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Self-Regulation in Securities Markets

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Abstract

This paper canvasses the trends in self-regulation and the role of self-regulation in securities markets in different parts of the world. The paper also describes the conditions in which self-regulation might be an effective element of securities markets regulation, particularly in emerging markets.

Use of self-regulation and self-regulatory organizations is often recommended in emerging markets as part of a broader strategy aimed at improving the effectiveness of securities regulation and market integrity. According to the International Organization of Securities Commissions, reliance on self-regulation is an optional feature of a regulatory regime. Self-regulatory organizations may support better-regulated and more efficient capital markets, but the value of self-regulation is again being questioned in many countries. Forces such as commercialization of exchanges, development of stronger statutory regulatory authorities, consolidation of financial services industry regulatory bodies, and globalization of capital markets are affecting the scope and effectiveness of self-regulation—and in particular the traditional role of securities exchanges as self-regulatory organizations.

The paper reviews different models of self-regulation, including exchange self-regulatory organizations, member (or independent) self-regulatory organizations, and industry or dealers' associations. It draws on examples of self-regulatory organizations from many markets to illustrate the degree of reliance on self-regulation, as well as the range of functions for which self-regulatory organizations are responsible, in markets around the world. Issues that are important to the effective operation of self-regulatory organizations are discussed, such as corporate governance, managing conflicts of interest, and regulatory oversight by government authorities.

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Self-Regulation in Securities Markets

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1. Introduction

Self-regulation is an important part of the regulatory structure of securities markets in many developing, as well as developed, economies. Use of self-regulation and of self-regulatory organizations (SROs) is often recommended in emerging markets as part of a broader strategy aimed at improving the effectiveness of securities regulation and market integrity.[1] Use of SROs may lead to more efficient capital markets, thus enabling businesses to tap public equity and debt markets for capital at a reasonable cost, which supports business expansion and economic development.

Recently, however, pressures on self-regulatory frameworks have increased in markets worldwide. In much of the world, the value of self-regulation is being debated anew. Forces such as commercialization of exchanges, development of stronger statutory regulatory authorities, consolidation of financial services industry regulatory bodies, and globalization of capital markets are affecting the scope and effectiveness of self-regulation – and in particular the traditional role of securities exchanges as SROs. In addition, the effectiveness of all financial regulatory systems is being re-examined in the aftermath of the international financial crisis of 2008 - 09. The crisis has again put issues in the governance of both regulators and financial intermediaries at the forefront. At the same time, SROs that are independent of market operators (for example FINRA in the United States) are gaining importance in a few countries.

Those developments raise questions about the degree of reliance on self-regulation that the World Bank and other policy advisers should recommend in emerging markets' capital markets.[2] This paper canvasses the trends in self-regulation and the role of self-regulation in different parts of the world. The paper also describes the conditions in which self-regulation might be an effective element of securities markets regulation in a particular country. In general terms, self-regulation now plays a minor role in Europe and the Middle East. It continues to play a strong role in North America, where independent SROs are assuming responsibilities from exchange SROs, and an expanding role in several Latin American countries. In Asia, reliance on self-regulation has been reduced, but it remains important in most countries.

In 2007, the Bank's Financial Sector Policy group completed a policy note on alternatives for a new self-regulatory structure for India's securities markets.[3] This paper builds on the work completed for India to deliver a more comprehensive examination of the issues from a general capital markets development perspective.

This paper uses experience from leading jurisdictions and important emerging markets to develop a policy framework for use in advising the Bank's clients on employing self-regulation in capital markets. The purpose is to analyze international trends and approaches to self-

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[1] The International Organization of Securities Commissions (IOSCO)'s Objectives and Principles of Securities Regulation, Principles 6 and 7, recognize that self-regulation may be a valuable complement to the regulator in achieving the objectives of securities regulation, but the Principles do not advocate the use of self-regulation in any jurisdiction. (IOSCO, 2003: 7.2 at page 12).

[2] For example, see SEC 2005, IOSCO Emerging Markets Committee 2005, and IOSCO Technical Committee 2006b.

[3] World Bank 2007, unpublished---

regulation and produce a useful reference for institutions such as the World Bank that are engaged in providing technical assistance, advice and policy research on the use of self-regulation in securities regulatory systems.

The paper neither endorses nor rejects the use of self-regulation nor does it advocate the adoption of any particular model of self-regulation where an SRO model is used. Rather, it is a tool to support a thorough and consistent approach to the issue of self-regulation in the Bank's capital markets work. The paper is also designed to support the analysis of self-regulation by government authorities, securities market participants, SROs, and other interested persons.

The Bank's work in the financial markets arena usually includes policy advice on improving the standards of regulation, market integrity, and investor protection in the markets. Experts on capital markets development (including advisers, practitioners, and academics) consider sound standards in those areas to be essential underpinnings in fostering successful capital markets. This paper outlines the conditions in which self-regulation and SROs can support achieving higher standards of regulation, market integrity, and investor protection. It also covers developing a self-regulatory system to form an effective part of a country's regulatory structure for capital markets.

Organization of the Paper

Following this introduction, the paper is organized into six chapters:

- Chapter 2, "International Landscape," reviews approaches to and recent trends in self-regulation around the world. It discusses the effect of the transformation of exchanges into for-profit companies on their regulatory responsibilities. It also reviews the degree of reliance on self-regulation internationally and the factors behind a reduced use of self-regulation in many jurisdictions. Alternatives to formal SROs in obtaining private sector input on regulatory initiatives are noted.

- Chapter 3, "Regulatory Models and Country Examples," sets out four basic models of reliance on self-regulation and compares approaches to self-regulation in six major developed markets.

- Chapter 4, "SRO Responsibilities," describes the main responsibilities of SROs and discusses the division of responsibilities between SROs and securities regulators. What regulatory functions are SROs best positioned to perform?

- Chapter 5, "Corporate Governance and Conflicts of Interest," reviews how SROs are organized and governed. It describes trends in SRO governance and the main principles of governance used internationally. A section covers conflicts of interest that exist in self-regulation and considers how both SROs and their supervising regulators are managing such conflicts.

- Chapter 6, "SRO Oversight and the Role of the Regulator," outlines the principles for oversight or supervision of SROs by government regulators as well as the recent trends in oversight programs. It also covers the role of securities regulators in supervising SRO governance.

- Chapter 7, "Implications for Emerging Markets," concludes the paper by analyzing the implications of the trends and issues examined for the use of self-regulation in emerging markets. It reviews factors to weigh when assessing the viability and benefits of using self-regulation in a market. This chapter suggests conditions in which self-regulation might appropriately be considered.

This paper describes regulation of participants in public securities markets, including both exchanges and OTC markets. The role of self-regulation in maintaining standards and protecting investors is important in this arena in many countries.

Regulatory regimes often have a private or "exempt" market for the sale of securities to sophisticated or "exempt" investors. The issuance, marketing, and trading of securities in private markets are frequently subject to limited regulation, including fewer rules and reduced levels supervision. Many SROs are not involved in this market, in particular exchange SROs, because exchanges focus on public markets. Some SROs are responsible for supervising all securities-related business of their members, however.

Many countries also apply lighter regulatory standards to wholesale or institutional markets when compared to standards for retail markets. Such an approach may be reflected in SROs' rules and programs where they are responsible for supervising members' dealings with both retail and institutional clients.

2. International Landscape

Self-regulation in securities markets takes a wide variety of forms around the world. No single definition of self-regulation is universally accepted. The term *self-regulation* may be used to refer to formal self-regulatory organizations (SROs), to standards set by financial industry associations, and to the internal supervision and compliance functions within financial firms.

Securities regulation systems that use a full-fledged system of self-regulation may be seen as a pyramid consisting of four tiers of regulation, as illustrated by figure 2-1.

The foundation of the system is internal "self-regulation" or internal controls used by financial firms. Those intermediaries may be considered tier 1 or the "front-line" gatekeepers in the system. The primary regulator represents the top tier: a securities commission or financial regulatory authority.

Tier 1 is equally important in any type of regulatory system, whether it uses formal self-regulation or not. Firms' internal supervision and compliance functions, including risk management systems, internal surveillance, internal controls and governance, are very important elements of an effective regulatory system. This front-line or tier 1 supervision of firms' own business operations must operate effectively in all regulatory systems.

The problems in financial institutions' risk management and supervision systems, which were exposed by the financial crisis, have reinforced the need for strong minimum standards for firms' internal systems, as well as the need for stronger supervision by regulators of the design, implementation and maintenance of those systems. This latter area is one where formal self-regulation by SROs can play a significant role in introducing better regulation and supervision of financial institutions' operations.

This paper primarily examines formal self-regulation by organizations with the power to regulate their members. Formal self-regulation is carried out through an *SRO*, which may be generally defined as a private institution that establishes, monitors compliance with, and enforces rules applicable to securities markets and the conduct of market participants.[4]

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[4] The International Council of Securities Associations (ICSA) defines an *SRO* as "a private, nongovernmental organization that should be dedicated to the public interest objectives of enhancing market integrity, investor protection, and market efficiency." ICSA (2006b) has developed a detailed description of *SROs*: nongovernmental organizations that (a) share a common set of public policy objectives including the enhancement of market integrity, market efficiency, and investor protection; (b) are actively supervised by the government regulator(s); (c) have statutory regulatory authority, authority that is delegated by government regulator(s), or both; (d) establish rules and regulations for firms and individuals that are subject to their regulatory authority; (e) monitor compliance with those rules and regulations and, in the case of SROs that regulate trading markets, conduct surveillance of markets; (f) have the authority to discipline members that violate applicable rules and regulations; (g) include industry representatives on their boards or otherwise ensure that industry members have a meaningful role in governance; and (h) maintain structures, policies, and procedures to ensure that conflicts of interest between their commercial and regulatory activities are appropriately managed.

The term SRO is often used somewhat loosely to refer to a private organization that performs industry, regulatory, or public interest functions under the supervision of a securities regulatory authority. But not all such organizations are SROs in the sense that they regulate their members' or participants' business conduct. *Regulate* in this context means "to organize and control an activity or process by making it subject to rules or laws."

For example, in the United States, the law classifies all exchanges, securities associations (such as FINRA), and clearing agencies as SROs. The Securities Exchange Act of 1934 requires SROs to be recognized by the SEC, and to regulate their members' compliance with both their own rules and federal securities laws. Many countries, however, do not formally define a self-regulatory organization in law, usually because the law covers approval of an exchange, which is the only form of SRO in most countries.

In the most complete form of self-regulation, an SRO has the authority to establish rules of conduct for its members or participants and to supervise compliance with, as well as enforce, those rules. This authority is usually based on law or delegation of power by a statutory regulator, but it may also be based on a contract with regulated firms. A full-fledged SRO performs three main regulatory functions:

- Rule making: Establishing rules and regulations governing the conduct of member firms and other regulated persons
- Supervision: Supervising members and markets to monitor compliance with the rules
- Enforcement: Enforcing compliance with the rules by investigating potential violations and disciplining individuals and firms that violate them.

An SRO can perform only one or two of those functions. For example, an SRO could focus on supervising compliance with regulations set by a statutory regulator. In civil code countries, SROs have a lesser role in rule making, sometimes because of legal limitations on government's ability to delegate regulatory powers as well as the need for explicit statutory authority. Also, an SRO's responsibilities for supervision and enforcement may cover only its own rules, or may extend to supervising compliance with securities laws and regulations to which its members are subject. As noted earlier, US SROs have a legal responsibility to supervise members' compliance with US federal securities laws. An SRO's enforcement jurisdiction is normally limited to licensed individuals and firms within the SRO's membership. Therefore investors, issuers and corporate officers cannot be subject to SRO enforcement actions.

SROs must be differentiated from government or statutory securities regulators such as securities commissions and financial supervisory authorities. Today, many securities regulatory authorities are operationally independent of government and its public service. As specialized administrative bodies, they are often self-governing and self-funding on the basis of regulatory fees. But securities regulatory authorities are creatures of government and report to a government minister or department. They are not private sector organizations.

As private sector organizations, SROs are accountable to their members or shareholders. Invariably, SROs are also accountable to their supervising (government) regulators by law or regulation, and through the regulator to the government. Supervising regulators – usually a securities commission or similar government financial regulator – are responsible for oversight of the operation and governance of SROs. Absent a regulatory failure, however, oversight should not extend to directing or managing SRO operations. An SRO is owned, governed, and managed independently from its supervising regulator – it is not an arm of the government regulator. (See chapter 5 on corporate governance and chapter 6 on SRO oversight.)

SROs also have a broader responsibility to all stakeholders in the capital markets, especially investors. Many SROs have express "public interest obligations" (as described in chapter 5), which reflect their broad, quasi-public mandates. Such mandates may be set out in law, regulation and / or in the SRO's corporate charter or by-laws.

Use of Self-Regulation

IOSCO's Objectives and Principles of Securities Regulation (the "Principles") state that self-regulation – in particular formal SROs – is an optional feature of a securities regulation system. The Principles recognize that self-regulation may be an appropriate tool of regulation, but they do not recommend that SROs be part of the regulatory structure in every jurisdiction. Principle 6 (IOSCO 2003: 12) states: "The regulatory regime should make appropriate use of self-regulatory organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets."

In its report on implementing its Principles, IOSCO states that use of an SRO may be appropriate where an SRO exists that has the capacity to carry out the purpose of regulation and to enforce compliance with rules by its members, and where the SRO is subject to adequate oversight by the regulator. SROs may be used where additional resources for regulation are needed in the system -- for example, in complex markets or small markets with limited government resources (IOSCO 2008: 29). IOSCO has developed a list of standards that an SRO should be required to meet to be approved. (See chapter 6 on SRO oversight.)

Types of SROs

This paper examines different forms of self-regulation and several models of SROs observed in the world.

Many types of SROs or similar bodies exist in capital markets that aim to meet at least some of the objectives of self-regulation as defined by IOSCO. These bodies include:

- **Exchange SROs –** securities exchanges with self-regulatory responsibilities.
- **Member or independent SROs –** SROs based on membership of securities dealers or brokers that are independent of market operators. In some cases, the organization may also function as an industry association for its members or play a role in organizing an OTC market, such as a bond market.

- **Industry or dealers' associations** – Some industry associations have limited self-regulatory functions that include setting rules or obligatory standards. Others are not formal SROs, but provide guidance, best practices, or set other standards for members.
- **Central securities depositories (CSDs) and clearing agencies** – CSDs and central counterparties often have limited self-regulatory functions. Both for-profit and non-profit (mutual) types of CSDs are prominent in global markets.

The most common form of formal SRO in the securities markets arena still is a securities exchange, although the role of exchanges as regulators is being diminished around the world. Exchanges in developed markets, and in many emerging markets, are now mostly for-profit companies. Of course, an exchange's primary activity has never been regulation. Furthermore, exchanges that are listed companies are, strictly speaking, neither self-regulatory bodies nor membership organizations, even though most retain jurisdiction over at least some of their participants' market and business conduct.

Member or "Independent SROs" that are not market operators are important in some countries, notably the United States, Canada, Japan, and the Republic of Korea. Those SROs are structured as membership organizations of securities dealers, although, in most cases today, their corporate governance is designed to limit member control of the SRO and the associated conflicts of interest. Such SROs have full-fledged SRO powers, including rule-making, supervision, and enforcement functions. Independent SROs do not own or operate an exchange or marketplace, although they often regulate markets as well as their member intermediaries. Some independent SROs also have a dual role as regulators and industry associations representing their members' interests. Others play a role in administering over-the-counter (OTC) markets, particularly for debt securities – for example, the JSDA in Japan and Brazil's ANBIMA.

Industry association SROs are membership organizations whose primary function is to represent members' interests, but that also have a self-regulatory role. They may set rules that apply to certain securities market activities or may promulgate binding codes of conduct. Those SROs generally have corporate governance systems dominated by their members. This type of SRO may not have full-fledged rule making, supervision, and enforcement programs; but nevertheless, they can play an important role in setting standards of conduct in securities markets. For example, such associations are important in Brazil and Egypt, as well as in international OTC markets – namely the International Capital Markets Association (ICMA) in debt markets. The International Swaps and Derivatives Association (ISDA) also plays a role in setting standards in derivatives markets, although it does not consider itself to be an SRO.

Finally, many countries have industry or trade associations representing securities market participants that are not SROs but that develop nonbinding codes of conduct and other forms of guidance for their members. They are not formal SROs with rule-making and enforcement powers, but they contribute to improving standards and the regulatory system by promoting best practices and voluntary adoption of standards. The increasing provision of guidance by industry associations may be considered a form of self-regulation. The UK Financial Services Authority (FSA) has strengthened this view by giving certain industry guidance semi-official status. France employs a similar approach, since regulations may provide that firms have a duty to implement standards set by associations such as the *Association française des marchés financiers* (AMAFI).

The FSA's approach, where the regulator establishes higher-level rules and the industry provides guidance or standards of practice on how to implement rules, has parallels to the concept of self-regulation as it applies to other jurisdictions.

Strictly speaking, guidance is not a form of regulation.[5] Compliance with guidance is not mandatory; members may choose to follow it or not. As the FSA (2007: section 2.9) states, "We are conscious that our use of Industry Guidance in this context should not create a second tier of regulation and that guidance providers are not quasi-regulators." Nevertheless, industry guidance is a means for private sector organizations to support both regulatory compliance and standards for intermediaries in securities markets. Such activities can both support regulators' efforts and help to enhance standards of market conduct.

Although industry associations that do not have the power to adopt rules are not SROs per se, it is noteworthy that several significant SROs started as industry associations, including the NASD in the US and the Investment Dealers Association (IDA) in Canada.[6] The NASD began as a voluntary organization of investment bankers to promote "high standards of commercial honor." Rules of Fair Practice for OTC markets and procedures for handling complaints against members were developed in 1937.[7] Originally, the NASD's self-regulatory functions were based on member participation, including administration of disciplinary functions, rather than the work of a professional staff.

Industry associations may perform other functions that support raising standards of conduct in the securities market, such as certification of industry personnel, and providing education or training for industry personnel. Depending upon the manner in which requirements prescribed by the relevant association are incorporated into the formal regulatory regime, these too can contribute to their performance of certain self-regulatory functions.

Membership in an SRO may be voluntary or mandatory. In a voluntary organization, an intermediary may choose to operate without becoming a member of an SRO and in that case would not be subject to its rules. Obviously, a voluntary system may be less effective if a material number of firms, or any significant firms, choose not to participate in the system. For this reason, in some countries SRO membership is mandatory for firms that provide securities business services to public investors, as in the United States and Canada, for example. In some cases, membership may be voluntary but, as a practical matter, is essential to carry on securities business. For example, in Japan membership in JSDA is not mandatory but all securities firms are members. In many countries membership in an exchange SRO is necessary for business purposes if participation in the primary or only securities exchange is essential to operate as a broker-dealer.

