

May 2002

# SECURITIES MARKETS

## Competition and Multiple Regulators Heighten Concerns about Self-Regulation



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# Contents

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<b>Letter</b>		1
	Results in Brief	1
	Background	3
	Increased Competition Has Heightened Some Market Participants’ Concerns about Conflicts of Interest	5
	Some Broker-Dealers Were Concerned about Rule Differences and Multiple Examinations	17
	Market Participants Have Discussed Alternative Approaches to Self-Regulation	24
	Conclusions	29
	Recommendations	30
	SEC, SRO, and Industry Comments and Our Evaluation	30
	Scope and Methodology	32
<b>Appendix I</b>	<b>Comments from the Securities and Exchange Commission</b>	36
<b>Appendix II</b>	<b>Comments from the National Association of Securities Dealers</b>	38
<b>Appendix III</b>	<b>Comments from Nasdaq</b>	41
<b>Appendix IV</b>	<b>Comments from the Securities Industry Association</b>	46

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## **Abbreviations**

DEA	designated examining authority
ECN	electronic communications network
MOU	memorandum of understanding
NASD	National Association of Securities Dealers
NASDR	National Association of Securities Dealers Regulation
NYSE	New York Stock Exchange
SEC	Securities and Exchange Commission
SIA	Securities Industry Association
SRO	self-regulatory organization



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United States General Accounting Office  
Washington, DC 20548

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May 3, 2002

### Congressional Committees

As competition among markets has increased, so have some market participants' concerns about the inherent conflicts of interest that securities self-regulatory organizations (SRO)<sup>1</sup> face in their dual roles as market operators and regulators. One response to increased competition—demutualization, or the conversion of SROs from member-owned organizations to shareholder-owned corporations—has raised questions about potential effects on conflicts of interests, particularly in for-profit entities. Additionally, broker-dealers<sup>2</sup> that are members of the two largest SROs, the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE), have continued to raise questions about the efficiency of SROs' rules and examinations.

Focusing on the issues market participants have identified, this report describes how the Securities and Exchange Commission (SEC), NASD, and NYSE have been addressing concerns about (1) the impact of increased competition, including demutualization, on the ability of SROs to effectively regulate members with which they compete and (2) possible regulatory inefficiencies associated with broker-dealer membership in multiple SROs. In addition, the report describes alternative approaches that some securities market participants have discussed as a means of addressing concerns about the current self-regulatory structure.

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## Results in Brief

Increased competition among SROs and their members for customer orders has heightened some members' concerns about the conflicts of interest inherent in the roles of SROs as both market operators and regulators. Nasdaq—the market currently operated by NASD—increasingly has been in competition with NASD members that operate

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<sup>1</sup> SROs have an extensive role in regulating the U.S. securities markets, including ensuring that members comply with federal securities laws and SRO rules. SROs include all the registered U.S. securities exchanges and clearing houses, the National Association of Securities Dealers, and the Municipal Securities Rulemaking Board.

<sup>2</sup> Broker-dealers are individuals or firms that buy and sell securities for customers or for themselves.

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electronic communications networks (ECN).<sup>3</sup> NYSE has faced competition for many years from members that trade NYSE-listed securities off of the exchange. 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. Market participants' views differed on whether demutualization will heighten the potential for such abuses. Despite SRO and SEC measures that are intended to address potential abuses of regulatory authority, these concerns persist.

Some broker-dealers that were subject to the jurisdiction of multiple SROs were also concerned about inefficiencies associated with SRO rules and examinations. The broker-dealers were concerned that differences among SRO rules and rule interpretations caused inefficiencies in the use of broker-dealers' compliance resources. No formal process exists, however, for addressing rule differences that might cause material inefficiencies in the regulatory process. According to regulators, the law does not require SRO rules to be the same, and many differences exist for legitimate business reasons. Broker-dealers with multiple SRO memberships also said that examinations by multiple SROs were unnecessarily burdensome. Efforts to improve examination coordination have not fully addressed their concerns, although such efforts continue.

Securities market participants have discussed alternatives that would address, at least in part, concerns about conflicts of interest and inefficiencies in the current self-regulatory structure. SEC officials said that the agency did not plan to dictate changes in the current structure, preferring to let the industry reach a consensus on the need for change and the type of change that is appropriate. Additionally, they said that industry initiatives, such as Nasdaq's application to register as an exchange, were transforming the regulatory landscape. In the meantime, SEC officials said that because the current self-regulatory structure had been working adequately, immediate action was not needed. Alternatives that have been discussed include having ECNs work within the current regulatory structure by registering as exchanges and thereby becoming SROs, as well as making more dramatic changes to the regulatory structure, such as consolidating self-regulation in a single entity not

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<sup>3</sup> ECNs are electronic trading systems that automatically execute matching buy and sell orders. They are a type of alternative trading system—an automated market in which orders are centralized, displayed, matched, and otherwise executed.

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affiliated with any market. None of the alternatives involving changes to the regulatory structure currently appears to have sufficient support from market participants for implementation.

This report recommends that the SEC Chairman work with the SROs and broker-dealer representatives to implement a formal process for systematically identifying and addressing material regulatory inefficiencies caused by differences in rules or rule interpretations among SROs and by multiple examinations of broker-dealers. The report also recommends that, in doing so, SEC explore with the SROs and broker-dealer representatives various methods for obtaining comprehensive feedback from market participants, including having a neutral party collect and assess market participants' views.

We received comments on a draft of this report from SEC, NASD, Nasdaq, the Securities Industry Association (SIA),<sup>4</sup> and an ECN. The respondents generally agreed with the report's conclusions and recommendations, however, three respondents expressed additional concerns. The comments are discussed in greater detail at the end of this letter, and the written comments are reprinted as appendixes I through IV.

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## Background

The federal regulatory structure of the U.S. securities markets was established by the Securities Exchange Act of 1934 (the Exchange Act). Congress also created SEC as an independent agency to oversee the securities markets and their participants. Under the Exchange Act, the U.S. securities markets are subject to a combination of industry self-regulation (with SEC oversight) and direct SEC regulation. This regulatory scheme was intended to give SROs responsibility for administering their ordinary affairs, including most of the daily oversight of the securities markets and broker-dealers.

The Exchange Act provides for different types of SROs, including national securities exchanges and national securities associations. Entities operating as national securities exchanges or associations are required to register as such with SEC. As of March 31, 2002, nine securities exchanges

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<sup>4</sup> SIA is a trade group that represents broker-dealers of taxable securities. SIA lobbies for its members' interests in Congress and before SEC and educates its members and the public about the securities industry.

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were registered with SEC as national securities exchanges.<sup>5</sup> As of the same date, NASD was the only registered national securities association; NASD Regulation (NASDR) is its regulatory arm. Although it is the SRO, NASD delegates to NASDR, its wholly owned subsidiary, SRO responsibilities for surveilling trading on Nasdaq and the over-the-counter market and for enforcing compliance by its members (and persons associated with its members) with applicable laws and rules. Nasdaq also surveils trading on its market and refers potential violations to NASDR and SEC for investigation. While NASD is currently the parent company of Nasdaq, NASD is in the process of selling Nasdaq.

Recognizing the inherent conflicts of interest that exist when SROs are both market operators and regulators, the Exchange Act states that to be registered as a national securities exchange or association, SEC must determine that the exchange's or association's rules do not impose any burden on competition and do not permit any unfair discrimination.<sup>6</sup> SROs are also responsible for enforcing members' compliance with their rules and with federal securities laws by conducting surveillance of trading in their markets and examining the operations of member broker-dealers.

The Exchange Act also mandates that securities SROs operate under direct SEC oversight and authorizes SEC to ensure that SROs do not abuse their regulatory powers.<sup>7</sup> SEC inspects SROs to ensure that they are fulfilling their SRO duties, focusing on, among other things, the quality of SRO financial operations examination programs; market surveillance, investigations, and disciplinary programs; and customer complaint review programs. SEC also reviews rule changes proposed by SROs for consistency with the Exchange Act and SEC rules. Finally, SEC provides direct regulation of the markets and their participants in a number of ways, including direct examinations of broker-dealers, investigations into

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<sup>5</sup> The exchanges were the American Stock Exchange, Boston Stock Exchange, Chicago Board Options Exchange, Cincinnati Stock Exchange, Chicago Stock Exchange, International Securities Exchange, NYSE, Philadelphia Stock Exchange, and Pacific Exchange.

<sup>6</sup> Sections 6(b) and 15A(b) of the Exchange Act set forth, respectively, the standards that national securities exchanges and national securities associations must meet.

<sup>7</sup> Sections 6, 15A, and 19 of the Exchange Act establish a statutory scheme for national securities exchanges and associations that vests both types of entities with almost identical self-regulatory responsibilities and imposes virtually the same oversight requirements on SEC.

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markets and their participants, disciplinary actions for violations of the Exchange Act, and promulgation of rules and regulations.

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## Increased Competition Has Heightened Some Market Participants' Concerns about Conflicts of Interest

Nasdaq increasingly has been in competition with NASD members that operate as ECNs, while NYSE has competed for many years with members that trade its listed securities off of the exchange. This competition has heightened some SRO members' concerns that an SRO could abuse its regulatory authority through rule-making processes, disciplinary actions, or use of proprietary information. Market participants expect that demutualization will increase the ability of exchanges and other markets to compete both domestically and internationally, however, their views differ on how it might affect potential abuses of regulatory authority related to conflicts of interest. SEC generally concluded that it is too soon to predict the effects of demutualization. Concerns about conflicts of interest persist despite measures by SEC and the SROs that are intended to address them.

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## Nasdaq's and NYSE's Competition with Members Creates Conflicts of Interest

NASD's dual roles as the owner-operator of Nasdaq and as the primary SRO for the 11 ECNs<sup>8</sup> that compete with Nasdaq have created conflicts of interest between NASD's economic interests and regulatory responsibilities, which NASD's pending spin off of Nasdaq is intended to mitigate (discussed further below). SEC regulations require ECNs, as registered broker-dealers, to be members of at least one SRO.<sup>9</sup> According to an ECN official, the ECNs chose NASD as their primary SRO because the unique trading rules as well as other features of the Nasdaq market were conducive to the growth of the ECNs' business.

ECNs are an alternative to the Nasdaq market for trading in Nasdaq stocks. They differ from Nasdaq and registered exchanges principally in that they do not require an intermediary to execute orders. ECNs match orders electronically and anonymously, while Nasdaq broker-dealers, in

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<sup>8</sup> According to Nasdaq, as of March 25, 2002, the 11 ECNs were Archipelago, Attain, B-Trade, Brut, GlobeNet, Instinet, Island, MarketXT, NexTrade, REDIBook, and Track ECN. In addition to these ECNs, other alternative trading systems exist, such as the Portfolio System for Institutional Trading, also known as POSIT.

<sup>9</sup> Under SEC regulations, an ECN must be registered either as a broker-dealer or as a national securities exchange that has the full regulatory responsibilities of an SRO. 17 C.F.R. § 242.301 (2001).

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their roles as market makers,<sup>10</sup> act as intermediaries for all customer orders. In deciding whether to use an ECN or a Nasdaq market maker, customers consider such factors as execution quality, transaction costs, and anonymity.

The number of ECNs and their share of total Nasdaq volume have grown significantly since 1993. According to SEC, in 1993 all alternative trading systems (including one ECN)<sup>11</sup> accounted for about 13 percent of the total volume in Nasdaq securities. By October 2001, ECNs alone accounted for over 30 percent of the total volume in Nasdaq securities.

