White Paper: Reinventing Self-Regulation

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I. INTRODUCTION

Sweeping changes are taking place in the securities industry. Technological developments have challenged many of the fundamental assumptions about how markets work and facilitated the creation of new competitive structures. Legislative and regulatory changes have broadened the options available to the market participants and these participants have taken advantage of these new opportunities. Alternative trading system ("ATS") and electronic communication networks ("ECNs") have proliferated, offering significant competition to traditional marketplaces. To respond to the increased competition, certain exchanges are considering plans to demutualize and become for-

profit enterprises, while the National Association of Securities Dealers, Inc. ("NASD") declared its intent to spin-off and privatize the Nasdaq Stock Market ("Nasdaq").

In addition to technological change, investor confidence has been shaken by many events over the past three years, including the collapse of the "high tech" bubble, failures of corporate governance, and misconduct by some market participants. Important changes have been implemented to address these problems, most notably the Sarbanes-Oxley Act of 2002. Recently, fresh questions have been raised about the governance and oversight of the New York Stock Exchange, raising broader issues about the regulatory framework of market self-regulation and pressures to re-examine that framework.[1]

SIA believes that increased competition and additional opportunities for innovation lowers costs and otherwise benefits investors, issuers and the securities industry alike. The rise of the ATSs and conversions to for-profit structures, however, raise concerns regarding the markets' status as self-regulatory organizations ("SROs").[2]/ Specifically, the combined roles of SROs as market overseers and as competitors may affect the SROs' ability and willingness to perform all their functions adequately, fairly and efficiently.[3]/ The Securities Exchange Act of 1934 ("Exchange Act") requires SROs to act as quasi-governmental bodies in implementing the federal securities laws as well as their own rules. Yet SROs also are membership organizations and as such represent the economic interests of their members. In addition, SROs are marketplaces concerned with preserving and enhancing their competitive positions. As competition increases among marketplaces and SROs aggressively pursue strategies to increase their market share, it is possible that both the relationship of SROs with their members and the SROs' ability to carry out their self-regulatory duties impartially will be strained.

In light of these market changes, this paper examines the benefits and drawbacks of the current self-regulatory structure as well as a variety of possible alternatives to the status quo. Specifically, Section II of the paper describes various guiding principles which should be integral considerations in any attempt to streamline the current regulatory regime. Section III describes the status quo and several regulatory alternatives to the status quo. For each alternative, the paper explores the questions of whether the concept is technically and practically feasible and whether the concept would benefit the investing public.

II. GUIDING PRINCIPLES IN EVALUATING REGULATORY OPTIONS

A variety of factors should be considered in analyzing which regulatory structure would be most appropriate. These factors, each of which is described below, should be present in any future regulatory model:

- Foster Investor Protection;
- Preserve Fair Competition;
- Eliminate Inefficiencies;
- Encourage Expert Regulation;
- Promote Reasonable and Fair Costs of Regulation;

- Foster Due Process; and
- Encourage Industry Participation and Self-Regulation.

A. Foster Investor Protection

Investor protection has been a cornerstone of the U.S. securities laws and the affiliated self-regulatory regime since the securities laws were enacted in the 1930's. The Exchange Act clearly sets forth this important goal, stating that the Act was adopted to "insure the maintenance of fair and honest markets."[4]/ Aside from any considerations of Congressional policy, bolstering public trust and confidence is essential to the future success of our Nation's capital markets, especially in light of the pressures that recent events have placed on investor confidence in the integrity of the markets. Any future regulatory scheme should continue to ensure that the public is protected from fraud and abuse, thus allowing the U.S. markets to continue to flourish. Two important aspects of investor protection in considering SRO issues are:

- ***Adequate Protection.*** Investors should be no less protected under a revised system than they are today.
- ***Core Safeguards.*** The core investor protection safeguards should not vary with the markets in which investors trade or the broker-dealer with which investors do business.

Preserve Fair Competition

Free markets and a competitive environment should determine the fundamental structure of the securities markets. Regulation should prevent fraud and abuse and ensure a level playing field. But, as Congress instructed when it enacted the Securities Acts Amendments of 1975 ("1975 Amendments"), regulators should foster, not dictate, the development of the national market system.[5]/ To promote competition without undermining the beneficial aspects of regulation, this report suggests the following:

- ***Avoid Regulation of Competitors.*** The growth of ATSs and ECNs and electronic trading by the SROs, among other things, has heightened the competition between traditional SROs and their members who sponsor electronic trading systems, thus making the conflict of interest between regulators and their members a more serious problem today than when the self-regulatory system originally was conceived. The SROs' demutualization plans further aggravate the conflict situation. Therefore, any changes to the regulatory system should avoid or limit these conflicts of interest whenever possible.
- ***Embrace Technology and Innovation.*** Any changes to the self-regulatory system should leave it sufficiently flexible to avoid stifling the development of new trading practices and technological innovations by exchanges, markets and broker-dealers.
- ***Assure Robust Governance.*** Any regulator with a membership system should not unfairly favor the larger members over their smaller competitors, and should provide for adequate representation of minority members.

- ***Foster Global Competitiveness.*** Reforms must leave markets free enough to position them on a level playing field with their global competitors, without undoing any protections that have made them safe, attractive places to trade.
- ***Ensure Fair Debate.*** No regulator should seek retribution or exact regulatory sanctions against any person who participates in the public policy debates on regulation.

C. Eliminate Inefficiencies

In the interest of cost savings for investors, the securities industry and the public generally, the regulatory system should maximize efficiency, minimize redundancy, and ensure appropriate, up-to-date regulation. Such a system should encourage the adoption of effective internal controls and risk management policies that foster the financial and operational integrity of market participants. The regulatory system should achieve these goals by employing the cost-benefit analysis contemplated in Section 3(f) of the Exchange Act.[6]/

- ***Avoid Duplication of Examinations.*** One examining entity should be adequate for each broker-dealer. Duplicate examinations are wasteful and costly, and there is no evidence that they lead to better enforcement.
- ***Harmonize Regulation.*** The NASD, the New York Stock Exchange ("NYSE") and the other exchanges have different priorities with regard to many issues. These differing agendas result in a variety of inconsistent rules for multi-membership broker-dealers. Any extra costs caused by the inconsistent rulemaking should be avoided in the future.
- ***End Conflicting Interpretations.*** Multiple regulators also issue different interpretations of similar rules. This inconsistency undermines the authority of the regulators and imposes unnecessary costs on regulated entities.
- ***Limit Inconsistent Disciplinary Action.*** With each SRO wedded to its own agenda, the severity of sanctions (if any) for a given violation may vary depending on the enforcing SRO. Limiting this disparity should be a priority of any regulatory change.
- ***Revise Obsolete Regulation.*** Regulations that were enacted years ago by some SROs have not been re-evaluated for their applicability and efficacy in today's trading environment. Cumbersome, obsolete regulation should be revised or deleted from the rulebooks.
- ***Foster Development of Effective Internal Controls.*** The regulatory system should support and encourage the development of effective internal controls by broker-dealers, including rigorous self-assessment and corrective action programs, without subjecting them to the undue risk of disciplinary action.
- ***Independent Arbitration Forum.*** To eliminate any possible competition between multiple arbitrators, customer complaints should be sent to a single, independent arbitration forum. Subject to SEC oversight, this adjudicator would settle disputes between the broker-regulator and its members and possibly disputes between brokers and their clients or markets and parties trading on them.

D. Encourage Expert Regulation

Any regulatory structure for the future should be crafted in such a way as to ensure that the industry is overseen by expert staff. In that regard, the following issues would seem to be important in ensuring that each SRO is a knowledgeable regulator.

- ***Encourage Specialized Knowledge in Regulator*.** The genius of self-regulation is that it puts regulatory decisions in the hands of people intimately familiar with the relevant facts. Any regulatory change should not abandon this valuable asset in favor of a distant, generalist regulator that is ignorant of the markets it regulates.
- ***Provide Regulator with Effective Industry Input and Resources.*** In order to promote expert regulation, regulators should be provided with effective industry resources to develop expert knowledge of market participants through a variety of channels – *e.g.*, advisory panels, focus groups, and town meetings.
- ***Ensure Regulator's Power, Prestige and Funding is Sufficient to Attract Qualified Staff.*** The pool of qualified regulatory staff is not large. If working at a self-regulatory organization is not sufficiently interesting, important, and adequately remunerative, no change in the regulatory structure will be adequate to ensure good regulation.
- ***Ensure Regulator Is Strong Enough to Participate in Larger Domestic and Global Regulatory Initiatives.*** The U.S. self-regulatory body should have a wide membership and expert leadership, so that its views on the future of securities regulation are well-considered and influential on a domestic and global scale.
- ***Tailor Regulation to Diversity of Regulated Entities.*** Regulation should be tailored to fit the diversity of regulated entities, not a "one-size-fits-all" approach. Encouraging regulatory specificity also may facilitate the development of expertise within the regulator.

E. Promote Reasonable and Fair Costs of Regulation

Costs considerations must be an integral part of the development of any new regulatory structure. The following principles should guide the evaluation process.

- ***Ensure Adequate Funding.*** Any future regulatory structure must be funded adequately to perform its regulatory functions.
- ***Share Costs of Regulation.*** The costs of regulation should be equitably shared (whether they are incurred directly or passed through indirectly) among all of the constituencies that benefit from it, including securities firms, issuers, investors and the markets themselves.
- ***Impose Cost-Based Fees.*** Costs should be apportioned to the industry on a fair basis and prices should be unbundled and cost-justified whenever possible. Imposing regulatory fees on the securities industry that exceed true costs of regulation acts as a tax on capital and imposes undue harm on the capital-raising system.

F. Assure Due Process

Any regulatory system should ensure that the public, investors and regulated entities are afforded due process. In particular, this due process principle would require the following:

- ***Implement Prospective Rulemaking.*** Regulatory actions should not occur in the enforcement context, but should be undertaken prospectively with appropriate opportunities for notice and comment.
- ***Use Enforcement Sanctions Appropriately.*** Regulation should focus less on enforcement of technical rule violations, and more on the evaluation and remediation of a firm's deficiencies or weaknesses. Enforcement should be reserved for egregious situations involving intentional or grossly negligent misconduct or situations where there is clear ham to markets or investors.