An SRO's powers and jurisdiction over its members may be based on contract or established in law, in either a mandatory or a voluntary SRO system. Often it is both: a member must enter into

[5] As previously noted, *regulate* in this context means "to organize and control an activity or process by making it subject to rules or laws."
[6] The NASD is now FINRA. The IDA is now the Investment Industry Regulatory Organization of Canada (IIROC).
[7] Fulton, Wallace, The Origin of the NASD – The OTC Market's Venture into Self-Regulation. The SEC registered the NASD as a national securities association in 1939.

a membership agreement with the SRO that requires the firm to comply with the SRO's rules, and the SRO's powers and authority have statutory backing in securities laws. In some jurisdictions, such as the US, the membership contract gives an SRO greater power over its members than the statutory regulator would have under the law.

Other securities industry bodies, including clearing agencies and central securities depositories (CSDs), may be considered SROs or have similar status under securities laws and regulations. Alternative trading systems (ATSs) also must be licensed or registered and have regulatory obligations in some countries. As a condition of using settlement or trading services, those bodies oblige their participants to comply with operational rules by contract. For example, a CSD must establish rules on participation, or access to its services, and operation of depository and settlement systems. But the operating rules apply only to use of the services; they do not usually extend to regulation of participants' conduct or their relationship with their customers.

Nevertheless, many countries, including the US, the UK, and Canada, treat CSDs as a form of SRO. This treatment may reflect the fact that regulators license and supervise CSDs because they provide essential market infrastructure services.[8] They play a significant role in setting standards for, and managing risk in, the securities industry. They have a limited form of regulatory authority in administering rules for participants, but their rules cover only how a participant uses clearing and settlement services. CSDs' rules generally do not extend to setting requirements for business conduct or other areas, although some make rules on risk management and internal controls; for example in Hong Kong SAR, China.

Mandate of Self-Regulators

The mandate or objectives of self-regulation are widely accepted to be protecting investors and maintaining market integrity. SROs are expected to act in the public interest over the specific interests of their members or, more typically today, their shareholders. The IOSCO SRO Consultative Committee (2000: 2) declared, "The broad objectives of self-regulation are the same as those identified for government regulation of financial markets … to preserve market integrity… to preserve financial integrity … and to protect investors." An SRO usually has a broad mandate to regulate and supervise members' or participants' conduct in the markets and in dealings with customers.

Notably, regulation is not the primary function of a large majority of SROs, because most SROs are exchanges. Only a handful of "pure SROs" exist, such as FINRA in the US and IIROC in Canada. Their primary, if not sole, function is regulation. This fact more than anything else distinguishes an independent SRO from an exchange SRO. Industry associations that operate as both independent SROs and lobbying groups for their members (and may operate certain markets, too, such as an OTC market) are a form of hybrid. Prominent examples include the

[8] The CPSS–IOSCO (2001: Recommendation 18) report on securities settlement systems provides that "Securities settlement systems should be subject to transparent and effective regulation and oversight. Central banks and securities regulators should cooperate with each other and with other relevant authorities."

Japan Securities Dealers Association (JSDA) and the Korean Financial Investment Association (KOFIA).[9]

Now that most exchanges are commercial entities, the nature of self-regulation is again being debated. Exchange SROs often state that self-regulation is akin to a product quality control function and is, therefore, basically a business function. This view ignores some fundamental differences between quality control and regulatory functions, however. Regulation is mandatory and applies to users of services, not the service provider. It entails the potential use of coercive powers to force regulated entities to comply with a set of rules. This is the case even if firms voluntarily join an SRO. SRO regulation is a form of private law, with complicated and legalistic rules, monitoring systems, and enforcement processes. Many exchanges are now struggling to define the line between quality control and regulation.

An SRO has a "public interest responsibility" under the law or regulations in many jurisdictions. Securities regulators supervise SROs primarily to ensure that they meet their "public interest responsibilities." IOSCO (IOSCO Technical Committee 2001: 4) comments on the role of exchanges: "A fair and efficient capital market is a public good. A well-run exchange is a key part of the capital market."[10]

Trends in Self-Regulation

Market and regulatory developments have considerably changed the nature, scope, and structure of self-regulation over the past two decades. A firm trend has been established away from SROs that are controlled by traditional broker-members to organizations that are increasingly independent of both broker-members and market operators. The organizational structure, corporate governance, operations, and oversight of SROs reflect these changes. Today, SROs are expected to be responsive to a wide range of stakeholders and to all market participants.

Demutualization of traditional exchanges, the launch of new commercial marketplaces, and intensive competition among marketplaces of all types have placed great pressure on exchanges' regulatory roles. Those trends have led to the transfer of regulatory powers and responsibilities from exchanges to statutory authorities in many countries (see, for example, IOSCO Technical Committee 2006a). A few exchanges have transferred or contracted regulatory activities to independent SROs, notably in North America.[11] Those forces, combined with a view predominant in Europe and certain other regions that regulation is primarily a role for public or

[9] KOFIA was created in 2009 by a merger of the Korea Securities Dealers Association, the Korea Futures Association and the Asset Management Association of Korea.

[10] The IOSCO Technical Committee (2001: 10) also noted in its report on exchange demutualization, "The fair and efficient functioning of an exchange is of significant benefit to the public. The efficiency of the secondary market in providing liquidity and accurate price discovery facilitates efficient raising of capital for commercial enterprises, benefiting both the wider corporate sector and the economy as a whole. The failure of an exchange to perform its regulatory functions properly will have a similarly wide impact."

[11] But note that at least in the US, an exchange that has contracted out regulation functions is still accountable to the SEC for the standard of regulation and for any regulatory failings. The contracted service provider should be an SRO itself, and subject to SEC oversight.

statutory authorities, have created an overall trend toward reduced reliance on self-regulation, particularly by exchange SROs.

In some emerging markets, government-controlled or quasi-governmental exchanges had regulatory authority by virtue of their organizational status. A number of exchanges in Africa and the Middle East are examples. In other emerging markets (for example, in Eastern Europe), new exchanges have been established on a commercial model. In a number of those countries, policy makers decided not to assign strong regulatory responsibilities to their exchanges when they were created or were moved from public to private sector status. Because SROs were never part of the landscape in those countries, decisions to assign most securities' market regulation functions to governmental authorities did not represent a trend away from self-regulation but rather a public policy decision not to rely on self-regulation as part of a capital markets reform program.

Despite those trends, self-regulation remains important in many countries. Many major exchanges continue to perform significant self-regulatory functions. To address concerns about conflicts of interest, most have restructured their organizations to ensure that SRO operations are fully or partly independent of business operations. In addition, the increasing importance of independent SROs in a few countries, including the US, might generate new interest in SRO systems in countries that are reforming their regulatory systems. Several emerging markets with large and successful capital markets have strengthened their SRO systems recently, including Brazil, Colombia, India, and Malaysia. Those countries have introduced reforms – or are considering them – to ensure the independence of SRO operations.

Even in countries where formal SROs do not exist, as in Europe, a trend is observed toward increased use of securities industry bodies to support the regulatory system by providing guidance, codes of conduct, continuing education and so on. Moreover, in those countries, exchanges usually continue to play an important role in supervising trading and setting standards of conduct in their markets.

The main factors behind the trend toward reduced reliance on self-regulation are discussed next.

- *Privatization of securities exchanges*: The widespread demutualization and privatization of securities exchanges is having far-reaching effects on the role of self-regulation because securities exchanges are the only, or at least predominant, form of formal SRO that exists in the great majority of markets. The ability of for-profit exchanges to perform regulatory roles effectively, given inherent conflicts of interest with their commercial objectives, continues to be debated. (This is so even though conflicts of interest were always inherent in self-regulation.) Many exchanges are retreating to a "business approach" to their regulatory roles by focusing on core regulation functions that directly impact the quality of their services. These functions include trading surveillance, or monitoring market integrity and quality, and listings requirements, which set quality standards for listed securities. Those reforms aim to mitigate conflicts of interest, as well as enable exchanges to focus on business priorities. (See chapter on conflicts of interest.)

- *Intensive competition*: Competitive forces are an important driver for changes to exchanges' regulatory roles in many countries. Intensive domestic and cross-border competition among exchange SROs increases exchanges' concerns about cost structures, the potential for regulatory arbitrage, and free riding by competing markets on the primary market's regulation. Exchanges also compete with private marketplaces, such as electronic communications networks (ECNs) and ATSs, which do not perform regulatory functions. Intensive competition also exacerbates conflicts; it may create incentives to cut regulatory costs, to divert resources to commercial priorities, and to avoid regulatory actions that could damage business interests.

New ATSs such as block matching systems and dark pools perform the commercial function of an exchange – matching buy and sell orders – without bearing the regulatory costs borne by a traditional exchange SRO. This gives the ATSs a competitive advantage. On the other hand, in the US several successful ATSs have registered with the SEC as national securities exchanges in order to obtain other benefits. An exchange must assume SRO responsibilities and either discharge them directly, or contract an existing SRO to perform regulatory functions. It appears that the ability to outsource most regulation functions to FINRA has increased the attractiveness of registering as an exchange.

- *Questions on the effectiveness of self-regulation*: Questions have been raised about how effective self-regulation really is in ensuring market integrity and protecting investors. Scandals and regulatory failures leading to reforms in self-regulation are nothing new, but the difference today is that the overall environment is less hospitable for self-regulation, leading more policy makers to question if it is still useful. Today investors' expectations, government scrutiny, and international standards of regulation are higher than ever, which increases pressure on SROs.

- *Internationalization:* Globalization of securities markets and major securities dealers makes it more difficult for exchanges and member associations to effectively regulate markets because they have a local, and usually a market-specific, focus. In developed markets, a significant amount of trading has a cross-market, OTC market, or cross-border aspect. As the number of products and strategies proliferates, the capability of exchanges focused on specific trading systems and products to effectively regulate overall market activity is increasingly questioned. Major dealers do business globally and are far less tied to affiliations with local exchanges and regulators than they were decades ago. Many SROs have taken steps to address this issue through bilateral and multilateral agreements to cooperate on regulatory matters and supervising cross-border trading. For example, the Intermarket Surveillance Group (ISG)[12] now comprises over 35 exchanges around the world.

- *Strengthening of government regulators*: Partly because of the preceding four points, governments are vesting greater authority in public regulatory bodies. The effect is to diminish, and in some cases virtually eliminate, the role of self-regulation. Globalization of the markets translates into a growing emphasis on meeting international standards and,

[12] www.isgportal.org

therefore, to strengthening the powers, resources, and independence of statutory regulators. IOSCO and other multilateral organizations, including the World Bank, have supported this effort by producing international standards and benchmarks in numerous areas. Market scandals have been another catalyst to strengthening government regulators, in response to pressure to increase standards of conduct in the markets. Government bodies have much broader jurisdiction and powers than SROs, and they are seen as stronger, more effective regulators.

- *Trend to consolidation of financial regulators:* A global trend toward consolidation of financial regulators is another factor in reducing reliance on self-regulation. Some governments believe that regulation is more efficient if fewer government agencies, rather than multiple public and private agencies, carry it out on a centralized basis. Others argue that the system benefits from the checks and balances inherent in the involvement of SROs, exchanges, the industry, and the regulators in response to the issues, which improves the content of new initiatives.

  A survey sponsored by the World Bank (de Luna-Martinez and Rose 2003) found that even five years ago 46 countries had consolidated some financial regulatory supervision (although the scope of regulatory powers of those agencies varied significantly). In the most advanced form of consolidation, some countries have created universal financial regulators that extend to banking, insurance an other sectors, such as the UK's Financial Services Authority.[13] The FSA supplanted a number of self-regulatory bodies, including the London Stock Exchange (LSE), which even lost its responsibility for listing rules.[14]

  The creation of a universal regulator does not necessarily mean the elimination of self-regulation, but its use is often reduced significantly in such cases, especially if a country aims to adopt the UK model. Other areas of the financial services industry, such as banking, do not share the securities industry's tradition of self-regulation. Finally, major reforms such as creation of a new central agency invariably include expanding the power and authority of the statutory regulator.

- *"Cooperative regulation"*: In some jurisdictions, the advent of a shared approach to regulatory policy and tasks between statutory regulators and SROs has increased the complexity of regulation and the amount of overlap between the two levels. Both statutory regulators and SROs are often active in the same areas. A World Federation of Exchanges (WFE 2005) survey on exchanges' regulatory roles showed extensive use of cooperative or shared regulation instead of a clear division of responsibilities. The lack of a clear separation of roles often leads to unnecessary duplication and delays resulting from protracted discussion and debate on policy and initiatives. It can also produce conflict, and even competition, over roles and policy. The greater the degree of co-involvement in issues and initiatives, the more time that must be devoted to coordinating

[13] As this paper was being finalized, the UK government announced reforms to the regulatory structure that would diminish the FSA's role in favour of the Bank of England.

[14] Arguably the LSE's role as the "UK Listing Authority" responsible for clearing issuers for listing on an exchange became untenable once other exchanges began competing for listing. However, the LSE also transferred administration of all listing rules and compliance functions to the FSA. The large majority of exchanges retain these functions as part of their listing operations.

between regulators and SROs. Cooperation is beneficial and necessary among regulators; but when regulators occupy the same fields it can lead to inefficiencies and delay in responding to problems.

SROs often seek informal consent and agreement from the regulators before filing a rule change for approval or before taking an initiative. This practice may lead to framing rules and policies in terms that are favored by the statutory regulator instead of by the industry. In the US the SEC has spearheaded many SRO initiatives or policies – for example, examination "sweeps" of broker-dealers focused on specific issues and corporate governance reforms introduced by the NYSE and Nasdaq for listed companies.

Given the overlaps involved in cooperative regulation and the constraints on SROs' independence today, the question arises: Do the benefits of self-regulation continue to outweigh the additional regulatory burden and costs?

- *Pressure to increase efficiency and lower costs:* Governments want to improve regulatory efficiency to make their markets more competitive with regional and global competitors. Controlling regulatory costs is an important factor in the efficiency and competitiveness of a capital market. At the same time, the securities industry is concerned about the ever-increasing costs of regulation at all levels. The industry is seeking more efficient and streamlined regulation. This concern lies behind pressures to consolidate SROs in countries with multiple SROs, such as Canada and the US. Regulation services agreements that enable an exchange to outsource certain regulatory functions to another SRO and other types of outsourcing arrangements are other ways of increasing efficiencies. For example in the US many exchanges retain FINRA to perform regulatory services.

The reasons that some countries continue to rely extensively on self-regulation or are strengthening their SRO systems are discussed next.

- *Increases overall level of regulatory resources*: Many countries rely on self-regulation because expansive resources are required to regulate securities markets effectively, especially in large and complex markets. This rationale applies in the US, for example. Government regulators often cannot obtain approval to invest in the professional staff and infrastructure that thorough regulation requires, even if the agency is "self-funding" on the basis of fees charged to market participants. Because securities dealers and exchanges benefit from sound regulation, policy makers may feel they should assume part of the burden and cost of regulation directly.

- *Uses knowledge and expertise of industry professionals*: The investment products, trading strategies, and risks involved in today's securities markets are complex and rapidly changing. The rules and systems required to effectively control and to regulate intermediaries' and exchanges' activities are complicated and require a very high level of expertise to understand and supervise. Self-regulation is often seen as a way to tap the knowledge of practitioners in the markets, especially if the regulator has difficulty attracting people with specialized knowledge.

- *Enables the regulator to focus on other priorities while relying on an SRO for front-line supervision of its members and regulated markets:* SROs are often referred to as front-line regulators. Annual compliance examinations, analysis of regulatory reports, and online market surveillance are resource-intensive tasks that require teams of experienced officers. If a regulator can rely on an exchange or another SRO to carry out thorough supervision of securities dealers' operations and market activity, the regulator is able to concentrate more resources on identifying and responding to major systemic risks, and to other priorities outside of the ambit of self-regulation.

In summary, in many countries, the role of self-regulation has been diminished or virtually eliminated, while in a smaller number of countries, self-regulation is stronger and more professional than ever. In other countries, where capital markets developed only recently, policy decisions were made not to rely extensively on self-regulation. Such decisions may be based on concerns about the efficiency of regulation, and the likely credibility of self-regulation in a market with no history of the concept. The central question is whether the general trend toward reduced reliance on SROs in global securities markets will continue, or if fresh interest in self-regulation will arise from ongoing reforms and pressures to continually raise standards of conduct and the quality of supervision.

The optimum approach to using self-regulation in a country depends on many factors that this paper explores. Depending on these factors, self-regulation may still make a valuable contribution in certain markets. If self-regulation is used, important decisions must be made about the scope of SRO responsibilities and powers, as well as the structure, governance, and supervision of SROs. Those subjects are being revisited even in countries with well-established self-regulatory systems.

3. Regulatory Models and Country Examples

This section describes four primary models for securities market regulation and provides examples from a number of countries' systems.

Models of Self-Regulation

Four basic regulatory structures, or models, are observed globally. The models are really points on a continuum, ranging from minimal reliance on SROs to significant reliance on SROs to regulate securities business. The four basic models are as follows:

1. **Government (Statutory) Model**
   A public authority is responsible for securities regulation. Exchanges are usually responsible for very limited supervision of their markets but are not considered to be SROs. *Examples:* France (AMF), UK (FSA), and most European Union countries.

2. **Limited Exchange SRO Model**
   A public authority is the primary regulator. It relies on exchanges to perform certain regulatory functions tied to operation of the market (for example, market surveillance and listing). *Examples:* Hong Kong SAR, China (HKEx), Singapore (SGX) Sweden (Nasdaq OMX Stockholm), US (NYSE).

3. **Strong Exchange SRO Model**
   A public authority is the primary regulator. It relies on exchanges to perform extensive regulatory functions that extend beyond their market operations, including regulating members' business conduct. *Examples:* Australia (ASX)[15]; Japan (TSE, and Osaka Securities Exchange, or OSE); Malaysia (Bursa Malaysia); US (CME). (ASX was traditionally a strong SRO; however as this paper was being finalized Australia announced that the government regulator ASIC would assume the majority of ASX's regulatory functions in 2010.)

4. **Independent Member SRO Model**
   A public authority is the primary regulator. It relies extensively on an independent SRO (a member organization that is not a market operator) to perform extensive regulatory functions. *Examples:* Canada (IIROC[16] and the Mutual Fund Dealers Association, or MFDA), Japan (JSDA), South Korea (KOFIA), US (FINRA and the National Futures Association, or NFA), Colombia (AMV).

