self-regulation implicitly assumes a cost–benefit trade-off: The government relinquishes direct regulatory control and oversight and shifts the financial burden of regulating to the SRO; although assuming the costs of regulating, the SRO gains the flexibility to adapt quickly to market change,[21] create more relevant regulations for its members, and maintain the authority to self-police its members.

Although philosophical commitment may provide the foundation for self-regulation, the perceived economic benefits to the participants often provide the motivation. Economics is a major driver of market systems. So it is with self-regulatory systems, whether the self-regulation be in the securities markets or any other product or service market that is believed to be in need of regulatory oversight. On a certain level, therefore, members of a self-regulated group must *a priori* believe that it is more economically beneficial to engage in self-regulation than to be subject to government regulation. This economic incentive is an important factor in the participant "buy-in" that is an essential part of any successful system.

The economics of regulation affect all market participants. When costs of compliance increase (whether through self- or government-regulatory schemes), the bulk of additional costs are passed on (directly or indirectly) to the consumer in the form of higher prices for the

[19]Louis Brandeis, *Other People's Money, And How the Bankers Use It* (New York: F.A. Stokes, 1914).
[20]See Note 8.
[21]Nicklas Lundblad and Anna Kiefer, "The Economic Efficiency of Self-Regulation: Two Case Studies," 17th BILETA Annual Conference, Free University, Amsterdam (5–6 April 2002): www.bileta.ac.uk/pages/Conference%20Papers.aspx.

particular product or service. Thus, an analysis of the success of any regulatory system must consider the accompanying effects on the market particulars and, overall, on the economy.

The balance of costs and benefits is not necessarily obvious at first glance, with costs often more easily identifiable than benefits. Quantifying the value of benefits in securities markets is especially difficult when the benefits are intangible, such as trust, confidence, and other reputational effects. In financial terms, the success of any such system depends on achieving an overall positive net present value (NPV) of the benefits to the providers of the services or products against the costs incurred. But above all, that positive NPV must also extend to the benefits of the market to investors, customers, and other stakeholders.

Costs to the self-regulated group are often intangible and defy precise measurement. For example, restrictions on product offerings and disclosure requirements may be hard to quantify as a cost. Such costs may be more akin to inhibitions on potential benefits (revenues). Also, regulatory prohibitions against a certain product result in a potential loss of revenue or an opportunity cost—not a direct, out-of-pocket "cost." Burdensome disclosure, while having an associated cost, may also directly affect potential sales.

Ultimately, the costs, whether or not they are directly identifiable and measurable, are factored into the prices charged to the consumer. Should the prices appear to be out of line with the potential benefits the industry and consumer will receive in terms of better functioning markets and stronger protections, the self-regulatory system will fail.

Yet, the benefits from association with that system may not directly translate into revenue for the participants. Instead, it may result in indirect benefits to the industry generally. For example, heightened public trust in a particular market may result from increased spending on self-regulatory rules and regulations.[22]

The cost–benefit analysis of self-regulation usually focuses on the following factors:

- *Flexibility and Efficiencies.* The concept of benefits includes not only direct revenue enhancements but also cost savings obtained through the efficiency of a self-regulatory system.
- *Expertise.* The industry knowledge and expertise residing within the SRO should enhance the quality, efficiency, and effectiveness of resulting rules and regulations.[23] Indeed, industry experts who influence rulemaking expect that the resulting rules should minimize costs and maximize the benefits. For example, streamlining regulations could result in achieving cost savings.
- *Minimized Resistance.* The aligning of member interests through the self-regulatory approach should enhance the willingness of members to adhere to a set of standards.[24] Less resistance often translates into cost savings realized by the enforcement/disciplinary arm of an SRO.
- *Higher Level of Standards.* The proscriptive nature of government regulation does not touch some of the subtleties of self-interest-based behavior. By not being bound by any set law, an SRO can tailor behavior beyond what is merely legal, toward what is beneficial for the continued smooth operation of the market. When this happens, all market participants benefit.[25]
- *Competition.* If government regulation is too heavy handed, it risks breaking under its own weight.[26] Anti-competitive behavior among current market participants may

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[22]See Bernard S. Black, "The Role of Self-Regulation in Supporting Korea's Securities Markets," *Journal of Korean Law*, vol. 3 (2003). Black cites the Korean market as an example where companies have recognized a need to associate themselves with reputable self-regulatory organizations in the United States in order to remain viable.
[23]See Lori Richards, "Speech by SEC Staff: Self-Regulation in the New Era" (11 September 2000).
[24]Ibid.
[25]Robert Pitofsky, "Self-Regulation and Antitrust," speech given at the DC Bar Association Symposium, Washington, DC (18 February 1998).
[26]See Note 23, p. 4.

impede benefits to other participants or potential participants. In either case, the ability of the market to attract new participants (members and investors) will decline.

For a self-regulatory system to appeal to those whom it regulates, benefits to the members (revenue, quality standards, efficiency, enhanced reputation) generally must outweigh the costs (compliance). As compliance costs rise, the self-regulatory system risks ineffectiveness if costs exceed benefits to members or to the public. Members may determine that the system no longer supports their best interests and withdraw their commitment, sometimes deciding to opt out of the system altogether.

Finally, rising compliance costs affect more than just the members of the self-regulatory group. The ultimate consumers must also believe that they are benefiting from the system (reasonable cost, safety of the product or service, trust in the stability of the market) or they will choose not to consume, eventually leading to a depressed market. When an industry passes on these costs to consumers, it risks either a negative reaction by the public (e.g., reduction in purchases or movement to competitors) or gaining the attention of the government, which may then determine that intercession is warranted.

Chapter 2. Self-Regulation in the U.S. Securities Markets

Although certain generic characteristics are common to most forms of self-regulation, self-regulation in the securities markets raises specific issues.

The overarching goals of any regulatory framework in this area must be to preserve market integrity (fair, efficient, transparent), preserve financial integrity (reduce systemic risk), and protect investors.[27]

Anything short of these goals jeopardizes the foundations upon which a securities system rests. When Congress created the self-regulatory system through the 1934 Act, it envisioned a system that achieved a balance between market efficiencies and investor protection. Running throughout the actual provisions of section 15A of the 1934 Act are references to "fair representation," "equitable allocation," and "a fair procedure for the disciplining of members." The provisions also make clear that the rules are designed to prevent fraudulent and manipulative acts and practices; promote just and equitable principles of trade; foster cooperation and coordination with persons engaged in regulating, clearing, settling, and processing information with respect to and facilitating transactions in securities; remove impediments to and perfect the mechanism of a free and open market and a national market system; and protect investors and the public interest.

The original ideology of this unique regulatory system envisioned the furtherance of economic interests and the nurturing of an open and orderly marketplace standing alongside the protection of investors. Practitioners, regulators, investors, and others are debating the viability of self-regulation, particularly in light of the complex business realignments and consolidations and the prevalence of increasingly sophisticated products and trading strategies. A number of questions focus attention on whether self-regulation can continue to adequately serve the purposes for which it was intended—to protect the public trust and the integrity of the marketplace—or whether change is in order.

- With the right structure and mix of regulation, can today's SROs continue to serve a valuable role in regulating the securities markets efficiently and cost-effectively?
- Can the current or a revised structure address the relatively new demands posed by mergers, acquisitions, and demutualization in the marketplaces?
- Is it possible to effectively manage the inherent and increasing conflicts of interest associated with regulating one's self in such a competitive marketplace?
- Has a tendency toward overspecialization by those in SRO rulemaking roles created "blind spots" that effectively prevent them from adequately assessing large-scale risks or formulating needed comprehensive strategies?
- Has the globalization of markets, both across geographic boundaries and product lines, injected issues that cannot be addressed by the current parochial SRO framework?
- With the demutualization of exchanges and in instances where the regulatory function remains a part, albeit an independent one, of the exchange, does the concept of member-based self-regulation remain relevant?

