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Self and Self-Regulation: Resolving the SRO Identity Crisis

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SELF AND SELF-REGULATION: RESOLVING THE SRO IDENTITY CRISIS

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Market-based self-regulatory organizations (SROs) are in the throes of an identity crisis. Once the physical hub of trading activity, securities exchanges have become primary nodes in a larger web of electronic securities trading. Their mantel of regulatory authority, a traditional source of reputational integrity, is now characterized as a yoke around their necks, stifling competitive initiatives while embarrassing them in successive marketplace scandals. Once the voice of the securities industry, SROs are now accused of advocating no interest more keenly than their own survival. Faced with these challenges, it is not surprising that many exchanges are looking for ways to shed their self-regulatory responsibilities and join the ranks of their erstwhile members as for-profit competitors.

And yet, the apparent crisis of faith in exchange-based regulation has called into question the broader idea of self regulation. New regulatory models—such as the one employed by Congress in creating the Public Company Accounting Oversight Board (PCAOB)—are being devised to fund and oversee regulation of the securities industry, without being accountable to it. SROs are taking pains to play down the ties of their industry personnel with (or distance them altogether from) the industry they regulate. Industry leaders and associations have even entertained the possibility of dismantling the current self-regulatory system entirely in favor of Securities and Exchange Commission (SEC) regulation.[1]

With all its shortcomings, however, self-regulation is inherently a sound—and perhaps somewhat underutilized—means of regulating securities market conduct. Even if exchange-based regulation has failed, policymakers should think twice before writing self-regulation out of the Exchange Act. Despite the extraordinary public attention devoted to stock

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1. *See* SEC. INDUS. ASS'N, REINVENTING SELF-REGULATION: WHITE PAPER FOR THE SIA'S AD HOC COMMITTEE ON REGULATORY IMPLICATIONS OF DEMUTUALIZATION (Jan. 5, 2000), *available at* http://www.sia.com/market_structure/html/sia whitepaperfinal.htm [hereinafter SIA White Paper]. Among other goals, the SIA (which has since merged with The Bond Market Association to form the Securities Industry and Financial Markets Association) called for a unitary SRO, with industry representation in regulatory oversight and a transparent fee system, which would serve as the sole source of SRO rulemaking and interpretations, examinations, and investigations. *See* Rachel McTague, *In Push for Single SRO for Brokers, SIA Enunciates Its Goals, Principles*, 38 Sec. Reg. & L. Rep. (BNA) No. 5, at 162 (Jan. 30, 2006).

exchanges and the NASD, there are many SROs that provide the critical infrastructure needed to ensure fair and efficient markets while sparing the SEC and the public the cost of securities oversight. SROs are also best positioned to debate and promulgate the ethical norms that govern the industry, as long as such responsibilities are confined to those spheres of activity where they work best. The presence of multiple SROs with overlapping memberships, if properly coordinated by the SEC to ensure standardization, can further help ensure fair representation of all industry groups in regulatory decisionmaking and promote better rulemaking.

I. SELF-AWARENESS

What does "self-regulation" mean? On a purely etymological level, it suggests a process by which a person, organization, or group of persons establishes and enforces rules to govern its, or their own, conduct without the need for regular outside intervention. This definition, of course, might well pick up any public company, financial institution, or other business entity that is required to establish internal controls for regulatory purposes. In the securities and commodities industries, the term is rooted in the historic private compacts among exchange members. The basic structure of self-regulation assumes (and the Exchange Act now requires)[2] that broker-dealers would be members of at least one SRO, that members would be fairly represented in the governance of SROs, and that SROs would undertake to enforce compliance with their rules by their members.[3]

The Exchange Act nevertheless has some difficulty articulating what should qualify as a self-regulatory organization, since the term itself was defined after the fact to refer to national securities exchanges, registered securities associations such as the NASD, registered clearing agencies, and other specialty bodies.[4] The source of congressional intent lies in the term "member," which includes, in addition to natural persons trading on the floor of an exchange and their associated brokerage firms, any "broker or dealer which agrees to be regulated" by an exchange or registered securities association and with respect to whom the exchange or association "undertakes to enforce compliance with the provisions of [the Act], the rules and regulations thereunder, and its own rules."[5]

Though the two are often analogized, self-regulation must be differentiated from *private ordering* in the sense that self-regulatory

2. *See* 15 U.S.C. § 78*o*(b)(8) (2000).

3. As discussed below, SROs have the additional responsibility of enforcing compliance by their members and controlling persons with the provisions of the Exchange Act and the rules and regulations thereunder. 15 U.S.C. §§ 78f(b)(1), 78*o*-3(b)(2) (2000).

4. *Id.* § 78c(a)(26). The only statutory self-regulatory organization recognized in section 3(a)(26) of the Exchange Act is the Municipal Securities Rulemaking Board (MSRB); however, other bodies with self-regulatory powers and duties, such as the Securities Investor Protection Corporation (SIPC), have been created by the Exchange Act. *See id.* § 78ccc(a)(1).

5. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881.

organizations operate under Commission oversight, receive limited immunity from the antitrust laws,[6] and must observe specific formalities for the adoption of new rules, policies, and procedures.[7] Private ordering remains an important component of the regulatory system for securities markets, particularly in those areas where securities regulators lack the jurisdiction to regulate their members' conduct.[8] Today, numerous securities trade associations promulgate "uniform rules" or best practices for their members, maintain standard agreements for interbroker transactions, collect statistical information about their members for the benefit of the public, and perform other market ordering functions.[9]

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6. *See, e.g.*, Silver v. N.Y. Stock Exch., 373 U.S. 341, 357 (1963); Gordon v. N.Y. Stock Exch., 422 U.S. 659 (1975); United States v. NASD, 422 U.S. 694 (1975); *In re* Stock Exchs. Options Trading Antitrust Litig., 317 F.3d 134 (2d Cir. 2003). *Cf.* A.L.A. Schecter Poultry Corp. v. United States, 295 U.S. 495 (1935) (striking down provisions of the National Industrial Recovery Act establishing a National Recovery Administration to oversee voluntary compliance with industry codes of competition).

The U.S. Supreme Court granted certiorari in Credit Suisse First Boston v. Billing, 426 F.3d 130 (2d Cir. 2005), *cert. granted*, 127 S. Ct. 762 (2006), *cert. vacated and granted*, 2007 U.S. LEXIS 3020 (March 19, 2007), on the question:

> [w]hether, in a private damages action under the antitrust laws . . . , the standard for implying antitrust immunity is the potential for conflict with the securities laws or . . . a specific expression of congressional intent to immunize such conduct and a showing that the SEC has power to compel the specific practices at issue.

Petition for Writ of Certiorari, Credit Suisse First Boston v. Billing, 2006 WL 616006, at *1 (2006) (No. 05-1157). The registration requirements for self-regulatory organizations and the statutory delimitation of the scope of their self-regulatory activity may thus remain a critical prerequisite to antitrust immunity.

7. 15 U.S.C. § 78s(b), (c) (2000) (establishing procedures for the filing of "any proposed rule or any proposed change in, addition to, or deletion from the rules of [each] self-regulatory organization"); *see also* 17 C.F.R. § 240.19b-4(c), (d) (2007) (requiring the filing, as a "proposed rule change," of any "stated policy, practice, or interpretation" of, or "interpretation of an existing rule" by, a self-regulatory organization).

8. *See, e.g.*, Securities Industry and Financial Markets Association (SIFMA), http://www.sifma.org/about (last visited Mar. 21, 2007) ("[SIFMA] represent[s] more than 650 member firms of all sizes, in all financial markets in the U.S. and around the world."); Counterparty Risk Management Policy Group II, http://www.crmpolicygroup.org (last visited Mar. 21, 2007) (describing itself as a group of senior officials from major financial institutions with the "primary purpose of . . . examin[ing] what additional steps should be taken by the private sector to promote the efficiency, effectiveness and stability of the global financial system"); Financial Market Lawyers Group (FMLG), http://www.newyorkfed.org/fmlg/ (last visited Mar. 21, 2007) (describing itself as a group sponsored by the Federal Reserve Bank of New York comprised of lawyers who "advise[ ] on legal issues relevant to over-the-counter foreign exchange and other financial markets" and "support foreign exchange and other financial markets trading in leading worldwide financial institutions").

9. *See, e.g.*, SIFMA Standard Agreements, http://www.bondmarkets.com/stdagrmnts.asp (last visited Mar. 21, 2007) (noting the guidelines, procedures and documentation for, inter alia, offerings of securities by government-sponsored enterprises, trading practices with respect to repurchase agreements, delivery guidelines and buy-in procedures for mortgage-backed securities, and standard documentation and supporting legal opinions for global master repurchase agreements and master securities loan agreements); SIFMA Bond Markets & Prices, http://www.investinginbonds.com/MarketAtAglance.asp (last visited Mar. 21, 2007) (providing

Such organizations have, however, historically lacked the wherewithal to monitor for compliance, as well as the legal ability or economic incentive to discipline non-compliant members: The inability of exchanges and industry associations to police securities markets effectively prior to the Crash of 1929—despite their anti-regulatory lobbying efforts—aptly illustrates how private ordering can break down in securities markets.[10] As such, industry norms are most likely enforced, if at all, through provisions in bilateral agreements between members. A systemic failure of such enforcement mechanisms, however rare, is almost certain to invite Commission intervention absent the buffering effect of self-regulatory compliance and disciplinary mechanisms.

The most basic self-regulatory function might be deemed *mutual* regulation, or the regulation of transactions among members through rules that "foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities."[11] This standardization function sets the rules governing the interaction of public orders, the execution of transactions, the comparison of trading logs by members, the settlement of such transactions, and the delivery of securities.[12] Rules of mutual

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data on municipal, government and corporate bonds; and mortgage and other asset-backed securities transactions); FMLG FXC Master Agreements, http://www.newyorkfed.org/fmlg/documentation/master.html (last visited Mar. 21, 2007) (standard documentation that sets forth common legal terms for foreign exchange and currency option transactions, "including payments and close-out netting provisions"); International Swaps and Derivatives Association (ISDA) Bookstore/Publications, http://www.isdadocs.org (last visited Mar. 21, 2007) (providing documentation for over-the-counter derivative transactions and accompanying protocols and user guides).

10. *See, e.g.*, MICHAEL E. PARRISH, SECURITIES REGULATION AND THE NEW DEAL 31–36 (1970) (describing the gap between the "managerial and moral responsibility for the national securities industry" the Investment Bankers Association had undertaken as a result of its anti-regulatory lobbying efforts and its "incommensurate . . . organizational development and . . . fund of economic intelligence," its "serious information lag" with respect to the operation of the larger marketplace, and its reluctance "to coerce either members or clients" to provide full disclosure); *id.* at 36–41 (describing stock exchanges' "reluctan[ce] to enforce standards of disclosure upon listed companies" and their inability and unwillingness to verify the accuracy of statements made in listing applications).

11. Order Granting Approval of a Proposed Rule Change Amending Rule 180 to Require Member Organizations to Use the Automated Liability Notification System of a Registered Clearing Agency, Exchange Act Release No. 55,132, 72 Fed. Reg. 3896 (Jan. 26, 2007).

12. The centrality of this function is evidenced by the fact that it is coordinated by a single SRO, the Depository Trust & Clearing Corporation, pursuant to section 17A of the Exchange Act regarding a national system for clearance and settlement of securities transactions. *See* 15 U.S.C. § 78q-1 (Supp. II 2002); RULES, BY-LAWS AND ORGANIZATION CERTIFICATE OF THE DEPOSITORY TRUST COMPANY, http://www.dtcc.com/CustomerFocus/dtc_rules.pdf. While exchanges and the NASD retain basic rules for the post-trade clearance and settlement of transactions, Congress has expressed a preference for uniformity across all markets in this area. *See* H.R. Rep. No. 94-229, at 102 (1975), *reprinted in* 1975 U.S.C.C.A.N. 321, 333 ("To assure the development of a modern, nationwide system for the safe and efficient handling of securities transactions in a manner which best serves the financial community and the investing public, the Senate bill and the House amendment directed the [Securities and Exchange] Commission to

regulation might also be deemed to include minimum capital requirements for broker-dealers who clear securities transactions, since members who agree to abide by uniform rules of execution and settlement must rely on each other's creditworthiness. The discipline or expulsion of noncompliant members is a clear restraint against trade, but one which is sanctioned as long as it is conducted under the supervision of the Commission.

A second, equally important self-regulatory function might be deemed *reciprocal* regulation, or the development of standards that govern relations between members and their public customers. While members may not be financially interested in the terms of their peers' transactions with the public, such norms of competition not only enhance the protection of investors by prohibiting predatory conduct, but also increase the profitability of being a market intermediary by credibly signaling the higher standard of care to which SRO members adhere.[13] Thus, members will commit to observe collectively-developed standards regarding business conduct and practices on the condition that other members do so as well.[14] Because such rules may also carry an anti-competitive tinge, even when they exist for otherwise valid regulatory reasons, some supervision by regulators or antitrust enforcement authorities is appropriate.

