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Roberta S. Karmel
Brooklyn Law School, roberta.karmel@brooklaw.edu

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SECURITIES INDUSTRY SELF-REGULATION—TESTED BY THE CRASH

ROBERTA S. KARMEL*

During the week of October 19, 1987, which witnessed the steepest stock market decline in modern history,[1] self-regulation proved its value by keeping the markets open, policing the financial viability of firms, and generally rallying the energies of market participants. However, this market crisis also exposed various weaknesses in the regulation of the financial services industry generally, and in securities self-regulation in particular.

Even earlier than October 1987, such diverse problems as the insider trading scandals[2] and the failure of the New York Stock Exchange, Inc. (NYSE) to maintain its one share/one vote listing requirement exposed gaps in the effectiveness of self-regulation.[3] Over a decade ago, self-regulation had failed to prevent the unsafe and unsound practices that led to the back office crisis and numerous brokerage firm collapses.[4] Yet, self-regulation continues to be advocated as a solution to market failure.[5]

The purpose of this Article is to summarize the benefits of self-regulation in the securities industry and the criticisms to which self-regulation has been exposed, and then to examine how self-regulation operated before and during the October 1987 market crisis. The author will suggest that improvements in self-regulation will require a strengthening of government oversight, which can be achieved only by rationalizing an increasingly incoherent regulatory structure.

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* Professor of Law, Brooklyn Law School; Partner, Kelley Drye & Warren; Director, New York Stock Exchange, Inc.; Former Commissioner, Securities and Exchange Commission (1977-80). A summer research stipend from Brooklyn Law School was of assistance in writing this Article. The research assistance of Brooklyn Law School student Lawrence R. Plotkin is also gratefully acknowledged. The date of this Article is August 1, 1988.

1. For an excellent news summary of the events of October 19 and 20, 1987 see Stewart & Hertzberg, *Terrible Tuesday; How the Stock Market Almost Disintegrated A Day After the Crash,* Wall St. J., Nov. 20, 1987, at 1, col. 6.

2. Securities and Exchange Commission v. Boesky, No. 86-8767, slip. op. (S.D.N.Y. Nov. 14, 1986); *see* Anders, *Boesky Insider-Trading Case May Hurt Confidence in the Markets, Spur Regulation,* Wall St. J., Nov. 17, 1986, at 29, col. 1; Stewart & Hertzberg, *Spreading Scandal; Fall of Ivan F. Boesky Leads to Broader Probe of Insider Information,* Wall St. J., Nov. 17, 1986, at 1, col. 6.

3. *See* Karmel, *Qualitative Standards for "Qualified Securities": SEC Regulation of Voting Rights,* 36 CATH. U.L. REV. 809 (1987).

4. REPORT AND RECOMMENDATIONS OF THE SECURITIES AND EXCHANGE COMMISSION, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS, H.R. DOC. NO. 231, 92d Cong., 1st Sess. (1971).

5. *See* STUDY BY THE STAFF OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, A REVIEW AND EVALUATION OF FEDERAL MARGIN REQUIREMENTS 20-26 (Dec. 1984) [hereinafter FED. MARGIN STUDY].

I. HISTORICAL OVERVIEW

Professional self-regulation is not unique to the securities industry;[6] nor is stock exchange regulation of issuers and members unique to the United States.[7] Nevertheless, self-regulation by national exchanges and other securities industry organizations (SROs)[8] has been so successful that it has been copied by other industries (for example the commodity futures industry),[9] other countries (such as the United Kingdom),[10] and proposed for new securities industry professionals (like financial planners).[11]

The current system of cooperative self-regulation by stock exchanges and other SROs, subject to government oversight by the Securities and Exchange Commission (SEC), is both historically rooted and legally grounded in the Securities Exchange Act of 1934 ("Exchange Act").[12] The statutory scheme of the Exchange Act, which envisioned an oversight role for the SEC, incorporated the NYSE and other securities exchanges in existence before 1934. Mr. Justice Douglas, as chairman of the SEC, articulated the SEC's oversight role as the taking of a leadership role by the exchanges "with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used."[13]

Before 1934 no analogue to stock exchanges for the over-the-counter (OTC) market existed, but in 1938 Congress passed the Maloney Act[14] to

6. Attorneys, accountants, and other professions enjoy self-regulation. *See* Kanaga, *Self-Regulation in Accounting: The Role of the AICPA,* 152 J. ACCT. 44 (Nov. 1981); Rhode, *Why the ABA Brothers: A Functional Perspective on Professional Codes,* 59 TEXAS L. REV. 689 (1981). The Securities and Exchange Commission (SEC) exercises some regulatory authority over attorneys pursuant to its rule 2(e), 17 C.F.R. § 201.2(e) (1970), and considerably more direct regulation of accountants pursuant to regulation X-S, 17 C.F.R. § 210.2-01-210.4-10 (1987).

7. *See* Page, *Self-Regulation: The Constitutional Dimension,* 49 MOD. L. REV. 141 (1986).

8. Under the Securities Exchange Act of 1934 ("Exchange Act"), the term "self-regulatory organizations" means any national securities exchange, registered securities association, or registered clearing agency, or (in certain contexts) the Municipal Securities Rulemaking Board. 15 U.S.C. § 78c(a)(26) (1982).

9. *See* Miller, *Self-Regulation of the Securities Markets: A Critical Examination,* 42 WASH. & LEE L. REV. 853, 853 n.1 (1985). Under the Commodity Exchange Act, the commodity Futures Trading Commission (CFTC) may designate a board of trade as a contract market, and these exchanges operate as self-regulators. 7 U.S.C. § 7 (1982 & Supp. IV 1986). In addition, the CFTC is authorized to register futures associations and to delegate regulatory responsibility to them. 7 U.S.C. § 21. The National Futures Association became operational on October 1, 1982, as the first industrywide SRO for the futures industry. NATIONAL FUTURES ASSOCIATION, A COMPLIANCE GUIDE: INTRODUCING BROKERS (1986).

10. The Financial Services Act, 1986, ch. 60.

11. *See* Note, *Financial Planning: Is It Time For A Self-Regulatory Organization?,* 53 BROOKLYN L. REV. 143 (1987).

12. 15 U.S.C. § 78a *et seq.* (1982 & Supp. IV 1986).

13. W. DOUGLAS, DEMOCRACY AND FINANCE 82 (1940).

14. Pub. L. No. 75-719, 52 Stat. 1070 (1938), codified as amended at 15 U.S.C. §§ 78o, 78o-3, 78cc, 78ff, 78q (1982 & Supp. IV 1986). *See generally* Booth, *Self-Regulation in a Democratic Society,* 50 J. AIR L. & COMM. 491, 494-96 (1985).

establish a framework for an OTC SRO. Only one such association, the National Association of Securities Dealers, Inc. (NASD) exists for OTC brokers and dealers.[15] Although the efficacy of self-regulation was called into question by stock market abuses reported in the 1963 SEC Special Study,[16] that Study concluded that self-regulation should be maintained and strengthened.[17]

The 1975 amendments[18] to the Exchange Act further strengthened the SEC's oversight role over the stock exchanges and NASD by, among other things, giving the SEC power to initiate SRO rulemaking,[19] expanding the SEC's role in SRO enforcement[20] and discipline,[21] and by allowing the SEC to play an active role in structuring the market.[22] Additionally, the 1975 amendments gave new SROs, such as clearing and transfer agencies, a statutory foundation.[23]

Although self-regulation is so firmly established that one can assume safely that it will continue to be an integral part of the regulation of the securities industry, self-regulation seems to exist in a legal and political vacuum, striving for a legitimacy that it may never fully attain. Since securities industry SROs are business enterprises as well as regulators, they can often bring together disparate constituencies to solve common problems and work toward common goals. In addition, securities industry SROs serve as a pragmatic compromise between proponents of greater regulation of commercial activities affected with a public interest and those who resist increased governmental encroachment on the private sector. Yet, because SROs compete with one another as marketplaces, and because there is a strong promotional component in self-regulation, SROs have a tendency to go too far in preferring the interests of dominant members over the interest of the public. For this reason, as well as because of inherent legal weaknesses, self-regulation needs to be supported by effective but sensitive government oversight, combined with a framework of government mandated standards on matters of national concern.

