Self-Regulation of the Securities Markets: A Critical Examination

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INTRODUCTION

While self-regulation has played an influential role in the governance of financial markets for some time,1 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. 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.

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.


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.

Lawmakers and regulators also have suggested that existing SROs take on additional tasks, such as the government securities markets and administering margin rules.\(^4\)

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.\(^5\) 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.\(^6\) 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
less rigidity in a process more within their control and, concomitantly, carried out by those who better understand the industry's dynamics.\(^7\) The regulated industry, moreover, wants insulation from direct governmental involvement.\(^8\)

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.\(^9\)

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. . . .”\(^10\) This article will explore the ramifications of these competitive activities on SROs’ regulatory roles.\(^11\)

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.”\(^12\) I will address in this article whether that

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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].
assessments 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,"\(^3\) leaves open whether direct governmental regulation—or simply relying on the common-law system of privately enforced rights\(^4\)—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.\(^5\)

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."\(^6\) Originated by Pareto in the Nineteenth Century, this theory provides an objective standard for deciding when and in what form regulation is needed.\(^7\) Regulation is desirable only when the free market fails to achieve optimum allocative efficiency.\(^8\) 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.


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.


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.19

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.20 In addition, removing direct regulation may eliminate tensions between government agencies and regulated industries.21


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.22

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.”23 Similarly, an SEC Commissioner describes self-regulation as “a shared, cooperative system of industry and federal regulation.”24

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.


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." Those who hold this view seem to assume that control by non-governmental agencies is, as such, preferable to that of a governmental agency. 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 as well as with a tendency to overregulate. 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. Some commentators fear that the absence of the checks and balances of government permit the abuse of rights of individuals and business entities. Others express concern about the anti-competitive aspects of self-regulation. 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.


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.


31. See B. OWEN & R. BRAEHTIGN, 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. 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. The Special Study found this concern warranted, 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.

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. . . ."

If self-regulation does tend to insulate an industry group from effective regulation, an illusory facade of protection is presented to the affected public. 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


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.


financial responsibility and specialist performance to the SROs despite dis-
satisfaction with how the SROs had administered these standards.38

Proponents of self-regulation stress that industry expertise is mobilized
by SROs, resulting in a more knowing, less clumsy method of regulation.39
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."40

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."41

The Special Study also questioned whether a regulated industry would
make the commitment of time and personnel necessary to accomplish effec-
tive 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
(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.

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 rational of bureaucratic develop-
ment 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.


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.\textsuperscript{42}

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.\textsuperscript{43} 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."\textsuperscript{44} Administrators of SROs are as prone to this remedy as their counterparts at government agencies.\textsuperscript{45}

The Exchange Act gives SROs a broad grant of regulatory authority.\textsuperscript{46}

\textsuperscript{42} Special Study, supra note 1, pt. 4, at 503.
\textsuperscript{44} Jaffe, James Landis and the Administrative Process, 78 Harv. L. Rev. 319, 322 (1964).
\textsuperscript{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).
\textsuperscript{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. 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.48

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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. 49

Considering the overall costs of self-regulatory processes, we should be concerned about congressional authority over independent agencies' budgets. 50 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. 51 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. 52

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

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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.53

As the Special Study recognized, SROs do not constitute a homogeneous membership having identical interests.54 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.55 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."56

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."57 William O. Douglas characterized industry self-regulation as able to "act swiftly and more subtly than a government bound by due process standards. . . ."58 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."59

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

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54. See Special Study, supra note 1, pt. 4, at 696.
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-Legitimating Bureaucracy, 93 Yale L. J. 780 (1984).
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. 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.

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." Formulation by an industry of standards of business conduct and enforcement of those standards is inherently restrictive of competition. As the United Kingdom White Paper explained, "it is a risk of regulation by practitioner-based organizations that 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.

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.

they may degenerate into cozy clubs or cartels. 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.

SROs act as quasi-public utilities, particularly in their operation of public marketplaces. 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. 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.

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. The exchanges and the NASD regulate their respective market facilities, pro-

65. U.K. White Paper, supra note 3, at 15; see also id. at 23-24.
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."72

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.73 In considering this legislation, Congress found exchange self-regulation wanting in important respects.74 Nonetheless, Congress believed that if buttressed with governmental oversight, the benefits of self-regulation would outweigh any shortcomings.75

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.76 In this role, the associations would be subject to more intensive oversight by the SEC than had been provided for the exchanges.77

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.


