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Draft: Not for Circulation

India: Role of Self-Regulatory Organizations in Securities Market Regulation

June 2007

Finance and Private Sector Development Unit
India Country Management Unit
South Asia Region

THE WORLD BANK

Acknowledgements

This note was prepared by a team consisting of Varsha Marathe, Financial Specialist, (SASPF), Clemente Del Valle, Lead Financial Specialist, (CCGM), and John Carson (Consultant, Compliax Consulting Inc.). The note drew extensively from a background paper on international trends in self-regulation prepared by John Carson. The note also greatly benefited from a paper prepared by the National Securities Dealers Association Inc. on experience of the NASD in self-regulation in the US securities market which is appended at Annex 2.

The peer reviewers are JaeHoon Yoo, Senior Financial Specialist, (CCGM); Alexander Berg, Head, Corporate Governance Policy Practice, (CCGPP), both from the World Bank and Robert Strahota, ex- USA Securities and Exchange Commission. The report was prepared under the overall guidance of Sadiq Ahmed (Director, SASPF), Simon Bell (Manager, SASPF). The team also received useful comments and suggestions from Priya Basu (Lead Economist, SASPF). The team would like to acknowledge the inputs and encouragement of the Capital Markets Division, Ministry of Finance, Securities and Exchange Board of India, National Stock Exchange, Bombay Stock Exchange and several other stakeholders in the Indian securities markets for various discussions and information sharing in preparing this note.

Abbreviations

AMF	Financial Market Authority, France
AMV	Autorregulador del Mercado de Valores de Colombia
ANMI	Association of National Stock Exchange Members of India
ASX	Australian Stock Exchange
ATS	Alternate Trading System
BSE	Bombay Stock Exchange
CSD	Central Securities Depositories
CME	Chicago Mercantile Exchange
EU	European Union
ETFs	Exchange Traded Funds
FSA	Financial Services Authority
HPEC	High Powered Expert Committee on 'Making Mumbai an International Financial Centre'
HKEx	Hong Kong Stock Exchange
ICSA	International Council of Securities Associations
IDA	Investment Dealers Association, Canada
IOSCO	International Organization of Securities Commissions
JSDA	Japan Securities Dealers Association
KYC	Know-Your-Client
LSE	London Stock Exchange
MiFID	Markets in Financial Instruments Directive
MFDA	Mutual Fund Dealers Association of Canada
MOU	Memorandum of Understanding
NASD	National Association of Securities Dealers Inc.
NFA	National Futures Association
NYSE	New York Stock Exchange
NSE	National Stock Exchange
NSDL	National Securities Depository Limited
OSE	Osaka Stock Exchange
OTC	Over the Counter
PBR	Principle-based Regulation
RR	Registered Representatives
RIEs	Regulated Investment Exchanges
SRO	Self Regulatory Organization
SEC	Securities Exchange Commission
SIFMA	Securities Industry and Financial Markets Association
TSE	Tokyo Stock Exchange
WFE	World Federation of Exchanges

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Executive Summary

The benefits and risks of self-regulation in effective and efficient regulation of a complex, dynamic and ever-changing financial services industry has attracted a great deal of attention in the last few years. Self-regulation typically involves a unique combination of private interests with government oversight, and provides a mechanism for the expertise and practices of the industry to be reflected in regulatory policy. On the other hand, many concerns about self-regulation focus on the undue influence of the industry on regulatory policy and the conflicts of interest that could arise between their regulatory responsibilities and business operations.

The debate on self-regulation is centered on questions such as: Are these existing self-regulatory arrangements sufficient? Should government change its oversight of self-regulatory institutions? Or should government assume a greater and more direct role in regulating? And where self-regulation is considered appropriate, how should self-regulation be structured to maximize its advantages and minimize its disadvantages?

The optimum role of self-regulation in any country depends on factors such as the level of sophistication of the securities industry, maturity of the regulatory systems, the level of resources available to the regulator, and the legal framework. India can draw lessons from international experience based on these and other factors.

A number of important general factors should be considered in deciding the preferred approach to self-regulation in Indian capital markets. These include 1) public policy objectives, 2) local factors in India's markets, 3) transitional issues, and 4) regulatory structure issues.

Significant public policy issues include identifying the drivers for change in the current regulatory system, the main regulatory priorities and key risks in the markets. Factors that are specific to the Indian capital markets include the size and complexity of the markets, the adequacy of current regulatory resources, and issues with the legal framework. The most critical transitional issue is the risk involved in making changes to the system, especially the risk that standards of regulation could fall.

The most important structural issue is the ownership and governance of the SROs. In particular, any structure involves conflicts of interest that must be managed appropriately. For instance, in a properly designed independent SRO, ownership would not carry any rights except the right to vote for a certain number of directors. Since the board of directors makes all the major policy decisions, the composition of the board is the biggest issue. Once the structure is established, it is vital for the SRO to have sufficient skills, resources and capacity to perform its responsibilities effectively.

The Note identifies four main theoretical options for securities markets self-regulation in India, based on precedents from international markets. There is no single "right" approach – the note outlines three options that employ SROs, which could be viable solutions for Indian capital markets (See Table 1 below for a summary of the three options). These are:

1. **Restructure the existing Exchange SRO system** to create a joint SRO subsidiary of NSE & BSE. The new entity would be responsible for both market

and member regulation. The Exchanges provide an existing platform for SRO functions that works reasonably well. This platform includes a governance structure, professional management, experienced staff, documented programs and procedures, and IT tools. But this option raises all of the issues on conflicts of interest at Exchange SROs.

2. **Hybrid structure:** NSE and BSE retain responsibility for market regulation, and create a new independent SRO for member regulation. This option is very similar to ANMI's proposal to create a member-based SRO (but the SRO should not be based on a trade association because of the significant conflicts of interest). It is based on the idea that supervising members is best done by a central regulator, but that regulating its own market is essential to an Exchange's market quality and brand.