G. Encourage Industry Participation and Self-Regulation

The securities industry should continue to play an active role in monitoring and shaping new regulatory developments that affect how broker-dealers may conduct their businesses. Regulatory decisions divorced from the realities of the marketplace would be a disservice to the investing public and an impediment to the capital formation process in general.

- ***Foster Integrity and Independence of Self-Regulation.*** A regulatory system should be responsive to the needs of all market participants – issuers, investors and broker-dealers alike – with minimal bureaucratization and politicization.

III. POTENTIAL REGULATORY MODELS

In light of these principles this report considers six options for responding to the many changes taking place in the securities markets. These are (1) the Status Quo, (2) the NASDR Model, (3) the DEA Model, (4) the Hybrid Model, (5) the Single SRO Model and (6) the SEC-Only Model. The evaluation of each model is based on an analysis of its advantages and disadvantages within the context of the guiding principles set forth in Section II.

A. Option 1: Status Quo

1. Structure

One response to the changes taking place in the securities markets is to retain the status quo. Currently, nine national securities exchanges, including the American Stock Exchange ("Amex"), Boston Stock Exchange ("BSE"), Chicago Board Options Exchange ("CBOE"), Chicago Stock Exchange ("CHX"), Cincinnati Stock Exchange ("CSE"), International Securities Exchange ("ISE"), NYSE, Pacific Stock Exchange ("PCX") and Philadelphia Stock Exchange ("Phlx") and one national securities association, the NASD, are registered with the SEC under Section 6 and Section 15A of the Exchange Act, respectively.[7]/ In addition, given the pending exchange application

of Nasdaq and the business interest in exchange status, it is likely that the number of exchanges will increase in the future.

Each of these SROs performs two basis functions: (1) the operation and promotion of a marketplace and (2) the regulation of the market center and the broker-dealer members of the market center. These regulatory functions are broad and diverse, covering surveillance of market activity, rulemaking, auditing of member firms for compliance with rules, disciplinary actions against member firms and their associated persons for rule violations and the arbitration of disputes. By continuing this structure, marketplaces would retain their affiliated self-regulatory functions or allocate those responsibilities to another SRO pursuant to Section 17(d) of the Exchange Act.[8]/ They would be permitted to keep the functions in the same corporate entity, even if the organization decides to demutualize, or to establish the regulatory arm of the SRO in a separate affiliated entity. The SEC would continue to oversee each of the SROs. A chart depicting the current regulatory structure is attached in the appendix as Option 1.

The current regulatory system can be, at times, complex, expensive and unfair. Some of the disadvantages of the current system are described in more detail below.

Conflicts of Interest Strain Public Trust and Confidence. As Congress recognized in enacting the Exchange Act and adopting the self-regulatory model, an inherent conflict of interest exists between the regulatory and market roles of the SROs. Specifically, the interests required of an SRO to regulate itself and its members are in conflict with its interests in promoting itself. For example, an SRO may utilize its regulatory power to imposed purely anti-competitive restraints as opposed to those justified by regulatory needs. Similarly, the SRO may resist change in the regulatory pattern because of vested economic interests in its preservation or insufficient knowledge of newly developing market conventions or investor needs. Indeed, these inherent conflicts percolate into the ongoing debates concerning the market data fees and bond market transparency initiatives.

To date, self-regulation paired with SEC oversight has proven effective, through a check and balance system that has managed to contain more serious types of conflicts of interest. The rise of ATSs and the push for the demutualization of existing exchanges, however, raise the question of whether the conflicts of interest will deepen to the point where regulatory change is needed. In conjunction with the introduction of the Order Handling Rules[12]/ and Regulation ATS,[13]/ more ATSs have been developed.[14]/ These electronic trading systems increasingly have been seen as competitors to the existing SROs, attracting order flow with promises of better, cheaper and speedier executions than those of the SROs. In fact, by 2000, news reports commonly reported that ATSs accounted for 30% of the trading in Nasdaq securities;[15]/ that percentage has increased even more since then. The NASD and NYSE have recognized this competitive threat and have countered with electronic trading proposals of their own.[16]/

Although this appears to be a success story of innovation spurred on by the competition in the market, various issues remain with these developments and their relationship to the

present self-regulatory structure. Under Regulation ATS, all ATSs must be registered as a broker-dealer and, therefore, must be registered with and regulated by the very SROs with whom they are competing. This regulation of direct competitors exacerbates the existing conflicts of interest inherent in the basis self-regulatory structure.

In addition to the competition from ATSs, SROs also are increasingly faced with competition from other SROs. For example, the competition between the options markets has escalated with the onset of multiple listings. Similarly, the repeal of NYSE Rule 390 is likely to accelerate competition among the NYSE, the NASD, the regional exchanges and third market firms. Such competition raises concerns about the SROs' ability to regulate firms when they are competing for those firms' order flow, particularly the SROs' ability to enforce best execution obligations for that order flow.

The conflict of interest is further aggravated by the pending structural changes by Nasdaq[17]/ and the demutualization plans under consideration at certain exchanges. As for-profit, public companies, a market may risk, for example, inappropriate cost-cutting of regulatory functions or anti-competitive oversight of its competitors. In addition, as public companies, these organizations must answer to their shareholders – who may include competitors of the exchange as well as competitors of the regulated members of the exchange. The for-profit structure may also raise due process concerns because the regulatory fines would flow to the SROs' bottom line.

Duplicative and Inconsistent Regulation. As we describe below, today's self-regulation is characterized by a high degree of redundancy and its attendant costs.

Broker-Dealer Examinations. Broker-dealers that are members of a number of SROs have been subject to multiple, overlapping SRO examinations.[18]/ In general, the requisite examinations are costly and time-consuming, and frequently more so than necessary. For example, broker-dealers commonly report a need for better trained examiners and more targeted examinations.[19]/ The frustration and costs associated with each examination is multiplied when the firm must undergo a similar examination several times by different regulators.

The SEC and the SROs have attempted to minimize some of the inefficiencies of multiple exams by establishing joint examinations programs,[20]/ but sufficient duplication remains to justify concern.[21]/ In addition, although the goals of the cooperative programs are laudable and necessary, practical coordination of the SROs on examinations has not yet been achieved.[22]/ In the joint examinations, the respective teams of examiners may agree on the format, but they remain subject to the different agendas and direction of their respective SROs.[23]/ Unlike the present process, a truly coordinated examination process must have a clear division of responsibilities and a willingness on the part of the examiners to accept the findings of another SRO's examiners, and this may not be easily achievable given the competition among the various SROs.

Rulemaking. The redundancy problem also reveals itself in the rulemaking process. At times, broker-dealers that are subject to the oversight of multiple SROs may

need to comply with multiple and inconsistent rules on the same issue. Furthermore, even when the various SROs have identical rules on a certain issue, each SRO may interpret those rules differently. The risk of such inconsistencies increases as the number of SROs increases.

Having ten existing SRO rulebooks, rather than one rulebook, increases the costs for each segment of the securities markets – the broker-dealer members, the SEC and the SROs as a group. The member broker-dealers must constantly monitor rule changes for each relevant SRO in order to maintain a working familiarity with the rules and to make any necessary modification to supervisory and compliance procedures. In addition, because any SRO rule changes must be reviewed by the SEC, the rule filing expenses of the SEC increase as the number of exchanges increase. The duplication of effort is particularly noticeable when the various SROs each separately file similar or identical rule changes. Correspondingly, the SROs as a group expend unnecessary resources internally to consider and prepare rule filings which duplicate filings of other SROs.[24]/ In all likelihood, the costs for the duplicative and inconsistent rules and rulemaking procedures will increase with the addition of any new exchanges.

Discipline and Enforcement. Like the rulemaking process, the broker-dealer members of multiple SROs must contend with inconsistent discipline and enforcement efforts from the multiple SROs. Each SRO has its own unique focus and interpretation for what activity constitutes a rule violation and what the appropriate sanction is for that violation.

Regulatory Competition. Competitive pressures may influence the regulatory decisions of the SROs. For example, to maintain its status as a tough regulator and to attract additional order flow based on its positive reputation, an SRO may resort to enforcement actions, rather than targeted remediation, to address rule violations. Similarly, the opposite situation may result. The competitive regulatory environment may encourage SROs to apply lax standards to increase their membership roles. This may lead to a race to the bottom in which marginal firms become members of the SRO which has the least rigorous standards.[25]/

Limited Feasibility. In the past, the SEC has suggested that a for-profit demutualized exchanges will need to create a separate corporate entity for their regulatory operations (see Option 2). Although the SEC has not instituted rulemaking in this regard, it appears likely that at least some changes to the status quo will be required.

B. Option 2: Multiple Exchanges with Separate Boards and Information Barriers for Their Regulatory Arms (NASDR Model)

1. Structure

An internal corporate restructuring which segregates the market and regulatory roles of any demutualized SROs may address some of the concerns about the current regulatory structure and its application to the changing marketplace. This option would be very

similar to the status quo. The multiple SROs, existing and future, would continue to exist and each SRO would continue to operate and regulate its market and members. The only difference between this option and the status quo is that each of the demutualized SROs would be required to undergo a corporate restructuring much like that undergone by the NASD.

As currently envisioned, the SRO would create a parent holding company, with at least two subsidiaries. One subsidiary would contain the regulatory arm of the SRO, which would have the SRO's examination, rulemaking and disciplinary authority, and the other subsidiary would contain the market center. A separate and independent board would govern each subsidiary and information barriers would separate the decisionmaking of one subsidiary from the other.[26]/ The NASDR Model is pictorially represented at Option 2 of the appendix.

2. Advantages

The NASDR Model has the advantages discussed above in reference to the status quo. Additionally, however, the corporate restructuring in this option is intended to improve upon the status quo by reducing the conflicts of interest caused by the demutualized, for-profit exchanges.