SEC and certain ECNs have attributed a significant part of the growth in the volume of Nasdaq securities traded on ECNs to the SEC order-handling rules<sup>12</sup> that SEC promulgated to enhance competition and pricing efficiency in the securities markets. Before the rules became effective in 1997, only ECN subscribers had access to the orders and, thus, to the prices that ECNs displayed for Nasdaq securities. Implementation of the rules resulted in ECNs' orders for Nasdaq securities being displayed and accessible to the public on Nasdaq, thereby providing the public an opportunity to obtain any better prices that might be available on ECNs.<sup>13</sup> According to one ECN, both Nasdaq's access to ECNs and the efficiencies that ECNs brought to the Nasdaq market through the electronic matching of orders have contributed to the overall growth of trading in Nasdaq securities.

NYSE, as an SRO that operates a market, has also confronted conflicts of interest between its economic interests and its regulatory responsibilities. Specifically, for many years the exchange has regulated competing member broker-dealers that trade its listed stocks off of the exchange.

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<sup>10</sup> A market maker maintains a market in a security by standing ready to buy or sell that security on a regular and continuous basis at publicly quoted prices.

<sup>11</sup> In 1993, SEC referred to automated screen-based trading systems used by institutions and broker-dealers, including what are now called ECNs and alternative trading systems, as proprietary trading systems. Of the current ECNs, only Instinet existed at that time.

<sup>12</sup> The order-handling rules are SEC Rule 11Ac1-4 (the Display Rule) and amendments to Rule 11Ac1-1 (the Quote Rule).

<sup>13</sup> In March 2000, SEC approved a Nasdaq rule change that allows ECNs to connect to the Nasdaq automated linkage for trading NYSE and American Stock Exchange-listed stocks, thereby allowing public access to these markets that is similar to that available for Nasdaq stocks.

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Customer orders for NYSE stocks that are not sent to the floor of the exchange to be executed are executed internally by a broker-dealer or in an alternative market. A broker-dealer internalizes an order when it executes a customer order for a security in house or directs the order to an affiliated dealer, instead of sending the order to an exchange or another market. Numerous large broker-dealers that are NYSE members have also established relationships with regional exchange specialists and sometimes route their orders to them instead of to NYSE. In addition, member broker-dealers direct orders to alternative markets, such as ECNs or third-market broker-dealers.<sup>14</sup> Competition with member broker-dealers may increase with the May 2000 rescission of NYSE Rule 390, which had restricted off-exchange trading by NYSE members in NYSE-listed securities.<sup>15</sup>

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### Competition and Demutualization Raise Concerns Among Some Market Participants about Regulatory Abuses

Some SRO members expressed concern that increased competition between SROs and their members had given SROs a greater incentive to abuse their regulatory authority. These members were concerned that SROs could adopt rules that unfairly impede the ability of members to compete against the SROs—for example, by adopting rules that give preference to noncompetitors' orders. An official from one broker-dealer also noted that an SRO might sanction a competing member more severely than other members by, for instance, inappropriately concluding that the member had failed to satisfy its best-execution obligation when it routed an order to a competing market for execution rather than to the SRO. ECNs have also expressed concern that an SRO, in its regulatory capacity, could obtain proprietary information from a member and, in its capacity as a market operator, inappropriately use the information. For example, an SRO might obtain proprietary information about its members' customers and then use that information to market its services to the customers.

Some institutional market users that were not SRO members were more broadly concerned about how conflicts of interest in the self-regulatory structure affected the fairness and efficiency of the securities markets.

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<sup>14</sup> Third-market broker-dealers are NASD members that trade exchange-listed securities without being members of the exchange.

<sup>15</sup> Adopted in 1976, NYSE Rule 390 was subsequently amended to apply only to stocks listed on NYSE as of April 26, 1979. Subject to many exceptions, the rule prohibited exchange members from dealing in NYSE-listed securities away from a national securities exchange. SEC approved the repeal of the rule on May 5, 2000.

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These market users asserted that the self-regulatory structure was inherently biased in favor of broker-dealers that were SRO members and owners and that SROs interpreted their rules to favor these broker-dealers. These market users, as well as some broker-dealers, told us that they did not believe that their concerns were addressed when these concerns diverged from the interests of the most powerful broker-dealers at the exchange. Market users also said that the current self-regulatory structure ultimately impeded market-driven innovations that could improve competition and benefit the investing public. One investment company official cited NYSE Rule 390, which had been in place for 20 years, as a classic example of the difficulty of repealing an anticompetitive SRO rule.<sup>16</sup>

Demutualization has heightened the concerns of some SRO members about the potential for abuses of regulatory authority.<sup>17</sup> They expressed concern that a demutualized, for-profit market operator might be more likely to misuse its regulatory authority or be less diligent in fulfilling its regulatory responsibilities in a desire to increase profits. For example, demutualized SROs might have a greater incentive to propose rules that unfairly disadvantage members or other markets or inappropriately sanction or otherwise discipline members against which the SROs compete. Other SRO members expressed concern that demutualized market operators might have a greater incentive to either insufficiently fund or otherwise inadequately fulfill their self-regulatory responsibilities.

However, other market participants believed demutualization could reduce at least some conflicts and lead to needed changes in market structure. Market users such as mutual funds asserted that by diversifying market ownership through the sale of stock, and thus reducing the influence of broker-dealers, demutualization could reduce the conflicts of

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<sup>16</sup> According to SEC, NYSE Rule 390's restrictions on off-board trading had been criticized as an inappropriate attempt to restrict competition among market centers. According to NYSE, the rule was intended, at least in part, to encourage broker representation of customer orders and to maximize the opportunity for investors' orders to interact with one another in a central location, the theory being that in these ways customers would receive better order execution.

<sup>17</sup> Although the motivations for demutualization are the same across markets, demutualization may not raise the same concerns outside the U.S. securities markets because of differences in market structure. For example, Commodity Futures Trading Commission officials told us that demutualization in the U.S. futures markets has raised fewer concerns related to conflicts of interest than it has in the U.S. securities markets because, due to the current structure of the markets, futures exchanges and their members generally have not been direct competitors.

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interest inherent in a self-regulatory structure based on member-owned markets that regulate themselves. According to these market users, diversifying the exchange ownership base could shift management's focus from the narrow interests of intermediaries to the broader interests of all market participants, potentially benefiting the investing public.

According to NYSE officials, demutualization and for-profit status raise no new issues for the exchange. NYSE could demutualize or its members could become its shareholders without any change in the incentives that currently motivate exchange actions. That is, demutualization does not introduce any new conflicts of interest issues. NYSE's chairman noted that the exchange would continue to have a strong economic incentive to preserve its reputation as a well-regulated entity, regardless of its organizational structure.

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### Demutualization Is Expected to Enhance Competitiveness, but Its Effects on Conflicts of Interest Are Not Yet Known

Demutualization is expected to enhance the ability of markets to compete by enabling them to raise capital in the securities markets to fund business efforts and by better aligning the economic interests of markets and their owners. Under current member-owned structures, actions markets might otherwise take to enhance their competitiveness might be rejected or adopted very slowly by member-owners that do not perceive a direct benefit from them. For example, member-owners (that is, broker-dealers) that derive income from acting as intermediaries in the trade execution process might be reluctant to support the introduction of technology if it reduces their income from acting as intermediaries. In contrast, shareholders of a demutualized exchange would be expected to support cost-effective technology that improves customer service and thus the competitiveness of the market, because they would expect it to increase the value of their investments by attracting more business to the exchange. To improve their competitiveness, Nasdaq and the Pacific Exchange,<sup>18</sup> as

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<sup>18</sup> In October 1999, the Pacific Exchange filed a proposal with SEC to separate its equities operation into a wholly owned corporate subsidiary, which SEC approved in May 2000. Subsequently, the exchange entered into a partnership with Archipelago Holdings, Inc., to allow a subsidiary—the Archipelago Exchange—to operate as a facility of the Pacific Exchange for trading equity securities. In September 2000, the Pacific Exchange announced its plan to convert into a for-profit stock corporation. In October 2001, SEC approved the rules allowing the facility to operate.

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well as several U.S. futures<sup>19</sup> and foreign exchanges,<sup>20</sup> have demutualized or are in the process of doing so. In 1999, NYSE also announced plans to demutualize but subsequently postponed its plans indefinitely.

An SEC economist said that the effects of demutualization could not be predicted, as they depended on a balance between the competing incentives of maximizing profits and providing effective regulation. The balance between these incentives would differ depending on who owned and controlled the market. Also, as under the current ownership structure, the incentive to reduce regulatory costs would be balanced against the risk that any resulting reduction in regulation might harm the public's confidence in the integrity of the market. A loss of public confidence could ultimately reduce profitability if, for example, investors moved their transactions to other markets.

SEC officials further explained that both for-profit and not-for-profit SROs face inherent conflicts of interest, but noted that demutualization has the potential to heighten or create variations of existing conflicts of interest. SEC officials stated, for example, that while all SROs face pressure to minimize the costs of fulfilling their regulatory obligations, for-profit entities could be more aggressive in promoting their commercial interests, such as by using regulatory fees to finance nonregulatory functions. SEC officials emphasized, however, that because conflicts of interest already exist within the not-for-profit structure, demutualization does not necessarily require a wholesale change in regulatory approach. They noted that the Exchange Act has significant safeguards to address conflicts of interest and abuses of regulatory power. Finally, in commenting on the growing trend among SROs to contract out certain regulatory services, SEC officials stressed that SROs are still legally responsible for fulfilling self-regulatory obligations that are contracted out.<sup>21</sup>

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<sup>19</sup> On November 13, 2000, the Chicago Mercantile Exchange became the first U.S. financial exchange to demutualize. On November 17, 2000, the New York Mercantile Exchange completed its demutualization. The Chicago Board of Trade was still in the process of demutualizing on March 31, 2002.

<sup>20</sup> Among the many foreign exchanges that have demutualized are the OM Stockholm Exchange (in 1993); the Australian Stock Exchange (in 1998); and in 2000, the Stock Exchange of Hong Kong, Bourse de Montreal, London Stock Exchange, and Toronto Stock Exchange.

<sup>21</sup> For example, the International Securities Exchange has contracted with NASDR to provide regulatory services.

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## Regulatory Measures Exist to Address Conflicts of Interest

NASD has attempted to address concerns about conflicts of interest by reorganizing its regulatory operations and is in the process of selling its market operations. In addition, NASD and NYSE officials told us that their markets have relied on internal controls to address these concerns. SEC has used its authority under the Exchange Act to monitor the markets and address concerns about abuses of regulatory authority.

## NASD Is Continuing to Reorganize and Has Used Internal Controls to Address Concerns about Conflicts of Interest

In 1996, NASD created NASDR as a separate nonprofit subsidiary to address concerns related to the conflicts between NASD's regulatory functions and market operations.<sup>22</sup> Beginning in March 2000, NASD began implementing plans to sell Nasdaq to NASD members and other investors in order to limit the common ownership of Nasdaq and NASDR. In November 2000, Nasdaq filed an application with SEC to register as a national securities exchange.<sup>23</sup> The planned restructuring will separate NASD and NASDR from Nasdaq and, in NASD's view, minimize any issues related to conflicts of interest, including those related to demutualization.<sup>24</sup> Under the restructuring, ECNs and other broker-dealers doing business with the public (holding customer accounts) will remain NASD members. They will continue to be regulated by NASD but will no longer be competing against an NASD-operated market.<sup>25</sup> According to NASD, the restructuring will be substantially complete with the sale of NASD's

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<sup>22</sup> The Rudman Commission recommended the restructuring in a 1995 report. The Commission was established to review the governance of NASD in response to allegations of collusion among Nasdaq market makers to fix prices.

