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# SELF-REGULATION OF THE SECURITIES MARKETS: A CRITICAL EXAMINATION

SAM SCOTT MILLER\*

## INTRODUCTION

While self-regulation has played an influential role in the governance of financial markets for some time,<sup>1</sup> government officials and other commentators have advanced assorted new self-regulatory schemes in the last few

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1. Self-regulation of the securities markets is carried out by industry-sponsored groups called self-regulatory organizations (SROs) under the oversight of the Securities and Exchange Commission (SEC). Ten national securities exchanges, one national securities association, ten registered clearing agencies and the Municipal Securities Rulemaking Board (MSRB) are currently registered under the Securities Exchange Act of 1934 (the Exchange Act). The exchanges and the National Association of Securities Dealers, Inc. (the NASD), the only registered national securities association, provide and regulate market facilities; promulgate rules governing the conduct of their members; inspect and monitor compliance of those members; and discipline members for violations. Clearing agencies furnish participants with comparison, clearance and settlement services. The MSRB issues rules governing transactions in municipal securities, but, unlike the NASD and the stock exchanges, has no authority to enforce its rules through disciplinary proceedings or otherwise. The SEC and the bank regulators are responsible for enforcement of the MSRB's rules.

For a general description of self-regulation in the securities markets, see SECURITIES AND EXCH. COMM'N, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H. DOC. No. 95, pt. 4, 88th Cong., 1st Sess. 692-728 (1964) [hereinafter cited as the SPECIAL STUDY]. The Special Study observed, "There are, no doubt, many other instances in which the policy of entrusting a degree of social control to 'private' groups has been adopted, but securities regulation is unique in featuring self-regulation as an essential and officially sanctioned part of the regulatory pattern." SPECIAL STUDY, pt. 4, at 501; see also Westwood & Howard, *Self-Government in the Securities Business*, 17 LAW & CONTEMP. PROBS. 518 (1952), in which the authors state: "In a manner thus far unique in our economic life, the securities business has evolved social controls through private agencies which are drastic and extensive."

This pattern has influenced regulation of the commodities markets. The Commodity Futures Trading Commission (CFTC), pursuant to section 17 of the Commodity Exchange Act, has registered the National Futures Association (NFA) as a self-regulatory organization. Modeled after the NASD, the NFA establishes rules relating to fair and equitable trading and is assuming certain regulatory functions of the CFTC, such as registration, fitness requirements, dispute resolution procedures and the like. Membership in the NFA is compulsory for all CFTC registrants, except floor brokers.

The NFA's development has been subject to intense negotiations within the industry and the government. The NFA seeks better cost control over regulatory expenses by eliminating inefficient overlap and conflict among self-regulatory programs. In addition, the NFA contemplates more effective policing by the industry itself of those segments operating outside the exchanges' present standards and surveillance. The NFA's organizing committee decided early on that membership should be compulsory for those who do business with the public and obtained legislative agreement in 1978. See *infra* note 127.

years, ostensibly as alternatives to direct governmental regulation.<sup>2</sup> These schemes include self-regulatory organizations (SROs) to govern investment advisers and investment companies, commodity futures merchants, small business investment companies, government securities dealers and financial planners, as well as to assist in processing exemptions from the prohibited-transaction rules under the Employee Retirement Income Security Act.<sup>3</sup>

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In addition to the SROs in the securities and commodities industries, the Federal Communications Commission proposed to establish an SRO, the Exchange Carriers Association, to assume responsibility for tariff filings and allocation of telephone revenues after the American Telephone and Telegraph divestiture. Self-regulation is also important to some professions, such as accounting and law.

Self-regulation sometimes takes forms other than associations. For example, self-certification is used by the National Highway Traffic Safety Administration (automotive manufacturers' safety compliance), the Coast Guard (small vessels' lighting requirements) and the Consumer Product Safety Commission (voluntary monitors of safety standards). Other types of self-regulation include the use of independent auditors, such as independent public accountants as auditors of financial statements, independent directors to prevent abuses of investment company shareholders, the Coast Guard's reliance on third-party inspections of pressurized containers, and the employment of parental reviews of day care centers by the Department of Health and Human Services. The term self-regulation also is used sometimes (although not in this article) to describe the mechanisms of the market.

2. See *infra* note 3; Remarks of SEC Commissioner James C. Treadway, Jr., to the American Law Institute-American Bar Association Conference on Broker-Dealer Regulation (Jan. 12, 1984) (noting trend towards shifting governmental functions to private sector).

3. Examining the issue of regulation, the SEC has considered self-regulation by mutual funds and their underwriters and investment advisers. See Investment Co. Act Rel. No. 13044 (Feb. 23, 1983); see also Cary, *Self-Regulation in the Securities Industry*, 49 A.B.A.J. 244, 247 (1963). Similarly, the CFTC is seeking to transfer regulatory functions to the NFA. Chairman Susan M. Phillips has said,

the only way that we can . . . support the industry growth is by increased reliance on self-regulation. We are working with the exchanges to assume more and we're also looking to NFA to take on more of our direct regulatory functions. Now all I think that's going to mean is that we will be able to reassess and reallocate our resources internally so that we can keep up with the industry growth. . . . Now from what I can tell in working with the leaders of the self-regulatory organizations, both the exchanges and NFA, they are having to swallow pretty hard and pick up some of the things that they relied on us to do in the past.

*CFTC Chairman Predicts Growth, Sees Challenge in International Markets*, 16 SEC. REG. & L. REP. (BNA) 169, 177 (1984); see also The Government Securities Acts Amendments of 1980, S. 2515 (bill that, *inter alia*, would have applied self-regulatory scheme to brokers and dealers in certain government-guaranteed securities); *Request for Comments on the Oversight of the U.S. Government and Agency Securities Markets*, Securities Exch. Act Rel. No. 21959 (April 19, 1985); Federal Reserve Bank of New York, *Capital Adequacy Guidelines for U.S. Government Securities Dealers* (1985); Department of Labor, *Participation of Self-Regulatory Organizations in the Prohibited Transaction Exemption Process—Solicitation of Comments*, 49 Fed. Reg. 48111 (Dec. 10, 1984); SPECIAL STUDY, *supra* note 1, pt. 4, at 692 (self-regulation should be extended to other areas of securities business); Television Network Program Procurement Comm., Interstate and Foreign Commerce, H.R. REP. No. 281, 88th Cong., 1st Sess. 109 (1963) (self-regulation proposed for broadcast industry); *The Small Business Investment Act Amendments of 1966, Hearings Before Subcomm. of Senate Comm. on Banking & Currency*, 89th Cong., 2d Sess. 45-55, 161-66, 174-78, 184-89 (1966) (self-regulation for small business investment companies). *But see* Address by SEC Commissioner Charles C. Cox Before the Investment

Lawmakers and regulators also have suggested that existing SROs take on additional tasks, such as the government securities markets and administering margin rules.<sup>4</sup>

Given this renewed interest, it is appropriate to revisit the myth of self-regulation and offer a critical analysis. This analysis will concentrate on the securities markets, where self-regulation has been most pervasive.

An examination of self-regulation reveals that through the self-regulatory device both the regulators and the regulated seek different objectives. (Perhaps it is the vagueness of the concept and its chameleon aspects that account for its mutual attraction). For regulators and their legislative overseers, the concept is attractive from a budgetary standpoint.<sup>5</sup> Activities that would otherwise have to be paid for by a governmental agency are carried out by a separate, industry-financed entity. In addition, regulators may concentrate efforts on their priorities and eliminate more prosaic functions.<sup>6</sup> At the same time, government aims at substituting a regulatory scheme as efficacious as that which it would provide directly.

Regulated industries, on the other hand, generally view self-regulation as more flexible and cheaper than direct governmental regulation. They see

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Adviser Operations and Regulation Conference, *The Commission and the Regulation of Financial Planners: Assuming the Appropriate Role* 11 (Oct. 29, 1984).

The United Kingdom has evinced interest in using self-regulation in its financial markets. The Government's White Paper setting forth a new system of regulation for the financial services industry contemplates that powers of authorization of investment businesses and of their regulation will be delegated to self-regulatory bodies. DEPARTMENT OF TRADE AND INDUSTRY, *FINANCIAL SERVICES IN THE UNITED KINGDOM* (1985) [hereinafter cited as the U.K. WHITE PAPER].

4. See The Public Securities Act of 1985, H.R. 2032, 99th Cong., 1st Sess., 131 CONG. REC. 1955, 1957-59 (expanding authority of Municipal Securities Rulemaking Board to include dealers in government and government agency securities); 17 SEC. REG. & L. REP. (BNA) 123 (1985) (Federal Reserve Board recommends SRO authority over margin requirements).

5. See Address by Barbara S. Thomas before the CSI/Institute of Chartered Accountants Conference (Oct. 25, 1983). From the perspective of an SEC Commissioner, Ms. Thomas described self-regulation as fulfilling:

a service which would be extraordinarily cumbersome for our federal government to perform. Currently, some 9,000 public companies are registered with the SEC, and perhaps twice that number of broker-dealers, investment advisers, investment companies, and other securities industry participants are subject to our jurisdiction. Our direct responsibilities for registration, reporting, legal interpretation, enforcement and oversight are considerable. If they were coupled with direct responsibility for the matters primarily administered by the self-regulatory organizations, we would face a herculean task. At our present staffing levels, we simply could not do it all. Thus, self-regulation has permitted the SEC to focus on major issues and generally to avoid many of the detailed regulatory responsibilities for the securities industry. In fact, in the face of our government's current movement towards deregulation, the self-regulatory organizations are even more critical and must now assume more responsibility towards ensuring the integrity of their members and of the market place.

6. See *supra* note 5; see also Background Paper on Self-Regulation v. Government Regulation of Financial Institutions, SEC Conf. on Major Issues Confronting the Nation's Financial Institutions and Markets in the 1980s, at 6, (Oct. 6-8, 1982) [hereinafter cited as the SEC Self-Regulation Paper].

less rigidity in a process more within their control and, concomitantly, carried out by those who better understand the industry's dynamics.<sup>7</sup> The regulated industry, moreover, wants insulation from direct governmental involvement.<sup>8</sup>

SROs are also business enterprises and competitors. This dichotomy of functions is illustrated by an interview of John J. Phelan, Jr., chairman of the New York Stock Exchange. Mr. Phelan first described the traditional responsibilities of the exchange:

We're a quasi-public institution, and we have a broad responsibility to the general public, the individual investor, the institutions, the listed companies, the member firms and the membership, as well. We have an obligation to oversee the marketplace, to see that the fairness we talk about is carried out. For member firms, we have a responsibility to oversee their financial viability and their operational viability and to see that they have sales practices that are consistent with good reputable practices. I also think we have an educational role, getting people to understand the process of a market and how the capital markets work.<sup>9</sup>

Mr. Phelan devoted the bulk of his comments, however, to the exchange as a competitor for new listings and new products. Mr. Phelan predicts that this competition will cause the exchange to become "far more of a marketing organization and far more aggressive on the sales side. . . ."<sup>10</sup> This article will explore the ramifications of these competitive activities on SROs' regulatory roles.<sup>11</sup>

The Securities and Exchange Commission's Report of Special Study of the Securities Markets (Special Study) conducted in the early 1960s concluded "that the basic statutory design of a substantial reliance on industry self-regulation appears to have stood the test of time and to have worked effectively in most areas."<sup>12</sup> I will address in this article whether that

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7. See Jennings, *Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission*, 29 *LAW & CONTEMP. PROBS.* 663, 664-65 (1964).

8. An exception is made, of course, to the extent required to sanction price fixing. See B. OWEN & R. BRAEUTIGAM, *THE REGULATION GAME* 6 (1978); cf. R. POSNER, *ECONOMIC ANALYSIS OF LAW* 268 (2d ed. 1977); Miller, *Regulation of Trading in Ginnie Maes*, 21 *DUQ. L. REV.* 39, 92-93 (1982).

9. *Views of the Big Board's New Leader*, *The New York Times*, May 25, 1984, at D-1, D-13.

10. *Id.*

11. For an interesting case study of SRO competition in which regulatory schemes have been used as counters by the exchanges against the NASD in opposing an expansive designation procedure for National Market System (NMS) securities, see SEC File No. S7-787, Securities Exch. Act Rel. No. 20902 (May 7, 1984).

12. See SPECIAL STUDY, *supra* note 1, pt. 4, at 504; accord, SEC Self-Regulation Paper, *supra* note 6, at 6; SECURITIES INDUSTRY STUDY—REPORT OF THE SUBCOMMITTEE ON SECURITIES, COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, S. DOC. NO. 13, 93d Cong., 1st Sess. 137 (1973) [hereinafter cited as the SENATE INDUSTRY STUDY].

assessment is currently justified. In any event the Special Study's additional conclusion that "self-regulation presents its own problems of practicality and efficiency, not unlike those of direct governmental regulation,"<sup>13</sup> leaves open whether direct governmental regulation—or simply relying on the common-law system of privately enforced rights<sup>14</sup>—might be more effective in some instances. Moreover, if self-regulation works as well as its proponents claim, one must wonder why the device has not been utilized in other financial sectors, such as the depository and insurance industries.<sup>15</sup>

This examination of self-regulation has been influenced by the efficiency view of regulation that looks for the balance when "it is theoretically impossible to make someone better-off (in economic terms) without making someone else worse-off."<sup>16</sup> Originated by Pareto in the Nineteenth Century, this theory provides an objective standard for deciding when and in what form regulation is needed.<sup>17</sup> Regulation is desirable only when the free market fails to achieve optimum allocative efficiency.<sup>18</sup> I do not propose to apply the efficiency theory as a rigid standard, however, recognizing that the designers of the self-regulatory framework of the Securities Exchange Act of 1934 were also concerned with equity and market abuses, concepts difficult to incorporate into the theory.