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).


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.\(^{78}\) Severe back-office problems in the securities industry,\(^{79}\) coupled with a perception that the industry had not been responsive to changing economic and technological conditions,\(^{80}\) had led Congress to review the workings of self-regulation.\(^ {81}\) 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,\(^ {82}\) and to facilitate a national market system.\(^ {83}\) Moreover, Congress created a new SRO, the Municipal Securities Rulemaking Board (MSRB).\(^ {84}\)

\(^{78}\) Pub. L. No. 94-29 (1975).


\(^{80}\) 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.


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.\(^{85}\)

2. The SRO must accept as members all persons meeting relevant capital and competency requirements,\(^{86}\) excepting only specified categories of persons.\(^{87}\)

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.\(^{88}\)

4. Fees, dues and other changes must be allocated equitably.\(^{89}\)

5. Rules of the SRO must be designed to prevent fraudulent and manipulative practices.\(^{90}\)

6. An SRO must enforce the Exchange Act and its own rules and impose appropriate sanctions on violators.\(^{91}\)

7. Rules must provide fair disciplinary procedures\(^{92}\) and minimum due process requirements.\(^{93}\)

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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(b)(1).
8. Rules must not impose any unnecessary burden on competition.\textsuperscript{94}

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.\textsuperscript{95} The amendments also had the effect of constraining the discretion of the SROs in determining policy outside the rulemaking process.\textsuperscript{96} Moreover, the SEC was given authority to amend any SRO rule in order to make it consistent with the Exchange Act.\textsuperscript{97} 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\textsuperscript{98} or to comply themselves.\textsuperscript{99}

Congress further provided in 1975 for the elimination of regulatory duplication.\textsuperscript{100} 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.\textsuperscript{101} The SEC may also allocate subject matter among SROs.\textsuperscript{102}

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.\textsuperscript{103}

\textbf{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

\begin{itemize}
\item \textsuperscript{94} Id. §§ 6(b)(8) and 15A(b)(9); cf. U.K. \textit{White Paper} \textit{supra} note 3, at 14, 23-24.
\item \textsuperscript{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).
\item \textsuperscript{97} Exchange Act § 19(c).
\item \textsuperscript{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).
\item \textsuperscript{100} Exchange Act § 17(d)(1); cf. §19(g)(2).
\item \textsuperscript{101} Exchange Act § 17(d)(1). These include, for example, responsibilities for examinations and enforcement.
\item \textsuperscript{103} See \textit{Merrill Lynch, Pierce, Fenner & Smith v. Ware}, 414 U.S. 117, 137 (1973); H.R. REP. No. 123, 94th Cong., 1st Sess. 62 (1975).
\end{itemize}
non-members. 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. 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. Sanctions include censure, fine, limitation of activities, suspension and bar.

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. SROs may require members and associated persons to attend recorded interviews and respond to questions under oath. If these persons invoke the privilege against self-incrimination, they may violate the SROs' rules.

SROs must provide notice and an opportunity to be heard concerning charges brought against affected persons. 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-
Hearings are held before panels composed of members and staff. Parties may be represented by counsel both before and at the hearings. 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 is probably applicable.

Decisions of such panels may be reviewed by the SROs' boards. Final disciplinary action is subject to review by the SEC, either on its own motion or on application of an aggrieved person. 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.

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

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).
118. See, e.g., NYSE rules 476(f) and (g); ASE rules 345(e) and (f); NASD Code of Procedure §15(a).
119. See Exchange Act §§15A(b)(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. §78o-3(f) and (g) (1970) (amended by Pub. L. No. 94-29, 89 Stat. 97 (1975)).
120. Exchange Act §25(a)(1).
opposite conclusions. 122 Various attacks on the NASD's disciplinary authority based on a theory of unconstitutional delegation of legislative authority by Congress also have been unsuccessful. 123 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. 124

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. . . ." 125 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." 126 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. 127 For example, NASD members are prohibited from dealings...
with non-members except upon the same terms as the general public. In order to participate in most underwritings, broker-dealers must be members of the NASD. Moreover, since 1983, all broker-dealers engaged in the over-the-counter securities business must belong to a national securities association; the only national securities association being the NASD.