One approach is to dismiss the SRO system as outdated, in light of the current volume of potential conflicts, and to suggest more formal government intervention. This would not be the first time that the United States has considered changing the securities markets' self-regulatory structure. Yet, because of the added costs of shifting primary regulatory responsibility to the SEC, the original SRO system has remained largely intact.

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[27]Report of the SRO Consultative Committee of the International Organization of Securities Commissions (May 2000).

Threats to the Current System

Within the last several years, numerous documented examples of how the current self-regulatory system is failing have refocused attention on the lack of effective enforcement by the SROs. Indeed, government-initiated enforcement cases serve to fuel the argument that the conditions under which the SRO system originated were vastly different from those that exist today.[28] In addition, the interconnectedness and global linking of many of the markets has highlighted the concern that a failure in one sector will have correlated effects on other markets.

In commenting on the London Stock Exchange's loss of regulatory responsibility following its demutualization and thus competition with other trading platforms, Howard Davies framed the debate well: "[T]he growth of competing trading platforms made it illogical for one of those platforms [the London Stock Exchange] to be the gate-keeper for the rest."[29] To add to the potential regulatory risks, flat volumes and falling transaction fees over the past few years have put potential pressure on regulatory budgets. The battle for market share could create anti-competitive incentives to regulate for the benefit of market share, not market participants. Furthermore, budgetary pressures could result in restrictive regulatory budgets to oversee such activities.

With increasing competition and growing enforcement actions, it is appropriate to reevaluate self-regulation in light of a number of shortcomings and vulnerabilities, including:

- *Systemic risk*—whether the current system perpetuates an unnecessary exposure to conflict of interest risk within both domestic and global securities markets;
- *Surveillance*—whether SROs have the resources and ability to oversee their members' activities, given the complexities of securities transactions conducted on global markets, including shifts in the size, speed, and venue of trading;
- *Funding mechanisms for regulatory efforts*—whether the current sources of funding for SROs' regulatory and enforcement work are sufficient or whether better alternatives exist;
- *Separation of regulatory and business functions*—whether the SRO can fund its regulatory work separately from its business operations so as to avoid conflicts arising from business pressures;[30]
- *Effects of exchange demutualizations, mergers, affiliations with members, and market consolidations*—whether new arrangements threaten investor protections and warrant consideration of new restrictions (e.g., ownership limitations, control restrictions, revised governance structures);
- *Market inefficiencies*—with more order flow dispersed across multiple markets, whether similar activities are subject to different or duplicative regulations;
- *Investor confidence*—whether declines in investor confidence (because of real or perceived conflicts of interest) threaten the continued vibrancy of the financial markets; and
- *Advantages of system*—whether there are competitive advantages that the current SRO system still has to offer the markets and what changes can be made without upsetting the balance that leads to innovation and market efficiencies.

A Continuum of Regulation

Trying to meet the objectives of self-regulation poses many challenges in today's climate. The financial markets of today are complex, interrelated, cross geographical borders, and involve hybrid and derivative products that are hard to regulate. But the ability to devise a system that meets the majority of these objectives is essential to maintaining the public's trust and confidence, without which the continued efficacy and integrity of the markets is jeopardized.

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[28]See Note 2.
[29]Howard Davies, "The Changing Face of Financial Regulation," Speech to the Securities and Exchange Board of India (23 March 2004).
[30]See Mark Schonfeld, SEC NE Regional Office Press Conference (12 April 2005).

It is possible to use existing groups and organizations in the United States to demonstrate a continuum of regulatory attributes that compose the system of self-regulation today. **Figure 1** illustrates the various levels of regulation along this continuum. Each stage or level on the continuum provides the participant with a higher reputational standard and the consumer with greater confidence in the quality of the product or service provided. Although the nature of some industries may not require the same level of safeguards as do others, generally the systemic risks of each model decrease as enhancements are added. The stages on this continuum are as follows:[31]

Figure 1. A Continuum of Regulation

No Regulation						Maximum Regulation
Individuals	Voluntary Trade Associations	Voluntary Standards & Voluntary Association	Compulsory Standards & Voluntary Association	Compulsory Association by Law	Government as Overseer	Government as Regulator

A. Individuals: Independent tradesmen with no association to any group (e.g., handyman who belongs to no associations). Generally, individual tradesmen have no overriding commitment to the public good. In order to sustain a viable level of business, the consumer must be reasonably satisfied with the cost/results of the product or service provided. Lack of access to information about the provider results in lower levels of confidence and higher reliance on any reputational information available. However, the consumer's expectations for protection are limited, because transactions are generally negotiated between those offering goods or services and those seeking to procure them on a transaction-by-transaction basis. Redress by the consumer for fraud, shoddy workmanship, or other complaints is by appeal to the appropriate legal resources.

B. Voluntary Trade Associations: A group of individuals sharing a particular trade, skill, or interest forms to represent their mutual interests (equivalent to many trade associations in their start-up phase). This type of group may share some intent to increase consumer confidence and thus the economic benefits that accrue to its members by being associated with the organization. It may also seek more direct benefits for its members through a collective approach (e.g., advertising, collective bargaining). To this end, the organization may take public positions on behalf of its members, lobby regulators and other rule makers to take certain positions, or set certain basic standards to which its members may adhere (e.g., quality standards or skill levels). Although the organization may undertake efforts to highlight benefits to the public of its organization or stances, the primary goal of this type of organization is to represent the interests of its members. The early stock exchanges that fixed commissions are an example of this group. Another example might be an investment club, where members participate in the group and adhere to written standards that govern the treatment of the group's pooled resources.

C. Voluntary Standards and Voluntary Association: Enhanced version of voluntary trade associations. Although representing the interests of its members remains paramount, this type of organization may focus its interest in the public good through the public positions it takes and through the promulgation of standards of practice guidelines (e.g., ethics, best practices) to which all members voluntarily agree to adhere; it also may establish minimal educational standards. Overall, this group may help to raise the level of practice within the market sector of its members. However, lobbying or other efforts may still appear to focus more on the continuing and overall economic interests of members. Typically, neither this group nor voluntary trade associations disciplines its members for noncompliance with these guidelines, possesses mechanisms for investigating alleged misconduct by members, or

[31]Although each industry or organization noted as examples of each group may not share all of the characteristics attributed to that group, they generally share a preponderance of those characteristics. Similarly, one industry or organization may share a number of characteristics with more than one type of association/grouping.

sanctions its members for infractions brought by outside authorities. Examples of this type of association would include the Investment Company Institute, the Investment Adviser Association, the Securities Industry and Financial Markets Association, and the National Investor Relations Institute.

D. Compulsory Standards and Voluntary Association: Membership in accredited or accrediting organization. Lack of membership in this type of organization does not affect the ability to work in that market sector, although it may reduce an individual's competitiveness for business. Membership confirms status and improves competitive position relative to nonmembers, which most likely results in higher earnings. Members must become accredited, usually through an examination process, and once accepted must adhere to the standards set by it or risk sanctions, which often include revocation of membership. This type of association generally promotes a collective commitment to the public good through raising the level of practice in the industry by setting certification standards and practice standards that may be followed by industry practitioners, as well as by members of the organization.

This type of organization most likely has within its ranks those with specialized expertise in the industry, which allows it to respond quickly to market developments through the formal comment process, position papers, or suggested best practices. Although not an SRO per se, it may at times appear to have certain characteristics common to one, especially if it (1) has mechanisms in place to investigate and discipline its members for infractions of its standards and (2) promotes standards or positions that focus on the public good and raising the integrity of that particular industry. Standards created by the organization may gain industry support to the extent that they become *de facto* standards for those far beyond the reach of the organization's actual membership. CFA Institute is an example of this type of organization; Certified Financial Planner Board of Standards is another.