Some aspects of self-regulation may also be characterized as purely *partitive*, in the sense that they are driven by the desire to balance the interests of one class of members (e.g., the managerial class, the specialist class, the "bulge bracket" firms) against the often conflicting interests of

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facilitate the establishment of the system and centralized in the Commission the authority and responsibility to regulate, coordinate and direct the operations of all persons involved in the securities handling process."); S. Rep. No. 94-75, at 5 (1975), *reprinted in* 1975 U.S.C.C.A.N. 179, 184 ("[The Senate Banking, Housing and Urban Affairs] Committee is persuaded that the present uncoordinated state of affairs with respect to securities processing should not be allowed to continue. When securities firms must deal with a dozen or more different clearing and depository systems in their daily securities operations, the result necessarily is excessive cost and poorer service to investors. A national clearance and settlement system is clearly needed.").

13. *See, e.g.*, Jonathan R. Macey & Maureen O'Hara, *From Markets to Venues: Securities Regulation in an Evolving World*, 58 STAN. L. REV. 563, 581–82 (2005). The requirement that all broker-dealers be members of an SRO, of course, correspondingly deters SROs from raising their standards to a level that would make entry into continued participation in the broker-dealer industry unreasonably prohibitive.

14. *Cf.* Dan M. Kahan, *The Logic of Reciprocity: Trust, Collective Action, and Law,* 102 MICH. L. REV. 71 (2003) (arguing that the "logic of reciprocity" may provide greater incentives to overcome collective-action problems than conspicuous rewards and punishments). In the context of broker-dealer regulation, such business conduct and practices comprise, among other things, rules regarding customer solicitation (e.g., advertising, sales practices, suitability, and know-your-customer diligence), personnel (e.g., qualifications, examinations, and supervision), fees (e.g., commissions, markup schedules, and terms of credit), and disclosures (e.g., confirmations and periodic statements). *See, e.g.*, NASD Rule 2000 Series (CCH Jan. 2005).

The model of reciprocity is reflected, when considering the international or supranational arenas, in agreements among states or regulatory bodies that require a market's or investment firm's home country regulator to apply and enforce minimum standards of regulation as a condition of permitting such market or firm to provide services in the territory of another member state or regulatory body. *See infra* notes 83–84 and accompanying text.

another. Rules regarding the affirmative and negative obligations of exchange specialists, as well as the obligations of market makers, were adopted for the benefit of public brokers. Because specialists profit from trading against customer order flow even as they facilitate the execution of public orders, a regulatory balance must be struck to ensure that the symbiotic relationship does not become parasitic.[15] Similarly, SRO rules regarding the form and minimum content of clearing arrangements ensure that the relationship between clearing and correspondent brokers is clearly defined with respect to all material terms.[16] One might view recent rules governing the automation of exchange trading systems as serving institutional interests (i.e., earnings from execution fees) at the expense of member firms with competing electronic trading systems or market making operations.

Finally, some aspects of self-regulation are not really "self"-regulatory at all, but merely serve a *gatekeeping* function.[17] For example, SROs adopt minimum quantitative standards for listed issues to create a reasonable expectation that such securities will trade in a liquid secondary market. Qualitative listing standards regarding corporate governance and investor protection also serve an important reputational goal for the SRO and its membership, as does the surveillance of markets for manipulative or deceptive conduct by insiders or other individuals improperly trading on the basis of material nonpublic information in an issuer's securities.[18] Such rulemaking is difficult to describe as "self-regulation" to the extent that issuers are not afforded significant representation in exchange governance structures.[19]

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15. SEC, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. No. 88-95, pt. 2, at 64–67, 142–57, 162–71 (1963); *see generally* George T. Simon & Kathryn M. Trkla, *The Regulation of Specialists and Implications for the Future*, 61 BUS. LAW. 217 (2005) (exploring the role of the specialist and how federal law regulates them).

16. *See, e.g.*, NYSE Rule 382 (requiring that agreements between NYSE members or member organizations that relate to the carrying of customer accounts specifically identify and allocate certain enumerated functions and responsibilities and be submitted to and approved by the Exchange); NASD Rule 3230 (requiring clearing or carrying agreements entered into by members to specify the respective functions and responsibilities of each party with respect to certain enumerated matters).

17. Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 53–54 (1986) (defining "gatekeeper liability").

18. Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. REV. 325, 329–30 (2001) (describing exchange listing standards developed before the enactment of the Exchange Act); John C. Coffee, Jr., *Racing Towards the Top: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1772 (2002) (noting that non-U.S. firms may choose to cross-list their securities in the United States, in part, based on the reputational value of a U.S. listing and the "higher likelihood of legal enforcement, the signal of profitable investment opportunities, the more credible promise of improved disclosure, contractual protections negotiated on entry into the U.S. market, [and] the enhanced analyst coverage" associated therewith).

19. *See infra* text accompanying notes 46–56.

Conferring regulatory authority on SROs for promulgating and enforcing such standards may, to a degree, be justified on the ground that it builds upon their commercial interests. As the burdens of federal regulation grow and listing fees and trading revenues are placed in jeopardy by over-regulation, the exchanges' commercial interest in acting as gatekeeper for the securities industry becomes far more attenuated. For example, surveillance of manipulative and deceptive conduct by members and their associated persons and other persons trading through the facilities of the exchange—while originally intended to curtail certain trading practices by exchange members and their customers in listed securities[20]—now fairly encompasses any manipulative or deceptive conduct under Rule 10b-5 and requires coordinated enforcement effort by all exchanges and the NASD.[21]

The taxonomy above illustrates the fundamental benefits and disadvantages of self-regulation. When the power of self-interest is harnessed to achieve common benefits, self-regulation (with the Commission's well-oiled shotgun behind the door) can be a very effective and affordable means of regulating the securities markets. Troubles abound, however, when SROs are asked to take on regulatory obligations that are at best tangential, and at worst inimical, to their managers' or members' interests. In these cases, reliance on self-regulation can be more of a hindrance than if promulgation or enforcement of rules were undertaken directly by the SEC or another regulator.

II. SELF-DOUBT

Although the premises of self-regulation have regularly been called into question, the concept has endured because lawmakers have generally regarded self-regulation to be a practical and efficient way to outsource the burdens of regulation to the private sector. Thus, despite the periodic scandals of exchange governance and member misconduct,[22] Congress and the Commission have reacted to public lapses in confidence by expanding the scope of self-regulatory responsibility and the Commission's oversight over SROs. In the present environment, by contrast, there is a growing lack of confidence on the part of SROs themselves and their own members in the axioms of self-regulation. This part discusses four reasons why self-regulation is now under assault: the incremental federalization of self-regulation, the diminishing representation of the securities industry in

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20. 15 U.S.C. § 78f(b)(5) (2000) ("The rules of the exchange are designed to prevent fraudulent and manipulative acts and practices . . . ."); *id.* § 78i(a) (prohibiting certain fraudulent conduct on exchanges).

21. *See, e.g.*, Concept Release Concerning Self-Regulation, Exchange Act Release No. 50,700, 69 Fed. Reg. 71,256, 71,265–66 (Dec. 8, 2004) (describing the formation of the Intermarket Surveillance Group and its role in coordinating the enforcement efforts of its SRO members).

22. Joel Seligman, *Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation During the First Seventy Years of the Securities and Exchange Commission*, 59 BUS. LAW. 1347, 1347–49 (2004).

SROs, the new-found self-interest of market-based SROs, and the difficulty in extending the concept of self-regulation internationally.

A. THE FEDERALIZATION OF SELF-REGULATION

One of the principal reasons for the decline of self-regulatory organizations may be the incremental federalization of securities law. While we think of the Exchange Act as creating a pervasive system of federal regulation, many elements of securities regulation were governed by rules of, or heavily influenced by, the eponymous exchanges for a significant part of the Act's history. Incremental federalization may have been inevitable—as it remains the one of the few tools Congress has to address the periodic scandals that shock the securities marketplace—but each successive tick of the one-way ratchet has reduced the autonomy of the securities industry, while increasing the costs and reputational stakes for SROs and their members.

The most celebrated example of incremental federalization at the expense of state or SRO regulation is the development of *disclosure and governance standards* for public companies.[23] For example, the Exchange Act, as originally enacted, largely limited the application of its periodic reporting, proxy solicitation, and insider reporting and trading provisions to exchange-listed firms.[24] Thus, exchanges could play a representative role in negotiating the federal disclosure and governance standards for top-tier companies that sought national credibility. In 1964, following its *Special Study of Securities Markets*,[25] the Commission gained the authority to extend these requirements to all over-the-counter issuers meeting the size

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23. *See generally* Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1 (1993) (discussing the displacement of state corporate governance norms by federal regulation).

24. Sections 13, 14, and 16 of the Exchange Act extend only to an issuer of a security registered pursuant to section 12 of the Exchange Act (and in the case of section 16, only with respect to registered classes of equity security). *See* 15 U.S.C. §§ 78m(a), 78n, 78p (Supp. II 2002). Certain over-the-counter firms that effected a registered securities offering under the Securities Act of 1933 were required to include an undertaking to file "such supplementary and periodic information, documents, and reports as may be required pursuant to section 13" in respect of securities registered under section 12, but were not required to comply with the corporate governance provisions of sections 14 and 16. *See* 15 U.S.C. §§ 78*o*(b), 78*l*(d) (1958); SEC, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 88-95, pt. 3, at 2–7 (1963); Securities Acts Amendments of 1964, Pub. L. No. 88-467, § 3(c), 78 Stat. 565 (adding subsection (g) to section 12 and amending section 15(d) of the Exchange Act); *see also* H.R. REP. NO. 1418, 88th Cong., 2d Sess. (1964), *reprinted in* 1964 U.S.C.C.A.N. 3013, 3027 (describing the addition of section 12(g) to the Exchange Act "to provide for registration of securities traded in the over-the-counter market and for disclosure by issuers thereof comparable to the registration and disclosures required in connection with listed securities by section 12(b) of that act"); *id.* at. 3037 (describing the extension of the requirement under section 15(d) that each registration statement filed under the Securities Act "must contain an undertaking to comply with the reporting requirements of section 13" to all Securities Act registrants).

25. H.R. DOC. NO. 88-95, pt. 3, at 7–17, 60–64.

and shareholder requirements of section 12(g).[26] Moreover, beginning in the 1970s and continuing to the present day, the Commission transformed the Exchange Act's periodic disclosure requirements into a system of forward-looking disclosure, rather than purely historical data. These developments considerably expanded the range of information required to be disclosed by all listed and unlisted companies, while simultaneously diminishing the scope and prestige of exchange standards.[27]

Exchanges retain the incentives and discretion to promulgate qualitative governance rules and standards that are stricter than Commission requirements as a means of reputationally distinguishing their listed issues.[28] Thus, in addition to the quantitative requirements for listing eligibility, the New York Stock Exchange (NYSE) has historically imposed obligations such as real-time disclosure of certain material information during volatile market conditions, and corporate governance rules respecting the independence of auditors, directors, and audit committees.[29] NYSE listing agreements also continue to provide important protections for investors in exchange-listed securities by restricting the dilution of their voting rights in various corporate finance transactions.[30]

Even in these areas, the Commission and Congress have sought to use exchange rules to further their regulatory goals. Exchange rulemaking and enforcement in the area of corporate governance, for example, often appears to have been prodded by the Commission as a means of circumventing statutory limitations on its own authority.[31] Legislation such as the Sarbanes-Oxley Act, which appears to be the first to mandate specific listing standards through legislation,[32] can only further erode the self-regulatory principle that exchanges autonomously develop standards for corporate governance.

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26. *See* Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565; Michael J. Simon & Robert L.D. Colby*, The National Market System for Over-the-Counter Stocks*, 55 GEO. WASH. L. REV. 17, 29–30 (1986).

27. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 465–66 (rev. ed. 1995).

28. *See* Karmel, *supra* note 18, at 329–30.

29. *See* NYSE, Inc., Listed Company Manual §§ 202.03, 303A.00 (2006) [hereinafter NYSE LCM].

30. *Id.* § 313.00(A).

31. Karmel, *supra* note 18, at 352; Comm. on Fed. Reg. of Sec., ABA, *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1487, 1490 (2002). Prominent examples are the Commission's efforts to require the NYSE to enforce its rule against dual class recapitalizations after its own Exchange Act Rule 19c-4 was vacated in *Business Roundtable v. SEC*, 905 F.2d 406, 417 (D.C. Cir. 1990), and to require exchanges to adopt rules governing auditor independence in the late 1990s. *See, e.g.*, Ira M. Millstein, *Introduction to the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, 54 BUS. LAW. 1057 (1999).