Reduces Conflicts of Interest. By strictly segregating the regulatory and market functions, this option seeks to focus each subsidiary on its respective responsibilities. The board of the market center subsidiary would concentrate on promoting the market center and maintaining its competitive status. The board of the regulatory arm would focus on the regulation. With the corporate separation and the information barriers in place, each board's aims and goals should not infiltrate the decisionmaking of the other board, thus decreasing the likelihood of inappropriately anti-competitive regulation.

Prior Experience with NASDR Model. The SEC and the industry have experience with this type of restructuring because of the NASD's creation of a separate, independent subsidiary, called NASD Regulation, Inc. ("NASDR"), responsible for the regulatory obligations of the NASD. Such experience provides valuable data for evaluating the NASDR Model generally and improving upon it, if necessary.

In 1996, the NASD created NASDR in response to a variety of criticisms aimed at its market and regulatory responsibilities. In 1994, amid criticism of the NASD's self-regulatory capacities, the NASD appointed a Select Committee on Structure and Governance, chaired by former United States Senator Warren Rudman to review the regulatory and governance structures of the NASD and Nasdaq.[27]/ This Committee inquired into the appropriateness of the NASD's structures for governance and oversight and operation of the Nasdaq stock market, the NASD's regulatory and disciplinary processes, the extent to which the NASD provided for appropriate representation of its constituencies, and its policy and rulemaking processes.[28]/ The Committee concluded that the NASD's governance structure "blur[r]ed the distinction between regulating the broker-dealer profession and overseeing the Nasdaq stock market."[29]/ To correct these

deficiencies, the Committee suggested that the NASD reorganize its corporate structure such that the Nasdaq market and NASD's regulatory functions would be in separate subsidiaries of the NASD, and that the NASD and these two subsidiaries would each have 50% or greater public representation on their boards of directors. Former Chairman Levitt noted the improved regulatory oversight of the reorganized NASD, stating that "[s]ince the SEC's historic enforcement action . . . the NASD has adopted an unprecedented number of changes to improve the fairness and efficiency of its operations."[30]/

Minimally Disruptive. In comparison to the other possible regulatory models discussed in this paper, this option represents only minimal or incremental change from the status quo. The model does not divest any SRO of its regulatory or other functions; it merely requires the SRO to repackage its existing roles. Furthermore, this repackaging may be fairly easy to accomplish through SEC rulemaking which could set forth guidelines for the segregation of the SROs' regulatory arms.

3. Disadvantages

Conflicts May Persist. Although the internal segregation of the regulatory and market roles of the SRO may reduce conflicts of interest to a certain extent, conflicts may persist. After all, the two functions remain in the same entity and that entity as a whole has an interest in promoting its own interests. For example, if the SRO uses the holding company structure, the board of the holding company still oversees the actions of both of the subsidiaries. Furthermore, despite the corporate separation and firewalls, each of the subsidiary's boards will consist of industry members per the Exchange Act's fair representation requirements.[31]/ Therefore, although each board will contain different people, the actual interests of the people on each board are likely to be very similar.

Only Addresses Conflicts Issues, not Duplication and Inconsistency. This model is designed to address only one of the problems in the current regulatory structure – conflicts of interest. It does not attempt to address any of the other disadvantages of the current situation. In particular, it ignores the costly duplication and inconsistencies of multiple SROs.

C. Option 3: Multiple SROs with Firms Designated to a Single SRO for Examination Purposes (DEA Model)

1. Structure

A third possibility would involve allocating inspection responsibilities among the SROs and expanding the concept of a designated examining authority.[32]/ The Commission has used its authority under Sections 17 and 19 of the Exchange Act to allocate to particular SROs oversight of broker-dealers that are members of more than one SRO "(common members").[33]/ For example, in order to avoid unnecessary duplication, the Commission appoints a single SRO as the DEA to examine common members for compliance with financial responsibility requirements.[34]/ When an SRO has been

named as a common member's DEA, all other SROs to which the common member belongs are relieved of the responsibility to examine the firm for compliance with applicable financial responsibility rules.[35]/ Pursuant to recent legislation, Congress has called for improved coordination of supervision of members and elimination of any unnecessary and burdensome duplication in the examination process.[36]/

Under this model, the SEC would require the DEA to expand its oversight duties of the common member. Like the current DEA program, each firm would be examined by one designated SRO, instead of multiple SROs. The DEA would be responsible for inspecting for compliance with its own rules as well as the rules of the other SROs. Like the status quo and the NASDR Model, this option would leave the current regulatory structure as is except for reallocation of examination responsibility. A chart portraying this model is attached in the appendix as Option 3.

2. Advantages

Eliminates Duplicate Examinations. In addition to the advantages of the status quo discussed above, the DEA Model would streamline the examination process and minimize the costly, duplicative examinations performed by multiple SROs.

3. Disadvantages

Improvement Limited to Duplicate Examinations. A disadvantage of this approach is its narrow focus. It only attempts to lessen the duplicative efforts of the SROs, leaving the conflicts of interest issues unaddressed. Furthermore, the focus on the SROs duplicative efforts is limited to broker-dealer examinations. The model fails to address the redundancies and inconsistencies in the multiple SROs' rulemaking and enforcement initiatives.

Interpreting Another SRO's Rules. In practice, expanding the authority of the DEA may increase costs, inconsistent action among the SROs and conflicts of interest between competing market centers. For example, the costs for each DEA may increase because each DEA must expend significant resources to maintain a working knowledge of the rules of each of the other SROs in addition to its own rules. Although the process may reduce overlapping exams, the broker-dealers may not realize significant cost savings because the DEA may find the interpretation and application of the other SROs' rules during the examination process more difficult than the relevant SRO's examiner. Furthermore, under this approach, the risk of inconsistent interpretation of any given rule increases. Using the expanded DEA concept, the potential exists for ten different interpretations of the rule of one SRO. Finally, by bestowing upon the DEA the front-line responsibility for interpreting and applying the rules of another SRO, this model may aggravate the conflicts between competing SROs by creating an incentive to construe another SROs rules in an anti-competitive fashion.

Conflicts of Interest Persist. Like the status quo, this option fails to address the conflict of interest concerns presented by demutualized, for-profit exchanges.

D. Option 4: One SRO for Member Firms: Markets Regulate Their Own Trading (Hybrid Model)

1. Structure

Another proposal that has received increased attention recently would restructure self-regulation on the basis of function, rather than on the basis of firm membership. Regulation would be broken down into two separate and distinct areas – one which relates to trading and markets and the other which relates to the operation of the firm and capital requirements. All the non-market-related self-regulatory functions would be combined into a single organization which could function irrespective of the various markets. Therefore, "each market would maintain the regulatory and surveillance functions solely for its own market – but member regulation, sales practices and all other aspects of intermarket trading would be overseen by a single SRO."[37]/

Division of Responsibilities for Non-Market-Related Regulation. This single, non-market-related SRO ("Firm SRO") would assume, for all registered broker-dealers, the rulemaking, surveillance and enforcement functions performed by the exchanges and the NASD with regard to all activities other than those specifically associated with the trading markets.[38]/ For example, only the Firm SRO – rather than ten or more SROs – would have jurisdiction over, among other things, sales practices, industry admission standards, financial responsibility requirements (like net capital and margin requirements), competence of personnel and recordkeeping rules. This Firm SRO would be assigned the responsibility for conducting examinations of broker-dealers. In addition, it would be solely responsible for disciplining infractions of the Firm SRO's rules. The current SROs would relinquish control over all this non-market-related regulation. As a prerequisite for this model, all registered broker-dealers must be a member of this organization. The SEC would oversee all of the activities of the Firm SRO, like it does today for the NASD and the exchanges. The Hybrid Model is represented in Option 4 in the appendix.

Division of Responsibilities for Market-Related Regulation. The market-related regulation may be divided between the Firm SRO and the market SROs in at least two ways. Under one variation, the Firm SRO would not have any rulemaking, surveillance or enforcement authority for access to the trading facilities, operation of the trading facilities, or the establishment and enforcement of listing or qualification standards for issuers. Each market center would have responsibility for trading-related activities, subject to SEC oversight. Therefore, the markets would continue to adopt and enforce rules as they do today, but their overall jurisdiction would be limited to trading regulation.[39]/

Under a second variation, the market SROs would retain their rulemaking authority with regard to trading activity, *e.g.*, access to the trading facilities, operation of the trading facilities and the establishment and enforcement of listing or qualification standards, but they would not have any enforcement authority with regard to those rules. The market SROs' authority would be similar to that of the Municipal Securities Rulemaking

Board.[40]/ The Firm SRO would be vested with the authority to enforce the trading rules of the market SRO. However, the market SROs would have the limited power to determine whether a rule violation may have occurred.

Governance. Although the governance of the Firm SRO may be structured in a variety of ways, any chosen structure should satisfy several basic principles. First, the board of the Firm SRO would consist of 50% public governors. Moreover, a system should be established to ensure that the organization attracts qualified public board members. Second, the remaining 50% of the board should be representative of all members of the industry over which the SRO has disciplinary authority, *i.e.*, all registered broker-dealers. In particular, the board selection process should ensure that smaller entities are fairly represented. This heightened fair representation requirement could be achieved through a carefully crafted nomination and voting process for selecting the board. Third, the Firm SRO members should not only be represented in the governance, but they also should be an effective and integral part of the functioning of the Firm SRO. An expanded advisory committee structure could provide the members with a voice in the new organization. Finally, it should be assumed that this organization would not in any way participate in the governance of any marketplace as such.

2. Advantages

Strengthens Investor Confidence by Reducing Conflicts of Interest. The introduction of a Firm SRO may eliminate some inherent conflicts of interest that are caused by today's SROs' dual capacities as regulators and markets. The Firm SRO in charge of the non-trading regulation would no longer have any direct connection to a profit-driven pursuit and, therefore, it would have no incentive to brandish its regulatory authority in an anti-competitive fashion.