In addition, the **Industry Association SRO Model** is a less developed version of model 4. These associations function mainly as voices of the industry and are mainly member-driven, but they also set standards or rules for specific securities market activities. *Examples:* International Capital Markets Association (ICMA); Brazil (Brazilian Financial and Capital Markets Association, or ANBIMA). As noted above, even under the statutory model industry

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[15] ASX was traditionally a strong SRO; however as this paper was being finalized Australia announced that the government regulator ASIC would assume the majority of ASX's regulatory functions in 2010.

[16] IIROC was created in 2008 following the merger of two independent SROs, the IDA and Market Regulation Services.

associations may play a role in setting standards, as in France (French Association of Financial Markets, or AMAFI).

Figure 3-1 illustrates the spectrum of models.

The most prevalent model today is the limited exchange SRO model. As discussed earlier, a trend away from the strong exchange SRO model has been observed. From a global perspective, a general shift towards stronger and more powerful statutory regulators has occurred. In the past two decades or so the legal and regulatory framework has improved greatly in many developed and emerging markets. This has clarified the roles and powers of regulators and SROs. Since exchanges pre-dated the creation of regulators in most countries, the division of powers and responsibilities between the two levels was often not clear in the past.

The following addresses the advantages and disadvantages of the four models.

Government Model

Many governments have concluded that assigning public regulation functions to a private body is not appropriate, especially in the case of a commercial company such as an exchange. In particular, governments throughout the EU have taken this view, as have a number of countries in Asia and the Middle East. Proponents of this model aim for strong, efficient regulation alongside competitive, innovative exchanges. In countries with small capital markets, having several layers of regulation is difficult to justify. Furthermore, countries that have limited experience with self-regulation may take the view that the government model will produce better regulation, especially if an SRO could be "captured" by the industry.

The government model promotes regulatory effectiveness and efficiency by centralizing responsibility in one body, thereby reducing the number of layers of regulation. Consolidating regulation in one statutory body should reduce costs to each regulated firm, as well as the overall costs of regulating the whole market. It is simpler for regulated firms and investors. If overall regulation and compliance costs are lower, the government model should make a country's capital markets more competitive, provided that the regulatory regime is effective.

Efficiencies are gained because infrastructure and activities are not duplicated between two or more bodies, and there is no need to coordinate activities. For instance, the American system is quite complicated with two regulatory authorities (the SEC and the Commodity Futures Trading Commission, or CFTC) and multiple SROs (both exchanges and independent SROs). The system results in significant duplication and overlap, especially since many regulated firms are subject to the jurisdiction of multiple SROs. The need to coordinate the rules and activities of all of those bodies increases the cost and complexity of such a system.

The government model arguably delivers stronger, more effective regulation because one agency with broad jurisdiction over all participants is responsible for all significant regulation functions. An SRO has only limited jurisdiction over its participants, members or listed companies. Also, because securities firms' businesses usually extend well beyond trading on a particular exchange or market (including corporate finance, mergers and acquisitions, trading in foreign markets, investment funds, and OTC trading), an exchange has limited ability and incentive to regulate many areas of securities business.

Of course, this model also minimizes conflicts of interest between the business and regulation activities of an exchange by strictly limiting the scope of exchanges' supervision activities. However, exchanges still have trading and listing rules under this model and usually have some responsibility for supervising trading (market surveillance). For example, a large majority of exchanges remain responsible for some regulation in areas such as trading operations, initial and ongoing requirements for listed companies, and derivatives contract specifications.

This model requires the government regulator to obtain significant resources to cover the full spectrum of regulatory responsibilities. A system that uses SROs is more likely to have greater overall levels of regulatory resources and expertise. Even with generous funding, a public regulator may not have the technical capacity or expertise to deal with all the detailed and technical rules and programs required to govern complex markets, investment products, and a wide range of financial intermediaries. A major reason for relying on self-regulation in large and complex markets such as the US is the sheer scale of regulation needs and the detailed technical expertise required to adequately regulate specialized markets and products.

Another potential disadvantage of this model is that a single government regulator may become too powerful or bureaucratic and thus less responsive to the needs of the industry. An SRO system provides some checks and balances in the regulatory system and gives a strong voice to the members of the SRO in regulatory policy.

Limited Exchange SRO Model

This model is becoming increasingly prevalent as governments increase the power and resources of statutory regulators. At the same time, exchanges' regulatory responsibilities are being reduced for the reasons discussed in the preceding section. A statutory regulator is responsible for most regulation but relies on exchanges to perform certain front-line regulation functions – usually market surveillance and basic listing standards. Exchanges set and administer rules in those areas – although the scope of the rules varies widely around the world. The NYSE model of retaining responsibility for regulating trading on its own market (after it transferred member regulation to FINRA) is the prevailing model in Australasia.

Exchanges often make the case that they are effective "front-line supervisors" of their markets because they are "close to the market." Exchange staff members have detailed knowledge of how the market works and the expertise required to deal with issues. An exchange also has a business incentive to provide sound regulation because market integrity and credibility with investors are essential factors in building and sustaining an attractive marketplace. Some authorities believe that given the business benefits of sound supervision, exchange should shoulder some responsibility for market supervision.

Obviously, a disadvantage to relying on an exchange is that conflicts of interest could negatively affect the performance of its responsibilities, as discussed in chapter 5.

Strong Exchange SRO model

In this model, the government regulator relies on an exchange to perform extensive regulatory functions that extend beyond its market operations. Those functions typically cover market regulation, regulation of members' business conduct and operations, and listing rules. (See the list of regulatory responsibilities in appendix A for areas typically covered by an exchange in this model.) If the exchange operates a clearinghouse or CSD, then it also regulates clearing and settlement systems.

Benefits of this approach are greater use of industry expertise and resources in regulating markets and member firms, and a reduced burden on the government regulator. Many countries require a regulated market to perform self-regulatory responsibilities and to act in the "public interest." Such factors can be especially important in emerging markets where budgets of statutory regulators are limited.

Nevertheless, this approach raises potentially serious conflict-of-interest problems because the exchange's regulation responsibilities are extensive. (Again, see chapter 5 on conflicts of interest.) Because much management time and attention are consumed by regulation, the exchange is probably less focused on its primary mandate of business and market development. The extensive costs of regulation would also reduce the exchange's competitiveness unless it can recover the costs by imposing additional fees.

By relying on an SRO to perform many responsibilities, the regulator has less control over detailed regulation or the day-to-day operations of markets and member firms. Regulators sometimes try to address this issue by imposing stringent oversight procedures on SROs, which add to costs and may lead to considerable duplication of effort.

Independent Member SRO model

This model is similar to the strong exchange SRO model, so many of the benefits are the same. The government regulator relies extensively on an independent member SRO instead of an exchange to carry out regulatory functions. An independent member SRO is a member-owned, non-profit organization that is purely a regulatory body – it is independent of exchanges and other market operators and does not have significant business operations. In some cases, those organizations also have industry association functions – notably the JSDA and KOFIA – but such functions are segregated from SRO operations, thus mitigating conflicts between the two roles.

The major advantage of this model is that it minimizes concerns about conflicts of interest that arise in exchange SROs, because no conflicts with business activities arise. Independent SROs have a singular, clear mission to provide effective regulation. Independent SROs are also seen as neutral and unbiased regulators because they do not have any business interests to protect. For this reason, the first recommendation in a recent CFA Institute study on self-regulation is "Where self-regulation is practiced, establish an independent SRO body that is separate and distinct from exchange/market operations to oversee the regulation of the securities market." The paper asserts that an independent SRO "removes the often subtle, yet effective, pressures regulatory and business arms can exert on each other" (CFA Institute 2007: 25).

Of course, the inherent conflict in self-regulation remains. And even if an SRO is independent of the markets it regulates, if the SRO doubles as an industry association representing its members' interests, other significant types of conflicts arise because the organization must balance regulation of its members with advocacy of their interests. Therefore, an independent member SRO should ideally be independent of both market operators *and* industry associations. However, some SROs remain hybrid organizations that perform both roles. If so, corporate governance and other policies should be in place to manage the conflicts, such as the policies adopted by JSDA in Japan.

The independent member SRO model supports competitive securities markets in two ways. First, it fosters business-focused, more competitive exchanges by relieving them of most regulatory responsibilities, thereby enabling them to focus on business development. Second, it supports competition among exchanges and other trading system operators by providing a neutral industry regulator that can regulate all markets as well as intermediaries. This support enables marketplaces to compete on a level playing field, relieves new entrants of the need to build SRO capabilities, and prevents dominant exchanges from using regulatory powers to impede competition.

If one independent regulator is responsible for regulating all marketplaces, another major benefit is simpler, uniform market regulation. One set of rules applies to trading in all markets, and the rules will be applied consistently to all markets and trading participants. Thus, compliance with the rules is simple and more efficient for participants. A single regulator also enhances fairness in the regulatory system, because all markets and participants are treated equally. For example, in Canada IIROC regulates trading on all 10 equities exchanges and ATSs across the country.

Finally, independent SROs are better positioned than exchanges to regulate all activities of securities dealers because an exchange's focus is increasingly on its participants' use of exchange facilities and products only.

Like model 3, the independent member SRO model is potentially less efficient than the government model because of duplication of work and the need for coordination with the government regulator. It is also similar to model 3 in that the regulator has less control over detailed regulation or day-to-day operations of markets and member firms.

Transferring regulation responsibilities from exchange SROs to independent SROs is an alternative to centralizing functions in a statutory regulator. As exchanges demutualize and shed regulation functions, traditional member-based self-regulation can be preserved only if independent SROs such as FINRA assume exchanges' regulation functions. But using Exchange SROs to provide front-line regulation remains an option for preserving a form of self-regulation. This option is important in countries where statutory regulators cannot assume the full regulatory burden and where creating a new SRO from scratch is not viable.

Where an exchange relies on an independent SRO to license and regulate the exchange's members or participants, a participant must become an SRO member to qualify as a trading participant in the exchange. For example, all NYSE members must be regulated by FINRA; in Canada, all TMX participants must be regulated by IIROC.

Industry Association SRO model

As noted previously, industry associations that also perform a limited range of SRO functions are another form of the independent member SRO. Several key differences distinguish the two. Independent member SROs perform extensive regulatory functions and their primary role is usually to act as an SRO. Their governance systems have strong representation from independent or non-member directors, and enforcement tribunals are similarly structured.

In contrast, the primary role of industry association SROs is to represent their members and regulatory functions are usually limited. The organizations set standards or rules but may not have well-developed supervision or enforcement programs. Their governance systems are member-driven, with few or no independent directors or committee representatives. As such, conflicts of interest are more likely to arise and are less easily managed.

In spite of the limitations of industry association SROs, they can still play a useful role in supplementing the work of government regulators, and they may help shape regulations set by government regulators as well.

Some countries have multiple SROs. A fragmented regulatory structure introduces additional complexities. The US markets best illustrate the complications that arise, with two independent SROs (FINRA and NFA) and numerous exchange SROs. Recently, the American SRO system has been simplified to some degree – the creation of FINRA through the merger of NASD and the NYSE's member regulation department, and mergers of exchanges have reduced the number of SROs and duplication of activities among SROs. In addition, outsourcing of regulation to large independent SROs such as FINRA and NFA means that the SRO functions administered directly by many Exchanges are limited in scope.

A single, consolidated SRO offers many advantages, including the following:

- *Uniform rules and policies for all members*: The SRO will apply one set of rules and interpretations to all firms involved in a business activity.
- *Uniform regulation programs*: One SRO will use a consistent approach to supervision, such as market surveillance and field examination programs.
- *Full picture of market and member firm activities*: One SRO sees the "full picture" of regulated activities, including all market activities and all members' operations.
- *Minimized duplication and gaps in regulation*: When supervision is divided among several SROs, duplication is unavoidable, especially where two or more exchanges have extensive cross memberships or cross listings. Gaps may also arise when regulation is fragmented.
- *Simplicity and clarity*: A single SRO offers a simpler system for members and investors because it is clear what body is responsible. This approach also minimizes problems of coordination, and even competition, among regulators.

- *Cost-effectiveness*: One SRO eliminates duplication of SRO infrastructure and reduces costs.
- *Centralization of management and staff expertise*: A single SRO centralizes available expertise in one organization, which can realize synergies and create the most professional environment.
- *Easier supervision*: A supervising regulator can more easily focus its oversight on one organization, rather than needing to supervise several entities and attempt to ensure consistency among them.
- *Minimized conflicts of interest*: Fewer conflicts of interest will arise in one independent SRO than in several smaller SROs that are based on fewer, more specialized member firms.

Other Views on Self-Regulation Models

Others have proposed different models of self-regulation. The US SEC proposed alternative structures for the SRO system in a 2005 concept release. The release reflected concerns about conflicts of interest in for-profit exchanges' responsibility for regulatory functions, and it canvassed the pros and cons of options ranging from abolishing SROs to creating one universal SRO (SEC 2005). One of the options, dubbed the "hybrid approach," is embodied in the creation of FINRA -- a single SRO to perform all member regulation functions -- while each exchange remains responsible for regulating its own market. The securities industry was very supportive of the new SRO, because for many years, it pushed for integrating the NYSE and NASD member regulation programs into a central SRO. In fact, the Securities Industry Association (the predecessor to the Securities and Financial Markets Association, or SIFMA) issued a paper in 2003 that proposed several models for the SRO system that were very similar to the models canvassed in the SEC release.

In a recent paper, the European Forum of Securities Associations (EFSA 2007) suggests that formal SROs are only one of three models of self-regulation. The others are (a) standards and guidance developed by industry associations that are recognized by the authorities and (b) standards and practices developed by industry bodies that firms may voluntarily adopt.

The CFA Institute (2007) paper describes a continuum of self-regulation from voluntary associations to formal SROs. The CFA notes that financial industry regulation around the world falls into either (a) a model that uses formal SROs or (b) a model based on government regulation. It adds that the latter model now prevails in Europe.

Country Examples

Table 3-1 describes the highlights of the regulatory structure in six major developed markets around the world. Discussion of the structure in several countries follows.

United States and Canada

In the US, consolidation of markets and SROs, as well as concerns over conflicts of interest and questions raised by the SEC, have produced major changes in the self-regulatory system in the last decade. As noted previously, FINRA was created to centralize member regulation of broker-dealers, and exchange mergers and acquisitions have reduced the number of SROs.[17]

Some have pushed for more far-reaching changes. SIFMA has long advocated streamlining of the SRO system. Others have questioned the viability of self-regulation itself.

Although the US is often held out as the leading example of strong self-regulation, the US model differs in important ways from the approach in most other countries that rely on SROs. Specifically:

- Self-regulation is not voluntary. All broker-dealers must be members of a recognized SRO.
- Separate statutory authorities regulate the securities and futures markets (the SEC and CFTC, respectively). This dichotomy has led to different approaches to reliance on, and oversight of, SROs in the two market segments.
- The system is fragmented into multiple SROs, with many firms regulated by several SROs.
- Both independent SROs and exchange SROs operate in the US.
- Exchanges have transferred regulatory functions to independent SROs rather than to government authorities as in other countries.

US SROs have been called a "peculiar mix of private sector self-regulation and delegated governmental regulation" (Karmel 2008). This mix arises because today (1) the SROs have limited independence from the SEC, (2) membership in an SRO is mandatory, and (3) SROs exercise authority in areas that the SEC effectively delegates to them.[18]

Following the creation of FINRA, NYSE Regulation continued to regulate the NYSE market and listed companies. In 2010 the NYSE agreed to outsource market regulation functions to FINRA as well. Similarly, Nasdaq is responsible for regulating its market but outsourced most of the functions involved to FINRA in order to address conflicts of interest. The exchanges have no responsibility for member firm regulation. FINRA is responsible for the following:

- Regulating all member firm business conduct and financial compliance and enforcement
- Performing all member firm compliance and financial examinations
- Administering investor arbitration and mediation functions
- Training, testing, and licensing of registered representatives
- Providing market regulation services by contract to Nasdaq and other exchanges, such as the International Securities Exchange.

[17] Major examples include mergers of NYSE and Amex; CME and NYMEX; CME and CBOT; the acquisition of PHLX by Nasdaq; and the acquisition of PSE by Archipelago and its subsequent merger into NYSE Euronext.
[18] This is not delegation in the legal sense of delegation of regulatory authority, but rather reliance on SROs to perform functions that the SEC is satisfied it does not need to perform directly.

In 2004, the SEC proposed significant changes to the American SRO system because of concerns about the effect of increasing competition among marketplaces, the greater conflicts of interest, and the fragmented structure of the SRO system. The proposals are one example of how the SEC's influence has played a major role in the American SRO system's structure. When the NASD decided to demutualize Nasdaq in 2000, several years of negotiations with the SEC over approval of the restructuring of both Nasdaq and the NASD led to a complete separation of the two and reforms in their corporate governance.[19] The SEC also significantly influenced major reforms in the NYSE's corporate governance and the setup of NYSE Regulation in 2003, as well as the governance structure of FINRA (Karmel 2008). (See chapter 5 on corporate governance.)

The Canadian system is similar to the American in some respects, in particular in relying mainly on independent SROs, and in requiring all securities and mutual fund dealers to be SRO members. The main difference is that greater consolidation of the SRO system has been achieved in Canada. A new entity, IIROC (the product of a merger of two independent SROs, the IDA, and Market Regulation Services) is responsible for all of the member regulation and most of the market regulation functions that the exchanges formerly performed. The demutualization and consolidation of five exchanges into TMX Group (over 10 years) facilitated SRO consolidation and the transfer of the great majority of regulation responsibilities to an independent SRO. Because Canada has no national securities commission, however, the efficiency of the system has been affected by the existence of multiple supervising regulators.

Europe

In most of Europe, the role of self-regulation was never extensive because of its civil law system and approach to government supervision of financial business. The UK was a notable exception; it relied almost entirely on self-regulation until 1997. However, the UK system of self-regulation was based on private arrangements and was largely informal until the Securities and Investments Board (SIB) was established in the 1980s. In contrast, the American self-regulatory system has been based on a statutory framework since the Securities and Exchange Act of 1933 was adopted. Therefore there were significant differences between the two systems, in particular in terms of government and regulatory oversight.