32. Sarbanes-Oxley Act of 2002 § 301, Pub. L. No. 107-204, 116 Stat. 745, 775 (codified at 15 U.S.C. § 78j-1(m)).

Standardization of *financial responsibility* rules for securities intermediaries, such as net capital, customer protection, and bookkeeping requirements, has also figured prominently in the downsizing of the SRO's special statutory mission.[33] While the unique expertise and mutual interest of exchange members in upholding high standards of financial responsibility might have militated in favor of keeping these rules largely within the purview of SRO regulation, the back office crisis and subsequent insolvencies of several brokerage firms put these rules squarely on the federalization agenda in the 1960s. Initially, the Congressional reaction favored a self-regulatory approach to the problem of customer protection: the Securities Investor Protection Act of 1970 provided a self-regulatory model for customer protection under the auspices of the Securities Investor Protection Corporation.[34] Within five years, however, Congress gave the Commission the authority to promulgate uniform net capital and customer protection rules for all registered broker-dealers.[35]

Today, while exchanges might not impose significant additional net capital requirements by rule, exchanges such as the NYSE and the Chicago Board Options Exchange (CBOE) still play a very important role in the application and interpretation of the Commission's rules and work closely with the Commission and the brokerage industry to adapt to marketplace developments. Two factors, however, threaten the future of this relationship. First, following the Gramm-Leach-Bliley Act of 1999, banking regulation can be expected to play a greater, if indirect, role in the standard setting process for financial responsibility rules.[36] Second, with the

33. Section 7(d) of the Securities Investor Protection Act of 1970, Pub. L. No. 91-598, 84 Stat. 1636, 1653, required the Commission to prescribe "safeguards with respect to the financial responsibility and related practices of brokers and dealers," and in particular, "the maintenance of reserves with respect to customers' deposits or credit balances." *See also* Broker-Dealers; Maintenance of Certain Basic Reserves, 37 Fed. Reg. 25,224 (Nov. 29, 1972) (adopting the Commission's customer protection rule, 17 C.F.R. § 240.15c3-3). Five years later, section 11(3) of the Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97, amended section 15(c)(3) of the Exchange Act to require the Commission to promulgate rules and regulations establishing minimum financial responsibility requirements for all brokers and dealers. 15 U.S.C. § 78*o*(c)(3) (2000). *See also* Adoption of Net Capital Rule, 40 Fed. Reg. 29,795, 29,795–96 (July 16, 1975) (revisions to Commission's net capital rule, pursuant to the Securities Acts Amendments of 1975, eliminating the exemption from the Commission's net capital rule for members of designated national securities exchanges required to comply with net capital rules of such exchanges).

34. *See infra* note 106. The Securities Investor Protection Corporation (SIPC) insures customer securities and cash balances through a fund maintained by assessments from its membership, which generally includes all registered broker-dealers. *See* 15 U.S.C. § 78ddd (2000). SIPC has significant powers to intervene in bankruptcy or insolvency proceedings involving its members and is responsible for the distribution of securities and funds to customers of an insolvent brokerage firm. *See* 15 U.S.C. §§ 78eee–78hhh (2000).

35. Steven L. Molinari & Nelson S. Kibler, *Broker-Dealers' Financial Responsibility under the Uniform Net Capital Rule—A Case for Liquidity*, 72 GEO. L.J. 1, 14–16 (1983–1984).

36. The Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999), is generally said to have repealed the long-standing prohibition under the Glass-Steagall Act against the

internationalization of investment firms, there have been parallel efforts to regulate financial responsibility on a groupwide basis rather than at the level of the individual SEC-regulated brokerage firm,[37] and to standardize capital requirements for all firms.[38] While SROs attempt to exercise some oversight over the corporate parents of their members,[39] the Commission is ultimately better positioned to enter into discussions with both domestic and foreign financial services regulators to harmonize such rules.

SRO *business conduct* regulation, while still the SROs' strongest suit, has also come under assault, particularly as a result of the expansion of private rights of action under Exchange Act Rule 10b-5 and increasing SEC rulemaking in all aspects of broker-dealers' customer relations. SRO rules continue to govern the gray area that does not rise to the level of fraud but nevertheless falls short of "just and equitable principles of trade."[40] SROs, such as the NASD, also play a significant compliance role with respect to newly registered brokerage firms, including screening for disqualifications, examining for competence, ensuring adequate supervisory personnel, and overseeing the use of advertising and sales literature. Even here, however, the Commission has stepped up its own efforts by dedicating compliance personnel to the oversight of broker-dealer operations.[41] The rise of

affiliation of commercial and investment banking. The Act permits bank holding companies that qualify as "financial holding companies" to provide other financial services—such as underwriting, brokerage, and insurance—through subsidiaries functionally regulated by the appropriate federal or state regulatory authority and under the "umbrella" supervision of the Federal Reserve Board. *Id.* at pt. [1]. Although the Federal Reserve Board may not generally apply capital standards to SEC-registered broker-dealer subsidiaries of a financial holding company, or look to such subsidiaries as a "source of strength" for a bank affiliate, *id.* § 111(c), the Board has stated that it "is responsible for assessing consolidated capital adequacy for FHCs with the ultimate objective of protecting the insured depository subsidiaries from the effects of disruptions in the nonbank portions of the organization." Board of Governors of the Federal Reserve System, SR Letter, SR 00-13 (SUP) (Aug. 15, 2000), *available at* http://www.federalreserve.gov/boarddocs/SR LETTERS/2000/SR0013.HTM.

37. *See, e.g.*, 15 U.S.C. § 78*o*(i) (Supp. II 2002). This section was enacted as part of the Gramm-Leach-Bliley Act of 1999 to provide a framework for Commission supervision of investment bank holding companies, including recordkeeping and reporting requirements and examination authority. *See also* Supervised Investment Bank Holding Companies, Exchange Act Release No. 49,831, 69 Fed. Reg. 34,472 (June 21, 2004) (adopting final rules creating a new framework for supervising an investment bank holding company).

38. *Cf. States Demand Role in Basel II Plans, New York State Banking Regulator Says*, 87 Banking Daily (BNA) No. 10, at 388 (Sept. 18, 2006) (describing state bank regulators' concerns that the process by which the Basel II capital accord is being implemented in the United States has been dominated by federal regulators).

39. NASD Rule 1017, *Application for Approval of Change in Ownership, Control or Business Operation* (2006) (requiring NASD approval for change in ownership or control of member firms); NYSE Rule 304(E), *Allied Members and Approved Persons* (2006) (requiring Exchange approval of persons who control a member or member organization).

40. Commission efforts to characterize unethical business practices as fraud must be predicated on implied representations or non-verbal conduct. *See generally* Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271 (1995) (describing the implied representations of broker-dealers that they will deal fairly with customers).

41. *See infra* Part III.A.

securities arbitration under SRO auspices may also have had the effect, at least in the context of private litigation, of eroding the boundary between SRO ethical norms and securities fraud. For example, arbitrators may, absent "manifest disregard of the law," inadvertently impose liability for conduct that falls short of the judicially developed contours of Rule 10b-5.[42]

Finally, the Commission's significant rulemaking in the area of *market structure* has considerably undermined the autonomy of exchanges to regulate the structure of their own market operations. The justification for conferring disciplinary authority on exchanges is their comprehensive ability to oversee and control participation in trading through their facilities; the power to exclude subsumes the power to discipline. Once exchanges are no longer able—or permitted—to mandate consolidation of order flow through their facilities, the source of self-regulatory authority wanes considerably. As others have discussed, over the past seventy years the Commission has cajoled or required the primary exchanges to abandon mandatory minimum commission schedules, off-board trading prohibitions (both with respect to other exchanges and the over-the-counter market), and restrictions on the ability of management or shareholders to delist companies from an exchange.[43]

Similarly, centralization of trading under Commission rules governing the national market system has supplanted the role traditionally played by exchanges and the NASD in developing priority, parity, and precedence rules for execution and execution quality and conflict-of-interest standards. Rules, such as the duty of best execution, order handling and routing obligations, and the prohibition against trading ahead of customer orders, are gradually being hardwired into inter-exchange communications systems built to Commission specifications.[44] Experts may disagree as to whether limiting the discretion of broker-dealers to choose among competing trading systems is appropriate, but a collateral effect of such initiatives is to minimize the roles of SROs in promulgating and enforcing "just and equitable principles of trade."[45]

42. *See, e.g.*, Barbara Black, *The Irony of Securities Arbitration Today: Why Do Brokerage Firms Need Judicial Protection?*, 72 U. CIN. L. REV. 415 (2003–2004).

43. Dale A. Oesterle, *Regulation NMS: Has the SEC Exceeded Its Congressional Mandate to Facilitate a "National Market System" in Securities Trading?,* 1 N.Y.U. J. L. & BUS. 613, 613–15 (2005); Laura Nyantung Beny, *U.S. Secondary Stock Markets: A Survey of Current Regulatory and Structural Issues and a Reform Proposal to Enhance Competition*, 2002 COLUM. BUS. L. REV. 399, 412–17, 462–63; Karmel, *supra* note 18, at 347–52.

44. *NYSE Sees Best Execution Differently from Amex, Nasdaq*, 38 Sec. L. Daily (BNA) No. 30, at 1278 (July 18, 2006). SEC Chief Economist Chester Spatt suggested that "Regulation NMS to some extent 'simplifies' a broker-dealer's duty of best execution by transferring some of the responsibility for best execution to the exchanges." *Id. See also* Simon & Colby, *supra* note 26, at 27–28.

45. *Compare* Lawrence E. Mitchell, *Structure as an Independent Variable in Assessing Stock Market Failures*, 72 GEO. WASH. L. REV. 547 (2004), Morris Mendelson & Junius W. Peake, *Intermediaries' or Investors': Whose Market Is It Anyway?*, 19 J. CORP. L. 443 (2000), *and* Yakov

B. THE CHANGING FACE OF SELF-REGULATION

Another development affecting the vitality of SROs is their increasing bureaucratization. One of the core assumptions of self-regulation is that SROs will be representative of the industry they regulate. Each national securities exchange and registered securities association, for example, must "assure a fair representation of its members in the selection of its directors and administration of its affairs."[46] The public interest was to be advanced by requiring "one or more directors" who would be "representative of issuers and investors and not be associated with a member of the exchange, broker or dealer."[47] Moreover, an expectation existed that organizations representative of the securities industry would be involved in SRO governance, disciplinary activity, and day-to-day decisionmaking.[48]

With the increasing size and specialization of SRO staff, SRO governance threatens to lose its representative status. Industry representation is largely confined to board oversight and member participation in the committee structure and disciplinary proceedings at various SROs.[49] Internal divisions between regulatory and operational arms further segregate

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Amihud & Haim Mendelson, *A New Approach to the Regulation of Securities Trading Across Markets*, 71 N.Y.U. L. REV. 1411 (1996), *with* Jonathan R. Macey & Maureen O'Hara, *From Markets to Venues: Securities Regulation in an Evolving World*, 58 STAN. L. REV. 563 (2005), *and* Mark Klock, *The SEC's New Regulation ATS: Placing the Myth of Market Fragmentation Ahead of Economic Theory and Evidence*, 51 FLA. L. REV. 753 (1999). *See, e.g.*, 15 U.S.C.S §§ 78f(b)(5), 78*o*-3(b)(6), 78*o*-4(b)(2)(B), 78*o*-5(b)(3) (LexisNexis 2006) (requiring national securities exchanges, national securities associations, and registered clearing agencies to have rules designated to promote "just and equitable principles of trade").

46. 15 U.S.C.S. §§ 78f(b)(3), 78*o*-3(b)(4) (LexisNexis 2006).

47. In practice, many exchanges sought to balance the number of "industry" directors on their boards with a comparable number of "public" (or "non-industry") directors. The proposed definition of "independent" directors in the SEC rules appears to be more restrictive than the traditional "public" or "non-industry" classification under prior exchange rules. *See* Listing and Trading of Affiliated Securities by a Self-Regulatory Organization, Exchange Act Release No. 50,699, 69 Fed. Reg. 71,126, 71,135 n.101 (reciting requirements of the Boston Stock Exchange's Constitution and the former Pacific Exchange's By-Laws establishing an equal proportion of "public" or "non-industry" and "industry" directors); NYSE CONST. art. 4, § 2 (CCH May 2002) (requiring, prior to the governance reforms contained in Exchange Act Release No. 48,946, that the board of the NYSE include, in addition to senior officers, 12 industry and 12 public directors); Letter from Neal Wolkoff, Acting CEO, AMEX, to Jonathan G. Katz, Sec'y, SEC 2 (Mar. 8, 2005), *available at* http://www.sec.gov/rules/proposed/s73904/nwolkoff 030805a.pdf (reflecting on AMEX's experience with a "largely independent board composed of many highly respected and accomplished individuals with no ties to the securities industry"); Letter from Robert Glauber, Chairman and CEO, NASD, to Jonathan G. Katz, Sec'y, SEC 8 (Mar. 8, 2005), *available at* http://www.sec.gov/rules/proposed/s73904/rrglauber030805.pdf (noting that, pursuant to its undertakings in connection with the 1996 settlement described in the 21(a) Report, the "NASD maintains a majority Public and Non-Industry membership on its Board of Governors," as defined in its by-laws and rules).

48. S. REP. NO. 75-1455, at 4–5 (1938) (describing the Maloney Act as creating a program of "cooperative regulation . . . [in which the task will be largely performed by] representative organizations of investment bankers, dealers, and brokers").

49. *Walter Says NASD Committed to Keeping 'Self' in Self-Regulation*, 38 Sec. Reg. & L. Rep. (BNA) No. 37, at 1534 (Sept. 14, 2006) (describing member involvement in SRO governance).

persons involved in regulatory decisions from individuals with operational experience in the securities industry.[50] It has also long been observed that the need to develop specialized compliance inspection and enforcement functions within each SRO results in the delegation of responsibility to full-time paid staffs, who may or may not have managerial or operational experience in any of the SRO's member firms.[51] While this does not necessarily imply that familiarity with firm operations cannot be acquired, it does suggest a lack of identity on the basis of which to establish a claim of self-representation in self-regulation.

