

TESTIMONY OF
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BEFORE THE
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES
UNITED STATES HOUSE OF REPRESENTATIVES
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HEARING ON
SELF-REGULATORY ORGANIZATIONS: EXPLORING THE NEED FOR REFORM

I. Introduction

Mr. Chairman and members of the Committee, I am Marc E. Lackritz, President of the Securities Industry Association.¹ SIA commends you for holding this hearing and appreciates the opportunity to testify on reforming the securities industry's self-regulatory system.

Our nation's securities markets are the most transparent, liquid, and dynamic in the world. New forms of competition, technological advances, globalization, and broader investor participation have driven phenomenal changes in the capital markets and the securities industry over the past decade. Our industry has embraced these changes, further strengthening the preeminent status of the U.S. capital markets across the globe.

Self-regulation – and the historical level of member cooperation in particular – has been a key ingredient in the regulatory framework within which our markets have thrived. For example, the extensive expertise of members and their involvement in the rule-making process has

¹ The Securities Industry Association brings together the shared interests of approximately 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated \$236.7 billion in domestic revenue and an estimated \$340 billion in global revenues. (More information about SIA is available at: www.sia.com.)

undoubtedly led to more effective, less costly self-regulatory rules. As the SEC has noted, self-regulation “has been viewed as having certain advantages over direct governmental regulation” because “[i]ndustry participants bring to bear expertise and intimate knowledge of the complexities of the securities industry.”² Self-regulatory organizations (“SROs”) also “supplement the resources of the government and reduce the need for large government bureaucracies” and “can adopt and enforce compliance with ethical standards beyond those required by law.”³

Notwithstanding these benefits, self-regulation has significant drawbacks: (1) major conflicts of interest between SROs’ roles as both market operators and regulators, and (2) regulatory inefficiencies resulting from duplication among multiple SROs. The proposed mergers between the NYSE and Archipelago Holdings, Inc. and The Nasdaq Stock Market (“Nasdaq”) and Instinet, LLC highlight the need, and present the opportunity, to bring the structure of self-regulation into the 21st century. They also heighten concerns about the potential for consolidated market centers to develop an unchecked monopolistic hold on market data to the detriment of investors and markets.

SIA supports the adoption of a hybrid self-regulatory model, which would split regulation into two functions. Each marketplace would have its own SRO, which would regulate and enforce all aspects of trading, markets, and listing requirements. The other type of organization would be a Single Member SRO that would handle regulations relating to the operations of broker-dealers. This body would be transparent to both the investing public and to its members. Both the public and broker-dealers would be involved in its governance, and the SEC would oversee its budget, funding, and performance. By eliminating unnecessary regulatory duplication and inherent conflicts of interest, a revamped self-regulatory structure can strengthen investor protection and increase the competitiveness of the U.S. capital markets.

² Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Stock Market (Aug. 8, 1996), available at <http://www.sec.gov/litigation/investreports.shtml>.

³ *Id.*

I. Strengths and Weaknesses of the Current SRO System

The success of today's self-regulatory governance is directly related to member involvement in the process.⁴ Self-policing by professionals who have the requisite working knowledge and expertise about marketplace intricacies and the technical aspects of regulation creates a self-regulatory system with valuable proper checks and balances. Supplemented by government oversight, this tiered regulatory system can provide a greater level of investor protection than the government alone might be able to achieve.

Because self-regulators are on the frontline of marketplace developments, they have an intimate knowledge of industry operations, trading, and sales practices. As a result, they can develop and revise rules – which are typically forward-looking and up-to-date with market realities – more quickly and frequently than traditional government regulators. In addition, SRO rules often set standards that exceed statutory or common law legal minimums. For example, the NASD requires that its member firms adhere to “just and equitable principles of trade,” a standard that in many instances exceeds the anti-fraud requirements of SEC statutes and rules.

In spite of how well self-regulation has worked, market participants, governmental bodies and investor advocates have recognized in recent years a growing need for structural reform of self-regulation. The main three concerns are:

- (1) Potential conflicts of interest due to the SROs' roles as both market operators and regulators;⁵
- (2) The profit motive of a shareholder-owned SRO detracting from self-regulation;⁶

⁴ See generally S. Rep. No. 94-75, at 22 (1975) (*accompanying* S. 249, 94th Cong., 1st Sess. (1975)) (“In enacting the Exchange Act, Congress balanced the limitation and dangers of permitting the securities industry to regulate itself against ‘the sheer ineffectiveness of attempting to assure [regulation] directly through the government on a wide scale.’”); SEC Report of Special Study of Securities Markets, H.R. Doc. No. 88-95, Part 4 (1963) (“Special Study”).