Minimizes Duplicate and Inconsistent Regulation. The consolidation of the non-market-related regulation under one roof should improve the quality, uniformity and comprehensiveness of today's approach to non-market-related regulation of broker-dealers. For example, the economies of scale of this approach should eliminate or reduce many of the inefficiencies and unnecessary costs present in the current regulatory system.[41]/ The Firm SRO would significantly reduce or eliminate (1) duplication of examinations, inspection reports, surveillance and other areas of overlapping jurisdiction; (2) the need for the maintenance and staffing of multiple SROs; (3) the inefficiency of monitoring and complying with two or more SROs; (4) inconsistent rules and rule interpretations and inconsistent enforcement thereof; (5) and the attendant costs of each of the above to the industry.[42]/

Reduces Regulatory Competition. Replacing the oversight functions of ten competing SROs with one Firm SRO should eliminate regulatory competition at least in the non-market-related oversight functions. This should address both race to the top and race to the bottom issues.

Functional Regulation. The Hybrid Model is likely to produce beneficial regulation because it links supervisory duties to expertise, and in particular, it leaves the technical details of trading regulation to the entities best equipped to understand them.

Feasible Approach. The question remains as to whether the concept of a Firm SRO is feasible in view of the present industry structure and the traditions that accompany it. From a political standpoint, this approach is supported by some powerful interests, just as it is much opposed by others. From an operational and legal standpoint, however, the concept appears feasible.

Legally Feasible. To create the Firm SRO, the Commission must cause today's SROs to relinquish non-trading authority over their members and must create a new organization with the necessary self-regulatory powers. The Commission currently has at its disposal many, if not all, the legal tools necessary to implement this hybrid concept. For example, under Sections 17(d), 11A, and 19(c) of the Exchange Act, the Commission has the authority to require the existing SROs to relinquish authority over their members if so directed. In addition, the SEC's new exemptive authority[43]/ may be used to relieve the existing SROs of any non-market-related duties which are mandated under the Exchange Act.[44]/ Similarly, the new Firm SRO may be formed as an SRO pursuant to Section 19 of the Exchange Act, just as traditional SROs are formed, and the SEC may again utilize its exemptive authority to relieve the Firm SRO of inapplicable requirements. The SEC's use of its existing authority in this situation may require rulemaking to implement this approach.

Operationally Feasible. From an operational standpoint, the industry has the capability to implement the concept because the job to be performed by the Firm SRO is collectively being done today by the exchanges and the NASD. Thus, there is sufficient personnel with the necessary technical expertise to continue to perform the job on a consolidated basis. The existing examination and surveillance structures may be modified for utilization by the Firm SRO. Indeed, cooperative efforts among SROs and the Commission to relieve duplicative regulation are paving the way toward uniform surveillance. Finally, the current use of technology-based surveillance programs should facilitate the transfer of responsibilities to a Firm SRO.

In addition, this hybrid approach has seen a level of SEC and Congressional approval and industry support in the past. For example, former Chairman Levitt stated that he found this hybrid approach "intriguing,"[45]/ although he reserved judgment as to the best regulatory approach pending further study. Annette Nazareth, Director of the SEC's Division of Market Regulation,[46]/ has similarly expressed her interest in the Hybrid Model. Others in the industry, including broker-dealers and SROs, also see value in this approach. For example, support for this approach has a long history with the SIA. The first SIA chairman endorsed this approach in 1973 during consideration of the national market system legislation.[47]/

Centralization of Regulatory Expertise. Another benefit of this approach is the centralization of regulatory expertise and experience in one entity. Rather than

dispersing the talented regulatory staff throughout many different SROs, the experienced regulators would join the one Firm SRO, thus limiting the constant issue of inexperienced regulators.

More Effective Liaison. Because the Firm SRO will speak with one marketplace and business neutral voice, it may prove to be a more effective liaison than the multiple SROs on matters of regulatory importance with the SEC, various governmental agencies, the states, global regulators and competitors and other organizations.

3. Disadvantages

Separation of Market and Surveillance. Separating the self-regulatory function of the securities markets from the operational market functions may degrade self-regulation by lessening the familiarity of the regulators with market processes. Synergy is lost when the two functions are separated.

Bureaucratic Tendencies. Any single entity which by its very nature is free from the pressure of peer competition can become intransigent and bureaucratic. Initiative and effort at self-improvement may diminish. Although Congressional and SEC oversight as well as a member-controlled decisional process should reduce that possibility, self-regulation without competition may not be a regulatory enhancement.

Boundary Issues. In some cases, the line between firm oversight issues and trading issues may be hard to draw. Some areas of oversight, like net capital, for example, may clearly fit within the jurisdiction of the Firm SRO. Other rules, however, like frontrunning, may have both trading and non-trading characteristics. For these rules, the Firm SRO and the marketplaces may both have a legitimate interest in the development, surveillance and enforcement of those rules.

Remaining Conflicts of Interest Regarding Trading. Although the conflicts of interest are reduced for non-market-related oversight, SROs still may set trading rules that disadvantage member broker-dealers that run competing markets or send order flow elsewhere. Like the current situation, the SEC's continued oversight and scrutiny of the trading rules and their enforcement as well as antitrust laws may or may not be sufficient to limit these conflicts of interest.

E. Option 5: All-Purpose Single SRO (Single SRO Model)

1. Structure

The regulatory structure also could be revised by expanding the concept of the Hybrid Model discussed above. Specifically, the trading regulation – in addition to the non-market-related regulation – would be moved into a single, all-purpose SRO ("Single SRO"). Therefore, the Single SRO would be vested with all rulemaking, surveillance and enforcement responsibility for all areas of regulation. Concurrently, the exchanges and the NASD would be divested of all their self-regulatory authority, leaving each as a

marketplace, much as ATSs are today. The Single SRO Model is set forth in chart form in Option 5 of the appendix.

2. Advantages

Like the Hybrid Model, the Single SRO should (1) decrease duplicative and inconsistent regulation; (2) centralize regulatory experience; (3) act as a more effective liaison to other organizations; and (4) be legally and practically feasible. In addition, the Single SRO would be advantageous for the following reasons:

Eliminates Remaining Regulatory Competition and Conflicts of Interest. The already reduced regulatory competition and conflicts of interest of the Hybrid Model will be completely eliminated in the Single SRO because all self-regulation, including trading and non-trading oversight, would be vested in a single entity.

Erases Boundary Issues of Hybrid Model. Placing all regulatory responsibilities in one entity eliminates any jurisdictional overlap.

Level Playing Field Among Competing Markets. Regulation ATS defined an ATS as an exchange which does not "set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization" or "discipline subscribers other than by exclusion from trading."[48]/ Stripping an exchange of its self-regulatory obligations makes it equivalent to an ATS. Therefore, the competitive position of each trading system in the market will solely depend upon its products and services, not its regulatory status.

Broader – if Not Deeper – Knowledge of Regulated Entities. By overseeing all market participants – traditional broker-dealers and trading systems alike – the Single SRO would have a comprehensive perspective of the securities industry. The deeper knowledge of the industry, however, may escape the regulator as described below in the disadvantages section.

3. Disadvantages

The Single SRO has many of the same disadvantages of the Firm SRO, including the risks of bureaucracy. The Single SRO, however, may have additional weaknesses, as described below.

Risk of Being Redundant of SEC. Farther removed from real industry concerns, the Single SRO could become a superfluous layer of regulation that adds little to the oversight provided by the SEC. Although the self-regulatory governance structure of the Single SRO may limit the risk, it can not be completely eliminated as a possible concern.

No Synergy with New Business Systems. Under the current regulatory system and even with the Firm SRO, the technical details of trading regulation remain with the entities actually engaged in the trading activity. By removing the trading regulation to a remote

entity, the synergy between the trading systems and the regulation is lost. For example, as exchanges and other market participants innovate, their systems would not be as well designed for easy surveillance because regulators could no longer shape development of the technology. The coordinated and concurrent innovation of the trading systems and their corresponding surveillance programs is forfeited.

F. Option 6: Single Regulatory Organization (SEC-Only Model)

1. Structure

Finally, a more drastic suggestion involves abolishing the concept of self-regulation entirely and expanding the duties of the SEC to cover all the regulatory responsibilities currently performed by the SROs, including the direct oversight of the market centers and broker-dealers. The SEC would become the sole rulemaker, examiner and enforcer for the industry. The SROs would be stripped of their self-regulatory responsibilities, thereby becoming mere marketplaces.[49]/ Firms would no longer be subject to the oversight of any SROs, just the SEC. Firms and exchanges would only influence the ultimate regulatory standards through the comment process at the SEC or through Congressional action. A chart representing the SEC-Only Model is located at Option 6 of the appendix.

2. Advantages

Avoids Limitations of Self-Regulation. By abolishing self-regulation entirely, any concerns associated with self-regulation are also eliminated. The inherent limitations in allowing an industry to regulate itself are well known:

the natural lack of enthusiasm for regulation on the part of the group to be regulated, the temptation to use a façade of industry regulation as a shield to ward off more meaningful regulation, the tendency for businessmen to use collective action to advance their interests through the imposition of purely anti-competitive restrains as opposed to those justified by regulatory needs, and a resistance to changes in the regulatory pattern because of vested economic interests in its preservation."[50]/

With oversight limited to the SEC as the sole regulator, these disadvantages of self-regulation would no longer be a concern.

Ends Duplicative and Inconsistent Regulation. Because the SEC would replace the regulatory activities of ten existing SROs, duplicate examinations, multiple and overlapping rules and conflicting interpretations and disciplinary actions would end, along with their associated costs.

Regulatory Expertise. Increasing the already considerable power of the SEC would serve to augment its status in the U.S. and the global securities industry. Furthermore, the more powerful and potentially more prestigious SEC could attract and keep talented staff, rather than competing with other regulators for that expertise.

3. Disadvantages

Although the adoption of the SEC-Only Model may eliminate many of the disadvantages of the current structure, including conflicts of interest and costly duplication, the structure will likely introduce a host of new problems. For example, Congress specifically avoided the creation of a massive SEC because of the fear that it would be monolithic, intractable, inflexible and unaccountable. Described below in more detail are a variety of possible pitfalls associated with this complete revamping of the regulatory structure of the securities industry. Given the many advantages of self-regulation over direct governmental regulation, some aspect of self-regulation – even in a modified form – is likely the better route. *See* Option 6 in the appendix for a chart of the SEC-only structure.

