SELF-REGULATION IN THE SECURITIES MARKETS

Transitions and New Possibilities

CFA Institute

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Executive Summary

Self-regulation in the securities markets is in transition. Whereas some countries have abandoned self-regulatory organizations (SROs) altogether, others are actively exploring the benefits offered by a system that provides a "front-line" regulator, such as an SRO.

This report examines the self-regulatory landscape since our publication of "Self-Regulation in Today's Securities Markets: Outdated System or Work in Progress?" in 2007. In light of recent questions raised in the United States about the utility of the self-regulatory system, we explore concerns about its continued value. Part 1 looks at the backdrop for this exploration: the unprecedented fines and sanctions recently levied against financial market SROs and the ever-increasing complexity of the financial markets. As evidenced by the last financial crisis, which started a downward spiral in economies around the world, financial markets are clearly interconnected and often interdependent. Consequently, conclusions about risk, structure, and even reform based on only one country's regulatory system have become imprudent. This report thus focuses on the use of self-regulation in a number of countries, and it highlights trends in those countries.

Part 2 highlights what contributes to a successful self-regulatory system in the securities markets, including particular characteristics that reinforce the credibility of the system—both with investors and with governing bodies in other jurisdictions. The ability to keep pace with innovative securities markets is a particularly challenging but necessary attribute. In this section, we consider a number of structures that can be viewed as meeting the definition of "self-regulatory" and focus on the particular form and characteristics used in evaluating self-regulation in select regions around the world. We assert that, despite all its failings, self-regulation is still much needed in today's markets.

Part 3 focuses on a re-examination in the United States of the current self-regulatory system and the use of SROs. Various reports and commissioners for the U.S. Securities and Exchange Commission themselves question whether the system has lost its relevance in a marketplace that appears to have outpaced and outgrown its ability to effectively self-regulate. Added to these questions are governance failures and weaknesses—most recently, the collusion between a commodities exchange SRO and those it was established to regulate as the SRO attempted to hide its oversight failures. The extent of the alleged failings reinforces one of the inherent conflicts within the SRO system—that of regulating one's own members. We also discuss the use of nonexchange, or "private," SROs in the United States.

Part 4 considers possibilities for self-regulation on an international basis. First, we present a suggested use aimed at addressing systemic risk; then, we discuss collaborative efforts between the United Sates and other regulators of securities markets. Next, we address the challenges and opportunities that emerging markets present for the development of self-regulatory systems. In particular, we review the use of cross-border collaboration in these markets and whether such structures have potential elsewhere, including in developed markets. We close with a discussion of an existing successful system of voluntary industry self-regulation that can serve as a prototype for future development in the financial markets.

Part 5, Conclusions and Policy Recommendations, contains the following:

- With its inherent conflicts and governance challenges, the self-regulatory system is far from perfect. Such a system is needed, however, in today's highly complex and technologically changing and evolving markets.
- Budgetary pressures on primary or statutory regulators, such as the U.S. SEC, strain their ability to address the full range of issues falling under their jurisdiction. Therefore, a front-line regulator, such as an SRO, is a valuable resource.
- To that end, we urge the SEC to revive its review of specific questions and issues raised in its 2004 releases about self-regulation and self-regulatory organizations. In particular, the SEC should give attention to reconciling the private versus "state actor" functions of the nonexchange SROs in the United States.
- We also urge that needed improvements to governance structures of SROs be made to enhance market and investor trust in regulatory systems. These improvements include ensuring the independence of SRO boards and regulatory/arbitration panels; increasing the transparency of financial, governance, and regulatory matters; and increasing the accountability of the governing bodies to both statutory regulators and investors.
- Self-regulation not only is needed in established markets but also has great potential in developing countries and can be useful in cross-border market dealings. Work should thus continue to help developing markets design and implement mutually enforceable systems to regulate securities dealers across borders.
- Attention should also be given to other areas that can benefit from a self-regulatory approach. For example, self-regulation may have a role in identifying and monitoring systemic risk.
- The membership and governing structure of the Global Investment Performance Standards (GIPS®) provides a useful prototype for voluntary self-regulation across borders that may be instructive for developing new forms of self-regulation in the financial markets.

1. Introduction

The securities market landscape has changed dramatically since CFA Institute published "Self-Regulation in Today's Securities Markets: Outdated System or Work in Progress?" in 2007. The financial crisis of 2008–2009 raised unprecedented concerns and considerations for the future of the financial markets. These concerns range from the governance and oversight of individual financial firms and individual market participants to the health of national regulatory systems and to the global nature of the intricately interconnected market system. Therefore, whereas the 2007 paper focused on the type of self-regulatory structure that is most effective,[1] any discussion of self-regulation for the future must be greatly expanded. No longer is addressing the regulatory needs of a single country useful without considering the effect on a broader scale. Nor is any discussion complete without factoring in the effect of increasingly complex products and practices on the ability of governmental regulators to regulate.

Self-regulation took much of the blame for the financial crisis that hit bottom in late 2008. Indeed, a number of entities showed they were incapable of self-discipline; they ranged from the large, systemically important banks that engaged in a massive leveraging of the financial system to the creditors who funded these institutions. Unfortunately, financial regulation in the 1990s and early 2000s had handed the determination of required regulatory capital to the very financial institutions subject to the rules. Some statutory regulators also applied what was known as "light-touch" regulation, which relied largely on the integrity and self-discipline of the firms being regulated. The results were disappointing, at best, and disastrous, at worst.

It is in this environment—of fundamental questions about the ability of markets and firms to regulate themselves—that this report reconsiders self-regulation. In doing so, we identify the means by which regions and nations are applying and adapting self-regulation, discuss the benefits and weaknesses of the approaches, and consider how some approaches give new life to this centuries-old regulatory tool.

[1] Part of the reason for this focus was to address two U.S. SEC releases on self-regulation: SEC Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations; Disclosure and Regulatory Reporting by Self-Regulatory Organizations; Recordkeeping Requirements for Self-Regulatory Organizations; Ownership and Voting Limitations for Members of Self-Regulatory Organizations; Listing and Trading of Affiliated Securities by a Self-Regulatory Organization (Release No. 34-50699; File No. S7-39-04); and SEC Concept Release Concerning Self-Regulation (Release No. 34-50700; File No. S7-40-04).

2. SRO Governance

In this part, we consider what a successful self-regulatory structure would look like, survey old and new forms of self-regulation, and discuss ways in which self-regulation is in transition.

The Keys to a Successful SRO Model

In evaluating the worth of self-regulation in today's markets, we need to measure the benefits of such a system against what is demanded by the climate in which it operates. Today, that climate is one of general skepticism and investor distrust of the markets and their effective regulation.[2]

Studies of the sentiments of market participants, such as the CFA Institute Global Market Sentiment Survey, show that investor trust in the financial markets is at an all-time low (CFA Institute 2012). Of the 6,783 respondents to the survey in late 2012, more than 56% said a poor ethical culture within financial firms has contributed to a lack of investor trust in the industry. The situation is exacerbated by a continuation of insider trading cases; revelations of market manipulation, corporate greed, and malfeasance; and a system that financially rewards some decision makers regardless of corporate performance or profitability. When a globally significant institution such as LIBOR is revealed to be based on greed and manipulation, the investing public in markets around the world can easily question the soundness of regulatory bodies. Therefore, regenerating and maintaining trust in the integrity of any regulatory structure is of paramount importance. Moreover, the events of the last few years call for even greater transparency and accountability on the part of market players, including regulators, if investor confidence is to be restored.

If self-regulation is to remain viable in this climate of distrust, it must prove that it is a system with integrity and with credible and fair procedures. It also must demonstrate that self-regulators can significantly contribute to the market—by providing needed help to primary or statutory regulators, such as the SEC, and by supporting, rather than unduly restricting, market innovation.

[2]In fact, skepticism about the value of self-regulation goes far beyond the financial marketplace. See, for example, the general discussion in Sharek, Schoen, and Loewenstein (2012): "Formulating and evaluating policies in a neutral, unbiased fashion can be difficult for those personally affected. When people have a stake in an issue, they tend to process information in a selective fashion that supports their personal interests, a phenomenon known as 'motivated reasoning'" (p. 2).

The paper "Self-Regulation in Today's Securities Markets" (CFA Institute 2007) presented 12 guidelines that must be addressed in creating a successful self-regulatory system. Although all the guidelines remain relevant in evaluating the effectiveness of an SRO today, two in particular are noteworthy for purposes of addressing the types of self-regulatory bodies that exist around the world.

First among the keys to the success of an SRO is its ability to maintain effective surveillance, supervision, and enforcement powers. Without an active surveillance program, a commitment to investigate questionable activities by its members, or an impartial enforcement process—including a method for due process—an SRO will lose credibility among investors, regulators, and the marketplace. In other words, it will be unable to operate effectively.

Second and equally important for an SRO's effectiveness is that it have the authority to create and enforce its policies and rules. The source of its authority affects the perception of an SRO. An SRO that was established through legislation or otherwise formally recognized by the primary regulator is likely to carry more weight than an organization that was only voluntarily organized or that provides only industry guidance to its members.