⁵ “Securities Markets: Competition and Multiple Regulators Heighten Concerns about Self-Regulation,” General Accounting Office, May 2002, GAO-02-362, available at <http://www.gao.gov/new.items/d02362.pdf>, at 1-2 (“GAO SRO Report”). The GAO also noted, “Heightened competitive pressures have generated concern that an SRO might abuse its regulatory authority – for example, by imposing rules or disciplinary actions that are unfair to the competitors it regulates.” The SEC shares this concern. “As intermarket competition increases, regulatory staff may come under pressure to permit market activity that attracts order flow to their market. . . . Also, SROs may have a tendency to abuse their SRO status by over-regulating members that operate markets that compete with the SRO’s own market for order flow.” Concept Release Concerning Self-Regulation, 69 Fed. Register 71256, 71262 (Dec. 8, 2004) (“SEC SRO Concept Release”).

- (3) Duplicative and conflicting regulation among multiple SROs, as well as redundant SRO regulatory staff and infrastructure.⁷

While all three of these concerns are valid, SIA is particularly concerned with redundant regulation. Regulatory duplication can, and does, occur with rulemaking, data reporting, examinations, and enforcement actions. On the rulemaking front alone, both the NYSE and the NASD frequently adopt separate rules on similar or identical topics, leaving many firms to have to cope with two different standards, including different record-keeping, procedural and audit trail requirements for the same product or service. Similarly, on the examination front firms have expressed concern about a lack of coordination among the SROs, and between the SROs and the SEC's Office of Compliance Inspections and Examinations ("OCIE"). In addition to the waste of regulatory resources, the cost on broker-dealers, especially smaller firms, should not be minimized. As the NASD's Chairman and CEO Robert Glauber said last week at our annual meeting,

"[m]ore and more regulations and higher and higher costs can put [smaller] firms in danger of failing, and that's a fate we don't want to impose on anyone. When firms go out of business, it is not only they and their employees that suffer, although that is bad enough. Investors are not well-served either, if the brokerage industry is effectively shrunken, and they are left with fewer choices."⁸

Fortunately, the senior staffs of both the NYSE and the NASD have been sensitive to these concerns in recent years. SIA has productively engaged with each SRO on specific problems that have surfaced. For example, in the past year both the NYSE and the NASD have

⁶ The SEC has stated that:

"SRO demutualization raises the concern that the profit motive of a shareholder-owned SRO could detract from self-regulation. For instance, shareholder-owned SROs may commit insufficient funds to regulatory operations or use their disciplinary function as a revenue generator with respect to member firms that operate competing trading systems or whose trading activity is otherwise perceived as undesirable."

SEC SRO Concept Release, at 71263.

⁷ "Multiple SROs can result in duplicative and conflicting SRO rules, rule interpretations, and inspection regimes, as well as redundant SRO regulatory staff and infrastructure across SROs." SEC SRO Concept Release at 71264. The GAO has noted similar "inefficiencies associated with SRO rules and examinations." GAO Report at 2.

⁸ Address by NASD Chairman and CEO Robert Glauber to SIA Annual Meeting, November 11, 2005 (available at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_015519).

considered new rules on gifts and entertainment given by broker-dealers or their employees to clients. Initially, the two SROs considered approaches that were quite different from each other. When we raised our concerns about inconsistencies in approach, the two SROs worked with each other and with our industry to devise a single principles-based approach to gifts and entertainment. We understand that approach is now in the process of being adopted. We are also heartened that on the examination front the two SROs have committed themselves to improving coordination between each other (as well as with the SEC's OCIE).⁹

Although these developments are helpful, duplication and redundancy will continue to occur as long as two separate entities regulate the same conduct of the same firms. The only effective long-term answer is to combine the SRO broker-dealer regulatory programs into one centrally managed entity.

The NYSE proposes as part of its proposed merger to undertake to create some additional separation between its regulatory unit and its business side. The NYSE is taking this step in light of concern that a for-profit SRO might neglect its regulatory responsibilities. As one consumer advocate recently stated in connection with the NYSE-Archipelago merger, “[t]he for-profit environment adds to the pressures and potential conflicts of interest.”¹⁰ This step may not entirely address the concern about the temptation for a for-profit exchange to seek to either neglect or misuse its regulatory powers. More importantly, the NYSE's proposed restructuring of its regulatory program is an opportunity (which we hope the NYSE will seize) to eliminate regulatory duplication by combining its broker-dealer regulatory functions with those of the NASD.¹¹

⁹ SIA has recently had productive discussions with the NYSE and NASD, as well as OCIE, on improving coordination among these three regulators' examination programs. An overview of the results to date of those discussions is available at <http://www.sia.com/RegulatoryCoordination/index.html>.