<sup>23</sup> Subsequently, Nasdaq filed three amendments to its initial filing, most recently on January 8, 2002. As of that date, Nasdaq's application was pending before SEC.

<sup>24</sup> To avoid concerns related to conflicts of interest involving the regulation of competing members, the Toronto Stock Exchange and the Montreal Exchange separated their market regulatory functions from their for-profit business functions.

<sup>25</sup> NASD will still own the American Stock Exchange and will thus continue to regulate exchange members competing with that market.

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remaining Nasdaq common stock, which is expected to occur by June 2002. However, NASD will retain an interest in Nasdaq after this date.<sup>26</sup>

According to one ECN, the planned spin-off of Nasdaq will not fully solve the conflict of interest problem because, not only will NASD retain an interest in Nasdaq, but Nasdaq will still be NASDR's biggest customer for its regulatory services. As such, NASDR could face a conflict between its ethical responsibility as a regulatory services provider and the economic incentive to, among other things, retain its largest revenue source. Accordingly, competitors might be concerned that NASDR will perform its regulatory services in a way that gives Nasdaq a competitive advantage.<sup>27</sup> Also, because Nasdaq has applied to become an SRO as part of NASD's plan to demutualize Nasdaq, the restructuring will not address conflicts of interest related to market-specific regulation by the new SRO.<sup>28</sup> That is, as an SRO, Nasdaq will have regulatory authority over members that operate or use competing markets.

In addition to adopting a structure designed to minimize conflicts between regulation and competition, NASD's self-regulatory functions are subject to its internal controls and the oversight of SEC and the NASD and NASDR boards of directors. The boards of directors, which include public members, are intended to provide additional assurance against abuses of regulatory authority. The NASD board, to which the Nasdaq board will

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<sup>26</sup> According to NASD, NASD's interest, if any, in Nasdaq common stock after the spin-off will depend on the extent to which the warrants for common stock that NASD sold as part of the transaction remain unexercised. Since some of the warrants need not be exercised until June 28, 2005, NASD's final interest in Nasdaq common stock might not be known until then. In addition, according to NASD, NASD will retain a controlling interest in Nasdaq through its ownership of voting preferred stock until Nasdaq becomes a registered exchange. Upon Nasdaq becoming a registered exchange, the voting preferred stock will be automatically redeemed. NASD currently owns 100 percent of the nonvoting Nasdaq preferred stock and may continue to do so after the spin-off is complete. However, should Nasdaq complete an initial public offering or other offering of equity securities, it must buy back the nonvoting preferred stock with the proceeds from the offering.

<sup>27</sup> According to NASD, its 10-year contract with Nasdaq can be terminated in the first 5 years for cause only. In the next 5 years, the contract can be terminated for cause or if Nasdaq is able to internalize the services provided by NASD or obtain them for significantly lower cost from a third party.

<sup>28</sup> SROs' regulatory responsibilities can generally be described as either broker-dealer/member-specific or market-specific. Member-specific regulation generally includes on-site examination of broker-dealers' compliance with financial and sales practice rules, while market-specific regulation generally includes market surveillance and the enforcement of exchange trading rules.

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NYSE Has Used Internal Controls to Address Concerns about Conflicts of Interest

continue reporting until the spin-off is complete, and the NASDR board both have a majority of public members, while the Nasdaq board has an equal number of public and industry members. The boards also receive advice from various standing advisory committees.<sup>29</sup> In addition, all NASD employees are required to sign a statement attesting that they will not share confidential information with any unauthorized person, inside or outside of the organization.

NASD officials described other internal procedures that should minimize abuses of regulatory authority. According to NASD officials, NASD generally solicits comments from its membership and the public on regulatory rule proposals, and its board takes those comments into account before NASD files these proposals with SEC.<sup>30</sup> In its disciplinary process, case initiation is governed by internal procedures that require approval from a staff body independent of NASDR enforcement and market regulation staff. After a complaint is filed, the case is heard before a three-member body that is also independent of these staff. If the matter is appealed, the appellate decision is rendered by the National Adjudicatory Council, which is made up of an equal number of industry and non-industry members.

An NYSE official told us that the exchange maintains strict internal controls to address concerns about conflicts of interest between its market operations and regulatory oversight. For example, NYSE cited controls to prevent market operations staff from gaining access to information on members that has been obtained for regulatory purposes. Additionally, NYSE policy requires that regulatory staff sign a statement attesting that they will not share confidential information with market operations staff. NYSE policy statements also include details on compliance with the securities laws, including the prohibition of any unfair treatment of customers or members.

NYSE's self-regulatory functions are also subject to the oversight of SEC and the NYSE board of directors, which is intended to provide additional

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<sup>29</sup> NASD has a formal plan that governs the relationship among the NASD, NASDR, and Nasdaq boards and that is intended to ensure the independence of the NASDR and Nasdaq boards.

<sup>30</sup> In contrast, according to an NASD official, Nasdaq's market structure rule proposals follow the procedure used by other SROs that operate a market—the rules are typically discussed with membership committees but are not sent out for public comment before being submitted to SEC.

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SEC Has Used Its Authority to Address Concerns about Regulatory Abuses and Related Issues

controls against abuses of regulatory authority. The board has 27 members—12 directors from the securities industry, 12 public directors that are independent of the securities industry, and 3 exchange officials. The board receives advice from various standing advisory committees, among them a committee comprising institutional market users. According to NYSE officials, institutional market users can voice their concerns to the board through this committee.

The NYSE disciplinary process is also governed by a three-member review panel. A disciplinary decision by this panel can be appealed to the NYSE Board of Directors, which renders its decision after consultation with a special review committee whose membership is balanced between industry and non-industry members.

SEC has used its authority under the Exchange Act to address concerns about abuses of regulatory authority arising from conflicts of interest, including those related to demutualization and other issues. SEC has addressed such conflicts through its oversight activities, which include reviewing and approving SRO proposals for new rules and amendments to existing rules, reviewing SRO final disciplinary proceedings, and other measures.

SEC reviews SRO proposals for new rules and for amendments to existing rules to ensure that they are not anticompetitive, unfairly discriminatory, or otherwise detrimental to the markets. Section 19(b)(1) of the Exchange Act requires SROs to file copies of proposals for new rules and amendments to existing rules with SEC.<sup>31</sup> Once a proposal is filed, SEC is required to publish notice of the proposal and provide an opportunity for public comment. SEC is also required, among other things, to consider the competitive effects of the rule. According to SEC, its rule reviews address the concerns of some SRO members that an SRO could abuse its authority by adopting rules that unfairly impede the ability of members to compete against the SRO. SEC officials noted, for example, that while an SRO could

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<sup>31</sup> In January 2001, SEC proposed a rule to allow SROs to implement or alter trading rules (other than those related to major market structure initiatives) without waiting for SEC approval, provided that the SROs had procedures for effective surveillance of activity covered by the trading rules and for enforcement of the rules. According to SEC, the proposed rule would foster innovation by allowing SROs to move more quickly and would reduce the regulatory burden of SROs as well as help them maintain their competitiveness. As of March 31, 2002, the rule had not been adopted.

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propose an anticompetitive or discriminatory rule, SEC would not approve it.

According to officials of one ECN, SEC's review of SRO rules, including the public comment process, has been one of the most effective ways for ECNs to have their concerns addressed. In particular, they said that SEC has addressed comments ECNs have submitted in response to SRO rule proposals. For example, ECNs expressed concerns about the anticompetitiveness of NASD's SuperMontage proposal, and NASD, at SEC's direction, modified the rule numerous times in an attempt to address ECN concerns.<sup>32</sup> More recently, another ECN expressed concern to SEC about the competitive effects of a proposed rule that would allow Nasdaq to charge higher transaction fees to members that report less than 95 percent of their trades through Nasdaq but use Nasdaq's quotation system or make limited use of its execution systems. The ECN was concerned, among other things, that the rule was filed under section 19(b)(3)(A) of the Exchange Act, under which such rules are effective on filing.<sup>33</sup> Following discussions with SEC, NASD refiled the rule proposal under section 19(b)(2) of the Exchange Act pursuant to which it would be subject to the public comment process and SEC approval before becoming effective.<sup>34</sup> According to SEC officials, SROs have withdrawn rule proposals after SEC expressed concern that the proposals might be anticompetitive.

Some market participants, although agreeing that SEC's public comment process provides a mechanism for addressing concerns about potentially anticompetitive activity by an SRO, also said that SEC lacks the resources, tools, and expertise to identify and adequately respond to all instances of

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<sup>32</sup> On October 1, 1999, Nasdaq filed proposed rule changes with SEC to establish order display and collection facilities and to modify its primary trading platform, collectively referred to as the SuperMontage proposal. Various aspects of the proposal were widely criticized as unfair or anticompetitive. After numerous amendments, SEC approved the proposal on January 19, 2001.

<sup>33</sup> Although rule proposals filed under section 19(b)(3)(A) of the Exchange Act are effective on filing, they are also subject to a 21-day comment period that begins at the time the notice of the filing is published in the *Federal Register*. The Exchange Act authorizes SEC, within 60 days of an SRO's filing of a rule under section 19(b)(3)(A), to annul the rule change and require that the rule be refiled under section 19(b)(2) of the Exchange Act.

<sup>34</sup> Notice of Filing of a Proposed Rule Change by the National Association of Securities Dealers, Inc., Relating to Member Transaction Fees, Securities and Exchange Commission Release No. 34-45506 (proposed Mar. 5, 2002).

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anticompetitive activity by an SRO toward member competitors. According to one ECN, an SRO committed to a course of anticompetitive activity through a variety of rulemaking and rule enforcement activities may be able to achieve success, particularly in the short term, using section 19(b)(3)(A) of the Exchange Act. This ECN was concerned about the ability of an SRO to potentially obtain a significant long-term competitive advantage over its member competitors through such activities, given the quickly evolving and highly competitive nature of the securities industry.

To ensure that SROs actions are not discriminatory or otherwise anticompetitive, SEC also reviews SROs' disciplinary actions during inspections. According to SEC, these reviews address the concerns of some SRO members that an SRO could abuse its regulatory authority by sanctioning a competing member inappropriately or more severely than a noncompeting member. The Exchange Act requires SROs, in administering their affairs, to provide fair representation for members. According to SEC, the fair application of SROs' authority to adjudicate disciplinary actions, including meting out fines and suspensions, may be particularly important, because these actions can have significant ramifications for broker-dealers. The Exchange Act provides SEC with a check on SRO disciplinary actions that are discriminatory or otherwise anticompetitive, requiring SROs that impose final disciplinary sanctions on members to also file notice with SEC. Such actions are subject to SEC's review after appropriate notice and an opportunity for a hearing. Upon appeal, SEC must determine whether the action is consistent with the Exchange Act, SEC rules, and SRO rules and then either affirm, modify, set aside, or remand the action to the SRO for further proceedings.

SEC uses additional approaches to addressing industry concerns, such as concept releases, special committees, and public hearings. For example, SEC published a concept release in December 1999 to obtain views on the fairness and reasonableness of fees charged for market information and on the role of revenues derived from such fees in funding SROs.<sup>35</sup> In commenting on the release, some SRO members questioned the fairness of funding SROs, which are competitors for customer order flow, with revenues from the sale of market information. Because of the diversity of comments received and concerns raised by the concept release, SEC

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<sup>35</sup> SEC Concept Release: Regulation of Market Information Fees and Revenues, Securities Exchange Act Release No. 34-42208 (Dec. 9, 1999).

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created an advisory committee on market information in August 2000 to provide the agency further guidance. SEC officials said they were reviewing the advisory committee's September 2001 report and the comments received since it was issued to determine how to address concerns about market data.