3. **New central independent SRO** for both market and member regulation. A single independent SRO is theoretically the cleanest and efficient solution. But it is difficult to develop and in fact is only now in the process of being implemented in the USA[1] and Canada.

Table 1: Summary of Three Main Options for India

Issues	**1. *Restructured Exchange SRO* (joint subsidiary of NSE & BSE)**	**2. *Exchange SROs for market regulation*; Independent SRO for member regulation**	**3. *Central independent SRO* for market and member regulation**
Who has proposed the model in India?	Bank Policy Note -- based on international Exchange SRO model	Similar to ANMI proposal except not based on trade association	Similar to SEBI's earlier suggestion except limited to current SRO responsibilities
International examples[2]	ASX (Australia) CME (U.S.) TSE (Japan)	New NASD – NYSE agreement in U.S.	Proposed merger of SROs in Canada.
1. Ownership	NSE & BSE jointly	- NSE & BSE separately for MARKET - Member intermediaries for MEMBER	Member intermediaries (notional ownership carries only right to vote for some directors)
2. Governance - Board	- Majority independent directors (7) - member (2), NSE (2) and BSE (2) directors - CEO	- NSE and BSE for MARKET, similar to #1 - Same as # 3. for MEMBER	- Majority independent directors (7) - member directors elected by members (6) - CEO
3. Responsib-ilities	Exchanges' current market and member regulation programs (excludes Listing)	- NSE and BSE – market conduct and surveillance - New independent SRO for member conduct and supervision	- Market conduct and surveillance of Exchange trading - Member conduct and supervision
4. Main Benefits	- Exchanges provide strong existing platform for SRO	- Exchanges have incentives to perform market	- Theoretically the most efficient model

[1] The recently announced NASD-NYSE SRO combination in the US is a consolidation of member regulation functions. The new SRO will perform market regulation for Nasdaq by contract, as the NASD does now, but the NYSE will retain market regulation functions, such as market surveillance.
[2] See Annex 1

Issues	**1. *Restructured Exchange SRO* (joint subsidiary of NSE & BSE)**	**2. *Exchange SROs for market regulation*; Independent SRO for member regulation**	**3. *Central independent SRO* for market and member regulation**
	- minimizes risks of structural change	regulation - Less challenging to create than "super SRO"	- Best addresses conflicts of interest at Exchanges
5. Key Risks	- Exchanges cannot agree to create joint subsidiary - Conflicts – SRO costs or issues still conflict with Exchanges' business interests	- MARKET: Conflicts – SRO costs or issues conflict with Exchanges' business interests - Same as # 3 for MEMBER, except transition risk is lower	- Transition risk –problems in creating new agency lead to gaps or lower standards - Conflicts -- excessive member influence in SRO - Potential for excessive SEBI influence
6. Conflicts of Interest	Exchange business vs. regulation conflict mitigated by creating joint SRO subsidiary with a separate, majority independent board.	- Same as # 1 for MARKET - Same as # 3 for MEMBER	Broker self-regulation conflict mitigated by majority independent board.
7. Funding	Exchanges and regulation fees for members	- NSE and BSE for MARKET - Regulation fees for MEMBER	Regulation fees for members, and perhaps contribution by Exchanges

The fourth theorectical model is the "Government model", where regulation functions are centralized in the statutory regulator, as in the UK. Under this approach, most SRO functions would be transferred from the Exchanges to SEBI. SEBI has a broader regulatory mandate and wider powers than a SRO, and thus could be more effective. However, the model does not appear to make sense in India because the markets are large (and growing rapidly), complex and diverse. SEBI probably could not effectively assume all regulatory responsibilities directly, due to constraints on its resources and capacity.

A phased approach to change would mitigate the risks involved in making major changes in the self-regulatory system. The Note describes two transitional approaches to developing a new, central SRO (if the authorities decide to create one). These approaches involve moving in phases from the current SRO system based on NSE and BSE to one of the 3 alternatives above.

Scope of SRO Regulation: It may be too ambitious to develop an all-encompassing solution to self-regulation of all sectors of the capital markets in one step. Creating a new "super SRO" to assume responsibility for regulating a range of investment industry sectors from mutual funds to merchant banks to investment advisors could lead to conflicts over priorities and detract from sector specialization. Therefore, the scope recommended in this report is to limit the formal SRO scheme to the securities markets in a first phase and later on consider the possibility of expanding it. As an alternative, the industry associations in the other sectors could be encouraged to take a stronger role in developing standards for their members, without becoming full-fledged SROs.

INTERNATIONAL TRENDS IN SELF-REGULATION

Self-regulation in securities markets takes a wide variety of forms around the world. There is no single definition of self-regulation or self-regulatory organization (SRO) that is universally agreed, and many jurisdictions do not formally define a self-regulatory organization in law. SROs may be generally defined as private institutions that establish, monitor compliance with, and enforce rules for securities markets and the conduct of market participants. SROs' powers are generally delegated by law or by regulation, and SROs' activities are supervised by government regulators.

International Trends in Reliance on Self-Regulation SROs were traditionally owned and governed by members, users or participants. The nature of self-regulation has evolved considerably since its inception in the early stages securities Exchanges' development. In the last decade the demutualization of Exchanges and increased competition among securities marketplaces has had a significant impact on self-regulation because the great majority of SROs are still securities Exchanges. The evolution has considerably changed the governance, scope, operation and nature of self-regulation.

In many parts of the world the value of self-regulation has increasingly been questioned, and the authorities have reduced reliance on the traditional Exchange model self-regulation. On one hand, in countries that continue to rely on SROs extensively, self-regulation is stronger, better resourced and more thorough than it has ever been. On the other hand, globally the role and power of SROs is more limited today in securities regulation. The core issue facing self-regulation is whether the trend towards reduced reliance on SROs in global securities markets will continue, leading to a narrow ambit for self-regulation, or whether self-regulation will continue to play an important role in regulating securities firms and markets in many jurisdictions.