The self-regulatory functions that European exchanges used to perform have been scaled back significantly by a combination of government policy decisions on securities regulation, by the regulatory framework established by the EU to harmonize rules and develop a single financial market, and by commercial pressures on exchanges. European exchanges were early adopters of the for-profit corporate model, and exchange consolidation has been underway in Europe for a decade. As a result, most self-regulatory responsibilities of exchanges (and a few other SROs) have been transferred to government regulators over the past decade or so.[20]

European jurisdictions are leading the move toward consolidation of regulatory and supervision functions in government authorities. The consensus in Europe is that regulation is a public

[19] The NASD had previously separated its operations into two companies, Nasdaq and NASD Regulation, as a result of the Nasdaq market maker collusion scandal in the 1990s.
[20] For example, see FESE comments on IOSCO Technical Committee 2006a.

function that private organizations should not perform, especially for-profit business organizations. The European Commission stated, “It is no longer appropriate for exchanges to carry out regulatory roles since they are commercial entities.” EU directives implemented under the Financial Services Action Plan mandate that a public “competent authority” in each country supervise securities markets. Those authorities all participate in the Council of European Securities Regulators (CESR), whose objective is to support the EU’s implementation of harmonized rules and regulatory structures across the EU.

Directives passed by the European Commission have required government regulators to assume many regulatory functions that were formerly delegated to exchanges. Specifically,

- The Market Abuse Directive transferred the primary responsibility for addressing market conduct to competent authorities.
- The Prospectus Directive confirmed that competent authorities must have responsibility for approving prospectuses and for many “listing” functions.
- The Markets in Financial Instruments Directive established a common framework for the regulation of exchange members and exchanges, as well as for detailed business conduct rules for intermediaries.

In France, the government decided in the mid-1990s that the EU single market would intensify inter-exchange competition and would require exchanges to become commercial entities. To position the French market for competition, the former Paris Bourse was set up as market operator, and regulation was centralized in two government authorities.[21] Three bodies were merged in 2003 to form the AMF (financial market authority). The AMF is responsible for regulation and for monitoring of market conduct, financial intermediaries, and issuers.

The UK took the view that commercial exchanges should not assume public mandates, including regulation of participating firms, in 1997. The UK government created the FSA as a universal financial regulator and transferred all significant powers of the former SROs to the FSA. The new regime represented a wholesale departure from the historical reliance on self-regulation in the city’s financial markets.

In 2000, the FSA stated in a submission to an EU committee:

> [W]e do not think that it would be appropriate to leave the setting, monitoring, and enforcement of EU legislative requirements to one or more self-regulatory organisations. Today’s markets require a more independent regulatory authority to provide all participants with a more objective approach to regulation. (FSA 2000: 10)

Fostering competition among market operators was one impetus for the UK’s reforms. Exchanges’ SRO roles could impede competition among exchanges. For example, the government transferred the LSE’s former role as “competent authority for listing” (a public role defined in law that includes clearing prospectuses) to the FSA because the LSE competes for listings with other UK (and EU) exchanges. The FSA runs the UK Listings Authority (UKLA),

[21] The predecessor authorities were Commission des opérations de bourse, the Conseil des marchés financiers, and the Conseil de discipline de la gestion financière.

which handles applications for equities and debt listings and sets continued listing rules. Securities on the UKLA's "Official List" are approved for trading on any recognized exchange in the UK.

The UK provides an interesting example of self-regulation in the field of regulating takeover bids. The UK Panel on Takeovers and Mergers is an independent, private sector body that sets the UK's Takeover Code and regulates takeover bids by applying the code. Its membership comprises experts from major financial and business institutions. The chairman, deputy chairmen, and up to 20 independent members are appointed by the panel on the recommendation of its nomination committee. In addition, a number of industry associations nominate members of the panel. Originally, compliance with the code was voluntary – it was a pure self-regulatory model. Following adoption of the EU's Directive on Takeover Bids, the UK gave the code statutory backing.[22]

European exchanges continue to perform limited market supervision and listing functions relating to their markets, most of which are as much business or operational as regulatory in nature. Functions such as market surveillance are shared with the securities regulators. The Federation of European Securities Exchanges (FESE) argues, "Competent authorities are in many cases too remote from trading to detect abuses and rely heavily on exchanges to identify market abuse, although the competent authorities might then assume primary responsibility for investigating the suspected abuse."[23] FESE's position is that exchanges and competent authorities must continue to partner to ensure market integrity.

For instance, UK "regulated investment exchanges" (RIEs), such as the LSE and the London International Financial Futures Exchange (LIFFE), retain some vestiges of self-regulation, although they are not considered to be SROs. They are responsible for limited market-monitoring functions, which are subject to FSA oversight. The RIEs have their own trading rules and are responsible for ensuring members comply with them. This is consistent with the supervisory roles retained by European exchanges in general. For instance, Euronext Paris still performs limited market surveillance functions for its markets based on its own trading rules, although the surveillance unit reports to AMF.[24]

Some organizations suggest that a new model of self-regulation is possible in Europe based on standards and guidance set by industry bodies. EFSA (2007) adds that because regulations applicable to 27 different EU countries will be difficult to apply and to amend, an opportunity exists to develop a limited form of "self-regulation" to fill the gap. The form of this so-called self-regulation is quite loosely described. EFSA suggests that it could be based on industry guidance, codes of conduct, best practices statements, or similar standards. Those standards could expand on existing law or regulations or could cover new ground. They might be voluntary or compulsory (presumably if backed by regulators) and might be recognized by regulators. However, competent authorities would be responsible for setting all regulations and enforcement.

[22] See http://www.thetakeoverpanel.org.uk/new/.
[23] See FESE comments on IOSCO Technical Committee 2006a.
[24] Euronext also performs limited listing functions, including setting basic listing rules and approving listing of securities.

The leading examples of this form of industry involvement in securities regulation are France and the UK. In the UK, the FSA's new policy enables it to "confirm" industry guidance on FSA rules. In France, under financial market regulations and the AMF rules the regulators may adopt professional guidance and standards set by industry associations such as AMAFI, with which regulated firms must then comply.

The FSA's approach aims to provide more support to firms in meeting their compliance obligations by recognizing guidance produced by industry bodies. The approach reflects the FSA's desire to focus on principles and high-level rules. Industry guidance supplements FSA rules by providing details on how to interpret and implement them. The industry expects it to be helpful in adjusting to principles-based regulation.

The FSA continues to provide its own guidance in its rulebook wherever it sees official guidance as beneficial. It will provide advice and assistance on its own guidance, but not on industry guidance.

When the FSA confirms guidance, it means the FSA agrees the guidance is a useful tool for firms.[25] The FSA stresses that firms need not follow industry guidance: "We want to be very clear that following industry guidance is one way, but not the only way, to meet your regulatory requirements."[26] If a firm does follow guidance, the FSA will not take action against the firm for violating the related rule, as long as it was appropriate for the firm to rely on the guidance.

Importantly, the FSA cannot enforce industry guidance, but the FSA may use it as evidence of industry practices in an enforcement action. Industry guidance is also not enforceable by clients in a civil lawsuit, although again the content of guidance will probably be admissible in court as evidence of sound industry practices.

The FSA intends to require bodies producing industry guidance to indicate recommended practices that go beyond the requirements of FSA rules.[27] The FSA's policy emphasizes that industry guidance falls well short of a required standard or practice. In particular,

- Industry guidance is optional, and it is not enforceable.
- The FSA will not request or rely on industry guidance to supplement any FSA rules.
- Industry bodies do not need to monitor compliance with guidance.
- Industry bodies do not need to provide advice on their guidance.

Asia

In Australasia, regulators continue to rely significantly on self-regulation in both developed and emerging markets. Exchanges in Australia; Hong Kong SAR, China; India; Japan; Korea;

[25] FSA website, Industry guidance FAQs, http://www.fsa.gov.uk/Pages/About/What/industry_guidance/faqs/index.shtml.
[26] Ibid.
[27] Ibid.

Malaysia; Singapore; and Thailand retain significant SRO responsibilities. Japan and Korea also have independent SROs.

The Australian Securities Exchange had maintained broad SRO responsibilities by law, but recently the government announced that most of the ASX's responsibilities will be transferred to the ASIC, the government authority, in 2010. To better address conflicts of interest, in 2006, the ASX established a separate subsidiary, ASX Markets Supervision, for its regulation functions. Governed by its own board of directors, the subsidiary is independently managed. It is responsible for regulation of the market, participants (members), issuers, prudential risk, and enforcement. To increase the efficiency of its SRO functions, the exchange seeks to eliminate areas of overlap with the commission's rules and processes.

Japan relies on both exchange SROs and independent SROs to regulate members and markets. Japanese exchanges (primarily the TSE and OSE) regulate their own markets, securities dealers that trade on the exchange, and companies listed on the exchange. The Japan Securities Dealers Association (JSDA) regulates all securities dealers and financial institutions that trade in securities, as well as OTC equity and debt markets. Both the exchanges and the JSDA are full-fledged SROs engaged in rule making, supervision, registration, and enforcement. The JSDA is both a trade association and an SRO. In addition, the Financial Futures Association of Japan regulates broker-dealers in the financial futures industry and the Japan Securities Investment Advisors Association regulates investment advisers.

India relies extensively on its two dominant securities exchanges to regulate trading, brokers, and listed issuers. Both the National Stock Exchange and the Bombay Stock Exchange, have important market regulation, member regulation, and listing regulation responsibilities, including extensive rules applicable to listed companies that are found only in the exchanges' listing agreements. Both the NSE and BSE are demutualized, albeit in different forms. They cooperate with, and are supervised by, the Securities and Exchange Board of India in carrying out those responsibilities.

In Hong Kong SAR, China, the Securities and Futures Commission assumed responsibility for supervision of broker-dealers (member regulation) from the exchanges in 2000 as part of an overall government policy to consolidate and demutualize Hong Kong SAR, China's exchanges. The HKEx's remaining self-regulatory role is to supervise compliance with its trading and listing rules, which are mostly business or operational rules. A Listing Committee that is independent of the Exchange administers the listing rules. The SFC has been primarily responsible for market conduct and trading abuses since 1990. It also performs market surveillance for violations of the law, so HKEx's surveillance role is quite limited.

Following an intensive review of HKEx's listing functions, the SFC decided not to take over full responsibility but to share it with the exchange. The HKEx Listing Rules were given statutory backing, and the SFC takes an active role in enforcing the rules as necessary. In addition, HKEx took steps to ensure that the listing rules are administered in an independent and neutral manner.

Malaysia retained a strong self-regulatory role for its new consolidated exchange. Malaysia's government developed a comprehensive strategy for the capital markets, including consolidation and demutualization of its exchanges, to foster innovation and market development. This path was similar to that followed in Singapore and Hong Kong SAR, China. The new exchange's regulatory role was reviewed as part of the demutualization plan. A primary goal was streamlining functions and eliminating duplication between the Securities Commission and the exchange. Bursa Malaysia maintains significant SRO responsibilities mainly because the SC felt that continuing to rely on self-regulation instead of assuming all responsibilities itself was important. The exchange has front-line responsibility for regulating trading in its markets and the business conduct of its members, and it is also responsible for listing. The SC clears prospectuses and sets the primary disclosure requirements.

South America

In 2006, Colombia established a new independent SRO, the securities self-regulator of Colombia (Autoregulador del Mercado de Valores, or AMV), to centrally regulate trading by all market intermediaries. The government mandated creation of a new self-regulatory system by law, and membership in an SRO is compulsory for all financial intermediaries that deal in securities markets, including banks, trust companies, and pension funds. The range of intermediaries covered by the system reflects the fact that many intermediaries participate directly in fixed-income markets, which is the biggest segment on the Colombian exchange (BVC) and in other trading systems.

AMV is mainly a market regulator; it does not regulate intermediaries' financial requirements or overall business conduct. As a private body, the SRO's rule-making powers are limited by Colombia's civil law system, but it does have its own regulations. AMV's primary activities are market supervision, licensing of market professionals, and enforcement.

Colombia's exchanges (now consolidated into one exchange) had a long history of self-regulation of brokers, but an independent SRO was needed to persuade other financial institutions to participate in the self-regulatory system and become SRO members. This is a novel approach in an emerging market, especially because Latin America has historically made limited use of self-regulation.

Brazil modernized the legal framework for its securities markets in 2007 when CVM, the securities regulator, issued a new regulation that created the regulatory basis for demutualization of exchanges and established new self-regulatory powers. With the demutualization of Bovespa, the exchange created a new entity, Bovespa Market Supervision (BSM), to perform SRO functions including rule making, supervision, market surveillance, examinations of intermediaries, and enforcement. In 2008, Bovespa merged with BM&F, Brazil's commodity futures exchange, to form BM&FBovespa, an integrated securities and commodities exchange. BSM is now BM&FBovespa Market Supervision, which is a wholly owned but independent subsidiary of the exchange.

BSM's operations and governance are fully independent of BM&FBovespa. BSM is responsible for supervising market participants' compliance with regulations of the securities regulator (CVM), the exchange, the clearing corporation (CBLC), and BSM's own rules, as concerns participants' business conducted on the exchange and CBLC. BSM also oversees application of the listing rules to issuers by the exchange. BSM's responsibilities are very broad because BM&FBovespa manages markets for equities, debt, derivatives, commodities, and other assets, as well as organized OTC markets for stocks, options, debt, and other assets.

BSM's board has three directors: two independent directors and BSM's chief regulatory officer. The board is responsible for setting BSM's strategy and budget and for supervising its operations. A supervisory board exercises BSM's regulatory powers. It is responsible for hearing appeals of decisions and applying penalties. It is composed of 11 members: 8 are independent, and 3 are appointed by market participants (only one represents intermediaries).

Brazil also had two industry associations that performed important self-regulatory functions in the OTC debt markets, investment funds market, and other off-exchange securities activities. These associations merged in 2009 to form ANBIMA (Brazilian Financial and Capital Markets Association). The association is a good example of industry associations that have developed SRO functions on a voluntary basis. ANBIMA does not have a statutory mandate, and membership is voluntary, although it does have memoranda of understanding (MOUs) with the regulator, CVM, concerning its regulatory responsibilities. Currently, ANBIMA is a self-governing member organization without independent directors or formal separation of industry association and SRO functions.

ANBIMA represents banks, investment banks, dealers, brokers, and asset managers that are active in the OTC markets. In addition to representing its members, ANBIMA carries out self-regulatory functions, provides certification, market infrastructure and transparency services, and promotes investor education. The association has adopted codes that set rules for trading, pricing, clearing, and settlement in OTC debt markets. It has also adopted five codes that set out rules for members' activities in investment funds, public offers, private banking, and custody, as well as certification requirements.

4. SRO Responsibilities

This chapter reviews the types of regulatory responsibilities that SROs typically perform, and comments on the division of responsibilities between a SRO and its supervising regulator.

Nature of SRO Responsibilities

SROs are usually responsible for specific market regulation and member regulation functions. Exchange SROs also regulate listed companies to varying degrees in their listing rules. The scope of an SRO's responsibility varies in different countries. Invariably, responsibility is shared with the government authority, which also supervises the SRO. Government regulators are usually responsible for higher-level activities, while SROs are usually responsible for front-line activities.

Market regulation covers rules to protect market integrity, market conduct rules, and exchange trading rules. Compliance with those rules is monitored through market surveillance programs, trading analysis, and examinations of firms' trading operations.

Member regulation refers to regulation of the operations of participants, securities dealers, or intermediaries. At the SRO level, it usually covers membership or access standards, rules on business conduct and sales practices, and financial compliance (including capital requirements). Compliance with those rules is monitored through compliance and financial examinations, financial and operations reporting to the SRO, and administration of membership rules.

SROs usually have responsibilities to investors, issuers, and the public imposed on them by law or regulation, and they are accountable to their supervising regulator. SROs are broadly accountable to stakeholders in the capital markets, not just to their members or shareholders. Those responsibilities require the SRO:

- to ensure compliance with its rules and, in some cases, securities regulations;
- to protect market integrity and investors by imposing rules on business conduct; and
- for SROs that regulate markets, to maintain a fair, efficient, and reputable public market.

Two recent international surveys have examined the division of responsibilities between government regulators and SROs. In 2004 the World Federation of Exchanges (WFE 2005) surveyed its members on their regulation responsibilities. The survey showed that a large majority of exchanges perform at least some market regulation. Many regulate trading members and supervise clearing and settlement activities. Many also perform a listings role and have some responsibility for listed company disclosure and corporate governance. The results show that each of the regulatory roles is usually shared with the government regulator.

In 2006, the International Council of Securities Associations (ICSA 2006b) conducted a survey of 10 major exchange and independent SROs. All the SROs surveyed regulate member firms. Almost all regulate markets, either exchange or OTC. The exchange SROs also regulated issuers.

In addition, almost all SROs performed other activities (for example, dispute resolution services, investor education, and education of market professionals).

The surveys confirmed that the scope of SRO regulation varies widely. To understand an SRO's responsibilities, one must examine the specific activities the organization is responsible for *and* how responsibility is shared with the supervising regulator. For example, table 4-1 shows a typical division of responsibilities for market regulation. (The table does not cover member or intermediary regulation.) Government regulators are usually responsible for higher-level activities (levels 1 and 2), and SROs are usually responsible for front-line activities (levels 3 and 4).

A legal framework should clearly establish the scope of an SRO's responsibilities and the division of responsibilities between the SRO and its supervising regulator. To minimize duplication of activities and overlapping supervision, the "job description" of an SRO should be clear. The division of responsibilities may be set out in law or regulation or, alternatively, through an MOU or guidelines.

Listing and Issuer Regulation

Strictly speaking, the functions of exchanges' listing departments and listed company regulation are not self-regulatory because issuers are not regulating themselves through the exchange, as broker-dealers traditionally have. Issuers usually have only nominal, if any, representation on exchange boards and committees. Listing is a regulatory function that exchanges perform on the basis of contract – the listing agreement. In practice, most exchanges treat listings as part of their self-regulatory – or at least their supervision – functions. The IOSCO Technical Committee (2001) specifically refers to listing as a "regulatory function." However, the regulatory functions of listing must be differentiated from exchanges' listing businesses, which are significant sources of revenue. In many cases exchanges face intensive competition for listing business.

Listing departments generally perform two different functions: (1) they apply the minimum standards for listing to new applicants; and (2) they impose continued listing rules in areas such as financial and business disclosure, protection of minority shareholders' interests, and corporate governance. The former is akin to establishing standards of product quality, but the latter is regulatory. In addition, many exchanges' listing departments perform marketing functions, although commercial functions are often performed separately. For example, NYSE Regulation is responsible for administering the NYSE's listing rules, but the "listing business" is part of the NYSE's business operations.

The division of responsibilities for listing functions between the statutory regulator and the exchange varies around the world. Almost all exchanges set their own initial listing standards (the LSE is a notable exception)[28], but statutory regulators have assumed the primary role for regulating public issuers. In some countries, exchanges traditionally performed the job of approving prospectuses too (requirements for approval for public trading of a security), but this function has moved to regulators around the world. The regulator sets disclosure standards for

[28] These are referred to as "admission to trading" standards in the EU and some other jurisdictions, to differentiate the exchange's standards from the regulator's requirements to authorize public trading of a security.

issuers in most countries. Conversely, many exchanges retain an important in role in setting corporate governance standards for listed issuers.

