
Self-Regulation Revisited: SEC Seeks Comment on Potential Enhancements to Securities Self-Regulatory System

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Advancements in technology, new market participants, and enhanced competition among markets have caused the Securities and Exchange Commission to analyze the structure of the nation's securities markets. [FN1] Spurred by these and other changes to the market, the SEC also has focused on the manner in which the various securities exchanges and the NASD ("self-regulatory organizations," or "SROs") govern themselves, proposing rule changes that, in its view, would strengthen SRO governance and SEC oversight of SROs. [FN2] In a recent Concept Release, [FN3] the SEC has cast a critical eye toward self-regulation more generally, posing some very fundamental questions about the system of industry oversight that has been an essential part of the securities markets for the last seven decades.

Why the Enhanced Concern About Self-Regulation?

Despite the long-standing history of self-regulation of the securities markets, the SEC increasingly has become concerned that various conflicts, inefficiencies, and funding issues call into question the efficacy the current system as a means of policing the markets. More specifically, the Concept Release notes the potential of some member firms to dominate the funding, governance, and regulatory programs of SROs charged with their oversight. The SEC also is concerned about the potential for internal conflicts between the regulatory and market functions of SROs, and about the possibility that increased competition for listings may make SROs less willing to enforce their listing standards.

Although these concerns certainly merit ongoing regulatory diligence, they decidedly are not new. In fact, many of these issues have existed since the onset of our current system of self-regulation. For example, the potential conflict between the self-regulatory and business interests of an SRO has characterized our markets since the inception of self-regulation; exchanges and the NASD have long operated trading markets while also regulating securities broker-dealers.

What is new, in the SEC's view, are a number of factors that exacerbate these conflicts of interest. For example, consolidation of broker-dealers has caused enhanced regulatory concern that SROs increasingly may be relying on fewer members for the bulk of their funding, raising the specter that SROs may be reluctant to exercise their regulatory responsibilities with respect to such members.

Similarly, the Concept Release indicates concern that the willingness of SROs to appropriately regulate their members might wane as a result of the increased competition for order flow among multiple markets, including electronic communication networks and alternative trading systems. Perhaps most importantly, there seems to be a general angst at the SEC that the move by several exchanges from mutual to for-profit enterprises is likely to detract from self-regulation.

Beyond these concerns, the Concept Release raises a number of questions about the efficiency of having multiple SROs, the resulting gaps in inter-market trading surveillance, and the problems of ensuring an appropriate level of SRO funding. Notwithstanding periodic efforts by broker-dealers, SROs, and the SEC to address duplicative and conflicting SRO rules and inspections, industry participants have noted that the current system continues to be less than optimal in terms of its built-in redundancies. [FN4] As intermarket trading of securities has increased, the SEC has become more concerned about the ability of any single SRO to have access to adequate data to ensure appropriate surveillance of the markets. [FN5]

In the face of these concerns and considerations, and notwithstanding its SRO Governance and Transparency Proposal, [FN6] the SEC has issued the Concept Release, which requests comment on seven alternatives to the current system.

Alternative Regulatory Approaches

Enhancing the current SRO system

The SEC suggests that one solution to the concerns cited above would be to merely deal with the identified limitations of self-regulation: SRO governance and intermarket surveillance. The SRO Governance and Transparency Proposal is designed to address many of the regulatory conflicts. To complement this effort, the SEC also could enhance the ability of regulators to monitor and regulate intermarket trading activity by implementing a more robust intermarket order audit trail for both the options and equity markets. Still, as the Concept Release notes, such incremental improvements would fail to address other inherent SRO limitations, such the inefficiencies of multiple SROs. [FN7]

Independent regulatory and market corporate subsidiaries

Another approach suggested by the Concept Release would involve increasing the regulatory independence of SROs through mandated restructurings. [FN8] For example, one option would be to require all SROs to create independent subsidiaries for regulatory and market operations under a common holding company, as the NASD did in 1996. Under this model, the regulatory staff of each SRO would be placed within an independent subsidiary, which would report directly to the corporate parent's board. This model would provide a clearer organizational separation than most SROs currently have, and promote an independent attitude in the regulatory subsidiary charged with addressing conflicts with members, market operations, issuers, and shareholders.