Recent SEC initiatives would increase this trend toward greater independence from the securities industry. Proposed rules respecting SRO governance, for example, would require SRO boards to consist of a majority of independent directors.[52] While the preference for outside directors is nothing new, stringent independence requirements would generally exclude individuals with any material ties to the securities industry.[53] When combined with the effect of the SEC's determination to permit for-profit exchanges (discussed below), member representation on SRO boards could decline to as little as 20%.[54] The SEC's SRO governance rules would also mandate greater separation between SROs' regulatory and operational functions,[55] and require internal controls to ensure regulatory monies do not subsidize operational activities.[56]

These developments will have numerous consequences on self-regulation. As SRO personnel begin to look more like the SEC, it will be increasingly difficult to envision SROs performing the traditional buffering function between industry competition and SEC regulation. Instead, SROs, such as the NASD, are likely to behave as if they are an extension of the Commission's own compliance and enforcement arms, with the added benefit that they are subsidized by industry fees and not constrained by the same statutory limitations on their power. NASD rulemaking initiatives, for example, may become increasingly driven by pressure from the Commission, rather than pressure for coordination by the industry.

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50. *See infra* text accompanying notes 68–71.

51. *See, e.g.*, Sam Scott Miller, *Self-Regulation of the Securities Market: A Critical Examination,* 42 WASH. & LEE L. REV. 853, 862–63 (1985) (citing William L. Cary, *Self-Regulation in the Securities Industry*, 49 A.B.A. J. 244, 247 (1963); SEC, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 88-95, pt. 4, at 602).

52. Listing and Trading of Affiliated Securities by a Self-Regulatory Organization, 69 Fed. Reg. at 71,126.

53. *See id.* (defining "independent director"); *see, e.g.*, *Walter Says NASD Committed to Keeping 'Self' in Self-Regulation*, *supra* note 49 (noting that the NASD Board of Governors has 7 industry directors out of 18 and NYSE regulation has no industry representation).

54. *See* Listing and Trading of Affiliated Securities by a Self-Regulatory Organization, 69 Fed. Reg. at 71,126 (to be codified at 17 C.F.R. § 240.6a-5(c)(5)).

55. *Id.* (to be codified at 17 C.F.R. §§ 240.6a-5(n)(1), 240.15Aa-3(n)(1)).

56. *Id.* (to be codified at 17 C.F.R. §§ 240.6a-5(n)(4), 240.15Aa-3(n)(4)).

More importantly, the agenda of self-regulators may retreat significantly from areas outside of the SEC's competence or expertise. Many aspects of today's securities markets are not subject to direct regulation by the Commission—such as over-the-counter derivatives transactions and corporate debt markets. These are areas in which SROs truly representative of the securities industry might make headway in spearheading the development of business conduct norms, much as the U.S. Treasury Department and Municipal Securities Rulemaking Board (MSRB) have developed idiosyncratic rules for the government and municipal securities markets. The NASD has made only modest forays into such issues, presumably because the industry has no desire to see Commission-dominated SROs creep into areas outside of the SEC's direct oversight.

C SELF-INTEREST

Even as recent trends have aligned the interests of SRO regulatory personnel with those of the SEC, they have created even greater opportunities for SRO operational personnel to leverage the value of their special statutory status. Historically, exchanges and other SROs were operated as not-for-profit organizations. While a limited number of exempt exchanges were permitted to operate on a for-profit basis outside of the statutory regime, exchanges largely existed to furnish facilities "for the convenient transaction of business by its members."[57] Abuses of exchange management, however frequent, were usually for the benefit of one faction (e.g., specialists or floor brokers) at the expense of another.[58] The profitability of a seat on the exchange and the access it conferred to its exclusive information and services, moreover, deterred members from "turning them into shares" that could be offered to the public.[59]

Although the Commission has acknowledged that national securities exchanges could be organized as for-profit entities, several factors contributed to the current trend to seek for-profit status.[60] First, technology made pure brokerage profitable. New electronic trading systems capitalized on technological improvements to offer more efficient, if non-traditional, venues for trade execution without sponsoring the intermediation of a dealer.[61] Virtually all of these systems were permitted to operate as registered broker-dealers in the United States, rather than as exchanges, in

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57. NYSE CONST. art. I, § 2(a).
58. *See* Seligman, *supra* note 22, at 1355.
59. Roberta S. Karmel, *Turning Seats Into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L. REV. 367, 372–73 (2002). *See also* Andreas M. Fleckner, *Stock Exchanges at the Crossroads*, 74 FORDHAM L. REV. 2541, 2564–66 (2006).
60. Exchange Act Release No. 38,672, 62 Fed. Reg. 30,485, 30,486 (June 4, 1997).
61. *See, e.g.*, Macey & O'Hara, *supra* note 13 (describing technological advances that affect trading).

order to facilitate their proliferation.[62] The mutual structure of the primary exchanges, encumbered as it was by members' (and in particular, specialists') self-interest, prevented the adoption of new execution technologies in favor of traditional intermediated trading. To the extent that many brokerage firms were investing in competing execution or market making technologies,[63] exchange members increasingly found themselves in direct competition with their regulators.[64]

Second, Commission rulemaking requires SROs to build linkage systems that would serve as the basis for intermarket connectivity. The Commission had long pressed exchanges and the NASD to develop technologies to improve execution quality for retail investors by facilitating access to their members' published quotations.[65] This eventually placed SROs—particularly, the NASD—in direct competition with members who operated electronic trading or market making systems, because they were essentially building systems that would eliminate internalization of orders in favor of a centralized (if not mandatory) limit order book.[66] In particular,

62. Exchange Act Release No. 38,672, 62 Fed. Reg. at 30,486. One system, the Arizona Stock Exchange, has been recognized as an "exchange" operating pursuant to a limited volume exemption from registration under section 5 of the Exchange Act. *See* Order Amending Exemption Order and Granting Amendment to Application for Exemption from Registration as an Exchange under section 5 of the Securities Exchange Act of 1934, Exchange Act Release No. 37,271, 61 Fed. Reg. 29,145 (June 3, 1996). To the extent that a limited-volume business model forecloses any benefits from economies of scale, it is not surprising that few trading systems have pursued such regulatory classification.

63. *See* Mark Borrelli, *Market Making in the Electronic Age*, 32 LOY. U. CHI. L.J. 815, 817 (2001).

64. *See* Gaston F. Ceron, *Moving the Market: Big Board Sets Expansion In Electronic Trading*, WALL ST. J, Aug. 28, 2006, at C3 (describing concerns of NYSE specialists and brokers that the lifting of the limits on electronic trading could sideline them and hurt their profits).

65. *See* Order Granting Temporary Approval, On An Accelerated Basis to a Proposed Rule Change by the National Association of Securities Dealers, Inc. to Establish the Order Confirmation Transaction Service Enhancement to the NASDAQ System, Exchange Act Release No. 25,263, 53 Fed. Reg. 1430 (Jan 19, 1988) (approving Nasdaq's SelectNet Service, formerly the Order Confirmation Transaction Service, on a temporary accelerated basis); National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change, Release No. 21,743, 50 Fed. Reg. 7432 (Feb. 22, 1985) (approving Nasdaq's Small Order Execution Service). *See also* Simon & Colby, *supra* note 26, at 73–76.

66. For example, in its application for registration as a freestanding national securities exchange, Nasdaq agreed to limit "Nasdaq Exchange transactions" to those trades that are "executed in the Exchange's systems and to amend its Exchange systems to require executions to occur pursuant" to price- and (with certain exceptions) time-priority rules. *See, e.g.*, In re Nasdaq Stock Market, Exchange Act Release No. 53,128, 71 Fed. Reg. 3550, 3550–51 (Jan. 23, 2006). This amendment obviated the need for the Commission to reconsider whether exchanges must have a central limit order book that ensures some price/time priority over dealer trades on the exchange. *Id.* at 3550–51; *see also* 17 C.F.R. § 240.3b-16 (2006) (interpreting the statutory definition of an "exchange" in section 3 of the Exchange Act, 15 U.S.C. § 78c(1), to require the use of "established, non-discretionary methods . . . under which . . . orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade"). It eliminated, however, the ability of members (such as market makers) to "preference" execution of customer orders against a designated quoting market participant's quote, irrespective of time priority, as long as the quote matched the contemporaneous best bid/best offer. *See, e.g.*, Former NASD Rule

SROs could offer the unique proposition of disintermediation and regulatory imprimatur. Why pay a market maker or an alternative trading system to display your order in Nasdaq when you can display your order directly in Nasdaq? Why risk a poor execution in an alternative trading system, when you are guaranteed an execution quality price on the NYSE? Together with trade-through rules that favor established markets, exchanges had a competitive edge over their members.[67]

Third, the Commission's separation of regulatory and operational functions within SROs made it possible for SROs to operate their facilities as profitable subsidiaries. In 1996, following the Nasdaq market making scandal, the NASD was required, inter alia, to segregate its market operations (which became the Nasdaq Stock Market) from its regulatory operations (NASD Regulation).[68] Parallel with, if not as a consequence of, the enactment of the Sarbanes-Oxley Act of 2002 and the governance reforms following the public debate over NYSE CEO Richard Grasso's compensation package, the Commission proposed to extend this structural segregation to other exchanges.[69] The Commission has also proposed to revamp the rules of exchange governance to require greater transparency and segregation of the regulatory and trading operations of SROs. And just as Nasdaq has spun off from the NASD to be a freestanding SRO (having delegated its self-regulatory responsibility to the NASD), the NYSE has formally separated its regulatory and business operations into independent subsidiaries to reduce conflicts of interest.[70]

With autonomy and the prospect of profitability, electronic trading could be used not only to improve member access to public quotes, but to supplant member activity in the over-the-counter markets. Nasdaq could transform its system for displaying and providing execution access to member quotations into an electronic trading system that would rival its competitors in the over-the-counter market. NYSE, AMEX, and the

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4710(b)(1)(B)(ii)(b) (CCH Jan. 2005). Thus, a market maker may not preferentially execute customer transactions against its own quote "on or through" the facilities of the Nasdaq Exchange.

67. *See* 17 C.F.R. § 242.611 (2005) (requiring trading centers to establish, maintain and enforce policies reasonably designed to prevent transactions on their markets that "trade-through" the protected quotations of other markets in NMS stocks).

68. SEC, REPORT PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934 REGARDING THE NASD AND THE NASDAQ MARKET (Aug. 8, 1996), *available at* http://www.sec.gov/litigation/investreport/nasdaq21a.htm.

69. Listing and Trading of Affiliated Securities by a Self-Regulatory Organization, Exchange Act Release No. 50,699, 69 Fed. Reg. 71,126, 71,129–30 (describing the proposed governance reforms adopted by the NYSE in December 2003 in the context of "Governance Concerns" relating to issuers of exchange-listed securities and to the NYSE itself in connection with its Chairman's compensation package, and the concomitant concerns over weaknesses in the regulatory programs of other SROs).

70. Order Granting Approval of Proposed Rule Change and Amendment Nos. 1, 3, and 5 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 6 and 8 Relating to the NYSE's Business Combination With Archipelago Holdings, Inc., Exchange Act Release No. 53,382, 71 Fed. Reg. 11,251–52 (Mar. 6, 2006).

regional exchanges, meanwhile, could build systems that would bypass exchange specialists or market makers, rather than rely upon their negative obligation to refrain from trading in an otherwise liquid market.[71]

Fourth, a for-profit structure was more conducive to expansion in the technology boom of the late 1990s. Raising capital as a non-profit membership organization would entail higher regulatory or trading fees, and thus would require membership and Commission scrutiny of each initiative. By contrast, a public offering, followed by strategic acquisitions for stock, allows SROs to expand operational capabilities rapidly by purchasing boutique technology firms rather than develop proprietary technologies.[72] Nasdaq's acquisition of Instinet and NYSE's merger with Archipelago—the two ECNs with the largest market share of National Market System (NMS) order flow—could not have taken place without access to capital markets.[73] Publicly held stock may also facilitate mergers with similarly structured international exchanges to the extent that cross-border trading or technological synergies exist.[74]

The potential adverse consequences of the for-profit transformation are manifest. SROs may lose their focus on serving as regulators for the securities industry and instead concentrate on maximizing shareholder revenues.[75] From an economic perspective, this is unobjectionable. There are many regulated industries (e.g., the telecommunications industry) where private companies operate public utilities and dictate (to a degree) the terms of competition for their competitors. But in no sense of the word are such

71. The goal of the various "hybrid" market structures implemented in recent years by various stock exchanges (including the NYSE and AMEX) is to augment opportunities for automated execution of public orders at published quotations without eliminating the entry and execution of floor-based orders. Specialists would continue, in such systems, to commit capital to bridge temporary gaps in supply and demand—particularly for large transactions that may not be entirely filled at the national best bid and offer—in exchange for preferential access to information, exclusive interfaces with exchange systems for managing their trading interest, and the limited ability to suspend automated executions or to conduct parallel floor auctions. *See, e.g.*, Order Approving Proposed Rule Change and Amendments and Notice of Filing and Order Granting Accelerated Approval to Amendments to Establish the Hybrid Market, Exchange Act Release No. 53,539, 71 Fed. Reg. 16,353 (proposed Mar. 31, 2006) (approving NYSE's proposed rule changes to establish the hybrid market); Order Approving a Proposed Rule Change and Amendments, and Notice of Filing and Order Granting Accelerated Approval to Amendment, To Establish a New Hybrid Trading System Known as AEMI[SM], Exchange Act Release No. 54,552, 71 Fed. Reg. 59,546 (Oct. 10, 2006) (approving AMEX's proposed rule changes to establish the "Auction & Electronic Market Integration" system).

