

**Statement of
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**before the
Subcommittee on Capital Markets, Insurance, and Government
Sponsored Enterprises Committee on Financial Services
U.S. House of Representatives**

**Hearing Entitled
"Reviewing U.S. Capital Market Structure: The New York Stock Exchange and Related
Issues"**

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Introduction

Chairman Baker, Ranking Member Kanjorski, members of the Subcommittee, I am Marc E. Lackritz, President of the Securities Industry Association.¹ SIA commends you for holding this hearing and appreciates the opportunity to testify on the important topic of the U.S. Capital Market Structure.

Mr. Chairman, our securities markets have long been the most transparent, liquid and dynamic in the world. Their success has and will always depend on one word: *trust*. Without trust our markets would not exist. This trust begins with investors' trust in the brokers and other intermediaries who handle their money and execute their instructions. It extends to trust between all of the counterparties in the markets that their transactions will settle in a timely and accurate manner. It also encompasses trust that regulators will make fair and well-informed decisions about how to regulate these complex markets, and will enforce their rules evenhandedly.

In the past two years we have faced serious threats to these multiple layers of trust. Investors' trust has been shaken by a long bear market, accounting and audit failures, revelations of wrongdoing at the highest corporate levels, and serious allegations of wrongdoing by some financial market participants. Congress and regulators have taken decisive steps, through enactment and implementation of the Sarbanes-Oxley Act and tough enforcement actions, to restore trust in these areas. Now questions are being raised about trust in an important part of the regulatory underpinnings of our markets. Specifically, revelations about governance difficulties at the New York Stock Exchange ("NYSE") have spawned criticisms about purported conflicts between the NYSE's role as a marketplace and its role as a regulator of its own activities and those of its members. It is entirely appropriate for the Subcommittee to examine these issues.

SIA has given a great deal of thought over many years to the structure of self-regulation. Three years ago, in connection with the debate that was then ongoing about the role of self-regulation in light of proposals by both the NYSE and The Nasdaq Stock Market ("Nasdaq") to become for-profit entities, SIA commissioned a White Paper titled "Reinventing Self-Regulation." The

purpose of the White Paper was to examine the purpose of self-regulation in light of major technological and competitive changes taking place in the securities industry, and to consider the advantages and disadvantages of different models for regulation of our Nation's securities markets. A copy of the White Paper, updated to reflect changes since its publication in 2000, is attached to my testimony.

Based on our experience with these issues, SIA believes that this debate should be shaped by several important considerations:

- **Investor Protection** – Regulation of markets and the securities industry should put investors' interests first and foremost. Effective, consistent and transparent regulation is essential to keeping investors' trust, the most essential element in the success of our markets.²
- **Competition** – Regulation should promote competition, rather than favoring or protecting one market over another.
- **Uniform National Standards** – The regulatory system should ensure the primacy of the SEC as a strong national regulator. The system also should include appropriate roles for, and coordination with, the self-regulatory organizations ("SROs"), the states, and broker-dealer firms, to achieve uniform national standards.
- **Expert Regulation** – The regulatory system should be structured in such a way as to ensure that the regulatory staff overseeing day-to-day activities possess the requisite expertise necessary to perform their duties. This can best be achieved if the regulator has: (i) effective industry input into the regulatory process; (ii) the power and prestige to attract talented staff; and (iii) the ability appropriately to tailor regulation to fit the diversity of entities that it regulates, rather than relying upon a "one-size-fits-all" approach.

As explained in more detail below, the current model of self-regulation has generally worked well for our Nation in meeting each of these goals, and SIA believes that this model should be preserved. However, self-regulation can only survive if the public maintains its trust that the system works properly. SIA believes that action should be taken in the near-term to address concerns about the NYSE's dual role as both marketplace and regulator. One near-term step should be to separate clearly the NYSE's member regulatory function from its function as a marketplace. My testimony below will highlight considerations that should shape how that can best be done. Additional action to address the structure of self-regulation more broadly may take longer, but should also be considered. We have every confidence that the Securities and Exchange Commission ("SEC"), under Chairman Donaldson's leadership, together with John Reed at the NYSE, will be able to respond to these concerns and separate the regulatory and marketplace roles of the NYSE in a manner that will lay to rest questions about the effectiveness of the NYSE's regulation of its marketplace and members.

Self-Regulation – A System Worth Strengthening

SIA believes that a self-regulatory system with the proper checks and balances can provide a greater level of investor protection than might otherwise be achievable. Self-regulation contemplates self-policing by professionals who have the requisite working knowledge and

expertise about the intricacies involved in the marketplace and the technical aspects of regulation, supplemented, of course, by government oversight. This tiered regulatory structure provides checks and balances, and can be both more effective and less costly than regulation by the government alone.