In considering the Securities Acts Amendments of 1975, the House Committee on Interstate and Foreign Commerce gave a more qualified endorsement:

the [self-regulatory] system has, on occasion, been found seriously deficient and it has not operated as effectively or as fairly as the public interest would require.

Nonetheless, in the last Congress, the Committee found that the system, as a whole, has worked and recommended that it be preserved and strengthened.

H.R. REP. NO. 123, 94th Cong., 1st Sess., at 48-49 (1975); *see also* II L. LOSS, SECURITIES REGULATION 1389-91 (1961).

13. SPECIAL STUDY, *supra* note 1, pt. 4, at 722.

14. *See* R. POSNER, *supra* note 8, at 271. Posner points out that the "concept of 'market failure' must be balanced by one of 'government failure'." *But cf.* LANDIS, THE ADMINISTRATIVE PROCESS 34-46 (1938).

15. *Cf.* Westwood & Howard, *supra* note 1, at 543-44. Increased involvement by depository institutions in securities activities has elicited a proposal by the NASD to extend its jurisdiction over persons who solicit or receive orders from public customers for the purchase or sale of securities or give investment advice or recommendations to such customers respecting securities transactions and are employed by non-broker-dealers who receive compensation in respect of such transactions from NASD members. NASD Notice to Members 83-72 (Dec. 20, 1983). The proposal has created considerable controversy in banking circles. *See* Zigas, *Regulatory Proposal Sparks Debate*, American Banker, Jan. 20, 1984, at 3.

16. Edwards, *The Regulation of Futures Markets: A Conceptual Framework*, Columbia Business School Working Paper Series # CSFM-23, at 9. *See, e.g.*, TASK GROUP ON REGULATION OF FINANCIAL SERVICES, BLUEPRINT FOR REFORM 41-42 (1984).

17. Thus "the effectiveness of self-regulation must be compared to the alternatives: no regulation or government regulation." TASK GROUP ON REGULATION OF FINANCIAL SERVICES, BLUEPRINT FOR REFORM 44 (1984). *But see* R. POSNER, *supra* note 8, at 10-12.

18. *See* Edwards, *supra* note 16, at 8-19. This is not to say that regulatory objectives may not relate to market efficiency. For instance, measures aimed primarily at consumer protection may also improve market efficiency by informing market decisions and increasing market activity. At the same time, we must keep in mind that regulation invokes cost and that incremental cost discourages use of markets, thus impairing allocative efficiency. *Id.* at 36-38.

## I. THE MYTH OF SELF-REGULATION

William O. Douglas provided the classic justification for self-regulation:

Self-regulation . . . can be pervasive and subtle in its conditioning influence over business practices and business morality. By and large, government can operate satisfactorily only by proscription. That leaves untouched large areas of conduct and activity; some of it susceptible of government regulation but in fact too minute for satisfactory control; some of it lying beyond the periphery of the law in the realm of ethics and morality. Into these larger areas self-government, and self-government alone, can effectively reach.<sup>19</sup>

Self-government can reach into "minute" areas of conduct as well as the realm of ethics and morality, because, it is contended, the expertise of industry participants can be deployed more efficiently and SROs are more responsive than "remote" government agencies.<sup>20</sup> In addition, removing direct regulation may eliminate tensions between government agencies and regulated industries.<sup>21</sup>

19. Address by William O. Douglas before the Bond Club of Hartford (Jan. 7, 1938). One commentator has suggested that Douglas' promotion of self-regulation under governmental oversight was inconsistent with his "Brandeis-like enthusiasm for economic and governmental deconcentration." J. SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 158 (1982).

In *Silver v. New York Stock Exchange*, 373 U.S. 341, 371 (1963), Mr. Justice Stewart, speaking for the minority, set forth the purpose of the self-regulation provisions of the Exchange Act: "to delegate governmental powers to working institutions which would undertake, at their own initiative, to enforce compliance with ethical as well as legal standards in a complex and changing industry." See SPECIAL STUDY, *supra* note 1, pt. 4, at 694 and 722; SENATE INDUSTRY STUDY, *supra* note 12, at 13, 149; II L. Loss, *supra* note 12, at 1361-62; Cary, *supra* note 3.

20. See SPECIAL STUDY, *supra* note 1, pt. 4, at 693 and 722; see also *Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 514 (1934) (discussing regulatory goals of Exchange Act). In testimony addressing the limitations of governmental regulation in the context of the future Exchange Act, John Dickinson, Assistant Secretary of Commerce, stated that:

In framing a regulatory measure, the practical problem of administration has always to be faced and when regulation gets beyond a certain point the sheer ineffectiveness of attempting to exercise it through government on a wide scale counter-balances the fact that possibly the exchanges might not be as diligent as the Government would be if the task were compact enough to fall within the limits of effective government performance.

*Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 514 (1934); see also U.K. WHITE PAPER, *supra* note 3, at 13; H.R. REP. No. 355, 98th Cong., 1st Sess. 6 (1983) (market changes and greater volume have increased responsibilities of self-regulatory organizations); SENATE INDUSTRY STUDY, *supra* note 12, at 149.

Commentators also viewed SROs as a more flexible mechanism for dealing with rapidly changing, dynamic industries. *Report to the Secretary of Commerce of the Comm. on Stock Exchange Regulations*, S. Res. No. 84, 73d Cong., 2d Sess. 6 (1934) [hereinafter cited as the Roper Report].

21. Jennings, *supra* note 7, at 678.

Self-regulation has deeper benefits,

because participation by the regulated in the regulatory process tends not only to make regulation more palatable but also, by making the participants more aware of the goals of regulation and of their own stake in it, to make them individually more likely to discipline themselves and to render "voluntary" obedience.<sup>22</sup>

Indeed, the House Subcommittee on Commerce and Finance asserts "the phrase 'self-regulation' must be consigned to the past. 'Cooperative regulation' best describes the common task of protecting investors and the public interest."<sup>23</sup> Similarly, an SEC Commissioner describes self-regulation as "a shared, cooperative system of industry and federal regulation."<sup>24</sup>

22. See SPECIAL STUDY, *supra* note 1, pt. 4, at 694 and 722; see also U.K. WHITE PAPER, *supra* note 3, at 6, 13; SENATE INDUSTRY STUDY, *supra* note 12, at 149. According to an SEC Commissioner,

The SROs also play an important educational function in the supervision process. These functions will need to be augmented for the future. As problems develop that are not limited to one or two firms, the SROs should assist in developing sound solutions and then should give widespread currency to those solutions, perhaps through circulars sent to the membership. They need to become a clearinghouse for better ideas, a library to house guild standards, as they evolve.

Remarks of Bevis Longstreth to the Fifteenth Annual Rocky Mountain State-Federal-Provincial Cooperative Securities Conference (Oct. 29, 1982). Cf. Foster, *Codification in Post-Mao China*, 30 AM. J. COMP. L. 395, 396 (1982) (characteristic communist method of law enforcement is innovative informal system emphasizing popular involvement and reeducation).

23. SUBCOMM. ON COMMERCE AND FINANCE OF THE HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 92d Cong., 2d Sess., REPORT OF SECURITIES INDUSTRY STUDY 85 (Subcomm. Print 1972); cf. SPECIAL STUDY, *supra* note 1, pt. 4, at 502; II L. LOSS, *supra* note 12, at 1362; W. DOUGLAS, DEMOCRACY AND FINANCE 64 (1940). The Senate Industry Study expressed concern about the term "self-regulation," because it might "lead to the impression that the industry and government fulfill the same function in the regulatory framework or that they enjoy the same order of authority or deserve the same degree of deference, whether by firms, courts or Congress." SENATE INDUSTRY STUDY, *supra* note 12, at 147.

24. Record of Proceedings, SEC Conf. on Major Issues Confronting the Nation's Financial Institutions and Markets in the 1980s, at 13 (Oct. 6-8, 1982). The New York Stock Exchange (NYSE) also has adopted the terminology of cooperative regulation:

Implicit in the concept is a common awareness that all participants in the securities industry regulatory process—firms, self-regulatory organizations and government regulators—all share the same essential goals of assuming high standards of protection and service to investors.

NYSE 1983 Annual Report 14. The Comptroller General asserted a more realistic—and restrained—foundation:

Industry regulation and Government regulation are not alternative, but complementary, components of the regulatory process. The relationships between self-regulatory organizations and the Commission are sometimes referred to as "partnerships" or "cooperative" regulatory systems. Although such references attempt to clarify self-regulatory relationships, they are nonetheless misleading unless tempered with the knowledge that industry and Government under self-regulation do not have the same regulatory perspective, responsibilities or powers.

Report by the Comptroller General of the United States, *Securities and Exchange Commission*



Proponents of the myth include some concerned about the "increasing burdens of government" and its unwieldy processes, "who look with hope to the assumption by non-state agencies of a portion of social control."<sup>25</sup> Those who hold this view seem to assume that control by non-governmental agencies is, as such, preferable to that of a governmental agency.<sup>26</sup> The alternative of dispensing with both means of control is rarely considered.

## II. CONCERNS

This review of the myth of self-regulation leads to a discussion of its criticisms. Paradoxically, SROs are charged with providing insulation from more effective governmental regulation<sup>27</sup> as well as with a tendency to overregulate.<sup>28</sup> Related to the latter charge, self-regulation has been criticized as more expensive than direct regulation and a means for submerging the costs of government programs.<sup>29</sup> Some commentators fear that the absence of the checks and balances of government permit the abuse of rights of individuals and business entities.<sup>30</sup> Others express concern about the anti-competitive aspects of self-regulation.<sup>31</sup> As this article addresses these con-

*Should Strengthen Its Inspection Oversight of the National Association of Securities Dealers 4-5* (1978) [hereinafter cited as Report by the Comptroller General].

25. Westwood & Howard, *supra* note 1, at 518.

26. See *United States v. Bloom*, 450 F. Supp. 323, 330 (1978); U.K. WHITE PAPER, *supra* note 3, at 13; cf. Lipton, *The SEC or the Exchanges: Who Should Do What and When? A Proposal to Allocate Regulatory Responsibilities for Securities Markets*, 16 U.C.D. L. REV. 527, 544 n. 73 (1983).

27. See SEC Self-Regulation Paper, *supra* note 6, at 6; see also SPECIAL STUDY, *supra* note 1, pt. 4, at 695; SENATE INDUSTRY STUDY, *supra* note 12, at 145; cf. Report by the Comptroller General, *supra* note 24, at 7.

28. Cf. Edwards, *supra* note 16, at 37. The Senate Industry Study also posed questions: about the present allocation of self-regulatory responsibility among the various exchanges and the NASD. That allocation, which represents historical rather than functional patterns, results in overlapping and duplicative regulation and different standards of conduct for firms engaged in the same lines of activity. . . . [T]he time has come to begin planning the framework which will guide the developments of the self-regulatory system in the future. In the revised system, a single nationwide entity would be responsible for regulation of the retail end of the securities business, including such matters as financial responsibility and selling practices, while each exchange would concentrate on regulating the use of its own trading facilities.

SENATE INDUSTRY STUDY, *supra* note 12, at 15, 16.

29. See Jennings, *supra* note 7, at 677; see also *Remarks of Philip F. Johnson Before Third Annual Commodities Law Institute*, 573 SEC. REG. L. REP. (BNA) E-1, 2 (Oct. 8, 1980) [hereinafter cited as Johnson Remarks]; cf. SEC Self-Regulation Paper, *supra* note 6, at 8.

30. See SENATE INDUSTRY STUDY, *supra* note 12, at 14, 17; Lowenfels, *A Lack of Fair Procedures in the Administrative Process: Disciplinary Proceedings at the Stock Exchanges and the NASD*, 64 CORNELL L. REV. 375 (1979).

31. See B. OWEN & R. BRAEUTIGAM, *supra* note 8, at 6; Miller, *supra* note 8, at 98-99 and nn. 252-53; SEC Self-Regulation Paper, *supra* note 6, at 6; SENATE INDUSTRY STUDY, *supra* note 12, at 2, 3, 19, 145, 157-64; *Hearings on Securities Industry Study Before the Subcomm. on Securities of the Senate Banking, Housing and Urban Affairs*, 92d Cong., 1st and 2d Sess., pt. 3, at 76 (1972).

cerns, I shall compare self-regulation to direct government regulation. At the same time it is important to remember that direct government regulation raises the same concerns.<sup>32</sup> Thus we should ask whether no regulation (other than that provided by privately enforced rights) might be a preferable alternative in some cases.