However, there is a clear international trend to vesting greater authority in public regulatory bodies. With globalization of the markets, financial scandals, and growing emphasis on international standards, regulators and organizations like IOSCO have been putting greater attention to the need for strengthening the capacity and the independence of the statutory regulator. Further, the metamorphosis in the global Exchange industry has led also to the transfer of regulatory powers and responsibilities from Exchanges to statutory authorities in many countries. But some Exchanges have also transferred or contracted regulatory activities to independent SROs. The increasing importance of independent SROs in a few countries may generate new interest in SRO systems, particularly in countries that are revising their current regulatory structure. Both regulators and Exchanges continue to reconsider the self-regulatory roles of Exchanges in light of their focus on business and market development.

Self-regulation is also being diminished because a number of countries have adopted the UK model of a universal, statutory financial regulator, or similar forms of consolidated regulation. In some cases, due to market scandals in several jurisdictions**,** the need to strengthen securities markets regulation as pressure to increase standards of conduct rises is a related factor which has led to expanded authority for public regulators. They have much broader jurisdiction and powers than SROs, and are seen as stronger, more effective regulators. Public regulators are expected to impose higher and more consistent national standards of regulation.

This note canvasses the role of self-regulation in a number of jurisdictions. In general terms, self-regulation now plays a minor role in Europe, the Middle East and Latin America. It continues to play a strong role in North America, where independent SROs are assuming responsibilities from Exchange SROs. In Asia reliance on self-regulation has been reduced but it remains important in most major markets.

Principles of Self-Regulation IOSCO's principles say SROs are an optional feature of a securities regulation system. They recognize that self-regulation may be an appropriate tool of regulation, but they do not recommend that SROs must be part of a country's regulatory structure. SROs may be used where additional resources for regulation are needed in the system, for example in complex markets or small markets with limited government resources.[3] IOSCO has developed a list of standards that a SRO should be required to meet in order to be approved.

Models of self-regulation In the context of reliance on self-regulation, four basic regulatory models are observed:

1) **Government (Statutory) Model** -- Regulation is performed by a public authority. Formal SROs do not exist. Exchanges are responsible for very limited supervision of their markets. *Examples:* UK (FSA), France (AMF), most EU countries.

2) **Limited Exchange SRO Model** – A public authority is the primary regulator; it relies on Exchange(s) to perform certain regulatory functions tied to operation of its market. *Examples:* Hong Kong, Singapore, Dubai, Sweden

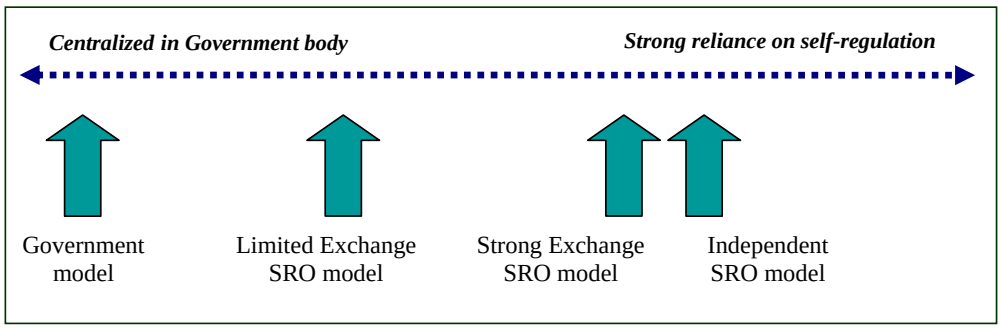
3) **Strong Exchange SRO Model** – A public authority is the primary regulator; it relies on Exchange(s) to perform extensive regulatory functions that extend beyond its market operations, including regulating members' business conduct. *Examples:* US (NYSE[4], CME), Australia (ASX), Japan (TSE, OSE), Malaysia (Bursa Malaysia)

4) **Independent SRO Model** – A public authority is the primary regulator; it relies extensively on an independent SRO (a member organization that is not a market operator) to perform extensive regulatory functions. *Examples:* US (NASD & NFA), Canada (IDA & MFDA), Japan (JSDA), Colombia (AMV)

The spectrum of models is illustrated in the chart below.

[3] Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation, IOSCO, October 2003, p. 29

[4] The NYSE will cease to be a "strong SRO model" after member regulation is centralized in the new SRO that NYSE and NASD have agreed to create, as discussed above.



Some countries have multiple SROs, which raises additional challenges for regulatory structure. The US markets best illustrate the complications that arise. If more than one SRO exists, the supervising government regulator should ensure that all SROs meet similar standards to ensure fairness and consistency. A single, consolidated SRO offers many advantages, including 1) uniform rules and policies for all members; 2) uniform approach to supervision programs; 3) one SRO sees the full picture of markets and member firms; 4) the system is simple and cost-efficient, eliminating duplication and gaps.

Today reliance on self-regulation makes sense where the government regulator may not have the resources or capacity to deal with the detailed rules, supervision programs and enforcement needs required to successfully regulate complex markets and intermediaries. SROs expand the overall level of regulatory resources and expertise available in a jurisdiction, which should improve the quality of regulation if it is managed efficiently. On the other hand, an SRO system introduces another layer of regulation, creating a more complicated and costly regime. The increased regulatory burden means higher costs of doing business.

The biggest risk has always been that self-regulation is subject to conflicts of interest, especially at Exchange SROs. These include: 1) conflicts with shareholders' and business interests based on the goals of earning profits and developing new business; 2) conflicts with members as owners that may lead to weak rulemaking or lax enforcement of rules; 3) conflicts with members as customers that may lead to compromises to preserve an Exchange's markets business; 4) conflicts with issuers due to competition for listings, which might lead to lower listing standards or weak enforcement of listing rules.

A wide range of approaches to managing conflicts of interest are employed by SROs and their supervising regulators. The organizational separation of the regulatory and the business operations of an Exchange is now established as a best practice. Some Exchanges have established separate entities with their own boards to house SRO operations, including the NYSE. Independent SROs face fewer conflicts, but the inherent conflict in members regulating themselves remains.