E. Compulsory Association by Law: Membership required in order to practice (e.g., doctors, attorneys, broker-dealers under U.S. securities laws). An organization with this level of regulation creates the standards that govern the members' activities and provides the mechanisms for investigating and sanctioning members for violations of these standards. Members must also agree to submit to oversight authority of all of their activities and allow for ongoing inspections of their activities. Members in this group typically must meet continuing education requirements to remain in good standing and retain their licenses. Thus, the individual's ability to continue to practice rests squarely within the auspices of the oversight organization. The government may bestow legal authority on the group to require membership and maintain the procedures, practices, and oversight.

Organizations of this type are motivated to self-regulate in order to ward off government intervention. To this end, they endeavor to maintain a high degree of public confidence by setting standards to promote the public good and establishing processes for monitoring the behavior of their members in order to detect problems that could undermine this goal. The public can avail itself of procedures established by these groups to file complaints against members.

Finely honed investigatory arms and review boards are funded by the organization and dedicated to reviewing complaints and allegations of misconduct, and they wield a range of powers, from censures and temporary suspensions of licenses to revocation of licenses and the ability to practice. Moreover, the public is often able to obtain disciplinary information on individuals, which allows a certain public policing of offenders in this group beyond what the internal disciplinary branch has imposed, thereby providing an added element of transparency and accountability. Examples of this group include the state boards of bar examiners, the state medical licensing boards, and the American Institute of Certified Public Accountants.

F. Government as Overseer: Government has oversight authority. Although the regulatory group retains authority to regulate and oversee its own operations, under this level of regulation, the government retains ultimate oversight authority in which it can override the group's regulatory proposals or impose rules and regulations as it deems warranted. The threat of governmental intervention in and of itself serves as a motivator to the self-regulatory group to conduct its activities in such a way as to stem any governmental action. Although the government's right to intervene is ever present (thereby providing a source of consumer protection), the government actually extends a fair degree of deference toward this group for several reasons.

This kind of group often engages in a highly specialized industry and is best equipped to perform the day-to-day oversight and rulemaking functions that specialized expertise allows, as well as to respond quickly to market developments. In addition, this type of organization often creates and maintains an extensive enforcement system, including detailed procedures for investigating and disciplining members. Moreover, the specialization and complexity of the industries subject to this self-regulation would strain the resources of governmental entities were the government to assume a more direct and active role in their regulation. The expertise contained in this group allows it to engage in rulemaking that is relevant to the business engaged in by the members. The current U.S. SROs and the national and regional exchanges are examples of this type of relationship, with the Securities and Exchange Commission as the government overseer.

G. Government as Regulator: Government has all regulatory responsibility. In this system, there is no self-regulation. Instead, the government takes active responsibility for all rules, regulations, enforcement, and oversight of the activities of the profession/industry.

Currently, financial regulation in all of the world's developed markets resides between the last two levels (at the right end of the regulatory continuum). Most recently in Europe, there has been a movement toward government as regulator. In Asia and the United States, government as overseer remains the norm.

Chapter 3. The Global Experience with Self-Regulation

As there is no one definition of self-regulation, there is no one global experience with self-regulation. Instead, the form that self-regulation assumes, and its ultimate success, varies among countries and industries. A particular country's experience with self-regulation may also fluctuate over the years, reflecting a sort of ebb and flow in the regulatory climate.

The Lack of a Single Model

Regulation of the financial services industry in the United Kingdom provides an example of a regulatory system that has reversed course—from self-regulation back to a centralized government oversight regime.

Historically, U.K. self-regulation grew

> *. . . out of trade associations, or the Stock Exchange. Members of professional bodies concluded that they would enhance trust and confidence in their offerings if they set some standards for themselves and their colleagues to meet. They recognized that their reputations stood or fell together. Doubtful dealing in one stock broking member of the Stock Exchange, for example, would potentially damage the interests of all others. So "club rules" were established, with some rough and ready policing of them usually involving the ultimate sanction of removal of a member from the club in the event of persistent breaches. This was what you might call the "golf club" approach to regulation.*[32]

Tensions eventually arose between the U.K. SROs, however, resulting in loss of public confidence and a greater role for the government as

> *. . . the definition of the boundaries of these clubs [the SROs] began to lose clarity. New competitors emerged, who in some cases defined themselves in opposition to the original members of the club. The big American investment banks did not think their reputations were linked to those of small British stock broking partnerships. . . . It was also apparent that while self-regulation was quite good at dealing with the bad apple in the barrel, it was not good at raising standards across the market, where consumer confidence, or the lack of it demanded such improvement.*[33]

The creation of the FSA in 2000 superseded the self-regulation of nine financial services organizations. In the process, the London Stock Exchange (LSE) was relieved of its responsibility for listing rules and policing corporate disclosures,[34] which some believe was "simply a reflection of changed social preferences."[35] If so, such changed preference may have reflected internal shifts in social policy, including changes made in response to the attention on corporate governance reforms. In any case, the creation of the FSA not only reflects shifting paradigms in the U.K. approach to regulation but also highlights the influence that certain large markets can have on the regulatory direction of others.[36] According to a World Bank staff report, by 2002, 29 percent of countries with schemes to supervise banking, securities, and insurance had moved to a single regulator, and an additional 30 percent had reduced their number of regulators from three to two across these three sectors.[37] The U.K. experience has also generated considerable debate between

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[32] See Note 29.
[33] Ibid.
[34] In 2000, the London Stock Exchange transferred its role as U.K. Listing Authority with HM Treasury to the FSA and voted to become a publicly traded company. See www.londonstockexchange.com/en-gb/about/cooverview/history/htm.
[35] See Note 14.
[36] For example, in Germany, the Bundesanstalt Fur Finanzdienstleistungsaufsicht ("BaFin") was created as one agency with different departments responsible for securities, banking, and insurance. Other departments cut across sectors focusing on "conglomerate supervision and international issues."
[37] Jose de Luna Martinez and Thomas A. Rose, "International Survey of Integrated Sector Supervision," World Bank Policy Research Working Paper 3096 (July 2003).

traditional statutory-based regulation made up of detailed rules and the FSA emphasis on principles-based regulation.

Although the United States may appear to lag in reforms implemented by other countries, both in response to the form of regulation and the number of regulators, it is also the country with the longest history of a dual government regulatory/self-regulatory structure in place, dating from the creation of the 1934 Act. In addition, the U.S. system is relatively unique in its requirement that certain market participants must become a member of an SRO. Although the U.S. structure may limit the risk that competitors will emerge to define themselves in opposition to the members of the original self-regulatory system, it may also force a system of buy-ins from its participants.[38]

Despite the U.K. example, varying forms of self-regulation remain widely prevalent throughout the world. As recently as 2000, the International Organization of Securities Commissions (IOSCO) endorsed the use of SROs as frontline regulators, subject to government oversight under general performance standards. Under the IOSCO approach, there is no "best" form of financial regulation; given the dynamic nature of the financial markets, what may qualify as "best" practice today will likely change tomorrow and will differ among jurisdictions. Rather, multiple forms of regulation and versions of "best" practice will continue to evolve. Regulation will continue to reflect the social norms and historical regulatory structures of each individual country or market. However, the vigilant functioning of the regulator is critical, especially as global market integration continues.

Principles-Based vs. Rules-Based Regulation

The genesis of this monograph was the 2004 SEC concept release addressing self-regulation in the United States. Since issuance of the concept release, debates on the future of self-regulation have ranged from the role of self-regulation in securities markets to the breadth of responsibilities for the government regulator. These debates have largely been driven by the consolidation activities both in the U.S. markets and globally, which have, in turn, been driven by spreading demutualization among securities exchanges.[39] Regulators both globally and in the United States have been questioning the scope of their role, the role of self-regulation, and how an overall regulatory system can support a demutualized market infrastructure while maintaining market trust and integrity.