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15. *See* [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) 77,516 (June 22, 1983). Until 1983, broker-dealers had the option of joining the NASD or SECO, which was an organization run by the SEC for non-NASD members. It had rules of fair practice, and SECO members were examined for records and financial compliance by the SEC. SECO was abolished by Pub. L. No. 98-38, 97 Stat. 205 (1983). The demise of SECO raises an interesting question about delegation of governmental authority to the SEC. *See infra* note 71.

16. SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKET, H.R. Doc. No. 95, 88th Cong., lst Sess. pt. 4, at 502 (1963) [hereinafter SPECIAL STUDY].

17. *Id.* pt. 5, at 201-02.

18. Pub. L. No. 94-29, 89 Stat. 97 (1975).

19. 15 U.S.C. § 78s(c) (1982 & Supp. IV 1986).

20. *Id.* at § 78s(g).

21. *Id.* at § 78s(d)-(e).

22. *Id.* at § 78k-l. *See* Calvin, *The National Market System: A Successful Adventure in Industry Self-Improvement,* 70 VA. L. REV. 785 (1984).

23. 15 U.S.C. § 78q-l (1982).

II. Methods of Regulation

A. Promotional Functions

Self-regulation, like government regulation, generally falls into three categories: promotional, standard setting, and disciplinary.[24] Promotional regulatory activity is designed to benefit or foster commercial activity. Among the forms it may take are cash grants, loans at less than market rates, rate making, or the distribution of franchises. Often, promotional regulation is directed at fledgling industries.[25]

Securities self-regulatory organizations are engaged in promotional activities. A notable example is the NYSE, which from 1792 until 1975 established fixed minimum commission rates for trading in securities.[26] Similarly, the NASD limits an underwriting concession in fixed price underwritings to its own members.[27] Both of these examples of promotional self-regulation proved to be controversial.

When the fixed minimum commission rate schedule of the NYSE ceased to be economically viable, and the marketplace began to undermine such regulation by a variety of rebative schemes, fixed commissions became susceptible to legal and political attack. After nearly 180 years of apparent legitimacy, a number of lawsuits were filed challenging the fixed minimum commission rate schedule under the antitrust laws.[28] The Department of Justice joined in this litigation as amicus curiae, arguing that fixed commissions were illegal. The United States Supreme Court, in *Gordon v. New York Stock Exchange, Inc.*,[29] ultimately declared that the NYSE was not engaging in price fixing in violation of the antitrust laws. However, the Court's holding rested on the fact that the SEC had oversight authority to regulate the reasonableness of commission rates.[30]

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24. *See* Senate Committee on Governmental Affairs, Study on Federal Regulation, Vol. V, S. Doc. No. 91, 95th Cong., 2d Sess. 97-110 (1978).

25. For example, when federal regulation of the airways began in 1938 and the Civil Aeronautics Board (CAB) was then established in 1940, Civil Aeronautics Act of 1938, Pub. L. No. 75-706, 1938 U.S. Code Cong. & Admin. News (52 Stat.) 973; 1940 Reorgan. Plan No. IV, § 7, 1940 U.S. Code Cong. & Admin. News (54 Stat.) 1235, air transportation was in its infancy. Part of the CAB's mission was to promote a nationwide air system. When the airline industry was mature, the CAB was abolished to promote economic deregulation and to enhance competition. Airline Deregulation Act of 1978, Pub. L. 95-504, § 40(a), 1978 U.S. Code Cong. & Admin. News (92 Stat.) 1744. The interests of consumers, rather than the interests of the industry assumed the greatest public interest. Kahn, *Industrial Policy and Deregulation*, 32 Fed. B. News & J. 21 (1985).

26. *See* Securities Industry Study, Report of the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, S. Doc. No. 13, 93d Cong., 1st Sess. 43-63 (1973) [hereinafter Securities Industry Study].

27. Art. III, § 24 of the NASD Rules of Fair Practice, NASD Manual (CCH) 2174 (Aug. 1986).

28. R. Karmel, Regulation By Prosecution 118-22 (1982).

29. 422 U.S. 659 (1975).

30. Gordon v. NYSE, Inc., 422 U.S. 659, 691 (1975).

Although the Supreme Court held that commission ratemaking by the NYSE was legal, commission rate making by the NYSE was invalidated by Congress. By amendments to the federal securities laws in 1975, Congress required that commission rates be established competitively.[31] Bowing to economic and political reality, the SEC actually unfixed stock exchange commission rates before this statutory provision took effect.[32]

The NASD's rules prohibiting discounts from fixed priced underwritings except to NASD members similarly became subject to attack in the so-called "Papilsky" proceedings.[33] Again, the Department of Justice urged that the NASD's rules were anticompetitive and should be invalidated. This controversy raged for many years, but after extensive proceedings before the SEC the debate ended in a victory for promotional self-regulation. The SEC decided to validate the NASD's rules, after dictating certain amendments to them.[34]

One of the lessons that can be learned from the foregoing examples is the importance of governmental oversight to promotional self-regulation. If the SEC had not had the power to determine whether commission rates set by the NYSE were reasonable, the judiciary could have found that the commission rates constituted price fixing under the antitrust laws and damage claims for untold amounts could have resulted. Similarly, in the absence of SEC oversight of NASD rulemaking exercised by way of the SEC's Papilsky proceedings, the NASD's regulation of underwriting concessions would very likely have been tested in the courts and could have been invalidated.

The reasons why the NYSE was unable to save the fixed commission rate structure, but the NASD was successful in the Papilsky proceedings are complex. However, one reason was that the NYSE was unable to persuade the SEC or Congress that the fixed commission rate schedule was of any benefit to the public. In contrast, the NASD managed to carry the burden of persuading the SEC that the Papilsky rules served a public function in making a positive contribution to capital formation. In other words, the NASD presented its regulations as serving some beneficial purpose beyond the economic self-interest of the NASD's own membership.

B. Standard Setting

Standard setting generally is promulgated to protect the public served by a business or professional group from unethical practitioners. The NASD,

31. 15 U.S.C. § 78f(e) (1982).

32. 17 C.F.R. § 240.19b-3 (1988).

33. This controversy stemmed from Papilsky v. Berndt [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) 95,627 (S.D.N.Y. June 24, 1976) which held that underwriter recapture by a mutual fund was available and legal in the absence of a contrary ruling by the NASD or SEC.