¹⁰ “As Exchanges Become Profit-Seekers, Concerns Rise Over Risk to Investors”, Wall Street Journal, November 8, 2005, at C1, C3, *quoting* Barbara Roper, Director, Consumer Federation of America.

¹¹ Similar concerns relating to Nasdaq becoming a for-profit company are less substantial due to the gradual shedding of the NASD's equity interest in Nasdaq. However, the NASD still has a stake in Nasdaq that it is trying to sell.

II. Structural Reform of Self-Regulation

The Hybrid SRO: Toward a Better System of Self-Regulation

Last winter, the Commission sought comment on a variety of self-regulatory models as possible alternatives to the current structure of self-regulation. Of the seven models the SEC proposed,¹² SIA believes the hybrid self-regulatory model offers the best alternative regulatory structure for preserving competitive, innovative markets while fostering more efficient, effective regulation. The hybrid model will require the SEC to designate a Single Member SRO to regulate broker-dealers with respect to membership rules.¹³ Separately, each SRO operating a market would be responsible for the oversight of its market operations regulation (*e.g.*, its trading rules), including enforcement of those trading rules.

The creation of the Single Member SRO addresses the two primary areas of weakness in the current self-regulatory structure we identified previously – conflicts of interest and regulatory inefficiency. In addition, the proposal will likely provide better investor protection. Enhanced regulatory efficiency will allow both the SROs and firms to use compliance resources more effectively. Regulatory accountability will be bolstered as the result of one entity being responsible for overseeing broker-dealer activity at the SRO level. Finally, the regulatory expertise of the SRO staff will expand as a single SRO gains the resources, power, and prestige to attract talented staff, and keeping that expertise close to the markets whose day-to-day activities it regulates. At the same time, the existence of multiple-market SROs, each with responsibility over those regulations applicable to its unique trading structures, will keep market expertise where it is most useful. Much of the innovation that makes the U.S. markets so strong occurs in market operations, so the maintenance of separate market SROs will foster continued competition and innovation and preserve U.S. capital market dominance.

¹² These ranged from a new system of competing broker-dealer SROs among which firms could periodically switch, to a single SRO to govern all broker-dealers and marketplaces, to simply moving all SRO functions into the SEC.

¹³ Membership rules under the control of the Single Member SRO would include, for example, registered representative qualification testing, customer accounts, sales practices, supervision, financial condition and margin.

In general, the SEC has already begun moving toward more universal capital market rules. For instance, parts of Regulation SHO¹⁴ and Regulation NMS¹⁵ reflect a convergence of rules. The hybrid model will build on this consolidation and streamlining of regulations, further increasing efficacy and efficiency, while eliminating redundancies and gaps in regulatory coverage.

Overseeing the Hybrid. We realize the Single Member component of the hybrid model would concentrate regulatory power and authority in one entity. Therefore, and notwithstanding our advocacy of the hybrid model, this regulatory structure will function effectively only if the SEC provides attentive, cost-effective regulatory oversight that includes the vigilant review of the Single Member SRO's costs and fee structures. Similarly, the Commission's robust review of the Single Member SRO's final disciplinary proceedings will counter any possible self-serving interest by the Single Member SRO in levying excessive enforcement fines that would be paid into its own coffers.

Additionally, strong public and member involvement will become even more important to prevent the Single Member SRO from becoming an unresponsive entity with prohibitive cost structures. While the Single Member SRO should have a majority of non-member representatives on its board, it will need substantial member input – especially from smaller cost-sensitive members – to effectively oversee regulation across a diverse group of members with divergent needs and business models.¹⁶ Member involvement and SEC oversight of the hybrid SRO also will be necessary to identify and harmonize any “boundary” issues between conduct rules subject to the Single Member SRO's regulatory oversight, and market rules subject to the continued oversight of the various market SROs.

¹⁴ See Exchange Act Release No. 50103 (Jul. 28, 2004), 69 Fed. Reg. 48008 (Aug. 6, 2004) (“Regulation SHO”).

¹⁵ See Regulation NMS.

¹⁶ The needs of fixed-income markets differ from those of equities markets, for instance. The knowledge members have about the ramifications of these differences is essential to ensure that a self-regulatory system works well for all participants.

The SEC should develop increased transparency requirements for the Single Member SRO, particularly concerning funding and budgetary issues. Making the Single Member SRO's operations transparent to both members and the investing public will place appropriate checks on the Single Member SRO and will enhance accountability to its constituents.