As noted in the Concept Release, however, this incremental change would not alleviate all current SRO limitations. The independent regulatory subsidiary would remain a component of a larger competitive enterprise and would be subject to business pressure on some level. Moreover, the influence of major members, issuers, and shareholders, and increased intermarket competitive

pressure still could have a detrimental impact on the regulatory budgeting process. Also, this proposal would do little to address concerns about unequal funding among SROs and regulation across markets. Nor would it address conflicting and redundant SRO activities. Finally, the segregation of market and regulatory functions could result in regulatory staff with less sophisticated market-specific knowledge.

Hybrid model

Another option would involve the SEC's designation of a market-neutral single self-regulatory organization ("Single Member SRO") to regulate all SRO members with respect to membership rules, including rules governing members' financial condition, margin practice, handling of customer accounts, registered representative registration, branch office supervision, and sales practices. [FN9] The Single Member SRO would be solely responsible for promulgating membership rules, inspecting members for compliance with those rules, and taking enforcement action against those members that fail to comply. Each SRO that operates a market ("Market SRO") would be solely responsible for its own market operations and market regulation.

This Hybrid model could improve upon the current system in a variety of respects. For instance, because the Single Member SRO would not be affiliated with a particular market, inherent conflicts that currently exist between the regulatory function and market operation of an SRO would be reduced. And because each trading market would have control over enforcement of its own trading rules, this approach would preserve the value of having market regulatory staff embedded within the Market SROs. The Hybrid approach also would eliminate duplicative regulation with respect to membership rules.

On the other hand, the Hybrid approach could reduce self-regulatory knowledge of business practices by removing the Single Member SRO from market operations. It also would present "boundary issues"; there could be problems determining whether a particular requirement should be characterized as a "member" rule or a "market" rule. [FN10] While the Single Member SRO approach could reduce certain conflicts, it would not resolve the conflicts arising from member funding and control, and from reliance on industry members for business experience.

Competing Hybrid model

The Competing Hybrid model is a variation on the Hybrid model. Rather than one Single Member SRO, the Competing Hybrid approach would permit the existence of multiple competing member SROs ("Competing Member SROs") that would register with the SEC and provide member regulatory services. Under this approach, each Market SRO member also would have to be a member of one of the Competing Member SROs.

This model has many of the same benefits as the pure Hybrid model, with two particular differences: (1) it would not require the elimination of one of the two existing primary regulators in favor of another; and (2) it could foster competitive discipline by allowing Competing Member SROs to compete with each other, and thereby discourage them from becoming unresponsive to the industry.

Despite its advantages, the Competing Hybrid approach has several potential significant drawbacks. In addition to the disadvantages discussed with regard to the Hybrid approach, competition could inspire the Competing Member SROs to reduce their fees to attract and keep members; the SEC ultimately would continue to be responsible for determining whether funding remained adequate. Also, this model only would eliminate conflicting rules if the Competing Member SROs adopted a uniform set of member rules, and might encourage "forum shopping" among broker-dealers.

Universal Industry Self-Regulator

Under a Universal Industry Self-Regulator model, the current SROs' self-regulatory authority for all market and member rules would be transferred to one industry self-regulatory organization, the Universal Industry Self-Regulator. Under this approach, all member firms would be registered directly with the Universal Industry Self-Regulator and all markets would be non-SROs registered with the Universal Industry Self-Regulator, similar to the status of alternative trading systems today. This approach likely would require legislation or significant restructuring of the current SROs.

This model could resolve weaknesses of prior alternatives in a variety of ways. For instance, it would erase the "boundary" issues associated with the Hybrid models; it would establish a level playing field among competing markets in that they would all be subject to the same uniform standards of a single SRO; it would eliminate conflicts with market operations, issuers, and shareholders, as well as regulatory redundancies; it would address the inefficiencies of multiple SROs; and it would facilitate the development of a consolidated order audit trail for intermarket trading.