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### Some Broker-Dealers Were Concerned about Rule Differences and Multiple Examinations

Some broker-dealers that were members of multiple SROs told us that differences in rules and their interpretations among SROs resulted in operational inefficiencies. While no formal process exists for ensuring consistency among rules that might cause material regulatory inefficiencies, regulatory officials said that the existing rule review and public comment process has been effective in addressing related concerns. An ongoing NASD effort could lead to the resolution of some of these concerns but regulatory cooperation will be required as NASD's authority is limited to its own rules. In addition, some broker-dealers with multiple SRO memberships said that examinations by multiple SROs were unnecessarily burdensome. Over the years, SEC and the SROs have taken steps to improve examination efficiency, most recently through efforts to improve examination coordination. However, some broker-dealers told us that these efforts have not fully addressed their concerns.

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### Some Broker-Dealers Were Concerned about Inefficiencies Associated with Differing Rules and Interpretations

According to both market participants and regulators, SROs generally had the same or similar rules. However, some broker-dealers with multiple SRO memberships—principally NASD and NYSE memberships—were concerned that differences in rules and rule interpretations among SROs were causing operational inefficiencies. Some broker-dealers had multiple memberships because, if they were active in more than one market, they could choose to become members of the SROs operating those markets; and, if they did business with the public, they were also required to belong to NASD.<sup>36</sup> Broker-dealers are subject to the regulatory oversight of each SRO to which they belong, as well as to the oversight of SEC and state securities regulators.

Some broker-dealers expressed concern about inefficiencies associated with monitoring and complying with SROs' varying rules and rule

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<sup>36</sup> According to NASD, more than 5,500 broker-dealers were NASD members as of March 31, 2002. According to NYSE, about 250 of these were also NYSE members with public customers.

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interpretations in areas such as determining what types of customer complaints to report, how long to retain certain written records, and which proficiency examinations broker-dealer employees must take and when. For example, NASD and NYSE do not use the same proficiency examinations for order takers, sales representatives, and branch managers. Further, NASD and NYSE rules and rule interpretations differ on matters such as whether order takers and sales representatives must pass the same proficiency examinations and when candidates that pass these examinations can be promoted to branch managers. According to some broker-dealers, to the extent that the skills and proficiency of order takers and sales representatives affect the quality of customer protection, these differences could result in varying levels of customer protection among firms, while at the same time, disadvantaging some firms in their ability to hire and retain staff.

When discussing the overall effect of differences in rules and their interpretations with officials of several broker-dealers, they stressed that their concerns were not about the cost of one or more specific instances of differences in rules and their interpretations, but about their cumulative effect on the efficient use of compliance resources. Broker-dealers emphasized that the purpose of compliance is to protect the integrity of the markets and investors, and the effort needed to sort out compliance with multiple rules and rule interpretations strains these resources. We could not assess the overall effect of differences in rules and their interpretations because of the anecdotal nature of the information provided.

While no formal process exists for addressing differences among SRO rules and interpretations that might cause material regulatory inefficiencies, SEC, NASDR, and NYSE officials told us that they have found the existing rule review and public comment process to be effective for addressing concerns about rules. According to SEC officials, SEC might use this process to try harmonizing proposed SRO rules if the agency identified significant differences or inconsistencies in them. They said that as part of the review process SEC staff ask SROs to justify any differences between a proposed rule and other SRO or SEC rules. For example, SEC officials told us that through this process they ensured that NASD and NYSE harmonized their rules on margin requirements for day traders. SEC also worked with NASD and NYSE to coordinate antimoney laundering and analyst disclosure rules. According to NYSE officials, only the reporting requirements for the money laundering rules differ. These officials also said that the exchange is working with NASD to develop uniform sales practice and margin rules for single stock futures.

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SEC also commented that, while the review and public comment process can address market participants' concerns that are raised at the time a rule proposal is filed, the burdens associated with different SRO rules may not become apparent until long after the rules have been implemented. SEC officials further noted that the Exchange Act does not require that all SRO rules be uniform. They said that SROs are entitled to set whatever rules they determine are appropriate for their markets as long as the rules comply with the Exchange Act. SEC officials stressed that the agency would not impede one SRO from establishing higher standards than another, noting that many of the differing rules exist for legitimate business reasons and reflect differences in business models among markets. NYSE officials also told us that most of NYSE-listed firms that do business with the public are larger broker-dealers and that the rules imposed on larger firms are not always appropriate for smaller firms.

An ongoing NASD rule modernization effort has identified differences among NASD and other SROs' rules and could lead to the resolution of some differences. In 1998, NASD began a review to identify rules that could be repealed or modernized. In May 2001, NASD issued a notice to members stating that it intended to expand and build upon this review with the goal of ensuring that NASD rules accomplish their objectives without imposing unnecessary regulatory burdens. NASD also indicated that it was developing an ongoing process for identifying rules with regulatory costs that outweighed their benefits, including rules that were obsolete because of technological changes. The SIA's response to the initiative discussed NASD rules that SIA concluded were inconsistent with those of other SROs and SEC. For example, SIA's response<sup>37</sup> cited an NASD rule on posting price quotations that SIA concluded was inconsistent with an SEC rule on displaying limit orders.<sup>38</sup> NASD stated that it had begun the process of meeting with other regulators, including NYSE and the states, in an effort to coordinate inconsistencies among various rules. It also provided other regulators with pertinent comments received in response to its notice to members. NASD officials told us that although NASD was coordinating its modernization efforts with other regulators and hoped to eliminate inconsistencies among rules, NASD could address only its own rules.

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<sup>37</sup> Comment letter from the SIA regarding Special NASD Notice to Members 01-35—Request for Comments on Rule Modernization Project (July 31, 2001).

<sup>38</sup> Limit orders are orders to buy or sell securities at specific prices (or better).

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## Regulators Have Improved Examination Coordination but Some Broker-Dealers Remain Concerned about Multiple Examinations

SEC and SROs have taken actions to improve the efficiency of SRO examinations of broker-dealers with multiple SRO memberships. These actions stemmed from (1) a 1976 SEC rule under which the agency assigns responsibility for conducting a broker-dealer's financial and operational soundness examinations to a single SRO, called the designated examining authority (DEA); (2) another 1976 SEC rule that facilitated agreements among SROs to reallocate certain oversight responsibilities; and (3) a 1995 memorandum of understanding (MOU) among SEC, four SROs, and state regulators to coordinate examinations. While acknowledging that coordination efforts have improved examination efficiency, some broker-dealers said that additional improvements in efficiency are needed.

## SEC and SROs Have Improved Examination Coordination

In its role as an SRO, NASD (through NASDR) is to periodically examine its members' operations<sup>39</sup> every 1 to 4 years (depending on, among other things, the size of the broker-dealer). Also in its role as an SRO, NYSE is to conduct annual examinations of members that do business with the public. NASD and NYSE examinations include two types of reviews. The financial and operational review determines compliance with requirements addressing business soundness. The sales practice review determines compliance with requirements addressing, among other things, the quality of trade execution, the existence of unauthorized trading, the fairness of pricing, and fair dealings with customers, as well as compliance with market-specific rules governing member conduct and trade execution. SROs may also conduct cause or special purpose examinations as necessary to address specific problems or industry concerns.

In 1976, SEC adopted rule 17d-1, under which it designates a single SRO as the DEA responsible for financial compliance examinations<sup>40</sup> of individual broker-dealers that are members of multiple SROs. This rule was adopted pursuant to the Securities Act Amendments of 1975, which authorizes SEC to adopt rules to relieve SROs of the duplicative responsibility of examining their members for compliance with the Exchange Act, its rules, and SRO rules when the broker-dealer is a member of more than one SRO. However, because Rule 17d-1 relates only to financial compliance

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<sup>39</sup> In addition to SRO examinations, a broker-dealer may also be subject to examinations by each state where it has offices and by SEC.

<sup>40</sup> The DEA is responsible for examining member broker-dealers for compliance with the Exchange Act and SEC and SRO rules and regulations related to financial responsibility, including SEC net capital and customer account protection rules.

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examinations, the common members of NASD and NYSE remained subject to sales practice examinations by both NASDR and NYSE.

According to SEC officials, the agency selects the DEA for common members based on the market the broker-dealer uses to execute a preponderance of its customer orders or the market in which the broker-dealer has the most memberships. As of March 31, 2002, according to NYSE officials, NYSE was the DEA for about 250 broker-dealers that were also members of and subject to examination by NASD. According to NYSE, these firms represented approximately 90 percent of customer assets in the securities industry.

Also in 1976, SEC adopted Rule 17d-2, which permitted SROs to establish joint plans for allocating certain regulatory responsibilities that involved their common members. Under the rule, which was also adopted as a result of the Securities Act Amendments of 1975, all plans must be filed with SEC for approval. SEC was to approve plans that, among other things, fostered cooperation and coordination among SROs. For example, SEC approved a plan in 1983 under which the American Stock Exchange, the Chicago Board Options Exchange, NASD, NYSE, the Pacific Exchange, and the Philadelphia Stock Exchange periodically rotate among themselves responsibility for options-related sales practice examinations for their common members. SEC approved other plans in the 1970s and 1980s, under which the American Stock Exchange and the regional exchanges deferred certain regulatory responsibilities of their common members to the DEA (either to NASD or NYSE).

Concurrent with proposed legislation<sup>41</sup> and related hearings, SEC, four SROs,<sup>42</sup> and the state securities regulators<sup>43</sup> entered an MOU in November 1995 to coordinate broker-dealer examinations. The MOU provided for the SROs and states (through the North American Securities Administrators

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<sup>41</sup> The proposed legislation was called the Capital Markets Deregulation and Liberalization Act of 1995 (H.R. 2131). Although the proposal did not become law, a provision that required SEC to improve coordination was subsequently included in the National Securities Market Improvement Act of 1996, which became section 17(k) of the Exchange Act.

<sup>42</sup> The four SROs that entered into the MOU were the American Stock Exchange, the Chicago Board Options Exchange, NASD, and NYSE.

<sup>43</sup> The North American Securities Administrators Association agreed to the MOU on behalf of state regulators. The association is an organization of state, provincial, and territorial securities administrators in Canada, Mexico, and the United States that is devoted to investor protection and efficient capital formation.

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Association) to meet requests from broker-dealers to coordinate specified on-site regulatory examinations. In responding to these requests, SROs were to share information and devise ways to avoid duplication. To the extent practicable, sales practice examinations conducted by the DEA and any other SROs were to be conducted simultaneously with the DEA's financial and operational examination. Cause examinations that resulted from customer complaints or other matters were not subject to the MOU, nor were the examinations that SEC conducted to evaluate the quality of SRO oversight. However, the MOU encouraged coordination and cooperation for all examinations to the extent possible.

An SEC official told us that the agency closely monitors and assesses SRO examination coordination. According to SEC and SRO officials, representatives of SEC, all SROs, and the states attend annual summits to discuss examination coordination, review examination results from the prior year, and develop plans for coordinating examinations for the coming year. In addition, regional SEC staff and SRO compliance staff are to meet quarterly to discuss and plan examination coordination, and SRO examiners are to meet monthly to plan specific examinations of common members. At these latter meetings, examiners are expected to, among other things, collaborate on fieldwork dates, document requests, and broker-dealer entrance and closeout meetings. SROs also are to share their prior examination reports before beginning fieldwork.