In *Silver v. New York Stock Exchange,* 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, 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." The Court next proceeded "to reconcile pursuit of the anti-trust aim of eliminating restraints on competition with

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

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. 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

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).
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).
commission rates. That they got away with the practice for so long, however, suggests the inherent deficiencies of self-regulatory systems. That even Congress was gullied 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, their removal has been gradual at best and important remnants of these anti-competitive devices are still in effect.

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" 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."

This competition is reflected in the controversy concerning trading of options. 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. 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.

The SEC questioned whether the allocation system should be extended to options on securities traded in the NASDAQ market. 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.
options related automated systems.\footnote{148} Similarly the NASD opposed the granting to exchanges of unlisted trading privileges in over-the-counter securities.\footnote{149} 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.\footnote{150}

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.\footnote{151}

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.\footnote{152} The NASD, on the other hand, has sought greater access to this order flow through the Intermarket Trading System and has urged adoption of a best-execution rule.\footnote{153} 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.\footnote{154} 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 marshall order flow. The traditional investment banking houses thus far have inhibited significant liberalization on the NYSE by

\begin{footnotes}
\footnotetext{148. NASD, Notice to Members 84-27 (May 15, 1984).}
\footnotetext{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).}
\footnotetext{150. See 17 Sec. Reg. L. Rep. (BNA) 647 (April 19, 1985).}
\footnotetext{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).}
\footnotetext{152. See Lipton, supra note 26, at 557.}
\footnotetext{153. Id. at 560 n. 146.}
\footnotetext{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).}
\end{footnotes}
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. 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.

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. 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. 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


competitive challenges by exchanges against their members.\footnote{159} 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.\footnote{160} Because of an interesting dichotomy of congressional views, this characterization is more accurate with respect to commodity exchanges.\footnote{161} 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.\footnote{162} Multiple securities markets, on the other hand, are a governmental objective.\footnote{163} Nonetheless, individual securities markets would seem to require collective activity in a manner comparable to that of a utility.\footnote{164} 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.”\footnote{165}

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.”\footnote{166} When non-governmental bodies act as surrogates of governmental powers, the “function of public oversight becomes critical.”\footnote{167} Public oversight must assure that the delegation of power is effective in carrying

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\footnote{159. See Securities Exch. Act Rel. No. 21383 (Oct. 9, 1984).}
\footnote{160. SPECIAL STUDY, supra note 1, pt. 4, at 701; H.R. REP. No. 1383, 73d Cong., 2d Sess. 15 (1934).}
\footnote{161. See Comment, Trade Associations Exclusionary Practices: An Affirmative Role for the Role of Reason, 66 COLUM. L. REV. 1486, 1492-93 (1966).}
\footnote{162. Id. at 1493; Selig, Steinmayer & Broida, Regulation of Commodity Market Traders, 18 REV. SEC. & COMMODITIES REG. 1-2 (1985).}
\footnote{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.}
\footnote{164. Cf. Associated Press v. United States, 326 U.S. 1 (1945).}
\footnote{165. SPECIAL STUDY, supra note 1, pt. 4, at 701.}
\footnote{166. J. LANDIS, supra note 14, at 15 (1938).}
\footnote{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.\textsuperscript{168} On the other hand, excessive oversight can preempt the self-regulatory process.\textsuperscript{169} 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


\textsuperscript{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.

\textit{Id.} at 6. In discussing the Market Oversight Surveillance System (MOSS) proposed by the SEC, Chairman Williams provided an example of Orwellian newpeak:

\textit{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.

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.\(^{170}\)

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.”\(^ {171}\) 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.”\(^ {172}\)

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.”\(^ {173}\) 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 programatic 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.”\(^ {174}\)

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.\(^ {175}\)

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\(^ {176}\) serves as a check to

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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).
174. Id. at II-5.
175. SEC Self-Regulation Paper, supra note 6, at 7.
industry domination. 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.

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

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.

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).
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."\(^3\)

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.\(^4\) 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.\(^5\) 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.


As an alternative, David A. Lipton has advanced a theory by which regulatory responsibilities would be allocated between the SEC and the SROs.185 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.186

Applying the first factor involves determining particular expertise, need for uniformity and duplicating efforts.187 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."188 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.189

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. 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

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. Thus, the guidelines suggest a secondary, limited role for self-regulation. Perhaps this is as it should be.