But as with other models discussed, this approach has limitations. The Universal Industry Self-Regulator might lack detailed, market-specific expertise. In addition, the regulator could become unresponsive to industry developments because of its size, scope, and lack of competition. Finally, implementing this model would effectively result in the elimination of the existing SROs' role and, thus, could be met with significant resistance.

Universal Non-Industry Regulator

Another approach, which also would require significant industry reshaping, would be the establishment of a universal, independent non-industry regulator ("Universal Non-Industry Regulator"). Under this approach, one non-industry entity that is independent, non-profit, and non-governmental would be assigned responsibility for all markets and member regulation for all members and all markets.

While not exactly analogous, this model could resemble the regulatory regime recently adopted for audits of public companies. Specifically, the Public Company Accounting Oversight Board was established as an independent, non-profit corporation to (among other things) oversee the audits of public companies. The board of the Universal Non-Industry Regulator would consist of full-time members, and would be tasked with overseeing member and market rules for all members and all markets. The SEC would have ongoing oversight responsibility for supervising the universal regulator, including appointing and removing members, approving its budget, and approving its

rules.

This model would have several advantages over other approaches. For instance, it would substantially eliminate conflicts with members, market operations, issuers, and shareholders; eliminate "boundary" concerns; reduce redundancies and other issues associated with multiple SROs; and facilitate cross-market surveillance.

This model also has potential downsides. For example, it could result in a lower degree of market-specific expertise in the regulator and more limited direct industry involvement. It could be inefficient, inflexible, and unresponsive to evolutionary market practices. Finally, this model likely would require legislation and could be met with resistance from the existing SROs, whose self-regulatory role would be eliminated.

SEC Regulation

Another alternative discussed in the Concept Release is the termination of the SRO system in favor of direct regulation of broker-dealers by the SEC. [\[FN11\]](#) Under this approach, the SEC would be solely responsible for all market and member regulation. The SEC would assume the current responsibilities of the SROs, including the promulgation of detailed member and market rules, the surveillance of members and markets, and the enforcement of member and market rules.

Direct SEC regulation would eliminate substantially all of the conflicts that exist between SRO regulation and members, market operations, issuers, and shareholders. The inefficiencies of multiple regulators also would be eliminated. Intermarket surveillance likely would be facilitated by this approach because the relevant regulatory data would be collected and examined by the Commission, rather than by disparate SROs. In addition, this model could potentially align the U.S. regulatory scheme more closely with those of several other countries.

An SEC-only approach, however, would present several difficulties. Indeed, in following the path of self-regulation, Congress acknowledged 30 years ago the need to balance "the limitation and dangers of permitting the securities industry to regulate itself against the 'sheer ineffectiveness of attempting to assure regulation directly through the government on a wide scale.'" [\[FN12\]](#) Moreover, the SEC abandoned its earlier foray into direct regulation of broker-dealers through its "SEC Only" or "SECO" program in the 1980s, and it seems unlikely that the agency would relish regaining responsibility for the day-to-day oversight of broker-dealers. Direct SEC regulation would be governed by the limitations and rules addressing federal rulemaking and would be undertaken in a political environment. Finally, the cost of carrying out all of the duties of the SROs could potentially be prohibitive.

The Critical Issue of Funding

Central to the debate as to an appropriate self-regulatory structure is the question of funding. SROs generally have had several sources of revenue, including regulatory fees, transaction fees, listing fees, and market data fees. In addition to the use of regulatory fees that are earmarked for self-regulatory expenses, SROs use the other categories of fees to cross-subsidize their regulatory activities.

For some time now there has been an ongoing debate over the appropriate level, distribution, and use of market data fees. [FN13] Important as a source of overall SRO funding, market data also is critical to investors. The Commission has repeatedly emphasized that consolidated market data must be affordable to retail investors and has evaluated whether proposed changes to market data fees are reasonably allocated among members, issuers, and others. [FN14] In doing so, the agency has been caught between those arguing that any assessment of market data fees should be limited to those fees that are directly related to producing the market data itself, and those advocating a more flexible approach in which market data fees may include some portion of the costs associated with operating and regulating the market that helped produce the data. Market data fees currently are available for regulatory purposes, but the issue of such cross-subsidization remains controversial.