Minimal Industry Input. In the current self-regulatory regime, the regulated entities, both the markets and the broker-dealers, are intimately and constantly involved with the regulatory process. The expertise and intimate familiarity with complex securities operations which members of the industry can bring to bear on regulatory problems can not be underestimated. Furthermore, self-regulation has the advantage of making the people who are subject to regulation actual participants in the regulatory process. By providing an opportunity to participate in the regulatory process, self-regulation may make the members of the securities industry more aware of goals of regulation and their own stake in them while at the same time making the imposition of regulatory controls more palatable because those regulations are more workable. Replacing self-regulation with direct agency oversight would distance the regulated entities from the regulatory process, thereby depriving the SEC of the benefit of their expertise and depriving the regulated entities of more direct input into the regulation which controls their day-to-day business operations.

Expensive and Bureaucratic. The principal reason Congress has relied so heavily on self-regulation in the securities industry to date is "the sheer ineffectiveness of attempting to assure [regulation] directly through the Government on a wide scale."[51]/ Scrapping self-regulation and vesting that regulatory power in the SEC would involve "a pronounced expansion of the SEC, the multiplication of branch offices, a large increase in the expenditure of public funds, an increase in the problem of avoiding the evils of bureaucracy and a minute, detailed, slow and rigid regulation of business conduct by law."[52]/

History of Failure. In the past, the Commission administered a program in which it directly oversaw certain broker-dealers, a program which ultimately was ceded as a failure. The SECO (SEC-only) program, initiated under former Sections 15(b)(8), (9), and (10) of the Exchange Act, applied to any broker-dealer registered under Section 15 of the Exchange Act that was not a member of a national securities association, *i.e.*, the NASD ("non-member" broker-dealers).[53]/ Enacted in 1964, these provisions empowered the Commission to establish for non-member broker-dealers and their associated persons a regulatory regime comparable to that adopted by the NASD for its members and their associated persons. In Rules 15b8-1, 15b9-1, and 15b10-1,[54]/ the

Commission established specific procedures and norms of conduct closely paralleling those of the NASD in areas such as qualification of associated persons, fees and assessments, standards for supervision of securities employees, discretionary accounts, and suitability of recommendations.[55]/ Specifically, Rule 15b8-1, enacted in 1965, empowered the Commission to proceed directly against registered SECO broker-dealers for failure to comply with these established standards.[56]/

Congress abolished the SECO program and the SEC rescinded Rule 15b8-1 in 1983.[57]/ In testimony before the House Subcommittee on behalf of the Commission, SEC Chairman John S. R. Shad testified about a comprehensive management study of the SECO program, which concluded that the SECO program was unnecessarily costly and diverted the SEC's limited resources away from areas of major concern, merely to duplicate the functions of the NASD. In fact, the study projected that greater expenditures would be required in the future to ensure that SECO firms were regulated as stringently as NASD firms.[58]/

Chairman Shad also testified that SROs were better able than the Commission to maintain ethical standards for the industry and to perform certain oversight functions. The House Report on the matter also cited the limitations of enforcement and compliance remedies available to the Commission in comparison to the remedies available to the NASD.[59]/

The failure by the Commission was specifically examined by the Commodity Futures Trading Commission ("CFTC") in conjunction with its review of the National Futures Association's application for registration.[60]/ As a result of the CFTC's review, it concluded that a program that required direct CFTC regulation for certain futures commission merchants would be difficult to administer, and the CFTC lacked sufficient resources to devote to such direct regulation.[61]/

In addition, currently, no constituency favors the "SEC-Only" concept. For example, no commentators or industry participants have advocated the model. Even if Congress supported the SEC-Only Model in theory, it would be reluctant to approve the necessary SEC budget increases – even if they were paid out of existing SEC fees. Current surplus SEC fees are used for other purposes. Given the combined opposition of Congress, the SEC, NASD and NYSE, among others, the likelihood of this model becoming a reality is quite small.

IV. CONCLUSTION

The changing market environment and the need to bolster investor confidence demand a review of the current regulatory structure of the securities industry. The analysis of the various regulatory alternatives in this paper is intended to facilitate a discussion as to the most beneficial way to respond to these new developments.

In addition, this analysis is intended to establish the conceptual framework for evaluating the issues specific to the SRO funding structure in the future. Each of the six regulatory

models discussed above is compatible with competing alternatives for assessing and allocating the costs of regulation. At present, SROs rely on four primary sources for the funding: (1) regulatory fees and assessments, which are paid by an SRO's members; (2) transaction services fees, which are paid by anyone who uses an SRO's facilities for executing, reporting and clearing transactions; (3) listing fees, which are paid by corporate issuers; and (4) market information fees, which are paid by all those who use or distribute the financial information disseminated by the SROs, including information vendors, broker-dealers, institutional investors, retail investors, the options and futures markets and others.[62]/ The issue of whether and how these sources of funding should be restructured and redistributed is subject to an ongoing SEC debate. The outcome of that debate is expected to further inform the Subcommittee's assessment of the different regulatory models.

[1] *See, e.g.*, "Wide SEC Review May Revamp Structure of U.S. Stock Markets," *The Wall Street Journal*, A1, Sept. 19, 2003; "States Press SEC to Fix NYSE," The Wall Street Journal, C1, Sept. 25, 2003; "At Behest of AIG Chief, Grasso Pushed NYSE Firm to Buy Stock," *The Wall Street Journal*, A1, Oct. 3, 2003.

[2]/ Throughout this paper, we use the term "SRO" to mean any national securities exchange or registered securities association. Therefore, the term "SRO" will encompass all the functions of the exchange or association, including both its self-regulatory responsibilities and its role as a marketplace. The term "SRO," as we use it here, will not be limited to the regulatory function. If we are making a distinction between the market and regulatory functions of an exchange or association, we will specifically refer to the individual roles, using such terms as "marketplace" and "regulatory arm."

[3]/ SIA is mindful of the state regulators' continued involvement in the regulatory process, which provides important investor protection safeguards in addition to those afforded by SROs.

[4]/ Section 2 of the Exchange Act.

[5]/ *See* Section 11A of the Exchange Act (national market system should assure "fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets").

[6]/ Section 3(f) of the Exchange Act states: "Whenever . . . the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."

[7]/ Other entities, such as clearing agencies and the Municipal Securities Rulemaking Board, meet the definition of an SRO set forth in Section 3(a)(26) of the

Exchange Act. SROs other than the national securities exchanges and associations, however, are outside the scope of this paper.

[8]/ Rule 17d-2 under the Exchange Act permits SROs to establish joint plans for allocating the regulatory responsibilities imposed by the Exchange Act with respect to common members. An SRO participating in a regulatory plan is relieved of regulatory responsibilities for a broker-dealer member of such SRO if those regulatory responsibilities have been designated to another SRO under the regulatory plan.

[9]/ *See*, *e.g.*, Australian Stock Exchange: Fact Book, Information Memorandum (1999) (demutualized since 1998, the Australian Stock Exchange continues its self-regulatory regime, overseeing market integrity, participation, conduct and listings). *See also* Chicago Mercantile Exchange Plan for Demutualization (Nov. 2, 1999) (CME states that it believes it can continue to perform its self-regulatory functions effectively as a for-profit exchange).

[10]/ Regulatory Examination Survey Report, Securities Industry Association (June 1998) ("Examination Report").

[11]/ *See*, *e.g.*, NASD Notice to Members 98-18 (Oct. 1998) (entitled "NASD Regulation Requests Comment on Whether Some Rules Should be Repealed As Obsolete or Amended To Provide Institutional Customer Exception").

[12]/ *See* Exchange Act Rel. No. 3719 (Sept. 6, 1996), 61 Fed. Reg. 48290 (1996) (adopting release for Order Handling Rules).

[13]/ *See* Exchange Act Release No. 40760 (Dec. 8, 1998), 63 Fed. Reg. 70844 (1998) ("ATS Release").

[14]/ Since the adoption of the Order Handling Release, the Commission has recognized a number of systems as ECNs. *See* ATS Release at 70865, n. 178 (mentioning, as examples, Instinet, Bloomberg Tradebook, Island, Archipelago, REDI, Attain, Brut, the Strike system, and PIM Global Equities – some of which have merged or otherwise consolidated in recent years). Similarly, the number of other ATSs – in addition to the ECNs – has risen dramatically since the adoption of Regulation ATS.

[15]/ *See*, *e.g.*, "Levitt Urges Central Market To Price Stocks," Wall St. Journal (Sept. 24, 1999) ("At present, the rapidly expanding ECNs account for about 30% of the volume of Nasdaq trading"). ATSs, however, have not had as great a competitive impact in the market for NYSE securities. The repeal of Rule NYSE 390, however, may pave the way for greater off-exchange trading of NYSE issues. *See*, *e.g.*, "NYSE Scraps Limit on Member Trade In Other Venues, but Seeks an SEC Rule," Wall St. Journal (Dec. 3, 1999).

[16]/ *See*, *e.g.*, "NYSE Studying Electronic System to Fill Small Trades Automatically," Wall St. Journal (Nov. 5, 1999) (responding to the threat of electronic

competitors, the NYSE proposed a new electronic trading system for the automatic execution of small orders); "Nasdaq Agrees to Adopt Auction System To Trade Its Shares and NYSE Issues," Wall St. Journal (Dec. 10, 1999) (taking advantage of the repeal of NYSE Rule 390, the NASD proposed an alliance with Primex and Wall Street's largest brokers to form an electronic auction market for NYSE-listed stocks).

[17]/ *See, e.g.*, Testimony of Frank G. Zarb, Chairman and CEO, National Association of Securities Dealers, Inc., Hearing on Public Ownership of the U.S. Stock Markets, Before the Senate Banking Committee (Sept. 28, 1999) (discussing recapitalization and restructuring of the NASD).

[18]/ *See* Examination Report at 3, 24.