SROs are able to develop standards that can fill in the margins of federal statutes or regulation. Because self-regulators have an intimate knowledge of industry operations, trading, and sales practices, they have an ability to develop and revise rules on a frequent basis, keeping them up-to-date with market realities. Moreover, SRO rules often are designed to set ethical standards that exceed the legal minimums. For example, the NASD requires that its member firms adhere to "just and equitable principles of trade,"³ a standard that in many instances exceeds the anti-fraud requirements of SEC statutes and rules. Because self-regulation utilizes the insight of those who are on the front line of marketplace developments, it can be more forward looking than traditional government regulation in anticipating problems. These characteristics mean that self-regulation can respond more quickly and directly to industry problems than direct government regulation.

A good recent example is the work of NASD on mutual fund breakpoints. In that instance, in late 2002 routine examinations by NASD examination staff identified a number of instances in which, due to flaws in internal operational systems and other complexities, broker-dealers had failed to deliver volume discounts known as "breakpoints" to investors purchasing mutual fund shares that offered breakpoint discounts. NASD responded by directing most major firms to conduct a "self-assessment" of their record of delivering breakpoint discounts to customers. NASD ensured that firms refunded their customers for any past breakpoint discounts that had been missed. NASD also assembled a joint "breakpoint task force" of representatives of the legal and operational side of the industry, as well as representatives from the buy-side and the utilities, to work with it on addressing the systems issues that led to the problem. The Task Force developed a series of recommendations to address the problems and is in the process of implementing those changes now. Thus, in a matter of months, NASD was able to work with the industry to identify and make recommendations for addressing a widespread operational problem and make whole any investors who had been disadvantaged by the problem.

Self-regulation is only one component in a larger regulatory system. SEC oversight is essential to that system. The SEC has been vigilant in overseeing the regulatory activities of SROs and has brought enforcement actions when necessary.⁴ The SEC also can and has discharged the functions that self-regulators currently perform. But in most instances, the division of labor among the SEC and the SROs reflects a strategy for optimizing investor protection, while reducing claims on the federal budget. Accordingly, SIA believes that self-regulation plays a unique role in serving investors and should be maintained and strengthened.

Challenges Facing Self-Regulation

The most recent controversy regarding governance at the NYSE and compensation to its senior staff, along with charges that the NYSE has been slow to address some allegations of improper market behavior, have led some to question whether markets and member regulation can coexist. But before this most recent controversy, other events raised questions about the need to alter the

current self-regulatory system. SIA has long advocated making timely improvements to self-regulation when appropriate, and strongly supported the elimination of unnecessary inconsistencies between federal regulation and self-regulation. Several factors may now suggest that the time is ripe for change.

1. Conflicts of Interest

When it enacted the Exchange Act and adopted the self-regulatory model, Congress recognized that there is an inherent conflict between the interest of an SRO in regulating itself and its members and its interest in promoting itself and its market. For example, an SRO might seek to impose regulatory requirements that are motivated more by a desire to generate fees for, or direct order flow to, its particular market rather than by a true regulatory need. To date, self-regulation paired with SEC oversight has worked as a check-and-balance system to contain more serious conflicts of interest. However, increased competitive pressures may exacerbate these conflicts of interest. Demutualization of exchanges (*i.e.*, the conversion of exchanges to for-profit entities) could also make these conflicts of interest more intense, as management may face increased pressure to cut the cost of regulatory functions, or use regulation for improper anticompetitive purposes, in order to maximize profits. Public trust and confidence in self-regulation will be badly damaged if the SEC and the SROs do not manage these conflicts effectively.

2. Competitive Considerations

In accordance with its congressional mandate, the SEC has fostered competition among markets in the National Market System.⁵ As a result, we have seen the development of many new or restructured trading systems, which has called into question the traditional pairing of markets and self-regulation. The development of Electronic Communications Networks ("ECNs") and other Alternative Trading Systems, the separation of Nasdaq from the NASD, the demutualization of Nasdaq and its application for exchange registration, are a few of the developments that have altered the existing landscape. ECNs compete with Nasdaq and the NYSE, yet must become members of an SRO.

