

MEMO# 18481

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SEC CONCEPT RELEASE RELATING TO SELF-REGULATORY ORGANIZATIONS

[18481] January 28, 2005 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 9-05 SEC RULES MEMBERS No. 19-05 RE: SEC CONCEPT RELEASE RELATING TO SELF-REGULATORY ORGANIZATIONS The Securities and Exchange Commission has published for comment a concept release relating to the role and operation of the self-regulatory system of the securities industry.¹ The Release examines a number of issues concerning securities industry self-regulation, including: (1) the inherent conflicts of interest between an SRO's regulatory obligations and the interests of its members, market operations, listed issuers, and, in the case of a demutualized SRO, its shareholders; (2) the costs and inefficiencies of the multiple SRO model; (3) the challenges of surveillance across markets by multiple SROs; and (4) the manner in which SROs generate revenue and how SROs fund regulatory operations. The concept release also examines a number of regulatory approaches or legislative initiatives that could be considered by the SEC to address concerns with the current SRO model. The most significant aspects of the Release are summarized below.

Inherent Conflicts With Members, Market Operations, Issuers, and Shareholders The Release states that among the most controversial features of the existing SRO system are the inherent conflicts that exists within every SRO between its regulatory functions and its members, market operations, listed issuers, and shareholders. The Release discusses several aspects of these conflicts, including how these conflicts may arise. Most significantly, the Release discusses the recent consolidation within the securities industry and the resulting dependence of SROs on a relatively small number of firms for the bulk of their funding, as well as the increased intermarket competition for trades and issuer listings. The Release requests comment on several issues relating to these conflicts. For example, the Release questions whether some of the governance changes recently made by SROs are 1 Securities Exchange Act Release No. 50700 (November 18, 2004) ("Release"). Comments on the concept release are due to the SEC no later than March 8, 2005. The concept release can be found on the SEC's website at <http://www.sec.gov/rules/concept/34-50700.htm>. 2 sufficient to effectively manage these conflicts, as well as how the SEC's rule proposals relating to SROs² would address concerns regarding SRO conflicts of interest.

Inefficiencies of Multiple SRO Structure The Release examines the "inherent inefficiency" of duplicative and potentially conflicting regulation relating to securities industry self-regulation. It states that the existence of multiple SROs can result in duplicative and conflicting SRO rules, rule interpretations, and inspection regimes as well as redundant SRO regulatory staff and infrastructure across SROs. The Release requests comment on several aspects of the inefficiencies of multiple SROs. In particular, the Release requests comment whether the lack of intermarket rules across markets trading the same type of securities is causing regulatory arbitrage and, if so, what is the impact of this on the SRO system. In addition, the Release requests comment on how