In evaluating types of authority, one must distinguish organizations that have rule-making authority from those that have more of an advocacy role—without enforceable rules or a disciplinary process for its members. Although a trade association, for example, may serve valuable purposes—promoting the interests of the industry and providing educational resources to its members—it does not retain the same credibility as enjoyed by an organization that exercises more formal self-regulatory powers. In fact, the existence of an advocacy function may raise questions about whether the organization is more a trade association than a "true" regulatory authority. To maximize effectiveness in a globally interconnected marketplace, the organization must have the credibility of a respected authority with actual power to regulate behavior within a home jurisdiction and also be recognized as such in "outside" jurisdictions.

In addition, in assessing the utility of self-regulation (or of any regulatory system, for that matter), one must decide the importance of "keeping ahead of the curve." Proponents of self-regulation argue that for regulation to work, market expertise with an eye to innovation is needed to enable surveillance and rule-making decisions to be made *ex ante*. Regulators are often seen to be addressing regulatory breaches *ex post* through enforcement actions.

As evidenced in our most recent global financial crisis, in fast-paced and highly innovative securities markets, regulators need to be more than reactive; the approach of "cleaning up" after a crisis or implementing volumes of new regulations aimed at filling a perceived gap in the regulatory scheme will no longer suffice to keep world markets afloat. Although the proliferation of new regulations may assuage public concerns at the time, many rules become quickly outdated as innovations and technology create either new roads around those specific rules or new products that technically fall outside the reach of the particular regulation.

The challenge facing global securities markets is to balance innovation with a regulatory structure that also protects investors. Given the complexity and breadth of markets today, primary regulators need the kind of help in such areas as market surveillance that "front-line" regulators—that is, SROs—can provide. This kind of help, in turn, frees primary regulators to focus resources on other compelling market integrity issues.

To help maintain market integrity and protect investors, however, SROs must have the authority to create and enforce rules, supervise members, and have strong surveillance mechanisms. Moreover, they must do so while creating trust not only in their own ability to regulate in a fair and efficient manner but also in the integrity of the markets they oversee. The creation of trust may be particularly important in emerging markets as they endeavor to create a credible regulatory system.

Adding to the balancing act is that securities markets need to innovate to remain vibrant and regulations must allow that innovation. The industry expertise that SROs provide can contribute to market innovation through understanding about what circumstances do or do not call for tighter restrictions on the development of new products and platforms. This expertise encourages the development of ahead-of-the-curve regulations. Because SROs may understand the risks better than the primary regulator, an SRO may be able to identify and propose rules more quickly than a primary regulator and thus provide some supervision and safety before a crisis occurs.

Globally, this balancing act is being played out in some markets, where getting the balance right is the priority. Innovations in self-regulation are also gaining traction. Despite the setbacks and reputational hits to self-regulation, the time is appropriate to consider the costs and benefits of self-regulation in the financial markets and the new and potential uses for SROs on a global basis.

A Survey of Self-Regulation: The Old and the New

Although some jurisdictions have a legal or official definition of what constitutes a self-regulatory organization, the term is open to interpretation, depending on the jurisdiction and the purpose of the SRO. For example, SROs include ***organizations whose authority is recognized in law or by the statutory regulator in a jurisdiction***; ***membership-based***

organizations that act as *de facto* legal authorities by self-policing and creating rules and policies for their members; ***informal or independent membership associations*** that often serve advisory and educational roles for their members (some trade associations fall into this group) and, in some cases, other market participants; and ***quasi-governmental entities*** that perform selected self-regulatory functions.

Determining Factors for SRO Structure

Regulatory Mandate

- *Source of authority*
- *Extent of authority*
- *Breadth of mandate*
- *Source of funding*

Accountability

- *Managing inherent conflicts of interest*
- *Transparency*
- *Liability*
- *Due process*

Scope of Enforcement

- *Extent of authority*
- *Methods*

History of System

- *Evolution of use*
- *Perceived benefits*
- *Perceived weaknesses*

In this report, we generally, though not exclusively, use the acronym SRO to refer to ***formal self-regulatory organizations*** that are recognized in law or regulation. These definitions have changed over the years as markets and market practices have changed. For example, securities exchanges are often recognized in law as SROs or as providing certain self-regulatory functions, but exchange demutualization over the past decade has sometimes caused a blurring of the lines between the exchange's traditional SRO functions and recent mutations. Along with demutualization have come alternative trading systems and operational changes that stretch the boundaries within and beyond a neat discussion of self-regulation. Thus, although exchanges provide a range of important self-regulatory services in many countries, they are not the primary focus of this report.

Nevertheless, we focus much attention in this report on evaluating the use of self-regulation in various jurisdictions and the forms it assumes. The primary determinants of where on the continuum a particular SRO falls largely relate to four main factors: (1) its regulatory mandate, (2) the degree of accountability imposed by law, (3) the scope of its enforcement authority, and (4) its evolution over time. We consider each of these factors.

Regulatory Mandate

In evaluating the nature of an SRO, it is important to first review the source of its mandate.

- *Source of authority.* Some SROs, like those in the United States and Canada, are recognized by statute or receive authority through official recognition channels, such as statutory regulators. Others claiming SRO status may not have authority grounded in law but may be recognized as a credible source for principal lawmakers.[3]

- *Extent of authority*. A benefit of self-regulation is that the SRO often assumes the role of front-line regulator. As such, it may operate fairly independently, with authority to create and enforce rules, albeit with prior review from its primary regulator. This authority is distinct from entities that are simply directed by the regulator to oversee certain areas of the market.

- *Breadth of mandate*. Closely aligned with an SRO's authority is the range of functions it is asked to perform. In addition to rule making, some have limited authority to discipline members for infractions—such as bringing enforcement actions, holding hearings, or barring members from the industry—or to conduct market surveillance.

[3]An example of this type of SRO is Romania's Stock Brokers' Association.

- *Source of funding*. Regulating one's members who also fund the operation of the SRO raises obvious conflicts of interest. When an SRO considers sanctioning a large member or investigating a member whose representatives sit on the governing board of the SRO, the organization's enforcement approach may, consciously or unconsciously, be affected. Funding provided by outside sources may lessen the tension.

Accountability

In light of the inherent conflicts of interest posed by the self-regulatory system, SROs must, if they are to be credible, have policies and procedures (governance and otherwise) to manage them. Without proper governance structures, not only will investors lack confidence in the SRO but also the marketplace will question the true authority of the entity. As noted in "Self-Regulation in Today's Securities Markets" (CFA Institute 2007), the first and foremost requirement for an effective self-regulatory system is a balancing of market integrity with market efficiency.

- *Management of inherent conflicts of interest*. With the demutualization of exchanges a decade ago, attention turned to how regulatory arms and profit centers would work together. Many exchanges have effectively addressed this issue by creating separate entities to perform the separate functions. The quality and the integrity of the procedures an SRO has for managing conflicts of interest are critical to its effectiveness as a respected authority.

- *Extent of transparency*. The clarity and the transparency of procedures for electing governing boards, creating rules, running discipline/enforcement programs, and resolving disputes, among other things, have a direct bearing on the credibility of an SRO. In particular, transparency about the entity's funding sources, its procedures for managing conflicts of interest, and the methods used for and reasoning behind its disciplinary decisions should be public information.

- *Legal liability*. If the SRO has rule-making and enforcement authority, the scope of this authority should be clear and consistently applied. Market participants should know how to approach resolution of disputes with the SRO, including whether (and to what extent) the SRO can be held legally responsible or whether it can claim immunity from prosecution for its failures or misdeeds.

- *Due process*. Due process considerations in the self-regulatory realm include both the process for stakeholder and industry input and the defense process when violations are charged. Moreover, an SRO's rule-making authority has greater credibility if the SRO provides the public with an opportunity to submit comments ahead of time and considers the feedback prior to the adoption of final rules. SROs are evaluated on their procedures for dispute resolution, including how a charged person is made aware of the action, the mechanism for "pleading his case," and appeal rights.

Scope of Enforcement

An entity's enforcement authority is integral to whether it is seen as a front-line regulator or similar to a trade association. In most cases, SROs have a mixture of enforcement authorities that permits them to enforce their own rules with regard to the licensing and fining of firms and individuals in violation of those rules. At the same time, such entities rarely have the means or the authority to try cases that would impose criminal penalties on either firms or individuals. Both its authority and its manner of enforcement are relevant to the role the entity assumes in the hierarchy of degrees of self-regulation.

History of System

In looking for trends in the evolution of self-regulation, a review of various countries' history of approaching regulation is useful. Although few countries with self-regulatory systems have disbanded their approach, some have questioned the utility of self-regulation in light of historical changes. Others have embraced the perceived benefits of their approach.

For example, some in the United States believe that the "administrative state" is changing, with primary regulators (and other administrative agencies) no longer able to handle increasingly overwhelming workloads. Since the 1950s and 1960s, the primary regulators have had to delegate more and more to self-directed entities (including SROs) in an attempt to address changes in the industry and the volume of work.