Certain of the alternative self-regulatory structures also pose interesting funding questions. For example, what is the appropriate mix of funding between member fees and market SRO fees for a Hybrid SRO? What might be the impact on self-regulation under an SEC-only approach given that the Commission is not "self-funding" and receives its budget appropriations from Congress? How does one guard against excessive fees that could arise as a result of the shift from multiple SROs to a single SRO, whether a Hybrid, Universal Industry, or even an SEC-only model of regulation? These are just a few of the funding related issues presented for public comment in the Concept Release.

Conclusion

Both the SEC and Congress periodically have assessed the self-regulatory system, and with that perspective the Concept Release might be viewed as simply another chapter in a cycle of periodic review. Moreover, any changes to the self-regulatory structure currently in place are some time away, as the SEC would have to review and assess the comments on the Concept Release, craft a specific proposal, and submit that proposal for public comment before adopting any modifications.

However, the SEC's focus on conflicts of interest--which extends well beyond the SRO context, as demonstrated by its recent modification of rules with respect to the governance of mutual funds and the Staff's emphasis on the disclosure by broker-dealers and investment advisers to their customers of potential conflicts of interest more generally [FN15]--shows no signs of lagging. When combined with the longstanding desire of industry participants to address inefficiencies and redundancies in the self-regulatory structure, it may be that we are on the brink of significant changes in the concept of "self-regulation."

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FN1. See [SEC Release No. 34-49325 \(Feb. 25, 2004\)](#), available at <

www.sec.gov/rules/proposed/34-49325.htm> (proposed Regulation NMS); see also SEC Release No. 34-50870 (Dec. 16, 2004), available at < www.sec.gov/rules/proposed/34-50870.htm> (reproposed Regulation NMS).

FN2. SEC Release No. 34-50699 (Nov. 18, 2004), available at < www.sec.gov/rules/proposed/34-50699.htm>.

FN3. SEC Release No. 34-50700 (Nov. 18, 2004), available at < www.sec.gov/rules/concept/34-50700.htm>, 69 Fed. Reg. 71256 (Dec. 8, 2004).

FN4. SIA Ad Hoc Committee on Regulatory Implications of Demutualization, "Reinventing Self-Regulation, White Paper for the Securities Industry Association," (Jan. 5, 2000, updated Oct. 14, 2003), at 12, available at < www.sia.com/market_structure/html/siawhitepaperfinal.htm>.

FN5. Concept Release, *supra* note 3, at 71276.

FN6. See *supra* note 2. The SEC queries whether the proposed rulemaking will adequately address the most pressing issues with self-regulation or whether additional, and perhaps more radical, steps may be necessary. Concept Release, *supra* note 3, at 71265, 71266.

FN7. Concept Release, *supra* note 3, at 71277.

FN8. *Id.*

FN9. *Id.*

FN10. *Id.* at 71278.

FN11. *Id.* at 71281-282.

FN12. S. Rep. No. 94-75, 94th Cong., 1st Sess. (Apr. 14, 1975).

FN13. See SEC Release No. 34-42208 (Dec. 9, 1999), available at < www.sec.gov/rules/concept/34-42208.htm> (market data fee Concept Release); Report of the Advisory Committee on Market Information: A Blueprint for Responsible Change (Sept. 14, 2001), available at < www.sec.gov/divisions/marketreg/marketinfo/finalreport.htm>.

FN14. See 15 U.S.C. § 78f(b)(4).

FN15. SEC Release No. IC-26520 (Sept. 7, 2004), available at < www.sec.gov/rules/final/ic-26520.htm> (adoption of mutual fund governance rules); Remarks of Stephen M. Cutler, Director, SEC Division of Enforcement, before the National Regulatory Services Investment Adviser/Broker-Dealer Compliance and Risk Management Conference (Sept. 9, 2003), available at < www.sec.gov/news/speech/spch090903smc.htm>.

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