34. Exchange Act Release No. 17,371, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) 82,705 (Dec. 12, 1980); Exchange Act Release No. 16,956, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) 82,621 (July 3, 1980).

for example, limits the maximum compensation underwriters may receive in public offerings of securities[35] through guidelines that deem excessive compensation to be "conduct inconsistent with high standards of commercial honor and just and equitable principals of trade."[36] This regulation of maximum compensation is the obverse of the promotional regulation that the NYSE engaged in when it established the minimum allowable brokers' commissions. The limits on underwriter compensation are designed to protect the public customer rather than the NASD membership, in much the same manner as state blue sky merit securities regulation protects the public.[37]

The margin requirements are a complicated combination of governmental and SRO standard setting. The Federal Reserve Board establishes the percentage of securities margin credit for initial stock purchases and interprets the margin regulations, but the SEC enforces them.[38] Nevertheless, the NYSE has its own margin rule and establishes maintenance margin requirements.[39] The commodities exchanges, by contrast, establish margin requirements for financial futures trading.[40]

Sometimes standard setting regulation can have an anticompetitive effect. Although licensing generally is considered a valid standard setting technique, licensing can be utilized to curtail the number of entrants into a business or profession. Used in this manner, licensing becomes a device to promote an industry's self-interest rather than standard setting for the protection of the public.

Prior to 1975, NYSE rules prohibited member firms from affiliations with institutional investors,[41] and the SEC endeavored to enforce this prohibition by rule.[42] However, these anticompetitive efforts were struck down by Congress in 1975 by amendments to the Exchange Act that have opened up both membership and access to the exchanges.[43]

C. Enforcement

To be effective, regulation must be enforced effectively. The primary way in which self-regulatory organizations have lost credibility in their enforcement activities is by uneven enforcement of standards. Uneven

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35. *See* Karmel, *Pegging Dealer Profits,* N.Y.L.J., Aug. 20, 1987 at l, col. l.

36. *Review of Corporate Financing, Interpretations of the Board of Governors Relating to Section l of Article III of the Rules of Fair Practice,* NASD Manual (CCH) 2151.02 (Oct. 1987).

37. *See* Karmel, *Blue-Sky Merit Regulation: Benefit to Investors or Burden on Commerce?,* 53 BROOKLYN L. REV. 105, 118-20 (1987).

38. 15 U.S.C. § 78g(a) (1982). *See* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 654 (2d ed. 1988).

39. NYSE Rule 431.

40. DIVISION OF TRADING AND MARKETS OF THE COMMODITY FUTURES TRADING COMMISSION, FOLLOW-UP REPORT ON FINANCIAL OVERSIGHT OF STOCK INDEX FUTURES MARKETS DURING OCTOBER 1987 (Jan. 6, 1988) at 27 [hereinafter CFTC FOLLOW-UP REPORT].

41. SECURITIES INDUSTRY STUDY, *supra* note 26, at 64-73.

42. *Id.* at 80-85.

43. 15 U.S.C. §§ 78f(b)92), 78f(c)(4), 78o-3(b)(3) (1982).

enforcement tends to discriminate against smaller businesses or less influential members of a profession and leave the self-regulatory organization open to two seemingly contradictory charges. First, the public will perceive a laxity in enforcement activities and clamor for more stringent punishment of wrongdoers. Second, those who are disciplined will claim that they were proceeded against without due process.[44]

In the early 1970s the securities industry had great difficulty coping with a severe bear market and the aftermath of the back office crisis of the late 1960s. The NYSE determined that the best way to deal with this crisis was a flexible interpretation of its net capital rule,[45] which sets a standard for the financial liquidity of broker-dealers. This strategy proved unsuccessful, however, and many old line firms either slid into bankruptcy or had to be bailed out by other member firms and the NYSE trust fund.[46]

The SEC and Congress thereafter criticized the NYSE for its ineffective enforcement of the net capital rule, and in the 1975 amendments to the federal securities laws Congress took responsibility for the net capital rule away from the NYSE.[47] The SEC now has direct responsibility for promulgating, interpreting, and enforcing the net capital rule.[48] Furthermore, the SEC is given broad power to compel exchanges to enforce their own rules.[49]

Nevertheless, business exigencies cannot always be sacrificed to strict enforcement of regulatory standards. If self-regulation in the securities industry did not serve certain basic needs of the industry, self-regulation would not have lasted so long and would not continue to thrive. SROs are marketplaces as well as regulatory bodies, and accordingly, SROs provide economic services to their members. This commercial utility provides the incentive for widespread membership and the fees to support standard setting and enforcement activities. At the same time, a brake on the enforcement function of the SROs results from the need of the self-regulators to remain sensitive to the interests of their membership constituency.

D. *Balancing Regulatory Functions*

As the foregoing examples indicate, self-regulatory organizations normally are expected to perform a variety of regulatory functions in order to satisfy different constituencies. Not only the members of the regulatory organizations, but also the clientele they serve must be satisfied that the regulators are performing well. In situations in which the promotional functions of self-regulation overwhelm other functions, the likely results are an attack under the antitrust laws or a loss of credibility that results in government regulation superseding self-regulation.

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44. Austin Municipal Securities, Inc. v. NASD, 757 F.2d 676 (5th Cir. 1985). *Cf.* Blinder, Robinson & Co. v. SEC, [Current] Fed. Sec. L. Rep. (CCH) 93,588 (D.C. Cir. Jan. 15, 1988).

45. NYSE Rule 325.

46. SECURITIES INDUSTRY STUDY, *supra* note 26, at 23-42.

47. 15 U.S.C. § 78o(c)(3) (1982 & Supp. IV 1987).

48. 17 C.F.R. § 240.15c3-1 (1988).

49. 15 U.S.C. § 78u(d) (1982 & Supp. IV 1987).

Yet, self-regulation that is solely for disciplinary purposes is rarely workable or effective. A business or profession ordinarily is not interested in taxing itself in order to provide funds for policing its own membership. For a number of years, the SEC has been trying to persuade the investment company industry to form a self-regulatory organization for the purpose of inspecting its members because the SEC does not have adequate funding to staff a vigorous government inspection program.[50] Despite the interest of mutual funds in assuring that none of their industry get into bookkeeping or financial difficulty, the SEC's proposals have not been received enthusiastically.[51] The promotional component of such self-regulation is negligible, and self-regulation would merely supplement a regulatory function already being performed, however inadequately, by the SEC.

III. Benefits of Self-Regulation

A. Ethics

Self-regulation, rather than governmental regulation, generally has been considered better able to address ethical, as opposed to legal, conduct. Such ethical norms are subsumed under the rubric of just and equitable principles of trade. Mr. Justice Douglas, when he was chairman of the SEC, stressed that self-regulation has the potential for establishing and enforcing "ethical standards beyond those any law can establish."[52] He pointed out that government can operate only by proscription, which leaves untouched large areas of conduct and activity too minute for satisfactory control, some "lying beyond the periphery of the law in the realm of ethics and morality. Into these larger areas self-government and self-government alone, can effectively reach."[53] Similarly, SEC Commissioner George Matthews stated that

> a great many of the abuses in the securities business are not matters of definite illegality, they are matters of ethics. . . . There is a vast field for the control of ethical practises in this business, which is not a field the Government can very well occupy.[54]

Indeed, the advantage of self-regulation over government regulation goes somewhat beyond the articulation of conduct which conforms to ethical

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50. Miller, *supra* note 9, at 864-65. *See Solicitation of Public Comments Concerning Issues to be Considered in Connection with the Investment Advisors Act Study Investment Advisors Act Exchange Act Release No. 717,* [1979-80] Fed. Sec. L. Rep. (CCH) 82,491 (Apr. 4, 1980); *see also Longstreth Lobbies for Mutual Fund SRO Before Lukewarm Industry,* Securities Week, Apr. 5, 1982 at 5.