A good example of this change is the SEC's delegation to, and reliance on, FINRA (Financial Industry Regulatory Authority) for a number of oversight and rule-making functions.[4] But as this "pushdown" increases, even the SROs need to rely on private industry groups for help (Bullard 2011). Thus, a new tier of self-regulation is being born. How this new layer will be structured and governed and whether it will be recognized in law or exist as a supplementary "feed" for current SROs will need to be resolved.

As an organization, CFA Institute has long supported the idea that, where possible, self-regulation is a preferred method of regulatory oversight. Indeed, in response to a 2 May 2013 survey in the CFA Institute *Financial NewsBrief* (to which 643 investors responded),

[4]Formerly the National Association of Securities Dealers (NASD), FINRA was created through the 2007 combination of the NASD and the regulatory arm of the NYSE, NYSE-R.

a strong majority of investors concurred with the view that self-regulation serves a useful purpose in today's securities and financial services marketplace. Almost 60% of respondents agreed that it does, whereas about 40% disagreed.

Nevertheless, the significance of the negative response is an indication of today's general concern about the adequacy and utility of self-regulation. Moreover, some confusion exists about what actually constitutes "self-regulation."

The following discussion highlights ongoing concerns about the efficacy of self-regulation, notes recent trends in the use of SROs, and offers suggestions for the use of self-regulatory systems that may exceed the boundaries of what exists today. Although by no means definitive, this discussion does reflect information we have obtained through research, questionnaires, and interviews with regulators and market participants in various jurisdictions around the world.

Self-Regulation in Transition

A number of jurisdictions appear to be relying more and more on a self-regulatory approach as their markets reach a critical size.[5] Developed markets have traditionally been prime candidates for using SROs for the oversight of markets experiencing growth in the volume and complexity of securities trading because such oversight is helped by those within an SRO who have specialized expertise that may otherwise be lacking. In such cases, the SRO is a critical component not only in regulatory oversight but also in providing the investor trust needed to fuel the growth of innovation.

Often, however, adoption of such structures needs a catalyst, such as a financial crisis. Indeed, a move to implement a new regime or regulatory approach is a common response in the aftermath of a crisis. For example, passage of both the Sarbanes–Oxley Act in 2002 and the Dodd–Frank Act eight years later followed marked changes in the financial and economic climate in the United States. Not everyone, however, believes that new rules are the necessary or appropriate response to financial crises. Some question whether correcting "bad" regulation (rather than correcting perceived underregulation) is the more appropriate response.[6]

[5]Consider this quotation from "The Role of Financial Self-Regulation in Developing Countries" (Bossone and Promisel 2000): "Even so, financial self-regulation in developing economies could help improve the efficiency–stability tradeoff. Because of their knowledge and experience, and because of their commercial interest, SRO members are better placed than government bureaucrats to design rules consistent with the operational features of their business, to keep their operational processes and infrastructures apace with technological progress, and to improve their business standards." For a discussion of the potential for the use of self-regulation in emerging markets, see Carson (2011).
[6]For example, Rouch (2010) questions "whether there is a need for a clearer, more coherent, public sector commitment to the need to foster and, wherever possible, rely upon effective standard-setting by market participants over more interventionist and rules-based reform strategies" (p. 2).

Balanced against the criticisms of the current system of self-regulation are relevant considerations for using SROs. In some cases, the arguments *for* the use of self-regulation stem from the same arguments proffered *against* the use of self-regulation. Some commentators have questioned the use of self-regulation in markets with increasingly complex products and strategies. Yet, others believe that the complexity of practices and products argues strongly for, rather than against, the use of SROs. They reason that the expertise an SRO can provide will increase understanding of current market practices, meaningful rule making, and effective surveillance appropriate for the sector of the industry it oversees. Coupled with relieving the strain on resources that SROs can provide, the SROs can bring specialized expertise to addressing front-line regulatory issues.

Arguably, the best use of a primary regulator in the financial markets is to consider market structure and innovation, to devote resources to enforcing broad and sweeping investor protections, and to encourage fair and efficient markets. To address these big-picture items, however, the regulator must be able to delegate certain front-line regulatory functions to trusted entities. Otherwise, primary regulators risk becoming mired in time-consuming, but not necessarily compelling or valuable, activities. If a primary regulator uses its limited resources for resolving complaints and disputes, compliance issues, registration and oversight of securities dealers, or surveillance of market trading, it may lack the resources to focus on systemic issues, including those of risk, competition, and transparency.

Primary regulators today also face an unprecedented challenge in keeping ahead of innovation. New financial instruments, practices, and trading platforms force regulators to operate beyond the bounds of the "traditional" securities world.

In addition to this challenge are advances in technology that require specialized expertise simply to track the trading of new products on new platforms. Asking a primary regulator laboring under limited resources to monitor such markets effectively is optimistic at best; at worst, it is unrealistic.

In summary, the most recent financial crisis—stemming largely from the use of such complicated strategies and instruments as credit default swaps and other leveraged derivatives—points to a need for regulation (both rule making and oversight) by those who understand the structures and their potential risks.

3. The Global SRO Landscape

We offer in this part a survey of the state of SRO use in North America and selected countries in other regions around the globe.

North America

North America houses the two most formalized SRO systems in the world. Both the United States and Canada have self-regulatory systems that are formally recognized by statute or regulation. In each case, the SRO is overseen by statutory regulators and is authorized to engage in rule making and enforcement, in the disciplining of member firms, and in surveillance of market activities.

United States

As discussed in "Self-Regulation in Today's Securities Markets" (CFA Institute 2007), the system of self-regulation in the United States is recognized by law and has changed little since it was created in the Securities Exchange Act of 1934. Through this law, the established SROs have the authority to propose new rules and regulations after first submitting them to the primary regulator, the SEC, for approval. The SEC recently took action to streamline this process for "routine" filings.

In 2004, in light of the demutualization of exchanges and the new conflicts of interest that resulted, the SEC sought public comment on a range of issues relevant to the SRO system. In particular, the proposal asked for consideration of possible reforms to the governance, disclosure, reporting, ownership, and voting requirements of self-regulators.[7] The SEC followed the rule proposal with a "concept release" that focused on exploring solutions to perceived failings within the SRO system, including its inherent conflicts of interest, inefficiencies, the challenges of surveillance across markets, and how SROs generate revenue

[7]SEC Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations; Disclosure and Regulatory Reporting by Self-Regulatory Organizations; Recordkeeping Requirements for Self-Regulatory Organizations; Ownership and Voting Limitations for Members of Self-Regulatory Organizations; Listing and Trading of Affiliated Securities by a Self-Regulatory Organization (Release No. 34-50699; File No. S7-40-04).

and fund regulatory operations.[8] To date, no substantial regulatory changes have been made to the system, although commentators, industry experts, and the SEC continue to note the need for improvements.

One of the underpinnings of self-regulatory systems is a belief that market participants will act in ways that align *their* interest in avoiding more restrictive or government oversight with the *public's* interest in effective and responsive regulation. But the financial crises of recent years have called this belief into question and given rise to new doubts about the utility of self-regulation.

Alan Greenspan, former chairman of the U.S. Federal Reserve, is a champion of the market discipline approach to regulation—arguably self-regulation on a micro scale that relies on the aligned public/private interests. But he had this to say in 2008 when testifying before a congressional oversight committee: "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief" (Andrews 2008).

He was not alone. In a 2011 report, the Boston Consulting Group[9] asserted that "self-regulation is not real regulation at all: at best, self-regulation is less effective than government regulation, and at worst, is merely 'an illusion' meant to deflect calls for government oversight" (p. 25).

Moreover, the U.S. Chamber of Commerce (2011) published a report that echoed similar concerns about the use of SROs:

> Despite their tremendous influence over the workings of the capital markets, these organizations are generally subject to few or none of the traditional checks and balances that constrain government agencies. This means they are devoid of or substantially lack critical elements of governance and operational transparency, substantive and procedural standards for decision making, and meaningful due process mechanisms that allow market participants to object to their determinations. . . . (p. 5)
>
> Nongovernmental organizations' influence has grown dramatically over the past few decades, but their level of accountability to their constituents has not kept pace. [Their rules] impact the capital markets much the same way as those of

[8]SEC Concept Release Concerning Self-Regulation (Release No. 34-50700; File No. S7-40-04).
[9]This report was written after the Dodd–Frank Act directed the SEC to review its structure and operations, which included an evaluation of the relationship between the SEC and SROs.