[19]/ The duration of exams varied widely – from 2.8 days for a state exam to 8.8 days for an NASD sales practice exam to 23.8 days for a CBOE sales practice exam – suggesting a lack of logic as to the scope of the exam. *See* Examination Report at 3, 24.

[20]/ The necessity for such cooperative undertakings itself points up the inefficiency in the system.

[21]/ According to the Examination Report, the coordinated process was no magic solution. Only 26% of firms requested coordinate exams and only 60% of those thought the process worked as expected. Examination Report at 3.

[22]/ *Id*. at 3, 24.

[23]/ The Examination Report found that:

Of those firms requesting a coordinated exam, more than half (53.8%) reported that examining authorities did not conduct entrance interviews together; the same proportion (53.8%) reported that examining authorities were on-site at the same time; 85.7% of the firms that had examiners on-site at the same time reported that examiners did divide up their tasks; firms were evenly divided about whether or not examiners requested the same documents; in most instances (83.3%), examiners did not conduct an exit interview together; and, finally, about sixty percent (57.7%) indicated that the coordination process worked as expected.

Examination Report at 3.

[24]/ An exchange's rule filings undergo a detailed internal development process involving in-house review, member comment, board approval and the formal filing.

[25]/ For a report alleging such regulatory arbitrage, *see* "Some Day Traders Make Short Sales of IPOs In Strategy Facing Some Regulatory Hurdles," Wall St. Journal (Aug. 18, 1999).

[26]/ Other corporate structures which effectively separate the regulatory and market functions of the SRO would also be permissible.

[27]/ Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market (Aug. 8, 1996) ("21(a) Report") at 4.

[28]/ *Id*.

[29]/ *Id*. (citing Executive Summary of Report of the NASD Select Committee on Structure and Governance (Sept. 15, 1995)).

[30]/ "SEC, Justice Agree: Much Progress at NASD and Nasdaq," 10 Sec. Indus. News 48 (Dec. 7, 1998).

[31]/ Sections 6(b)(3) and 15A(b)(4) of the Exchange Act.

[32]/ A disadvantage of the DEA Model and the NASDR Model, individually, is the limited problems each model confronts. To address a greater number of these concerns, the DEA and NASDR Models could be combined in one structure. Here, the SROs would be required to reorganize their corporate structure so as to segregate the regulatory and market functions and each firm would be examined by only one SRO, the DEA. By combining the two approaches, a greater number of regulatory issues are addressed, thus increasing the advantages and decreasing the disadvantages of each model standing alone. A full discussion of the benefits and drawbacks of the NASDR and DEA Models are set forth above in Sections III(2) and (3), respectively.

[33]/ *See* Sections 17 and 19 of the Exchange Act and the rules thereunder.

[34]/ With respect to a common member, Section 17(d)(1) of the Exchange Act authorizes the Commission, by rule or order, to relieve an SRO of the responsibility to receive regulatory reports, to examine for and enforce compliance with applicable statutes, rules and regulations, or to perform other specified regulatory functions.

[35]/ *See* Exchange Act Rel. No. 23192 (May 1, 1986), 51 Fed. Reg. 17426 (1986).

[36]/ *See* Section 108 of the National Securities Markets Improvement Act of 1996, Pub. L. 104-290.

[37]/ *See* Levitt Speech.

[38]/ Presently, in large part, the NASD surveils, administers and enforces the Municipal Securities Rulemaking Board's ("MSRB") rules applicable to municipal securities dealers and the Department of Treasury's rules applicable to government securities dealers. As currently envisioned, the Firm SRO would assume these responsibilities.

[39]/ Presumably all markets, including ATSs registered as such, would operate in this manner.

[40]/ The MSRB is the primary rulemaking authority for the municipal bond market. Although Congress gave the MSRB the task of proposing and adopting rules governing dealers in municipal securities subject to the oversight of the SEC, Congress did not give the MSRB the power to enforce its rules. Responsibility for the examination and enforcement of MSRB rules is delegated to the NASD for all securities firms and to the Federal Deposit Insurance Corporation, the Federal Reserve Board and the Comptroller of the Currency for banks.

[41]/ It is important to note that the cost savings realized by combining the self-regulatory functions into one organization may not be as great as anticipated. The new regulatory body would require an administrative structure and support staff that currently is shared with their host SRO. Funding for the operations of a single regulatory body would continue to be provided by the industry members, so that there may not a significant decline in their overall operating costs.

[42]/ For the most part, an SRO's regulatory expenditures are not required to be disclosed to the public, and therefore, the SROs' financial statements generally do not disclose the costs associated with various regulatory functions or services. The one exception is the NASD which separates the expenses of the NASDR and Nasdaq. *See* Exchange Act Rel. No. 42208 (Dec. 9, 1999), 64 Fed. Reg. 70613 (1999). The lack of useful cost information makes a detailed analysis of the cost benefits of the Hybrid Model difficult. Such a study was performed in 1975 and that study concluded that a potential savings to the industry of approximately 35% of previous regulatory expenditures was possible, primarily as a result of the "elimination of various areas of regulatory duplication." *See* Memorandum from Richard N. Priest, Vice President, NYSE, to Jack Schindel, Treasurer, NASD (June 12, 1975).

[43]/ In 1996 Congress provided the Commission with broad authority to exempt any person from any of the provisions of the Exchange Act. *See* Section 36 of the Exchange Act.

[44]/ *See, e.g.*, Section of the Exchange Act (an exchange must be able "to enforce compliance by its members and persons associated with its members, with the provisions of this title, the rules and regulations thereunder, and the rules of the exchange").

[45]/ *See* Speech by SEC Chairman Arthur Levitt, Columbia Law School, New York, N.Y. (Sept. 23, 1999) ("Levitt Speech").. *See also* Speech by SEC Commissioner Laura Unger, Bond Market Association, Fifth Annual Legal and Compliance Seminar, New York, N.Y. (Oct. 28, 1999). *See also* "Battle Lines Forming Over Single SRO Plan," Securities Industry News (Oct. 18, 1999) (stating that Commissioner Unger supports single SRO plan.)

[46]/ *See, e.g.*, "SEC's Nazareth Finds 'More Intriguing' Hybrid Structure for Market Regulation" (Oct. 15, 1999) ("A hybrid model [as opposed to a single SRO], Nazareth told the [National Society of Compliance Professionals] makes sense. She reasoned that each market – which more often than not will be electronic rather than having a trading floor – has an interest in retaining its own integrity.")

[47]/ *See* Report of the Subcommittee on Securities, Senate Committee on Banking, Housing and Urban Affairs (19743) (SIA Chairman Robert Gardiner stated that self-regulatory activities would be more effective if broken down into two separate and distinct self-regulatory areas – one for trading and markets and the other for firm and capital requirements).

[48]/ Rule 300(a) under the Exchange Act.

[49]/ For example in Regulation ATS, ATSs are specifically defined as exchanges which do not perform self-regulatory functions. *See* Rule 300 under the Exchange Act.

[50]/ Securities Industry Study, Report of the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, United States Senate (April 6, 1973) at 145.

[51]/ Hearing on H.R. 7852 and H.R. 8720 Before the House Committee on Interstate and Foreign Commerce, 73rd Cong., 1st Sess. at 514 (testimony of John Dickinson).

[52]/ S. Rep. No. 1455, 75th Cong., 3d Sess. 3 (1938).

[53]/ For a discussion of the SECO rules, *see* Exchange Act Rel. No. 7697 (Sept. 7, 1965), 30 Fed. Reg. 11673 (1965); Exchange Act Rel. No. 8135 (July 27, 1967), 32 Fed. Reg. 11637 (1967); and Exchange Act Rel. No. 8308 (May 8, 1968), 33 Fed. Reg. 7075 (1968).

[54]/ *See* Rules 15b8-1, 15b9-1, and 15b10-1 under the Exchange Act.

[55]/ Exchange Act Rel. No. 32018 (Mar. 25, 1993), 58 Fed. Reg. 16151-01 (l993).

[56]/ *Id.* n.11 (listing Commission actions).

[57]/ *See* Public Law 98-38, Sec. 3, 97 Stat. 205, 206-07 (1983), codified at Sections 15(b)(8) and 15(b)(9). *See also* Exchange Act Rel. No. 20409 (Nov. 22, 1983), 48 Fed. Reg. 53688 (1983).

[58]/ The House Committee report stated "that any attempt to put SECO regulation on a par with that provided by the NASD would require significant expenditures by the Commission for additional staff and administrative costs." H.R. Rep. No. 98-106, at 7 (1983).