To further foster the regulatory efficiency offered by the hybrid structure, market SROs should be permitted to continue to outsource their market enforcement activities. We understand that the ability to outsource such activities, while retaining ultimate responsibility as an SRO, has worked well for various existing SROs.¹⁷

Fueling the Hybrid. The final issue for the SEC to resolve is how to fund the Single Member SRO. SIA believes that any future self-regulatory structure must be adequately funded. The goal of the hybrid is not to stint on regulation, but to make each regulatory dollar more effective. At the same time, fees for regulation should be apportioned to the industry on a fair and reasonable basis, and should be unbundled and cost-justified whenever possible. Imposing regulatory fees that exceed the true costs of regulation acts as a tax on capital and imposes undue harm on the capital-raising system. SIA recommends that the SROs define the costs necessary to meet their self-regulatory obligations, prepare and make public a budget to meet those obligations, and then fairly apportion those costs among members by making periodic filings with the Commission subject to public notice and comment.

Regulatory funding for the Single Member SRO should come from regulatory fees assessed on broker-dealers, as well as from the issuers and other constituents of the trading markets. Trading markets will benefit significantly from regulatory oversight of broker-dealers and the various examination and continuing education programs conducted by the Single Member SRO under a hybrid model. Such regulation and education initiatives foster the market integrity and investor confidence that bring so much business to the U.S. capital markets. Under

¹⁷ For example, the American Stock Exchange ("Amex") and Nasdaq have delegated regulatory activities to the NASD. See, e.g., Exchange Act Release No. 37107 (Apr. 11, 1996), 61 Fed. Reg. 16948 (Apr. 18, 1996) (creating the NASDR and Nasdaq as two operating subsidiaries of NASD); SEC Set to Release Proposals on SRO Governance, But Details Are Still Thin, Securities Week, Nov. 8, 2004, available at 2004 WLNR 14154116 (quoting NASD chairman and CEO Robert Glauber's statement that the NASD "will continue to regulate Nasdaq and Amex under contract.").

the hybrid model, markets would receive these benefits, and market SROs should assume some of the associated regulatory and administrative costs.

Market data fees should only fund the collection and dissemination of market data – not regulatory costs.¹⁸ Combining the broker-dealer regulatory functions of the NASD and NYSE should result in savings that may offset much of the loss of market data fees as a revenue source. If there is still a shortfall due to the elimination of market data fees as a funding source, the industry is willing to pay higher regulatory fees to the Single Member SRO than it now pays to the NYSE and NASD in exchange for relief from the burdens of duplicative regulation and market data fees that vastly exceed their costs. Our only qualification is that any increase in regulatory fees on member firms should be, with the SEC's assistance, allocated in a fair manner among all member firms such that there is not an undue burden on smaller firms.¹⁹

Significance of the NYSE-Archipelago Merger

We strongly believe that the proposed NYSE- Archipelago merger represents an important opportunity to address the valid concerns raised by critics of self-regulation. The following are some observations about the NYSE-Archipelago merger.

(1). The merger both illustrates and accelerates the trend toward increased consolidation of, and competition between, market centers. While this competition is in most respects a very healthy development, it does raise conflict of interest questions about the NYSE's continued regulation of broker-dealers that could be potential competitors for order flow or for development of new investment products.

(2). The merger underscores the significance of increased competition, not just narrowly between U.S. market centers, but also globally among all capital markets. This competition applies to securities exchanges and financial intermediaries of all stripes. Unnecessary

¹⁸ The SEC estimates that in 2003 market data fees provided 18 per cent of the funding of the NYSE and NASD. SEC Concept Release Concerning Self-Regulation, 69 Red. Reg. 71256, 71270 (Dec. 8, 2004).

¹⁹ For example, such fees might be based on any number of factors designed to approximate the degree of resources required of the Single Member SRO in overseeing a particular firm, such as the number of registered representatives of a firm, or the scope and nature of its customer base or operations.

regulatory duplication is a weight around the ankles of financial intermediaries in the United States that has a real cost in terms of the future competitiveness of our capital markets. The merger represents an opportunity to address this regulatory duplication.

(3). The merger raises exactly the issues about conflicts between shareholders' interests and regulatory authority about which the SEC and SIA have both voiced concerns.

In fairness, the NYSE proposes some steps to address several of these issues. Each of its regulatory divisions (Listed Company Compliance, Member Firm Regulation, Market Surveillance, Enforcement and Dispute Resolution/Arbitration) and its 700 employees will be moved into a separate affiliated non-profit entity, which will regulate all aspects of the NYSE parent's markets, as well as the activities of the Pacific Stock Exchange (which Archipelago now owns).