> government agencies, yet they are not similarly bound by the APA [Administrative Procedure Act],[10] the congressional appropriations process, or other comparable checks on their power. . . . Unchallenged and largely unchecked, the influence of those organizations can be very detrimental to the development of vibrant capital markets. (p. 21)

Moreover, some regulators have expressed concerns about whether self-regulation in today's markets has kept pace with the changing landscape of the securities markets. In a 2012 speech, newly appointed SEC Commissioner Daniel Gallagher strongly questioned the use of self-regulation in an environment that differs dramatically from what originally gave rise to self-regulation in the United States. Noting that the original concept of self-regulation in the financial markets envisioned "private, mutualized, self-regulating exchanges and a simple association of dealers" (Gallagher 2012) based on the 1792 Buttonwood Agreement, Gallagher asserted that the fundamentals of our current financial markets differ greatly from what started out as a simple, mutual-based regulatory system. He posited that the complexity of investment products, the techniques of trading (e.g., dark pools and high-frequency trading, alternative trading systems), technology, and geographical reach/global interconnectedness have radically changed the landscape of the financial markets from the time when self-regulation was feasible. Gallagher characterized today's financial markets as "altered beyond recognition, with computers tied into demutualized, for-profit exchanges, some global in nature, and using algorithms to trade decimalized securities at speeds measured in microseconds." He noted that "for decades now, we've been building upon a self-regulatory framework premised on circumstances that no longer exist, a framework that permeates every aspect of market structure." In calling for a re-examination of self-regulation and market structure in the United States, he directly questioned whether exchanges should remain SROs and whether their current approach of outsourcing many regulatory responsibilities to other SROs abrogates the underlying principle of self-regulation.

[10]Among other things, the APA governs how U.S. administrative agencies create regulations, the information such agencies must make available to the public, and how federal courts review agency decisions.

Breakdown at CBOE

The debate about the ability of SROs to manage the inherent conflicts of interest relating to oversight of members was strikingly reintroduced in June 2013 when the SEC imposed a $6 million penalty on the Chicago Board Options Exchange (CBOE). The fine stemmed from a finding that the CBOE had failed to police and control a conflict of interest with a member firm, had interfered with the SEC's investigation of the matter, and maintained an inadequate surveillance operation/program. The SEC charged the CBOE and an affiliate with "various systemic breakdowns in their regulatory and compliance functions as a self-regulatory organization, including a failure to enforce or even fully comprehend rules to prevent abusive short selling." It was the first time the SEC had imposed a fine on an exchange for such a failure of regulatory oversight.

Given its prominence and size, the CBOE's alleged missteps reignited serious questioning of SRO powers, especially with respect to member oversight. "The proper regulation of the markets relies on SROs to aggressively police their member firms and enforce their rules as well as the securities laws," said Andrew J. Ceresney, co-director of the SEC's Division of Enforcement. Among other things, the SEC found that not only did the CBOE fail to adequately oversee the activities of its member but it also assisted that member in responding to an investigation, including the provision of inaccurate and misleading information that formed the member's response.

In addition to the flagrant actions with respect to this particular member, the SEC's order notes other CBOE regulatory and compliance failures between 2008 and 2012, including providing unauthorized "customer accommodation" payments to some, but not other, members; inadequate enforcement of its firm quote and priority rules for certain orders and trades; and failures with respect to requiring the registration of persons associated with its proprietary trading members. And by departing from established requirements for SRO rule making, the CBOE changed certain trading functions on its exchange without first filing rule proposals with the SEC.

Gallagher's critique of SROs was recently echoed by another SEC commissioner, although for different reasons. Commissioner Luis Aguilar voiced his concerns about SROs' inherent conflicts of interest and the need for strong SEC oversight in a speech on 8 May 2013. Specifically, he noted the increased competition many exchange SROs face from broker/dealer internalization networks and foreign trading markets. As exchanges face pressure to attract more order flow, they may pressure their self-regulatory units to favor certain members, issuers, and shareholders when weighing enforcement actions, which raises concerns about the ability of an SRO to regulate its own members. He noted as an example the SEC's $5 million penalty imposed on the NYSE in 2012 for compliance breaches that gave certain customers a trading advantage.[11] It was the first time the SEC had imposed a financial penalty on an exchange (Aguilar 2013).

In its 2011 report, the Boston Consulting Group noted three areas in need of improvement in the U.S. SRO system: strengthening the oversight of SROs, centralizing and coordinating the approach to SRO interactions, and strengthening the processes for SRO rule proposals (see Boston Consulting Group 2011).

Another concern about SROs focuses on their susceptibility to "industry capture," as noted by SEC staffers. In a study prepared by the Division of Investment Management on the feasibility of outsourcing the investment adviser examination function to FINRA or another SRO, staffers wrote,

> Multiple SROs could focus expertise and better accommodate industry diversity, but also could more likely lead to SRO "capture" by the discrete industry group from which SRO staff are drawn and to which they may return after their service. Even a single SRO, because it is not only funded by the industry it oversees, but also may include industry representatives in its governance structure or otherwise have a different relationship with industry than an independent government regulatory agency, could possibly have enhanced susceptibility to industry capture. (SEC Division of Investment Management 2011, p. 33)

In addition to the exchanges, two SROs—FINRA and the National Futures Association (NFA), which are viewed as "private" SROs—are funded exclusively by their members. Yet, in a number of instances, these SROs avail themselves of privileges typically reserved for government agencies. As former SEC Commissioner Roberta Karmel observed, SROs are "a peculiar mix of private sector self-regulation and delegated governmental regulation" (Karmel 2008, p. 1). This mix invites questions about governance and due process issues.

- *FINRA*. At present, FINRA is the largest SRO that reports to the SEC; it also has expanded duties in that a number of exchanges outsource market surveillance to FINRA. Perhaps because of its size, breadth, visibility, and the funding level of executive

[11] Among other violations, the NYSE was found to have consistently released data to its proprietary customers ahead of the consolidated feed, violating both the "not unreasonably discriminatory" and the "fair and reasonable" standards; see www.sec.gov/litigation/admin/2012/34-67857.

salaries, FINRA has become a focal point and lightning rod for many of the questions raised about the SRO system in general. In particular, it bears the brunt of criticism pertaining to so-called private SROs.[12]

At least one SEC commissioner has recently questioned the role of FINRA in the U.S. SRO system, asking whether it is becoming a "deputy SEC," whether the additional duties it has undertaken are undermining the performance of its "core duties," and whether its enjoyment of immunity based on its "quasi-governmental status" is appropriate (Gallagher 2012).[13]

Because of its range of activities, FINRA also highlights issues about its ability to achieve the appropriate balance that allows an SRO to remain responsive to its members while also meeting its duties to the primary regulator—in this case, the SEC. These issues fall into several categories: FINRA's right to claim sovereign immunity; its due process procedures, including the inability of those being investigated to claim Fifth Amendment protection from self-incrimination; potential conflicts of interest; and its involvement with mandatory arbitration (see Karmel 2008).[14]

- Sovereign immunity. On the one hand, like private membership organizations, FINRA does not have subpoena power when policing its members and is not subject to Freedom of Information Act (FOIA) requests. On the other hand, it sometimes operates as a semi-government entity. Like the SEC, for example, FINRA can invoke a claim of sovereign immunity.[15]

  Although sovereign immunity protects federal and state governments from being sued, it does not generally extend to nongovernmental agencies. FINRA's ability to claim protection of a government entity (sovereign immunity) while not having to

[12]Note 121 in the SEC paper "The Institution of Experience: Self-Regulatory Organizations in the Securities Industry, 1792–2010" states, "At three years of age, FINRA possessed an unprecedented authority over securities markets and had harnessed the institutional experience of more than two hundred years of self-regulation."
[13]Commissioner Gallagher went on to question whether "non-SRO exchanges [should] continue to enjoy immunity based on their historical quasi-governmental status" (Gallagher 2012).
[14]Irwin, Lane, Mendelson, and Tighe (2012) also raised a number of questions about FINRA's governance structure and lack of transparency.
[15]As stated in the "Brief of Amici Curiae Public Citizen, Consumer Action, Project on Government Oversight, and U.S. PIRG in Support of Petition for a Writ of Certiorari" to the U.S. Supreme Court regarding *Standard Investment Chartered, Inc. v. National Association of Securities Dealers et al.* (October 2011), "The extension of sovereign immunity to SROs . . . produces the bizarre result that a corporate entity—which lacks the democratic accountability that legitimizes our federal and state governments—can avail itself of the same protections as actual governments subject to oversight in the democratic process" (p. 5).

comply with certain duties of government entities (responding to FOIA requests) raises questions about how it operates as a regulator and whether general notions of market integrity are implicated.

- No rights against self-incrimination. As another anomaly, FINRA does not allow its members to plead the Fifth Amendment defense. Yet, it does have the authority to pass on the information gathered to prosecute those members. For example, FINRA rules require its members to cooperate with investigations it undertakes. It then is allowed to share information with other federal agencies and regulators in investigations. FINRA members can be forced to testify during such an investigation even though the information gathered in a "private" FINRA investigation can then be used against a member in actions later taken by "public" government agencies and federal authorities. In contrast, these same individuals would have a constitutional right against testifying in government prosecutions. That FINRA members are compelled to cooperate in investigations or risk sanctions (which thus requires forfeiting a constitutional right with respect to self-incrimination) raises due process concerns.[16]

- Feedback on rule proposals. FINRA seems to be taking steps to address another due process concern that sometimes arises with respect to its rule-making function. Like the SEC, FINRA has been criticized for robust cost–benefit analyses prior to adoption and implementation of its proposals, something that FINRA's president, Richard Ketchum, has said will change in the future (Paraskeva 2012). Ketchum also said,

> We have an obligation to reach out at an earlier stage in the process to be more transparent about the rule making we are thinking about. This should have regard to the costs, any alternatives to the rule and why the alternatives are not satisfactory.[17]

[16]Even though FINRA makes regulations that have a big impact on the markets, it is not "bound by the APA, the congressional appropriations process, or their comparable checks on [its] power. . . . Nongovernmental policy makers should adopt regulatory due process standards that meet or exceed those of government agencies. . . . As government delegates regulatory authority, explicitly or implicitly, it should also impose Administrative Procedure Act (APA) or similar due process and transparency requirements on SROs and other nongovernmental organizations" (Ryan 2011, pp. 5–6).