Corporate governance The concern on how to manage the conflicts of interest among other key factors, has highlighted the public interest responsibilities imposed on SROs that has reflected in requirements on board composition, particularly the need for independent directors and fair representation of users. An SRO's board of directors has a duty to ensure that the organization meets its public interest responsibilities. Members'

role in the governance and administration of SROs has been reduced significantly in recent times. SROs have evolved into complex institutions overseen by stakeholder or shareholder boards, run by executive managements, with operations that employ many professional staff with specialized knowledge and expertise. Of course the governance structure that is suitable for an investor-owned Exchange, a member-owned Exchange and an independent SRO varies significantly. Regulators have developed a flexible approach to corporate governance of SROs that enables governance requirements to be tailored to the type of institution involved.

SRO Oversight IOSCO emphasizes the need for effective oversight of an SRO by supervising regulators. Oversight includes processes such as periodic reviews or inspections of the SRO, reporting requirements, review of corporate governance arrangements and review and/or approval of SRO rules. The purpose of an oversight program is to ensure that a SRO is meeting its legal and regulatory responsibilities and is capable of performing its regulatory functions effectively. Oversight means supervision -- it should not extend to directing an SRO's affairs or managing its operations, which would compromise the SRO's independent governance and the benefits of self-regulation.

IOSCO states that the professional standards for an SRO should be similar to those of a regulator. The strength of an oversight program depends on factors such as the SRO's mandate, the scope of its regulatory responsibilities and the types of conflicts of interest it faces.

1. Introduction

The benefits and risks of self-regulation in effective and efficient regulation of a complex, dynamic and ever-changing financial services industry has attracted a great deal of attention in the last few years. Self-regulation typically involves a unique combination of private interests with government oversight[5], and provides a mechanism for the expertise and practices of the industry to be reflected in regulatory policy. It is also considered to result in better compliance of regulation as there is greater industry buy-in for regulations informed by industry expertise. On the other hand, many concerns about self-regulation focus on the undue influence of the industry on regulatory policy and the conflicts of interest that could arise between their regulatory responsibilities and business operations.

In part these concerns have arisen due to increased public expectations that retail investors' interests are adequately protected in the wake of scandals and regulatory problems. The recent wave of demutualization and consolidation of stock Exchanges, many of which continue to operate as self regulatory organizations, has also contributed to the heightened concerns about self-regulation. All these concerns have raised certain public policy challenges including the question 'who should regulate'? The debate is centered on questions such as: Are these existing self-regulatory arrangements sufficient? Should government change its oversight of self-regulatory institutions? Or should government assume a greater and more direct role in regulating? And where self-regulation is considered appropriate, how should self-regulation be structured to maximize its advantages and minimize its disadvantages?

While deciding what the optimum situation for any country depends on the level of sophistication of the securities industry, maturity of the regulatory systems, limited access to resources by the regulator and safe and reliable market infrastructure processes, there are lessons that could be drawn from international experience to apply to India's situation. This note explores the concept of self regulation and its evolution, international trends in self-regulation, the issues in the Indian market including unprecedented growth of markets in recent years which make relevant a healthy debate on the role of self-regulation and key options for self-regulation in Indian markets drawing on cross-country experience.

1.1 Definition and evolution of self-regulation in financial markets

Self-regulation in securities markets takes a wide variety of forms around the world. There is no single definition of self-regulation or self-regulatory organization (SRO) that is universally agreed, and many jurisdictions do not formally define a self-regulatory organization in law. The term SRO is often used somewhat loosely to refer to organizations that perform industry services, regulatory or public interest functions under the supervision of a securities regulatory authority. This includes several types of organizations that administer rules applicable to members or participants, including Exchanges, clearing houses, Central Securities Depositories (CSDs) and securities dealer associations.

[5] IOSCO 2000

SROs may be generally defined as private institutions that establish, monitor compliance with, and enforce rules for securities markets and the conduct of market participants. Most SROs today have statutory authority to perform their regulatory responsibilities, but an SRO can obtain jurisdiction by contract with its members. SROs usually supplement their legal authority by contract, as members agree to comply with the SRO's rules and to be subject to its jurisdiction. SROs' activities are supervised by government regulators. Bodies such as the International Council of Securities Associations (ISCA) have developed more comprehensive definitions of a SRO.[6]

In the last decade the demutualization of Exchanges and increased competition among securities marketplaces has had a significant impact on self-regulation because the great majority of SROs are still securities Exchanges. The ability of for-profit Exchanges to effectively perform regulatory roles given potential conflicts with their commercial objectives continues to be debated. Many Exchanges are retreating to a commercial approach to their regulatory roles and focusing on core regulation functions that directly impact product quality and add value to their services.

In the last five years a strong trend towards clearer organizational separation of Exchanges' business and SRO functions has emerged. Many Exchanges have established independent entities with separate governance for SRO functions. In addition, some countries' authorities have transferred specific Exchange regulation responsibilities to government regulators. Other Exchanges have transferred responsibilities to independent SROs. These reforms mitigate conflicts of interest between business and SRO functions.

The evolution of self-regulation has considerably changed the governance, scope, operation and the very nature of self-regulation over recent decades. On one hand, self-regulation is stronger, better resourced and more thorough than it has ever been. On the other hand, the role and power of self-regulation is more limited than ever. The core issue facing self-regulation is whether the trend towards reduced reliance on SROs in global securities markets will continue. Will self-regulation continue to decline in importance, or will it continue to play an important role in regulating securities firms and markets in many jurisdictions (within a system established by the government regulator)?