72. Norman S. Poser, *The Stock Exchanges of the United States and Europe: Automation, Globalization, and Consolidation*, 22 U. PA. J. INT'L ECON. L. 497, 513 (2001).

73. Brian Blackstone, *U.S. Approves Exchange Deals*, WALL ST. J., Nov. 17, 2005, at C3 (describing Nasdaq's acquisition of Instinet and NYSE's merger with Archipelago).

74. *See, e.g.*, Boston Options Exchange, http://www.bostonoptions.com/ove/ope.php (last visited Oct. 20, 2006) (describing Boston Options Exchange Group LLC, a joint venture among Montreal Exchange, Boston Stock Exchange and various member firms that manages all issues relating to trading on the options exchange).

75. James D. Cox, *Brands vs. Generics: Self-Regulation by Competitors*, 2000 COLUM. BUS. L. REV. 15, 19 (2000).

specially licensed firms considered self-regulators representative of their customers—at least no more than a taxicab medallion transforms a New York cab driver into a traffic cop. Moreover, there is no consensus that stock exchanges are essential utilities, the quotations of which must be accessible by all broker-dealers, as long as common members are able to limit significant price variations across markets.[76]

A second consequence of this transformation is the impact on public perception of the fairness of the marketplace.[77] One of the important ceremonial duties of SROs is to take public remedial measures to address misconduct by their members and listed issuers so that Congress and the Commission do not have to resort to the more cumbersome combination of legislation and regulation. When exchanges themselves become the source of scandal, this function is lost. The scandal surrounding NYSE CEO Richard Grasso's compensation package, for example, while in theory solely a concern of the members of the exchange (as a private company), reflects the sense of civic responsibility to which SRO management is (thought to be) held.[78] This level of public accountability will no longer be tenable when SRO shareholders require that their agents operate with the morals of the marketplace.

D. CROSS-BORDER MERGERS AND JOINT VENTURES

The globalization imperative has permeated the financial services sector. Shareholders of both the NYSE Group and Euronext, one of the largest non-U.S. stock exchanges, have approved the merger of the two

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76. *Compare* Junius Peake, *Entropy and the National Market System,* 1 BROOK. J. CORP. FIN. & COM. L. 301 (2007) *with* Roger Blanc, *Intermarket Competition and Monopoly Power in the U.S. Securities Market*, 1 BROOK. J. CORP. FIN. & COM. L. 273 (2007).

77. Caroline Bradley, *Demutualization of Financial Exchanges: Business as Usual?,* 21 NW. J. INT'L L. & BUS. 657, 658 (2001) (discussing the reasons behind the historical organization of certain financial services as mutual businesses).

78. *See, e.g.*, *The Post-Grasso Exchange*, N.Y. TIMES, Nov. 4, 2003, at A1 ("While unproven, the suggestion that the exchange's boss was compensated generously to perpetuate an outdated system that benefited insiders is potent because the institution is riddled with untenable conflicts of interest. The exchange must be drastically overhauled if it is to regain investors' trust."); Jesse Eisinger, *The Well-Paid Regulator*, WALL ST. J., Sept. 11, 2003, at C1 ("Whatever the NYSE wants to pay its CEO is fine. But only if the NYSE is stripped of its regulatory authority. It's untenable for a regulator to simultaneously be running a business, especially one besieged by superior competition. Investors need to trust that when those who run the markets throw out pieties about disclosure and fairness, they are sincere. The way to restore investor trust is not for Mr. Grasso to give back fractions of his wealth, but to give up a bit of his power."). At the time, the NYSE was a "Type A" not-for-profit corporation under section 402 of the N.Y. Not-For-Profit Corporation Law. The NYSE Group, Inc. (the new holding company of the NYSE and its affiliates) became a public corporation on March 8, 2006, following the completion of the merger of the New York Stock Exchange into Archipelago Holdings, Inc. the prior day. *See* Steve Gelsi, *Moving the Market: NYSE Begins Its Life Today as a Listed Stock*, WALL ST. J., Mar. 8, 2006, at C5; Aaron Lucchetti & Kara Scannell, *NYSE's Trading Overload Draws Attention of the SEC*, WALL ST. J., Mar. 1, 2007, at C1.

entities.[79] Deutsche Börse and Borsa Italiana have also at various times been in negotiations to join the NYSE-Euronext combination.[80] Meanwhile, Nasdaq has gradually increased its stake in the London Stock Exchange even as its increasing hostile takeover offers have been rebuffed.[81] More modest initiatives have also taken place, such as the Boston Stock Exchange's joint venture with the Montreal Stock Exchange to develop a common operating platform for options trading.[82] And yet, to date, the Commission has addressed only in the broadest terms how or on what terms a non-U.S. stock exchange can maintain a presence in the United States without running afoul of the statutory prohibition against trading by U.S. brokers on unregistered exchanges.[83]

On the one hand, the Commission cannot deny the inevitable conglomeration of national exchanges into transnational exchanges.[84] Investors have reaped significant benefits from the consolidation of regional exchanges in the United States and national exchanges in the EU in terms of

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79. *See generally* Roberta S. Karmel, *The Once and Future New York Stock Exchange: The Regulation of Global Exchanges*, 1 BROOK. J. CORP. FIN. & COM. L. 355 (2007).

80. Gaston F. Ceron, *NYSE Group's Shareholders Approve Takeover of Euronext*, N.Y. TIMES, Dec. 21, 2006, at C3.

81. Alistair MacDonald & Gren Manuel, *Nasdaq Gets Tough in LSE Bid*, WALL ST. J., Dec. 13, 2006, at C3 (describing Nasdaq's hostile £2.7 billion bid to acquire a simple majority of LSE's shares); *Britain Hopes to Limit Changes at Exchange*, REUTERS, Sept. 14, 2006 (noting U.K. officials' concern that ownership of the LSE by Nasdaq could trigger the application of U.S. law). *See also* Alistair MacDonald, *With Nasdaq-LSE Deal Doubtful, Exchanges' Next Steps are Unclear*, WALL ST. J., Feb. 10, 2007, at B3; Alistair MacDonald, *LSE, Available Again, May Seek New Partner—After Nasdaq Bows Out, Local Deals Could Prove Difficult to Put Together*, WALL ST. J., Feb. 13, 2007, at C2.

82. *See* Boston Options Exchange, http://www.bostonoptions.com/ove/ope.php (last visited Oct. 20, 2006).

83. 15 U.S.C. § 78e (2000) (prohibiting any broker, dealer, or exchange from using any facility of an exchange within or subject to U.S. jurisdiction unless such exchange is registered under section 6 of the Exchange Act or exempted by the Commission upon application). Only one non-U.S. exchange currently operates pursuant to a limited-volume exemption. *See* Order Granting Limited Volume Exemption From Registration as an Exchange Under Section 5 of the Securities Exchange Act, Exchange Act Release No. 41,199, 64 Fed. Reg. 14,953 (Mar 29, 1999); Letter from Robert L. D. Colby, Deputy Director Division of Market Regulation, SEC, to Steven Lofchie, Partner, Davis, Polk & Wardwell (June 21, 2001) (commenting on an SEC no-action position relating to Tradepoint Stock Exchange/virt-x exchange); Exchange Act Release No. 38,672, 62 Fed. Reg. 30,485, 30,486 (proposed June 4, 1997).

On March 1, 2007, Erik R. Sirri, Director of the SEC's Division of Market Regulation, revived discussion of proposals to exempt foreign exchanges from registration under section 6 subject to conditions established by rule. Erik R. Sirri, Dir., SEC Division of Market Regulation, Trading Foreign Shares, Speech in Boston, Massachusetts (Mar. 1, 2007), *available at* http://www.sec.gov/news/speech/2007/spch030107ers.htm. *See also* Regulation of Exchanges, Exchange Act Release No. 38,672, 62 Fed. Reg. 30,485, 30,522–23 (Part VII.B.1) (June 4, 1997) (soliciting comment on a proposal to rely on home-country regulation of non-U.S. securities exchanges).

84. Christopher Cox, Chairman, SEC, Speech at Harvard Business School Global Leadership Forum, Ronald Reagan International Center: Cross-Border Exchange Mergers in the Context of Global Trade (June 22, 2006), *available at* http://www.sec.gov/news/speech/2006/spch062206cc.htm.

access to trading opportunities, variety of listed securities, and improvements in exchange technology and services.[85] At present, cross-border synergies must come primarily from the latter, since the resulting business combinations will operate largely as holding companies for separately regulated and operated national exchanges.[86] But cross-border mergers would ultimately prove meaningless if U.S. institutional and retail investors were unable to trade directly with European investors or if the current restrictions on contact between non-U.S. brokers and exchanges were to remain in place.

On the other hand, the Commission is reluctant to concede that U.S. federal regulation or self-regulation stops at the U.S. border. U.S. disclosure standards for exchange-listed companies would rapidly lose significance if the SEC did not hold all companies listed on cross-border exchanges up to the same standards as if they had a significant U.S. shareholder base. U.S. investors would potentially be exposed to more manipulative or deceptive conduct (as defined by the Commission) if foreign exchanges are subject to laxer standards than U.S. markets. One might expect that international efforts at harmonizing regulatory standards will pave the way for common rules of market conduct,[87] but the longstanding difficulties in reaching an agreement on accounting standards suggests that such efforts will be protracted.[88]

Exchanges face a dilemma of sorts as well. They could, consistent with current regulations, attempt to rig cross-border trading and listing mechanisms that provide some appearance of cross-border activity to U.S. investors. Prior to the Sarbanes-Oxley Act of 2002, for example, the NYSE had developed a special body of listing standards that it had aggressively marketed to non-U.S. companies.[89] Exchanges could quietly offer cross-border trading opportunities in non-U.S. securities through the facilities of their members with U.S. affiliates, in the same manner as many electronic

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85. Karmel, *supra* note 79, at 356–58.

86. *See* Aaron Lucchetti, *NYSE-Euronext: One, but Two*, WALL ST. J., Sept. 22, 2006, at C4 (describing the holding company structure developed by NYSE Group and Euronext NV to avoid U.S. regulation of European market operations and vice versa).

87. Caroline Bradley, *Private International Law-Making for the Financial Markets*, 29 FORDHAM INT'L L.J. 127, 130–31 (2005).

88. *See* SEC, STUDY PURSUANT TO SECTION 108(D) OF THE SARBANES-OXLEY ACT OF 2002 ON THE ADOPTION BY THE UNITED STATES FINANCIAL REPORTING SYSTEM OF A PRINCIPLES-BASED ACCOUNTING SYSTEM 38 (Jul. 25, 2003) (describing efforts between the Financial Accounting Standards Board and the International Accounting Standards Board to seek greater convergence of U.S. and international accounting standards as "long-term").

89. NYSE LCM § 103.00 (2006) (discussing the NYSE's Alternate Listing Standards for "foreign private issuers," which among other things, apply quantitative standards regarding share distribution based on global rather than U.S. share volume and limit interim financial disclosures or corporate governance standards that may conflict with home country laws or practices); *see also* John C. Coffee, Jr., *supra* note 18, at, 1830 (discussing the "inconsistent distinction" that U.S. law makes between foreign and domestic issuers and its adverse impact on attempts by non-U.S. exchanges to improve listing standards).

trading systems operated by U.S. investment banks and brokerage firms provided access to foreign markets.[90] Foreign derivatives exchanges, conversely, could to a limited extent familiarize U.S. investors and intermediaries with their products even though they could not be "offered" in the United States.[91]

A full-scale cross-border linkage, however, would either entail enforcing U.S. regulation abroad (consistent with SRO's gatekeeping responsibilities), or require exchanges to shed their own SRO responsibilities (at least with respect to federal law).[92] In other contexts, the lower standard of gatekeeping responsibility has made it easier to permit such cross-border access. In the U.S. commodity futures markets, where the regulatory responsibilities of designated contract markets are more limited, the Commodity Futures Trading Commission (CFTC) has permitted foreign exchanges to offer electronic access to U.S. Future Commissions Merchants (FCMs) through an informal regulatory process.[93] In the EU, the Investment Services Directive (soon to be replaced by the even more ambitious Markets in Financial Instruments Directive, or MiFID) has similarly permitted investment firms in any EU member state to obtain remote access to the regulated markets of any other EU member state based on a system of coordinated home/host country regulation.[94] Because listing and trading on U.S. exchanges triggers the full application of U.S. federal securities law—and requires U.S. exchanges to enforce that law as part of their statutory mandate[95]—U.S. exchanges have struggled to keep up in the global mergers race.

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90. John Ramsay, *Rule 15a-6 and the International Marketplace: Time for A New Idea?*, 33 LAW & POL'Y INT'L BUS. 507, 517–22 (2002).