[17]See http://blogs.reuters.com/financial-regulatory-forum/2012/10/09/u-s-self-regulatory-bodies-move-toward-cost-benefit-analysis/.

- Conflicts of interest. A third area of FINRA's operations raises concerns about potential conflicts of interest, including its oversight of an industry in which it invests.[18] In particular, 10 of the 21 members on FINRA's board of governors operate in the industry the SRO regulates. Although this number is a minority, the large number of industry representatives has consequences for the perceived independence of the board's decisions and regulatory actions taken by the regulator. Concerns also exist about FINRA's investment activities and the fact that it invests in the securities markets while it oversees broker/dealers, many of whom are dually registered (Irwin, Lane, Mendelson, and Tighe 2012). For example, although it liquidated holdings in auction rate securities (ARS) in 2007 and noted the collapse of the ARS market in its 2008 annual report, FINRA has been criticized for not doing enough to warn investors at the time the market was imploding.[19]

- Mandatory arbitration. A final area that has generated attention is FINRA's use of mandatory arbitration. The methods used by an SRO to resolve disputes are important for setting the barometer for what is considered fair and credible. A criterion often used in evaluating the barometer is whether procedures provide an accused with "his day in court." To practice in the industry, broker/dealers must become members of FINRA. In doing so, members must agree to mandatory arbitration of matters in dispute between the broker/dealer and its customers. According to FINRA's 2011 annual report, it derives income from fees for dispute resolution, including arbitrations and mediation processes, which creates a potential "captive audience" issue (U.S. Chamber of Commerce 2011).[20] The mandatory arbitration clauses used by FINRA have thus raised questions about whether its members are being deprived of due process. Although not abandoning its use, FINRA is making strides in addressing some complaints about the arbitration *process*. In early 2012, it implemented the

[18]In a 29 May 2012 letter to the House Committee on Financial Services, the Project on Government Oversight (POGO) noted that FINRA spent nearly $4 million on lobbying between 2008 and 2011, according to the Center for Responsive Politics. Those prone to see conflict-of-interest issues at FINRA also raise the issue of compensation. FINRA distinguishes itself in the high compensation awarded its executives. POGO calls the FINRA process for selecting executives "incestuous."

[19]A POGO letter of 23 February 2010 to the House Committee on Financial Services, House Committee on Oversight and Government Reform, Senate Committee on Banking, Housing and Urban Affairs, and Senate Committee on Finance asserted that FINRA failed to warn the public about auction rate securities when it had liquidated its own holdings in 2007. Although it described the collapse of this market in its 2008 annual report, FINRA also failed to mention its 2007 liquidation (pp. 2–3).

[20]The U.S. Chamber report advocates for clearly articulated standards for nongovernmental, as well as governmental, organizations: (1) substantive standards or principles upon which policy-making decisions are based; (2) procedural standards to be followed when engaging in policy-making activities; and (3) due process standards to allow private parties to challenge decisions. The report also notes that claimants' damage awards from arbitrations are at less than 50%, which is a potentially discouraging factor in deciding whether to even bring a claim.

"all-public" option for customer arbitrations, through which investors can choose to use all-public panels in certain cases. In addition, in April 2013, FINRA's board approved changes to its arbitration rules aimed at simplifying the process for investors by allowing them to choose an all-public panel more easily than in the past.[21]

- *NFA*. The National Futures Association is the other U.S. private (i.e., nonexchange) SRO. It primarily oversees the derivatives industry, and that mandate was expanded after adoption of Dodd–Frank in 2010 to include oversight of the OTC derivatives swap market to go along with its oversight of retail off-exchange foreign currency trading and on-exchange traded futures. The NFA's funding is derived solely from membership dues and assessment fees. Membership is mandatory for those who conduct business with the public on the U.S. futures exchanges and in the retail off-exchange foreign currency market and for swap dealers and major swap participants.

  Like FINRA, the NFA has conduct rules for its members, conducts member examinations, and has the authority to take enforcement action to discipline members for violations of its rules. It also provides market surveillance. And like FINRA, it has come under fire for various of its SRO functions, including its arbitration practices. For example, in a 23 July 2012 letter to certain members of Congress, the Project on Government Oversight (POGO) asked Congress to reduce the Commodity Futures Trading Commission's reliance on the NFA and other SROs. The argument was that the NFA is "inherently conflicted." In particular, the letter asserts not only that groups like the NFA are conflicted because they are funded by the firms they oversee but also that they are less accountable than federal agencies because they are not held to the same ethics and transparency requirements.[22]

Canada

Canada has two national SROs—the Investment Industry Regulatory Organization of Canada and the Mutual Fund Dealers Association of Canada.

[21]See, however, the 2013 speech in which SEC Commissioner Aguilar, citing the need to support investor choice, called for an SEC review aimed at ending mandatory arbitration agreements (www.sec.gov/news/speech/2013/spch041613laa.htm). In an interesting twist, a U.S. District Court recently held that the SEC could not be compelled under FOIA to produce its documents related to "audits, inspections, and reviews" of FINRA's arbitration system. The court reasoned that Exemption 8 precluded the disclosure of the documents because they were "related to examination, operating, or conditions reports prepared by, on behalf of, or for the use of the SEC"; see *Public Investors Arbitration Bar Association v. SEC*, D.D.C., Civil Action No. 11-2285 (BAH), 14 March 2013.

[22]See www.pogo.org/our-work/letters/2012/fo-fra-20120724-pogo-opposes-self-regulation.html.

- *Investment Industry Regulatory Organization of Canada*. IIROC (formed by the 2008 merger of the Investment Dealers Association of Canada and Market Regulation Services) oversees investment dealers and enforces the rules of the stock exchanges. It is engaged in "setting and enforcing rules regarding the proficiency, business and financial conduct of dealer firms and their registered employees and through setting and enforcing market integrity rules regarding trading activity on Canadian equity marketplaces."[23] Among other things, IIROC creates rules; screens advisers employed by IIROC-regulated firms; conducts financial, business, and trading conduct compliance reviews; investigates potential dealer or market misconduct (which includes bringing disciplinary actions); and conducts market surveillance for all Canadian equity markets. Funded by its membership, the organization conducts no lobbying activities directly.

  In a country with separate securities commissions, IIROC's breadth of authority is far-reaching because it operates under Recognition Orders from the official provincial securities commissions. These commissions, as members of the Canadian Securities Administrators (CSA), retain oversight authority for IIROC's operations, including regular oversight audit reviews.

  Like FINRA, IIROC also proposes and implements new rules for its members and follows a similar process in doing so. The public is provided with a comment period for proposals. All final rule proposals must receive approval by the CSA before they can be implemented.

- *Mutual Fund Dealers Association of Canada*. The MFDA was established in 1998 by the CSA and was formed through the efforts of the Investment Dealers Association of Canada and the Investment Funds Institute of Canada. It oversees the operations, standards of practice, and business conduct of mutual fund dealers. Like IIROC, the MFDA operates in accordance with recognition from the securities commissions in various Canadian provinces. The MFDA makes a point of stating that it "performs no industry representation or trade association activities for its Members."[24]

Central and South America

The system of self-regulation (and the use of SROs) in Central and South America has been expanding in recent years. The regulatory strategy has been adopted most prominently in Brazil and Colombia, both of which have developed economically viable self-regulatory systems.

[23]See www.iiroc.ca/about/ourroleandmandate.
[24]See www.mfda.ca/about/aboutMFDA.html.

Brazil

In Brazil, the Bovespa Market Supervision (BSM) was created by the Commissão de Valores Mobiliários (CVM), Brazil's securities and exchange commission, to be a separate arm to manage conflicts of interest and conduct market surveillance for the Brazilian exchange. BSM also has rule-making and enforcement duties, conducts examinations of intermediaries, oversees listing rules, and supervises market participants (Carson 2011). Although funded by the exchange, BSM's budget is directly reviewed by CVM, to which it also must submit periodic reports.

Brazil also has the organization APIMEC, whose oversight authority is formally recognized in CVM regulations. Until 2010, this SRO served only as a certifying entity for research analysts. Since then, however, with the enactment of CVM Instrução n 483/10, APIMEC is authorized to act as a self-regulatory entity. Today, it is a not-for-profit organization that requires all research reports to be filed at APIMEC. In terms of enforcement, this SRO institutes a preliminary procedure in accordance with due process requirements. APIMEC can prosecute those who fail to comply with its regulations and can impose sanctions. The process also allows for appeal to a higher level within the SRO.