### A. *Insulation*

From the outset of governmental involvement in self-regulation, critics of self-regulation have expressed concern that SROs might not be sufficiently dedicated to their regulatory tasks.<sup>33</sup> The Special Study found this concern warranted,<sup>34</sup> recognizing that,

No business is eager for regulation . . . and it is only natural to expect less zeal for almost any aspect of the job on the part of a self-regulator than may be true of an outsider whose own business is not involved. . . . To the extent that these are matters of degree the self-regulator, absent governmental oversight, is generally and understandably motivated by self-interest to lean toward the lesser degree.<sup>35</sup>

Congress and the SEC may have acquiesced in the assumption of regulatory powers by the SRO for motives that facilitated insulation. One commentator has observed that "Congress granted to the SEC broad discretionary powers to cope with problems that the lawmakers found too delicate or taxing to handle directly. The SEC, no more anxious than Congress to confront these problems, shifted many of them to self-regulatory organizations. . . ." <sup>36</sup>

If self-regulation does tend to insulate an industry group from effective regulation, an illusory facade of protection is presented to the affected public.<sup>37</sup> For instance, the Securities Industry Study Report of the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs (Senate Industry Study) found that the SEC had abdicated standards of

32. See, e.g., Urban & Mancke, *Federal Regulation of Whiskey Labeling: From the Repeal of Prohibition to the Present*, 15 J. LAW & ECON. 411 (1972); Jordan, *Producer Protection, Prior Market Structure and the Effects of Government Regulation*, 15 J. LAW & ECON. 151 (1972).

33. See *Hearings on H.R. 7852 and H.R. 8720 Before the House Committee on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 514 (1934) (discussing limitations of governmental regulation in context of Exchange Act).

34. SPECIAL STUDY, *supra* note 1, pt. 4, at 695 and 722. In addition to the built-in reluctance to address some problems, SROs on occasion may actively oppose regulatory initiatives by the SEC. See J. SELIGMAN, *supra* note 19, at 189.

35. SPECIAL STUDY, *supra* note 1, pt. 4, at 695.

36. Werner, *The SEC as a Market Regulator*, 70 VA. L. REV. 755, 756 (1984).

37. See Blumrosen, *Six Conditions for Meaningful Self-Regulation*, 69 A.B.A.J. 1264 (1983).

financial responsibility and specialist performance to the SROs despite dissatisfaction with how the SROs had administered these standards.<sup>38</sup>

Proponents of self-regulation stress that industry expertise is mobilized by SROs, resulting in a more knowing, less clumsy method of regulation.<sup>39</sup> Not much attention has been given, however, to how this industry expertise is conscripted. Indeed, one might wonder how SROs avoid "the slowness, the ponderousness, the routine, the complication of procedures, and the maladapted responses of 'bureaucratic' organizations to the needs which they should satisfy and the frustrations which their members, clients or subjects consequently endure."<sup>40</sup>

SROs generally do not appear to have any greater access to industry expertise than their governmental counterparts. The industry committees or panels of volunteers that are held out as serving this purpose in fact have very little capability to assume unfamiliar regulatory tasks. The Special Study recognized the "compromise with the ideal of self-regulation by industry members—and the special advantages attributed to it—in the direction of full-time paid staffs."<sup>41</sup>

The Special Study also questioned whether a regulated industry would make the commitment of time and personnel necessary to accomplish effective self-regulation:

To the extent that emphasis is placed on "self," i.e., members of an industry actually regulating themselves, self-regulation depends on the efforts of part-time volunteers who can be expected to sacrifice

38. See SENATE INDUSTRY STUDY, *supra* note 12, at 178; see also SEC, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS—REPORT AND RECOMMENDATIONS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. REP. NO. 231, 92d Cong., 2d Sess. 63-65, 101 (1971); H. BARUCH, WALL STREET SECURITY RISK ch. 10 (1971); J. SELIGMAN, *supra* note 19, at 450-66; Kripke, *Fifty Years of Securities Regulation in Search of a Purpose*, 21 SAN DIEGO L. REV. 257, 259 (1984).

39. See, e.g., Westwood & Howard, *supra* note 1, at 529.

40. M. CROZIER, THE BUREAUCRATIC PHENOMENON 3 (1964). Crozier also describes several positive reasons for the existence of bureaucracies: "A main rationale of bureaucratic development is the elimination of power relationships and personal dependencies—to administer things instead of governing men. The ideal of bureaucracy is a world where people are bound by impersonal rules and not by personal influence and arbitrary command." *Id.* at 107.

41. SPECIAL STUDY, *supra* note 1, pt. 4, at 696. Even if the ideal existed, the Special Study identified a further drawback of parochialism:

Securities regulation entails the adjustment and accommodation of different and sometimes competing aims and policies. The considerations involved frequently transcend the confines of a particular market or market institution, or even of the entire securities business, requiring that more general interest and policies be taken into account. But a group of exchange members or over-the-counter dealers regulating their own market, even assuming the greatest of zeal, may have no awareness of, or may ignore or even flaunt, these wider concerns of public interest.

*Id.*; cf. National Ass'n of Sec. Dealers, Inc., 5 S.E.C. 627, 628 (1939).

A former SEC chairman and professed admirer of self-regulation acknowledges that "as the scope of self-regulation enlarges, it will become increasingly arduous without an effective staff." See Cary, *supra* note 3, at 245; see also SPECIAL STUDY, *supra* note 1, pt. 4, at 602.

only a limited amount of their time and energy otherwise available for private pursuits. . . . Thus the balance between the roles of part-time volunteers and full-time paid staffs presents problems of theoretical and practical adjustment as the nature and scope of self-regulatory responsibility is altered by changing circumstances.<sup>42</sup>

Those industry personnel who do contribute their expertise to regulatory processes might also be enlisted by governmental agencies.

### B. Overregulation

Like other institutions, SROs promote their service. Because of sensitivity to criticism from their overseers and a tendency to anticipate that criticism, SROs in some instances may be more active than optimal efficiency would dictate.<sup>43</sup> Moreover, as Louis Jaffe reflected, "[t]he nostrum most approved by an administrator for the ills of a regulated industry is more regulation; to him it seems as obvious as to the doctors of another era that the remedy for unsuccessful bleeding is more bleeding."<sup>44</sup> Administrators of SROs are as prone to this remedy as their counterparts at government agencies.<sup>45</sup>

The Exchange Act gives SROs a broad grant of regulatory authority.<sup>46</sup>

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42. SPECIAL STUDY, *supra* note 1, pt. 4, at 503.

43. Edwards, *supra* note 16, at 37-38. Cf. TASK GROUP ON REGULATION OF FINANCIAL SERVICES, BLUEPRINT FOR REFORM 37-38 (1984); Benham & Benham, *Regulating Through the Profession: A Perspective on Information Control*, 18 J. LAW & ECON. 421 (1975).

44. Jaffe, *James Landis and the Administrative Process*, 78 HARV. L. REV. 319, 322 (1964).

45. In a proposal to adopt rule 476A, providing for the imposition of fines for minor violations of Exchange rules, the NYSE acknowledged that, "currently, when the Exchange discovers a technical, inadvertent or otherwise clearly minor Exchange rule violation, its only practical response may be to issue a verbal or written caution to the person or persons calling attention to the need to comply fully with all requirements of all applicable Exchange rules and warning against future violations." Failing to explain why this approach is inadequate, the NYSE merely has asserted the existence of a "regulatory need." File No. SR-NYSE-84-27; Securities Exch. Act Rel. No. 21327, 49 Fed. Reg. 37201 (1984).

46. Section 19(g)(1) of the Exchange Act, which was adopted as part of the 1975 Amendments, requires each SRO to enforce compliance by its members and associated persons with the Exchange Act and rules adopted thereunder (including SRO rules). Associated persons (defined in §3(a)(21)) include a corporate parent or affiliates, regardless of whether they are engaged in securities activities or where their activities are carried out. Qualifications to this obligation include (a) Exchange Act §17(d), which contemplates that the SEC will avoid duplication and foster coordination among SROs (see rules 17d-1 and 17d-2 thereunder); (b) Exchange Act §19(g)(1), which incorporates the rule of reason in qualifying the obligation to enforce compliance with the phrase "absent reasonable justification or excuse"; and (c) Exchange Act §19(g)(2) which authorizes the SEC to relieve an SRO of obligations to enforce compliance by members or classes of associated persons. Rule 19g2-1, adopted thereunder, establishes three classes of persons: (i) securities persons, (ii) controlling persons, and (iii) all others. Depending on the classification of an associated person, the rule relieves an SRO from the obligation to enforce compliance. Non-securities subsidiaries of a member's parent generally will not be of interest to an SRO. See Securities Exch. Act Rel. No. 12994 (Nov. 18, 1976) (10 SEC Docket 998); see also NYSE rule 304 and Information Memo 81-8 (Feb. 4, 1981) concerning approved persons.

Perhaps caused in part by competitive zeal, SROs also evidence an inclination to expand their areas of regulation.<sup>47</sup> Nonetheless, the SROs may be constrained by the growth of multi-service financial conglomerates. Given the present compartmentalization of financial regulation and the concomitant purview of the Exchange Act, the stock exchanges and the NASD would have difficulty regulating, for example, insurance or thrift activities, not to mention dry-goods or construction. While it might be contended that SROs are as suitable as government agencies for functional regulation, the absence of a tradition of self-regulation in the non-securities sectors of financial markets means that such sectors would have to generate SROs from scratch. Moreover, the performance of SROs in the securities arena suggests that self-regulation in non-securities areas may not be such a wise course.

### C. Cost of Self-Regulation

If SROs are overregulating, it follows that such regulation is more expensive than it should be. Although this is equally true of overzealous government regulators, it is, nonetheless, possible that the dynamics of self-regulation lend themselves to compounding costs. Government regulators may view SROs as an off-balance sheet means of leveraging the overall regulatory scheme, and SRO officials may be enthusiastic accomplices.

In promoting the idea of an SRO for investment companies, an SEC Commissioner stated:

The rapid growth and change in the industry have greatly increased the Commission's workload. On top of the continuing projects which the Commission has undertaken, including its comprehensive review of the regulatory and disclosure requirements applicable to investment companies, have come greatly increased filings and a host of novel regulatory issues. Beyond these burdens, of course, is the Commission's responsibility for inspections. Here is the nub of the problem. Despite increasing demands in responsibilities, the Commission's staff resources have been cut back. This problem is likely to persist for the foreseeable future. . . . We are finding it increasingly difficult to respond to the growth and change in the industry and to maintain a cycle of inspections that assures adequate public confidence and protection of investors.<sup>48</sup>

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47. SPECIAL STUDY, *supra* note 1, pt. 4, at 502. Over the protest of other SROs, for example, the NYSE recently changed its member firm regulatory fee structure, stating that: "[t]he Exchange computes the new fee on member firms' gross revenues . . . a basis that reflects the over-all nature of a member's business, rather than—as in the past—solely on the basis of Exchange trades. . . ." NYSE 1983 Annual Report 15. See Securities Exch. Act Rel. No. 20843 (April 9, 1984). *But see* Exch. Act §§6(b)(5) and 15A(b)(6); S. REP. No. 75, 94th Cong., 1st Sess. 47 (1975).

48. See Remarks by Bevis Longstreth to Mutual Funds and Investment Management Conference: *Investment Company Self-Regulation—The Time Is Now* (March 24, 1982); see also *supra*

This "deficiency," the Commissioner asserted, should be supplied by an SRO. Unfortunately, neither the Commissioner nor the SEC collegially has addressed the alternative of doing fewer inspections but in a more productive way.<sup>49</sup>

Considering the overall costs of self-regulatory processes, we should be concerned about congressional authority over independent agencies' budgets.<sup>50</sup> If Congress denies authority for a program, and a regulator simply proceeds with the program, shifting the cost to the industry by means of a self-regulatory system, the regulator has circumvented the legislative process. Regulators could thus avoid fiscal accountability.<sup>51</sup> After all, regulation becomes no less intense or comprehensive by being assigned to an SRO. Moreover, given the oversight obligation on the part of government, assigning an area to a self-regulator might result in a greater overall regulatory burden than if carried out by a government agency directly.<sup>52</sup>

#### D. Abuse of Rights

An SRO exercises governmental power in several ways that may adversely affect the interests of particular persons. The SRO may impose disciplinary

note 5 (comments of former SEC Commissioner Thomas discussing self-regulation).

As suggested in 1978 by Harold Williams, then chairman of the SEC, an SRO for investment companies would conduct inspections, set business practice standards, enact certain economic regulations and discipline its members. The later proposal was limited to inspections.

49. In a presentation to the Securities Regulation Institute of the University of California on January 21, 1983, SEC Chairman John S.R. Shad pointed out that the Commission had conducted 1,065 investment company and advisor inspections in its 1982 fiscal year, up 26% from the prior fiscal year and the highest level in recent years. *See* Remarks of John S.R. Shad to Securities Regulation Institute of the University of California (Jan. 21, 1983); *see also* 15 SEC. REG. L. REP. (BNA) 457 (Mar. 11, 1983). SEC Chairman Shad attributed these results in part to improved management techniques and automation. Mr. Shad asserted that fees received as a percentage of the SEC budget had increased to 94% in fiscal 1982 (principally due to the growth of money market funds).