91. *See, e.g.*, Eurex, SEC No-Action Letter, 2005 SEC No-Act. LEXIS 662 (July 27, 2005); London International Financial Futures and Options Exchange, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 359 (Mar. 6, 1996) (permitting non-U.S. exchanges to familiarize certain registered broker-dealers and large financial institutions in the United States with certain of their equity, index, and exchange-traded fund options).

92. Poser, *supra* note 72, at 534–35. At present, the only available option is for exchanges to deregister and operate as "alternative trading systems" or brokerage firms. To do so, however, would require that exchanges give up the authority to regulate their members' business conduct and discipline their members. *See* Regulation ATS, 17 C.F.R. § 242.300(a)(2) (2005) (defining the types of alternative trading system that may elect to register as a broker-dealer rather than as an exchange).

93. The CFTC has recently reaffirmed that it will continue to grant no-action relief permitting foreign commodity exchanges to provide direct access to their electronic trading systems to U.S. firms and their associated persons. *See* Boards of Trade Located Outside of the United States and No-Action Relief From the Requirement To Become a Designated Contract Market or Derivatives Transaction Execution Facility, CFTC Policy Statement, 71 Fed. Reg. 64,443 (Nov. 2, 2006).

94. Council Directive 2004/39, arts. 33, 2004 O.J. (L145) 1, 26 (EC) (Apr. 21, 2004).

95. Exchange Act § 6, 15 U.S.C. § 78f(b)(1) (2000); Exchange Act 15A(b)(2), 15 U.S.C. § 78*o*-3(b)(2) (2000); Exchange Act § 19(h), 15 U.S.C. § 78s(h) (2000).

III. SELF-IMPROVEMENT

Despite significant ambivalence about the future of self-regulation, the reform proposals advanced by the industry and the Commission do not break new ground.[96] This is in part because the NASD and the Commission have subtly transformed themselves to fill the gaps in traditional market-based self-regulation. Given the Commission's SRO governance initiatives and the NASD's own reputation of being too removed from its membership's interests, it is hard to see any benefit from completely revamping the Exchange Act to eliminate or curtail self-regulation.[97] Indeed, the presence of multiple SROs under one or more hybrid models might well complement the Commission's and the NASD's authority by providing a greater degree of responsiveness and representativeness to the regulatory framework. The success of any such model would depend on an appropriate allocation of responsibilities.

A. NO SRO?

Proposals for reforming regulation of the securities industry with a dominant regulator not beholden to the industry would replace SROs with direct Commission regulation or a new non-industry regulator along the lines of the PCAOB. It is difficult to believe that *direct Commission regulation* of registered broker-dealers alone could replace self-regulation. It may appear inevitable that the Commission will continue to take steps in this direction,[98] given the international trend of replacing self-regulation of individual markets with oversight by a single governmental or non-governmental regulator.[99] In addition to its traditional enforcement activities

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96. For example, the Securities Industry Association's Ad Hoc Committee on the Regulatory Implications of Demutualization proposed five alternative models, including (1) multiple exchanges with separate boards and information barriers, as is the case with the NASDR and Nasdaq; (2) multiple SROs with firms designated to a single SRO for examination purposes; (3) a hybrid model, in which member regulation is effected by a single SRO, and individual markets regulate their own trading; (4) a single SRO for all purposes; and (5) SEC regulation. *See* SIA White Paper, *supra* note 1, at 14. The Commission published a modified version of these alternatives in its concept release on SRO governance. *See* Concept Release Concerning Self-Regulation, Exchange Act Release No. 50,700 (Nov. 18, 2004), 69 Fed. Reg. 71,256 (Dec. 8, 2004).

97. *Cf.* Letter from Thomas W. Sexton, III, Vice President and General Counsel, Nat'l Futures Ass'n, to Eileen Donovan, Acting Secretary, CFTC (Sept. 6, 2006), *available at* http://www.nfa.futures.org/news/newsComment.asp?ArticleID=1640 ("[A]pplaud[ing] the Commission's decision not to include registered futures associations in the current proposed acceptable practices for exchange governance and conflicts of interest.").

98. Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 775 (2006).

99. *See id.* at 833–34 (listing various nations that have opted to create "central agencies" for the supervision of capital markets in emulation of the SEC). One frequently cited example is the creation of the U.K. Financial Services Authority (FSA), which replaced or assumed the powers of

under the antifraud laws, the Commission has established an Office of Compliance Inspections and Examinations (OCIE) to administer a "nationwide examination and inspection program for registered self-regulatory organizations, broker-dealers, transfer agents, clearing agencies, investment companies, and investment advisers."[100] The Commission staff also frequently consults with industry personnel about risk management issues, in part under the aegis of its material associated persons reporting requirements. The Commission's unpleasant experience with the short-lived SECO program, however, has discouraged it from arrogating an exclusive role in the regulatory process.[101] In addition to the significant financial cost of maintaining the compliance and enforcement staff necessary to make such regulation feasible, there is the added difficulty of adopting and interpreting rules to govern industry conduct within the confines of the Administrative Procedure Act.[102]

Moreover, if a new *non-governmental regulator* were employed, it is hard to see how any such regulator would differ significantly from the NASD, which has already emerged as the de facto exclusive regulator of

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the individual U.K. self-regulatory bodies for financial services in 2000. The FSA describes itself as:

> [A]n independent non-governmental body, given statutory powers by the Financial Services and Markets Act 2000. We are a company limited by guarantee and financed by the financial services industry. The Treasury appoints the FSA Board, which currently consists of a Chairman, a Chief Executive Officer, three Managing Directors, and 10 non-executive directors (including a lead non-executive member, the Deputy Chairman). This Board sets our overall policy, but day-to-day decisions and management of the staff are the responsibility of the Executive.

FSA, Who Are We, http://www.fsa.gov.uk/Pages/About/Who/index.shtml (last visited Jan. 29, 2006).

100. SEC, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, *available at* http://www.sec.gov/about/whatwedo.shtml (last visited Jan. 29, 2006). In a recent report, the U.S. Chamber of Commerce has proposed that the "SEC should realign its organizational structure to improve its efficiency and mirror the contours of the current capital markets, including, for example, by folding [OCIE] back into the operating divisions to facilitate consistent interpretations of applicable rules." COMM'N ON THE REG. OF U.S. CAPITAL MKTS. IN THE 21ST CENTURY, REPORT AND RECOMMENDATIONS 6 (Mar. 2007), *available at* http://www.uschamber.com/publications/reports/0703capmarketscomm.

101. Proposed Rule Change National Association of Securities Dealers, Inc.; Conversion of SECO Broker/Dealers, Exchange Act Release No. 20,273, 1983 SEC LEXIS 569 (Oct. 12, 1983) (converting SECO broker-dealers into NASD members).

102. For example, while OCIE routinely examines registered broker-dealers for compliance with the requirement to obtain best execution for customer transactions, the Commission has never adopted a best execution rule, preferring instead to rely upon SRO rulemaking and enforcement actions. *See, e.g.*, OCIE, Examinations of Broker-Dealers Offering Online Trading: Summary of Findings and Recommendations (Jan. 25, 2001), *available at* http://www.sec.gov/news/studies/online.htm (discussing OCIE staff reviews of best-execution practices at on-line brokerage firms).

brokerage firms for most aspects of broker-dealer business conduct.[103] The allure of a universal non-industry regulator would appear to be twofold: its members would be appointed by the Commission, and it would derive its funding from a statutory levy on broker-dealers, rather than membership dues and service fees.[104] Putting aside concerns about the constitutionality of such a structure,[105] legislatively chartered self-regulatory organizations such as the MSRB as well as quasi-SRO membership organizations such as SIPC have long successfully combined executive/Commission appointments and industry representation.[106] Preserving a general statute of SRO registration, rather than chartering individual SROs by legislation, may also facilitate the formation, consolidation, and dissolution of specialty SROs without the need for Congressional intervention.

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103. Within days of this Symposium, the NASD and the NYSE announced the signing of a "letter of intent" to merge their oversight functions into a new self-regulatory organization. *See* Gaston F. Ceron, *NYSE, NASD Link Regulatory Arms*, WALL ST. J., at C4 (Nov. 28, 2006). As part of the merger, NYSE Regulation announced that "approximately 470" staff members in its regulation, arbitration, risk assessment and related enforcement units would join the new SRO. *See* News Release, NYSE Regulation Consolidation Plan by Richard G. Ketchum, Chief Executive Officer, NYSE Regulation, Inc. (Nov. 28, 2006) *available at* http://www.nyse.com/Frameset.html?nyseref=&displayPage=/content/articles/1164712197534.html.

104. At present, SROs cover the costs of self-regulation through regulatory fees assessed on members, listing fees assessed on issuers, market data fees assessed on the sale of quotation and transaction information to the public, and transaction fees assessed on transactions executed through their facilities. To ensure adequate funding for SRO services, SROs have, inter alia, been given the right to sell consolidated quotation and a privilege to sell transaction information collected from their members under national market system plans. *See* Regulation NMS, 17 C.F.R. §§ 243.601–243.602 (2000). As described above, however, proposed Commission rules would specifically prohibit the use of regulatory fees, fines, and penalties to fund operational activities. *See supra* p. 332; *see also supra* notes 55–56 and accompanying text.

105. Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 1029–60 (2005). *See* Free Enterprise Fund v. PCAOB, 2007 WL 891675 (D.D.C. Mar. 21, 2007) (granting summary judgment to PCAOB on question of its constitutionality under "separation-of-powers principles," the Appointments Clause, and the "non-delegation doctrine").

106. The MSRB is a board composed of fifteen members that has the powers and duties of a self-regulatory organization under the Exchange Act and whose rules are enforceable against any broker, dealer or municipal securities dealer (including the municipal securities division of a bank) that effects transactions in municipal securities. *See* Exchange Act § 15B(b), (c)(1), 15 U.S.C. § 78*o*-4(b), (c)(1) (Supp. II 2002); Exchange Act § 3(a)(26), 15 U.S.C. § 78c(a)(26) (2000) (defining "self-regulatory organization"). SIPC, while not a "self-regulatory organization" under the Exchange Act, is a nonprofit membership organization "the members of which shall be all persons registered as brokers or dealers under section . . . 78*o*(b) of the 1934 Act" (with exceptions) and whose by-laws and rule changes are generally subject to Commission approval. 15 U.S.C. § 78ccc(a)(2)(A), (e) (2000) The MSRB's board is composed of fifteen members appointed by the Commission, five of whom are representatives of the broker-dealer industry and five of whom are representatives of the banking industry. Exchange Act § 15B(b)(1), 15 U.S.C. § 78*o*-4(b)(1) (Supp. II 2002). SIPC's board is composed of seven persons, five of whom appointed by the President with the advice and consent of the Senate (three of whom are "associated with, and representative of different aspects of, the securities industry") and two of whom are appointed by the Federal Reserve Board and the Secretary of the Treasury, respectively. 15 U.S.C. § 78ccc(c)(2).

While it is in the Commission's interest to reduce the reliance upon cross-subsidization of SRO regulatory activities, the necessity of formally removing this authority from the regulatory body—by establishing statutory assessments or levies on members or market participants—is unclear. To a degree, the regulatory monopoly on other revenue sources has distorted the efficiency of market operations because the Commission has never sought to ensure that SROs will dedicate those funds for regulatory purposes rather than operational objectives.[107] Disentangling SRO services from SRO funding and requiring a separate source of funding for member regulation would improve SRO accounting and accountability. But this is unrelated to whether SROs are able to set appropriate fees for the regulation of their members. It may be far more efficient to eliminate cross-subsidies for regulation and allow SROs to set membership fees, than to mandate member assessments or a statutory levy.

B. IS THERE A NEED FOR "MARKET BASED" SELF-REGULATION?

If some consolidation of member supervision is desirable, should other self-regulatory responsibilities also be consolidated? "Market based" self-regulation may be justified by a desire on the part of the Commission and individual exchanges to retain flexibility in governing the obligations of market makers and specialists and to facilitate variety in trading rules while ensuring compatibility with intermarket systems.[108] For example, the Commission has expressed concern that since trading rules currently governing the conduct of market makers and specialists differ to a sufficient degree from exchange to exchange that it might be difficult to implement a single SRO model.[109] In practice, such trading rules may not need to be subject to Commission approval if the Commission were to use its authority to define what the affirmative and negative obligations (if any) of market makers and specialists should be.[110] Given the difficulty of drafting such rules, the Commission has preferred to exercise the right to disapprove of individual rule changes.

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107. *See, e.g.*, Joel Seligman, *Rethinking Securities Markets: The SEC Advisory Committee on Market Information and the Future of the National Market System*, 57 BUS. LAW 637, 659–61 (2002).

108. *See, e.g.*, SIA White Paper, *supra* note 1, at pt. III.E.3 ("[A disadvantage of a single SRO model is that under] "under the current regulatory system . . . , 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.").

109. Concept Release Concerning Self-Regulation, Exchange Act Release No. 50,700, 69 Fed. Reg. 71,256, 71,280 (Dec. 8, 2004).

110. *See, e.g.*, 17 C.F.R. § 240.11b-1 (2006); Simon & Trkla, *supra* note 15, at 346–47.