Colombia

In Colombia, the Autoregulador del Mercado de Valores de Colombia (AMV) oversees all types of intermediaries, whose membership in AMV is mandatory. Established by statute (Law 964 of 2005), AMV's activities are regulated by the government and the Superintendencia Financiera de Colombia (SFC). It assists the SFC by serving as a front-line regulator with respect to regulation, supervision, enforcement, certification of professionals, and the handling of complaints and dispute resolution.

When a breach of disciplinary or market rules occurs, AMV is responsible for a two-stage process of investigation, which may result in sanctions varying from a fine to restricting the ability to act as an intermediary in the Colombian market. AMV is a private, not-for-profit entity that is funded by its members.

Since 2010, AMV has offered a voluntary self-regulation scheme for the foreign exchange market, in which most of the foreign currency trade professionals participate. Currently under consideration is expansion of AMV's reach over other market participants, such as financial advisers, if those professionals are recognized by law.

Both the industry and the government in Colombia have high hopes for the self-regulation model being used. Of particular interest to the SRO is fostering the governance structure to maintain industry representation while improving both its independence and its enforcement process.

Europe

Today, self-regulation plays a minor role in Europe.[25] The antipathy toward self-regulation went so far following the 2008 financial crisis that some statutory regulators seeking information from FINRA reportedly went to the SEC rather than calling the SRO directly. Despite this harsh perspective, one market—the United Kingdom—traditionally has been sympathetic to the merits of self-regulation.

Regulation in U.K. financial markets evolved over hundreds of years from a decidedly self-regulatory model to a more centralized body (the former Financial Services Authority, FSA) in 1997 as a consequence of breaches in ethical market practices (see Boston Consulting Group 2011, pp. 25–26). In 2013, the United Kingdom rolled out a new regulatory structure. Dubbed a "twin peaks" approach, this structure splits financial oversight between two regulatory bodies: The Financial Conduct Authority, a stand-alone entity, is charged with supervising behavior at financial institutions and has more authority to address misconduct and impose higher fines; the Prudential Regulation Authority, a subsidiary of the Bank of England, oversees banks' and insurers' capital holdings, enforces compliance with rules to curb bonuses, and monitors risk.

Although at first blush this new structure appears to be a rejection of an SRO approach, some question whether it can survive. In particular, the concentration of regulatory authority within the central bank over the financial markets may ultimately require a return to reliance on SROs for certain market activities.

Asia Pacific

According to the 3rd Comparative Analysis of Asian Securities Regulators & SROs and Market Characteristics,[26] SROs in China (SAC, Securities Association of China), Japan (Japan Securities Dealers Association), the Philippines (CMIC, Capital Markets Integrity Corporation),[27] Romania (RSBA, Romanian Stock Brokers' Association), Thailand (the Thai Bond Market Association for the bond market), and Turkey (TSPAKB, The Association of Capital Market Intermediary Institutions of Turkey) consider themselves to have

[25]EU Internal Market Commissioner Michel Barnier has indicated he does not favor self-regulation; he seems to be addressing not the actual use of SROs but, rather, his belief that "self-regulation" connotes a less stringent type of market regulation than governmental regulation (see www.euractiv.com/euro-finance/barnier-dont-believe-self-regula-news-358458).

[26]This analysis can be found at www.scribd.com/doc/126080023/3rd-Comparative-Analysis-of-Asian-Securities-Regulator-Final. Data were provided by participating organizations at the 8th ASF Tokyo Round Table (compiled as of 8 November 2012).

[27]The self-regulatory body in the Philippines was spun off into an SRO in early 2012.

significant self-regulatory functions and responsibilities.[28] But all these SROs (except for the Philippines') self-report that they are SROs *and* "industry associations." Although the concept of "self-regulation" can mean different things in different jurisdictions, admissions of being an industry association raise questions about whether the entity maintains clear separation between its regulatory function and its membership services. The combination also heightens concerns that the SRO might advocate or engage in other trade association functions on behalf of its members rather than on behalf of all market participants. This type of structure can discredit the perception of the SROs as impartial and credible authorities.[29]

With respect to rule-making functions, these countries describe their activities as follows.

Japan

Viewed by many as serving the functions of a legally recognized SRO, the Japan Securities Dealers Association (JSDA) oversees the regulation of securities dealers, who must be registered in order to work in the securities business in Japan. The JSDA gains its oversight authority from Japan's Financial Instruments and Exchange Act, which provides a framework of "(Authorized) Financial Instruments Firms Association." Primarily funded by membership fees, the not-for-profit JSDA establishes and implements self-regulatory rules; provides qualification examinations, renewal training, and registration for securities sales representatives; and engages in customer complaint and mediation services.

The JSDA was established as an industry association focused on "gathering the industry voice." Currently, however, it sees itself as an association with two different roles—one as an SRO and the other as an industry association (lobbying entity). To that end, it recognizes and seeks to manage the conflicts of interest by "setting up an organizational firewall."

India

India has recently made significant strides in creating a self-regulatory system as part of its developing financial marketplace. At a board meeting of the Securities and Exchange Board of India (SEBI) in August 2012, it approved a proposal to establish an SRO for the mutual fund distribution business. SEBI proposed amended regulations in early January 2013 that effectively launched India's first official self-regulatory body in the financial services area.

[28]Although Hong Kong SAR and South Korea are often noted for their self-regulatory models, the 3rd Comparative Analysis did not contain information on either.

[29]For example, although Romania's Stock Brokers' Association lists itself in the analysis as an SRO, it does not appear to create regulations, other than professional ethics standards for its members. Instead, it plays a part in the policy-developing process by "assuming the role of a consultative organism for the principal lawmakers" (3rd Comparative Analysis, p. 12), including the Romanian National Securities Commission.

Malaysia

Bursa Malaysia, formerly known as the Kuala Lumpur Stock Exchange, acts as "the frontline regulator of the Malaysian capital market"[30] and is viewed by many as an exchange SRO. Responsible for activities relating to the regulation and surveillance of the securities and derivatives markets, Bursa Malaysia oversees the conduct of its members and has enforcement authority. Under the revamped rules that became effective on 2 May 2013, Bursa Malaysia seeks to simplify and streamline its rules generally without compromising investor protections.

[30]See www.bursamalaysia.com/quick-links/brokers/.

4. The Future of Self-Regulation Internationally

In this section, we first discuss a new paradigm for self-governance aimed at mitigating systemic risk and then take a look at forms that go beyond traditional information sharing. Finally, we consider the possibility of the expanded use of self-regulation in emerging markets and cross-border activities.

A New Paradigm for Self-Governance to Mitigate Systemic Risk

The interconnection among global financial markets was highlighted in the 2008 financial crisis. In light of the worldwide domino effect that occurred in the crisis, the need for cross-border surveillance and cooperation is greater than ever.[31] Recognition of this need has raised novel questions about the potential for self-regulation in the future.

One argument for reinventing self-regulation is to use it as a means of monitoring and controlling systemic risk on a global basis. In his 2010 article "Rethinking the Future of Self-Regulation in the Financial Industry," Saule Omarova argued that

> any meaningful long-term regulatory reform in the financial services sector must seriously consider the potential role of industry self-regulation as a key mechanism of controlling and minimizing systemic risk.

He noted, in particular, the advantages that self-regulation has over direct government regulation and "pure market-based regulatory mechanisms." But he stated that to involve SROs in this role requires taking a "new normative approach"—namely, fundamentally restructuring the current system to one of "embedded self-regulation."[32]

[31]See Group of Thirty (2009), whose report calls for higher levels of national and international policy coordination.

[32]A system of "embedded regulation" would seek to "redefine the delicate balance between financial institutions' freedom to regulate their own increasingly complex activities in the most economically efficient ways, on the one hand, and their duty to conduct their legitimate profit- and risk-generating business in accordance with the overarching public interest in preserving financial stability, on the other. The goal of this model is to enhance the ability of private market participants to adopt and enforce rules governing their business activities but combine it with a greater, and more explicit, responsibility for the broader economic and societal effects of such activities" (Omarova 2010, p. 701).

Those who favor requiring market participants to have "skin in the game" may find Omarova's theory for this new paradigm particularly appealing because it would place the responsibility for risk taking directly on the participants. He believes that

> by injecting public policy interests directly and explicitly into the very center of the financial industry's self-regulatory arrangements, the model of embedded self-regulation seeks to redefine the broader social role of the private financial sector and impose the primary responsibility for guarding financial stability against excessive risks on the collective creator of such risks. (p. 702)

Of course, such a system would require a number of changes to the current system—not the least of them being the creation of an incentive structure appealing enough to motivate the financial services industry to embrace public policy considerations in its approach to risk. Omarova recognizes this factor but defers defining.[33]

Moving beyond Traditional Information Sharing

In light of the interconnectedness of capital markets, regulators in a number of countries already recognize the range of benefits that cooperation with respect to regulations would provide. The SEC Office of International Affairs, for example, has long engaged in efforts to promote cooperation and information sharing among securities regulators and authorities around the world.[34]

In addition to collaborations with individual countries, the SEC engages with international organizations, such as the International Organization of Securities Commissions, the Financial Stability Board,[35] the Council of Securities Regulators of the Americas, and

[33]Omarova (2010) also notes that none of the "mainstream reform proposals has addressed explicitly the future of industry self-regulation as part of the long-term regulatory transformation in the financial service sector" (p. 683) but that "with respect to globalization and cross-border fluidity of financial activities, industry self-regulation also has significant potential advantages over direct government regulation. In today's globalized world, cross-border arbitrage significantly undermines national governments' ability to implement and enforce laws and regulations they consider vital for the purposes of maintaining their domestic economic stability or meeting other socio-economic or political goals" (p. 691).