51. *Id.; Money Fund Officials Lend Lukewarm Support to SEC's SRO Notion,* Securities Week, Oct. 26, 1981, at 5.

52. Securities Industry Study, *supra* note 26, at 149.

53. *Id.*

54. *Hearings on S. 3255 Before the Senate Committee on Banking and Currency,* 75th Cong., 3d Sess. 10 (1938).

standards. Self-regulation gives industry exchange members the glue to stick together to make the system work. In times of crisis, members of a self-regulatory organization are motivated morally, as well as financially, to insure the long-term survival of their common enterprise.

B. Cost

It is generally argued that self-regulation is less costly than government regulation, and therefore, self-regulation is preferable to the "sheer ineffectiveness of attempting to exercise [regulation] directly through the Government on a wide scale."[55] The alternative to securities industry self-regulation would be a greatly expanded SEC, with more branch offices and "a large increase in the expenditure of public funds; an increase in the problems of avoiding the evils of bureaucracy; and a minute, detailed, and rigid regulation of business conduct by law."[56] Not only would the SEC have to police the actions of dishonest brokers and dealers, but also "those unwilling or unable to conform to rigid standards of financial responsibility, professional conduct, and technical proficiency."[57]

Yet, the lower cost of self-regulation may merely be that the government spends less. To the extent that self-regulation can operate more casually and without regard to constraints that are imposed upon government regulators, self-regulatory organizations may achieve goals more efficiently and at a lower cost. Whether the total cost of self-regulation of the securities industry is less than government regulation is, at least, an open question, since self-regulation is "an off-balance sheet means of leveraging the overall regulatory scheme."[58]

C. Flexibility

Government regulators are responsible for providing effective controls on behavior. They are not necessarily responsible for the economic health or survival of a regulated industry, although the SEC engages in more promotional regulation than is customarily perceived.[59] Nevertheless, the government's primary goal is investor protection and its primary technique is command and control rulemaking backed up by prosecution of offenders. Accordingly, the SEC is more inclined to be concerned about compliance with statutes and regulations than to initiate solutions to industry problems.

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55. *Hearings on H.R. 7852 and H.R. 8720 Before the House Committee on Interstate and Foreign Commerce,* 73d Cong., 2d Sess. 514 (1934) (testimony of Assistant Secretary of Commerce John Dickinson).

56. SENATE REPORT ON S. 3255, 75th Cong., 3d Sess. 3 (1938).

57. *Id.* at 4.

58. Miller, *supra* note 9, at 864.

59. The SEC's responsibilities to facilitate the establishment of a national market system are promotional. *See generally* Seligman, *The Future of the National Market System,* 10 J. CORP. L. 79 (1984); Poster, *Restructuring the Stock Markets: A Critical Look at the SEC's National Market System,* 56 N.Y.U. L. REV. 883 (1981).

Further, the SEC must operate in conformity with various statutes now imposed upon government, such as the Sunshine Act,[60] Ethics in Government Act,[61] and Freedom of Information Act.[62] These restrictions on governmental action imbue government regulators with a certain inherent inflexibility that can be overcome at times, but with difficulty.

Securities industry self-regulation, especially since 1975, is likewise rigid and circumscribed in certain ways. For example, the SEC formally must approve rule changes and even changes in interpretations.[63] Disciplinary hearings are subject to a variety of due process restrictions.[64] In exercising oversight of enforcement and surveillance, the SEC is perhaps overly concerned about audit trails and written justifications for action, so that efficiency and effectiveness by SRO staffs are sometimes sacrificed. Nevertheless, self-regulators can operate more freely and with greater flexibility than government regulators because they are directly accountable to their own members, as well as to the SEC. They have greater freedom in hiring and firing, in budgeting, in programming, and in the deployment of their resources. They are businesses, as well as regulators and are made immediately mindful of the costs and benefits of regulatory programs. Because SRO governance is immediately subject to the interest of various constituent groups, regulation can be more flexible and realistically imposed. SROs have freedom to experiment and even to fail, but at the same time, they are under greater pressure to insure the success of the industries that they regulate.

D. *Expertise*

Because self-regulation springs from the industry that it regulates, it is informed by the experience of that industry. Further, because self-regulators are able to pay higher salaries there is greater continuity of staff. A self-regulator is able to call upon industry leaders for voluntary service. A self-regulator is able to achieve compromise among the various constituencies in order to achieve a consensus in rulemaking. As stated in the SEC's 1963 Special Study,

> The expertness and immediacy of self-regulation often provide the most expedient and practical means for regulation. By making those regulated actual participants in the regulatory process they become more aware of the goals of regulation and their own stake in it.[65]

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60. 5 U.S.C. § 552b (1982 & Supp. IV 1987).
61. 28 U.S.C. §§ 591-98 (1982 & Supp. IV 1987).
62. 5 U.S.C. § 552 (1982 & Supp. IV 1987).
63. 15 U.S.C. § 78s(b)(2)(B) (1982).
64. 15 U.S.C. § 78s(e), (f) (1982).
65. SPECIAL STUDY, *supra* note 16, pt. 5 at 197-98.

IV. Weaknesses of Self-Regulation

A. Delegation

One of the most ambitious examples of self-regulation in American history was condemned to failure by the Supreme Court. The National Industrial Recovery Act of 1933,[66] passed during the Great Depression, was an effort to provide a mechanism for federal governmental direction of an economic recovery. Instead of providing for direct government regulation to curtail competition and restore economic stability, the bill promoted industry-wide agreements on wages, hours, and trade practices. In return for an exemption from the antitrust laws, each industry was expected to meet its obligation to the public welfare. Although the bill provided for Presidential approval of the industry codes, the only standards for the exercise of executive discretion were that trade associations should be truly representative, with no inequitable restrictions on membership, and that the codes proposed should not tend to promote monopolies.

In *Schechter Poultry Corp. v. United States,*[67] a unanimous Supreme Court held that this grand experiment in self-regulation was an unconstitutional delegation of governmental power by Congress to private parties and the Executive Branch. Even Mr. Justice Cardozo, concurring, was troubled by the "positive" functions of the codes. The codes were not intended merely to eliminate "business practices that would be characterized by general acceptation as oppressive or unfair."[68] The codes also were to include ordinances "desirable or helpful for the well-being or prosperity of the industry affected."[69] This grant of power to business and the President was, in Justice Cardozo's view, "delegation running riot."[70]

This notion of unconstitutional delegation seems to have reached its high-water mark in the *Schechter Poultry* case. The decision is ambiguous in that it is not entirely clear that the statutory defect was unconstitutional delegation of power by Congress to the President, as opposed to a grant of governmental power to the private sector. However, regardless of whether self-regulation involves an exercise of power that is basically governmental or basically private, when self-regulation enjoys certain privileges, such as immunity from the antitrust laws, or certain coercive powers, such as the ability to discipline or expel, self-regulation begins to have a governmental aura. Accordingly, the question of whether governmental power is being improperly delegated then arises.[71]

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66. Pub. L. No. 67, 48 Stat. 195 (1933).

67. 295 U.S. 495 (1935).