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[6] ISCA states that SROs can be defined as non-governmental organizations that: (1) share a common set of public policy objectives including the enhancement of market integrity, market efficiency and investor protection; (2) are actively supervised by the government regulator(s); (3) have statutory regulatory authority and/or authority that is delegated by government regulator(s); (4) establish rules and regulations for firms and individuals that are subject to their regulatory authority; (5) monitor compliance with those rules and regulations and, in the case of SROs that regulate trading markets, conduct surveillance of markets; (6) have the authority to discipline members that violate applicable rules and regulations; (7) include industry representatives on their boards or otherwise ensure that industry members have a meaningful role in governance; and, (8) maintain structures, policies and procedures to ensure that conflicts of interest between their commercial and regulatory activities are appropriately managed. *Self-Regulation in Financial Markets: An Exploratory Study*, Working Group on Self-Regulation of the International Council of Securities Associations (ICSA), September 2006, http://www.icsa.bz/pdf/Self-RegulationFinancialMarkets.pdf

1.2 Changing Contours of Indian Securities Market

A rapidly growing capital market in terms of intermediaries, products and sophistication is exerting pressure on the traditional regulatory environment. India's equity market is perhaps one of the most vibrant among emerging markets**.** India has 23 stock Exchanges; however, trading is concentrated in only two of the country's largest stock Exchanges viz. the National Stock Exchange and the Bombay Stock Exchange. Over the last decade, the equity market in India has witnessed a series of reforms, innovation, growth in volumes and greater sophistication. (Table 1.1). The equity derivatives market as well has grown substantially from 18 percent of GDP in end-March 2003 to 137 percent of GDP in end-March 2006. This growth is particularly impressive given that it has been achieved in a span of only three years.

Table 1.1 India: Selected Indices of Stock Market Development, Selected Years, 1991-2006

	1991	**1993**	**1999**	**2001**	**2003**	**2004**	**2006**
Listings	2556	3263	5863	5795	5644	5593	4793
Market Capitalization (% of GDP)	16.6	34.8	41.0	22.8	45.9	49	85
Cash Market Turnover (% of market capitalization)	57	27	193	191	139	101	79

Source: Standards & Poor's; SEBI Annual Report, various years

This increase in volume and value of turnover has been as a result of a number of reforms that were put in place which included setting up of the securities market regulator, Securities and Exchange Board of India (SEBI) and introduction of rules and regulations governing different types of intermediaries (including private sector mutual funds and foreign institutional investors). Needless to say, in large part this increase has also been possible due to innovations in securities trading infrastructure which witnessed setting up of electronic trading platforms in several parts of the country and a resilient online risk management system which ensured retail investor confidence and growing participation. All these changes have caused the Indian equity markets to become more institutional in nature. The number of products and intermediaries in the market have also increased manifold (Table 1.2).

Table 1.2 India: Equity Market Structure

	1993	**2006**
Stock Exchanges	12	22
Brokers	5290 (1991)	9269
Depositories (set up in 1996)	NA	2
Depository Participants	NA	241
Mutual Funds	9	38 of which 8 are state-owned
Mutual Fund Distributors	NA	31000
FIIs	18	882
Investment Banks	74	130
Retail Investors	3.9 million (1991)	21 million (2002)

Source: SEBI Annual Reports, various issues

The wide range of reforms has made the regulators' job in oversight of these burgeoning markets and intermediaries increasingly complex and demanding. The real question is not whether regulation is vital but what form of regulation is put in place to ensure a safe and efficient market.

1.3 Indian experience with Self-Regulation

While Exchange self-regulation has been in existence in the Indian securities markets for several decades, non-Exchange self-regulation is relatively new. Even prior to the setting up of SEBI, self-regulation was being conducted through stock exchanges, whose regulatory functions have been well established[7] in law. It has been well documented[8] that the integrity and efficiency of the equity markets was far from satisfactory in the early 1990s partly due to the conflicts of interest arising from Exchange self-regulation. The introduction of economic liberalization, deregulation and financial sector reforms in 1991 and setting up of a statutory regulator in 1992 led to significant reforms in the equity markets such as revamping the governance structures of stock exchanges, introduction of competition and structural and institutional changes in the financial services sector. The legal framework that set up SEBI in 1992 authorized it to promote and regulate self-regulatory organizations to carry out its functions[9].

The reforms in the securities market included broadening the make-up of the Board of Directors of the stock exchanges by inducting independent directors and government nominee directors, creating the position of a SEBI-appointed executive director and the establishment of the NSE by government financial institutions as a non-mutual Exchange. These reforms reduced the influence of broker members on the governing body and brought in significant changes in market microstructure design which resulted in greater efficiency, transparency and safety of the markets.

Less elaborate supervision arrangements exist for other segments of the securities market in the form of 'associations' of market participants such as through the Association of National Stock Exchange Brokers, Association of Merchant Bankers of India, Association of Mutual Funds of India, etc. SEBI has so far designated these associations for promotion of SROs, however, has not officially recognized these associations as SROs. Member associations in the securities market do not have any disciplinary or enforcement role like the stock exchanges have; however, they have broadly incorporated SEBI's policy objectives in its charter. Only 'SEBI-recognized' intermediaries are permitted into the member associations and any change in their charter needs to be approved by SEBI.

In 2004, SEBI issued a regulation aimed at getting the industry associations (brokers, mutual funds, merchant banks, etc) to convert into SROs. These regulations explicitly exclude the stock exchanges. The response from the industry was not favorable since the industry perceived a high cost in becoming SROs and the risk of limiting their member focus. Further, the governance arrangements in the regulations were viewed as giving SEBI excessive influence. More recently, the NSE brokers association (ANMI) has become an exception to this view; they are considering applying to become an SRO and plan to include other brokers' associations to become a national member SRO.

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[7] Stock Exchanges, once recognized by the Central Government, have the authority as well as the obligation, under the Securities Contract (Regulation) Act, 1956 to fine, expel, suspend or otherwise penalize their member stockbrokers.

[8] Shah, A. & Thomas, S. (1997), Securities markets, *in* K. S. Parikh, ed., 'India Development Report 1997', Oxford University Press, chapter 10, pp. 167–192.