One result of these changes is that now there is a greater theoretical danger that SROs can use their regulatory authority to harm competitors.⁶ For example, an SRO could cite a member firm for failure to discharge its duty of best execution by routing orders to a competing marketplace.⁷ For-profit markets, with fiduciary duties to shareholders, may face complex decisions about whether and how to sanction members for regulatory failures. Annette Nazareth, the Director of the SEC's Division of Market Regulation, recognized this critical point when she stated that "the trend toward demutualization and public ownership of exchanges raises several issues that merit further analysis . . . [D]oes the fiduciary responsibility of a board member to maximize shareholder value conflict with his or her duty to run a well-funded and vigorous self-regulatory operation? What steps can be taken to mitigate any potential conflicts?"⁸

In addition to competition within the National Market System, competition in the global marketplace also has to be considered. Here the concern is not so much potential conflicts of interest within U.S. regulators as it is inefficiencies in the system of regulation that create costs for U.S. broker-dealers and U.S. market centers that foreign competitors do not face. As

discussed below, many aspects of the current structure of U.S. securities regulation create issues of unnecessary duplication of effort and uncoordinated examination or enforcement actions. The problem is not limited to SROs, but also encompasses uncertainties about the respective roles of state regulators and the SEC in setting standards for participants in national markets.

3. Regulatory Redundancy and Inconsistency Hurt Investor Protection

The industry has long believed that duplicative and inconsistent regulation diminishes investor protection and contributes to the cost of regulation. All major broker-dealers and many smaller firms are members of more than one SRO. SROs currently impose differing regulatory requirements upon member firms. In May 2002, the General Accounting Office issued a report outlining concerns about multiple self-regulatory efforts and related competitive issues.⁹ As a follow up to that report, the NYSE and NASD solicited comment on ways to improve regulatory consistency and the examination process. SIA made a number of suggestions in response.¹⁰

Inconsistent regulation may compromise investor protections for a number of reasons. Investor protections should not be subject to the happenstance of whether a broker-dealer is a member of one SRO as opposed to another. Differing requirements can raise the specter of "regulatory arbitrage" (moving from regulation under one SRO to regulation under a different one with more lenient requirements), undermining the efforts of some SROs to set better standards than others. Uniformity is not a goal in and of itself, and some differences, especially with respect to trading practices, may be justified.¹¹ But investor protection goals should drive the self-regulatory process, not historical accident or circumstance.

Redundant regulation also hurts investors. Investors ultimately pay for costs of compliance, through higher fees or costs. We owe it to investors to give them the best protection at the lowest cost. Having ten existing SRO rulebooks,¹² rather than one rulebook, increases the costs for each segment of the securities markets – the investors, the issuers, the broker-dealer members, the SEC and the SROs. 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 SEC staff's burdens increase as the number of exchange rule filings increase, resulting in delays in the regulatory approval process. The duplication of effort can be particularly noticeable when the various SROs each separately file similar or identical rule changes. For example, recently the NYSE and the NASD both adopted rules regulating analysts. Although the SROs have made substantial efforts to coordinate their respective rules, they are not identical. In part because of the inconsistencies and resulting confusion, SIA has taken the unusual step of asking the SEC to adopt rules that would supplant both the NYSE and NASD rules.¹³

Another example of duplicative regulation lies in the area of on-site SRO examinations of broker-dealers. Section 108 of the National Securities Markets Improvements Act of 1996 directed the SEC to improve coordination of SRO examinations.¹⁴ That effort has reduced somewhat the duplication for, and unnecessary burdens on, firms. The SEC's Office of Compliance, Inspections, and Examinations has worked diligently with the SROs to improve the

situation, but these efforts have not permanently "solved" the problem and coordination remains a challenge.

Prospects for Change

SIA believes that there are opportunities to improve the self-regulatory structure and stands ready to contribute to that effort. SIA hopes that an improved regulatory structure can preserve the goals we share – effective and efficient regulation, which includes self-regulation.

Recently, critics allege that the corporate governance structure of the NYSE prevented meaningful oversight of staff compensation. At the urging of Chairman Donaldson, the NYSE is reconsidering that structure.¹⁵ SIA welcomes efforts to improve corporate governance and transparency within the SROs.

The White Paper that SIA prepared in 2000 to examine these concerns evaluated the advantages and disadvantages of six different approaches to self-regulation. These ranged from maintaining the *status quo*, at one end, to simply abolishing self-regulation and moving the job of the SROs into the SEC, at the other extreme. While our White Paper does not recommend any single approach, it is a useful document for charting the opportunities and dangers on the road ahead.

This discussion would not be complete without consideration of how regulation can coexist with a market. One possible solution to these issues is to separate to some degree the trading activities of the market place from the regulatory functions. There are different ways to implement such an approach, such as by removing regulatory activities from the marketplace reporting lines and by putting them in a separate unit within that same organization. Regulatory activity would then be better able to enjoy both the benefits of self-regulation, while at the same time having meaningful and effective oversight, perhaps by public board members or committees. SIA believes that the time has come to consider in some manner separating out the NYSE's regulatory functions from its marketplace functions.

SIA stands ready, willing and eager to work with the Congress, the SEC, the SROs, and all other interested parties to address these important concerns.