68. Schechter Poultry Corp. v. United States, 295 U.S. 495, 552 (1935) (Cardozo, J., concurring).

69. *Id.* at 552-53.

70. *Id.* at 553.

71. *See* Lane, *Schechter and the FTC: A Roving Commission,* 39 Bus. Lawyer 153 (1983); Lawrence, *Private Exercise of Governmental Power,* 61 Ind. L.J. 647 (1986).

Questions concerning the exercise of government power by a private body have arisen in the context of SRO disciplinary proceedings. The rules of the NYSE provide that a member or a person associated with a member can be sanctioned and even barred from employment with a member firm, for refusing to appear, testify, and cooperate with the exchange in an NYSE investigation.[72] Several sanctioned parties have claimed that such sanctions are a denial of due process and the constitutional privilege against self-incrimination. However, the SEC and the courts have held that self-regulatory sanctioning is not government action. Rather, "this is but one of many instances where government relies on self-policing by private organizations to effectuate the purposes underlying federal regulatory statutes."[73]

On the other hand, in *Austin Municipal Securities v. National Association of Securities Dealers,*[74] in a suit for humiliation and defamation by a disciplined NASD firm, the Fifth Circuit held that the NASD, the District Business Conduct Committees, which prosecute and adjudicate disciplinary matters, and staff members are absolutely immune from personal liability for action within the scope of their disciplinary duties. Although the Fifth Circuit recognized that the NASD was not a government agency, the NASD and related defendants were accorded the same immunity as government prosecutional agencies and officials. The plaintiffs contended that the members of the District Business Conduct Committee could not be impartial in their regulation and discipline because the members of the committee were competitors with the firms they regulated. The court recognized that this contention of partiality reached the heart of the self-regulatory system which Congress created "so that the membership could apply specialized business expertise in the regulation of this complex industry."[75] The court did not focus on the issue of undue delegation of governmental power, but rather on whether the regulatory system adequately protected members against abuse. The Fifth Circuit held that the pervasive oversight authority by the SEC in the promulgation and enforcement of NASD regulations and disciplinary procedures was sufficient to check any potential abuses.[76]

72. NYSE Rule 477.

73. United States v. Solomon, 509 F.2d 863, 869 (2d Cir. 1975). Furthermore, the SEC's oversight authority over the NYSE does not "convert the Exchange into a branch of government." In the matter of Vincent Musso, Exchange Act Release No. 17984 (July 30, 1981). Complaints about improper delegation of governmental power also have arisen in the context of standard setting. Critics of the SEC have claimed that it has improperly delegated its responsibilities to determine accounting principles to the FASB. Such a charge goes beyond the notion that the SEC has abdicated a statutory duty to a private body, and encompasses the idea that the FASB is mediating between various constituencies, particularly accountants and issuers, which is a Congressional function, and adjudicating important private rights, which is a judicial function. H. KRIPKE, THE SEC AND CORPORATE DISCLOSE: REGULATION IN SEARCH OF A PURPOSE 149-58 (1979).

74. 757 F.2d 676 (5th Cir. 1985).

75. Austin Mun. Sec., Inc. v. NASD, 757 F.2d 676, 690 (5th Cir. 1985).

76. *Id.*

B. *Due Process and Regulatory Laxity*

As the foregoing cases suggest, a close link exists between the problems of delegation of government power and the need to provide due process to members of SROs who become the subjects of enforcement action. Under section 19(e) of the Exchange Act, the SEC possesses clearly delineated oversight of SRO discipline. If a member is disciplined by an SRO, the sanction may be reviewed by the SEC on its own motion or by appeal by the member. The SEC review may be de novo or on the record, and the SEC must make a finding as to whether the SRO had grounds to find the sanctioned conduct to be in violation of SRO regulations or the Exchange Act. Further, the SEC must determine whether the SRO provisions at issue are and were applied in a manner consistent with the purposes of the Exchange Act.[77]

Because of the powerful influence that an SRO can exert upon its members, SRO disciplinary proceedings must assure adherence to fundamental principles of justice and fair play. This includes adequate notice of charges of wrongdoing, an opportunity for a hearing, the ability to offer evidence and cross-examine, representation by counsel, a record, and a reasoned explanation of any sanctions imposed.[78]

Due process considerations also require the SROs to be fairly representative of the regulated membership, and to be sensitive to the public interest. These concerns have led to considerable focus on SRO governance and the SEC's oversight of the governance process.[79] Due process also is relevant to the notice and comment requirement for rulemaking procedures, which are designed to elicit disparate points of view and to build a record to support the reasonableness of standards adopted.[80]

The very formality of these due process safeguards makes for slower, more bureaucratic, less innovative, and less effective SRO enforcement. Further, because SROs are not government bodies, they cannot issue subpoenas and their investigation depends upon voluntary cooperation. Although the SROs can take action against their own members for failure to produce records or give testimony,[81] they have no recourse against outside sources of information who refuse to cooperate. As a result, the SROs often are perceived to be ineffective. For example, the NYSE was criticized for its failure to uncover and prosecute the Boesky related insider trading

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77. 15 U.S.C. § 78s(e)(2) (1982).

78. Nachbar, *Contract Market Self-Regulation Under the Commodity Exchange Act*, 31 CLEV. ST. L. REV. 573, 584-85 (1982).

79. *See* 15 U.S.C. §§ 78f(b)(3) and 78o-3(b)(4) (1982). The NYSE Constitution provides for a board of 24 directors, of which 12 must be public directors. The industry directors are divided into a variety of constituencies. NYSE CONST. art. IV, § 2.

80. Although SROs are not directly subject to the notice and comment requirements of the Administrative Procedure Act, 5 U.S.C. § 551, 552 (1982 & Supp. 1986), all SRO rules must be filed with the SEC for approval, and before they become effective, they are published for comment by the SEC. 15 U.S.C. § 78(b) (1982).

81. *See, e.g.*, In the matter of Vincent Musso, *supra* note 73.

cases, but successful investigation of these cases required action not only by the SEC but also by the Department of Justice.[82]

Attitudinal problems contribute to the perception that surveillance and enforcement is not sufficiently strict. Vigorous policing by self-regulators of their own members is inherently difficult. Furthermore, since SROs compete against each other in the marketplace and as regulators, it is extremely difficult for one SRO to uphold a standard that a competitor does not enforce. For example, when the American Stock Exchange developed a standard on common stock voting rights that differed from the NYSE's one share/one vote standard, and the NASD had no standard on common stock voting rights, the NYSE failed to enforce its one share/one vote listing standard.[83] These disparate standards moved the SEC to take action to develop a uniform national standard.[84]

Finding an appropriate balance between ineffective and overzealous enforcement of business or professional standards is one of the most difficult challenges faced by any self-regulator. Government oversight is, therefore, essential to assure that articulated standards are fairly but rigorously enforced, and to provide some form of appeal to a public body from arbitrary and capricious action. The SEC Special Study stated this proposition as follows:

> [S]elf regulation by a member organization involves some degree of impairment of competition and public control is necessary not only to insure that such impairment is compensated for by effective regulation, but also to insure that the kinds and extent of impairment are only such and no greater than required by the exigencies of regulation. Inherent in self-regulation is the "private" formulation of restrictive standards of business conduct and their enforcement by, at the very least, exclusionary practises. It is essential that the standards and their application not be left to the unfettered discretion, or perhaps even lack of bona fide regulatory purposes, of the private regulators.[85]

C. Duplication

In many areas NYSE regulation duplicates SEC regulation, as well as the regulation of other stock exchanges and the NASD. This is economically costly and also burdensome in other ways. Blue Sky regulation of the states

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82. TESTIMONY OF JOHN J. PHELAN, CHAIRMAN AND CEO, NYSE, BEFORE THE HOUSE COMM. ON OVERSIGHT AND INVESTIGATIONS OF THE COMM. ON ENERGY AND COMMERCE, Dec. 11, 1986. *See* J.B. Stewart & D. Hertzberg, *Chairman of Jeffries to Admit Felonies, Settles SEC Market Manipulation Charge,* Wall St. J., Mar. 20, 1987, at 3, col. 1.