Since the concept release, we have seen initial formation of broad agreement on a need to move from parochial regulatory structures that dominate today to consistently designed regulatory structures and regulation throughout the world that forcefully address conflicts of interest, surveillance, and other issues. Without a consistent and assertive regulatory structure, maintaining trust, confidence, efficiency, and effectiveness in the markets remains at risk. It also invites regulatory arbitrage, whereby market participants seek out lightly regulated markets.

Embedded in the debate over the practice of regulation is a concurrent debate between "principles-based" regulation as practiced in the United Kingdom versus "rules-based" regulation as espoused in the United States. Some argue the distinction between the two is more a matter of semantics, a branding exercise designed to distinguish the two systems. Realistically, all rules-based systems have principles, whether explicitly stated or not, and all principles-based systems require some level of detailed rules for compliance. Where the distinction between the two systems is important is the degree to which market participants have the flexibility and latitude to make judgments regarding regulatory compliance, for example, whether a particular situation requires compliance at all, and if so, how that compliance is to be achieved. Such flexibility risks a lack of consistency for compliance and enforcement.

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[38] Howard Davies, "What's Left for Self-Regulation?" David Hume Lecture Series, Hong Kong (March 2004).

[39] According to IOSCO "demutualized exchanges have become the dominant providers of securities markets globally. The trend among derivative exchanges is similar." *Consultation Report, Regulatory Issues Arising From Exchange Evolution*, IOSCO (March 2006), p. 4: www.iosco.org/library/pubdocs/pdf/IOSCOPD212.pdf.

Regardless of semantics, the concept of broad principles may encourage adherence to the "spirit" rather than the "letter" of the regulation. It may also encourage market forces to develop optimal approaches to achieve that "spirit" rather than a regulatory enforcement of the "letter." It becomes the responsibility of the regulated to demonstrate integrity, skill, and diligence in achieving the goals of the regulation.[40] On the other hand, such principles leave much more room for debate over how to meet the objectives of the principles as well as room for conflict if the regulator believes a violation has occurred. By contrast, a prescriptive-based regime sets a clear, detailed process to follow. If the process is not followed, the regulated is in violation.

The success of either system may ultimately reflect the cultural norms and expectations of the participants and regulator. Where participants and regulators expect detailed rules, a flexible system with rules that lack such detail may prove more challenging because of the greater uncertainty in such a regime.

Self-Regulation in Demutualized Exchanges

The role of self-regulation within demutualized exchanges varies widely. As noted previously, in the United Kingdom in 2000, the authority for official listing activities of the London Stock Exchange was transferred to the FSA upon the LSE's demutualization. The demutualization of the LSE and the creation of the FSA have been viewed as a strong move away from self-regulation and toward a centralized regulatory system. As noted previously, however, the FSA actually may be seen to practice a form of "subtle self-regulation" that encourages industry participants to develop best practice guidelines.[41]

Although European exchanges, such as those run by Deutsche Bourse, still practice self-regulation, the European Union Financial Services Action Plan (FSAP)[42] and the Markets in Financial Instruments Directive (MiFID) set out a broad framework for the regulation of securities and derivative markets for EU member states.[43] On the other hand, in Asia and Australia, where the major markets have demutualized, self-regulation is still practiced but with active oversight by the government regulator. In the United States, with the demutualization of both NASDAQ and NYSE, the debate regarding the appropriate role of self-regulation and self-regulatory structures still continues. One major difference between self-regulation in the United States and the rest of the world is the regulation of broker-dealers. In contrast to U.S. requirements that all broker-dealers register and be a member of a recognized SRO, in other jurisdictions where self-regulation exists, registration of broker-dealers typically rests with the government regulator, although oversight may continue to reside with the self-regulator.[44]

How regulation and self-regulation can coexist in a demutualized marketplace, and the scope of regulatory responsibilities, centers largely on the ability of the exchange and regulator to agree on procedures to manage potential conflicts of interest between a demutualized exchange's regulatory responsibilities and commercial activities. This debate has intensified as more exchanges have demutualized.

In the United States, the NASD decided to divest itself of all commercial interests in NASDAQ upon NASDAQ's demutualization. This divestiture was completed in 2006. On the other

[40] *Interim Report of the Committee on Capital Markets Regulation,* Section II: Reform of the Regulatory Process (30 November 2006), p. 64 (www.capmktsreg.org/research.html).

[41] The FSA creates regulations based on principles and then looks to industry to "fill in the gaps" by creating best practices or otherwise providing guidance. Some within the United Kingdom refer to this as a type of "soft self-regulation." Exchanges retain authority relating to membership rules, market operations, supervision of nonmarket trading, and the responsibility to disclose infractions or related information to the FSA.

[42] See http://europa.eu/scadplus/leg/en/lvb/l24210.htm.

[43] See FSA Consultation Paper 06/14, "Implementing MiFID for Firms and Markets" (July 2006): www.fsa.gov.uk/pubs/cp/cp06_14.pdf.

[44] See, for example, the Australian Stock Exchange. In order to participate in the markets, a broker must first register and be approved by the Australian Securities and Investment Commission (ASIC). However, in order to trade on the Australian Stock Exchange (ASX), the broker must first become a member. This is a relatively routine procedure once the broker is registered with ASIC. A similar system exists in Singapore.

hand, with the demutualization of the NYSE, NYSE Regulation remained an entity within the overall profit-making NYSE Group. In order to maintain a measure of independence, NYSE Regulation answers to an independent board and the head of Regulation reports solely to the NYSE Regulation board of directors.[45] With some modifications, the NYSE model of maintaining the self-regulatory function within the commercial entity appears to be the norm in Asia and Australia. In fact, the NASD may be the only self-regulator that completely separated its former exchange function (NASDAQ) from its regulatory responsibilities. Opponents of exchanges retaining their self-regulatory responsibilities argue that the conflicts of interest between commercial activities and regulatory responsibilities cannot ultimately be managed. They also are concerned that the self-regulatory function may be starved of resources through budget cuts because of commercial priorities.

In addition, opponents are uneasy about the potential to use the self-regulatory function as a barrier to entry from competition. They worry that the exchange can use its regulatory function to become a "gatekeeper" that prevents a competitive exchange or other trading network from entering the market it oversees. The risk of monopoly power may have an adverse impact on trading costs and, thus, market efficiency.

Opponents also fear that allowing an exchange to internally self-regulate will ultimately result in a competitive "regulatory race to the bottom," weakening regulatory safeguards and regulatory policies that discourage potential exchange competition. The danger becomes even greater in periods of systemic market crisis, where the internal self-regulator may be subject to undue pressure to address commercial needs before regulatory needs.

The exchanges counter that they have a strong commercial motive to maintain the quality of their internal self-regulatory function. They claim that significant resources have been invested in building and maintaining a "regulatory asset" and that such an asset is the source of the market integrity in which market participants place their trust and confidence when trading on the exchange.

The exchanges also maintain that budget cutting to starve the regulatory function would be counterproductive to maintaining the regulatory asset. The issue of budget cuts must be balanced against investments in new technologies that result in improved efficiencies and lower operating costs. The exchanges also contend that they are open to competition and that if they were to try to use its regulatory function as a barrier to entry, the government regulator would intervene.

The exchanges further point out that a separated SRO would still be subject to conflicts of interest through a board if it is dominated by industry participants. Thus, the issue of conflicts of interest is moot whether the SRO's regulatory function is internal or separated. Conflicts can be managed only through appropriate conflict of interest procedures.

Finally, the exchanges assert that they are best positioned to bring market expertise to regulation and to react quickly to market events, especially in cases of systemic shocks. Exchanges stress that rather than a race to the bottom, their ability to maintain control of the self-regulatory function would more likely result in a "regulatory race to the top."

Although there are merits to both sides of the argument, a separated and completely independent SRO has a number of primary advantages.