[34]See, for example, "SEC and Turkey Securities Regulator Announce Terms of Reference for Enhanced Cooperation and Collaboration" (22 July 2011); "SEC, SEBI Announce Increased Cooperation and Collaboration of Capacity Building Events in India" (8 January 2008); "SEC and Japan Financial Services Agency Announce Terms for Increased Cooperation and Collaboration" (30 January 2006); "SEC and CSRC Announce Terms of Reference for Enhanced Dialogue" (2 May 2006): www.sec.gov/about/offices/oia/oia_crossborder.shtml.

[35]The Financial Stability Board, established by the Finance Ministers and Central Bank Governors of the Group of Seven, coordinates "at the international level the work of national financial authorities and international standard-setting bodies to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability" (see www.financialstabilityboard.org/).

the Financial Action Task Force.[36] This important, cooperative work reflects the need for *global* information sharing, surveillance, and enforcement mechanisms to safeguard the web of capital markets, which often appear to be in a tenuous balancing act with each other.

Today, the SEC has entered into memorandums of understanding in approximately 80 jurisdictions, which are useful in establishing cooperative relationships and for the sharing of information. Understandings of this sort are limited, however, in terms of how much access each country has to the other's records.

In looking toward new means of cooperation among countries, we may need to look beyond the "traditional" way of sharing information and overseeing markets. Emerging markets, in particular, highlight the potential for an expanded use of self-regulation—both within individual countries and by working together across borders.

The Challenge and Opportunity in Emerging Markets

Although self-regulation is grossly underused around the world, some financial markets are realizing its potential and are beginning to take advantage of what self-regulation can offer in terms of efficiency and utility. The use of self-regulation may reach its potential in the securities regulatory structure of emerging markets. Because some estimates are that emerging markets will constitute 50% of the world economy by 2020, the potential for SROs in these markets is an issue worth exploring.[37]

Emerging markets, especially those whose financial sectors are in the early stages of development, may lack the financial and personnel resources to fuel both a primary regulator and an SRO. The limited competition in the securities markets of some countries may also result in a type of trade monopoly rather than efficient and balanced regulation.[38] Yet, a strong case

[36]The Financial Action Task Force is an intergovernmental body established in 1989 by the ministers of its member jurisdictions. Its objectives are "to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system" (see www.fatf-gafi.org/pages/aboutus/).
[37]See "Emerging Markets Will Soon Make Up 50% of World Economy," *Canadian Press* (10 June 2013): http://www.cbc.ca/news/business/story/2013/06/10/business-montreal-conference.html.
[38]Bossone and Promisel (2000) noted that "incentives to induce private-sector self-policing would mobilize resources that would complement the public sector's scarce resources used to enforce rules and best practice standards" (p. 4).

can be made that these developing markets should avail themselves of the self-regulatory structure that has been modeled by other countries. In fact, self-regulation, far from being an impediment to market development, could be essential for market development.

New and developing markets need infrastructure that promotes innovation and growth to develop their markets and increase capital formation. But countries that do not have reliable inspection, enforcement, and disciplinary systems lack the basic tools to hold themselves out as "clean" markets that can foster growth and investor confidence. SROs, which are composed of those with an understanding of the market, are the closest to the market and can take on responsibilities for overseeing trading, broker/dealers, surveillance, enforcement, and market movements.

The lack of resources (and lack of authority) for primary securities regulators in developing markets poses enormous challenges for regulators wishing to conduct proper inspections and establish adequate disciplinary and enforcement functions. SROs can be used to fill this void. In fact, even where primary regulators lack direct mandates from their governments, an SRO could operate with a great deal of independence to oversee and police its own members through its ability to withdraw licenses for member infractions. This ability alone could provide substantial help to jurisdictions that are trying to create clean markets. SROs also can conduct examinations and provide discipline for large parts of a market, thus freeing primary regulators from the concerns of such smaller issues as the review and resolution of individual claims (in much the same way that FINRA handles customer disputes for all the exchanges).

Healthy SROs in the emerging markets would benefit from the expertise that members bring to rule writing and surveillance activities, which allows a more nimble response to market developments than the government can provide.

Given the global nature of today's financial markets, the growing trend among emerging-market countries to harmonize their regulations across borders should not come as a surprise. If the goal for these jurisdictions is market development, regional harmonization through the use and collaboration of SROs offers great potential benefits to all market participants.

As noted, market innovation and growth are based largely on the existence of a *credible* market structure with mechanisms for monitoring and enforcement. Yet, governments may move slowly to create mutual recognition pacts or treaties for the securities markets. Thus, developing an effective monitoring and enforcement system across borders is difficult and may take many years to implement.

One way to circumvent this problem is for financial regulators and SROs to enter into *contractual* arrangements with colleagues from other nations that allow each party to investigate securities market infractions across borders. Even by itself, this type of arrangement could open new doors to information sharing and cooperation among neighboring countries that could propel growth in credible market structures.

Cross-border exchanges have the potential to provide other benefits, such as allowing countries to essentially "pool" their resources and raise the aggregate level of capital in the region. Many emerging markets lack the volume they need to grow. But with regional harmonization, markets and the region as a whole stand a chance of nimbly and quickly developing their markets with efficiency and uniformity.

A harmonized approach for SROs would readily lend itself to including cross-border licensing, disciplinary actions, joint examinations, and other licensing issues. By cooperating across borders, SROs in the emerging markets could jointly provide the services needed to fuel a developing market, benefiting all participating countries. (Oversight of broker/dealers and exchanges/listing platforms particularly lends itself to this use.)

If emerging-market countries are to develop regulatory securities markets, the SROs—in particular, the exchanges—not necessarily the government authorities, need to join forces. This relatively new integrated market form of self-regulation presents fertile opportunities for developing markets because commercial agreements bypass the slow bureaucracy of political processes.

And certain regions are taking steps or exploring the process to do just that. Examples include the Latin American Integrated Market (officially, the Mercado Integrado Latinoamericano, known as MILA); Eastern Caribbean; the East African Securities Regulatory Association; and the Balkans in Eastern Europe.

MILA, in particular, provides an example of how countries can work together to boost a collectively viable market where the individual ones would still be fledging.[39] Launched in May 2011 and comprising the stock exchanges in Chile, Colombia, and Peru, the MILA "integrated market" allows more than simply increased trading for each country. It also facilitates capital flows for the entire market.[40] Moreover, by entering into commercial agreements with each other, the exchanges allow trading and market development that

[39]See www.mercadomila.com.
[40]See www.nasdaq.com/article/latin-america-market-integration-still-underwhelming-but-promising-cm150179.

benefit the region on a scale that would be unobtainable for some time if left to the political forces of each country. The benefits prompted one writer to note, "In this, politicians are rushing to catch up with the private sector."[41]

The Inter-American Development Bank, in recognition of MILA's success and promise, has provided support for its development.[42] The benefits are also attracting others in the region. Mexico, for example, is reviewing legislation in hopes of joining MILA as early as 2014. Panama and Costa Rica also have indicated their interest in joining.

This self-regulatory approach highlights the maxim that "the best way to compete is by working together."[43]

An International Model

We discuss in this section an example of a standard setter that has become the *de facto* law in more than 30 countries. Cross-border cooperation is not the only example of self-regulation that departs from the "traditional" SRO format.

In the future, as regulators and market participants identify new uses for self-regulation, they will need to look beyond the traditional, single-country forms. In terms of a fully functioning process that models self-regulation in the financial services arena, the GIPS standards offers a fully operational and efficient model.

Composed and maintained by volunteers representing countries around the world—all in agreement to adopt and comply with the GIPS standards—the Standards have become "the standard" in the investment industry. On a number of levels, the operating and governance structure of the GIPS organization can serve as a prototype for the creation of self-regulation in other sectors of the industry on a global basis.

First introduced in 1987 and targeted for a 1 January 1993 implementation date, what was originally known as the AIMR-PPS (i.e., the Association for Investment Management and Research Performance Presentation Standards) became the first recognized set

[41]See www.economist.com/node/18529807.
[42]See www.iadb.org/en/topics/trade/mila-strengthening-financial-integration,6839.html.
[43]See www.oxfordbusinessgroup.com/news/regional-platform-three-countries-come-together-create-integrated-latin-american-market.

of guidelines for the presentation of investment performance.[44] As noted in the foreword to the 1993 version of the Standards ("Standards" refers to the AIMR-PPS and GIPS standards), the Standards were designed to

> satisfy several goals: to improve the service offered to investment management clients, to enhance the professionalism of the industry, and *to bolster the notion of self-regulation*. (p. vi, emphasis added)

From their inception, the creation and implementation of the Standards exhibited many of the characteristics of the work of an international self-regulatory body. Among other subcommittees (Leverage/Derivatives Subcommittee, Bank Trust Subcommittee, and Real Estate Subcommittee) that contributed substantially to creating the substance of the Standards was an International Subcommittee. From this beginning grew the framework of what has become an example for international self-regulation.