50. The securities industry, and indirectly public investors, bear the costs of self-regulatory organizations. The SEC, like other government agencies, is funded by the taxpayers, though various fees charged by the Commission offset a substantial part of the budget. This budgetary happenstance could be altered legislatively and should not by itself dictate public policy.

51. *See* Johnson Remarks, *supra* note 29, at E-1. NASD District Business Conduct Committees have postponed determination on matters presented to them in order to apply pressure against defendants to achieve sanctions, such as reimbursement to customers, that are not within the NASD's direct power.

52. *See* SPECIAL STUDY, *supra* note 1, pt. 4. at 694-95. The Special Study answers the criticism that self-regulation may be more burdensome than governmental regulation with the argument that

participation by the regulated in the regulatory process tends not only to make regulation more palatable but also, by making the participants more aware of the goals of regulation and of their own stake in it, to make them individually more likely to discipline themselves and to render 'voluntary' obedience. . . .

[T]hose whose concern about conduct has been directed 'beyond the periphery of law in the realm of ethics and morality' are less likely to give rise to regulatory concern in the narrow sense. *Id.*;

*see also* Jennings, *supra* note 7, at 677.

sanctions, deny membership and prohibit members from doing business with particular non-members or in certain securities.<sup>53</sup>

As the Special Study recognized, SROs do not constitute a homogeneous membership having identical interests.<sup>54</sup> Moreover, some industry participants may be able to dominate an SRO and then create competitive disadvantages for smaller members or those firms attempting to enter a market.<sup>55</sup> Because of this disparity of interests and the ability to influence the SRO, the Special Study regarded as "essential that regulatory structures and procedures be such that the legitimate rights and interests of no affected group are overridden and that inaction-producing impasses are promptly and appropriately resolved."<sup>56</sup>

The legislative history of self-regulation reflects that part of its appeal was "nonlegal, quick acting, nonreviewable disciplinary measures [by comparison with] the slower moving processes of an administrative agency or the courts."<sup>57</sup> William O. Douglas characterized industry self-regulation as able to "act swiftly and more subtly than a government bound by due process standards. . . ."<sup>58</sup> A critic of these processes charges, however, that "[a] paucity of procedural guidelines, a lack of adherence to such guidelines as they exist, an excess of discretionary power vested in staff personnel, arbitrary decisions, and a generally haphazard approach . . . permeate the proceedings of the two major exchanges and the NASD."<sup>59</sup>

Of course, the statutory scheme established in 1934 was not altogether bereft of procedural protections,<sup>60</sup> and Congress subsequently has augmented

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53. See *Securities Acts Amendments of 1975, Report to the Senate Committee on Banking, Housing and Urban Affairs*, S. REP. No. 75, 94th Cong., 1st Sess. 24 (1975) [hereinafter cited as 1975 SENATE COMMITTEE REPORT]; SENATE INDUSTRY STUDY, *supra* note 12, at 14.

54. See SPECIAL STUDY, *supra* note 1, pt. 4, at 696.

55. Domination may occur because of the larger resources commanded by a particular group of participants with similar interests or because of political advantages in an SRO's internal processes. Cf. *Order Disapproving Proposed Rule Change SR-CBOE-84-16 and Approving Proposed Rule Change SR-CBOE-84-15*, Securities Exch. Act. Rel. No. 22058 (May 21, 1985); *Chicago Board Options Exchange Inc.*, Securities Exch. Act Rel. No. 21439 (Oct. 31, 1984).

56. See SPECIAL STUDY, *supra* note 1, pt. 4 at 696; see also Roper Report, *supra* note 20, at 10.

57. Roper Report, *supra* note 20, at 8, 12.

58. J. SELIGMAN, *supra* note 19, at 158. A due process defined by adversary procedures undoubtedly is an unstated assumption of this advantage. Although beyond the scope of this article, the theory of "internal" administrative law being developed by Jerry Mashaw in the context of social welfare programs offers an alternative means of dealing with the time and cost constraints of the procedural safeguards and appellate review that traditionally have been intrinsic to our notions of due process. See J. MASHAW, *BUREAUCRATIC JUSTICE* (1983); Mashaw, *The Management Side of Due Process*, 59 CORNELL L. REV. 772 (1974); Verkuil, *The Self-Legitimizing Bureaucracy*, 93 YALE L. J. 780 (1984).

59. See Lowenfels, *supra* note 30, at 376; *Silver v. New York Stock Exchange*, 373 U.S. 341 (1963) (illustrating arbitrariness identified by Lowenfels). But see Poser, *Reply to Lowenfels*, 64 CORNELL L. REV. 402 (1979).

60. See, e.g., Exchange Act §6 (exchanges must submit data concerning rules of procedure as condition to registration) and Exchange Act §19(b) (SEC authorized to alter or supplement exchange rules as condition to registration).

these protections.<sup>61</sup> Nonetheless, the appeal of summary processes to the drafters of the initial scheme, and the drafters' belief that due process was too cumbersome an element to fit neatly into the self-regulatory scheme gives reason to consider the treatment by SROs of their members on occasion, whether for competitive or other reasons.<sup>62</sup>

### E. Impact on Competition

Negative impact on competition may be the most severe drawback of self-regulation. The Senate Industry Report expressed concern that "exchanges have undertaken to regulate the activities of their members in areas which essentially require economic determinations rather than decisions as to whether particular activities are inequitable, manipulative, fraudulent or deceptive. The decision-making process in these areas has created serious problems for the self-regulatory system."<sup>63</sup> Formulation by an industry of standards of business conduct and enforcement of those standards is inherently restrictive of competition.<sup>64</sup> As the United Kingdom White Paper explained, "it is a risk of regulation by practitioner-based organizations that

61. The Maloney Act provided procedural safeguards for members of national securities associations. Exchange Act §15A; see, e.g., *National Ass'n of Sec. Dealers*, 17 S.E.C. 459 (1944). The Securities Acts Amendments of 1975 subsequently extended these safeguards to exchange members. Exchange Act §6(b)(6)-(7).

62. Under NYSE rule 476A, for instance, the NYSE may simply impose a fine of up to \$5,000 for "any violation of an Exchange rule which the Exchange determines to be minor in nature." The NYSE would

serve on the person to be fined a written statement setting forth the rule violated, the act or omission constituting the violation, the fine imposed, and the date by which the fine must be paid or the person must contest the matter. The person may pay the fine, thereby waiving his right to a disciplinary proceeding under Rule 476 and any review of the matter by a Hearing Panel or the Exchange Board of Directors, or he may contest the fine by submitting a written answer. If the fine is contested, the matter becomes a "disciplinary proceeding" before a Hearing Panel under Rule 476. The Hearing Panel will then determine guilt or innocence and will be free to impose any disciplinary sanction permitted under Rule 476. In such a case, the Hearing Panel will also determine whether the rule violation was minor in nature.

Securities Exch. Act Rel. No. 21327, 49 Fed. Reg. 37201 (1984).

Notwithstanding the exchange's claim of efficiency for this process, the practical working of such a rule is likely to put the person charged at a disadvantage. The previous requirement that a hearing panel review settlements provides some protection both for persons charged and for the integrity of the disciplinary process. The proposed procedure will tip the balance of cost and risk against those charged with rule violations.

63. SENATE INDUSTRY STUDY, *supra* note 12, at 15. The Senate Industry Study reported that some ten years after *Silver v. New York Stock Exchange*, neither of the principal stock exchanges had established procedures for providing notice or a hearing for non-members adversely affected by their actions. *Id.* at 154; see also *infra* notes 125-41 and accompanying text.

64. See *Silver v. New York Stock Exchange*, 373 U.S. 341 (1963); SPECIAL STUDY, *supra* note 1, pt. 4, at 502, cf. Maurizi, *Occupational Licensing and the Public Interest*, 82 J. POL. ECONOMY 339 (1974); Benham & Benham, *supra* note 43; Urban & Mancke, *supra* note 32; Jordan, *supra* note 32; Plott, *Occupational Self-Regulation: A Case Study of the Oklahoma Dry Cleaners*, 8 J. LAW & ECON. 195 (1965).



they may degenerate into cosy clubs or cartels.”<sup>65</sup> Referring back to the standard of optimal allocative efficiency, however, it is important to keep in mind that government regulation may be at least as anti-competitive as self-regulation. Thus, the first consideration should be whether any regulation is needed.<sup>66</sup>

SROs act as quasi-public utilities, particularly in their operation of public marketplaces.<sup>67</sup> This raises different issues from those relating to standards of business conduct. Here SROs are competing against each other in seeking to attract participants to their respective markets. Reconciling the role of competing promoter with disinterested regulator is not easy. This incongruous pairing of roles can only lead to confusion on the part of the regulated, not to mention the SROs themselves.

### F. The Dilemma

Should regulation in the financial markets always be direct? The tendency of SROs to insulate a regulated industry would be avoided; a layer of arguably redundant regulation would be removed and costs might be reduced; full due process standards would avoid competitive and other abuses; and the impact on competition could be monitored more closely and, hopefully, ameliorated. Supporters of self-regulation will counter that SROs can better provide detailed regulation, deal with ethics and morals, be more responsive, eliminate regulatory tensions and foster participation by the regulated, as well as that SROs are somehow inherently preferable as a means of social control.<sup>68</sup> Empirical support for these contentions, however, is noticeably absent. Even with day-to-day regulation of floor activities on stock exchanges, probably the most difficult area for the SEC to assume, experience with the self-regulatory alternative makes one skeptical.<sup>69</sup>

## III. THE WORKINGS OF SELF-REGULATION

As noted earlier, self-regulation appears to have played a more important role in the securities markets than in any other sector of the economy.<sup>70</sup> The exchanges and the NASD<sup>71</sup> regulate their respective market facilities, pro-

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65. U.K. WHITE PAPER, *supra* note 3, at 15; *see also id.* at 23-24.

66. Edwards, *supra* note 16, at 46.

67. *See* SPECIAL STUDY, *supra* note 1, pt. 4, at 502.

68. *See supra* notes 19-26 and accompanying text (discussing myth of self-regulation).

69. *See infra* note 183 and accompanying text.

70. *See supra* notes 1 & 2; Cary, *supra* note 3. “Self-regulation does not seem to have played as major a role in the regulation of other financial institutions as it has in the securities industry. The expansion of self-regulation into those areas raises issues as to whether new SROs should be formed and, if so, what activities they would perform.” SEC Self-Regulation Paper, *supra* note 6, at 9. Except for the SEC, financial regulators generally have employed direct oversight, although they rely to some extent on independent public accountants, an alternative method of self-regulation.

71. Until recently broker-dealers that chose not to join the NASD were regulated directly by the SEC through its SECO (SEC only) program, but 1983 amendments to the Exchange Act

mulgate rules of conduct for their members and enforce those rules as well as the securities laws. SRO rulemaking covers sales practices and ethical norms, trading and other business practices, and financial and operational responsibility. As described by the SEC, "[SROs] are responsible for establishing, reviewing with a view to assuming compliance, and enforcing standards of conduct. SRO's have been particularly important in the regulation of ethical standards, business practices, and financial responsibility."<sup>72</sup>

### A. *The Statutory Scheme*

While American stock exchanges have regulated members' conduct since the Nineteenth Century, it was not until 1934 that the Exchange Act created government-supervised self-regulation.<sup>73</sup> In considering this legislation, Congress found exchange self-regulation wanting in important respects.<sup>74</sup> Nonetheless, Congress believed that if buttressed with governmental oversight, the benefits of self-regulation would outweigh any shortcomings.<sup>75</sup>

Then in 1938 Congress passed the Maloney Act, which provided for associations of participant members to assume a regulatory role for the over-the-counter market similar to that of the exchanges for their marketplaces.<sup>76</sup> In this role, the associations would be subject to more intensive oversight by the SEC than had been provided for the exchanges.<sup>77</sup>

eliminated the SECO program and required membership in a national securities association for all broker-dealers except those who execute securities transactions only on securities exchanges to which they belong. See Securities Exch. Act Rel. No. 20273 (1983).

72. SEC Self-Regulation Paper, *supra* note 6, at 1.

73. See Jennings, *supra* note 7, at 667-77 (describing evolution of self-regulatory system). Speculation on and shortcomings of stock exchanges had been of recurring legislative concern since early in the century. See generally 42 CONG. REC. 1347, 1349 (Jan. 31, 1908) (statement of President Roosevelt); *Regulation of the Stock Exchange, Hearings on S. 3895 Before the Senate Comm. on Banking and Currency*, 63d Cong., 2d Sess. (1914); Tracy & MacChesney, *The Securities Exchange Act of 1934*, 32 MICH. L. REV. 1025, 1033-36 (1934); White, *The Hughes Investigation*, 17 J. POL. ECON. 528 (1909).

74. See *Silver v. New York Stock Exchange*, 373 U.S. 341, 350-52 (1963).

75. See *Hearings on H.R. 7852 and H.R. 7820 Before the House Committee on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 544 (1934); see also SENATE INDUSTRY STUDY, *supra* note 12, at 137-43 (discussing congressional debate over utility of self-regulation); J. SELIGMAN, *supra* note 19, at 73-100 (discussing evolution of self-regulation).