It is commendable for an exchange to prioritize protecting its "regulatory asset" and the resources invested in that asset. However, the argument of building and protecting a regulatory asset contains an implicit assumption that only the exchange as regulator can maintain and grow that asset. It seems reasonable that a separated SRO would be favorably

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[45] See www.nyse.com/regulation/about/1145486469139.html. In July 2007, the NASD and the member regulation functions of the NYSE combined to form the Financial Industry Regulatory Authority (FINRA). All subsequent references in this paper to NASD or NYSE Regulation are to occurrences prior to this change.

inclined to an exchange pursuing higher regulatory standards. Furthermore, the value of the regulatory asset extends beyond the exchange to that of a broad, economywide public good. A separated SRO would be in an advantageous position to protect that economic asset.

The risk of self-regulation as a barrier to entry raises the significant concern of loss of market responsiveness and rising trading costs as the exchange gains monopoly power. In such a circumstance, it may be difficult for an internal self-regulator to act as an impartial arbiter against exchange competition. The government regulator as ultimate arbiter may only be able to act in an *ex-post* fashion in order to undo the harm caused by the anti-competitive policies.

Although strong conflict of interest procedures may be in place to insulate the internal self-regulator, those procedures may be insufficient to protect against pressures from poor commercial decisions by management or instances of systemic shocks that affect commercial operations. This observation does not intend to implicate current exchange managements, who by all accounts appear to have the best intentions of maintaining market integrity. However, future decision makers may make poor decisions, implement inappropriate incentives, or be unable to adequately address an exogenous crisis. Any of these or other examples may exert pressure on profitability and corresponding measures to lower regulatory standards. Management may even have sincere expectations that standards will be raised after the crisis is averted. Regardless of conflict of interest procedures, an internal self-regulator may find commercial pressures difficult to avoid and eventually succumb to them. Experience gained from the time of the Wall Street crash in 1929 through the accounting scandals of recent years suggests that an internal self-regulator (or self-regulator 100 percent dependent on industry funding) has difficulty adequately addressing a crisis because of industry pressure.

Finally, there are instances where a market may be served by only one exchange or where a separated SRO is wholly reliant on the exchange for its revenues (with no other potential funding sources). In such instances, the separated SRO may lack the ability to free itself of the pressures and conflicts of interest inherent in an internal SRO. Where the ability for true independence is potentially compromised (whether internal or separated), it will fall to the government regulator to provide vigilant oversight.

Commonalities of Regulation

> *The full benefits of global exchange mergers will occur when trading platforms are fully integrated based on computer technology. When this integration happens, trades will not take place in New York or London or Paris. They will take place on a satellite over the Atlantic Ocean. What home-country regulator will be responsible for, and what home-country laws will apply, to those trades?*[46]

As the quote above posits, at some point in the not-distant future, global trading will most likely become commonplace. Whether or not a jurisdiction practices self-regulation or a government-centralized form of regulation, eventually a common regulatory framework will be needed to address cross-border issues. Although most jurisdictions view the effectiveness of regulation from a "local' perspective, future regulation must also address the need for a global regulatory framework. Our review of regulatory models confirms that certain commonalities present themselves in most regulatory schemes.

First and foremost is the need to balance market integrity with market efficiency. In a simple sense, efforts to improve market integrity require regulations that instill trust and confidence in the markets. Unfortunately, regulatory structures with higher standards also impose an expense on those market participants in the form of higher transaction costs. (In rational markets, those higher standards and transaction costs may be offset by lower cost of capital to capital users, less risk for capital providers, and greater amounts of capital provided, i.e., greater liquidity).

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[46]See Note 40, pp. 69–70.

On the other hand, market efficiency relates to the ability of the market to efficiently price and provide liquidity to traded securities at low cost. At first glance, market integrity and efficiency may seem to be in opposition. In reality, they balance one another. A market without rules would not be efficient because it would lack integrity (investor trust and confidence). A market with too many rules would also prove inefficient because such rules would make the cost of trading uneconomic. Thus, the integrity versus efficiency debate is really an attempt at balancing higher operating costs (integrity) against lower trading costs and pricing efficiency to arrive at an optimal value (cost of capital) for the market as a whole (an efficient and trusted pricing and trading mechanism).

There are a number of regulatory commonalities necessary to maintain that balance. IOSCO has identified 3 broad common objectives and 30 broad principles (see Appendix A) for securities regulation.[47] IOSCO's fundamental objectives of securities regulation are to protect investors; ensure that markets are fair, efficient, and transparent; and reduce systemic risk.

Regulators may agree with the need for a common framework but generally believe that the framework they use is the appropriate global standard. Lost in the debate are the commonalities and the recognition that "best" practice for one market may not work in another market. As IOSCO has pointed out, "There is no universal right regulatory path to follow."[48] For example, the approach to regulation in the United States is not necessarily the best approach to regulation in Europe or Asia, although the shared goals of market integrity and efficiency are the same.

With respect to exchange regulation, we have identified 10 additional areas that reflect the standards and requirements that help frame the activities of most exchanges. Although the actual practice of them varies from jurisdiction to jurisdiction, it is important to recognize the commonalities of exchange regulation, regardless of the specific jurisdiction. The 10 areas that are addressed by most exchanges are:

- Product approval standards (listing, delisting, and new products);
- Trading rules and execution standards;
- Transparency standards;
- Transaction reporting standards;
- Arbitration, mediation, litigation, or other dispute resolution procedures;
- Rulemaking transparency standards;
- Broker-dealer registration requirements;
- Collective investment scheme registration requirements;
- Surveillance standards; and
- Enforcement procedures.

In addition to these standards, markets often rely on model memorandums of understanding (MOUs) for memorializing agreements between exchanges/markets and regulators for cross-trading (borders or markets) activities and for establishing practices for oversight between regulator and self-regulator.[49]

As noted, although the standards are common, implementation is jurisdiction specific. In the United Kingdom, all standards fall under the authority of the FSA (although the LSE retains responsibility for surveillance). In the United States, the SEC retains the authority

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[47] See "Objectives and Principles of Securities Regulation," IOSCO report (May 2003): www.iosco.org/library/index.cfm?section=pubdocs&year=2003.
[48] See "Issues Paper on Exchange Demutualization," IOSCO (June 2001), p. 15 (www.iosco.org/library/pubdocs/pdf/IOSCOPD119.pdf); see also "Self-Regulation in Financial Markets: Results of an Exploratory Survey," *Research Report*, Securities Industry and Financial Markets Association (29 January 2007): www.sifma.org/research/pdf/RRVol2-1.pdf.
[49] See IOSCO Principle 7 in Appendix A.

for broker-dealer and investment adviser standards, while the other standards fall generally within the purview of the SROs. In Asia and Australia, registration and enforcement (and in some cases listing) remain the responsibility of the government regulator. The commonality is the key issue. All of the 10 standards fit within IOSCO Principle 26 (see Appendix A), which states "there should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different participants."[50]

[50]See *Consultation Report, Regulatory Issues Arising from Exchange Evolution,* IOSCO (March 2006), p. 3 (www.iosco.org/library/pubdocs/pdf/IOSCOPD212.pdf).

Chapter 4. Characteristics of Effective Self-Regulatory Systems

The long-term success of most self-regulatory organizations depends on embracing some or all of certain characteristics that create common goals, guidelines, and incentives for that organization. The financial services industry raises additional issues that must be addressed in any analysis of self-regulation.

Guidelines for a Successful System

The success of an SRO in the securities market is dependent in large part on its ability to commit to, or develop, the following goals and attributes:

Commitment. First among the goals for successful self-regulation is the commitment of its members. Although participants in any market seek to maximize their benefits, those in a self-regulatory system must be acutely conscious of, and committed to, safeguarding the public's interest. This commitment to maintain a system that is fair to investors underlies the ultimate success of a system dependent on market integrity.[51] A successful SRO thus must be able to establish a system of checks and balances that allows it to remain innovative and responsive to market changes while continuing to regulate its members.