The Standards were adopted initially in the United States and Canada, but by 1995, AIMR had recognized the need for and benefit of globally accepted standards for the presentation of investment performance and thus funded development of the global investment performance presentation standards. The GIPS standards were launched in early 1999 as the "global standard by which firms [could] calculate and present performance to clients and prospective clients."

As stated in the preamble of the February 1999 edition of the GIPS standards,

> The financial markets and the investment management industry are becoming increasingly global in nature. Given the variety of financial entities and countries involved, this globalization of the investment process and the exponential growth of assets under management demonstrate the need to standardize the calculation and presentation of investment performance. (p. 2)

[44]The first introduction of the AIMR-PPS standards occurred through the September/October 1987 issue of the *Financial Analysts Journal*. Through the merger of the Financial Analysts Federation and the Institute of Chartered Financial Analysts into AIMR in 1990, the resulting Board of Governors endorsed the AIMR-PPS standards. Guided by an Implementation Committee and funded by AIMR, the Standards reflected the "response of AIMR members and other investment professionals who have embraced the idea of establishing a set of guidelines for the presentation of investment performance."

Recognizing the need for an effective governance structure for the future, in 2000, AIMR established the Investment Performance Council to maintain and develop high-quality standards on an ongoing basis. Since then, the GIPS standards have gone through a number of iterations and platforms.

By April 2001, approximately 25 countries had adopted or were adopting the GIPS standards or were creating a "local investment performance standard." Countries that had no local standard were encouraged to adopt the GIPS standards and translate them into the local language or to adopt the GIPS standards as core standards and supplement them where necessary by requirements and well-established practices of individual jurisdictions. The goal was to eventually establish the GIPS standards as the "gold standard" by incorporating "many of the regulatory and well-established best practices that exist in local markets around the world."[45]

The path to achieving this gold standard is significant in its own right for creating a basis for comparability of reported past investment performance, but two other aspects are also noteworthy in terms of self-regulatory success. First, although compliance with the GIPS standards is entirely voluntary, the Standards themselves have become *de facto* law in the United States. The industry response to the Standards has created a climate in which noncompliant firms are at a competitive disadvantage. Thus, the industry has chosen to regulate itself in this area, effectively usurping the need for "official" regulators to propose or implement regulations for reporting past investment performance. Yet, as with any effective self-regulatory system, the specter of enforcement is still present. In their examination process, staff of the SEC monitor claims of compliance with the GIPS standards and have imposed sanctions against firms for misrepresentation.

Second, the GIPS governance structure provides a "United Nations approach" to how an effective self-regulatory system can operate on an international basis. The GIPS Council and the GIPS Executive Committee work in tandem to create a mechanism that provides representation for all 37 country sponsors of the Standards on a country-by-country basis while also giving voice to technical areas that represent stakeholders. Although comprising entirely voluntary participants, this governance structure operates much like a legislative governance model, with representatives elected by regional chairs. Through this governance framework, new Standards are proposed, vetted, and implemented on a global basis—all without the intervention of an official regulatory body.

[45]This statement is from the 2004 edition of *Global Investment Performance Standards*, which amended and restated the AIMR-PPS standards as the U.S. and Canadian version of the GIPS standards.

GIPS Standards and Local Market Regulators Working Together

The self-regulatory nature of the GIPS standards necessitates a strong commitment to ethical integrity. Self-regulation also assists regulators in exercising their responsibility for ensuring the fair disclosure of information within financial markets. The GIPS Executive Committee encourages regulators to

- recognize the benefit of voluntary compliance with standards that represent global best practices,
- give consideration to taking enforcement actions against firms that falsely claim compliance with the GIPS standards, and
- recognize and encourage independent third-party verification.

Where existing laws, regulations, or industry standards already impose requirements related to the calculation and presentation of investment performance, firms are strongly encouraged to comply with the GIPS standards in addition to applicable regulatory requirements. Compliance with applicable law and/or regulation does not necessarily lead to compliance with the GIPS standards. In cases in which laws and/or regulations conflict with the GIPS standards, firms are required to comply with the laws and regulations and make full disclosure of the conflict in the compliant presentation.

This dual interplay of industry action, together with a self-sustaining voluntary governance structure, helps make the GIPS standards a potential prototype for envisioning global self-regulation in other sectors of the investment industry.

5. Conclusions and Policy Recommendations

The ability of SROs to adequately oversee a marketplace dominated by trading algorithms, dark pools, high-frequency trading, and blurred lines between investment advisory and commissioned sales has been questioned in recent years. We believe, however, that despite differences in the securities regulatory landscape that existed when they were first created, SROs and the market expertise they offer are now more important than ever. In fact, the ever-evolving complexities of the securities markets argue for more, rather than fewer, uses of SROs, if only to take advantage of their understanding of market practices.

In part, this need is a function of the state of financial market regulation today. Regulators do not always hire professionals from the industry—partly because they cannot pay them enough to lure them away from careers in the financial industry and partly because, in certain countries, national law forbids hiring professionals from the industry. Thus, although many regulators are excellent policymakers, they may lack specialized knowledge of the increasingly complex products and trading mechanisms prevalent today. Moreover, they may lack the ability to anticipate what changes are already on the way.

First, to formulate policies, propose and implement new regulations, and administer effective enforcement programs for these markets, regulators must understand the intricacies of the markets they oversee. But primary regulators cannot be everywhere at once, and many are facing budgetary pressures as a result of a weak global economy and increased demands on the regulators. Consequently, for primary regulators to perform their primary responsibilities, the regulatory system must be able to outsource some duties to those with market expertise—that is, those in self-regulatory organizations. From a resource standpoint, therefore, SROs—those who are "closest to the action"—have a use in reducing the workload of primary regulators. And the SROs do so in a way that contributes valuable expertise in an efficient manner.

Second, one of the strengths of SROs is that they can react more quickly and nimbly than regulators to developments in the securities market. Rather than risking impeding market growth through laborious and detailed regulation (often a complaint levied against capital market regulators), SROs can foster innovations and keep up with developments that need monitoring. In this respect, not only *does* the governmental regulator often lag behind new development but also it *should* because if it did not, regulation could stifle the innovations that drive vibrant capital markets.

In addition to recognizing the value of the more traditional SRO system, attention needs to be given to the development of future self-regulatory systems that capitalize on the strengths that self-regulation can bring to the global marketplace. Whether to reduce systemic risk, establish cross-border cooperation to facilitate growth for emerging markets, or apply the GIPS governance structure to other areas of financial markets, the value of effective self-regulation cannot be dismissed. SROs may be the very vehicles needed for the future.

Nevertheless, SROs need to evolve so that their activities are palatable and transparent to market participants. Unless these organizations are seen to enhance market integrity, their activities could have the reverse effect. To that end, we propose the following recommendations designed to make SROs an accepted and trusted part of the global financial market regulatory system.

First, SROs can enhance the perceived integrity of their activities by ensuring that their internal governance structures are appropriate to their mandates. Among the most important elements of good governance is ensuring that independent board members make up a majority of the SRO's governing board. With regard to financial market SROs, independent board members should be knowledgeable about investment practices and markets and should be able to comprehend how proposed rules would affect investor interests and market integrity.

Second, SROs should ensure that they function transparently with regard to their internal governance, their regulatory activities, and their financial resources. In particular,

- SROs should be subject to the same transparency requirements that are imposed on primary or statutory regulators.
- SROs and their primary regulators should ensure the transparency of the SROs' enforcement operations. For example, SROs should be transparent about the operation of their adjudication mechanisms, including being transparent about the background and potential conflicts of interest for individual arbitrators. SROs should disclose their decisions on a case-by-case basis and provide aggregate statistics about trends in their decisions. SRO members should not have to cede their personal rights, such as the right against self-incrimination, to become a member of the SRO.
- Statutory regulators must provide adequate oversight of SROs. Adequate oversight would need to balance organic development of self-regulation with ensuring that the statutory regulators have adequate funding, qualified staff, and up-to-date technology to properly oversee SROs in their jurisdictions.

- Statutory regulators should take advantage of SROs of various types to enhance regulatory oversight and efficiency. SROs can handle such tasks as registration of firms and individuals in the industry and can provide front-line monitoring of market activity and member behavior. They also can initiate civil enforcement actions and handle conflicts between investors and members.

- Statutory regulators need to take advantage of pockets of expertise in the SROs to handle specific technical issues. They also should accept the use of standardized global structures, such as the GIPS standards, to avert the need for more rigid and costly regulation or regulatory oversight.

- Statutory regulators should help identify and support systems that use self-regulation beyond "traditional" structures, including reliance on contractual agreements to aid development of SRO systems across borders.

- The regulatory system needs to contractually establish accountability to avoid bureaucratic gaps in regulatory coverage.

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