76. Maloney Act, Pub. L. No. 719, 75th Cong., 3d Sess. (1938). See II L. Loss, *supra* note 12, at 1362-63 (discussing New Deal antecedents of Maloney Act). The discovery of the embezzlement by Richard Whitney, a member and former president of the New York Stock Exchange, of securities belonging to customers as well as the Exchange's gratuity fund facilitated enactment of this legislation. See J. SELIGMAN, *supra* note 19, at 183-89. See F. PECORA, *WALL STREET UNDER OATH* 258-82, 287-89, 300-03 (1939) (florid description of abuses of and on Exchange prior to enactment of Exchange Act).

77. Section 15A(b) of Exchange Act required the SEC to make more definitive findings with respect to the functioning of securities associations before permitting registration than in the case of the exchanges. Moreover, while exchanges only had to furnish the SEC with rule amendments after their adoption, associations were required under §15A(g) to file such changes with the SEC for review in advance of effectiveness. See SENATE INDUSTRY STUDY, *supra* note 12, at 145 (discussing amendments to self-regulatory scheme).

The resulting bifurcated structure continued basically unchanged until enactment of the Securities Acts Amendments of 1975.<sup>78</sup> Severe back-office problems in the securities industry,<sup>79</sup> coupled with a perception that the industry had not been responsive to changing economic and technological conditions,<sup>80</sup> had led Congress to review the workings of self-regulation.<sup>81</sup> Although Congress again recognized self-regulation as part of the scheme of governance for the securities industry, it found fault both with the SROs and with the SEC in its oversight function. Accordingly, in the 1975 amendments Congress imposed a much more comprehensive SEC oversight role. These amendments were also supposed to remove impediments to competitive, fair and orderly markets,<sup>82</sup> and to facilitate a national market system.<sup>83</sup> Moreover, Congress created a new SRO, the Municipal Securities Rulemaking Board (MSRB).<sup>84</sup>

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78. Pub. L. No. 94-29 (1975).

79. See generally H.R. REP. NO. 123, 94th Cong., 1st Sess. 44-45 (1975); J. SELIGMAN, *supra* note 19, at 450-66; H. BARUCH, *WALL STREET SECURITY RISK* (1971).

80. 1975 SENATE COMMITTEE REPORT, *supra* note 53.

81. See N. WOLFSON, R. PHILLIPS & T. RUSSO, *REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS* ¶ 12.01 (1977).

82. These impediments were identified as: (a) fixing of brokerage commission rates, (b) restrictions on access to markets and on market making, (c) opposition to integration of markets by vested interests, (d) monopolistic control of the dissemination of market information, and (e) the absence of effective control of market development operations by the SEC. 1975 SENATE COMMITTEE REPORT, *supra* note 53, at 1; see generally SENATE INDUSTRY STUDY, *supra* note 12.

83. Section 11A of the amended Exchange Act directs the SEC to facilitate a national market system and generally provides specifications for the system. Section 17A defines a system for clearing and settling securities transactions. Sections 17A(c) and 11A(b) require registration of, respectively, securities transfer agents and securities information processors.

Although the SROs have played a pivotal role in developing—or impeding, as the case may be—the national market system, detailed treatment of this subject is outside the scope of this article. See SUBCOMM. ON OVERSIGHT AND INVESTIGATION OF THE HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, *NATIONAL MARKET SYSTEM: FIVE YEAR STATUS REPORT*, 96th Cong., 2d Sess. (Comm. Print 96-IFC 56); Cohen, *The National Market System—A Modest Proposal*, 46 GEO. WASH. L. REV. 743 (1978); Harman, *The Evolution of the National Market System—An Overview*, 33 BUS. LAW. 2275 (1978); Macey & Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. ILL. L. REV. 315 (1985); Melton, *Corporate Equities and the National Market System*, FRBNY QUAR. REV. 13 (Winter 1978-79); Poser, *Restructuring in Stock Markets: A Critical Look at the SEC's National Market System*, 56 N.Y.U.L. REV. 883 (1981); Werner, *Adventure in Social Control of Finance: The National Market System for Securities*, 75 COLUM. L. REV. 1233 (1975); Werner, *The SEC as a Market Regulator*, 70 VA. L. REV. 755 (1984).

84. Exchange Act §15B(b). In creating the MSRB, Congress again chose self-regulation over direct governmental regulation as the preferred means of comprehensive governance of securities markets. SENATE COMMITTEE REPORT, *supra* note 53, at 46. See generally Dikeman, *Municipal Securities Rulemaking Board: A New Concept of Self-Regulation*, 29 VAND. L. REV. 903 (1976); Wallison, *Self-Regulation of the Municipal Securities Industry*, 6 SEC. REG. L. J. 291 (1979); Comment, *Federal Regulation of Municipal Securities: A Constitutional and Statutory Analysis*, 1976 DUKE L.J. 1261, 1270-74. Prior to the 1975 amendments, municipal securities dealers had long been successful in fending off this and other forms of regulation. See J. SELIGMAN, *supra* note 19, at 187-88.

The Exchange Act previously had required registration of SROs, thus providing a measure of implicit control, but had not defined the authority of national securities exchanges over their members. Congress amended section 6 of the Exchange Act to extend the more definitive scheme applicable to the NASD under section 15A of the Act to the exchanges. Under this new scheme, the SEC was to judge applications for registration by SROs according to the following standards:

1. The SRO must have the capacity to carry out the purposes of the Exchange Act and must enforce compliance by its members with the Act as well as the SRO's own rules.<sup>85</sup>

2. The SRO must accept as members all persons meeting relevant capital and competency requirements,<sup>86</sup> excepting only specified categories of persons.<sup>87</sup>

3. Rules of the SRO must provide for fair representation of its membership in the SRO's governance as well as one or more directors who are representatives of issuers and investors.<sup>88</sup>

4. Fees, dues and other charges must be allocated equitably.<sup>89</sup>

5. Rules of the SRO must be designed to prevent fraudulent and manipulative practices.<sup>90</sup>

6. An SRO must enforce the Exchange Act and its own rules and impose appropriate sanctions on violators.<sup>91</sup>

7. Rules must provide fair disciplinary procedures<sup>92</sup> and minimum due process requirements.<sup>93</sup>

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85. Exchange Act §§6(b)(1) and 15A(b)(2); *cf.* U.K. WHITE PAPER, *supra* note 3, at 14, 19.

86. Exchange Act §§6(b)(2) and 15A(b)(3). Nonetheless, a national securities exchange may limit the number of members as well as those permitted to effect transactions on the floor of the exchange. Exchange Act §6(c)(4). A registered securities association may not impose such limitations. Exchange Act §15A(b)(3).

87. *Id.* §3(a)(39). Under §§6(c)(2) and 15A(g)(2) an SRO may refrain from banning such statutorily disqualified persons, although it must give advance notice of such person's membership to the SEC who may then direct the SRO to ban the person if the SEC finds denial necessary or appropriate in the public interest or for the protection of investors.

88. *Id.* §§6(b)(3) and 15A(b)(4). Congress rejected an earlier version of this section that would have provided the "public" directors with independent staff.

89. *Id.* §§ 6(b)(4) and 15A(b)(5).

90. *Id.* §§ 6(b)(5) and 15A(b)(6).

91. *Id.* §§ 6(b)(6) and 15A(b)(7). A registered securities association must also enforce compliance with the rules of the MSRB. *Id.* §15A(b)(2).

92. *Id.* §§ 6(b)(7) and 15A(b)(8).

93. *Id.* §§ 6(d)(1) and 15A(h)(1).

8. Rules must not impose any unnecessary burden on competition.<sup>94</sup>

The 1975 Amendments thus added various safeguards to the rulemaking processes of SROs. Although SROs had previously been required to file proposed rule changes with the SEC, the amendments required an additional statement of the basis and purpose of the rule and that interested parties be afforded an opportunity to be heard.<sup>95</sup> The amendments also had the effect of constraining the discretion of the SROs in determining policy outside the rulemaking process.<sup>96</sup> Moreover, the SEC was given authority to amend any SRO rule in order to make it consistent with the Exchange Act.<sup>97</sup> In addition, Congress conferred on the SEC an array of powers under section 19(h) to deal with SROs' failure to enforce their rules or the Exchange Act<sup>98</sup> or to comply themselves.<sup>99</sup>

Congress further provided in 1975 for the elimination of regulatory duplication.<sup>100</sup> When a person is a member of more than one SRO, the SEC may relieve the SRO of some or all of its regulatory responsibility concerning the member.<sup>101</sup> The SEC may also allocate subject matter among SROs.<sup>102</sup>

In completing this brief overview of the federal scheme provided in the Exchange Act for self-regulatory organizations, it should be mentioned that state regulation consistent with the Exchange Act is not preempted.<sup>103</sup>

### B. *Impact of SROs on Their Members*

SROs may affect the interests of their members in several ways. First, SROs may take disciplinary action against their members; second, SROs may deny membership; and third, SROs may require members to stop doing business or particular transactions with non-members or a particular class of

94. *Id.* §§ 6(b)(8) and 15A(b)(9); *cf.* U.K. WHITE PAPER *supra* note 3, at 14, 23-24.

95. Exchange Act § 19(b)(1). The SEC is required to publish notice of proposed rule changes and comply generally with rulemaking procedures of the Administrative Procedures Act. 5 U.S.C. §553 (1971).

96. Exchange Act rule 19b-4, 17 C.F.R. §196-4 (1985); *cf.* *National Ass'n of Sec. Dealers*, 17 S.E.C. 459 (1944).

97. Exchange Act § 19(c).

98. Congress believed that during the back-office crisis of the late 1960s, "some exchanges refused to compel strict adherence to financial responsibility requirements, which action in some cases permitted its [sic] member firms to continue in business in jeopardy to their customers." H.R. REP. No. 123, 94th Cong., 1st Sess. 49 (1975).

99. *See, e.g., Philadelphia Stock Exch.*, Securities Exch. Act Rel. No. 16648 (1980).

100. Exchange Act § 17(d)(1); *cf.* §19(g)(2).

101. Exchange Act § 17(d)(1). These include, for example, responsibilities for examinations and enforcement.

102. *Id.*; *see* Exchange Act rules 17d-1 and d-2, 17 C.F.R. §§ 240.17d-1-240.17d-2 (1984), setting forth the guidelines for such allocation; *cf.* U.K. WHITE PAPER, *supra* note 3, at 15-16; *Coordination of Securities and Commodities Regulation*, Securities Exch. Act Release No. 19706 (April 28, 1983).

103. *See Merrill Lynch, Pierce, Fenner & Smith v. Ware*, 414 U.S. 117, 137 (1973); H.R. REP. No. 123, 94th Cong., 1st Sess. 62 (1975).

non-members.<sup>104</sup> An analysis of these possible responses by SROs indicates that each may have serious competitive overtones.

### C. Disciplinary Actions

The Exchange Act requires that national securities exchanges and associations provide for enforcement of the Act and their own rules.<sup>105</sup> Acts subject to discipline also include conduct inconsistent with just and equitable principles of trade and acts detrimental to the interest or welfare of the SROs or reflecting adversely upon their reputation.<sup>106</sup> Sanctions include censure, fine, limitation of activities, suspension and bar.<sup>107</sup>

The SROs have enforcement staff who investigate misconduct. In addition, members are required to advise the SROs of certain matters that may involve violation of these provisions.<sup>108</sup> SROs may require members and associated persons to attend recorded interviews and respond to questions under oath.<sup>109</sup> If these persons invoke the privilege against self-incrimination, they may violate the SROs' rules.<sup>110</sup>

SROs must provide notice and an opportunity to be heard concerning charges brought against affected persons.<sup>111</sup> Sections 6(d)(1) and 15A(h)(1) of the Exchange Act set forth specific safeguards for disciplinary actions, and sections 6(b)(7) and 15A(b)(8) superimpose a standard of "fair proce-

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104. See SENATE INDUSTRY STUDY, *supra* note 12, at 150.

105. Exchange Act §§6(b)(1) and 15A(b)(2). The latter provision also requires that members of a national securities association be appropriately disciplined for violation of the rules of the Municipal Securities Rulemaking Board. See *Baird v. Franklin*, 141 F. 2d 238, 244 (2d Cir.), *cert. denied*, 323 U.S. 337 (1944).

106. See, e.g., NYSE rule 476; ASE rule 345; NASD Rules of Fair Practice; *Crimmins v. American Stock Exchange*, 368 F. Supp. 270, 277 (S.D.N.Y. 1973), *aff'd*, 503 F.2d 560 (2d Cir. 1974) (registered representative presumed to possess knowledge of ethical standards of his profession).

107. See, e.g., NYSE rule 476; ASE Constitution, art. V, §§ 1(c) and 4; NASD By-Laws, art. VII, §3.

108. See, e.g., NYSE rules 345 and 351.

109. NYSE rule 476(a)(11); *Richard Newberger*, NYSE Hearing Panel Decision 80-39 (July 11, 1980); ASE rule 341; NASD Rules of Fair Practice, art. IV, §5.