83. Karmel, *supra* note 3.

84. Voting Rights Listing Standards—Disenfranchisement Rule, Exchange Act Release No. 25,891, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) 84,247 (July 7, 1988).

85. SPECIAL STUDY, *supra* note 16, pt. 4, at 502 (footnote omitted).

duplicates much SEC and SRO regulation.[86] Recently, foreign regulators have embarked upon regulatory schemes that also overlap with U.S. regulation.[87]

Although the SEC and the securities industry have done remarkably well in evolving mechanisms for sharing regulatory responsibility,[88] this sharing frequently leads to a lack of accountability, either because it is unclear who is responsible for a case or program, or because there is a short circuiting of the political process.[89] While competition among regulators may decrease the likelihood of wholly inappropriate or overly rigid rules, competition also weakens regulation. In short, regulatory duplication can lead to both underregulation and overregulation. In addition, the regulated industry bears the price of such inappropriate regulation.

In recent years government regulation has become unpopular, but the political pendulum may swing in the direction of reregulation in the future. In that event, serious consideration should be given to a methodology for allocating responsibilities between the SEC and SROs. One commentator has suggested the following guidelines:

> 1. Decisions requiring technical expertise should be resolved by the regulatory institution with the greatest expertise.
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> 2. Decisions involving conflicts of interest between the self-interests of a regulatory party and a specific regulatory goal should be resolved by the regulatory institution not involved in the conflict.
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> 3. Decisions requiring uniformity of approach for different SROs should be administered by the SEC.
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> 4. Decisions requiring diversity of approach for each SRO based upon differences in market structure should be administered by the individual SRO.
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> * * *
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> 5. The Commission should resolve a problem when it has ultimate regulatory authority over a regulatory issue and has already decided upon a specific resolution for which it needs no further technical assistance.[90]

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86. *See* Karmel, *supra* note 37.

87. *See* Page, *supra* note 7.

88. 15 U.S.C. § 78q(d) (1982); *see* 17 C.F.R. § 240.17d-2 (1988). *See generally* Lipton, *Governance of Our Securities Markets and the Failure to Allocate Regulatory Responsibility,* 34 CATH. U. L. REV. 397 (1985).

89. Miller, *supra* note 9, at 865.

90. Lipton, *The SEC or the Exchanges: Who Should Do What and When? A Proposal to Allocate Regulatory Responsibilities for Securities Markets,* 16 U.C. DAVIS L. REV. 527, 545-47 (1983).

One difficulty with this proposal is that the securities have become inextricably linked to the financial futures markets,[91] and the commodities exchanges are SROs under a different statute[92] with oversight by the Commodity Futures Trading Commission (CFTC). Although the dominant member firms belong to the securities and commodities exchanges, these exchanges are in competition with one another, as are their respective government regulators. This situation makes a rational allocation of regulatory responsibilities very difficult.

D. *Antitrust Immunity*

Antitrust problems are persistently lurking in self-regulatory activities. The promotional activities of self-regulatory organizations are susceptible to attack as pricefixing, economic boycotts, or other prohibited anti-competitive conduct.[93] Equally troubling, however, is the questionable status of standard setting and disciplinary activities. Compulsory membership in a business or professional association, in conjunction with the power to discipline members, is basically a combination in restraint of trade and is violative of the antitrust laws.[94] Yet, absent compulsory membership and the power to expel, self-regulation is a feckless mechanism for the establishment of high standards or the protection of the public.

Some degree of immunity from the antitrust laws probably is essential to any effective self-regulatory scheme. However, the courts are loathe to imply a repeal of the antitrust laws. In *Silver v. New York Stock Exchange,*[95] the Supreme Court addressed the question of whether the federal securities laws immunized NYSE regulation from antitrust attack. The Court held that NYSE regulation was immunized from antitrust attack only to the extent necessary to make the securities laws work. The *Silver* holding was elaborated upon further in *Gordon v. New York Stock Exchange.*[96] In *Gordon,* the concurring opinion of Justice Douglas is particularly instructive, because Justice Douglas points out that mere jurisdiction by the SEC over exchange activity does not prevent anticompetitive conduct from violating the antitrust laws. According to Justice Douglas, what is required to prevent anticompetitive conduct from violating the antitrust laws is active and aggressive governmental oversight.[97]

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91. REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS (Jan. 8, 1988), CCH Special Report No. 1267 (Jan 12, 1988) [hereinafter BRADY REPORT].

92. 7 U.S.C. §§ 7, 7a (1982).

93. *See generally* Smythe, *Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for an Accommodation,* 62 N.C.L. REV. 475 (1984).

94. Kissam, *Antitrust Law and Professional Behavior,* 62 TEX. L. REV. 1 (1983); Monroe, *Trade and Professional Associations: An Overview of Horizontal Restraints,* 9 U. DAYTON L. REV. 479 (1984).

95. 373 U.S. 341 (1963).

96. 422 U.S. 659 (1975).

97. Gordon v. New York Stock Exchange, 442 U.S. 659, 692 (1975) (Douglas, J., concurring).

In the 1975 Amendments to the Exchange Act, the SEC was directed to focus on competition as an objective in SRO oversight. Fair competition became an objective of the national market system[98] and national clearing system.[99] In making rules and regulations under the Exchange Act, the SEC must consider the impact of its actions on competition and refrain from adopting any regulation that would burden competition unduly.[100] Nevertheless, the SEC is entitled to balance competitive concerns against other statutory issues and has been permitted to do so in reviewing SRO action.[101]

Despite these statutory checks in the Exchange Act on anticompetitive behavior, the danger that self-regulation will be used as an anticompetitive tool remains ever present. On the one hand, self-regulation works because it is in the economic best interests of its members. On the other hand, where short-term interests or the interests of a particular constituent group are able to overwhelm long-term interests, or the interests of the securities industry as a whole, serious problems can emerge.

A serious current challenge to self-regulation, against which anticompetitive interests should be guarded, is harmonizing equity trading and trading in such derivative products as options and futures. When various competing self-regulators, of which the NYSE is only one, are vying to sell different products and to make different pricing mechanisms for stocks paramount, the public interest has to be brought to bear on the question of appropriate regulation. To permit these competing self-regulators to decide such critical issues without government oversight would be unwise.

Generally, SEC oversight is an adequate check on anticompetitive regulation by exchanges. However, many of today's market structure problems extend beyond the SEC's jurisdiction. Thus, the SEC may not be capable of solving these problems, and the partial exemption from the anti-trust laws enjoyed by the securities industry may be abused.