[9] Section 11 (2) (d) of the SEBI Act, 1992

As described above, self-regulation in India has been limited to Exchange SROs. Outside of the Exchanges, other segments of the industry have largely been organized as trade/member associations that perform lobbying and member promotion activities. Further, these associations, unlike their counterparts in other countries, have played a narrower role in improving the standards of their members through codes of conduct, common operating rules/valuation criteria or certification requirements[10].

1.4 Genesis of policy note

As in other markets, Exchange demutualization, scandals and issues in regulation have raised the issue of whether the current structure of self-regulation in India is adequate. In response to these developments and changing contours of the Indian markets, the Finance Minister announced in his Union Budget Speech (2006-2007) plans 'to **take forward the idea of Self Regulating Organizations (SRO) for different market participants under regulations that will be made by SEBI and, if necessary, supported by an enabling law'**. At the request of the Government of India, the World Bank has prepared this note that examines international trends in self-regulation and describes four possible alternative approaches to self-regulation in India's capital markets. The note examines the strengths and weaknesses of each in the context of Indian capital markets. The principal audience for this note is the Ministry of Finance, Capital Market Department and the securities market regulator, SEBI.

The objectives of this note are:

- to review recent trends in self regulation around the world including changes in organization and responsibilities of the self regulatory organizations (SROs), reliance on self regulatory organizations by government regulators and oversight of SROs by government regulators.
- The note will document analytical material on the diversity of approaches to this issue of self regulation and comment on the advantages and disadvantages of different approaches taken by different governments.
- Based on the study, as requested by the GoI, the Bank will assist SEBI in examining its SRO regulations and assist them in moving to an effective SRO mechanism.

While the principal focus of the note is on self-regulation in the Exchange-traded securities markets, to complete the broad frame of analysis for financial markets, the note also covers the corporate debt market and the non-Exchange securities markets more broadly. This becomes relevant when one considers the increased oversight that is being required of the securities market regulator, SEBI, following introduction of uniform trade reporting system for the corporate debt market. In this context, SEBI is considering a greater role for self-regulatory organizations to help ease the burden of regulating the corporate debt market.

[10] Barring the Association of Mutual Funds of India which has been instrumental in issuing valuation guidelines for non-liquid bonds, certification examination for its sales force etc. More recently, the Fixed Income Money Market and Derivatives Association has also begun to issue standards and guidelines for relating to valuation and derivative products for its members.

This Note aims to provide a starting point to develop a specific proposal for a reformed self-regulatory system in India. The objective is to assist the authorities and other stakeholders in India by setting out alternative approaches to self-regulation that would produce effective and practical results in the Indian context. As mentioned earlier, the analysis and suggestions are based on international trends in self-regulation and international standards in addressing the many issues that arise in reforming the SRO structure.

1.5 Organization of Policy Note

This note reviews recent trends in self regulation around the world including changes in organization and responsibilities of the self regulatory organizations (SROs), reliance on self regulatory organizations by government regulators and oversight of SROs by government regulators. This will help in supporting a clearer understanding on how modern schemes of self regulation operate in more advanced markets, how the SROs have evolved over time from member-directed private entities (Stock Exchanges) that operated quite independently from the regulators (where they existed), to a model where the SRO functions as an effective private regulator with a broader set of responsibilities (regulation, supervision and enforcement) under the oversight of the government regulator.

The note documents analytical material on the diversity of approaches to this issue of self regulation and comments on the advantages and disadvantages of different approaches taken by different governments around the globe with the objective of providing a useful input to the decision making process that the government needs to engage in order to decide on the kind of scheme they need to promote in conjunction with the industry.

Chapter 2 summarizes important general factors to consider in deciding the preferred approach to self-regulation in Indian capital markets. These include:

1) Public policy objectives,
2) Local factors in India's markets,
3) Regulatory structure issues and,
4) Transitional issues.

Chapter 3 describes the four main theoretical options for securities markets self-regulation. We believe that three options that employ SROs are viable solutions for Indian capital markets. We do not suggest the "Government model" which centralizes all functions in the statutory regulator, for reasons set out below. There is no single "right" approach – several approaches are workable based on international experience.

Chapter 3 also describes two transitional approaches to developing a new, central SRO if the authorities decide to create one. The transitional approaches involve moving in phases from the current SRO system based on NSE and BSE to one of the three main alternatives. A phased approach to change would mitigate the risks involved in making major changes in the self-regulatory system.

Chapter 4 describes alternatives for addressing institutions and industry segments outside of the listed securities markets – Depositories, mutual funds, merchant banks, OTC securities trading, and investment advisors.

Annex 1 to this Note describes international trends and experience with SROs and sets out examples of the approach employed in several countries with significant capital markets that rely on self-regulation in varying degrees.

Annex 2 reviews in greater detail the experience of the NASD in self-regulation in the US market.

Annex 3 provides the accepted division of roles and responsibilities between the regulator and the SROs.

Annex 4 describes how different jurisdictions have dealt with the conflicts of interest that usually occur with self-regulatory organizations.

2. Factors to consider in introducing changes to the Self-Regulatory System

In considering any major changes to the SRO system, a number of important issues must be addressed, including both substantive issues and issues arising in the process of implementing changes. This section examines the macro and micro factors that need to be deliberated upon by the Indian policy makers before making major changes to the current self-regulatory system. Examples drawing from the experiences of relevant countries which have considered similar issues have been highlighted in this section with the details described in Annex-1.