110. See, e.g., *United States v. Solomon*, 509 F.2d 863 (2d Cir. 1975); *United States v. Sloan*, 388 F. Supp. 1062 (S.D.N.Y. 1975); *In re Lawrence H. Abercrombie*, Securities Exch. Act Rel. No. 16285 (Oct. 18, 1975). ASE Disciplinary rule 11 (b) prohibits legal objections to the exchange's inquiries until there is a hearing on the matter under investigation. Denial of the right against self-incrimination is based on the theory that membership in an SRO is a privilege and that in return for such privilege, one commits to abide by certain rules. See *Belton v. Hatch*, 109 N.Y. 593, 17 N.E. 225 (1888); MEYER, LAW OF STOCKBROKERS AND STOCK EXCHANGES 37-46 (1931). A system of self-regulation would not be effective, the theory goes, without the ability to compel self-incriminating testimony, which the member (or its associated person) has agreed to provide in exchange for the privilege of membership.

111. See *Silver v. New York Stock Exch.*, 373 U.S. 341 (1963); *Crimmins v. American Stock Exch.*, 368 F. Supp. 270, 281 (S.D.N.Y. 1973), *aff'd*, 503 F. 2d 560 (2d Cir. 1974); *cf. Intercontinental Industries v. American Stock Exch.*, 452 F. 2d 935, 941 (5th Cir. 1971), *cert. denied*, 409 U.S. 842 (1972) (delisting proceeding).

dures" for all such actions.<sup>112</sup> Discovery rights for respondents in SRO disciplinary proceedings, however, are limited.<sup>113</sup>

Hearings are held before panels composed of members and staff.<sup>114</sup> Parties may be represented by counsel both before and at the hearings.<sup>115</sup> Hearing panels are not bound by formal rules of evidence and base their decisions on "businessmen's judgment." Although rules of the SROs do not prescribe a standard of proof, the preponderance standard used by the SEC in disciplinary proceedings involving charges of violations of the anti-fraud provisions of the federal securities laws and approved by the Supreme Court in *Steadman v. SEC*<sup>116</sup> is probably applicable.<sup>117</sup>

Decisions of such panels may be reviewed by the SROs' boards.<sup>118</sup> Final disciplinary action is subject to review by the SEC, either on its own motion or on application of an aggrieved person.<sup>119</sup> The SEC may set aside or reduce the sanction or it may remand the proceeding to the SRO; it may not increase the sanction. Persons aggrieved by the SEC decisions may obtain review by a United States Court of Appeals, which may affirm, modify or set aside the SEC's order.<sup>120</sup>

Several courts have found disciplinary actions of exchanges to be governmental in character and, therefore, subject to the requirements of due process.<sup>121</sup> Courts that have reviewed NASD actions, however, have reached

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112. See *Merrill Lynch, Pierce, Fenner & Smith v. NASD*, 616 F.2d 1363, 1371 (5th Cir. 1980).

113. Such respondents generally are not permitted to take prehearing depositions and are not entitled to the prehearing production of documents. The NYSE and ASE rules do not permit discovery of documents prepared in connection with proceedings, although the NYSE's Department of Enforcement and the ASE's Compliance Department say that they will provide voluntarily exculpatory evidence and statements of witnesses intended to be called.

114. NYSE Hearing Panels are chaired by employees of the exchange who are supposed to be independent from the departments that issue the charges and the investigative and prosecutorial arms of the exchange. NYSE rule 476(b). At the ASE, the Director of Hearings, an employee of the exchange, chooses panel members from the securities industry but does not sit on such panels herself. Formal disciplinary proceedings of the NASD are held before hearing panels that are usually subcommittees of District Business Conduct Committees and their industry representatives.

115. See, e.g., ASE Constitution, art. V, sec. 1(a).

116. 450 U.S. 91 (1981).

117. See *In re Walter T. Newman*, Securities Exch. Act Rel. No. 18932 (Aug. 4, 1982); Admin. Proc. File No. 3-6045.

118. See, e.g., NYSE rules 476(f) and (g); ASE rules 345(e) and (i); NASD Code of Procedure §15(a).

119. See Exchange Act §§15A(h)(3), 19(d), 19(e), and rule 19d-2 thereunder. Prior to the 1975 amendments, the SEC could review only disciplinary actions of the NASD. 15 U.S.C. §780-3(f) and (g) (1970) (amended by Pub. L. No. 94-29, 89 Stat. 97 (1975)).

120. Exchange Act §25(a)(1).

121. *Intercontinental Indus., Inc. v. American Stock Exch.*, 452 F.2d 935, 940-43 (5th Cir. 1971), cert. denied, 409 U.S. 842 (1972) (delisting proceeding requires minimum procedural protections); *Villani v. New York Stock Exch.*, 348 F. Supp. 1185, 1188 n.1 (S.D.N.Y. 1972) (due process requirements apply to NYSE disciplinary hearings), *aff'd sub. nom. Sloan v. New York Stock Exch.*, 489 F.2d 1 (2d Cir. 1973); *Crimmins v. American Stock Exch.*, 346 F. Supp.

opposite conclusions.<sup>122</sup> Various attacks on the NASD's disciplinary authority based on a theory of unconstitutional delegation of legislative authority by Congress also have been unsuccessful.<sup>123</sup> It is curious that similar challenges have not been made to the disciplinary authority of the exchanges, although the SEC has asserted that the exchanges' disciplinary powers were not conferred by Congress.<sup>124</sup>

#### D. SROs and Competition Among Members

Self-regulatory schemes are subject to the danger that "a group of competitors agreeing to impose restrictions upon themselves . . . will use its power, intentionally or unintentionally, to limit competition or disadvantage non-member competitors. . . ." <sup>125</sup> This peril is exacerbated by the commingling of disciplinary and market-regulation functions, such as reallocation of specialists' stocks by exchanges, as well as by the vagueness of SRO precepts such as the "high standards of commercial honor" and "just and equitable principles of trade."<sup>126</sup> To illustrate, the Batten Committee, formed by the NYSE to study its stock allocation system, recommended in a report in 1976 that the specialists' function as well as the criteria for allocation of stocks be better defined. The committee pointed to the difficulty of proving violations of the exchange's rules because of the vagueness of terms such as "reasonable" and "good business practices." The competitive ramifications of this process are considerable.

Indeed, competitive advantages are a significant attraction to SRO membership.<sup>127</sup> For example, NASD members are prohibited from dealings

1256, 1259 (S.D.N.Y. 1972) (minimum due process applies to exchange disciplinary proceeding, though this does not automatically include right to counsel), *aff'd*, 503 F.2d 560 (2d Cir. 1974).

122. *United States v. Bloom*, 450 F. Supp. 323, 330 (E.D. Pa. 1978) (NASD is not governmental actor); *Harwell v. Growth Programs, Inc.*, 315 F. Supp. 1184 (W.D. Tex. 1970) (NASD is a governmental actor), *rev'd on other grounds*, 451 F. 2d 240 (5th Cir. 1971), *modified per curiam*, 459 F. 2d 461 (5th Cir.), *cert. denied*, 409 U.S. 876 (1972); see Comment, *Governmental Action and the National Association of Securities Dealers*, 47 *FORDHAM L. REV.* 585 (1979); see also Westwood & Howard, *supra* note 1, at 529-30.

123. See, e.g., *Sorrell v. SEC*, 679 F.2d 1323, 1325 (9th Cir. 1982); *First Jersey Securities, Inc. v. Bergen*, 605 F.2d 690, 697 (3d Cir. 1979), *cert. denied*, 444 U.S. 1074 (1980); *Todd & Co., Inc. v. SEC*, 557 F.2d 1008, 1012 (3d Cir. 1977); *R. H. Johnson & Co., v. SEC*, 198 F.2d 690, 695 (2d Cir.), *cert. denied*, 344 U.S. 855 (1952).

124. *In re Harold C. Allen*, Securities Exch. Act Rel. No. 14763 (May 16, 1978), *aff'd sub. nom. Allen v. SEC*, 577 F.2d 388 (7th Cir. 1978). Moreover, until the 1975 amendments to the Exchange Act, exchange disciplinary actions were not appealable to the SEC.

125. SENATE INDUSTRY STUDY, *supra* note 12, at 19; see generally Comment, *Trade Association Exclusionary Practices: An Affirmative Role for the Rule of Reason*, 66 *COLUM. L. REV.* 1486 (1966); MEYER, *LAW OF STOCKBROKERS AND STOCK EXCHANGES* 60-64 (1931).

126. See *supra* note 106 and accompanying text; cf. *Colonial Realty Co. v. Bache*, 358 F.2d 178, 183 n.6 (2d Cir. 1966).

127. Comment, *Over-the-Counter Trading and the Maloney Act*, 48 *YALE L. J.* 633, 646-47 (1939); cf. Miller, *supra* note 8, at 102. The only alternative to economic benefits is compulsory membership, which was the method authorized by Congress for organizations created under § 17 of the CFTC Act. See 17 C.F.R. § 170.15 (1985) (mandatory membership



with non-members except upon the same terms as the general public.<sup>128</sup> In order to participate in most underwritings, broker-dealers must be members of the NASD.<sup>129</sup> Moreover, since 1983, all broker-dealers engaged in the over-the-counter securities business must belong to a national securities association;<sup>130</sup> the only national securities association being the NASD.

In *Silver v. New York Stock Exchange*,<sup>131</sup> the United States Supreme Court dealt with an abuse of power by an SRO. Two broker-dealers who were not members of the NYSE arranged with members for direct wire connections to their corporate securities trading departments. The member firms applied to and were granted temporary approval by the NYSE of the wire connection. The NYSE also approved a direct teletype connection to a member firm and a stock ticker service from the floor of the exchange. Several months later, the NYSE disapproved and instructed its member firms to discontinue these arrangements. No notice was given to the non-members nor was any explanation furnished. An inhibited ability to obtain commissions and communicate with other firms, as well as the stigma attached to the NYSE's disapproval, diminished the volume of business and profits of the non-members. The non-members alleged that the NYSE and its members had conspired to deprive the non-members of their wire connections and stock ticker services in violation of sections 1 and 2 of the Sherman Act.

Emphasizing the lack of procedural safeguards,<sup>132</sup> the Court questioned "whether the New York Stock Exchange is to be held liable to a non-member broker-dealer under the anti-trust laws or regarded as impliedly immune therefrom when, pursuant to rules the Exchange has adopted under the Securities Exchange Act of 1934, it orders a number of its members to remove private direct telephone wire connections previously in operation between their office and those of the non-member, without giving the non-member notice, assigning him any reason for the action, or affording him an opportunity to be heard."<sup>133</sup> The Court next proceeded "to reconcile pursuit of the anti-trust aim of eliminating restraints on competition with

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in registered futures associations by futures commission merchants); S. REP. No. 95-850, 95th Cong., 2d Sess. 31 (1978). Compulsory membership subsequently was adopted with respect to national securities associations. Exchange Act § 15(b)(8).

128. NASD Rules of Fair Practice, art. III, §25, NASD MANUAL D-13; see Comment, *Governmental Action and the National Association of Securities Dealers*, 47 *FORDHAM L. REV.* 585, 587 (1979).

129. See Westwood & Howard, *supra* note 1, at 527-28, 539 n. 118.

130. Exchange Act § 15(b)(8); Pub. L. No. 98-38 (1983); see *Amendments to the Securities Exchange Act of 1934, Report to Accompany H.R. 2681*, No. 98-106, 98th Cong., 1st Sess. (1983).

131. 373 U.S. 341 (1983).

132. *Id.* at 358. In *Silver v. New York Stock Exchange*, the Court stated that had there been "Commission jurisdiction and ensuing judicial review for scrutiny of a particular exchange ruling, as there is under the 1938 Maloney Act amendments to the Exchange Act to examine disciplinary action by a registered securities association . . . a different case would arise concerning exemption from laws designed to prevent anticompetitive activity. . . ." *Id.* at 358 n.12.

133. *Id.* at 358.

the effective operation of a public policy contemplating that securities exchanges will engage in self-regulation which may well have anti-competitive effects in general and in specific applications.”<sup>134</sup> It then accommodated the NYSE’s power under the Exchange Act “to adopt rules governing its members’ relations with non-members” with the anti-trust laws by enunciating the principle that repeal of the anti-trust laws would be “implied only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary.”<sup>135</sup>

Applying this principle, the Court found that the lack of notice to a non-member to explain why a rule was being invoked to damage him and of an opportunity to refute the case against him was fatal to the validity of the action taken by the NYSE.<sup>136</sup> The Court said,

The point is not that the antitrust laws impose the requirement of notice and a hearing here, but rather that, in acting without according petitioners these safeguards in response to their request, the Exchange had plainly exceeded the scope of its authority under the Securities Exchange Act to engage in self-regulation and therefore has not even reached the threshold of justification under the statute for what would otherwise be an antitrust violation. . . . [I]t is perfectly clear that the Exchange can offer no justification under the Securities Exchange Act for its collective action in denying petitioners the private wire connections without notice and an opportunity for hearing, and that the Exchange has therefore violated §1 of the Sherman Act. . . .<sup>137</sup>

While *Silver* represents an effective judicial response to an anti-competitive abuse of its power by an SRO, ferreting out such abuses can be difficult. Anti-competitive measures may be mixed with and camouflaged by regulatory purposes.<sup>138</sup> The long saga of institutional membership on the exchange illustrates the obfuscation of anti-competitive purposes by regulatory trappings. It is not surprising that the exchanges and their members would exclude heavy commission payors in order to protect the system of fixed

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134. *Id.* at 349.

135. *Id.* at 357; see *Thill Securities Corp. v. New York Stock Exchange*, 433 F.2d 264 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971).