Under the 1995 MOU, SEC agreed to maintain a computerized database to monitor examination coordination. SEC developed the criteria for coordinated examinations under the MOU as well as a database to track the number of broker-dealers that requested and received coordinated examinations. Under SEC criteria, examinations are coordinated when the SROs have at least 1 day of concurrent fieldwork at the targeted broker-dealer. An SEC official told us, however, that concurrent fieldwork was only one measure of coordination and did not completely reflect the quality of coordination. However, using this measure, SEC calculated that from 1997 through 2000 an average of 90 percent of those requesting coordinated examinations received them and that in 2000 96 percent of requestors received coordinated examinations. According to SEC officials, requests for coordinated examinations could not be honored because other scheduled examinations took longer than expected or because examiners had been reassigned to previously unscheduled cause examinations.

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## Some Broker-Dealers Have Remained Concerned about Multiple Examinations

SEC's most recent efforts to address concerns about multiple examinations have focused on improving examination coordination. In a June 1998 report,<sup>44</sup> SIA concluded that, although SEC and the SROs had made considerable progress toward improving examination coordination for broker-dealers with multiple SRO memberships, more work remained to be done to reduce duplication of efforts. In discussions with us, some broker-dealers expressed continued dissatisfaction with inefficiencies associated with multiple examinations. For example, although examinations could take a few weeks, according to some broker-dealers, when all examination steps (including both pre- and post-examination) were taken into account, firms could be subject to some part of the examination process continuously throughout the year, even with coordination. Because of the anecdotal nature of the information provided, we could not determine the extent to which multiple examinations caused inefficiencies or the extent to which efforts to address inefficiencies through improved coordination were successful.

SRO data show that broker-dealers' participation in the coordinated examination program has been declining. For example, the total number of NYSE and NASD member firms participating in the program declined from about 63 percent in 1998 to about 54 percent in 2000. According to SEC officials, these numbers do not necessarily indicate problems with the coordinated examination program, since broker-dealers opt in or out of the program for many reasons. SEC officials told us that some broker-dealers that have tried the coordinated examination program have concluded that it is more efficient for them to have two separate examinations. They said that an average of five broker-dealers participating in the coordinated examination program leave the program each year, typically because they lacked the space to accommodate the larger teams that accompany concurrent examinations or otherwise found the examinations to be disruptive to their operations. For example, some broker-dealers have concluded that it is not efficient for them to have staff with expertise in different areas of the firm's operations (such as sales practices and finance) available to interact with examiners at the same time.

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<sup>44</sup> SIA surveyed its members about examinations done in 1997, the first full year that the MOU was in effect, and reported the results in *Regulatory Examination Survey Report*, SIA, June 1998.

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SEC officials told us that they were aware of broker-dealers' concerns about examination coordination and that these concerns had been addressed on a case-by-case basis. SEC officials stated that they often sought informal feedback from individual broker-dealers and industry trade groups and would continue to urge broker-dealers to discuss examinations and the examination process with SEC and SRO staff. SEC officials also said that in mid-2001, the agency began a pilot program to coordinate the examinations of one large broker-dealer. The pilot includes SEC, NYSE, NASDR, the Chicago Board Options Exchange, and a number of state regulators. SEC expects the program to help determine whether the agency can enhance information sharing among regulators and alleviate any burdens associated with broker-dealers being examined by multiple regulators.

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## Market Participants Have Discussed Alternative Approaches to Self-Regulation

Securities market participants have discussed alternative approaches to self-regulation that would address, at least in part, concerns about the current self-regulatory structure. SEC officials said that the agency did not plan to dictate changes in the current structure to address these concerns but instead preferred that market participants reach a consensus on whether a need for change existed and, if so, the type of change that would be appropriate. One alternative would expand the DEA program beyond financial compliance to cover sales practices. An alternative some ECNs have discussed for addressing their concerns involves registering as exchanges and becoming SROs. Also, the broader securities industry has discussed alternatives that would more dramatically change or replace the current self-regulatory structure. These alternatives were detailed in an SIA report published in January 2000<sup>45</sup> and included consolidating responsibility for broker-dealer self-regulation and cross-market issues in a single entity not affiliated with any market (hybrid SRO model), consolidating all self-regulation—market-specific and broker-dealer—in a single entity (single SRO model), or having SEC assume all the regulatory functions currently performed by SROs (SEC-only model). At this time, none of these models appears to have the support from market participants needed for implementation.

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<sup>45</sup> *Reinventing Self-Regulation, White Paper of the Securities Industry Association's Ad Hoc Committee on Regulatory Implications of De-Mutualization*, Jan. 5, 2000.

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## SEC Does Not Plan to Dictate Change

According to SEC officials, the agency does not plan to dictate changes to the regulatory structure. SEC officials told us that they believed the agency had the authority it needed to make changes but preferred that the industry reach a consensus on whether the need for change existed and, if so, what type. Additionally, they said that industry initiatives, such as Nasdaq's application to register as an exchange, were transforming the regulatory landscape. They elaborated that if Nasdaq became an exchange, it would separate from NASD, mitigating ECN concerns about conflicts of interest. In the meantime, SEC officials said that the current self-regulatory structure had been working adequately and that immediate action was not needed. SEC noted that members could initiate improvements through their SROs, express opposition to a proposed course of action directly to the SRO, or voice their concerns to SEC. Additionally, broker-dealers could respond to proposed SRO rules both through SRO committees and during the public comment process and could also use their membership in organizations such as SIA to lobby for change.

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## The DEA Program Could Be Expanded

The Exchange Act provisions under which SEC assigns a single SRO as DEA with responsibility for financial compliance examinations could be amended to include sales practice examinations. The result would be that each broker-dealer would have only one examining SRO, thereby eliminating examinations by multiple SROs. However, this approach would not address the conflicts of interest that arise when SROs that operate a market regulate competitors or the differences in rules and rule interpretations among SROs.

SEC opposed a provision to expand the DEA program that was included in proposed 1995 legislation.<sup>46</sup> In related congressional hearings, the then SEC chairman testified that, while SROs currently monitor trading activities in their own markets, the provision would seem to require that DEAs also monitor trading in other SROs' markets, which could be costly and significantly less effective than the current system. The chairman also pointed out that while an SRO has considerable incentive to enforce its own rules, its incentive to enforce the rules of other SROs might not be as strong. He stated that requiring an SRO to enforce the rules of another

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<sup>46</sup> The provision, which did not become law, was included in the Capital Markets Deregulation and Liberalization Act of 1995, H.R. 2131, 104th Cong. (1995).

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SRO would be inconsistent with section 19(g) of the Exchange Act, under which each SRO is to enforce compliance with its own rules.

Some market participants have also discussed a proposal that would allow broker-dealers, rather than SEC, to select their DEAs. NASD officials were concerned that this proposal could threaten NASD's ability to provide affordable regulatory services to small firms. NASD officials said that, under this proposal, the large broker-dealers might select NYSE as their DEA, while the small ones might select NASD. NASD would then lose the revenue from large broker-dealers that currently subsidizes the cost of regulatory services for smaller broker-dealers. For example, according to NASD officials, the smallest NASD member pays \$600 in annual fees, but the average examination for such a broker-dealer costs from \$7,000 to \$10,000. According to NASD officials, allowing broker-dealers to select their DEAs could threaten the existence of NASD and thousands of small broker-dealers.

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## ECNs Could Become SROs

An ECN or other alternative trading system could become an SRO by registering as an exchange and in doing so would avoid regulation by a competing SRO. Having each ECN become an SRO would reduce conflicts of interest that can arise when SROs that operate a market regulate ECNs. However, this alternative would not address the regulatory inefficiencies that result from broker-dealers having multiple SRO memberships. Three ECNs—Island, Archipelago, and NexTrade—have explored becoming securities exchanges, although no formal filings are currently before SEC. Archipelago has since become a facility of the Pacific Exchange.

NASD officials expressed a general concern that, if SROs proliferate, regulatory information would be reported to different regulators without adequate coordination. Because no one regulator would see all relevant information, abuses could continue undetected. They were further concerned that competition among regulators—to be distinguished from competition among markets—could lead to a race to the lowest regulatory standards and undermine investor confidence in the securities markets. Other market participants have observed that by marketing the quality of their services to potential clients, competing regulators could create higher regulatory standards. One ECN emphasized that SEC's existing SRO oversight programs focus on assessing whether regulatory service providers meet acceptable levels of performance.

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## Broker-Dealers and Cross-Market Rules Would Be the Responsibility of a Single Entity (the Hybrid SRO Model)

The SIA report endorsed replacing the current self-regulatory structure with the hybrid SRO model, a proposal that was discussed in the early 1970s. Under the hybrid SRO model, a single entity unaffiliated with any market would be created to assume responsibility for broker-dealer oversight and cross-market rules, including those related to sales practices, industry admissions, financial responsibility, and cross-market trading. Individual SROs would remain responsible for market-specific rules such as those related to listings, governance, and market-specific trading.

Although some SIA members said it was premature to revamp the current regulatory structure, the majority supported the hybrid SRO model because they believed that it would reduce member-related conflicts of interest and SRO inefficiencies. According to SIA, potential conflicts of interest would be reduced because the new SRO would not be affiliated with a competing market. Eliminating duplicative SRO examinations would reduce inefficiencies in areas such as rulemaking, examinations, and staffing. SEC officials agreed that consolidating member regulation into one SRO was an advantage of the hybrid SRO model. They noted that the industry was moving toward a hybrid model as Nasdaq separated from NASD and NASD contracted to provide regulatory services to more SROs. Although NASD officials told us that they did not have an official position on the hybrid SRO model, NASD has supported the concept of separating market-specific and member regulation in the past. In February 2000 testimony, the then NASD chairman noted that NASD's separation of Nasdaq and NASDR is the first step toward "the right regulatory model: the hybrid SRO model."<sup>47</sup>

In stating its opposition to self-regulatory changes, the NYSE chairman said that spinning off NYSE regulation into an unaffiliated regulatory entity would weaken investor protection and do irreparable harm to the NYSE brand name. He noted that funding a separate regulatory body independent of the exchange would eliminate economic efficiencies and synergies that result from the integration of regulation into the NYSE market as a whole. NYSE officials told us that because the hybrid model separates member from market-specific regulation, the hybrid regulator's examinations would not review the operations of the entire broker-dealer and thus would be less effective than examinations conducted under the

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<sup>47</sup> Testimony by Frank Zarb, chairman, NASD: Committee on Banking, Housing and Urban Affairs; United States Senate (Washington, D.C.: Feb. 29, 2000).

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current regulatory approach. NYSE officials also said that the exchange had postponed its plan to demutualize for several reasons, including concern that such action might have had the negative consequence of forcing NYSE to separate its regulatory and market functions. SIA agreed that the disadvantages of the hybrid SRO model included the model's inability to address market-specific conflicts of interest. SIA and others concluded, however, that the advantage of having personnel with specialized knowledge overseeing market operations outweighed this disadvantage.

According to the SIA report, SIA attempted to gather data showing that the hybrid SRO model would be a cost-effective approach to self-regulation. However, it was unable to obtain the data it needed from the SROs. In the absence of active support from NYSE and SEC for the model, SIA is not currently pursuing it as a means of addressing market participants' concerns about conflicts of interest and regulatory inefficiencies.

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### Markets and Broker-Dealers Would Be Regulated by One Entity (the Single SRO Model)

The SIA report also discussed the single-SRO model as a means of addressing concerns about both conflicts of interest and regulatory inefficiencies. Under this model, a single SRO would be vested with responsibility for all regulatory functions currently performed by the SROs, including market-specific and broker-dealer regulation. According to SIA, the single SRO model could eliminate the conflicts of interest and regulatory inefficiencies associated with multiple SROs, including those that would remain under the hybrid SRO model. However, SIA did not endorse this alternative, primarily because of the risk that self-regulation would become too far removed from the functioning of the markets—a point of view that was similar to NYSE's comments on the hybrid model.