Mutual Benefit. A majority of the members must feel that they are benefiting from self-regulation (however the benefit is defined). In addition, no members should benefit disproportionately from the self-regulatory system at the expense of other members. The benefit is likely to be perceived as economic, reflecting increased consumer/investor confidence in the product or service being produced. The objectives of both the self-regulatory organization and the government also must be compatible: to protect the public from undue harm (be it in the form of products, services, or investments) and thereby enhance public confidence.

Industry Representation. Industry representation provides specialized input into the development of regulations and policies that outsiders may lack. Additionally, members may more willingly comply with rules created by other members, adding to effective self-policing by SRO members. However, industry representation must refrain from becoming self-serving at the expense of the customers.

Public Participation. As consumers of products produced under self-regulation, public representation can help keep the self-regulatory system faithful to the public good and not tilted in favor of the industry good.

Cost-Efficiency. The costs of complying with the self-imposed regulations should be lower than the costs of complying with government-imposed regulations. Ultimately, this results in greater benefits to the customer (in the form of lower costs). Incentives for participating in a self-regulatory system have long included the perception that the participant is better off economically from participating in the system than from being subject to government regulations and that certain efficiencies are achieved under an SRO system.

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[51] This type of market integrity encompasses several aspects, including (1) investors believe that they are dealt with fairly, they pay a fair price, and their transactions are processed in a fair and orderly manner; (2) investors believe that market infractions are fairly addressed through a strong enforcement function; (3) investors are entitled to full and accurate disclosure with respect to all aspects of the market—full and accurate disclosure includes not just transparent price disclosure but transaction fee disclosure, member financial disclosure, and disciplinary disclosure (to the point practicable); (4) a commitment that transactions by investors will take precedence over those of market makers or other SRO participants. Rules, regulations, inspections, and enforcement mechanisms must all work to achieve this end.

Transparency and Accountability. In order to gain and maintain the trust of the public and government authorities, the self-regulatory rulemaking and enforcement processes should remain transparent and unambiguous.[52] Moreover, to the extent that the public is provided the opportunity to participate in the rulemaking process (through public forums, submitting comments, providing input to the regulatory arm), the system benefits through a more vibrant exchange of ideas. In response, the SRO must also establish clear standards for conduct by its members, including an enforcement program that investigates and imposes sanctions.

Independence from the Market Regulated. The SRO should be independent of all regulated markets that it oversees. Care must be exercised to avoid undue reliance upon the business arm to fund or supplement the regulatory function such that it compromises regulatory integrity (e.g., allowances for certain large members, inconsistent application of rules). Neither the market (for profit or not) nor the regulator should have undue influence on one another.

Independent Board. Within the SRO it is essential that an independent board continuously align member self-interest with the investor's desire for a free and fair market. An open election process, in which board representation takes into account all stakeholders, including investors—and not just SRO members—helps to establish a strong corporate governance structure and provide investors with a greater chance for a stronger voice in the organization.

Adequate Funding. Self-regulatory systems are often weakened by the conflicts of interest that stem from inadequate funding when the business or operations side of an SRO assumes responsibility for funding the regulatory arm. Therefore, it is critical that a mechanism exists for providing the necessary funding of an SRO's operations separate and apart from the business/operations arm when the SRO remains a part of the legal umbrella of the market (exchange).

There has been much discussion about the appropriate sources of budgetary funds for SRO regulatory functions. Diversified regulatory budgets, with revenues derived from the SROs' market activities (transaction and data fees, etc.) as well as regulatory actions, are necessary.

Government Oversight. Regardless of the internal controls that a self-regulatory system creates to guide its activities, the threat of government oversight appears to increase the ultimate success of this type of regulation. Even if the government maintains a "hands off" approach with respect to the self-regulatory group, the specter of intervention serves as an effective deterrent in reminding the group of the pending consequences should the balancing of its self-interests become misaligned with its obligations to the public.

There is general agreement that a self-regulatory system operates best when there is a governmental authority that will step in should that system prove inadequate. The level of government oversight might fluctuate in relation to perceived or real shortcomings (and their magnitude) in the SRO's ability to protect the public. The second Chairman of the SEC, and later Supreme Court Justice, William O. Douglas once said that the primary role of the SEC is to "keep a shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used."[53] The government's role is to maintain the trust and confidence in the markets with the threat that the "shotgun is behind the door" if necessary. Government oversight activities should include ensuring that rules are

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[52]Such transparency includes (1) open rulemaking that allows the public an opportunity to submit comments on rule proposals; (2) an enforcement program that sets out clear parameters for conduct and, to the extent possible, makes public the outcome of any enforcement actions; (3) posting of periodic reports (performance, financial, and enforcement) of the SRO's activities in a public forum; (4) the ability of public participants to request disciplinary investigations; (5) reparations for public participants who have been damaged by member rule violations; (6) educational outreach programs to help the public understand the products available in the market; (7) governing boards that include stakeholder representatives, not just industry members.
[53]William O. Douglas, *Democracy and Finance* (New Haven, CT: Yale University Press, 1940), p. 82.

consistently enforced, that investor interests are adequately safeguarded, and that the process is not being subverted.[54]

Policy and Rulemaking Powers. The expertise that SRO insiders bring to the rulemaking process is generally considered one of the most important benefits of self-regulation. Those with knowledge of the industry can draft rules that are more directly related to the realities of the business. In order to maintain the integrity of the system, however, the rulemaking functions must be transparent and provide all stakeholders (brokers, investors, issuers) with the opportunity for input. They should be flexible, with mechanisms in place to revise rules and regulations, as appropriate, in keeping with market developments.

Effective Surveillance, Supervision, and Enforcement Powers. Ultimately, the primary reason for our capital markets is the allocation of capital through an efficient mechanism to allow capital providers to invest in capital users. Given the nature of any member-based association, it is essential that customers (the capital providers) have a means to monitor whether members are honest and fair in their dealings.[55] An important aspect of achieving customer trust and protection includes disclosure and best price/best information about the investment and the broker. When things go wrong, a fair system of recourse, including fair investigation, enforcement, and recompense, is also necessary.

As industries and professions have become more global in nature, the ability of an SRO to oversee the activities of its members on a broad basis has become critical. Investors trade easily among multiple markets and in multiple currencies, even as trading strategies have become more sophisticated. Such ease of trading and sophistication of strategies raise the potential for misdeeds, such as money laundering. The threat of illegal activities has escalated the need for industry SROs to develop networks with similar bodies around the world. Effective monitoring of cross-market and cross-border activities is essential. Such systems require coordinated efforts of communication, commitment, and harmonization to be effective.

SROs must implement and support an enforcement program that starts with active surveillance for wrongdoing, is vigorously committed to investigating questionable activities of its members, and applies clear rules of accepted practices in its oversight. The process must be consistently applied, impartial toward all members, and supported from within by a surveillance and enforcement program that has clearly delineated sanctions for different types of misconduct. Given the importance of maintaining the public's trust when investors are wronged, a method of due process is required. Members and the investing public alike should view the process as "fair."

In order to retain the public and governmental trust that continuation of such a system demands, an SRO must demonstrate that it has implemented the types of controls that allow it to monitor the behavior of its members on an ongoing basis and bring appropriate enforcement action, where necessary.

Ineffective Systems

Self-regulatory systems appear to fail for several reasons. Given the conflicts inherent in any system that relies upon regulating members who provide the business, unresolved internal conflicts of interest can lead to tension between the self-regulator and government; this tension, in turn, may ultimately undermine the government's deference to the self-regulatory group.[56]

Loss of Public Trust. When any regulatory system fails, the loss of public trust and confidence usually produces a long-term effect on various segments of the regulated and other markets.

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[54]Dale Arthur Oesterle, "Securities Markets Regulation: Time to Move to a Market-Based Approach," *Policy Analysis*, Cato Institute, no. 374 (21 June 2000), p. 5 (www.cato.org/pubs/pas/pa374.pdf). Oesterle gives the example of the 1998 NYSE floor broker trading scandal, when certain brokers were trading for their own accounts ahead of clients.
[55]Ibid.
[56]See Note 38.