136. *Silver v. New York Stock Exchange*, 373 U.S. at 361-67.

137. *Id.* at 364-65. In considering the 1975 amendments, Congress recognized the potential conflict of judicial review of a determination by the SEC that the anticompetitive effects of an SRO rule were outweighed by the rule’s advancement of the purposes of the Exchange Act; nonetheless, Congress chose to expand the scope of such review, expressing both its confidence in the courts’ ability to reconcile regulatory and competitive factors and its intent to monitor that reconciliation. H.R. REP. No. 229, 94th Cong., 1st Sess. 100-01 (1975). Legislative consideration of anti-trust immunity of self-regulatory organizations is treated in Heckmann, *Antitrust Immunity*, 8 REV. SEC. REG. 841 (1975); see Report, *Antitrust Immunity Under the Commodity Exchange Act*, 35 RECORD OF N.Y.C.B.A. 233, 234-46 (1980) (discussing case law dealing with conflict between antitrust laws and federal regulatory schemes).

138. See, e.g., In re Rules of the New York Stock Exchange, 10 S.E.C. 270, 288-92 (1941).

commission rates. That they got away with the practice for so long, however, suggests the inherent deficiencies of self-regulatory systems.<sup>139</sup> That even Congress was gulled in 1975 into continuing the institutional exclusion in section 11(a) of the Exchange Act, albeit in attenuated form, is evidence of the political impact of the keepers of the preserve.

Still another example of the ability of competitors to manipulate the self-regulatory scheme to exclude competition is provided by the off-board trading rules. Despite the long apparent anti-competitive effects of such rules,<sup>140</sup> their removal has been gradual at best and important remnants of these anti-competitive devices are still in effect.<sup>141</sup>

### E. SROs as Competitors

In addition to affecting competition among their members, SROs compete against each other in developing new products and trading processes and are dependent upon their members for business. The NYSE calls itself a "customer-driven business organization"<sup>142</sup> and reports that "a growing array of financial products have competed for a share of the over-all pool of investable funds and commissions. And this has intensified the competition . . . among the various markets in which either similar or entirely different products are traded."<sup>143</sup>

This competition is reflected in the controversy concerning trading of options.<sup>144</sup> Until recently the SEC has not permitted multiple trading, that is, the trading of a class of options in more than one market. Instead, optionable securities were allocated among the exchanges by lottery.<sup>145</sup> Upon such allocation, options on these securities became an exclusive franchise. For instance, the NYSE has been granted approval to trade stock options but opposition by other SROs was withdrawn only after the NYSE agreed not to compete through multiple trading of options.<sup>146</sup>

The SEC questioned whether the allocation system should be extended to options on securities traded in the NASDAQ market.<sup>147</sup> In response, the NASD contended the lottery system would result in the NASD receiving "an insufficient number of underlying securities to justify the cost of developing

139. See N. WOLFSON, R. PHILLIPS & T. Russo, *supra* note 81, at ¶ 12.07 (discussing institutional membership).

140. See, e.g., STAFF REPORT ON RULE 394, H.R. Serial No. 73e, HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, SUBCOMM. ON COMMERCE AND FINANCE, 92d Cong., 1st Sess., pt. 6, at 3293, 3372 (1972); cf. *In re* Rules of the New York Stock Exchange, 10 S.E.C. 270 (1941).

141. See rule 19c-3 under the Exchange Act.

142. NYSE 1984 Annual Report 6.

143. NYSE 1983 Annual Report 23.

144. See Securities Exch. Act Rel. No. 20853 (April 12, 1984); see also Securities Exch. Act Rel. No. 16863 (May 30, 1980).

145. See Securities Exch. Act Rel. No. 22026, sec. IV (May 8, 1985).

146. 17 SEC. REG. & L. REP. (BNA) 291 (1985).

147. Securities Exch. Act Rel. No. 20853 (April 12, 1984).

options related automated systems."<sup>148</sup> Similarly the NASD opposed the granting to exchanges of unlisted trading privileges in over-the-counter securities.<sup>149</sup> The SEC concluded that multiple trading should be allowed for options on stocks traded over-the-counter but not, at least for the time being, those on exchange-listed stocks.<sup>150</sup>

Early in 1984, the SEC convened a meeting attended by officials of the options exchanges and member firms, at which the exchanges agreed to a six-month moratorium on introducing new products. While the proliferation of new products has created confusion in the marketplace and accompanying regulatory concern, the use of self-regulation under a governmental umbrella to implement agreements not to compete, such as this moratorium on new products, the moratorium on multiple trading and the allocation plan, clearly restrain trade.<sup>151</sup>

As another example of competition among the self-regulators, the primary exchanges, that is, the NYSE and the ASE, have fought aggressively to keep trades on their floors despite the objectives of the national market system. For instance, these exchanges have opposed a best-execution rule that would interrupt the order routing systems of major securities firms that generally funnel orders automatically to their floors.<sup>152</sup> The NASD, on the other hand, has sought greater access to this order flow through the Inter-market Trading System and has urged adoption of a best-execution rule.<sup>153</sup> Finally, the regional exchanges have argued vigorously against elements of a national market system that they perceive would likely result in loss of order flow to the higher-volume exchanges.

The multifaceted competition common in the self-regulatory area is also illustrated by the current efforts of the primary exchanges to amend their rules to permit diversified firms to operate specialist units on those exchanges.<sup>154</sup> These efforts generally have been supported by those firms with broad distribution capability but have been opposed by the more traditional investment banking houses lacking such capability. The latter firms fear being put at a competitive disadvantage because of the ability of the distribution firms to marshal order flow. The traditional investment banking houses thus far have inhibited significant liberalization on the NYSE by

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148. NASD, Notice to Members 84-27 (May 15, 1984).

149. See *In re Unlisted Trading Privileges in Over-the-Counter Securities*, SEC File No. 57-37-84; 49 Fed. Reg. 46156 (Nov. 23, 1984) (notice).

150. See 17 SEC. REG. L. REP. (BNA) 647 (April 19, 1985).

151. See Comments of the United States Department of Justice, *In re New York Stock Exchange Trading of Listed Stock Options*, SEC File No. SR-NYSE-84-3 (June 15, 1984); *In re Over-the-Counter Trading of Standardized Options on Over-the-Counter Securities*, SEC File No. SR-NASD-80-10 (June 15, 1984).

152. See Lipton, *supra* note 26, at 557.

153. *Id.* at 560 n. 146.

154. Current rules of the exchanges do not expressly prohibit specialist activities for such firms but effectively preclude them for those who also engage in widespread research and investment banking activities. See, e.g., ASE rules 190 and 193, NYSE rule 98; Securities Exch. Act Rel. No. 22396 (Sept. 11, 1985).

successfully lobbying for a provision in the proposed rule that a firm acting as a specialist in a particular issue could not act as managing underwriter of such issue. The efforts of the traditional banking houses were less successful at the ASE, which rejected similar requests for limitations and restrictions on diversification.

In its review of self-regulation undertaken in the early 1970s, Congress found that SROs were ill-suited to cope with competitive questions.<sup>155</sup> This finding should have come as no surprise. SROs like other business enterprises seek expanded revenues and market share. Their officials naturally will garner whatever government support can be mustered toward these objectives. The antitrust umbrella is a tactical device in the competitive struggle.<sup>156</sup>

Moreover, the SROs are competing to some extent with their members. Espousal of anti-internalization rules by the exchanges is a case in point. Although their advocacy of such rules is couched in terms of concerns about best execution of customers' orders and fragmentation of markets, the exchanges are obviously aware of the volume that might be lost to their larger members.<sup>157</sup> Thus, such concerns may disguise an effort to create new artificial restraints against retail firms competing as market makers that are inconsistent with the goals expressed by Congress in section 11A(a)(1)(c) of the Exchange Act of economically efficient execution of securities transactions, fair competition among brokers and dealers and the practicability of brokers executing investors' orders in the best market.

Similarly, the off-board trading rules of exchanges prevent member firms' execution of principal transactions in listed securities (or those admitted to unlisted trading privileges) other than on those exchanges.<sup>158</sup> Again, such restrictions serve to limit competition among the exchanges and their members as well as the NASD, and, therefore, augment the exchanges' turnover. The advent of 24-hour trading is likely to intensify this competitive tension.

Likewise the aggressive proliferation by the exchanges of new trading vehicles serves to increase competitive tension. Like their members, the exchanges are attempting to diversify their product base as well as to protect their market share of existing products. They must grow and generate new sources of revenue in order to maintain their respective market shares. The advent of computer brokerage systems that channel orders directly to automated order-routing and execution systems also presents opportunities for

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155. SENATE INDUSTRY STUDY, *supra* note 12, at 2, 3.

156. It is perhaps recognition of this potential for perversion of the governmental insulator that has led to the expansion of the SEC's market regulatory role beyond oversight. See Lipton, *supra* note 26, at 529-31; Moylan, *The Place of Self-Regulation in the Securities Industry*, 6 SEC. REG. L.J. 49, 53-58 (1978). But see Werner, *The SEC as a Market Regulator*, 70 VA. L. REV. 755 (1984).

157. See generally Securities Exch. Act Rel. No. 16888 (June 11, 1980) [1980 Transfer Binder] FED. SEC. L. REP. (CCH) 82,608; 17 C.F.R. § 140.19c-3 (1982).

158. See, e.g., New York Stock Exchange Rule 390 (CCH) ¶ 2390 (1981).

competitive challenges by exchanges against their members.<sup>159</sup> Because of their trading, communications and clearing and settlement facilities and their collaborative relationship with the SEC and other government agencies, these SROs enjoy structural advantages over their membership. The conflicts engendered by a quasi-governmental body competing with its regulated stable should be of great concern to congressional overseers.

#### F. SROs as Public Utilities

The operation of marketplaces by SROs may place them in the role of a public utility.<sup>160</sup> Because of an interesting dichotomy of congressional views, this characterization is more accurate with respect to commodity exchanges.<sup>161</sup> In the commodity context, a multiplicity of exchanges generally has been believed to undermine the objective of bringing all participants together to create optimum market conditions.<sup>162</sup> Multiple securities markets, on the other hand, are a governmental objective.<sup>163</sup> Nonetheless, individual securities markets would seem to require collective activity in a manner comparable to that of a utility.<sup>164</sup> Indeed the Special Study stated that "it would seem that the contents and procedures of regulation should be no less effective than those for other public utilities."<sup>165</sup>

#### G. Oversight

James Landis pointed out that "the mere proscription of abuses was insufficient to effect the realization of the broad objectives that lay behind the movement for securities legislation. The primary emphasis of administrative activity had to center upon the guidance and supervision of the industry as a whole."<sup>166</sup> When non-governmental bodies act as surrogates of governmental powers, the "function of public oversight becomes critical."<sup>167</sup> Public oversight must assure that the delegation of power is effective in carrying

159. See Securities Exch. Act Rel. No. 21383 (Oct. 9, 1984).

160. SPECIAL STUDY, *supra* note 1, pt. 4, at 701; H.R. REP. No. 1383, 73d Cong., 2d Sess. 15 (1934).

161. See Comment, *Trade Associations Exclusionary Practices: An Affirmative Role for the Role of Reason*, 66 COLUM. L. REV. 1486, 1492-93 (1966).

162. *Id.* at 1493; Selig, Steinmayer & Broida, *Regulation of Commodity Market Traders*, 18 REV. SEC. & COMMODITIES REG. 1-2 (1985).

163. Exchange Act §11A(a)(1)(c)(ii). Multiple markets do occur in the case of some agricultural commodities, such as wheat, and have become common for financial futures.

164. *Cf. Associated Press v. United States*, 326 U.S. 1 (1945).

165. SPECIAL STUDY, *supra* note 1, pt. 4, at 701.

166. J. LANDIS, *supra* note 14, at 15 (1938).

167. *Id.* at 697-98. "The governmental power may be delegated to greater or lesser degree, but governmental authority is held in reserve to assure that each regulatory need is met fully and effectively." *Id.* at 698; see SENATE INDUSTRY STUDY, *supra* note 12, at 137. As George Washington observed in a letter to John Jay on August 1, 1786: "Experience has taught us, that men will not adopt and carry into execution measures the best calculated for their own good, without the intervention of a coercive power." While SROs were not extant at the time, this observation might well be applied to such groups.

out the regulatory functions and that this power is not used to injure the public or discriminate against private interests.<sup>168</sup> On the other hand, excessive oversight can preempt the self-regulatory process.<sup>169</sup> The Special Study observed,

A non-governmental agency having responsibility to carry out public regulatory objectives cannot be expected to exercise the full measure of responsibility if the Commission is looking over its shoulder and directing or second-guessing each individual action that it takes. Furthermore, the existence of the power of oversight, and the risk that in the exercise of that power its own standing and prestige may be tarnished by having its performance called into question, provides

168. J. LANDIS, *supra* note 14, at 697. SROs are not authorized to act independent of SEC oversight. H.R. REP. No. 123, 94th Cong., 1st Sess. 48.