While moving regulation out of the parent organization is a necessary step, we doubt that it will be sufficient. Specifically, the new entity, titled "NYSE Regulation," will be under the control of a board of directors that will have an unspecified number of its members drawn from the NYSE parent's own board. Moreover, the very fact that NYSE apparently seeks to maintain regulation of its broker-dealer members under the NYSE name and with the oversight of some of its directors, rather than spin it off into a separate entity under a different name with entirely separate directors, suggests that the NYSE sees value in continued "branding" of its regulatory authority over broker-dealers.

The most important shortcoming is that the NYSE's proposal avoids the critical issue of regulatory duplication between itself and the NASD in regulating dually registered broker-dealers. Fortunately, senior NYSE officials in recent public statements have seemed to recognize this, and have suggested they are "open to the idea of a 'joint venture' with the NASD."²⁰ The NASD staff has also signaled that it is receptive to this approach.²¹

²⁰ *Big Board and NASD Consider Merging Parts of Regulatory Units*, Wall Street Journal, C3 (November 11, 2005). Senior NASD officials have also signaled receptivity to a hybrid SRO. *See New Theorem for Merging Regulators: 1>2*, Wall Street Journal, C3 (November 14, 2005).

²¹ *See* Address by NASD Chairman and CEO Robert Glauber, note 8 *supra*.

This convergence of views suggests that this is an ideal moment for implementing significant structural reform to self-regulation. We strongly urge the SEC to take the lead in pushing forward on the opportunities created by these developments. If the SEC, SROs, market participants and investors work together to refine the NYSE's proposal for spinning off its regulatory unit, this could be the vehicle for driving self-regulation into the 21st century.

III. Eliminating Excessive Market Data Fees

Regardless of the outcome of regulatory consolidation, it is vitally important that the SEC deal immediately with longstanding concerns by market participants about the opaque and non-accountable way in which market data fees are currently set.²² It is doubtful that Congress ever intended for market data to generate revenues for SROs to subsidize their regulatory obligations or to fund competitive business activities in the manner that it does today. The purpose of disseminating market data is to create transparency in the prices that investors receive for buying and selling securities and, where there are competing market centers, to increase investor choice and opportunity. For that reason, SIA advocates a revised method for funding regulation that does not depend on revenue from market data fees. We do not believe our proposed cost-based approach for establishing market data fees puts the SEC in a role of rate maker, but instead encourages it to rely on its oversight role over SROs to ensure that access to this information is available on terms that are "fair and reasonable" and "not unreasonably discriminatory."

The current approach to market data fees hurts the transparency of prices and imposes unjustifiable costs on market participants and, ultimately, investors. We applaud the SEC's expressed intention to address many open issues concerning market data fees in the context of SRO reform.²³ We strongly believe the resolution of these issues – sooner than later – is of the utmost importance for the integrity of the markets. Our proposed cost-based approach will minimize many of the conflicts of interest related to market data fees that SROs face now. The conflicts arise from control over a monopoly product with the ability to use the monopoly

²² For a more detailed discussion of SIA's concerns about market data fee practices that we believe the SEC should consider reforming, *see* letter to Jonathan G. Katz, Secretary, SEC, from Marc E. Lackritz, SIA, (Feb. 1, 2005) at 24 *et seq.*, available at http://www.sia.com/2005_comment_letters/4601.pdf

²³ *See* SEC Release Adopting Regulation NMS, 70 Fed. Reg. at 37560 (June 29, 2005).

revenue to subsidize other activities. We believe the narrow cost-based approach is the most straightforward method to accomplish this, and is most closely aligned with the congressional purposes underlying the Exchange Act.

The proposed NYSE and Nasdaq mergers heighten the significance of this issue further by raising the danger that the current lack of transparency and competitiveness in setting market data fees will tilt toward an oligopoly controlled by just two consolidated for-profit market centers. Unless market data fees become cost-based, the SEC will find itself in the position of establishing the profitability of for-profit exchanges as part of its statutory duty to determine that the fees charged for this mandated product – which generate a substantial share of the NYSE’s and Nasdaq’s revenue – are “fair and reasonable.”

Conclusion

America’s securities markets are the envy of the world, but we must be vigilant about removing unnecessary regulatory inefficiencies if we are to maintain our international preeminence. SIA is eager to work with Congress, the SEC, the SROs, and all other interested parties to ensure that our markets remain the most transparent, liquid, and dynamic, with unparalleled levels of investor protection.

Thank you.