Country Examples

Table 4-2 summarizes the division of regulatory responsibilities between regulators and SROs in the same six developed markets shown in chapter 3. The table covers six key responsibilities that SROs perform in many countries.
ASX clearly stated the nature of its self-regulatory role on its website: it is not a regulator.

> It is more accurate to describe ASX as a regulated commercial organisation that monitors specific aspects of the businesses of other organisations (for example, the governance of listed companies and the on-exchange or on-market trade execution by brokers). ASX does so as a condition of the licences it has been granted by government to conduct its own commercial undertakings.[29]

ASX does not regulate compliance with laws or regulations, or participants' overall business conduct or off-exchange trading. ASIC regulates dealings with customers.

[29] ASX website, http://www.asx.com.au/supervision/approach/index.htm. The ASX website contains charts showing what ASX does, and does not do, as an SRO. The charts illustrate the scope of many SROs' responsibilities.

5. Corporate Governance and Conflicts of Interest

This chapter discusses two of the most critical issues that any SRO system must address: ownership and corporate governance. It also covers the related subject of managing conflicts of interest.

Evolution of Corporate Governance

In a mutual or cooperative ownership model, the owners are usually members or participants regulated by the SRO, so membership or participation also defines the jurisdiction of the organization. Corporate governance of SROs is a critical issue because the composition of the board of directors and related governance policies determine how major decisions on corporate policy are made. Those decisions include selection of management, setting corporate strategy and overall regulatory policy, adoption of rules, and deciding the approach to supervision programs and enforcement.

IOSCO (CPSS–IOSCO Technical Committee 2001: Recommendation 13) has stated:

> Governance arrangements encompass the relationships between management and owners and other interested parties, including users and authorities representing the public interest. The key components of governance include the ownership structure, the composition of the board, the reporting lines between management and board, and the processes that make management accountable for its performance.

The nature of SRO governance has evolved considerably since the days when SROs began as member-driven institutions. Historically, member representatives dominated SRO boards and committees, and committees composed of member personnel usually set policies and rules, or had significant influence over them. Today, SRO functions are seen as quasi-public responsibilities that must serve the interests of multiple stakeholders, in particular investors. Members' roles in the governance and administration of all types of SROs have been reduced significantly in the past two decades. Consequently, the corporate governance structures of SROs now include representation from a wide range of stakeholders.

Today, SROs are run by executive management teams and operated mainly by professional staff with specialized knowledge and expertise. Members' involvement in the internal administration of SROs is limited – mainly to participation in corporate governance and policy development. Therefore the division of responsibilities between the board of directors and management is an important element of corporate governance. Boards are now mainly responsible for strategy, corporate policy and supervision of management, consistent with the functions of boards of public companies. In the past, SRO boards were usually heavily involved in operations.

The most significant corporate governance issues at SROs concern the degree of independence an SRO should have from its owners, regulated persons, and regulators. The composition of an SRO's board of directors, management, and committees needs to strike a delicate balance between the level of independence needed to be a credible regulator and to manage conflicts of interest on the one hand, and the level of involvement that regulated firms, market operators, and supervising regulators should have to ensure the effectiveness and accountability of the SRO on the other.

SRO governance and management have become increasingly independent of regulated firms, in both exchange SROs (because of demutualization and transition to shareholder corporations) and independent member SROs. This change has mitigated conflicts of interest that are inherent in self-regulation. Nonetheless, an SRO must maintain a reasonable degree of industry involvement, especially in policy development, to retain the benefits – and, in fact, the very nature – of self-regulation.

For exchange SROs, maintaining a high degree of independence from the exchange's business as a market operator, as well as from its shareholders' business interests, is widely considered to be imperative in minimizing the potential for conflicts and retaining the credibility of self-regulatory functions.

In addition, SROs must be reasonably independent of their supervising regulators. Otherwise, an SRO may be seen as another arm of the regulator, and a number of the benefits of self-regulation will be reduced or even lost. Where the line should be drawn is difficult to say. An appropriate balance should be achieved between maintaining effective oversight of an SRO and giving the SRO the flexibility to develop its own regulatory priorities and program.

SROs' public interest responsibilities are an important consideration. A major challenge in SROs' governance is balancing their responsibilities and duties to owners, members, or users (which may be the same group or different groups) on one hand[30], and to the public and other stakeholders on the other[31]. How those duties are balanced has become a major focus of government regulators' supervision of SROs in the past decade, as discussed in the next section of this chapter. Oversight of corporate governance is also one of the main tools used by regulators to manage conflicts of interest in SROs, as discussed in the third section of this chapter.

Transparency is an important principle of SRO governance, which reflects SROs' quasi-public status and responsibilities to multiple stakeholders. Transparency in governance is achieved by making public the following types of information:

- Publication of corporate governance policies and procedures
- Publication of directors' qualifications
- Publication of annual reports
- Public notice and comment processes on rule changes
- General publication of rules and policy notices
- Public reporting on the SRO's regulatory plans and performance

[30] For example, an SRO may have a duty to treat members fairly and without discrimination, to provide fair representation of members in its governance system, and to be responsive to members' needs and concerns.
[31] An exchange SRO usually has a duty to provide a fair and orderly market, to effectively regulate its members and market, and to generally act in the public interest.

- Publication of disciplinary decisions and penalties

In some countries, the results of regulators' oversight assessments of the SROs are also made public by regulators (for example, in Australia and Canada). Of course, listed exchanges are also subject to the same disclosure rules as any listed company.

Types of Corporate Governance Structures

The governance structure of SROs differs depending on their ownership and corporate structure. Most SROs' ownership and governance are based on either a member organization (mutual) model or a corporate model. Boards of directors that include representation from a range of stakeholders are common to both models. For instance, demutualized exchanges' boards usually include representation from several market participants and other stakeholders. Market participants include trading participants or members, institutional and retail investors, and issuers.

The member or mutual model was by far the leading model for SROs in the past because most exchanges SROs were mutual organizations. In that model, an SRO is owned by members or participants and operates on a non-profit or cost-recovery basis. It remains the ownership and governance model for independent SROs. The significance of ownership or membership in a membership-based SRO is limited, however, because ownership does not carry any "equity rights" – the primary right of a member is to participate in governance and to elect a certain number of directors. This ownership structure is vital to preserving the private sector status of an SRO and as the basis for funding the SRO's operations.

The advent of exchanges organized on a corporate model has complicated the governance of SRO functions significantly because the exchanges have shareholder-based governance structures, similar to any private or public company. Shareholders as investors own the exchange. Of course, the corporate model is designed to serve the exchange as a business entity; it complicates only governance of SRO operations. However, most exchanges are still subject to special laws or regulations on board composition, which usually require a majority of independent directors and often mandate fair representation of users and other stakeholders in the exchange.

Is an exchange still an SRO after ownership is separated from trading participation? If members no longer significantly influence an exchange's governance and regulatory policy, the "self" is removed from self-regulation. The concept of self-regulation means that regulated persons have a significant degree of influence over the rules, policies, and operations of the SRO. But members or participants may or may not be shareholders in a demutualized exchange. If members' ownership position is small, their representation in governance is mainly through advisory committees or customer groups. The board may include a few directors from intermediaries in their capacity as major stakeholders. As such, most exchanges today are really private regulators, not self-regulators. In this sense, their jurisdiction over trading participants has the same basis as their jurisdiction over listed issuers: it is based on contract (described in chapter 4). For this reason, today exchanges are often described as *front-line regulators* instead of self-regulators.

Following several decades of evolution, international best practice in developed markets is for independent directors to comprise at least 50% of SRO boards, if not a majority of the directors. This practice applies to both independent SROs and exchanges that remain mutual organizations. It also applies to regulation subsidiaries established by public exchanges. If independent directors make up half or more of the directors, it is more likely that the board will reflect the interests of all stakeholders and that conflicts of interest will be managed well, because members do not control the board. At the same time, most SROs believe that strong representation from regulated firms should be maintained because it is integral to the concept of self-regulation. (It should be noted that members or regulated firms usually have other mechanisms to participate in policy formation and to provide input on regulatory programs. These include participation in industry advisory committees, which often provide useful input, guidance and recommendations to management and the board of an SRO.)

Independent directors may also be called "public directors" to reinforce their duty to represent the public interest. For example, FINRA has a majority of "public governors." Even if non-member directors are simply labeled independent directors, one of their core roles is to address the public interest responsibility of the SRO. For instance, Canada's IIROC has independent directors who, in many respects, act like public directors.

At most demutualized exchanges, especially if listed, independent directors have supplanted the concept of "public directors" because all directors usually represent shareholders. Some exceptions exist: in Hong Kong SAR, China, Singapore and India, demutualized exchanges retain the category of "public interest" directors by law, even after demutualization and listing of their exchanges. Government or the regulator appoints the public directors. The objective is to reinforce the exchanges' express public interest obligations, over and above requiring a majority of the board to be independent. Those exchanges all retain important SRO responsibilities.

Most developed markets do not require public directors for listed exchanges, but they do require that a majority of the board be made up of independent directors. One important difference exists between an independent director at an exchange SRO and those in the wider corporate world. At an exchange, an independent director must be independent of regulated persons (that is, trading participants) as well as independent of the exchange as a corporation and its controlling shareholders. Furthermore, independent directors do not expressly represent investors or the public; their primary duty is the same as any director's: to act in the best interests of the corporation in accordance with corporate law norms.

Regulators' Supervision of Corporate Governance

Corporate governance is particularly important in regulators' licensing and supervision of exchanges, SROs, and similar institutions. A 2006 IOSCO paper on exchange demutualization states, "4Most regulators have focused on governance arrangements as the primary means of ensuring that exchanges have robust arrangements for maintaining a proper balance between the exchange's commercial interests and its regulatory responsibilities" (IOSCO Technical Committee 2006b: 12). The paper explains:

> A primary focus for [IOSCO] members in seeking to ensure that an exchange's decision-making and operational processes pay proper regard to, and protect, the public interest has been to require appropriate corporate governance arrangements. The overall aim is to ensure that the governing body includes individuals directly representing the broader public interest or who at least have the independence to consider whether the exchange is giving due weight to its regulatory responsibilities.

Today regulators must deal with a wide range of ownership and corporate governance structures among SROs, especially at securities exchanges**.** Not long ago, most SROs were non-profit utilities, mostly operating under a mutual governance model. Nowadays, exchanges and CSDs often operate as commercial enterprises under a corporate model of governance. In some countries, the local exchanges, SROs, and CSDs operate with very different governance structures, which complicate a regulator's job of supervising governance. The governance structure that is suitable for an investor-owned exchange, a member-owned exchange, and an independent SRO varies significantly.

Regulators have developed a flexible approach to corporate governance of SROs that enables governance requirements, licensing conditions, and oversight programs to be tailored to the type of institution involved. No standard model for corporate governance of institutions such as exchanges and SROs exists, nor have the regulators established across-the-board standards in this area at either the national or international level. The ownership, composition of the board, and approach to management reflect the laws, regulations, and history of each jurisdiction, as well as the particular history, mandate, and functions of each SRO.

Most regulators around the world apply general standards of corporate governance to exchanges and SROs, regardless of the corporate structure or ownership selected. The terms and conditions of licensing or recognition of the SRO must be met, regardless of how it is organized. For example, exchanges and SROs are usually required to ensure "fair representation" of user interests, so stakeholders, not just owners, must be represented on their boards. However, regulators usually interpret the requirements differently, depending on the nature, ownership and corporate structure of the SRO, so the standards are flexible enough to accommodate different corporate structures.

Although this principles-based approach may lack certainty or appear onerous to some, its key benefit is that it provides much-needed flexibility to the regulatory regime. The standards can apply to a listed exchange or to a non-profit, mutual SRO. The UK FSA's REC (recognition) Handbook is a good example. It sets out general governance requirements for recognized investment exchanges and clearinghouses but does not mandate a specific approach.[32] It lists a number of broadly worded factors relating to corporate governance that the FSA will consider in assessing whether an applicant for recognition is "fit and proper." In 2004, the FSA also issued a

[32] FSA Handbook, REC Handbook, Recognized Investment Exchanges and Recognized Clearing Houses. http://www.fsa.gov.uk/pubs/hb-releases/rel49/rel49rec.pdf

letter to recognized bodies that expanded on its views on sound corporate governance of recognized bodies.[33]

An SRO must demonstrate that it meets the requirements on corporate governance established by law or regulation to be licensed or recognized. In addition to those general requirements, a regulator may establish specific corporate governance requirements that are tailored to a particular SRO as part of its licensing or supervision process. Any significant changes to an SRO's corporate governance structure are subject to the review and approval of the regulator, in accordance with the terms of licensing or recognition.

The US SEC has used its approval process for changes in SRO corporate governance structures to require significant corporate governance reforms. For instance, when Nasdaq and the NYSE demutualized, each agreed to restructure its board and operations in response to SEC concerns about conflicts of interest. NYSE Euronext and its NYSE Regulation subsidiary do not have any industry representatives at all on their boards. FINRA, which is strictly a regulator, maintained a large number of industry directors (but still a minority overall) after lengthy negotiations with the SEC on its new structure.

NYSE Regulation was established as an independent subsidiary of NYSE in 2003. NYSE Regulation has an independent board, and its CEO reports only to that board. The board is made up of six independent directors (who have no affiliation to the NYSE Euronext board or to any listed company or member organization), three directors who are also NYSE Euronext directors, and the CEO of NYSE Regulation. This structure aims to maintain the independence of regulation within a for-profit, public corporation while preserving extensive communication and information sharing between business and regulatory activities.[34] Following the NYSE-Euronext merger, the status of NYSE Regulation is unchanged.

FINRA's board of governors comprises 11 public governors, 10 industry representatives, the SRO's CEO, and its chairman (for a total 23 directors). The industry seats are divided among different types of members.

In 2004, the SEC (2005) proposed formal rules on SRO corporate governance. The new rules would "strengthen" SRO governance and SEC oversight of SROs. Those proposals have not been formally implemented, but their principles are reflected in the new governance structures adopted by the NYSE and FINRA, as well as other US exchanges. The main proposals would require the following:

- Greater disclosure of governance information
- Majority of independent directors on boards and all board committees[35]

[33] Letter from Gay Huey Evans, Director, Markets Division, to Chief Executives of all Recognized Bodies, regarding Corporate Governance of Recognized Bodies, March 31, 2004: http://www.fsa.gov.uk/pubs/ceo/ceo_recbod_31mar04.pdf.

[34] NYSE website, http://www.nyse.com/regulation/nyse/1145313073247.html

[35] The definition of *independence* is strict: a person who has no material relationship with the SRO or any of its affiliates, members, or (for exchanges) issuers listed or traded on an exchange. People employed by an exchange or an SRO or a member within the past three years are also excluded.

- Specific board committees made up of independent directors only (including a Nominating Committee, Governance Committee, and Audit Committee)
- Regulatory Oversight Committee to oversee effectiveness of the SRO's regulatory program also composed solely of independent directors.

The Securities Industry Association (now the SIFMA) opposed those changes, arguing as follows:

> The legitimacy of today's self-regulatory governance is directly related to member involvement in the process…. we are concerned that if the SEC moves towards a structure that relies on professional SRO staff devoid of member involvement, it will deprive SROs of the industry expertise and guidance that is at the root of their own legitimacy as self-regulators.[36]

Professor Roberta Karmel (2008) argues that the changes imposed in the governance of FINRA and NYSE Regulation transformed the SROs into quasi-governmental agencies with minimal member influence and participation on policy making. She feels that FINRA's accountability to its members has been undermined by the governance reforms imposed by the SEC. "In the final analysis, FINRA is accountable only [to] the SEC" (Karmel 2008: 63). In her view, as SEC oversight and intervention in FINRA continues to expand, its status as a private sector SRO is in jeopardy. It could effectively become an arm of the SEC.

Conflicts of Interest

The biggest risk of self-regulation has always been conflicts of interest. Since conflicts of interest are inherent in the concept of self-regulation, the objective is not to eliminate all conflicts – rather it is to ensure that potential conflicts are properly managed, with a view to ensuring that conflicts do not inappropriately influence an organization's policies and activities.

Recent changes in financial markets have heightened concerns about conflicts, especially for exchange SROs, because corporate business models arguably create greater conflicts of interest between an exchange's self-regulatory responsibilities and its business activities. Independent SROs face fewer conflicts, but the inherent conflict in members regulating themselves remains. Their conflicts are greater if the organization doubles as a trade association, which creates conflicts between regulating members and advocacy on their behalf.

Demutualization of exchanges is widely viewed as increasing the conflicts of interest that have always been present in self-regulation. Managing conflicts between the business and regulatory functions is the most significant regulatory and governance issue to arise with the advent of for-profit exchanges. SROs and supervising regulators use a wide range of approaches in managing conflicts of interest. The issue has been addressed mainly by reducing the regulatory responsibilities of exchanges, by creating independent SRO units to handle regulation functions, or by introducing other changes designed to manage the conflicts.

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[36] SIA comment letter to SEC regarding SRO governance and transparency proposal, March 9, 2005, pp. 3–4. http://www.sec.gov/rules/concept/s74004/melackritz030905.pdf.

An exchange SRO's regulatory mandate may conflict with the interests of several groups: (1) shareholders' interests in business development and profitability; (2) members' interests as major customers and, in some cases, owners of the SRO; and (3) listed companies' interests as major customers. Intensive competition among exchanges has exacerbated each type of conflict: competition for investment, trading business, and listing business has grown globally and is also intensive in some domestic markets. Table 4-3 summarizes the main conflicts of interest that arise.

IOSCO outlined a number of conflict-of-interest issues in papers released in 2001 and 2006 (IOSCO Technical Committee 2001, 2006b). IOCSO's concern is "risks to the maintenance of a proper balance between an exchange's public interest obligations and its commercial interests". (IOSCO Technical Committee 2006b: 6). It noted that for-profit exchanges have proven to be much more disciplined cost managers than mutual exchanges, so they are likely to cut resources for regulation in order to reduce costs. The structure of most exchange SROs, where regulation departments depend on funding from business operations, increases the conflicts. The conflicts with members are aggravated for any SRO that is overly dependent on revenues or fees from a small number of large members.

In its 2004 review of the corporate governance of SROs, the SEC (2005) cited fears about increasing conflicts. The SEC suggested the following:

- Consolidation in the securities industry and competition among exchanges has exacerbated conflicts with members.
- SROs might reduce regulatory scrutiny to attract business as competition for order flow intensifies.
- Competition for listings might lead to lower listing standards.
- Conflicts with shareholders are sharper where markets compete intensively.