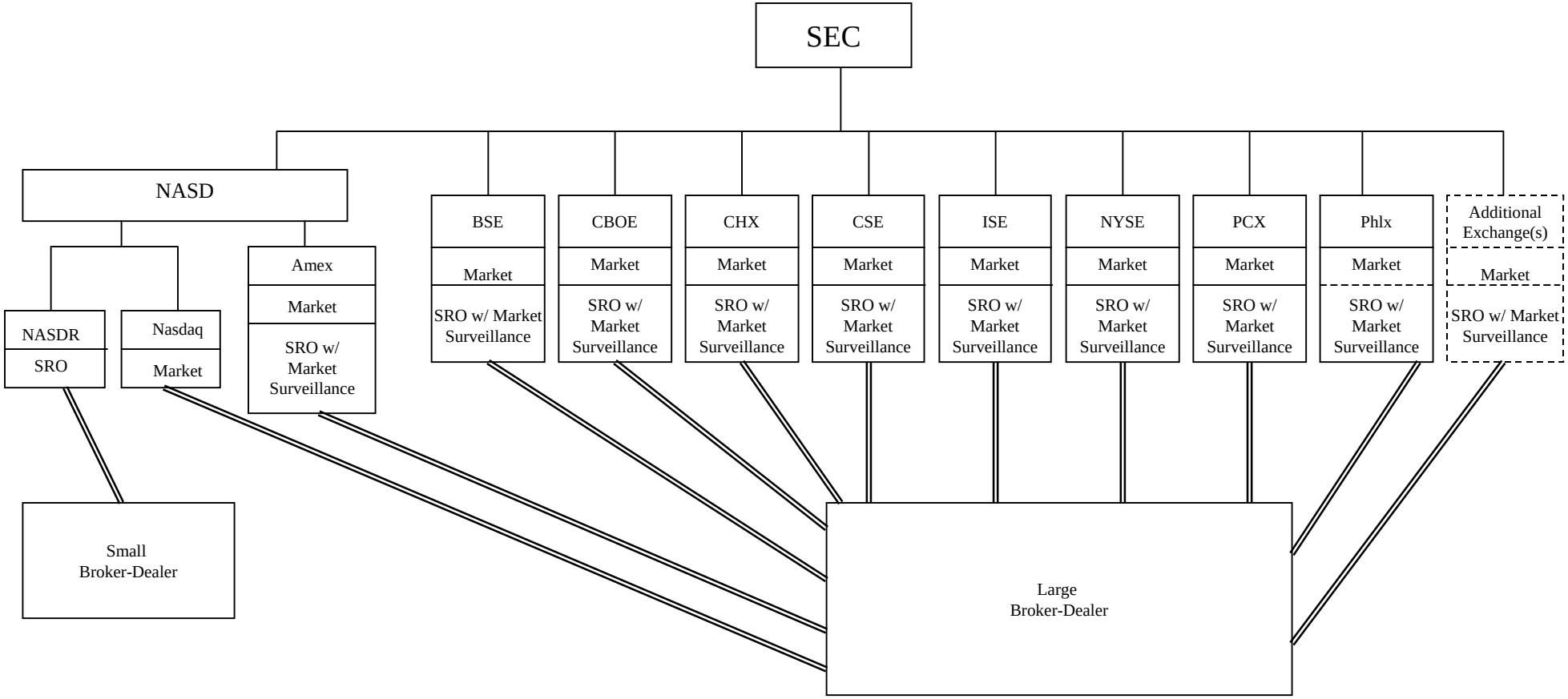
[59]/ *Id.* at 6.

[60]/ Registered Futures Associations; Mandatory Memberships, 17 CFR Part 170 (June 7, 1983), 49 Fed. Reg. 26304-01 (1983).

[61]/ *Id.*

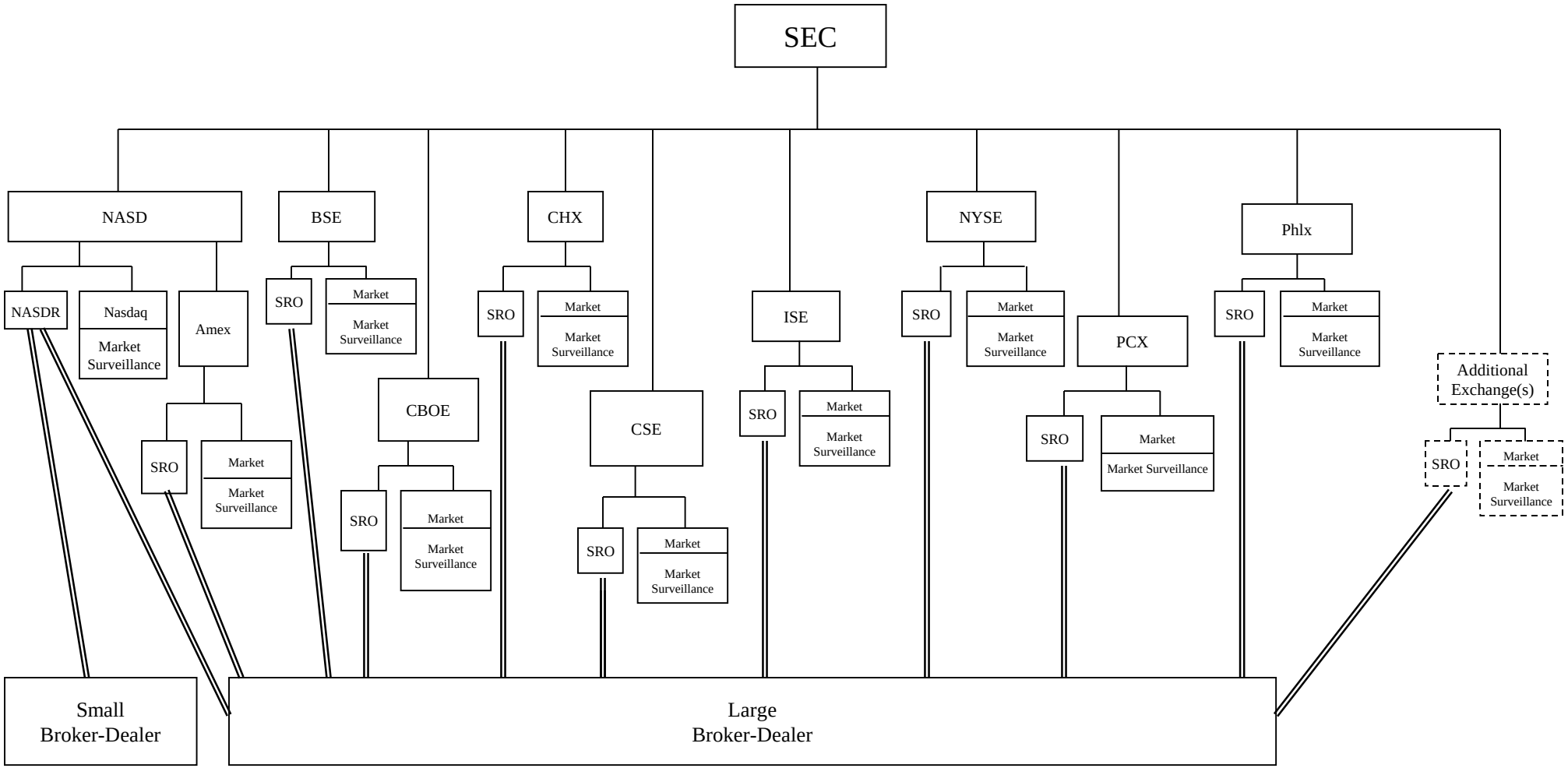
[62]/ Exchange Act. Rel. No. 42208 (Dec. 9, 1999), 64 Fed. Reg. 70613 (1999).

OPTION 1: Status Quo



Option 1: The regulatory structure remains the same as today.

OPTION 2: NASDR Model



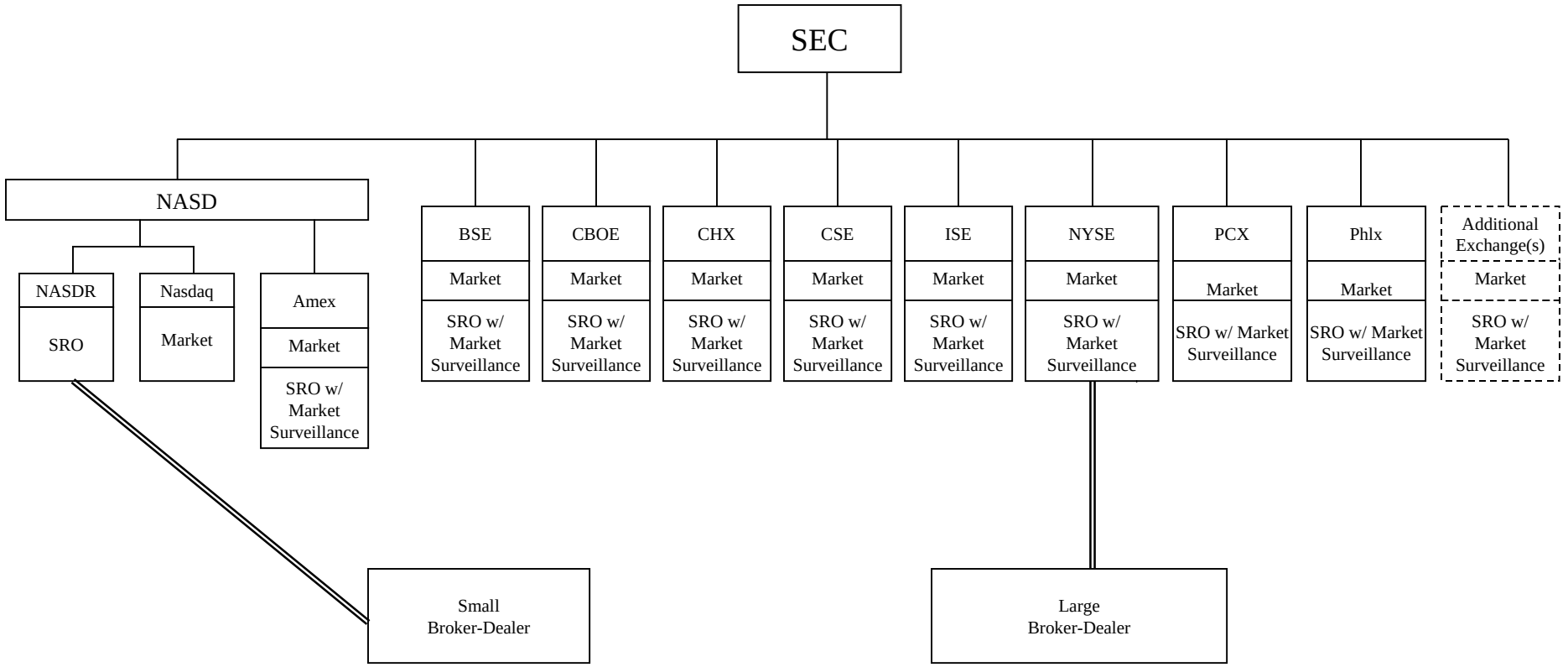
Option 2: The multiple SROs continue to exist and each SRO would continue to operate its market and regulate its market and members. Each demutualized SRO, however, would separate its self-regulatory functions from the market-place it regulates by creating a NASDR-like subsidiary for the SRO's examination, rulemaking and disciplinary authority.