V. The Crash and Its Aftermath

A. *The Market Break*

The 22.6% decline of 508 points in the Dow Jones Industrial Average (DJIA) on October 19, 1987 was historically unprecedented.[102] Further, the next day, October 20, 1987, the market nearly closed because of the inability of specialists and other market makers to continue trading.[103] The immediate political reaction to the crash was a plethora of studies by government

98. 15 U.S.C. § 78k-l(a)(l)(C)(ii) (1982).

99. 15 U.S.C. § 78q-l(a)(2) (1982).

100. 15 U.S.C. § 78w(a) (1982 & Supp. 1986).

101. Bradford Nat'l Clearing Corp. v. SEC, 590 F.2d 1085 (D.C. Cir. 1978).

102. Wells Fargo Investment Advisors, *Anatomy of a Decline: The Role of Index-Related Trading in the Market's Record Fall*, Nov. 9, 1987, at l.

103. J. B. Stewart & D. Hertzberg, *Terrible Tuesday, How The Stock Market Almost Disintegrated A Day After the Crash*, Wall St. J., Nov. 20, 1987, at 1, col. 6.

bodies and SROs, including the NYSE,[104] Chicago Mercantile Exchange,[105] a blue-ribbon Presidential Commission (the "Brady Commission"),[106] the SEC,[107] and the CFTC.[108] Subsequently, the President appointed a consortium of regulators, headed by the Treasury Department and including the Chairmen of the Federal Reserve Board, SEC, and CFTC (the "Working Group"), which issued a report.[109]

The reports published in the wake of the crash differed markedly on the causes of the crash and recommendations for preventing such market volatility in the future.[110] However, all of the reports focused on the interrelationship between stocks and financial futures and addressed whether trading in financial futures caused the crash. All of the reports also focused on the need for regulatory reform. The Brady Report concluded that from an economic viewpoint, the markets for stocks, stock index futures, and stock options, although traditionally viewed as separate markets, are in fact one market. Therefore, one regulator should oversee intermarket issues.[111] Among the intermarket issues the various reports discuss are price and position limits, sometimes referred to as "circuit breakers,"[112] margin levels,[113] short-sale regulations,[114] systems improvements,[115] basket trading,[116] and clearance and settlement systems coordination.[117]

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104. N. deB. Katzenbach, An Overview of Program Trading and Its Impact on Current Market Practices (Dec. 21, 1987) (hereinafter Katzenbach Report].

105. M.H. Miller, J.D. Hawke, B. Malkiel & M. Scholes, Preliminary Report of the Committee of Inquiry Appointed by the CME to Examine Events Surrounding October 19, 1987 (Dec. 22, 1987).

106. Brady Report, *supra* note 91.

107. Report by the Division of Market Regulation of the U.S. Securities and Exchange Commission, The October 1987 Market Break (Feb. 1988) [hereinafter SEC Report].

108. Division of Economic Analysis and Division of Trading and Markets, Final Report on Stock Index Futures and Cash Market Activity During October 1987 to the U.S. Commodity Futures Trading Commission (Jan. 1988) [hereinafter CFTC Final Report]; CFTC Follow-Up Report, *supra* note 40; Division of Economic Analysis and the Division of Trading and Markets, Interim Report on Stock Index Futures and Cash Market Activity During October 1987 to the U.S. Commodity Futures Trading Commission (Nov. 9, 1987) [hereinafter CFTC Interim Report].

109. Interim Report of the Working Group on Financial Markets Submitted to the President of the United States (May 1988) [hereinafter Working Group Report]; *see also* U.S. General Accounting Office, Report to Congressional Requesters, Financial Markets Preliminary Observation on the October 1987 Crash (Jan. 1988) [hereinafter GAO Report].

110. *See generally* Karmel, *The Rashamon Effect in the After-the-Crash Reports,* 21 Rev. of Sec. & Commodities Reg. (Standard & Poor's) 101 (1988).

111. Brady Report, *supra* note 91 at 59, 69.

112. *Id.* at 66-67, 69; Working Group Report, *supra* note 109, at 4-5.

113. Working Group Report, *supra* note 109, at 6; Brady Report, *supra* note 91, at 69.

114. Brady Report, *supra* note 91, SEC Report, *supra* note 107, at 3-26.

115. SEC Report, *supra* note 107, at 7-7; GAO Report, *supra* note 109, at 79, 97-98.

116. Katzenbach Report, *supra* note 104, at 29; SEC Report, *supra* note 107, at 3-17.

117. Working Group Report, *supra* note 109, at 7-11.

With the passage of time it has become increasingly clear, however, that competing commodities and securities exchanges will not voluntarily or easily harmonize regulations that are perceived to give one marketplace a competitive edge over another. In addition, neither the SEC nor the CFTC are inclined to cede jurisdiction to the other. Further, an administration committed to deregulation has not been willing to push existing regulators or SROs to action.[118] Accordingly, it has been left to the SROs to develop individual responses to the crash.

B. Self-Regulatory Mechanisms Developed

During the week of October 19, 1987, the crisis in the financial markets tested the securities self-regulatory process. Efforts to maintain liquidity and continuity in the stock market and to keep the markets open severely strained NYSE and other market systems, as well as the financial resources of specialists and market-makers. Surveillance systems were likewise strained. While market pressures demonstrated some inadequacies in self-regulatory systems and the financial and operational capabilities of members, the SROs developed a number of mechanisms for dealing with the crisis that demonstrated some of the pluses of self-regulation.

For example, instead of giving in to pressures to close the market, the NYSE engaged in temporary trading halts in certain stocks that could not be priced.[119] Because of the strain on computer and other systems and concerns about volatility, the NYSE eliminated the computer-to-computer connections for program trading and recommended that its member firms not engage in program trading. This reduction of the volume of program trading lasted for several weeks.[120] A speedy arbitration process for questioned trades (QTs) was developed by floor members. Although informal floor arbitration for QTs normally works well, this speedy arbitration system worked even better. Despite the enormous amount of money involved, members willingly compromised disputes.[121] The NYSE shortened trading hours in order to let firms improve their ability to clear and settle trades.[122]

During the crisis, SROs were in immediate and continuous telephone contact with their members and kept informed about the financial condition of firms. As soon as problems developed, they were handled expeditiously. Even with regard to problems at one of the service bureaus, which is not a member or in any way regulated by the NYSE or SEC, the NYSE was able to obtain the voluntary cooperation of the service bureau to take

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118. *See generally* Karmel, *The Working Group Report,* N.Y.L.J., June 16, 1988, at 10-11.

119. TESTIMONY OF JOHN J. PHELAN, CHAIRMAN AND CEO, NYSE, BEFORE THE SEN. COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, Feb. 5, 1988, at 10-11.

120. Crossen, *Program Trading Eases Under Rules Set by Big Board,* Wall St. J., Nov. 5, 1987, at 2, col. 3; Wallace, *Fewer Program Traders Return,* N.Y. Times, Nov. 10, 1987, at D8, col. 4.

121. SEC REPORT, *supra* note 107, at 10-9.

122. *Id.*

necessary action to improve its computer capabilities.[123] The NYSE encouraged firms to add capital where necessary. A number of specialist takeovers were arranged, and in that connection, the NYSE rule changes were approved by a special meeting of the Board of Directors on October 22, 1987.[124]

It is doubtful that the instant communications network that was set up for informal decisionmaking and oversight, and the development of innovative regulatory initiatives, could have been conducted by government regulators. The NYSE was able to obtain information quickly and without resistance and to enlist voluntary compliance with its directives from its members.