In addition, and in contrast to broker-dealer regulation, SEC officials said that it might not be appropriate or feasible to give a single SRO responsibility for surveilling all the markets because of differences in the way trades are executed in each. That is, Nasdaq, NYSE, and other markets have different rules that reflect their different ways of executing trades. SEC has taken the position that SROs should continue to have ultimate responsibility for enforcing rules unique to the SRO or relating to transactions executed in the SRO's market. Market operators have generally shared this view.

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## SEC Would Assume All Regulatory Responsibility (the SEC-Only Model)

The SEC-only model would address concerns about conflicts of interest and regulatory inefficiencies by eliminating all self-regulation. Under this model, SEC would assume all the regulatory functions currently performed by SROs. Under a variation of this alternative that is not discussed in the SIA report, SEC would assume just NASD's obligation to regulate ECNs and other alternative trading systems. SIA did not endorse the SEC-only model because doing so would eliminate self-regulation of the securities industry, taking with it the expertise that market participants contribute. SIA also expected the SEC-only model to be more expensive and bureaucratic, because implementing it would require additional SEC staff and mechanisms to replace SRO regulatory staff and processes. In addition, according to the report and SEC, a previous SEC attempt at direct regulation was not successful, owing to its high cost and low quality (relative to self-regulation), convincing SEC and other market participants that it was not a feasible regulatory approach.<sup>48</sup>

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## Conclusions

As competition continues to drive the evolution of the securities markets, concerns about the conflicts of interest inherent in the current self-regulatory structure have grown in importance. Such concerns, if not effectively addressed, could undermine the cooperative nature of self-regulation and erode confidence in the fairness of the securities markets. As a result, an ongoing challenge for SEC and the SROs will be to respond effectively to both real and perceived conflicts of interest.

The extent of the regulatory burden generated by differences in SROs' rules and their interpretation and by multiple examinations of broker-dealers is unknown. Obtaining a better understanding of related concerns could help address the dissatisfaction some broker-dealers have expressed with the current self-regulatory structure. For example, differences in rules and their interpretations have been used to justify the need for multiple examinations. As a result, the success of efforts to address concerns about multiple examinations could be related to how concerns about differences in rules are addressed. To improve its understanding of broker-dealers' concerns, SEC could work with NASD, NYSE, and other

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<sup>48</sup> In 1965, SEC became responsible for direct regulation of a small number of broker-dealers that traded only in the over-the-counter market. This program, called the Securities and Exchange Only, or SECO program, was designed to provide participating firms with a regulatory alternative to NASD. In 1983, SEC concluded that the industry would be better served if the program were discontinued, because needed improvements would be costly and not an efficient use of agency resources.

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market participants to identify and address differences in rules that might cause material inefficiencies in the regulatory process. SEC could also work with these market participants and through its ongoing pilot program to better assess whether further improvements in examination coordination could address the most significant problems associated with multiple examinations of broker-dealers. As part of these efforts, SEC could instruct the SROs to provide the agency with formal assessments of broker-dealers' satisfaction with the coordinated examination program, including determining why some broker-dealers choose not to participate and why others terminate their participation, and of market participants' specific concerns about rules. For example, a survey that is representative of broker-dealers and that is administered by a neutral party could be used to determine the nature and extent of concerns about rules and examinations. Such information might also be useful to SEC and the industry in assessing the effectiveness of the current regulatory structure.

Some broker-dealers and market participants believe that the concerns raised by changes in the markets warrant further examination of alternatives for revising the self-regulatory structure. In contrast, SEC has observed that the regulatory landscape is in the process of transformation and that, thus far, the current self-regulatory structure has been working adequately. Without additional SEC and industry support, major changes are not expected.

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## Recommendations

We recommend that the chairman, SEC, work with the SROs and broker-dealer representatives to implement a formal process for systematically identifying and addressing material regulatory inefficiencies caused by differences in rules or rule interpretations among SROs and by multiple examinations of broker-dealers. In doing so, we recommend that SEC explore with the SROs and other market participants various methods for obtaining comprehensive feedback from market participants, such as having the SROs use a neutral party to independently collect and assess market participants' views.

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## SEC, SRO, and Industry Comments and Our Evaluation

We requested comments on a draft of this report from the heads, or their designees, of SEC, NASD, Nasdaq, NYSE, SIA, and three ECNs. We received written comments from SEC, NASD, Nasdaq, and SIA that are summarized below and reprinted in appendixes I through IV. In addition, we received oral comments from the general counsel of one ECN on March 18, 2002; they are also summarized below. Finally, we received technical comments from SEC, NASD, NYSE, SIA, and a second ECN that

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are incorporated into the report as appropriate. The third ECN did not provide comments. The respondents generally agreed with the conclusions and recommendations in the draft report, however, three respondents expressed additional concerns.

SEC officials endorsed our recommendations and indicated that the agency would work closely with NASD and NYSE to implement them. NASD, which also agreed with our recommendations, highlighted its efforts to resolve issues caused by differences in rules or rules interpretations through its rule modernization project. NASD noted that its authority is limited to addressing NASD rules and cited the importance of SEC participation to further efforts to reduce inconsistencies in rules.

Nasdaq commented that the draft report generally provided an accurate characterization both of the debate about conflicts of interest between the primary SROs—NYSE and Nasdaq—and their respective markets and of some of the steps that are being taken to mitigate those conflicts. However, Nasdaq also said that the report largely overlooked a serious challenge to the integrity of the self-regulatory system—that is, the alignment of regional stock exchanges with ECNs for trading Nasdaq stocks. Nasdaq commented that these alignments have copied Nasdaq’s “competing dealer” market structure without also adopting the safeguards necessary to regulate such a market. While this issue may deserve additional attention, our report focused on concerns about potential abuses of regulatory authority by SROs that regulate members against which they compete for order flow rather than on the broader issues of competition among markets or the quality of self-regulation SROs provide. The draft report did note that SEC assesses the quality of all the SROs’ regulatory programs, which includes those of the regional exchanges. It also stated that the concerns addressed were identified through a variety of means, including discussions with Nasdaq officials and other market participants, and that they did not represent all existing concerns.

SIA agreed with the report’s conclusions and recommendations but also expressed concern that SROs often file rule changes with SEC without prior public notice or opportunity for comment. As a result, affected firms learn of proposed rule changes only when the rules are published for comment in the *Federal Register*. SIA expressed a similar concern about rule interpretations or clarifications that inadvertently impose new substantive obligations on members, noting that SROs also issue these changes without any public notice or opportunity for comment. Accordingly, SIA suggested that market participants be engaged at the outset of the regulatory dialogue in order to produce more balanced,

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resource-efficient regulation. We recognize that the need for public comment must be balanced against the need for SROs to expeditiously implement rules that can affect their competitiveness and that SEC and the industry have been attempting to balance these sometimes conflicting demands. To the extent that the timing of the public comment process is a factor causing differences in rules and their interpretations, this issue could be explored as part of SEC's and the industry's efforts to implement our recommendations.

The ECN that provided oral comments on the draft report focused on concerns about conflicts of interest in the self-regulatory structure as SROs increasingly compete with the members they regulate. The ECN commented that the report did not capture the full extent of the "dysfunction" and competitive conflict in the current self-regulatory structure, emphasizing its concern that ECNs had no viable alternative to being regulated by a competitor. The final report includes some additional information the ECNs provided in response to the draft that further illustrates the nature of their concerns.

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## Scope and Methodology

To review how SEC, NASD, and NYSE are addressing concerns about (1) the impact of increased competition, including demutualization, on the ability of SROs to effectively regulate members with which they compete and (2) possible regulatory inefficiencies associated with broker-dealer membership in multiple SROs, we reviewed relevant securities laws and SRO rules, SEC concept releases and studies, SEC and SRO proposed rule changes, an NASDR rule modernization notice, industry and academic studies and research papers, and articles in academic and industry publications. We also reviewed comment letters received on releases and proposals published in the *Federal Register*. In addition, we interviewed officials of two federal agencies (the Commodity Futures Trading Commission and SEC); three SROs (NASD (including Nasdaq and NASDR), the National Futures Association,<sup>49</sup> and NYSE); three ECNs; the Arizona Stock Exchange; two industry associations (SIA and the Investment Company Institute<sup>50</sup>); three investment companies that manage

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<sup>49</sup> The National Futures Association is an SRO that is responsible, under Commodity Futures Trading Commission oversight, for qualifying commodity futures professionals and for regulating the sales practices, business conduct, and financial condition of its member firms.

<sup>50</sup> The Investment Company Institute is a trade group that represents mutual funds.

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mutual funds or pension funds; eight registered broker-dealers (in addition to the three ECNs); and two industry experts. We also identified the concerns that are addressed in the report through these document reviews and interviews. As a result, the concerns identified do not necessarily represent all those that exist. Our review focused on the two largest SROs in the equities markets—NASD and NYSE—because concerns related to the dual role of SROs as market operators and regulators applied primarily to these SROs. They were also the SROs that were the subject of concerns about the efficiency of SRO rules and examinations affecting members that belong to multiple SROs. Our review focused primarily on the securities markets because the issues that have arisen in these markets have not yet surfaced to the same extent in other markets.

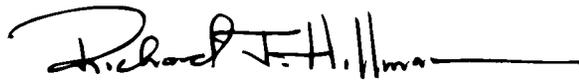
To describe alternative approaches that some securities market participants have discussed as a means of addressing concerns about the current self-regulatory structure, we reviewed industry and academic studies and research papers, articles in academic or industry publications, and congressional hearing records. We discussed the alternatives identified with the officials cited above.

We did our work in Chicago, IL; New York, NY; and Washington, D.C., between October 2000 and March 2002 in accordance with generally accepted government auditing standards.

We will send copies of this report to other interested congressional committees. We will also send copies to the chairman of SEC, chairmen and chief executive officers of NASD and Nasdaq, president of NASDR, chairman and chief executive officer of NYSE, chairman and president of SIA, and the three ECNs. Copies will be made available to others upon request.

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For any questions regarding this report please, contact me at (202) 512-8678, hillmanr@gao.gov, or Cecile Trop, Assistant Director, at (312) 220-7705, tropc@gao.gov. Key contributors include Roger Kolar, Melvin Thomas, Sindy Udell, and Emily Chalmers.

A handwritten signature in black ink that reads "Richard J. Hillman" followed by a horizontal line.

Richard J. Hillman  
Director, Financial Markets  
and Community Investment

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List of Congressional Committees

The Honorable Paul S. Sarbanes  
Chairman

The Honorable Phil Gramm  
Ranking Minority Member  
Committee on Banking, Housing and Urban Affairs  
United States Senate

The Honorable Michael G. Oxley  
Chairman

The Honorable John J. LaFalce  
Ranking Minority Member  
Committee on Financial Services  
House of Representatives

The Honorable W. J. "Billy" Tauzin  
Chairman

The Honorable John D. Dingell  
Ranking Minority Member  
Committee on Energy and Commerce  
House of Representatives

# Appendix I: Comments from the Securities and Exchange Commission



UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

April 2, 2002

Richard J. Hillman  
Director, Financial Markets  
and Community Investment  
United States General Accounting Office  
441 G Street, N.W.  
Washington, DC 20548

Dear Mr. Hillman:

We appreciate the opportunity to comment on the General Accounting Office's ("GAO") draft report entitled Securities Markets: Competition and Multiple Regulators Heighten Concerns About Self-Regulation, GAO-02-362.

We commend the GAO for its considerable efforts in investigating market participants' concerns regarding the impact of increased competition on the ability of self-regulatory organizations ("SROs") to effectively regulate members with which they compete, and the potential for regulatory inefficiencies associated with broker-dealer memberships in multiple SROs. With respect to the latter area, the Report highlights the concerns of some broker-dealers with multiple SRO memberships that differences in SRO rules and their interpretations result in operational inefficiencies and that examinations by multiple SROs are unnecessarily burdensome. The Report generally recommends that the Commission work with the SROs and other market participants to identify and address any material regulatory inefficiencies and unnecessary burdens.