Future Exchanges

SRO/Examination

Market Surveillance

OPTION 3: DEA Model



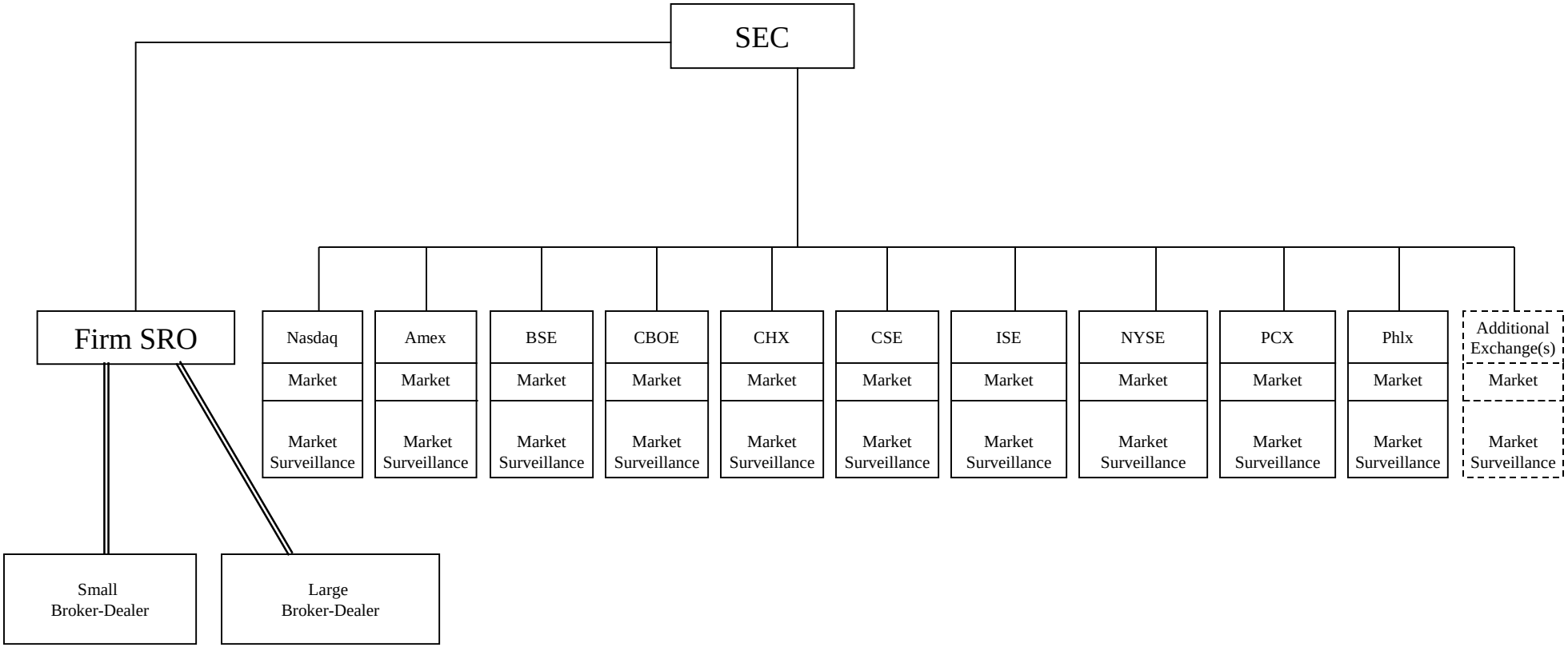
Option 3: The multiple SROs continue to exist and each SRO would continue to operate its market and regulate its market and members. Each firm, however, would be designated to a single SRO for examination purposes.

Future Exchanges

SRO/Examination

Market Surveillance

OPTION 4: Hybrid Model



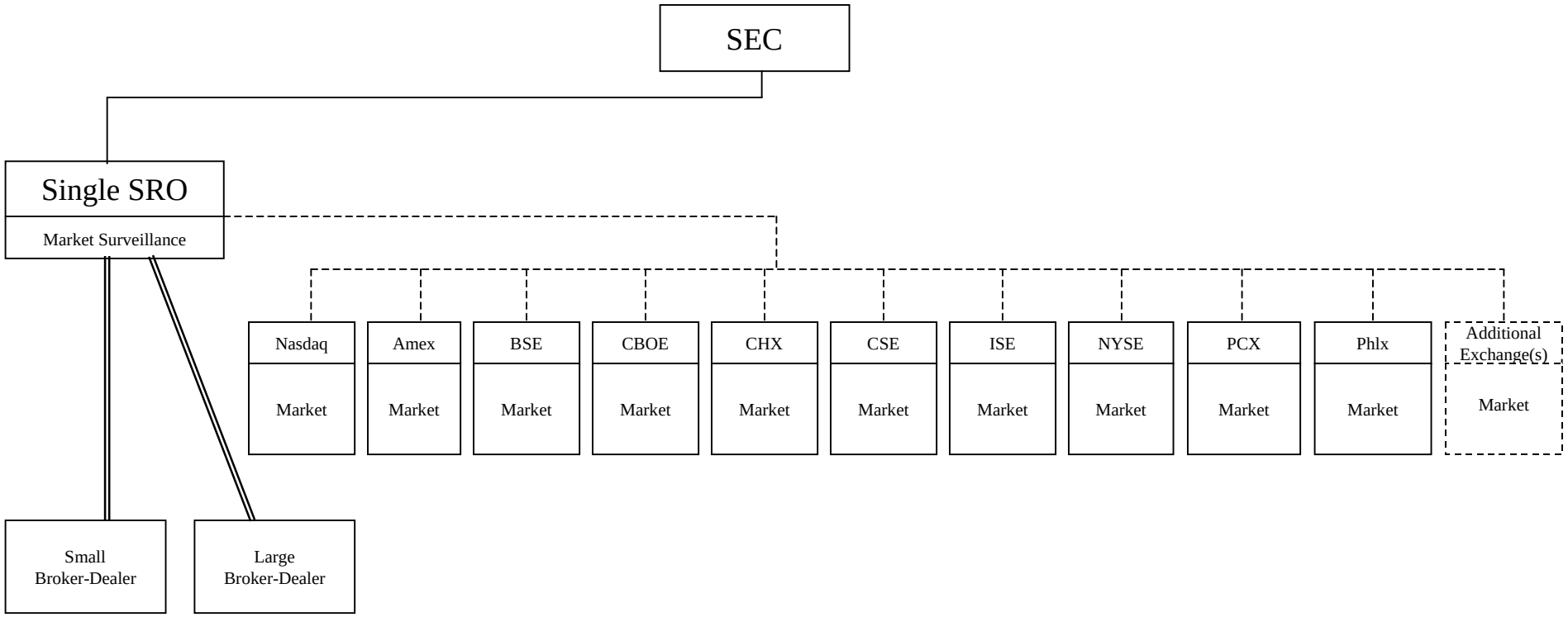
Option 4: Each market would retain its market-related self-regulatory responsibilities. A single SRO – the "Firm SRO" – would, however, assume, for all registered broker-dealers, all the non-market-related rulemaking, surveillance and enforcement functions performed currently by the exchanges and the NASD. A further sub-alternative is to limit the marketplaces only to rulemaking and/or surveillance, but require the Firm SRO to conduct all enforcement activities.

Future Exchanges

SRO/Examination

Market Surveillance

OPTION 5: Single SRO Model



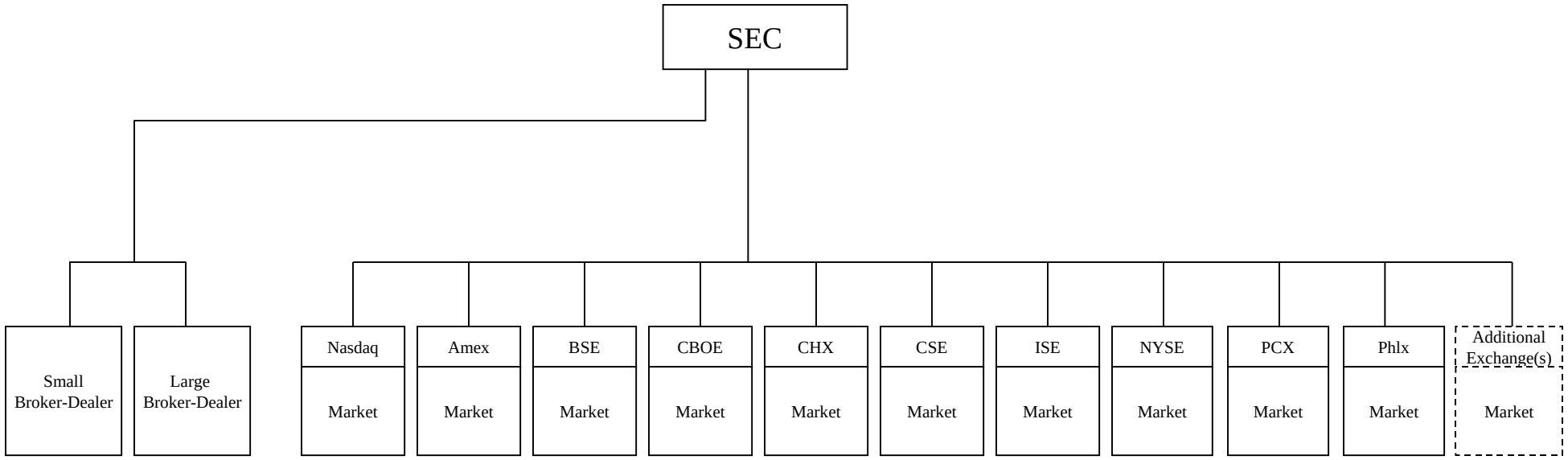
Option 5: The SROs would be stripped of their self-regulatory responsibilities, thereby becoming mere marketplaces. A single SRO would be responsible for all the regulatory functions currently performed by the SROs, including both market-related and non-market-related responsibilities.

Future Exchanges

SRO/Examination

Market Surveillance

OPTION 6: SEC-Only Model



Option 6: The SROs would be stripped of their self-regulatory responsibilities, thereby becoming mere marketplaces. An enhanced SEC would be responsible for all the regulatory functions currently performed by the SROs.