169. Letter from Harold M. Williams, Chairman of the SEC, to James H. Scheuer, Chairman of the House Subcommittee on Consumer Protection and Finance, at 2 (April 15, 1980). The SEC Chairman added that

Effective self-regulation also requires that the relationship between the Commission and the industry reflect the unique and difficult role of the SROs. A stock exchange or other self-regulatory organization is expected to perform what are sometimes two mutually inconsistent roles. As a marketplace, it competes for business and depends upon the support of its members for economic survival, while at the same time regulating the conduct of those members. Obviously, there are times when the self-regulators may have difficulty in balancing the interests of their members against their duties and responsibilities under the 1934 Act. It is the Commission's responsibility in performing its oversight role to ensure that each self-regulator is indeed striking that balance appropriately.

*Id.* In discussing the Market Oversight Surveillance System (MOSS) proposed by the SEC, Chairman Williams provided an example of Orwellian newspeak:

At the bottom, the objections to MOSS are predicated chiefly on the assumption that it will somehow duplicate or supplant existing SRO surveillance. On the contrary, however, although MOSS will enhance the Commission's capability to oversee the surveillance efforts of the SROs, the proposed system is not "redundant" of the existing SRO surveillance systems. While MOSS will process the same raw data as do the SROs, some on a daily basis, and some on a delayed basis, this information will be used for a different purpose. The Commission's objective is to ensure, on an exception basis, that the SROs routinely perform their statutory duties. The use of the underlying data for direct regulatory purposes, such as through disciplinary and other proceedings against SRO members, is largely the province of the SROs themselves.

*Id.* at 6.

The SEC intended MOSS to serve five primary functions:

- i. To monitor trading in securities markets on an exception basis;
- ii. To perform market reconstructions permitting review of historical trading;
- iii. To provide inspection support information for SEC investigations;
- iv. To assist in coordinating SRO and SEC investigations; and
- v. To assist the SEC in determining the economic impact of existing or proposed rule.

See HOUSING AND URBAN AFFAIRS AND THE HOUSE COMM. ON ENERGY AND COMMERCE REGARDING IMPLEMENTATIONS OF THE MOSS, SECOND SIX-MONTH REPORT TO THE SENATE COMM. ON BANKING (Oct. 1, 1981); S. REP. No. 96-752, 96th Cong., 2d Sess. (1980).

strong compulsion for the assumption and proper discharge of the self-regulatory functions. Thus, the very nature of the self-regulatory role points, at the same time, to the need for autonomy and the sufficiency of thorough oversight and broad powers in reserve.<sup>170</sup>

This suggests a fine balancing between restraint and action. In practice, however, the Commission has appeared to vacillate between near abdication and blanket second-guessing of SRO determinations.

The Senate Industry Study found shortcomings in oversight that had "not by and large been the result of the SEC's lack of authority but rather of its apparent lack of the will to use [its] powers."<sup>171</sup> Earlier, the Special Study acknowledged that the Commission had been less than successful "in the exercise of its powers and responsibilities to regulate conduct in the securities markets, directly or *by supervision of self-regulation*."<sup>172</sup>

The Reagan Administration's SEC Transition Team, on the other hand, asserted that oversight activities had been carried out "at a level which is both unnecessary and highly undesirable."<sup>173</sup> The Transition Team criticized SEC concentration on "insignificant detail," saying that the SEC staff was "often ill-trained and poorly equipped to evaluate in a meaningful way the programmatic activities of these self-regulatory organizations. They concentrate on the insignificant and the trivial and cause needless expenditures of government funds and self-regulatory organization funds in pursuing issues which have little relevance or importance to investor protection."<sup>174</sup>

The SEC's own view of its oversight role is set out in the SEC Paper on Self-Regulation:

The Commission engages in a number of SRO oversight activities. It approves SRO rules and reviews disciplinary actions. In addition, its staff conducts regular examinations of SRO's to ensure that they are complying with their responsibilities under the Exchange Act. The staff focuses particularly on whether the SRO's inspection and enforcement programs are adequate to assure compliance by their members. Where staff identifies deficiencies, it directs the SRO to take corrective action and inspects to see that corrective action is taken.<sup>175</sup>

The evolution of SROs from industry-dominated institutions to quasi-public bodies may lessen somewhat the need for governmental oversight. For example, the increasing role of public governors<sup>176</sup> serves as a check to

170. SPECIAL STUDY, *supra* note 1, pt. 4, at 703.

171. SENATE INDUSTRY STUDY, *supra* note 12, at 180; see Report by the Comptroller General, *supra* note 24, at 6, 7, 12; Jennings, *supra* note 7, at 664-67.

172. SPECIAL STUDY, *supra* note 1, pt. 4, at 719 (emphasis added).

173. SEC Transition Team, Final Report II-4 (Dec. 22, 1980).

174. *Id.* at II-5.

175. SEC Self-Regulation Paper, *supra* note 6, at 7.

176. See 1975 SENATE COMMITTEE REPORT, *supra* note 53, at 24, 273; H.R. REP. No. 123, 94th Cong., 1st Sess. at 60-61 (1975); H.R. REP. No. 229, 94th Cong., 1st Sess. at 98 (1975).



industry domination.<sup>177</sup> Because of the episodic nature of their role, however, public governors have limited influence and may sometimes be co-opted by member interests. In any event, SROs are funded by and most closely involved with their members. Effective oversight is an essential countervailing force.

#### *H. Disclosure of Self-Regulatory Actions*

Section 19(d) of the Exchange Act requires SROs to file all quasi-adjudicatory decisions with the SEC for review. Congress has previously indicated its concern that the absence of public scrutiny damaged public confidence.<sup>178</sup>

Although industry groups have generally been adverse to disclosure of SRO disciplinary actions, Congress and regulatory agencies have favored such disclosure,<sup>179</sup> and the SROs have followed along.<sup>180</sup>

#### CONCLUSION

The history of self-regulation in the securities markets suggests consideration of whether the device is an adequate alternative to direct governmental regulation—and in certain instances whether regulation is even needed. Before the Exchange Act, the securities exchanges acquiesced in brazen manipulation, overreaching and self-dealing. Afterwards,

it was self-regulation that gave us such things as fixed commissions and a baroque system of reciprocal commission practices for years. . . . Likewise, restrictions on corporate membership and public and foreign ownership of member firms on exchanges hardly stand as shining accomplishments of self-regulation. The same could be said about the back-office crisis and net capital problems of the late 1960's, and a few other things.<sup>181</sup>

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177. See *Chicago Board Opinions Exchange*, Securities Exch. Act Rel. No. 21439 (Oct. 31, 1984) (discussing influence of public governors).

178. See H.R. REP. No. 229, 94th Cong., 1st Sess., at 26 (1975).

179. SENATE INDUSTRY STUDY, *supra* note 12, at 14, 152-53; SEC, Report of the Advisory Committee on Enforcement Policies and Practices 60-61 (June 1, 1972); Securities Exch. Act Rel. No. 10152 (May 17, 1973); SPECIAL STUDY, *supra* note 1, pt. 4, at 577. Even Bank regulators have reconsidered their traditionally reticent disclosure policies. See Federal Deposit Insurance Corporation, *Deposit Insurance in a Changing Environment* IV 11-12, 15-16 (1983).

180. See, e.g., American Stock Exchange Rules of Procedure in Disciplinary Matters, Rule 12. On the other hand, the NYSE recently has contended in its submission of a proposed rule to impose fines for uncontested minor violations of the SRO's rules that it does not intend to publicize such violations since it "believes that publicity would itself constitute a penalty that would be disproportionate to the minor rule violation." File No. SR-NYSE-84-27; Securities Exch. Act Rel. No. 21327 (1984).

181. Remarks of SEC Commissioner James Treadway, Jr. to the American Law Institute—American Bar Association Conference on Broker-Dealer Regulation (Jan. 12, 1984).

Given the current competitive stresses occurring among SROs as they seek to preserve and expand their market share, there is little reason to expect they will perform more admirably in the future. The ability of SROs to impinge on the livelihood of their members and to establish anti-competitive restraints suggests at least that self-regulation should be carefully circumscribed and monitored.

Moreover, the increasing overlap and confusion of financial services across traditional categories of providers suggests issues that should be addressed by agencies other than bands of competitors formed along lines demarcated by Congress in the 1930s and, at least in part, archaic. The "growing diversification of securities firms into non-securities activities [does] not dictate that the jurisdiction of the self-regulatory organizations should thereby be automatically extended. . . ." <sup>182</sup>

One solution might be to redesign the regulatory structure to limit the SROs' purview to market facilities. SROs would seem to be best able to deal with the problems of their marketplaces, but even here they have only performed competently when forced to do so by governmental overseers.<sup>183</sup> The SEC might also designate a market czar whose province would be the overall market system. The SEC could give this market overseer the authority to relieve any self-regulatory organization of the power to regulate certain members or participants.<sup>184</sup> While such a system would not eliminate the competitive conflicts among SRO marketplaces, these conflicts could be resolved more directly by recognizing the SROs as public utilities and regulating them as such. It is tempting to suggest that the ideal reform would eliminate all quasi-governmental roles of the SROs and permit them to survive or perish by the vicissitudes of the marketplace to which they pay obeisance; however, this suggestion is restrained by the difficulty of distinguishing between market operation and market regulation. The overlap of such functions may be inevitable in a system such as that contemplated by the Exchange Act.

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182. Securities Exch. Act Rel. No. 12994 (Nov. 18, 1976); see 1975 SENATE COMMITTEE REPORT, *supra* note 53, at 28, 133. Sections 6(b)(5) and 15A(b)(6) of the Exchange Act limit their grants of rulemaking authority to exchanges and securities associations to matters related to the purposes of the Exchange Act or the administration of the SRO. Thus, SRO jurisdiction is not co-extensive with the diversified ambit of securities firms. See 1975 SENATE COMMITTEE REPORT, *supra* note 53, at 47.

183. See Jennings, *supra* note 7, at 672-74. Concerns about the adequacy of self-regulatory processes in dealing with assorted market abuses, including those taking place on exchanges, forced a moratorium on new options programs and expanding existing programs from 1977 to 1980 (BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, CFTC AND SEC, A STUDY OF THE EFFECTS ON THE ECONOMY OF TRADING IN FUTURES AND OPTIONS III-31, 32 (1984)) while the SEC undertook a comprehensive review of options trading. SEC REPORT OF THE SPECIAL STUDY OF THE OPTIONS MARKETS, H.R. REP. NO. IFC-3, 96th Cong., 1st Sess. (1978).

184. Securities Exch. Act §17(d)(1); see 1975 SENATE COMMITTEE REPORT, *supra* note 53, at 33; N. WOLFSON, R. PHILLIPS, T. RUSSO, *supra* note 81, at 774.

As an alternative, David A. Lipton has advanced a theory by which regulatory responsibilities would be allocated between the SEC and the SROs.<sup>185</sup> Professor Lipton has outlined two factors of efficiency,

(i) the institutional resources that must be expended by the regulatory body in order to obtain a satisfactory resolution of any particular regulatory issue, and (ii) the likelihood that the institution can make its decision free from the influence of conflicting interests that might prevent the particular resolution of a specific problem from being in the best interests of the trading market.<sup>186</sup>

Applying the first factor involves determining particular expertise, need for uniformity and duplicating efforts.<sup>187</sup> Where conflicts of interest are present, Professor Lipton assumes generally the "greater inherent regulatory utility" of the SEC since it is "an independent, bi-partisan government regulatory agency designed to be relatively insulated from the political process."<sup>188</sup> Accordingly, he suggests the following guidelines:

1. Decisions requiring technical expertise should be resolved by the regulatory institution with the greatest expertise. . . .
2. Decisions involving conflicts of interest . . . should be resolved by the regulatory institution not involved in the conflict. . . .
3. Decisions requiring uniformity of approach for different SROs should be administered by the SEC. . . .
4. Decisions requiring diversity . . . based upon differences in market structure should be administered by the individual SRO. . . .
5. The Commission should resolve a problem when it has ultimate regulatory authority over a regulatory authority issue and has already decided upon a specific resolution for which it needs no further technical assistance.<sup>189</sup>

The guidelines result from a thoughtful analysis of how decisions are best made, *given the existing self-regulatory scheme*. As such, they should assist decision-makers involved in these regulatory processes.<sup>190</sup> Their application should help resolve the problems of cooperative regulation. Nonetheless, rigid application of the guidelines might leave the SROs with a severely circumscribed field of authority. The second criteria of lack of conflict alone would preempt a significant area of SRO jurisdiction. Under the statutory dictates of a national market system, very few issues would fall into the diversity-required criteria; most would require some uniformity and thus fall

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185. Lipton, *supra* note 26.

186. *Id.* at 543-44 (footnotes omitted).

187. *Id.* at 544.

188. *Id.* at 544-45.

189. *Id.* at 545-47 (footnotes omitted).

190. In his conclusion, Professor Lipton suggests that similar guidelines might be used "to resolve whether an industry should regulate itself at all or be regulated by the government." *Id.* at 572.

to the SEC under the third guideline. The first guideline is likely to be established in particular cases by application of the guidelines in previous situations. The final guideline reflects that self-regulation takes place at the sufferance of the SEC.<sup>191</sup> Thus, the guidelines suggest a secondary, limited role for self-regulation. Perhaps this is as it should be.

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191. Werner, *The SEC as a Market Regulator*, 70 VA. L. REV. 755 (1984).