#### Inefficiencies Associated with Differing Rules and Interpretations Among SROs

As the report recognizes, the Commission staff has worked on several fronts over the past few years to harmonize SRO rules that address similar behavior. In reviewing SRO rule proposals, for example, the Commission staff evaluates any significant differences or inconsistencies between the specific proposal and other existing or proposed SRO rules. In particular, the Division staff generally asks the particular SRO to justify any differences between its proposal and the rules of another SRO or the Commission. The rule review process, including the public comment process, has been relatively effective in addressing broker-dealers' concerns about inconsistent or conflicting regulations. Nevertheless, the process can only work to address market participants' concerns raised at the time a rule proposal is filed. The burdens associated with different SRO rules may not become apparent until long after the rules have been implemented.

Accordingly, we agree with the GAO that it would be helpful for the SROs to gather information on a more formal basis about potential regulatory inefficiencies created by

differing SRO rules. To implement the GAO's recommendation, we intend to write to the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers ("NASD") to ask them to conduct a representative survey of their members to elicit their members' specific concerns, and to provide the Commission with the results. We understand that the NASD is already conducting a comprehensive review of its rules, including hiring an outside consultant to assist it in evaluating the results of its survey.

Certain Broker-Dealers' Concerns About Multiple Examinations

As noted by the GAO, the Commission staff and the relevant SROs have improved the coordination of regulatory examinations over the past several years. The Commission staff closely monitors and assesses examination coordination by the SROs. In fact, the Commission staff and SRO officials meet regularly to address, among other things, examination coordination. In addition, Commission and SRO officials and state securities regulators attend annual summits to discuss exam coordination, to review exam results from the prior year, and to develop plans for coordinated exams for the coming year. Furthermore, the Commission staff has conducted a number of new coordination efforts in an effort to make examinations more effective and efficient. While the Commission staff informally seeks feedback from individual broker-dealers and from industry trade groups regarding coordination, we will ask the NYSE and NASD to consider conducting a survey of their members to aid in assessing broker-dealer satisfaction with the coordinated examination program.

Conclusions

While we continually strive to eliminate regulatory inefficiencies, there may be occasions when different rules or examinations by different expert regulators may be desirable. Markets, for instance, may wish to have different rules to reflect their differing market structures, and certain SROs may wish to have higher standards than others. Nevertheless, we agree with the GAO that it would be helpful to implement a more formal process to identify unnecessary regulatory inefficiencies, and so we intend to work closely with the NASD and the NYSE to implement your recommendation. These efforts should dovetail with the efforts of Commissioner Glassman, who -- at Chairman Pitt's request -- is spearheading a review of the Commission's rules in an effort to modernize them.

Thank you for the opportunity to comment, and for the courtesy shown to the staff during the course of your study.

Sincerely,



Annette L. Nazareth  
Director  
Division of Market Regulation



Lori Richards  
Director  
Office of Compliance Inspections and  
Examinations

# Appendix II: Comments from the National Association of Securities Dealers



**Robert R. Glauber**  
Chairman & Chief Executive Officer

April 1, 2002

Mr. Richard J. Hillman  
Director, Financial Markets and Community Investment  
General Accounting Office  
Washington, D.C. 20548

Dear Mr. Hillman:

This letter provides our comments on GAO's draft report *Securities Markets: Competition and Multiple Regulators Heighten Concerns About Self-Regulation* (GAO -02-362). Thank you for the opportunity to offer these comments.

Your report covers an important issue for the regulation of the securities markets: whether conflicts of interests faced by self-regulators that operate markets can harm self-regulation. We agree with the significance the report places on this issue. While the concept of an SRO necessarily involves some potential conflicts, NASD has taken great pains to minimize conflicts between regulation and market operation. During the period covered by this report, the NASD owned Nasdaq. To deal with possible conflicts caused by an ownership structure that has a market and its self-regulator under one roof, we formed NASD Regulation in 1996 as a separate subsidiary with its own board of directors. In the last year we have completed the further step of divesting ownership of Nasdaq, subject to SEC action to register Nasdaq as a separate exchange. Although we, like other self-regulators, employ strict internal controls to minimize the problem of potential conflicts, we alone among US self-regulators have taken the extraordinary steps of first, organizationally separating regulation and market operation and subsequently, divesting ownership of the market.

The NASD's commitment to strong, effective regulation of the industry is shown not only by our unique structure and our internal controls, but also by the significant resources we deploy toward that end. For example, in 2001, NASDR spent about \$400 million, about a quarter of which was for regulation of Nasdaq. In addition, Nasdaq spent about \$15 million on its own internal regulatory operations, such as listing qualification. We believe that this resource commitment is unmatched in the industry.

In addition to our unique structure and massive resource commitment, we also are leaders in using technology to improve regulation of the industry, and are hard at work on using it to improve further both field examinations and market surveillance. For example, our INSITE (Integrated National Surveillance and Information Technology Enhancements) Surveillance

National Association of Securities Dealers, Inc. 1735 K Street NW, Washington, DC 20006-1500 202 728 8000

April 1, 2002  
Page 2

system will provide the most advanced risk-based field examination capability of any securities regulator or self-regulator. It uses sophisticated statistical analysis and data mining techniques to spot risk in member firms, tracking member activity from internal NASDR databases and from clearing firm data to find unusual activity patterns. INSITE detects changes in the sales practice, trading, underwriting and financial responsibility areas of member firm operations, and sets red flags for early regulatory intervention, outside of the traditional, calendar driven cycle. Our district staffs are now piloting INSITE, and by mid-year, it will be fully implemented in each District Office.

We are also enhancing our market surveillance systems, particularly ADS and SONAR, already some of the most sophisticated in the industry. ADS (Advanced Detection System) is a parameter break detection and discovery tool used to find suspicious activity using pattern recognition across the trades and quotations in the Nasdaq database. It integrates data mining, pattern matching, and visualization techniques into one large-scale application that is now used for problem detection in trade reporting, market integrity, best execution, and front running. SONAR (Securities Observation, News Analysis, and Regulation) monitors the markets exhaustively and accurately for indications of insider trading and fraud and pulls together all the information needed for the analyst to deal with the problems he or she finds. It includes a text-mining tool for use on financial press and EDGAR filings, allows fast, easy change of financial models, and deploys an expert system to spot problems. I would like to reiterate Mary Schapiro's invitation to you and your staff to see a demonstration of these important regulatory advances.

The draft GAO report (at page 27) makes the following recommendations:

We recommend that the Chairman, SEC, work with the SROs and broker-dealer representatives to implement a formal process for systematically identifying and addressing material regulatory inefficiencies caused by differences in rules or rule interpretations among SROs and by multiple examinations of broker-dealers. In doing so, we recommend that SEC explore various methods for obtaining comprehensive feedback from market participants, including use of a neutral party to independently collect and assess views on the effectiveness of SEC and SRO regulations.

We agree with the recommendation and point out (as noted in the report) that we have been working through our Rule Modernization Project to resolve issues caused by differences in rules or rule interpretations, but we can only address our own rules. We believe that the participation of the SEC would further the effort to reduce inconsistencies. In addition, we endorse the idea of seeking comprehensive feedback from market participants, which is also a goal of our Rule Modernization Project.

Attachment omitted.

April 1, 2002  
Page 3

Our detailed comments on your draft are contained in the attached document, which makes specific recommendations on the report's language we believe should be changed.

Thank you again for the opportunity to comment on your draft. If you have any questions, please do not hesitate to contact me or Mary Schapiro.

Sincerely,



# Appendix III: Comments from Nasdaq



Richard G. Ketchum  
President

March 27, 2002

Mr. Richard J. Hillman  
Director  
Financial Markets and Community Investment  
U.S. General Accounting Office  
Washington, DC 20548

Re: March 12, 2002 Draft Report on Securities Markets "Competition and Multiple Regulators Heighten Concerns and Self-Regulation"

Dear Mr. Hillman:

I appreciate the opportunity to share with you the views of the Nasdaq Stock Market, Inc. ("Nasdaq") regarding the captioned Draft Report. We believe that the Draft Report generally provides an accurate characterization of the debate with respect to potential conflicts of interest between the primary self-regulatory organizations ("SROs") and their respective affiliated markets and some of the steps being taken to mitigate those potential conflicts. We believe that by focusing primarily on Nasdaq and the New York Stock Exchange, however, the Draft Report largely overlooks one of the more serious challenges to the integrity of the self-regulatory system—the participation in that system by regional exchanges that have aligned themselves with electronic communications networks ("ECNs"). These regional markets have copied the Nasdaq competing dealer market structure without also adopting the regulatory safeguards necessary to regulate properly such a market.<sup>1</sup> We believe that these "exchange light" market models could lead to a regulatory race to the bottom whereby broker-dealers, in an effort to cut costs, move to thinly regulated markets to avoid the cost of regulation. Ultimately, such a move, which is becoming more likely in the increasingly competitive market for trading Nasdaq securities, could undermine investor confidence in the markets. In this respect, and as discussed further below, we respectfully disagree with the premise of your statement on page 27 of the Draft Report that the GAO focused on the NASD and NYSE "because concerns related to the dual role of SROs as market operators and regulators applied primarily to these SROs." It is our hope that in response to this letter you will

<sup>1</sup> The Draft Report at page 24 mentions without elaboration the NASD's concern that competition among regulators could lead to a race to the lowest regulatory standards and undermine investor confidence in the securities markets.

The Nasdaq Stock Market, Inc., an NASD Company  
1735 K Street, NW, Washington, DC 20006 202 728 8020 | Fax 202 728 8075 | richard.ketchum@nasd.com

examine the potential detrimental impact on the self-regulatory system of recent alignments between regional registered national securities exchanges and ECNs.

**Threat of Exchange Light Regulation to Self-Regulatory System**

*The CSE Model*

One SRO regulatory model warranting further GAO attention because of its potential detrimental impact on the self-regulatory system involves that of the Cincinnati Stock Exchange ("CSE"), which is expanding its program to trade Nasdaq securities. Nasdaq contends that the CSE has attempted to copy the Nasdaq competing dealer regulatory structure to attempt to attract ECNs and market makers while lacking the resources and many of the important investor protections that are necessary for adequately regulating such a market.<sup>2</sup>

Based on public financial information that the CSE provides to the SEC, it is evident that the CSE's total expenditures are less than 1/10<sup>th</sup> of those that Nasdaq spends on regulation alone in a given year. Presumably not all of the CSE's budget goes to fund its regulatory program. The CSE itself has claimed that its regulatory function is as robust as and in some instances more robust than that of the Nasdaq Stock Market, and yet the financial realities make the accuracy of those statements highly suspect.<sup>3</sup> The GAO may wish to determine how much the CSE actually spends on regulation in a given year to determine the relative proportion of the exchange's resources that are committed to regulation.

But funding is not the only element necessary for a robust regulatory program. One of the more important aspects of a regulatory program is the existence of an order audit trail. It is common knowledge in the industry that order information with respect to Nasdaq securities must be reported to the NASD's OATS system. The OATS rules and technical specifications have been vetted by the SEC and by the industry through the public notice and comment process. OATS information, supplemented by trade reporting information, is analyzed by a highly trained NASDR regulatory staff to surveil for violations of Nasdaq and SEC rules.