Arguably, however, most of the conflicts have always existed in self-regulation. Exchanges also argue that the conflicts with shareholders' interests are less of an issue than traditional conflicts with members because exchanges have a strong business incentive to maintain high standards to protect their reputation and "brand."

Conflicts of interest are obviously greater for an SRO that is responsible for a wide range of regulatory responsibilities. An exchange that is responsible for market regulation, member business conduct, listing, and clearinghouse operations obviously has greater conflicts to manage than an exchange that has only limited market surveillance and listing functions. This reasoning is behind the reduction in regulatory responsibilities of many for-profit exchanges.

Management of Conflicts of Interest

SROs and supervising regulators use a wide range of approaches in managing conflicts of interest. In IOSCO's 2008 Implementation Report, its standards on implementing its principles for self-regulation state that (1) the law or regulator should ensure that potential conflicts of interest at an SRO should be avoided or resolved, and (2) an SRO should have procedures in place to address potential conflicts of interest.

ICSA (2006a), a group of independent SROs, developed a set of "Best Practices for SROs" in managing conflicts of interest. They include the following:

- An SRO should ensure that market participants and qualified independent directors have a meaningful role in its governance.
- An SRO should establish appropriate structures, policies, and procedures to ensure that potential conflicts of interest between its regulatory and commercial or advocacy activities are appropriately managed. ICSA suggests the following:
    - Use firewalls to separate regulatory operations from business or advocacy operations.
    - Have a separate governing body to oversee regulatory operations.
    - Separate organizational structures for regulatory and business operations.
    - House regulatory operations in separate and secure premises.
    - Contract out all or part of the SRO's regulatory responsibilities.
    - Establish policies and procedures on management of conflicts of interest.

The government of Hong Kong SAR, China, working with the SFC, implemented a comprehensive set of conflict management safeguards when it merged and demutualized Hong Kong SAR, China's exchanges in 2000. The safeguards include the following:

- The exchange and its directors have a legal duty to act in the public interest, and to place the public interest first in the event of any conflict between it and the exchange's business interests.
- The maximum shareholding is 5 percent unless exempted by the SFC.
- The board of HKEx has public interest directors, who are appointed by the Hong Kong SAR, China government.
- The SFC has a power of direction over the HKEx where conflict arises in regulation.
- The exchange maintains strict separation of its regulation and risk management department from business units.
- The HKEx has established a Conflicts Committee to address conflicts that arise in relationships with listed companies.
- The SFC can assume the exchange's regulatory responsibilities in any case where it is not satisfied that a conflict can be managed.
- The SFC administered HKEx's self-listing process.
- The chief executive of Hong Kong SAR, China must approve HKEx's chairman, and the SFC must approve HKEx's CEO and chief operating officer.

Several approaches to managing or reducing conflicts of interest are discussed next.

Corporate governance

As discussed in the second section of this chapter, supervision of corporate governance is one of the primary means that securities regulators worldwide use to ensure that SROs meet their public interest and regulatory responsibilities and manage conflicts appropriately. In the EU, the Markets in Financial Instruments Directive (MiFID) requires all regulated markets to have governance arrangements to identify and manage the potential adverse consequences of any conflict of interest between the regulated market, its owners or its operators, and the sound functioning of the market.

Transferring regulation responsibilities

Chapters 2 and 3 discussed the trend of transferring responsibilities for regulation. For instance, the UK government transferred the "Listing Authority" function from the LSE to the FSA in 2000 because it did not believe that an exchange that competes with other exchanges for listings should have authority to establish general standards for public listing of issuers.

In Hong Kong SAR, China, the SFC assumed responsibility for supervision of broker-dealers (member regulation) from the exchanges in 2000 as part of an overall government policy to consolidate and demutualize Hong Kong SAR, China's exchanges. The HKEx's remaining self-regulatory role is to supervise compliance with its trading rules, which are mostly business or operational rules. The SFC has been primarily responsible for market conduct and trading abuses since 1990.

Before Nasdaq was spun off from the NASD, the two organizations concluded, with the SEC's encouragement, that conflicts were much better managed if the business was separated from the regulator. They decided that Nasdaq would be more successful as a business and the NASD more successful as an SRO if their roles were separated.

Organizational separation of business and regulation

The organizational separation of the regulatory and the business operations of an exchange is now established as a best practice for exchanges that retain significant SRO functions. Some exchanges have established separate subsidiary companies with independent boards of directors and management to house SRO operations, including the NYSE and ASX.

In 2007, France's Association française des marchés financiers (AMAFI) surveyed 41 organizations for IOSCO's SRO Consultative Committee.[37] The survey covered 25 exchange and 16 member associations or CSDs. It showed that of 31 organizations that operated or regulated markets, 21 formally separated their commercial and regulatory activities, and 5 did not. (The others did not respond, perhaps because they had no commercial activities.)

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[37] AFEI/VD – 29/04/08 – SRO Consultative Committee Working Group on Self Regulation (unpublished). The Association française des marchés financiers (AMAFI) is the representative body for professionals working in the securities industry and financial markets in France. AMAFI has more than 120 members. Most are investment firms, but some are credit institutions authorized to provide investment services. AMAFI's primary mandate is to represent the interests of its members.

The survey covered six self-regulatory and trade association organizations such as ICMA, JSDA, and KSDA (now KOFIA). Of these, only two had separate reporting lines for the two functions, and none had separate entities or premises.

Of the 25 exchanges, 17 reported they had formal procedures for managing conflicts of interest, and the government regulator reviews the procedures of 15 of the 17.

NYSE Regulation's independent status was outlined previously. Similarly, the Tokyo Stock Exchange (TSE) established a TSE Regulation subsidiary. ASX established ASX Markets Supervision in 2006 to oversee supervision of issuers, participants, futures, and prudential risk and enforcement. The ASXMS board has three directors from the ASX board and two independent directors. As noted earlier, Brazil's Bovespa recently created a new independent entity, now BM&FBovespa Market Supervision, to perform SRO functions.

Other exchanges have addressed conflicts by formally separating management of regulation functions from business operations within a single corporate structure. This group includes HKEx, which has strong firewalls between the business and the Stock Exchange's listings department and the Nasdaq OMX Nordic Exchanges in Scandinavia.

Several independent SROs have organizationally separated their regulatory and trade association operations. Arguably, the best practice is to formally separate the roles in different organizations. But like exchanges, some associations perform dual roles with separate governance and organizational structures for regulation functions. The AFEI survey cited above showed that six industry associations have both self-regulatory and trade association functions, including the JSDA, KOFIA and ICMA.

In Japan, the JSDA remains a dual-purpose institution, but in 2004, it adopted a new organizational structure to separate the governance of its SRO operations. An independent Self-Regulation Board is entrusted with decision making on SRO matters. Its 11-member board consists of the JSDA chairman, the vice chairman in charge of regulation, five representatives of member firms, and four public members. Separate departments conduct industry association and SRO operations. Finally, an independent board that includes public representatives oversees JSDA's self-regulatory operations.

In Canada, the IDA (now IIROC) became a pure SRO in 2006 after splitting off its trade association arm into a new organization.

Conflicts and supervision committees

To reinforce the independence of SRO functions, a number of SROs have created board-level regulatory oversight committees. Their job is to supervise the SRO's regulation programs and to ensure the independence and effectiveness of the SRO department, particularly in light of the conflicts of interest previously noted. Several US exchanges have established such committees, which typically have a majority of independent directors.

Other exchange SROs have created conflicts committees to address any conflicts between a listed exchange and listed companies that it regulates. This appears to be an emerging best practice among demutualized exchanges. Such committees are in place at HKEx, SGX and TMX. The committees generally review any dealings with companies that the exchange either competes with or has business dealings with to ensure that listings rules are administered in an unbiased manner, and they report their assessment to the regulator. In Hong Kong SAR, China, issues are referred to the SFC if a conflict could even be perceived—for example, a listing application from a company that provides back office services to the HKEx.

Regulatory oversight

Stronger supervision of SROs by government regulators has been an almost universal response to greater conflicts at exchange SROs, with a particular focus on reviewing how exchanges manage conflicts of interest. This supervision includes both the policies and procedures adopted to address conflicts and the handling of specific cases of conflict. IOSCO has suggested that if an SRO has a conflict of interest, the regulator should assume responsibility for the investigation of a matter.

Regulators and listed exchanges have also adopted special procedures for self-listing that address conflicts of interest in processing listing applications, monitoring an exchange's compliance with continued listing rules, and surveillance of trading in an exchange's stock.

International experience demonstrates that there is no clear right or wrong approach to managing conflicts of interest. For-profit markets are still a recent phenomenon, and both exchanges and regulators are working through the issues as they unfold. Various responses to conflicts are still being tested.

6. SRO Oversight and Role of the Regulator

This chapter discusses the nature of a government regulator's oversight of a SRO's operations.

Concept of Oversight

IOSCO emphasizes the need for effective oversight of an SRO by supervising regulators. IOSCO's principle 7 states: "SROs should be subject to oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and responsibilities". (IOSCO 2003: 12).

The supervising regulator must approve SROs – including exchanges – in almost all jurisdictions. This authority usually means that an SRO must be licensed or "recognized." Once an SRO is licensed, it is subject to ongoing supervision to ensure that it continues to meet the terms of license and its legal obligations.

For example, in the UK, exchanges and clearinghouses must be recognized by the FSA. The FSA issues a recognition order that sets out the terms and conditions of recognition. Failure to observe the terms and conditions could lead to withdrawal of recognition, which means that the organization is not approved to operate.

The fact that the great majority of SROs, including exchanges, are virtual or de facto monopolies in their national markets reinforces the importance of licensing and supervision. In practice supervision is the primary oversight tool because withdrawing a license to operate is not practical, especially if the exchange is the only or the primary market in a jurisdiction. SRO oversight should ensure that an SRO does not act in an anti-competitive or unfair manner. SROs should act impartially in making decisions on membership or access, when interpreting SRO rules, and in administering enforcement functions. IOSCO states that the professional standards for an SRO should be similar to those of a regulator.

SROs are licensed and subject to oversight because they provide essential infrastructure for capital markets. In most cases, a market participant – whether an investor, issuer, or intermediary – must obtain access to this infrastructure to participate in the market. Another factor is that SROs have public interest responsibilities, as explained in chapter 5. IOSCO (2006a: 6) states with reference to exchanges:

> Most jurisdictions regard the proper functioning of their exchanges as critical to the efficient operation of their capital markets. They therefore see a strong public interest in exchanges operating their markets in a way that promotes market efficiency and commands market confidence… The fair and efficient functioning of an exchange is of significant benefit to the public. The efficiency of the secondary market in providing liquidity and accurate price discovery facilitates efficient raising of capital for commercial enterprises, benefiting both the wider corporate sector and the economy as a whole. The failure of an exchange to perform its regulatory functions properly will have a similarly wide impact.

Oversight includes processes such as periodic reviews or inspections of the SRO, reporting requirements, review of corporate governance arrangements, and review or approval of SRO rules. The purpose of an oversight program is to ensure that an SRO is meeting its legal and regulatory responsibilities and is capable of performing its regulatory functions effectively. Supervision of an SRO by a public authority is needed to ensure the SRO is accountable and to ensure that conflicts of interest are managed appropriately.

Oversight means supervision – it should not extend to directing an SRO's affairs or managing its operations, which would compromise the SRO's independent governance and the benefits of self-regulation.

Most regulators have strengthened oversight of exchanges and SROs in the past decade, in part because of the commercial nature of exchanges today. The nature and strength of an oversight program for a particular SRO depends on factors such as the SRO's mandate, the scope of its regulatory responsibilities, and the types of conflicts of interest it faces. In the case of an exchange, its size and market share are also important. Operation of oversight programs now requires a significant level of resources – at both the regulator and SRO levels. Some SROs believe that the level of scrutiny has become excessive and amounts to continuous monitoring of the SRO's performance of its functions, rather than oversight. Obviously such costs can adversely affect competitiveness.

In some countries, the regulator has the power to recommend, or to require an SRO to adopt, specific rules if the SRO does not do so voluntarily. In the US, the SEC has additional powers to abrogate, add to, or delete from existing SRO rules.[38] Use of such powers is rare; instead, government regulators and SROs usually discuss regulatory initiatives on a regular basis. If a regulator believes that an SRO should take a specific action or adopt a certain rule, it usually advises the SRO of its views informally. The two organizations often discuss what the most effective approach to an issue is and try to reach agreement on a common view.

In most countries, all SRO rule changes must be filed with and approved by the regulator before they can become effective. SRO rule proposals must usually be issued for public comment before they are finalized. This process provides transparency and enables stakeholders to make submissions on proposed rules. The process needs to be meaningful in order to be beneficial. Often the World Bank finds that the consultative process is more form than substance.

IOSCO (2008: 29–36) has established standards that an SRO should be required to meet as a condition of approval. The standards listed in table 6-1 should be seen as ongoing obligations for an SRO, not just as standards for the initial approval or licensing of an SRO.

[38] The CFTC's powers over futures exchanges are more limited.

Elements of Oversight Programs

An oversight program has the following main objectives:

- Ensure that the SRO has appropriate corporate governance policies and procedures and that it observes them.
- Ensure that the SRO's rules cover its regulation responsibilities and are fair and balanced.
- Assess whether the SRO's regulation responsibilities and risk management responsibilities have been met, including that its systems and processes meet appropriate standards. The regulator should ensure that the SRO has effective compliance, supervision and enforcement programs.
- Ensure that identified conflicts of interest have been addressed.
- Identify any shortcomings or needs that require a response from the SRO.

In addition, the supervising regulator should ensure that an SRO continues to meet all the conditions of its license and other obligations imposed on the SRO by law or regulation.

Table 6-2 sets out the main processes that regulators use in oversight programs, as well as the purposes of each process.

The approach to the oversight program and the basic procedures involved are often agreed and documented in an MOU between the supervising regulator and the SRO.

7. Implications for Emerging Markets

The primary purpose of this paper is to explain the nature of self-regulation and to address the potential utility of self-regulation in emerging markets. The efficacy of self-regulation in a particular market depends on that market's circumstances and particular characteristics. Self-regulation should neither be adopted automatically nor rejected out of hand. This chapter examines the implications of the issues and trends outlined in this paper for the use of self-regulation in emerging markets.

Considerations in Emerging Markets

Developing countries, in particular those aiming to develop capital markets that are competitive regionally or globally, are being pressed to improve standards of conduct in securities markets and to build more effective capacity to regulate and supervise their markets. To this end, some are evaluating whether self-regulation can play an important role in raising standards of conduct and supervision. Other developing countries have adopted the European model, which minimizes the use of formal SROs, in favor of a strong statutory regulator. Even in Europe, however, the regulators are seeking to make better use of industry knowledge and input in implementing regulation. Therefore, emerging markets should consider how best to leverage private sector participation in their regulatory systems.

The international trends described in this paper demonstrate that the conventional models of self-regulation that existed 20 or more years ago have changed dramatically. Where SROs are still relied on, the concept of an SRO as a closed club controlled by member firms in the traditional broker community is no longer valid. SROs have evolved into organizations that must be responsive to the interests of a wider range of stakeholders and that are more publicly accountable.

Arguably, the main reason to consider using self-regulation is that it enables additional resources and expertise to be applied to regulation. In large and complex securities markets, even large and well-resourced regulatory authorities find it a challenge to set all the rules and standards and to deploy thorough supervision programs that will monitor compliance in all activities. This challenge applies to both developed and emerging markets. It is the basic rationale for the historical reliance on self-regulation in the US regulatory system.

SROs can enhance regulation when they complement and supplement the government regulators' programs and resources by:

- *Adopting rules that target specific types of activity and specific products*. For example, futures and options exchange SROs have detailed anti-manipulation rules to protect market integrity in their markets.
- *Developing sophisticated risk management policies and systems.* SROs often govern specific industry activities. For example, many exchanges provide central counterparty (CCP) services to address counterparty risk. Clearing, settlement, and depository agencies have extensive rules and policies that are designed to control settlement risk.

- *Implementing comprehensive surveillance and supervision programs.* A SRO can ensure detailed monitoring of the business of financial firms and activity on markets. Examples include inspections of members' corporate governance, business conduct, internal controls, and financial compliance, as well as market surveillance of trading on exchanges or OTC markets.

In emerging markets that are considering expanding the role of self-regulation, the authorities should understand that self-regulation can work only if the regulators and the industry share a genuine commitment to raising standards using a two-tier system of government and private regulation. This commitment requires a clear division of responsibilities between the two levels of regulation and a reasonable degree of independent governance and management at the SRO level. This approach may be difficult to achieve in countries with little tradition of self-regulation. An SRO should not be considered a form of "private arm" of the regulator; it must have sufficient independence to be responsive to the needs of its stakeholders.

On the other hand, a weak statutory regulator with a strong SRO is neither appropriate nor sustainable. In some emerging markets, the local exchange has been more powerful than the regulator, which has not produced adequate regulation and supervision. An SRO is not a substitute for a strong regulator, and governments should not rely on SROs because of a lack of resources or political support for strengthening the regulator. An SRO can supplement the regulator's resources to enhance regulation, but it should not be used as a substitute for a properly resourced regulator. Building a strong public regulator as the primary regulatory body, which can effectively oversee local exchanges and SROs, is essential to meeting international standards.

Although reliance on exchange SROs is declining in the world, the local exchange remains a viable option to carry out SRO responsibilities in many emerging markets, especially if the exchange is not a demutualized or commercial entity. Exchanges often have existing regulatory capacity, as well as the resources, knowledge, and incentive to improve regulation and market conduct. If conflicts of interest are an issue, the exchange could concentrate on trading rules and market surveillance, leaving supervision of securities dealers to the government regulator. As this paper discusses, many developed markets also use other methods of managing conflicts of interest.

Where a valuable role for a formal SRO is not realistically achievable, or when the size of the market does not justify the cost of a two-tier system, the European model of creating a government regulator with independent operational authority is preferred. It is more efficient than a two-tier system. The resources required to develop a formal SRO are worth investing only if the SRO would have sufficient responsibilities and authority to contribute significantly to raising standards of conduct through continuing education and quality of regulation. Under the government regulator model, a form of self-regulation can still add value to the system through the work of industry associations representing securities dealers and other market participants. As this paper discusses, such organizations can help raise standards and improve compliance by adopting codes of conduct, providing guidance on implementing rules, and influencing regulatory developments.