When a financial regulatory system fails, that loss of public trust can quickly reverberate throughout the economy.

One of the more dramatic failures in recent history involved the auditing profession in the United States and resulted in not only a new form of regulation but also sweeping and substantive changes in 2002 when the Sarbanes-Oxley Act resulted in the creation of the Public Company Accounting Oversight Board (PCAOB).

For many years preceding and following the 1934 Act, the auditing profession was largely a self-regulated industry with little active government involvement beyond SEC oversight and occasional intervention.[57] The self-regulation of the profession appeared to be self-sustaining. The accounting self-governing body relied solely on funding by the member companies in order to fulfill its regulatory mission. This regulatory body, consisting of members of the profession, created the standards by which the profession operated and for many years maintained a reasonable level of public trust in audited financial statements. Although this arrangement long-signaled potential conflict, in the absence of serious scandal or obvious breakdowns in the system, it was perceived to work adequately, even amid some criticism about its propriety.[58]

Over a period of decades, the historical trust between investor and auditor did eventually break down. Because of accounting firms' reliance on their audit clients for revenues (derived from both audit and, more important, non-audit or consulting engagements), auditors came to identify with the managers of the companies they audited, rather than with the shareowners and other investors on whose behalf the audit requirement was established. This reliance on clients for revenues began to subvert the self-regulatory process as the auditing profession failed to ensure that investors had full and fair disclosure. The loss of confidence by the investing public ultimately resulted in a decline of influence and self-regulatory responsibility by the profession.

When it became apparent that the existing model for audit self-regulation was broken, U.S. Congress, in the Sarbanes-Oxley Act of 2002, wrested control of both audit rulemaking and enforcement functions away from the audit profession and transferred them to the PCAOB.[59] The creation of the PCAOB represented a drastic response by the government to intercede in what had been a long era of self-regulation by the audit profession. Congress not only replaced the regulation of auditors with an oversight board but also dramatically changed the regulatory landscape. The auditing profession no longer enjoys the latitude of earlier, self-regulating days but instead is subject to strict and specific engagement and reporting requirements. The audit profession has gone from being largely unregulated to one thrust under the weight of numerous and stringent new rules.

Unresolved Conflicts of Interest. The very nature of an SRO poses certain inherent conflicts of interest. The SRO is responsible for setting limitations on the very members on whose economic interests it depends to remain a viable entity.

An SRO loses its effectiveness, and ultimately its authority to self-regulate, when its own interests significantly interfere with its ability to govern. Conflicts between the SRO's regulatory functions and its business interests can substantially reduce its ability to self-govern in a manner that maintains the trust of the public and the overseeing government authority.

Developments in the financial markets around the world have highlighted the tensions between regulators and the regulated and the balance that must be established in order for

[57]Although jurisdictional authority lay with the SEC, the audit profession was largely overseen by the American Institute of Certified Public Accountants, which generally created the rules and regulations that governed the profession.

[58]For example, in the 25 years before creation of the PCAOB, no one negative review of any large accounting firm had been rendered through the peer review process. See Lisa Buckser-Schulz, "Congratulations to Arthur Andersen: Why Self-Regulation of the Accounting Industry Doesn't Work," *Institutional Investor Advocate*, vol. 4 (First Quarter 2002), p. 2.

[59]See Note 3, pp. 714–743, for detailed discussion of the activities that led to the creation of the PCAOB.

a system to maintain stability. In extreme examples of failure, the government may respond with a set of stringent regulations that far outdistance the ones under which the self-regulator previously operated.

Tensions between the government and SRO or the SRO and its members also may lead customers to question whether their interests are secondary to other agendas. This problem particularly arises where an SRO may be subject to investigations of its members for allegations of misconduct and may have to divert resources to respond to those investigations. For example, when the public loses trust in a market or the ability of a regulator to monitor that market, it responds by withholding investing in that market, whether it be in the form of purchasing goods or services or in trading securities.

Howard Davies, former chairman of the United Kingdom's FSA, perhaps summed up best the questions to be asked of any regulatory structure.

> *The one piece of advice which I would offer to any country reviewing its regulatory structure, is that it should ask very carefully whether the self-regulatory mechanisms in place are sufficiently robust to be left alone? Is there a genuine community of interest, on which robust self-regulation can be built? Are there appropriate sanctions which can be used to punish miscreants? Does the system retain the confidence of those whom it is intended to protect? Where the answers to these questions are no, then it is time to consider putting a statutory framework in place.*[60]

Of course, the demise of any self-regulatory system is particular to forces at work at the time.[61]

Loss of Unity. New competitors may not embrace the rules that a self-regulating entity may have adopted and thus define themselves apart from or in opposition to the established participants. If competitors define themselves in opposition to the members of the regulated body ("the club")[62], the internal integrity necessary for it to function is called into question. Given that the success of self-regulation relies on the buy-in of its members, any substantial splitting off of this group splinters the unity that is required for effective self-regulation and ultimately undermines its success.

Anti-Competitive Behavior. SRO members may develop regulatory schemes that result in barriers to entry for potential new members or anti-competitive practices among current SRO members, thereby sacrificing innovation and the public interest.[63] High compliance costs can also serve as a barrier to entry. If the fixed costs of regulation are sufficiently high, they may become onerous for the smaller members of the SRO. Such costs risk stifling both competition and innovation.[64]

Lack of Adequate Funding. On a basic level, the mere lack of resources to enforce rules and regulations raises questions by the public and outside regulators alike about the system's ability to police its members. The structures of many SROs tend to exacerbate the tensions between their funding arms and regulatory branches. When the regulatory functions are overly dependent upon the revenue of a few members, the integrity of the regulatory process particularly can be called into question. If SRO members are able to use budget control of

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[60]See Note 29.
[61]Davies (see Note 29) cited a number of factors that led to the demise of self-regulation in the United Kingdom, including (1) new competitors began to define themselves in opposition to the original members of the club, (2) self-regulation was not good at raising standards across the industry when lagging consumer confidence demanded it, and (3) growth of competing trading platforms made it unreasonable for one of the platforms to regulate the rest.
[62]See Note 29.
[63]Report of the Taskforce on Industry Self-Regulation, *Industry Self-Regulation in Consumer Markets,* Commonwealth of Australia (August 2000).
[64]Ibid.

the SRO to influence rulemaking, enforcement, studies, reviews, or other regulatory activities, the process becomes corrupted and the public interest can suffer.[65]

Overreaching of Governmental Authority. If the government exceeds its role as an oversight body (and instead becomes an active standard-setter), it may undermine the SRO's ability to regulate independently. In some instances, when the government has lost trust in the SRO to implement warranted policy, this further governmental action may be appropriate. On the other hand, if the government compels the SRO to implement a policy that the SRO feels is not in the best interests of the market it represents, the SRO becomes an unwilling agent of the government rather than an independent body.

[65] See Note 3, pp. 717, 722.

Chapter 5. Conclusions and Recommendations

As securities markets undergo cross-border consolidations, national regulation is quickly giving way to global considerations. Although certain regulatory systems may retain aspects of self-regulation, a global marketplace requires consideration of broad principles and an oversight framework that is applicable for all systems. Of utmost importance is the creation of a system that is able to provide investors with relevant information and protections.

With these goals in mind, we make the following four recommendations as a step in addressing the needs of an increasingly global securities marketplace.

Recommendation 1: Where self-regulation is practiced, establish an independent SRO body that is separate and distinct from exchange/market operations to oversee the regulation of the securities market.

Success for securities industry regulation relies on maintaining market efficiency, integrity, trust, and confidence. Although a number of market self-regulators house the regulatory function within the organization, the increased risk for conflicts and future crises are cause for significant concern. Separating the SRO from the exchange or exchanges that it regulates helps to provide an additional level of protection, particularly in jurisdictions where exchanges have demutualized and become for-profit entities.