significant the inefficiencies are resulting from multiple SROs overseeing the activities of the same members. **Intermarket Surveillance** The Release discusses SRO supervision of intermarket trading, which the Release notes has caused the SRO system to come under increasing strain. It states that because trading now takes place in multiple active markets, it is possible for traders to hide illegal trading activity by dispersing trades across markets. The Release requests comment on several issues relating to intermarket surveillance and regulation, including to what extent the market model of multiple competing SROs creates gaps in intermarket trading surveillance and what types of illicit trading activity can be hidden from regulators by dispersing trading across multiple markets. **SRO Funding** The Release examines the funding of SRO regulatory operations. It states that one of the key historical benefits of the SRO system is its self-funding structure, which leverages the limited resources of the Commission. The Release also discusses the five primary sources of SRO funding: (a) regulatory fees; (b) transaction fees; (c) listing fees; (d) market data fees; and (e) other miscellaneous fees. The Release requests comment on several aspects of each of these primary sources. For example, the Release notes that under current SRO cost structures, SRO funding for regulatory operations is not derived strictly from revenue associated with regulatory fees and operations. The Release requests comment on whether SRO funding for regulatory operations should be derived only from regulatory fees and, if so, how the Commission should address a situation in which an SRO does not generate sufficient regulatory revenue to fully fund regulatory operations. The Release also discusses how inter-market competition has impacted SRO transaction fees and listing fee revenue and requests comment on, among other things, the resulting effect on the SROs' ability to fulfill their regulatory obligations. Finally, the Release discusses issues surrounding market data revenue and requests comment on whether such revenue should be used to cross subsidize SRO regulatory operations. 2 See Memorandum to Equity Markets Advisory Committee No. 2-05 and SEC Rules Members No. 3-05, dated January 6, 2005 [18389] ("SRO Rule Proposals"). 3 **Alternative Regulatory Approaches** The Release discusses a variety of regulatory approaches or legislative initiatives that could be considered by the SEC to address concerns with the current SRO model. Specifically, the Release examines: (1) proposed enhancements to the current SRO system; (2) implementing an independent regulatory and market corporate subsidiary model; (3) implementing a hybrid model; (4) implementing a competing hybrid model; (5) implementing a universal industry self-regulator model; (6) implementing a universal non-industry regulator model; and (7) establishing direct Commission regulation of the securities industry. For each approach, the Release requests comment on the extent to which changes proposed in the SRO Rule Proposals effectively manage inherent SRO limitations and whether these proposed changes would continue to provide the benefits of the current SRO system. **Proposed Enhancements to the Current SRO System** The Release notes that while the current SRO system to date has provided essential regulation, the system has inherent limitations that should be addressed. The Release discusses possible enhancements that could be implemented to address SRO limitations. The Release also discusses the SRO Rule Proposals and states that, if adopted, the proposed rulemaking would strengthen SRO governance, enhance SRO disclosure and reporting requirements, and address various issues that have arisen with respect to shareholder-owned SROs. **Independent Regulatory and Market Corporate Subsidiaries** The Release states that another approach would be to require that all SROs create independent subsidiaries for regulatory and market operations. Under this model, regulatory staff of each SRO would be placed within an independent regulatory subsidiary, which would report directly to the corporate parent's board. Substantially all regulatory operations would be housed in the regulatory subsidiary, including examination, rulemaking, and enforcement responsibilities. All market operations responsibilities would be placed within an independent market subsidiary. **Hybrid Model**

Another option would be the Commission's designation of a market neutral single self-regulatory organization ("Single Member SRO") to regulate all SRO members with respect to membership rules. The Single Member SRO would be solely responsible for promulgating membership rules, inspecting members for compliance with "member" 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. Competing Hybrid Model Under the competing hybrid model, Market SROs would exist as in the pure hybrid model and market regulation would be conducted separately from member regulation. Instead of one Single Member SRO, however, this approach would permit the existence of multiple 4 competing member SROs ("Competing Member SROs"), which would be required to be registered with the Commission and, thereby, authorized to provide member regulatory services. Under this approach, each Market SRO member would also have to be a member of one of the Competing Member SROs. The Competing Member SROs would be responsible for promulgating member rules, inspecting members for compliance with those rules, and taking enforcement action against those members that fail to comply. Under this approach, Market SROs would retain their market regulatory responsibilities. Universal Industry Self-Regulator Another approach would require the establishment of a universal industry self-regulator ("Universal Industry Self-Regulator"). Under this model, one industry self-regulatory organization would be responsible for all market and member rules for all members and all markets. The current SROs' self-regulatory authority would be transferred to the Universal Industry Self-Regulator, including member and market rulemaking, member and market surveillance, and member and market rule enforcement. Under this approach, all member firms would be registered directly with the Universal Industry Self-Regulator, all markets would be non-SROs registered with the Universal Industry Self-Regulator, and the markets' self-regulatory authority would be eliminated. Universal Non-Industry Regulator Another approach would be the establishment of a universal non-industry regulator ("Universal Non-Industry Regulator"). Under this approach, one non-industry entity would be designated to be responsible for all markets and member regulation for all members and all markets. As with the Universal Industry Self-Regulator, this model would require all member firms to be registered with the Universal Non-Industry Regulator. The Universal Non-Industry Regulator would be solely responsible for promulgating member and market rules, inspecting for compliance with those rules, and taking enforcement action with respect to member and market rules. The Release notes that, while not exactly analogous, this model could resemble the regulatory regime recently adopted for audits of public companies, which puts authority in the hands of the Public Company Accounting Oversight Board. SEC Regulation The final proposed alternative would be the termination of the SRO system in favor of direct Commission regulation of the industry. Under this approach, the Commission would be solely responsible for the regulation of all members and all markets. All member firms and markets would be required to register directly with the Commission under this model. The Commission would be responsible for the promulgation of detailed member and market rules, the surveillance of members and markets, and the enforcement of member and market rules. Ari Burstein Associate Counsel