Conclusion

Despite our recent problems, America's securities markets remain the envy of the world. The United States continues to offer investors and companies the most transparent, liquid and dynamic markets available, with unparalleled levels of investor protection. SIA wants to see the continued success of a thoughtfully regulated securities market in the U.S., one that maintains the trust of investors and all market participants. We are confident that, by working together, we can seize this opportunity to make improvements to the regulatory system that guards investors' interests. We hope to continue to play a role in this critical effort.

Thank you.

Footnotes:

1. The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Bankers Association, brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated \$222 billion in domestic revenue and \$356 billion in global revenues.

2. Section 3(f) of the Securities Exchange Act of 1934 (the "Exchange Act") provides that:

Whenever pursuant to this title the Commission is engaged in rulemaking, or in the review of a rule of 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.

3. NASD By-Laws, Art. XI, §.1; Conduct Rule 2110.

4. Most recently, the SEC accepted an offer of settlement from the Chicago Stock Exchange concerning its regulatory program. Release No. 34-48566 / September 30, 2003.

5. Section 11A of the Exchange Act directs the SEC to "facilitate the establishment of a national market system for securities [in which there is] fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets...."

6. SIA is not alleging that any SRO has used its authority inappropriately; we only note that such a risk exists. The separation of NASD and Nasdaq is premised, in part, on this concern.

7. Again, as a theoretical matter, the improper use of regulatory power might actually harm investors in such circumstances, by forcing broker-dealers to execute trades in markets offering inferior executions.

8. Remarks of Annette L. Nazareth, Director, Division of Market Regulation, SEC, before the Fourth Annual Securities Industry Association Conference on Market Structure, June 13, 2003.

9. GAO, *Securities Markets, Competition and Multiple Regulators Heighten Concerns about Self-Regulation*, GAO-02-362

10. Letter from Michael H. Stone, President SIA Compliance and Legal Division and Christopher Franke, Chairman, SIA Self-Regulation and Supervisory Practices Committee, to Barbara Sweeney, NASD, and Donald Van Weezel, NYSE, August, 19, 2002.

11. Regulatory uniformity is a complex issue that goes beyond the scope of this testimony. Recently, the SEC published a concept release in response to a Nasdaq petition, which raises a number of these issues. Release 34-47849, File No. S7-11-03. With particular reference to trading rules, as distinguished from "upstairs" regulation, there may be justifications for regulatory differences in different markets. Generally, SIA supports trading and related rules that are consistent with broad principles, even if they are not identical under all circumstances. See letter from Donald D. Kittell, Executive Vice President, SIA, to Jonathan Katz, Secretary, SEC, June 27, 2003.

12. 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.

13. NASD Rule 1050 (Registration of Research Analysts) and amendments to Rule 1120 (Continuing Education Requirements) and Rule 2711 (Research Analysts and Research Reports) and NYSE Exchange Rule 472 ("Communications with the Public") and Rule 351 ("Reporting Requirements"). Such a step also would help coordinate policy with respect to SEC Regulation AC as well as with the Global Settlement on Analysts.

14. *See* amended Section 17(k) of the Exchange Act.

15. Statement of the Honorable William H. Donaldson, Chairman, U.S. Securities & Exchange Commission Testimony Concerning Recent Commission Activity To Enhance Investor Protections before the U.S. Senate Committee on Banking, Housing and Urban Affairs, September 30, 2003:

"I would now like to turn to an issue that is important both from a regulatory standpoint and from the standpoint of the investing public: the critical need for sound governance practices by self-regulatory organizations. I believe that self-regulatory organizations should be exemplars of good governance. At a minimum, SROs should demand of themselves the same high standards of governance that the New York Stock Exchange and Nasdaq proposed for their listed issuers in the wake of several widely publicized corporate scandals. To further that goal, this past March I directed each self-regulatory organization to undertake a review of its own governance practices.

Since then, disclosure of the pay package awarded to the former Chairman of the New York Stock Exchange has heightened the scrutiny that the Commission, the securities industry, the investing public, and the media are paying to exchange governance standards that reflect the highest commitment to independent and transparent decision-making. Prior to the current controversy, the NYSE and a few other self-regulatory organizations instituted special governance committees to further study how their structures and processes might be improved. I applaud these efforts but I believe that more remains to be done. I have assurances that the NYSE's new interim Chairman, John Reed, will reexamine these governance issues in more depth. I look forward to working with Mr. Reed on this important initiative."

See also, "SEC is Looking to the 'Nasdaq Model'," *WSJ*, Oct. 14, 2003 at c11; and "Reed Won't Call For Separating NYSE's Roles" *WSJ*, Oct. 3, 2003