In summary, there is no single "right" approach to the use of self-regulation in capital markets. International experience teaches that different approaches to self-regulation are workable, and also that a formal SRO is not a necessary feature of a regulatory system. Based on experience in many jurisdictions, a set of conditions that would support successful reliance on self-regulation in a capital market may be identified. The greater the number of the following conditions that apply, the greater is the likelihood that self-regulation would be useful and credible:

- Securities markets are large and complex enough to benefit from private regulatory bodies that provide additional resources and specialized expertise, and the markets are large and active enough to support the extra costs involved.
- The market has a tradition of reasonably effective self-regulation, and SRO(s) have knowledgeable staff members and a useful regulatory infrastructure to offer.
- Government and statutory regulators believe that relying on self-regulation is appropriate, as a matter of public policy.
- Government and statutory regulators agree to give the SRO(s) a reasonable degree of independence in governing and managing its affairs, including in setting its rules, policies, and programs.
- The government regulator's and the SRO's responsibilities are clearly delineated to minimize overlapping authority and duplication of activities.
- The statutory regulator is capable of providing effective oversight of the SRO(s) and ensuring that conflicts of interest are managed appropriately.
- Sufficient powers to regulate markets and market participants are (or can be) granted to SROs by law or regulation (which may be supplemented by contracts with members).
- The securities industry supports self-regulation and is willing to participate in its governance and administration, to comply with SRO rules, and to fund the extra costs involved in an additional layer of regulation.[39]
- The exchanges support their continued responsibility for specific regulatory functions, or alternatively they will support the creation of an independent SRO to carry out specific responsibilities.

Of course, the preceding list reflects an ideal set of conditions to support the utility and success of self-regulation. Self-regulation has obviously been successful in many markets that have not met all of the criteria listed. Indeed, many developed markets that have a history of self-regulation did not meet a number of those conditions in the past and do not meet all of them today. Relying on self-regulation can be appropriate in less than ideal conditions, as long as most of the conditions are met to a reasonable extent. If many are not present, it might be possible to build an SRO incrementally, starting with a narrow range of responsibilities.

[39] Securities firms or other participants should not see self-regulation as a means to reduce the effectiveness of regulation and to "get the regulator off our backs." Rather, they should see self-regulation as a means of delivering more practical, responsive, and efficient regulation.

Impact of the Financial Crisis

As noted in the Introduction chapter, the recent financial crisis and its aftermath have called into question the effectiveness of financial regulation systems. In particular, the crisis has raised serious issues about the reliability of regulation systems that place a significant degree of reliance on financial institutions' own corporate governance – including internal supervision and compliance systems and risk management systems – to ensure compliance with laws and regulations and the financial integrity of their institutions.

In many countries, the cost of government "bailouts" and the need for significant government intervention in the financial system have raised demands for regulatory reform. Potential reforms may take several forms, ranging from (1) adoption of stronger laws and regulations to (2) changes in the structure of regulatory systems (including consolidating financial regulators), (3) improved governance and accountability of financial regulators, and (4) stronger supervision of compliance with laws and rules by financial institutions.

The crisis has demonstrated that sophisticated compliance systems and risk controls failed to address the risk of holding complex instruments, such as credit derivatives, and of selling them to clients. The reasons for the failures are still being debated, but the fact that they occurred raises troubling questions about the effectiveness of both firms' internal governance and regulatory supervision of those firms. The types of problems that have arisen are partly the result of a failure to adequately supervise financial firms, failures by both firms and their regulators to fully understand and control the business and product risks that firms assumed, as well as firms' failure to properly manage those risks.

The effectiveness of principles-based regulation in certain areas is currently under intense critical scrutiny to assess whether more prescriptive rules are needed to ensure that appropriate minimum standards of supervision and risk management are adopted. Similarly, "light touch" regulation is no longer in favor. Regulators' reliance on the perceived effectiveness of major financial institutions' internal supervision and risk management systems led regulators to adopt less frequent and more limited "risk-based" direct examination of firms' operations. More limited types of regulatory examinations and supervision may have contributed to the assumption of bigger risks by financial firms, to weaknesses in firms' internal risk management systems, and to the regulators' failure to identify the nature and scale of the systemic risks involved.

Because many of the failures involved banks, investment banks, and insurance firms that were mainly regulated by banking supervisors and other government regulators, or involved financial products that were not regulated by securities regulators, the direct effect of the crisis on securities regulators in general – and on self-regulation in particular – has been limited. Furthermore, exchange SROs are generally not involved in the OTC credit instruments that undermined the financial positions of many institutions. Exchanges do not trade, and generally are not involved in regulating, those OTC instruments.

Nevertheless, given the need for government support or intervention to avoid the failure of a number of major global investment banks and the apparent regulatory failures, the question of how self-regulation will be affected naturally arises. Demands for stronger financial regulation and consolidation of financial regulators could reduce reliance on self-regulation if the conflicts of interest inherent in self-regulation and the decentralization of supervision that a self-regulation system produces cause authorities to concentrate more powers in government regulators.

Conversely, the crisis may be an opportunity for SROs to demonstrate how they can contribute to stronger regulation of securities firms. Since the financial crisis revealed a need to bolster regulatory resources and capacity, that need could lead to increased reliance on self-regulation. Even with expanded budgets, few government regulators are likely to obtain the resources and expertise that will be necessary to significantly expand supervision of securities firms. Where SROs have the necessary jurisdiction, they can play an important role in ensuring sound supervision of regulated firms.. The crisis reinforces the need for strong, knowledgeable front-line regulators that are very familiar with the firms and that have the resources to carry out thorough, regular examinations of the firms.

As front-line regulators, many SROs have developed extensive and sophisticated supervision and field examination programs that aim to continuously assess their members' compliance and risk levels in a range of operations. Depending on an SRO's responsibilities, the programs may cover securities firms' corporate governance and supervision responsibilities, risk management systems, business conduct, sales practices, trading conduct, and financial compliance. SROs that have developed such capacity are arguably natural candidates to contribute to stronger regulation by developing more stringent supervision and examination programs and by increasing resources invested in them to increase the depth and frequency of supervisory reviews.

By reassessing the adequacy of SRO rules, SROs can also support better regulation in areas traditionally covered by their rules. SRO rules are often more detailed than securities regulations because they cover a narrower range of products, trading mechanisms, and compliance issues. In some cases, more-prescriptive rules may be required, while in others more extensive guidance may be adequate to ensure that the industry adopts appropriate new, higher minimum standards.

To the extent that government regulators continue to believe that reliance on securities firms' internal supervision and compliance systems is appropriate or necessary, one can ask how the design, documentation, and implementation of those systems can be better supervised to better protect the financial system and investors. SROs can play a direct role in this effort through their rules on supervision requirements and examination programs that vet firms' policies and procedures and assess how effectively they are being implemented.

By encouraging trading on exchange platforms or settlement through recognized clearing agencies, financial authorities are exploring ways to reduce the risk in trading complex OTC derivative instruments that were the source of systemic risk and many firms' financial difficulties. On the trading side, exchanges can provide price transparency and discovery that has been lacking in OTC markets. However, many OTC transactions are not suitable for exchange trading because of their specialized or customized nature. Customized derivatives can be reported, cleared, and settled through organized clearing corporations or CSDs that not only provide a central counterparty that guarantees trades, but also impose sophisticated risk management and control systems. Many centralized counterparties are owned by exchanges. Several exchanges, including the CME and the Intercontinental Exchange (ICE), have launched settlement services for credit default swaps. The self-regulatory roles of exchanges and CSDs are, therefore, expanding in areas such as the supervision of credit derivative trading, the size of firms' risk positions in securities and other financial instruments, and the settlement risk in such instruments.

Exchanges have frequently promoted the benefits of the price transparency and trade monitoring provided by organized markets. They have warned of the dangers posed by widespread trading of OTC instruments that lack basic trade reporting, price transparency, and clearing mechanisms. Regulators mostly ignored such warnings, often viewing OTC markets (in particular derivatives markets) as a form of competition and innovation, rather than as a source of increased risk that needed to be monitored. Large, leveraged holdings of OTC instruments that are not reported to, or monitored by, any regulatory authority or central agency pose huge systemic risks. Now that the size of those risks has been made painfully clear, opportunities clearly arise for exchanges and SROs to provide facilities that will enable reporting and monitoring of activity in such instruments, if not to trade them directly. At a minimum, exchanges and CSDs will be able to offer their extensive expertise in risk management of clearing and settlement systems to authorities who are seeking better ways to monitor and control activity in OTC markets.

In summary, the regulatory lessons from the financial crisis will require a concerted response. Government alone cannot provide an effective response. Active engagement of market participants—in particular through industry organizations such as SROs and other industry bodies with some self-regulatory capacity—will be necessary to craft practical regulatory responses and to act effectively on policy changes. Therefore, a significant opportunity exists for SROs and industry bodies to play a constructive and increased role, especially if they take their public interest mandates seriously with the objective of becoming part of the solution.

Regulatory Reform: Substantive Policy Issues

When one considers introducing an SRO system or reforming an existing system, a number of important issues must be addressed. The concerns include both (1) substantive policy issues on the design of the regulatory system and (2) process issues that arise in implementing regulatory reform.

Policy makers should consider the following issues in addressing whether self-regulation is appropriate for their markets and, if it is, how the system should be designed.

- *Strategy for capital markets*: What should the government's strategy be for developing the nation's capital markets? Any strategy should consider the competitive position of the capital markets both regionally and internationally. A strategy should encompass the following:
    - How capital markets can best support economic development
    - Fostering market development, competition, and innovation to better meet the needs of issuers and investors
    - Raising standards of regulation and conduct to ensure that investors and other participants are treated fairly, and to improve market integrity

- Achieving an appropriate cost level for regulation of capital markets
- Ensuring that the nation's exchanges and market institutions have the business focus, competitive positioning, and governance standards required to succeed in their missions.[40]

- *Commitment to self-regulation***:** Do investors and market participants have a sufficient degree of confidence in self-regulation to make the system viable, both today and going forward? Are members of an SRO committed to the concept of self-regulation, and are they prepared to invest the requisite time and resources? Do the authorities believe relying on self-regulation in capital markets is appropriate?

- *Size and complexity of capital markets*: Does the capital market need, and can it support, two layers of regulation?

- *Effective and efficient regulation*: What approach do the authorities and the industry believe will deliver the most efficient and effective regulation of the nation's capital markets? Do the benefits of self-regulation outweigh the potential extra costs and disadvantages? The issue of regulatory efficiency and costs is significant, especially given global competition across markets. Finally, can the conflicts of interest that arise be managed appropriately?

- *Regulatory priorities and key risks*: The authorities and capital market participants should determine and agree on what regulatory issues and market risks need to be prioritized. Does the existing system adequately address those issues and manage those risks? If not, how should the system be reformed to respond more effectively to the issues, and what role should an SRO play?

- *Fairness and consistency*: In choosing a particular SRO structure, the fairness and the consistency of regulation of different segments of the capital markets and financial services industry need to be maintained. This means that players in different segments of the industry that offer similar services should be treated equally.

- *Funding***:** Who should pay for the cost of regulation? Market participants fund government regulators to a significant degree in most countries. Which groups of market participants should fund a self-regulatory system, and how should the costs be allocated among groups or members of a group? Those issues are invariably contentious.

- *Legal framework*: Does or will an SRO have sufficient powers to perform the responsibilities allocated to it? If not, is changing the law applicable to SROs practical? Most SROs today have statutory authority to perform their regulatory responsibilities, but an SRO can also obtain or reinforce jurisdiction by contract with its members.

[40] Of course broader factors that are beyond the control of a securities regulator affect capital market development and policy, such as macro-economic conditions, the adequacy of the legal system, i.e. legislation, the legal profession and the judiciary, social conditions, and so on.

Because SROs are private bodies, some countries' civil code legal systems limit an SRO's rule-making authority or limit the degree to which a regulator can delegate activities to an SRO. Such obstacles may be addressed by relying on an SRO mainly to supervise compliance with regulations, by designing effective working agreements, or through MOUs to clarify the SRO's role and working relationship with the regulator.

- *Supervision of an SRO*: Does the supervising regulator have the powers and the capacity to effectively oversee SRO operations?

In some cases a more limited role for self-regulation may be appropriate; for example an SRO that is mainly responsible for supervision of compliance with regulations set by the regulator.

Comparative Advantages of Regulatory Institutions

As one designs a regulatory structure, an important question is this: what body is best positioned to perform a given responsibility? A regulatory system is more efficient if responsibilities are assigned to the body that has the powers, resources, skills, and knowledge to perform them most effectively. If one uses this framework of analysis, the assets of an SRO or similar organization (such as an industry association) should be compared to the statutory regulators' assets as they pertain to specific regulatory activities.

The first question is whether the SRO has, or can obtain, sufficient skills, resources, and capacity to perform its responsibilities effectively. If sufficient capacity does not exist or cannot be developed, building a regulatory structure that relies on SROs will not yield the desired result.

Factors that should be considered include the following:

- Which body has the legal jurisdiction to make rules and to supervise the market participants involved?
- Which body has the power and authority to investigate, discipline, and impose effective sanctions on the market participants involved? Most SROs have the power only to collect evidence from and to discipline member firms and their employees.
- Do significant conflicts of interest arise? Conflicts of interest always exist in self-regulation systems but vary depending on the type of regulation and institution involved.
- Is there an existing self-regulatory structure that can serve as a foundation for the system?
- Who possesses the knowledge, expertise, and skills required to regulate the activity in question?
- Which body has access to the information and data needed? For example, would an SRO have access to all relevant records and information, or could an SRO obtain the necessary access?
- Which body has the necessary regulatory tools (including information technology tools)?
- Which body has the funding and resources to do the job?

Regulatory Reform: Process Issues

When one decides whether to initiate regulatory reform, significant process issues must also be considered, which include the following:

- *Design risks:* The authorities should articulate the key drivers for changing the current approach to self-regulation and should assess the importance of achieving the objectives of reforming the system. Those objectives should be compared to the risks involved in designing changes to the system. Major changes carry risk, and the broader the scope of the planned changes, the greater the risk of problems or even failure. The major risks are:
    - Increased conflicts of interest
    - Ensuring the SRO operates with real and effective independence
    - The potential for "regulatory capture" of the SRO system by regulated firms or by one powerful segment of the industry
    - Inadequate corporate governance or management
    - Failure to build effective and capable new organizations
    - Disruption of standards of regulation and supervision during the transition period because of organizational conflict and uncertainty
    - Reduced standards of regulation and supervision under the new system
    - Overloading the SRO system with new responsibilities that it does not have time to build the capacity to address
    - Excessive interference by the statutory regulator in the governance and operation of SROs
    - Failure to design the new system properly, leading to excessive duplication of activities and cost.

- *Transitional risks:* Transitional risks are temporary risks that arise from the process of implementing changes in an organization or, in the case of regulatory systems, among a group of organizations. Whenever structural changes are made to a regulatory system, important transitional issues must be addressed. These include ensuring that:
    - Regulatory processes continue uninterrupted, especially supervision of markets and intermediaries.
    - Regulated persons remain within the legal jurisdiction of a regulator at all times.
    - Open files and cases are transferred to new bodies without loss of jurisdiction.
    - The transition to new management and governance is as seamless as possible.
    - Human resources issues are addressed, including maintaining staff morale, retaining staff, and addressing the contractual rights of any staff members who are transferred.
    - Dispute resolution mechanisms are agreed to address any unforeseen issues that arise during the transition period.

  If major changes are contemplated, the industry and the authorities might consider taking an evolutionary or staged approach to implementation so they minimize the transitional risks involved. In addition, the approach to reforming the SRO system should be designed to mitigate transitional risks. For example, if maintaining high standards of regulation during the transition is considered to be a big risk, develop a plan to minimize the risk. This plan might consist of arrangements to ensure continuity in managers and staff members, for instance.

A project management approach should be taken when making any significant changes in the system. A detailed action plan is required that covers all steps that each body involved must take. Project management and execution of action plans will require dedicated staff members at various institutions, probably supported by expert advisers and professionals such as legal counsel.

- *Stakeholders' views:* In considering any changes to the present system of regulation, it is important to understand and consider the views of the stakeholders. Stakeholders include a broad range of participants:
    - Intermediaries (securities dealers, investment banks)
    - Retail and institutional investors
    - Government and statutory authorities,
    - Exchanges, ATSs, clearing agencies and any existing SROs
    - Industry associations.

  What is the degree of support for change compared with the resistance to change? Building consensus among the stakeholders on a "common vision" for the regulatory structure is desirable.

- *Legal and regulatory risk*: If institutions' regulatory responsibilities are changed in the new structure, plans to minimize legal and regulatory risk are needed. Transfers of responsibilities will likely require (1) transfer of rules from one body's rulebook to another's, (2) transfer of responsibility for supervision programs, (3) transfer of experienced managers and staff, and (4) transfer of infrastructure including information technology systems and tools. Agreement must be reached on the precise division of responsibilities, and documented in legal agreements or MOUs. Suitable arrangements will be necessary for the transfers of those responsibilities and assets, as well as for handling of open files and cases.

- *Regulatory approvals:* The plan must identify the required legal and regulatory approvals. A formal application process should be developed for approval of changes in regulated bodies' structures, responsibilities, and rules. The process must cover developing new or revised terms and conditions for licensing or recognizing SROs and exchanges. As noted earlier, IOSCO has published a framework for licensing conditions. An SRO applicant should be required to establish that it has, or is capable of putting in place, a sound corporate governance system, effective management, and the institutional capacity to fulfill its regulatory responsibilities.

Appendix A

Outline of Typical SRO Responsibilities

The functions traditionally covered by full-fledged exchange SROs cover the four areas outlined in this appendix. An independent SRO does not have listing rules and might not be responsible for market regulation.

1. **Member (Broker-Dealer) Regulation**

    1.1 Membership or registration of members or participants
    1.2 Licensing or registration of individuals
    1.3 Compliance, supervisory, and internal control policies and procedures
    1.4 Capital adequacy regulations (net capital and margin requirements)
    1.5 Financial examinations
    1.6 Books, records, and accounts requirements
    1.7 Business conduct and sales compliance rules
    1.8 Duties to clients
    1.9 Compliance examinations
    1.10 Customer complaint handling and dispute resolution

2. **Market Regulation**

    2.1 Qualifications for access to trading by firms and traders
    2.2 Market conduct rules (market integrity and ethical standards)
    2.3 Trading rules (operational and trading system "business rules")
    2.4 Market quality rules (for example, market-maker obligations)
    2.5 Market surveillance
    2.7 Market investigations

3. **Listings Standards and Rules**

    3.1 New listing standards
    3.2 Continued listing rules
    3.3 Corporate disclosure rules
    3.4 Corporate governance rules
    3.4 Shareholder protection rules (for transactions that affect public or minority shareholders)
    3.5 Reporting requirements

4. **Enforcement**

    4.1 Formal investigations
    4.2 Emergency powers
    4.3 Disciplinary procedures

Exchanges that operate CSDs or clearinghouses also have clearing and settlement rules, risk management requirements, and dispute resolution and remedies for failures.