The Commission's wariness is not altogether unreasonable, given that different products will require different levels of intermediation as circumstances change. For example, the Commission has observed that options exchanges may require different trading rules than stock exchanges because of the greater need for market intermediaries and member-generated quotations in less liquid options markets.[111] But this is equally true for other products which do not necessarily trade on exchanges. As discussed below, it may be preferable to develop uniform criteria for intermediation by product, rather than through a system in which the Commission haggles with individual SROs over rule changes in an attempt to ensure no one exchange has an advantage over the others.[112] Individual markets may then seek no-action or exemptive relief if their proposed trading rules come into conflict with Commission or SRO rules, much as other securities intermediaries do today.

Second, uniformity in market structure does not necessarily require exchange-based self-regulation. If a central limit order book or display facility for all securities were envisioned, it would make sense for a single utility or regulator to take charge of the operation of that system (whether it be the NASD or a separately constituted SRO for that purpose). Likewise, if the Commission were ultimately to determine that competitive forces should guide the centralization of order flow, the role of a market utility SRO would consist exclusively of collecting and displaying market information (much like the NASD's Alternative Display Facility or SIAC's CQ and CT Services). In such a world, exchange markets would essentially be first among equals, but would not enjoy special privileges (or incur special obligations) as a result of their primacy in the marketplace.

The Commission's pursuit of an intermediate market structure—involving automated execution of public orders across markets through intermarket linkages[113]—creates the need for a series of hubs through which orders may be publicly displayed and accessed by other market centers and broker-dealers. Regulation of SRO "market" rules provides a convenient way for the Commission to ensure enhanced oversight over the critical joints in the marketplace while continuing to espouse a policy of competing trading venues with hardwired linkages. But other regulatory categories

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111. Competitive Developments in the Options Markets, Exchange Act Release No. 49,175, 69 Fed. Reg. 6124, 6128–30 (Feb. 9, 2004) (describing institutionalized payment for order flow arrangements, specialist guarantees, and internalization on options markets).

112. For example, if certain thresholds of payment for order flow or internalization are tolerated on options exchanges as a means of encouraging market maker participation, such standards could be developed by an options SRO, independent of any single options market, and applied across the board to all options exchanges. *See id.* at 6130–31 (discussing concerns with exchange payments for order flow, specialist guarantees, and internalization on options exchanges and the options exchanges' conflicts of interest).

113. Of course, that is the Commission's mandate under section 11A of the Exchange Act. *See* 15 U.S.C. § 78k-1(a)(1)(d) (2000).

exist—such as the securities information processor (SIP)—which could perform the same function (with some legislative modification). A network of registered SIPs, like telecommunications providers or public utilities, could be regulated as essential facilities of the marketplace—subject to fair access requirements and reasonable rates—without the need for the full complement of SRO rules.[114] More importantly, such franchises could be awarded on the basis of the superiority of their connectivity, rather than be awarded by default to legacy exchanges who have had significant incentives to diminish interaction of their captive order flow with the rest of the market.

C. SEPARATION OF PROMULGATION, COMPLIANCE, AND ENFORCEMENT

Another frequently mentioned approach to reforming self-regulation is to separate SRO functions by process, rather than subject matter. The Exchange Act currently exposes SROs to disciplinary sanction if they fail to enforce the rules they promulgate.[115] Some commentators have suggested that the task of promulgating rules need not be performed by the same entity that is responsible for ensuring compliance with or prosecuting violations of those rules.[116] Thus, one could employ a universal regulator for compliance inspections and enforcement of the rules of several different SROs. In other situations, SRO standard setting—without any formal compliance or enforcement process—might permit a degree of regulatory supervision over activities that would not be feasible if the SRO were compelled by the Exchange Act to enforce such rules through formal disciplinary action.

This model is in use today in areas where the Commission's jurisdictional authority brushes against other domestic regulatory authorities. For example, in the government and municipal securities markets, where both banks and broker-dealers are able to act as government or municipal securities brokers and dealers, rulemaking authority is given to one body (the MSRB and the Secretary of the Treasury, respectively), while compliance and enforcement activities are undertaken by an "appropriate regulatory authority."[117] Regional exchanges have outsourced many of their compliance and enforcement functions to the NASD,[118] while the SEC has

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114. Onnig H. Dombalagian, *Licensing the Word on the Street: The SEC's Role in Regulating Information*, 55 BUFF. L. REV. 1 (2007).

115. *See* 15 U.S.C. § 78s(g) (2000).

116. Ernest E. Badway & Jonathan M. Busch, *Ending Securities Industry Self-Regulation as We Know It*, 57 RUTGERS L. REV. 1351, 1351 (2005).

117. The Exchange Act defines the "appropriate regulatory authority" for these purposes as the Commission for registered broker-dealers and the relevant federal or state bank regulator for banks and departments or divisions thereof. *See* 15 U.S.C. § 78c(a)(34) (Supp. IV 2004).

118. *See* 15 U.S.C.S. § 78q(d) (LexisNexis 2006), and 17 C.F.R. § 240.17d-2 (2007) promulgated thereunder. *See also* Regulation of Exchanges, Exchange Act Release No. 38,672, 62

long required the selection of an exclusive "designated examining authority" for monitoring compliance with financial responsibility rules.[119] The SEC and Department of Justice are responsible for civil and criminal enforcement actions, respectively, under the federal securities laws.[120] The CFTC and SEC jointly promulgate rules for security futures products and security futures exchanges, while each separately undertakes disciplinary and enforcement action with respect to registered FCMs and broker-dealers respectively.

There are clear advantages to such a model. Industry participants in SRO governance are best positioned to identify emerging practices that require greater regulatory scrutiny and to define appropriate norms of business conduct. They may, however, be more reluctant to explore new theories of liability if there is a possibility that their own firms may have engaged in similar conduct. To the extent that securities markets become increasingly specialized, it may be desirable to have SROs composed of representative industry members dedicated to rulemaking for particular products or market sectors, as discussed in Part IV, *infra*.[121] Subject to the SEC's oversight and coordination, a universal compliance and enforcement SRO could make it easier for industry leaders to participate more effectively in the articulation of "just and equitable principles of trade" without the duplication of enforcement personnel.

For instruments that are not directly subject to regulation by financial regulators, industry SROs may provide some market discipline for intermediaries even in the absence of a formal compliance or enforcement regime. There may be areas where SROs might be more willing to undertake information-gathering initiatives—such as centralized monitoring of credit exposure—if the information gathered thereby will not be used for enforcement purposes other than determining eligibility for continued SRO membership or initiating internal disciplinary proceedings. Many such functions are performed under the aegis of trade associations today, but an

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Fed. Reg. 30,485, 30,159 (June 4, 1997) (listing the existing agreements under Exchange Act Rule 17d-2 between various exchanges, the NYSE and the NASD).

119. *See* 15 U.S.C. § 78q(d)(1), (k)(5) (Supp. IV 2004) ("[T]he term 'examining authority' means a self-regulatory organization registered with the Commission under this title (other than a registered clearing agency) with the authority to examine, inspect, and otherwise oversee the activities of a registered broker or dealer."); *see also* 17 C.F.R. § 400.3 (2006) ("Designated examining authority and Examining Authority mean (1) in the case of a registered government securities broker or dealer that belongs to only one self-regulatory organization, such self-regulatory organization, and (2) in the case of a registered government securities broker or dealer that belongs to more than one self-regulatory organization, the self-regulatory organization designated by the Commission pursuant to section 17(d) of the Act (15 U.S.C. § 78q(d)) as the entity with responsibility for examining such registered government securities broker or dealer.").

120. *See* 15 U.S.C. § 78u (Supp. II 2002) (providing the SEC the authority to investigate and bring civil enforcement actions); *id.* § 78ff (Supp. II 2002) (providing criminal penalties for willful violations).

121. Joel Seligman, *Should Investment Companies Be Subject to a New Statutory Self Regulatory Organization?*, 83 WASH. U. L. Q. 1115, 1125 (2005).

"SRO-lite" regime would provide a modicum of public accountability and SEC involvement.

This model also has the potential to simplify cross-border regulation. SROs might, for example, adopt rules governing the conduct of their U.S. and non-U.S. members, which could be enforced under each country's securities or commercial law regime. For example, the Commission and the NASD could serve as the enforcement authorities for such SRO rules in the United States, while other jurisdictions might elect to provide for the enforcement of SRO rules through disciplinary action by a regulated market or government regulator, private rights of action under contract or commercial fraud regimes, or some other industry sanction. Current memoranda of understanding among securities regulators could be amplified, as cross-border activities expand, to facilitate parallel enforcement and, where necessary, negotiate the minimum level of protection U.S. and non-U.S. regulators might require for any self-regulatory regime. The Commission could thus maintain the view that such markets are governed by uniform rules, although the details of inspections and enforcement would vary by jurisdiction.

The risks of this model are evident. Any separation of rulemaking and enforcement powers would raise concerns about inconsistent interpretation, underallocation or overallocation of enforcement resources to particular rules, and the resolution of redundancies across multiple SROs.[122] The Commission (in coordination with foreign regulatory or self-regulatory authorities) would have to exert significant authority both upon the approval of promulgated rules and in the course of its oversight of SRO disciplinary and enforcement actions to ensure that consistency is maintained. The Commission would also have to orchestrate the allocation of responsibilities among substantive rule promulgators to avoid gaps and conflicts. For example, different products may entail different rules governing advertising, capital and margin requirements, execution standards, and clearance and settlement mechanisms. Ensuring that such rules operate as interoperable modules in the face of latent conflicts or conflicting interpretive guidance would require the Commission to use its authority to modify or amend SRO rules more aggressively than it has in the past.

IV. SELF-ACTUALIZATION

There are many directions that the self-regulatory structure of the marketplace could take, depending largely on whether the securities

122. One possibility is to take advantage of the Exchange Act's existing if neglected concept of "affiliated securities associations," which might seek to register for the purpose of drafting specialized rules for enforcement by the NASD or other registered affiliate. *See* 15 U.S.C. § 78*o*-3(c), (d) (2000).

industry prefers predictability and certainty to autonomy and accountability. If the fundamental concept of self-regulation remains valid, the task is to define those circumstances in which the industry's efforts may be deployed to serve the shared collective interest in minimum standards of conduct, while centralizing or even federalizing other areas where greater conflicts with the public interest are perceived to arise.

A. SRO v. Non-SRO Activities

As discussed in Part I, *supra*, self-regulation stands the best chance of succeeding when the SRO is responsible for enforcing mutual or reciprocal norms of conduct which require industry expertise to administer. Thus, execution protocols, clearance and settlement functions, risk management, and sales and marketing practices for emerging products are all likely to remain within SRO control. By contrast, there are several aspects of the current self-regulatory system, where as a result of Congressional or Commission action, the potential for an effective self-regulatory role has gradually disappeared. In these cases, one can envision replacing SRO regulation with a combination of Commission regulation and a universal NASD-like regulator or a licensed technology provider.

A national market system mechanism for disseminating quotation and transaction information mandated by the Commission could be centralized and operated independently of existing SROs.[123] While individual markets remain free to choose the types of information they would like to disclose and on what terms, the Commission has preempted the role of self-regulation by dictating the minimum information that must be disclosed: by all market centers through intermarket mechanisms: SROs exercise at best residual authority to implement the technical requirements of those mandates—for example, distinguishing reportable trades from non-reportable ones, specifying the information to be provided and the timeframes within which they must be reported. These functions, however, could best be performed by the Commission or single regulator, or by a national market system plan with broad industry representation.[124] Alternatively, rules could be established by individual product regulators for the industry, but actual systems would be maintained (and revenues would be collected and distributed) by an independent service provider.

Corporate governance standards are another area where the mandate for centralization under the Sarbanes-Oxley Act increasingly makes SRO regulation an artifact. Congress and the Commission have increasingly resorted to codifying the costs and benefits of exchange listing—e.g.,

123. Onnig H. Dombalagian, *Demythologizing the Stock Exchange,* 38 U. RICH. L. REV. 1069, 1146 (2006).
124. *Id.*

exemption from blue-sky rules[125] in exchange for heightened corporate governance standards.[126] Exchanges, meanwhile, have shown increasingly less stomach for enforcing rules that threaten to erode the number of new and existing listed companies.[127] Codifying higher corporate governance standards for companies that trade in highly liquid markets can take place in other fora—such as an NMS plan or as a condition of becoming a publicly quoted company. Markets again would remain free to set their own additional standards, but would be relieved of their historical gatekeeping function.

More generally, an attitudinal shift should take place in which an SRO's enforcement obligations do not include policies and procedures to monitor for compliance with and enforce Commission rulemaking. SROs are more than capable of undertaking a cost/benefit assessment with respect to the enforcement of their rules, but have no real discretion with respect to their statutory obligation to enforce federal law. This creates an exceptional hurdle for any new SRO that seeks to register as an exchange or national securities association, while imposing little, if any, real sanctions on existing SROs that fail to live up to that responsibility. If any of the hybrid models is adopted, a single self-regulator such as the NASD could be made responsible for this statutory mandate, while allowing other SROs the freedom to devote limited resources to achieve more modest regulatory goals.