2.1 Public Policy Objectives

2.1.1 Strategy for capital markets

An overarching question that needs to be considered is the Government's strategy for developing the capital markets. This includes views on the competitive position of India's capital markets, regionally and internationally. A strategy should encompass:

- Fostering market development and innovation
- How capital markets can best support economic development
- The need to improve standards of conduct / regulatory standards in the market (investor protection)
- Appropriate level of cost of regulation
- Competitive positioning and business focus of the Exchanges

The recent report of the High Powered Expert Committee on 'Making Mumbai an International Financial Centre' articulates the need to move towards principle-based regulation[11] as one way to make India's financial markets (which are primarily based in Mumbai) competitive, as the city bids to become an international financial center. This recommendation is made citing evidence accumulated over the last decade in the UK (when compared to the US) that principles-based regulations might be more effective that rules based regulation, in averting financial malfeasance. A PBR regime has the effect of co-opting the regulated entity into becoming an integral player along with the regulator through a cooperative process of self-regulation at the level of the individual, firm and market.[12]

In the context of the self-regulation debate, PBR could have important implications. For example, the UK experience created the Financial Services Authority as a universal financial regulator in 1997 and transferred all of the significant powers of the former SROs to the FSA. In November 2006 the FSA released plans to encourage greater use of industry guidance as it moves towards a more principles-based approach to regulation. The plan sets out a standard process for the FSA to recognize

[11] PBR relies on compliance not just with letter of the law such as rules and regulations, but with its spirit as well. A principles-based approach to regulation involves a regulator moving away, where possible, from dictating how a firm should reach a desired regulatory outcome. This approach considers first whether firms, supplemented by guidance as appropriate, could assume the responsibility to achieve the desired outcomes in the context of their business processes and existing supervisory obligations.

[12] Report of the High Powered Expert Committee on Making Mumbai an International Financial Centre, 2007

industry guidance which will give industry guidance semi-official status[13]. The FSA approach, where the regulator establishes the higher-level rules and the industry provides guidance or standards of practice on how to implement them, has parallels to the concept of self-regulation as it applies to other jurisdictions.

More recently, the securities industry trade association in the US, Securities Industry and Financial Markets Association (SIFMA), in its testimony before the Senate Banking, Housing and Urban Affairs Subcommittee on Securities, Insurance and Investments on the consolidation of NASD and the regulatory functions of the New York Stock Exchange, suggested that the single SRO should adopt principles based regulation and that a single SRO is a significant step towards increasing the competitiveness of the US markets.

While debating on an appropriate strategy for the capital markets in India, the Indian policy makers will need to analyze the above recommendation of the Indian HPEC and what it means in the context of capital market regulation and competitiveness of the Indian financial markets.

In addition to the above broader public policy question, the following questions offer a useful framework of issues for the policy makers as they consider a model of self-regulation appropriate to their market conditions:

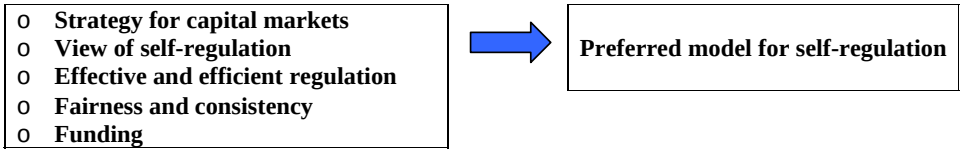
2.1.2 View of self-regulation.
Do the authorities believe it is appropriate to rely on self-regulation in capital markets? What is the level of confidence in self-regulation in India, today and going forward?

2.1.3 Effective and efficient regulation.
What approach do the authorities and the industry believe will deliver the most efficient and effective regulation?

2.1.4 Fairness and consistency
In choosing a particular SRO structure the fairness and consistency of regulation of different segments of the capital markets and financial services industry needs to be maintained.

2.1.5 Funding.
Who should pay for the cost of regulation? The issue of costs becomes paramount not only within a country's markets, but with globalization across markets as well.

Figure-2.1 Illustrative factors that affect choice of preferred model for self-regulation



[13] This plan has since been accepted by The Financial Services Authority (FSA) when it confirmed on May 16, 2007 that its supervision of outsourcing by firms will in future take account of industry guidance which has been issued by MiFID (Markets in Financial Instruments Directive) Connect [MiFID Connect is a joint project set up by 11 trade associations to support their members in implementing the Directive].

2.2 Local Circumstances in India

Once the higher level public policy question has been considered, it is very important to consider the local circumstances in the capital markets. A key starting point should be to understand if the current regulatory system is working and what is the imperative for change to the current system.

2.2.1 Imperative for change to the current system.

Conflicts of interest

The conflict between the Exchanges' business priorities and their regulation functions is increasing as the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE) become more commercial and investors become significant owners. These conflicts will be exacerbated if the Exchanges become listed companies. Furthermore, plans to develop the SRO system will demand increasing resources and commitments to regulation functions, which will further sharpen the conflicts in the Exchanges' roles. The potential for conflicts of interest in demutualized Exchanges was recognized by the Committee on Demutualization in India, which noted that "a demutualized for-profit Exchange will face an issue of conflict between its regulatory responsibility and its desire to maximize profits for its shareholders".

On the other hand, demutualization of Exchanges was carried out in India in order to reduce conflicts of interest at broker-controlled Exchanges. These conflicts could arise again in a new SRO structure unless it is carefully designed to minimize them.

Box 2.1 Conflicts of Interest in Exchange Self-Regulation

Ownership and governance conflict:

- Regulation of significant owners of an Exchange (for example members or trading participants that are major shareholders) is difficult.
- Directors face conflicts in reconciling duties to shareholders with their public duty as a regulator.

Conflict between Exchange's Business and Regulation Mandates:

- Business interest in maximizing revenue often conflicts with duties as a regulator
- Regulation of major customers such as members (or trading participants) and listed companies produces tensions between business interests and regulation responsibilities
- Funding and resources -- competition for resources between business and regulation needs
- Funding and resources -- desire to drive down costs puts pressure on non-revenue producing areas like regulation.

Conflicts in the Integrity of Self-Regulation Programs:

- Maintaining high regulatory standards and rules may negatively impact business development and relationships with customers
- Thoroughness of regulatory programs may be lacking at SROs
- Customer pressures could result in biased administration of rules
- Customer pressures could compromise the independence of investigations and enforcement programs.