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Glossary

This glossary lists organizations and other abbreviations or acronyms used in the paper.

Organizations

This paper uses the abbreviations or acronyms listed below for organizations. The following color pattern denotes the type of organization:

Exchange SRO	Securities regulator
Independent SRO	Industry association

AMAFI	Association française des marchés financiers (France)
AMF	Autorité des marchés financiers (France)
AMV	Autorregulador del Mercado de Valores (Colombia)
ANBIMA	Brazilian Financial and Capital Markets Association
ASIC	Australian Securities and Investments Commission
ASX	Australian Securities Exchange
BM&FBovespa	BM&FBovespa S.A. (Brazil)
BSE	Bombay Stock Exchange Limited (India)
BSM	BM&FBovespa Market Supervision (Brazil)
CFTC	Commodity Futures Trading Commission (US)
CME	Chicago Mercantile Exchange (US)
EFSA	European Forum of Securities Associations
FESE	Federation of European Securities Exchanges
FINRA	Financial Industry Regulatory Authority (US)
FSA	Financial Services Authority (UK)
HKEx	Hong Kong Exchanges & Clearing
ICMA	International Capital Markets Association
ICSA	International Council of Securities Associations (association of SROs and trade associations)
IDA	Investment Dealers Association (Canada; now merged into IIROC)
IIROC	Investment Industry Regulatory Organization of Canada
IOSCO	International Organization of Securities Commissions
ISDA	International Swaps and Derivatives Association
ISE	International Securities Exchange (US)
JSDA	Japan Securities Dealers Association
KOFIA	Korean Financial Investment Association (Republic of Korea)
LSE	London Stock Exchange (UK)
MFDA	Mutual Fund Dealers Association (Canada)
NASD	National Association of Securities Dealers (US; now merged into FINRA)

Nasdaq	Nasdaq Stock Exchange (US)
NFA	National Futures Association (US)
NSE	National Stock Exchange (India)
NYSE	New York Stock Exchange (now part of NYSE Euronext)
OSE	Osaka Stock Exchange (Japan)
SEBI	Securities and Exchange Board of India
SEC	Securities and Exchange Commission (US)
SFC	Securities and Futures Commission (Hong Kong SAR, China)
SGX	Singapore Exchange
SIFMA	Securities and Financial Markets Association (US)
TMX	TMX Group (Toronto and Montreal Exchanges, Canada)
TSE	Tokyo Stock Exchange (Japan)
WFE	World Federation of Exchanges

List of Abbreviations and Acronyms

This paper uses the following abbreviations and acronyms:

ATS	alternative trading system
CSD	central securities depository (includes clearing and settlement agency)
CEO	chief executive officer
EU	European Union
MOU	memorandum of understanding
OTC	over the counter
SRO	self-regulatory organization

Figure 2-1

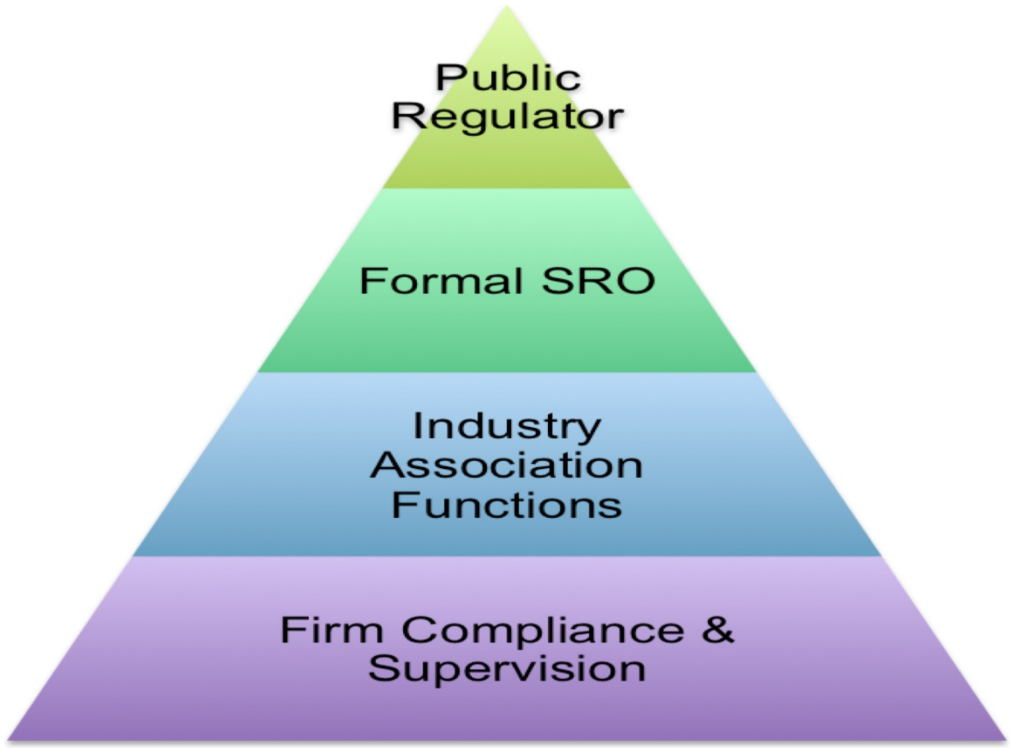

Figure 3-1: Spectrum of Models of Self-Regulation

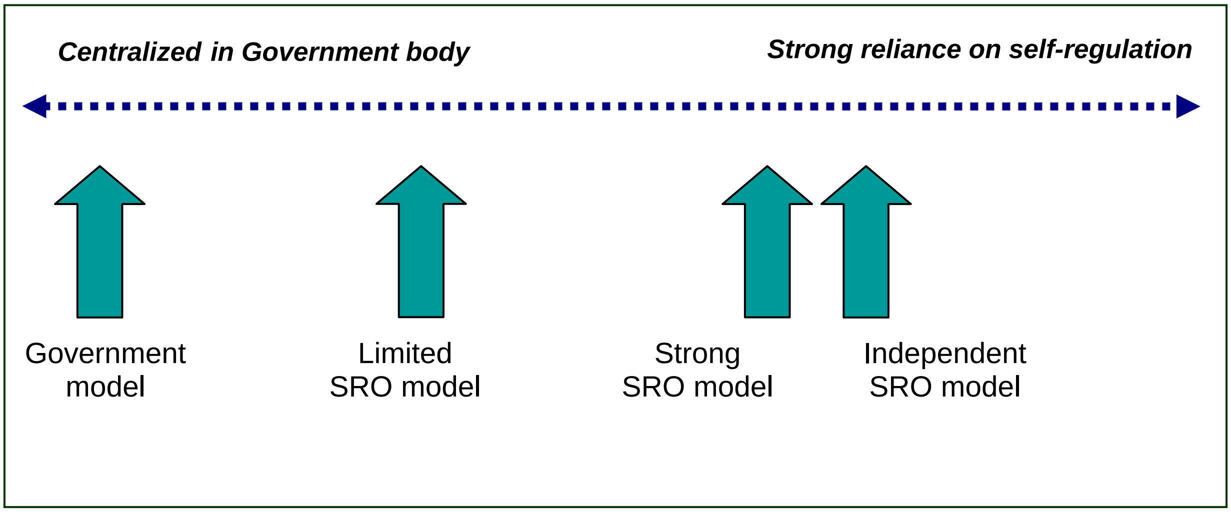

Table 3-1: Regulatory Structure in Six Major Markets

	UK	*France*	*Australia**
Regulatory Model	**Government model**. Universal financial regulator. No SROs. A number of recognized Exchanges have limited market regulation functions.	**Government model.** Central capital markets regulator. No SROs. Exchange (Euronext) has limited market regulation & listing functions.	**Strong Exchange SRO model.** Separate securities regulator. ASIC is primary regulator. Australian Securities Exchange (ASX) has significant SRO responsibilities.
Reliance on self-regulation	Exchanges have minimal supervision role for their markets. No SROs. Industry associations may provide guidance on standards and compliance	Exchanges have minimal supervision role for their markets. No SROs. Industry associations may provide guidance on standards and compliance	Extensive reliance on Exchange to perform self-regulatory responsibilities in securities and futures markets.
Recent changes	Establishment of FSA in conjunction with opening London markets to international players. Transfer of SRO responsibilities to FSA.	2 government authorities merged to form a single body (AMF) to regulate capital markets. SRO functions transferred to government authorities in 1990s.	ASX has reorganized to reinforce the independence of its SRO operations.
Major driver of model of regulation	Govt. policy to establish one statutory body as a universal financial regulator. Exchanges seen as licensed, competitive businesses.	Govt. policy to establish AMF as central regulator and to position Bourse as competitive business. A public body should perform regulation.	Govt. policy to require market operators to perform SRO responsibilities. Extensive checks and balances adopted to address conflicts of interest.

***** This outlines the Australian model prior to the transfer of market regulation responsibilities from ASX to ASIC in 2010.

	US	*Canada*	*Hong Kong SAR, China*
Regulatory Model	**Strong Exchange & Independent SRO models.** Significant reliance on self-regulation. Fragmented SRO structure based on numerous Exchanges and 2 independent SROs.	**Independent SRO model.** Commissions are primary regulators. Significant reliance on self-regulation by 2 independent SROs.	**Limited Exchange SRO model.** SFC is primary regulator. HKEx has front-line SRO responsibilities.
Reliance on self-regulation	Extensive reliance on self-regulation in both securities and futures markets by statute. All Exchanges are SROs and have legal obligation to carry out SRO functions. FINRA and NFA are independent SROs.	Extensive reliance on self-regulation by 2 independent SROs (a securities SRO and a mutual fund dealer SRO). TMX now has minimal regulatory functions.	Limited reliance on HKEx as a SRO for securities and futures markets.
Recent changes	NASD and NYSE agreed to consolidate member regulation in a new SRO, FINRA. Also, SEC proposed significant reforms in SRO governance.	Several Exchanges used to be full-fledged SROs. All Exchanges have now merged into TMX. Exchanges' former member and market regulation functions now performed by IIROC, an independent SRO.	In conjunction with creation and demutualization of new HKEx, SFC assumed responsibility for regulating intermediaries and for most market regulation functions. SFC decided not to take over listings functions but has a strong role in issuer regulation issues.
Major driver of model of regulation	Congress established the structure based on reliance on self-regulation by Exchanges and NASD. SROs are now subject to strong oversight by SEC. CFTC oversight of SROs / Exchanges in commodity futures industry is lower.	Commissions support reliance on SROs for front-line regulation. Securities industry pushed for consolidation of SROs and for independent SROs to provide efficient, uniform and neutral regulation, and to foster competitors to TMX. TMX aims to focus on its business and offload regulation responsibilities.	Government policy to establish Commission (SFC) as primary regulator, and to establish HKEx as a dynamic business to foster a globally competitive capital market. HKEx wanted to retain front-line regulation role.

Table 4-1: Division of Regulatory Responsibilities

Level of regulation	*Responsibilities*	*Regulatory activities*
1. Overall market regulation	Overall supervision of markets and intermediaries' market conduct and trading practices	▪ Rule making ▪ Supervision ▪ Enforcement
2. Market conduct standards	Principles of fair dealing, regulation of insider trading, deceptive and manipulative trading	▪ Rule making ▪ Supervision ▪ Enforcement
3. Exchange trading rules	Market integrity rules and trading practice rules for each marketplace	▪ Rule making ▪ Supervision ▪ Enforcement
4. Market surveillance	Monitoring of trading in each marketplace for compliance with rules	▪ Supervision (market surveillance, trading analysis) ▪ Investigations and enforcement

Table 4-2: Division of Regulatory Responsibilities in 6 Major Markets

Highlighted boxes show areas where SROs have significant responsibilities.

	US	*Canada*	*Hong Kong SAR, China*
Market Regulation	Exchanges are primary regulators of their securities and futures markets. Nasdaq contracts FINRA for most functions. FINRA and NFA regulate some markets by contract. SEC sets high-level anti-fraud rules. Several authorities regulate debt markets.	IIROC independent SRO does market surveillance & sets market conduct rules for all equities markets. The SRO is also the main regulator of debt markets. Commissions set high-level principles.	SFC is primarily responsible for market conduct. HKEx monitors its securities and futures markets for compliance with Exchange trading rules. HKEx lists corporate bonds.
Listings	Exchanges (mainly NYSE, Nasdaq & Amex) set listing requirements and approve listing. Set some Listing Rules (ongoing obligations of listed companies). Issuer regulation shared with SEC.	TMX sets listing requirements and approves listing, and also sets many Listing Rules. Issuer regulation is shared with Commissions.	HKEx sets listing requirements and approves listing. Listing applications must be dually filed with SFC for comment. Issuer regulation shared with SFC. HKEx sets many Listing Rules.
Issuer Disclosure & Governance	SEC sets disclosure requirements. Exchanges monitor compliance with	Commissions set disclosure and CG standards. SRO monitors	HKEx and SFC share responsibility. Disclosure must be dually filed with

	timely disclosure. CG standards shared.	compliance with timely disclosure.	SFC.
Member / Intermediary Regulation	FINRA is primarily responsible for rules and compliance examinations. In futures industry NFA and Exchange SROs share responsibility.	SROs (IIROC and MFDA) are primarily responsible for rules and compliance inspections of members.	SFC is primarily responsible for regulation of securities dealers.
Enforcement	SROs for SRO rules. SROs can also enforce members' compliance with securities laws.	SROs for SRO rules.	HKEx for its rules.
CSD Regulation	Independent CSD	Independent CSD	HKEx regulates its own clearing houses.

	UK	***France***	***Australia****
Market Regulation	FSA is mainly responsible for market conduct and surveillance in all markets. Exchanges monitor trading on their markets for compliance with their trading rules. LSE lists all types of bonds.	AMF is mainly responsible market conduct and surveillance. Exchanges monitor trading on their markets for compliance with their trading rules. Euronext acquired 51% of Euro MTS debt trading system in 2005.	ASX sets most market conduct and trading rules for securities and futures markets (ASX merged with SFE in 2006.) Full market surveillance responsibility for ASX rules and for identifying breaches of law. Debt is not traded on ASX and is not a SRO responsibility.
Listings	FSA sets listing rules and approves listing. LSE has admission to trading standards.	Euronext sets listing requirements and approves listing. Euronext sets some basic Listing Rules. Issuer regulation is primarily AMF.	ASX sets listing requirements and approves listing. Sets Listing Rules.
Issuer Disclosure & Governance	FSA	AMF	ASX shares role with ASIC. ASX sets some rules and monitors compliance with timely disclosure.
Member/Intermediary Regulation	FSA has full responsibility.	AMF has full responsibility.	ASX shares role with ASIC.
Enforcement	FSA. Exchanges have limited role.	AMF. Exchange has limited role.	ASX for breaches of ASX rules.
CSD Regulation	Independent CSD	Independent CSD	ASX subsidiary sets rules.

***** This outlines the Australian model prior to the transfer of market regulation responsibilities from ASX to ASIC in 2010.

Table 4-3: Conflicts of Interest in Self-Regulation

Conflicts between exchange's business and regulation mandates:

- An exchange's business interests and duty to its shareholders to maximize profits may conflict with its duties as a regulator.
- Directors face conflicts in reconciling their duties to shareholders with their public interest responsibilities in overseeing a regulator.
- Regulation of members (or trading participants) produces tensions between business interests and regulation responsibilities.
- Regulation of listed companies produces tensions between business interests and regulation responsibilities.
- Funding of regulation may suffer because of competition for resources between business and regulation needs and because efforts to reduce costs put pressure on non-revenue-producing areas like regulation.

Conflicts in the integrity of self-regulation programs:

- High standards in rules may have a negative effect on attracting trading or listings business.
- Maintaining high standards of supervision may negatively affect business development and relationships with customers.
- Pressure from big customers could result in biased administration of rules.
- Customer pressures could compromise the independence of investigations and enforcement programs.

Table 6-1: IOSCO Standards for SROs

IOSCO Standards for SROs

An SRO should be required to meet this IOSCO list of standards or conditions and must do the following:

- Have the capacity to carry out the purposes of governing laws, regulations, and SRO rules.
- Be able to enforce compliance by its members and associated people with those laws, regulations, and rules.
- Treat all members of the SRO and applicants for membership in a fair and consistent manner.
- Develop rules that are designed to set standards of behavior for its members and to promote investor protection.
- Submit its rules to the regulator for review and/or approval, as the regulator deems appropriate, and ensure that the rules of the SRO are consistent with the public policy directives established by the regulator.
- Cooperate with the regulator and other SROs to investigate and enforce applicable laws and regulations.
- Enforce its own rules, and impose appropriate sanctions for noncompliance.
- Ensure a fair representation of members in selection of its directors and administration of its affairs. *
- Avoid rules that may create uncompetitive situations.
- Avoid using its regulatory role to allow any market participant unfairly to gain advantage in the market.

* Qualified by “where applicable (e.g., a mutual organization)” later in the document.

Source: IOSCO 2008: 32–33.

Table 6-2: Elements of Oversight Programs

Oversight process	***Purpose***
Corporate governance standards and review	▪ Ensure that an SRO meets high standards of corporate governance. ▪ Ensure that an SRO is responsive to all stakeholders and its public interest mandate.
Rule review and approval	▪ Ensure compliance and consistency with the law and conditions of license. ▪ Ensure that SRO rules are consistent with its regulatory mandate and objectives and with securities regulations. ▪ Ensure that SRO rules are fair and balanced, having regard to the interests of all stakeholders. ▪ Ensure SRO rules are consistent with the public interest
Monitoring of SRO reports	▪ Maintain awareness of status of SRO programs, activities, and financial condition, as well as current regulatory matters. ▪ Provide ongoing supervision and advice. ▪ Help in coordination of activities with an SRO.
SRO self-assessment of its performance and operations	▪ Ensure sound management and governance of the SRO. ▪ Provide input to regulator in developing its targeted examination of an SRO. ▪ Establish how the SRO measures and rates its own performance. ▪ Identify areas of risk and areas for improvement.
Examination of an SRO	▪ Provide an independent assessment of the SRO's performance. ▪ Review how well the SRO is meeting its responsibilities. ▪ Review adequacy of the SRO's regulatory programs and resources. ▪ Ensure that conflicts of interest are managed appropriately. ▪ Identify significant risk areas. ▪ Identify findings that require changes or other responses from an SRO.
Regular communication	▪ Maintain awareness of the SRO's and regulator's activities, rule proposals, and initiatives. ▪ Ensure consistency in policy and regulatory approach. ▪ Coordinate initiatives and activities.