A regulator that is separate from the market being regulated is better able to oversee the inherent conflicts of interest than is a structure where regulator and business operations are integrated. Separation injects additional independence into the system and removes the often subtle, yet effective, pressures regulatory and business arms can exert on each other. It also empowers the regulator to develop an integrated system of oversight and enforcement that is consistent, fair, and impartial, without the pressures exerted by more influential members. Together, they realize substantial movement toward restoring integrity to, and shoring up investor confidence in, a system that has become flawed over the years.

Recommendation 2: Eliminate dual or wasteful regulatory oversight conducted by multiple regulatory offices.

In the United States, financial market regulation is split between the SEC and the Commodity Futures Trading Commission, with bank regulation falling under a number of banking regulators as well. In addition, each individual state has its own securities regulators, and each of the individual securities markets/exchanges, its own SRO. The presence of multiple government regulators or SROs has been a source of continuing criticism for their duplicative and conflicting rules and standards. Clearly, a strong argument can be made to streamline the regulatory structures in such jurisdictions. Some are beginning to argue that the United States

> *should stop pursuing the "outdated national treatment model" and "explore ways of mutual recognition" . . . [such that] financial intermediaries such as broker-dealers and investment advisers should not have to be licensed in the United States in order to conduct business here, so long as their licensure in a foreign country meets certain minimum standards set by the SEC.*[66]

We support the recent step in the United States to integrate broker-dealer registration and regulation into one SRO while market regulation, listing standards, and surveillance remain the responsibilities of the individual market SROs. One of the major intentions of the current SRO system has been to achieve efficiencies not generally found in government-enforced regulation. An integrated approach to creating rules and regulations will streamline the process and ultimately bestow cost efficiencies on those who have suffered under multiple compliance systems.

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[66]Speech by Edward F. Greene, General Counsel, Citigroup, quoted in "Citigroup General Counsel Blames SEC in Part for Loss of Global Edge in Markets," *Securities Regulation & Law Report,* vol. 38, no. 46, pp. 1944–1945. The *Financial Times* has also quoted Treasury Secretary Hank Paulson as arguing that "the U.S. should move towards a more flexible, U.K.-style approach to regulating its capital markets to preserve its global competitiveness," Jeremy Grant and Krishna Guha, *Financial Times* (20 November 2006), p. 1.

This approach aligns with practices around the world, where broker-dealers are generally regulated directly by the government and market operations remain the responsibility of the individual market regulator. Such an approach also provides the regulator with an opportunity to work with other jurisdictions to align standards and procedures and strengthen the enforcement program on a coordinated basis.

But we do not think efforts should end here. As markets consolidate, product lines overlap, and jurisdictional issues arise, additional streamlining becomes necessary. As with the restructuring that now vests oversight of broker-dealers in one regulatory body, other areas—both within the U.S. financial services arena as well as within various securities markets around the world—would benefit from a reformulated approach to regulation.

Recommendation 3: Recognize a common framework for regulation, especially in keeping with International Organization of Securities Commissions (IOSCO) principles for securities regulation.

We recognize that the practice of regulation—whether through a self-regulatory system or otherwise—is jurisdiction specific. As the financial services industry moves toward a global marketplace, however, we must focus more on the commonly shared goals and principles of regulation and less on the specific jurisdictional issues. Any such recognitions are necessary to not only create a framework in which investor interests remain at the forefront but to foster harmonization of regulations that must occur in any global market. Moreover, the eventual development of best practice standards that derive from a common regulatory framework ultimately fuels the development of new financial products that add to the dynamism of the capital markets.

We, therefore, recommend the recognition of a global regulatory framework that includes, but is not limited to, the standards discussed in Chapter 4. This framework would provide a viable means for regulators in all jurisdictions to establish comity with other regulators as securities markets merge, consolidate, and harmonize. Although a voluntary system, buy-ins from major markets would ultimately improve investor trust and confidence in the markets around the globe.

Recommendation 4: Recognize an existing or new global organization that would rate each market in terms of compliance with this common framework.

The 3 broad principles and 30 objectives developed by IOSCO (see Appendix A) and the 10 additional exchange-specific standards provide the basis for a common minimum regulatory framework. However, there is no global mechanism to encourage either government regulators or exchanges to actually adopt any of these common regulations.

Given that implementation of regulation is jurisdiction specific, it is impractical to develop a mechanism to force such regulations upon all jurisdictions. In addition, some may argue it may even be unreasonable to expect a particular market to meet all of the common regulations in some cases. However, in such cases it is critically important that market participants clearly understand the additional risks entailed in investing in such a "low regulation" market.[67]

Most importantly, there should be an ability to further develop the common framework outlined here and assess whether (or how well) a market adheres to that framework. Once the common regulatory framework is fully developed, markets should be encouraged to voluntarily adopt it. Full development of the standards and oversight could be achieved through market mechanisms. Namely, an existing or new global organization could rate each market as to whether it meets, exceeds, or falls short of the common framework.[68] These

[67]We recommend that all markets meet the minimum regulatory standards in order for investors to properly price risk. However, if markets do not meet minimum standards, it should be made clear to investors that those market lack the minimum standards.

ratings would be published and serve to clearly notify investors of the regulatory risks they may be taking when investing in any particular market.

There have been instances of market failures in countries with well-regarded government regulators. These failures may be partially because of investor overconfidence in the regulatory standards being enforced by the well-regarded regulator. However, the regulator, while reputable, may have accepted, for whatever reason, to enforce a different level of standards for a particular market within its jurisdiction.

Most obvious here is the SEC, which does not impose common listing standards on U.S. markets but leaves the promulgation and implementation of such regulations to the market-specific SROs. The concern in situations such as this is that investors may not fully appreciate the variance in regulatory standards among markets in the same jurisdiction.

Our proposed global "adviser" would rate each market with respect to meeting the common regulatory framework regardless of jurisdiction. Thus, in the instance of two markets within the same sovereign regulatory jurisdiction in which one meets and the other does not meet the common regulatory standards, investors would be so warned and presumably take into consideration the differences in risk.

[68]Although IOSCO may seem the obvious choice, there may be restrictions within IOSCO's mandate that would prevent it from rating markets. It seems reasonable that a private organization could do the rating, in a similar way that Transparency International rates the integrity of various countries around the world. Alternatively, an international organization such as the World Bank or International Monetary Fund could undertake the rating in the same way that the IMF currently assesses adherence to Basel banking standards.

Appendix A. IOSCO Principles of Securities Regulation

In its 2003 report, "Objectives and Principles of Securities Regulation," IOSCO offers the following 30 principles, which we quote here:[69]

A. Principles Relating to the Regulator

1. The responsibilities of the regulator should be clear and objectively stated.
2. The regulator should be operationally independent and accountable in the exercise of its functions and powers.
3. The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
4. The regulator should adopt clear and consistent regulatory processes.
5. The staff of the regulator should observe the highest professional standards including appropriate standards of confidentiality.

B. Principles for Self-Regulation

6. The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.
7. SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

C. Principles for Enforcement of Securities Regulation

8. The regulator should have comprehensive inspection, investigation and surveillance powers.
9. The regulator should have comprehensive enforcement powers.
10. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.

D. Principles for Cooperation in Regulation

11. The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.
12. Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.
13. The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.

E. Principles for Issuers

14. There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.
15. Holders of securities in a company should be treated in a fair and equitable manner.
16. Accounting and auditing standards should be of a high and internationally acceptable quality.

F. Principles for Collective Investment Schemes

17. The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.
18. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.

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[69] See Note 47, pp. i–iii.

19. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.
20. Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.

G. Principles for Market Intermediaries

21. Regulation should provide for minimum entry standards for market intermediaries.
22. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.
23. Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.
24. There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

H. Principles for the Secondary Market

25. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.
26. There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.
27. Regulation should promote transparency of trading.
28. Regulation should be designed to detect and deter manipulation and other unfair trading practices.
29. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.
30. Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.

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