The CSE has claimed that its own audit trail method, which it refers to as Firm Order Submission ("FOS"), is superior to OATS. Yet, we do not believe that an adequate independent assessment has been made to determine whether FOS is sufficient for the proper surveillance of the CSE as it enters the market for Nasdaq securities. If FOS is insufficient, we believe there is some doubt as to whether the CSE's regulatory program is sufficient for surveilling that market. If the CSE's order audit trail and its regulatory program as a whole are insufficient, we believe that investors could be

<sup>2</sup> For a broader discussion of Nasdaq's views with respect to the CSE regulatory model see letters to Jonathan Katz, Secretary, SEC, from Richard Ketchum, President, Nasdaq (January 9, 2002) and from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq (March 6, 2002).

<sup>3</sup> See letter to Jonathan Katz, Secretary, SEC, from Jeffrey T. Brown, Vice President Regulation and General Counsel, CSE (January 24, 2002).

exposed to trading abuses by market professionals, which ultimately could undermine investors' confidence in the entire self-regulatory system. Therefore, we respectfully request that the GAO work with the SEC in assessing whether the CSE's resources, rules and systems are adequate for properly regulating the CSE. In its examination, the GAO may wish to ask the CSE the following questions:

- Does the CSE have the necessary rules in place to ensure that customer orders are protected from overreaching by professional traders? How will the CSE's recent proposal to remove a number of important customer protection rules with respect to Nasdaq securities (SR-CSE-01-04) impact those safeguards?
- Does the CSE have the necessary systems in place to surveil adequately for trading abuses by an expanded member base?
- What is the underlying purpose of FOS? (*i.e.*, was it developed and is it used for the purpose of reconstructing markets to surveil for trading abuses or does it primarily serve other, non-regulatory functions?)
- Does FOS allow for the prompt and efficient reconstruction of markets or does it require a substantial degree of manual processing?
- Is FOS mandatory? If so and a CSE member fails to comply, what CSE rules is it violating?
- If FOS is a voluntary system, has the CSE put in place alternative safeguards to ensure that any information lost regarding orders that members choose not to put into the system is captured through other automated means?
- Are any modifications to FOS necessary to adapt it to trading in Nasdaq securities?
- What data elements does FOS capture? In particular, does FOS include all trades between the dealer and its customers? Does it track orders originated by or received by a dealer even if those orders are not sent to the CSE's limit order book? If FOS does not in itself capture all necessary data elements to reconstruct trading activity, does the CSE use data gathered from other systems (*e.g.*, trade reporting and trade comparison information) to supplement the FOS audit trail?
- Does the CSE have the necessary regulatory staff in place to analyze the data from FOS and any other supplemental data?
- Have the FOS rules and technical specifications been sufficiently vetted and, if necessary, approved by the SEC staff?

We believe that unsatisfactory or incomplete answers to the above questions, in the absence of sufficient remedies by the CSE, could lead to regulatory problems that could damage investors' confidence in the self-regulatory system.

*The PCX/ARCA Model*

Another regulatory model worth examining is the PCX/ARCA model. In October of 2001, the SEC approved a proposal by the Pacific Exchange ("PCX") to establish an affiliate of the Archipelago ECN as a facility of the PCX.<sup>4</sup> To our knowledge, the approval of the PCX/ARCA arrangement marks the first time the SEC has permitted a market to operate as a registered securities exchange without important components of the market being owned or controlled by a regulated entity. Rather the regulation of the new Archipelago Exchange ("ArcaEx") is based principally on a complex series of contractual arrangements. Should there ever be a regulatory problem involving one or more of the affiliates of ARCA, Nasdaq contends that the real-time regulation of the ArcaEx could be compromised and the SEC's oversight of that market could be held at bay while the SEC staff and the courts attempt to untangle the myriad of commercial agreements upon which that regulation is based.

One prime area for future dispute concerns the line dividing ArcaEx's quasi-regulatory role in regulating the day-to-day operation of the ArcaEx market and PCX's role as the SRO of that market. We believe this issue can only be resolved by a definitive statement by the SEC, the PCX or by a court explaining which ArcaEx business activities are and which are not "inconsistent with the regulatory and oversight functions of the PCX and PCXE", the phrase used by PCX/ARCA to define ARCA's regulatory reach. In the order approving the ARCA/PCX arrangement, the SEC attempted to clarify the meaning of this phrase by stating: "This means that Archipelago Exchange LLC will not interfere with the PCX's self-regulatory responsibilities." This explanation is merely tautological, however, and does nothing to describe what PCX's self-regulatory responsibilities are with respect to the regulation of ArcaEx.

We believe that the legal/regulatory battle that could result from the ambiguity of PCX's regulatory duties vis-à-vis ArcaEx, even though the arrangement is unique to PCX/ARCA, could injure investor confidence in the self-regulatory model. PCX/ARCA's planned merger with Redi ECN will only further complicate the regulatory picture of the ARCA conglomerate. Although we are hopeful that PCX will file with the SEC a rule proposal for effecting such a substantial merger, we are not aware that any has been filed to date. We believe that the absence of SEC-approved rules that discuss the regulatory treatment of Redi as a PCX affiliate will add further uncertainty to the self-regulatory system.

<sup>4</sup> Exchange Act Release No. 44983, October 25, 2001 (order approving File No. SR-PCX-00-25) (PCX/ARCA Order). Many of the concerns raised below were also discussed in Nasdaq's comments to the SEC on the proposed merger between PCX and ARCA. See letters to Jonathan Katz, Secretary, SEC, from Richard Ketchum, President, Nasdaq (June 4, 2001, and January 22, 2001).

Therefore, we respectfully request that the GAO examine the regulatory structure of PCX/ARCA, including its pending merger with Redi, to determine whether adequate safeguards have been put in place to offer regulatory certainty with respect to that market.

In examining the PCX/ARCA/Redi regulatory model the GAO may wish to review the regulatory structure in place for ArcaEx's affiliated broker-dealer, WAVE. WAVE, for those PCX members that choose to use it, will serve as the sole means for routing orders off of ArcaEx. PCX members that choose not to use WAVE will be prohibited from using certain ArcaEx order types that are available to WAVE users. At the same time, WAVE will also serve as an introducing broker to offer users direct access to ArcaEx. Finally, the same WAVE will operate an ECN for securities not eligible to be traded on ArcaEx. The SEC was so concerned about the potential for a conflict of interest between the ARCA conglomerate and WAVE, that the SEC determined that certain functions of WAVE made it a facility of the PCX and, therefore, subject to regulation as an exchange. With respect to other functions that the same affiliate performed, however, the SEC applied the much more lenient broker-dealer regulatory structure. We believe that this bifurcated regulatory structure based on functions combined with the contractual nature of ArcaEx's regulation raise a number of troubling regulatory issues. We believe that these issues should be thoroughly examined by the GAO to determine what impact they may have on the self-regulatory structure.

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We would like to thank you again for allowing us to provide you with our thoughts on these complex and important issues. If we can be of further assistance, please do not hesitate to call.

Respectfully,



Richard Ketchum

# Appendix IV: Comments from the Securities Industry Association



**Securities Industry Association**

120 Broadway • New York, NY 10271-0080 • (212) 608-1500 • Fax (212) 608-1604

April 3, 2002

Mr. Richard Hillman  
Director, Financial Markets and Community Investment  
U.S. General Accounting Office  
441 G Street, N.W.  
Washington D.C. 20548

Dear Mr. Hillman:

The Securities Industry Association<sup>1</sup> ("SIA") appreciates the opportunity to comment on the draft report of the United States General Accounting Office ("GAO") entitled *Securities Markets: Competition and Multiple Regulators Heighten Concerns about Self-Regulation* ("GAO Report" or "Report").

SIA commends the GAO for undertaking this important and timely review of the existing regulatory structure. As noted in the Report, industry participants are facing a high degree of unnecessary duplication, inconsistency and inefficiencies associated with the current multiple self-regulatory organization ("SRO") structure.

Although each SRO clearly has its own regulatory responsibility and agenda, duplicative and conflicting regulation across SROs is both inefficient and costly. Such rules yield little benefit while depleting valuable administrative and economic resources from all segments of the securities industry. Specifically, broker-dealers that are members of more than one SRO are often subject to multiple and inconsistent rules on the same subject, as well as each SRO's varying interpretation of what constitutes a rule violation and what the appropriate sanction (if any) is for a violation. Customers likewise may be confused as they "shop" for the brokerage that supplies services according to the rules and interpretations of a given SRO. By reducing existing redundancy and discrepancies, the totality of self-regulatory costs for broker-dealers, including the cost of

<sup>1</sup> The Securities Industry Association brings together the shared interests of nearly 700 securities firms to accomplish common goals. SIA member firms (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. The U.S. securities industry manages the accounts of nearly 80 million investors directly and indirectly through corporate, thrift, and pension plans, and generates \$358 billion of revenue. Securities firms employ approximately 760,000 individuals in the United States. (More information about SIA is available on its home page: <http://www.sia.com>.)

compliance and supervision will be reduced significantly, thereby allowing member firms to utilize resources more efficiently and effectively to benefit investors. Similarly, there will be corresponding cost savings to the SROs since each expends valuable staffing and operating resources to monitor and examine broker-dealer activity on identical or similar subjects. Indeed, SROs as a group expend unnecessary resources internally to consider and prepare rule filings which duplicate filings of other SROs.

Notwithstanding the SEC and some SROs' attempts to identify and address some of these issues, inconsistent and redundant rulemaking still persists. Indeed, as acknowledged in the GAO Report, no formal regulatory process exists for assuring consistency among rules. Nor is it enough to point to the existing rule review and public comment process as the solution to these difficulties. The fact is SROs often file rule changes with the SEC without affording interested parties any prior public notice or opportunity for comment. Consequently, affected firms first learn of a proposed change upon its publication in the *Federal Register* well into the regulatory dialogue. This absence of industry vetting is particularly troublesome in the case of SRO "clarification" or "informational" releases through which SROs may inadvertently impose new substantive obligations upon members without providing for any public notice or comment prior to implementation.

SIA, therefore, supports the GAO's recommendation that the SEC work with the SROs and broker-dealer community to implement a formal process for systemically identifying and harmonizing material regulatory inefficiencies caused by differences in rules or rule implementations among SROs. We would further suggest engaging market participants at the outset of the regulatory dialogue, which we believe will produce more balanced, resource-efficient regulation that ultimately benefits investors, regulators and broker-dealers alike.

As with the duplicative rulemaking by multiple SROs, the redundancy problem also reveals itself in the broker-dealer examination context. As noted by the GAO, multi-member firms are subject to multiple, overlapping SRO examinations, which are costly and extremely time consuming. Although the SEC and SROs have attempted to minimize some of the inefficiencies of multiple examinations by establishing joint examination programs, sufficient duplications remain since the practical coordination of the SROs on examinations has not yet been achieved. For example, in a joint examination, the respective teams of examiners may agree on the format, but remain subject to the different agendas and directions of their respective SROs. There often is neither a clear division of responsibilities nor a willingness on the part of the examiners to accept the findings of another SRO examiner. Consequently the objectives of the joint examination process are not often realized. SIA, therefore, also would support any efforts to better coordinate the examination process in order to alleviate the burdens associated with multi-regulator examinations of broker dealers.

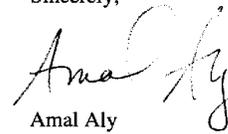
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**Appendix IV: Comments from the Securities  
Industry Association**

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Again, we thank you for the opportunity to respond to the GAO draft report and to work with your staff on this matter. If you have any questions or require further information, please feel free to contact me at (212) 618-0568.

Sincerely,



Amal Aly  
Vice President &  
Associate General Counsel, SIA

cc: Cecile Trop, Assistant Director, Financial Markets & Community Investment, GAO

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