Almost immediately after the crash, the NASD Board recommended a series of new regulations to strengthen OTC market-making by imposing affirmative obligations to the market on market-makers and protecting orders from individual customers.[125] The NYSE imposed a type of circuit breaker on index arbitrage,[126] imposed more stringent capital requirements on specialists,[127] and is developing plans for trading baskets.[128] Both the NYSE and NASD had been developing new compliance regulations for proprietary trading before the crash, and this rulemaking has gone forward.[129]

C. *The Future of Securities Self-Regulation*

Despite the accomplishments of self-regulation, it is unlikely that the SROs will be able to solve the structural problems in the markets on their own. SROs have a poor record of dealing with competitive issues in the markets,[130] and there is no reason to believe that they will be capable of resolving the struggles for control of the pricing mechanism for stocks between the primary and derivative markets. Further, the SEC will be unable to exercise effective oversight on these intermarket issues because commodities regulation is under the jurisdiction of the CFTC.

An example of the intractable nature of the problems faced by SROs can be demonstrated by the disparity in the margin regulation of securities

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123. *See id.* at 2-25.

124. *Id.* at 4-62 to 4-65.

125. *See* NASD Memo of Nov. 20, 1987, 87-77, Request for Comments on Proposed Amendments to the Rules of Practice and Procedures for the NASD's SOES and to Schedule D of the NASD's By-Laws; Swartz, *NASD Seeks to Halt Firms' Refusal to Trade,* Wall St. J., Nov. 17, 1987, at 2, col. 2.

126. Ricks, *Outcry Grows Against Program Trading; SEC Provisionally Backs Big Board Curb,* Wall St. J., Apr. 21, 1988, at 4, col. 2.

127. Swartz, *Big Board Votes Specialist Capital Jump, Signaling Changes for Market Makers,* Wall St. J., Apr. 8, 1988, at 3, col. 2.

128. *See* Sterngold, *John Phelan's New Game Plan,* N.Y. Times, June 26, 1988, at § 3, p. 1, col. 2.

129. NYSE Proposed Rule 342.30; *see* Exchange Act Release No. 24,363 (Apr. 17, 1987); NASD Notice to Member 88-11 (Feb. 8, 1988).

130. SECURITIES INDUSTRY STUDY, *supra* note 26, at 2-3.

and financial futures. Section 7(a) of the Exchange Act directs the Board of Governors of the Federal Reserve Board to prescribe rules from time to time with respect to the amount of credit that may be initially extended and subsequently maintained on any security.[131] Although the Federal Reserve Board has fixed the margin requirement at various levels ranging from 40 percent to 100 percent, since November 1974 the margin requirement has stood at 50 percent of current market value.[132] While the Federal Reserve Board promulgates and interprets the margin regulations,[133] the SEC enforces them. Further, the Federal Reserve Board has never established margin maintenance requirements, as opposed to initial margin requirements. However, the NYSE has a maintenance requirement of 25 percent, in general, of securities long in a customer's account.[134]

In 1982, trading began on futures exchanges for contracts based on common stock indexes. In contrast to the securities markets, and even though the Federal Reserve Board once claimed the authority to set margin requirements,[135] futures contracts are not subject to federal margin levels. The CFTC has authority to prescribe margin levels for futures only in emergency situations. Otherwise, margin levels are set by the commodities exchanges.[136]

Such margins are set at a much lower rate than margins on stocks, or even options. Of particular relevance to recent stock market volatility are the margins for stock index futures, because of the various trading strategies that link index futures and equities. In July 1986, the margin requirements for these products ranged from a low of 3.8 percent for the Major Market Maxi to a high of 5.2 percent for the Value Line. The popular S&P 500 had a margin of 4.7 percent, and all of the indexes offered more leverage than was available in the stockmarket in the late 1920s.[137] Moreover, unlike other commodity-futures contracts, stock index futures cannot be settled by physical delivery, but must be settled in cash.[138]

Much has been made of the distinction between securities margin as a credit regulation device and commodities margin as a performance bond that does not include any extension of credit.[139] While it is true that commodity margin functions as a good faith payment on an unfulfilled contractual obligation, whereas securities margin is a downpayment for property that has already changed ownership, this is a distinction without

131. 15 U.S.C. § 78q(a) (1987).

132. L. Loss, *supra* note 38, at 654.

133. For a summary of these regulations, see E.N. GADSBY, 11A BUSINESS ORGANIZATIONS § 3A.02 (1984).

134. NYSE Rule 431(c)-(e).

135. FED. MARGIN STUDY, *supra* note 5, at 53.

136. CFTC FOLLOW-UP REPORT, *supra* note 40, at 27; SEC REPORT, *supra* note 107, at 3-21.

137. B.T. BYRNE, JR., THE STOCK INDEX FUTURES MARKET 43 (1987).

138. 7 U.S.C. § 2a (1986).

139. CFTC FOLLOW-UP REPORT, *supra* note 40, at 14-15.

a difference insofar as the effect of leverage on speculation is concerned. Further, the availability of cash settlement increases the leverage in the trading of index futures.[140]

The SEC Report and the Katzenbach Report, therefore, both recommended that consideration be given not only to rationalizing the differences between security and futures margins, but also to the feasibility and desirability of physical settlement for index products.[141] The Brady Report also recommended that margins should be made consistent to control speculation and financial leverage.[142] The CFTC Report, however, focused on customer defaults and danger to the clearinghouses, rather than market volatility, and therefore, concluded that margin levels were generally sufficient.[143]

The Working Group, with SEC Chairman Ruder dissenting,[144] adopted the CFTC's view and recommended that no regulatory action be taken on the level or regulation of margin.[145] This may have been due to the unwillingness of Federal Reserve Board Chairman Greenspan to accept any responsibility for regulating the securities or commodities markets.[146] Additionally, the Federal Reserve Board has been anxious to get out of the business of regulating margin for a number of years.[147]

Yet, the history of SRO regulation on establishing strict financial standards in a competitive situation is not promising. Setting margin levels is much like setting net capital levels. A nationwide standard is necessary and appropriate. There is no reason to assume that SROs such as the securities and commodities exchanges, which are not even subject to oversight by the same regulator, will act jointly to establish a uniform standard that will reduce leverage and transaction velocity.

VI. CONCLUSION

Securities self-regulation is a valuable and sensitive mechanism for keeping the securities markets reasonably open and honest. Despite its shortcomings, both theoretical and practical, it works. Yet, such self-regulation requires strict and consistent government oversight, as Congress recognized in the 1975 amendments.

Vigorous and consistent oversight has been undermined, however, by the regulatory competition between the SEC and CFTC. While the competition between the commodities and securities exchanges may be salutary

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140. SEC REPORT, *supra* note 5, at 3-19.

141. *Id.* at 3-20, 3-22; KATZENBACH REPORT, *supra* note 104, at 30.

142. BRADY REPORT, *supra* note 91, at 69.

143. CFTC FOLLOW-UP REPORT, *supra* note 40, at 193.

144. WORKING GROUP REPORT, *supra* note 109, at 11-12.

145. *Id.* at 5-7.

146. TESTIMONY OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, Feb. 2, 1988, at 22-23.

147. *See* FED. MARGIN STUDY, *supra* note 5.

in certain respects, from an economic and business viewpoint, conflicting regulatory and oversight schemes are questionable public policy.