B. MULTIPLE REGULATORS

As suggested above, if a single regulator system is adopted, other SROs could play an important, if peripheral, role in setting standards for industry conduct. Many complaints are raised about the monolithic nature of SRO rulemaking, whether it be domination of self-regulatory bodies by major investment firms, the imposition of uniform rules on dissimilar products, or structural differences in business practices. A system of multiple SROs with clear mandates, minimal overlap, and sufficient members to demonstrate credibility and minimize abuse may assuage some of these concerns.

One possible demarcation would be based on *size and geographic scope*. The Maloney Act contemplated the registration of multiple national securities associations, as long as "the number and geographical distribution of its members and the scope of their transactions" was sufficient to enable each such association to carry out the purposes of the Act.[128] A case could be made that smaller or regional brokerage firms might prefer a degree of autonomy to define their own business practices, or at least to distance

125. 15 U.S.C. § 77r(a)–(b) (2000).
126. *See id.* § 78j-1(m) (Supp. II 2002).
127. *See, e.g.*, Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).
128. 15 U.S.C. § 78*o*-3(b)(1) (2000).

themselves from the bulge bracket firms that are perceived to exercise inordinate influence over the NASD and NYSE. Such arrangements could also facilitate the de-registration of regional exchanges by allowing their members to reorganize as a looser regional securities association with a more limited set of rules enforced by the NASD.

In principle, such associations should not be objectionable since the informal segregation of bulge bracket and smaller brokerage firms exists today to a certain degree. The roster of NYSE member organizations includes nearly all of the bulge bracket investment banks headquartered in New York City.[129] As a result, these firms are subject to NYSE rules (as well as NASD rules, if they are engaged in public business) and NYSE enforcement, while the nation's remaining broker-dealers are subject to NASD rules (as well as regional exchange rules) and NASD enforcement.[130] Federal financial responsibility rules also provide special provisions for computing the net capital and customer reserve requirements of the largest investment banks.

The question remains, of course, whether regional associations would promote better business practices, or simply create opportunities to dilute existing principles of trade. A strong case would need to be made that the rules of any regional securities association that differ from NASD business conduct rules are necessary or desirable for the particular region or class of brokers or otherwise outweigh the benefits obtained through standardization of NASD compliance and enforcement practices. To the extent, however, that the NASD's regional district personnel have developed unique practices or procedures, the codification of such practices or procedures in regional SRO rules may have some benefit.

A second possible categorization of special purpose SROs might turn on the *business model* of their members. Today, for example, carrying brokers responsible for handling customer funds and securities and collecting margins for leveraged accounts are generally regulated under NYSE and DTCC or OCC rules. While, one could envision SROs that develop specialized rules for electronic trading systems, market makers and specialists, and other standard business models in the broker-dealer community, the formation of such SROs is unlikely for a number of reasons. First, the rapid consolidation of firms that perform similar activities may undermine the fundamental criterion that an SRO possess the necessary diversity of membership to avoid domination by a handful of

129. As of this writing, the NYSE's member firm directory includes approximately 206 companies that conduct business with the public. *See* News Release, New York Stock Exch., NYSE Firms Report Third-Quarter 2006 Results (Dec. 6, 2006), *available at* http://www.nyse.com/press/1165317470489.html.

130. Exchange Act Release No. 38,672, 62 Fed. Reg. 30,485 (June 4, 1997) (describing the existing agreements under Exchange Act Rule 17d-2 between various exchanges, the NYSE and the NASD).

powerful interests. Second, to the extent that markets must be designed to facilitate the interaction of different business models (e.g., specialists and public brokers), allowing each to define the parameters of their business conduct without the participation of the other would create opportunities for overreaching or abuse. Third, the integration of different business models with individual firms could enhance the potential for redundant rules.

The most compelling case for the creation of limited purpose SROs is *product regulation*. As discussed above, special SROs have been created for the regulation of various products that may be traded both by broker-dealers and by other financial intermediaries. Thus, the MSRB regulates banks and broker-dealers trading municipal debt, and security futures exchanges jointly regulated by the SEC and CFTC regulate broker-dealers and futures commission merchants that trade security futures products. Within the securities markets, separate SROs exist that focus on the regulation of options markets (e.g., CBOE) and options transactions (e.g., OCC), equity markets and equity transactions (e.g., DTCC), and other products.[131]

Products that might benefit from special purpose SROs are corporate debt and exchange-traded and over-the-counter derivatives. While exchanges historically traded government and corporate bonds as well as listed stocks, the migration of debt trading into institutional over-the-counter markets has had both benefits and disadvantages. Debt securities had largely escaped national market system regulation until the late 1990s because such rules were predicated upon the ability to build upon existing quotation and execution mechanisms of stock exchanges. The Commission prodded the NASD to build display and execution mechanisms for listed and unlisted equity securities in the over-the-counter market, but these mechanisms could not be easily grafted to the even more decentralized world of debt. Only recently, with the increasing automation of the debt market, has the NASD undertaken to extend such mechanisms to debt securities.

On the other hand, the extension of regulatory approaches devised for equity securities to debt securities without the opportunity for the industry to develop alternative approaches can have unfavorable consequences.[132] The obligation to obtain the best execution of a debt transaction reasonable under the circumstances poses particular difficulties in debt markets, where

131. The Fixed Income Clearing Corporation, a subsidiary of the Depositary Trust & Clearing Corporation, performs post-trade comparison, netting and settlement of government and mortgage-backed securities transactions. Each division offers "product-specific services" to its members—such as pool notification for mortgage-backed securities transactions—and maintains separate rules and a separate collateral margin pool. *See* The Fixed Income Clearing Corporation, http://www.ficc.com (last visited Feb. 22, 2007).

132. Letter from Marjorie Gross, Bond Market Association, to Jonathan Katz, Sec'y, SEC (Mar. 8, 2005), *available at* http://www.sec.gov/rules/concept/s74004/mgross030805.pdf (commenting on SRO Concept Release and advocating a "debt market SRO" along the lines of the MSRB).

dealer quotations are not centralized.[133] Transaction reporting protocols for debt securities underwent several rounds of modification and remains subject to criticism because of the greater volatility of debt prices resulting from the relative illiquidity and size of debt transactions.[134] As the retailization of corporate debt continues, however, the Commission and self-regulators are likely to face even greater pressure to adopt rules governing corporate debt transactions. As with the MSRB, a specialty regulator for corporate debt—or an SRO dedicated to drafting specific rules governing all debt transactions—might be the optimal approach.

Exchange-traded options and derivatives also operate pursuant to unique rules driven by the nature of options markets that may merit a single derivatives market self-regulator. As discussed above, special trading rules have been developed by options exchanges to induce greater participation by market making and order routing intermediaries on options exchanges.[135] Portfolio margining systems for options and derivatives transactions in U.S. securities markets have not developed as quickly as in U.S. futures markets in part because of the need for multiple options and non-options SROs to amend their rules in concert.[136] Options firms have also had difficulty in "regularly and rigorously" reviewing their order routing practices in part because of the lack of uniformity in current execution quality reporting practices by options exchanges.[137]

Over-the-counter derivatives present an even more compelling case for a self-regulatory scheme because such products are subject to minimal regulation by federal financial regulators. The Commodity Futures Modernization Act of 2000 has exempted "swap agreements" among "eligible contract participants" from off-board trading restrictions on financial futures and most federal securities regulation (other than certain

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133. *Changes to NASD's Best Execution Rule Okayed by SEC Over BMA, Others' Concerns*, 38 Sec. Reg. & L. Rep. (BNA) No. 36, at 1504 (Aug. 30, 2006).

134. *See* Order Approving a Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1 Thereto Relating to the Dissemination of TRACE Trade Information, Exchange Act Release No. 53,031, 71 Fed. Reg. 634 (Jan. 5, 2006) (recounting history of TRACE facility for reporting of corporate debt transactions).

135. *See* Competitive Developments in the Options Markets, Exchange Act Release No. 49,175, 69 Fed. Reg. 6124 (Feb. 9, 2004).

136. *See e.g.*, Notice of Filing of Proposed Rule Change Relating to Customer Portfolio Margining Requirements, Exchange Act Release No. 53,576, 71 Fed. Reg. 17,519, 17,527 (Apr. 6, 2006) and Exchange Act Release No. 53,577, 71 Fed. Reg. 17,539, 17,547 (Apr. 6, 2006) (filing of proposed rule changes by the NYSE and the CBOE relating to portfolio margining, both noting the role of the NYSE's Rule 431 Committee—composed of several member organizations and several SROs including the NYSE, CBOE, and NASD as well as representatives from the SIA Ad Hoc Committee on Portfolio Margining—in making recommendations for portfolio margining).

137. OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, SEC, REPORT CONCERNING EXAMINATIONS OF OPTIONS ORDER ROUTING AND EXECUTION 10 (Mar. 8, 2007) ("The Staff also found that because standardized execution quality statistics are not provided by each of the options exchanges, most firms analyze only the execution quality provided to their own customer orders. The lack of standardized, widely available execution quality data may affect thorough best execution reviews by firms.").

antifraud rules for equity-based swaps).[138] While such exemptions may be appropriate in light of the wide range of financial institutions that trade such products and their relative sophistication, there is no recognized public forum in which industry members may seek to self-regulate. Standard agreements developed by the International Swaps and Derivatives Association and voluntary disclosure efforts encouraged by the Federal Reserve Board and others to control counterparty credit exposure provide some mutual self-regulation,[139] but only modest effort has been undertaken to develop business conduct standards or other forms of reciprocal self-regulation despite frequently recited concerns about the leverage of hedge funds, institutional investors, and other swap counterparties and the lack of infrastructure in the swaps marketplace.[140]

The advantage of a self-regulatory scheme over informal industry coordination is the antitrust immunity conferred by the SRO structure. As with the original arrangements that led to the creation of the NASD under the Maloney Act, banks and broker-dealers that act as swap intermediaries could agree to transact on more favorable terms with one another than with non-SRO members as a means of encouraging compliance with industry norms. Such arrangements could include the participation in black-box or other mechanisms that monitor direct and indirect counterparty credit exposure as a supplement to bilateral risk management measures. Swap intermediaries that failed to adhere to such standards would not be subject to civil or criminal enforcement, but rather the traditional SRO sanction: paying higher fees to lay off positions with member intermediaries.

C. BETTER ENFORCEMENT TOOLS

Congress and the Commission may also wish to consider whether concurrent public or private enforcement of SRO rules would improve the self-regulatory model, particularly if self-regulatory concepts are to be leveraged to international linkages. The conceptual core of SRO regulation is standard-setting. Delegating compliance and enforcement functions to SROs has some theoretical basis—to the extent that industry members have

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138. *See* 7 U.S.C. § 2(g) (2006). The Commodity Exchange Act's off-board trading prohibition does not apply to or govern, among other transactions, any non-agricultural commodity transaction between certain "eligible contract participants" that is subject to individual negotiation by the parties and is not executed or traded on a trading facility.

139. *See, e.g.*, COUNTERPARTY RISK MANAGEMENT POLICY GROUP II, TOWARD GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE 11 (July 27, 2005) (presenting recommendations and guiding principles, classified as (i) "actions that individual institutions can and should take at their own initiative," (ii) "actions which can be taken only by institutions collectively in collaboration with industry trade groups," and (iii) "actions which require complementary and/or cooperative actions by the official sector").

140. *Lawmakers Seek GAO Report on Tech Woes in Derivatives Market*, 38 Sec. Reg. & L. Rep. (BNA) No. 24, at 1008 (June 9, 2006) (requesting that GAO determine the adequacy of the legal, technological and paperwork handling infrastructure of credit derivatives markets).

a mutual or reciprocal interest in the regulation of their competitors—but has largely been viewed as a means of avoiding the direct financial and political costs to the SEC of policing the securities industry's business conduct. At the same time, given the significant skepticism about the efficiency of private litigation, it is unlikely that private rights of action for infringement of SRO rules would be viewed as a favorable option.

One approach would be to undertake concurrent public enforcement action against firms that willfully violate SRO rules, either through a pattern of misconduct or egregious violations. The unrestricted scope of Rule 10b-5 and varying standards of scienter makes it an undesirable tool for regulation of securities intermediaries, but a more focused Commission rule that targets abusive business conduct defined by a registered standard-setter presents a more compelling case for Commission action. A new Commission rule to supplant Rule 10b-5 enforcement actions would also create a fresh opportunity to deter the implication of private rights of action. SROs may also wish to consider whether there are market-oriented approaches to enforcing SRO rules. Greater disclosure in confirmation statements regarding execution quality—such as presenting contemporaneous price quotations, realized spreads, or other information—would create a powerful disincentive to violate best execution rules, even if private enforcement action against questionable transactions is generally prohibited for conduct short of fraud.

V. CONCLUSION

The irony should not be lost that the Commission is considering whether to write exchanges out of the Exchange Act: It suggests that in harnessing the power of exchanges for the benefit of investors, we have extinguished their innate incentives to bring order to the securities markets. The concept of self-regulation, however, has permeated so many operational aspects of the securities industry that it would be very difficult to eliminate it entirely from the federal regulatory framework. Investors have benefited from the continuing dialogue between the Commission and self-regulatory bodies as listings have multiplied, securities grown more complex, and market structures evolved in various product areas. A product-oriented system of self-regulation, with consolidated NASD enforcement, might serve as a worthy heir to the legacy of self-regulatory exchanges.