Size and complexity of capital markets

In any jurisdiction that is assessing the role of self-regulation, the key question is: Do the markets need, and can they support, two layers of regulation? In India the large, complex and rapidly expanding securities markets arguably require two layers of regulation. In recent years the range of products, trading activity, number of clients and size of intermediaries' sales networks have expanded significantly as highlighted in the earlier section. This growing activity is difficult to control unless a robust self-regulatory structure is in place. The markets have long supported two layers of regulation and, based on activity levels and revenues, they should be capable of continuing, and indeed expanding, investments in self-regulation.

The IOSCO principles for SROs state that 'the regulatory regime should make appropriate use of self-regulatory organizations that exercise some direct oversight responsibility for their respective areas and to the extent appropriate to the size and complexity of the markets'. Arguably, for India, because the securities industry is expansive, very active and complex, this imposes a significant burden on the regulators. So the regulators can benefit from the regulatory resources that the private sector can provide. However, the objective of delivering regulation efficiently should be a top priority in order to ensure that India's markets remain competitive.

2.2.2 **Regulatory priorities and key risks**

The authorities and the industry should decide what regulatory issues need to be prioritized and focus on the key risks in the market that are driving changes to the SRO system in India. A few examples of the different types of priorities and regulatory response could be:

- If the priority is to improve standards of business conduct at brokers, the system should be designed to produce a more effective member regulation system.
- If the priority is strengthening market surveillance and monitoring of the increasingly complex and sophisticated markets then the system should be designed to produce a more effective market regulation system.
- If the growing complexity of products and markets is increasing the focus on investor protection, the system should be designed to increase investor awareness in addition to a strong member regulation system.

2.2.3 **Legal framework**

Most SROs today have statutory authority to perform their regulatory responsibilities, but an SRO can obtain jurisdiction by contract with its members. SROs usually supplement their legal authority by contract, as members agree to comply with the SRO's rules and to be subject to its jurisdiction. SROs' activities are supervised by government regulators.

The current situation in India is that SEBI is authorized to promote and regulate self-regulatory organizations to carry out its functions[14] as detailed in

[14] Section 11 (2) (d) of the SEBI Act, 1992

the SEBI Act. While the responsibilities of stock exchanges have been well-established, the 'associations' of market participants such as the Association of National Stock Exchange Brokers, Association of Merchant Bankers of India, Association of Mutual Funds of India, etc are only designated as associations for promotion and regulation of SROs. SEBI has not officially recognized these associations as SROs.

As mentioned earlier, in 2004, SEBI issued regulations for registering and regulating SROs. In the context of these regulations, an SRO was defined as 'an organization of intermediaries which is representing a particular segment of the securities market and which is duly recognized by the Board (SEBI) under these regulations, but excludes a stock exchange'. The response was not favorable since the industry perceived a high cost in becoming SROs and the risk of limiting their member focus.

As the Indian authorities contemplate an SRO scheme for the Indian markets, the following questions are relevant: Do (or under a new structure, will) the SROs have sufficient powers to perform the responsibilities allocated to them? If needed, how practical is it to change the law or regulations applicable to SROs? Is there a clear division of responsibilities both among SROs and between SROs and supervising regulators? The division of responsibilities may be set out in law or regulation, or alternatively through operational guidelines based on a policy decision. In the short term, at a minimum, SEBI will need to make changes to the SRO Regulations 2004 in order to accommodate a new structure along the lines discussed in this Policy Note.

2.2.4 **Stakeholders' views.**

In considering any changes to the present system of regulation, it is important to understand the views that important stakeholders, including intermediaries, the regulator, government, politicians, Exchanges or SROs, and investors have on self-regulation? What is the degree of support for change versus resistance to change? In discussions with the Ministry, SEBI, NSE, BSE, ANMI and the BSE Brokers' Association, it appeared that most stakeholders are open to change provided that a new structure will clearly deliver improvements. The Exchanges were particularly concerned about transition risks and the possibility that a new structure could prove to be less effective or subject to greater conflicts of interest.

While regulation of the Indian markets has improved markedly due to reforms made in the last decade, demands on the regulatory structure are increasing. At the same time, there is scope for further improvement to meet international standards of supervision. As a result, there seems to be a growing consensus that changes are needed. On the other hand, concerns are expressed about the risks of introducing a new regulatory structure, particularly ensuring that any system is efficient and that conflicts of interest are minimized and well managed. Stakeholders agree that a clear division of responsibilities between SEBI and SROs is needed.

The key elements of oversight programs internationally include: corporate governance standards and review, rule review and approval, monitoring of

SRO reports and SRO self-assessment of its performance and operations. In India, SEBI has been overseeing the Exchanges' self-regulation programs for many years so has established procedures in this area. However, the perception is that a lot could be done to reduce the overlap that exists between SEBI's and the Exchanges' activities, particularly in the area of member regulation. This points to the need to clearly differentiate regulatory responsibilities and oversight procedures. Further as Exchanges get involved in sophisticated products and business lines, SEBI would need to improve its capacity to effectively oversee and supervise SROs?

2.3 Regulatory Structure Issues in Restructuring of the SRO System

Having examined some of the issues that need to be addressed given the specific local circumstances in India, this section looks at the key regulatory issues that need to be tackled while proposing any restructuring to the SRO system. These include:

- Ownership and Governance
- SRO responsibilities
- Oversight
- Exchanges' Roles
  - Market Regulation
  - Member Regulation
  - Listing
  - Clearing
- OTC Trading

It is vital for a SRO to have sufficient skills, resources and capacity to perform its responsibilities effectively. This is a threshold question: if sufficient capacity does not exist or cannot be developed, building a regulatory structure that relies on SROs will not yield the desired result.

2.3.1 Ownership and Governance

IOSCO principles state that "Governance arrangements encompass the relationships between management and owners and other interested parties, including users and authorities representing the public interest. The key components of governance include the ownership structure, the composition of the board, the reporting lines between management and board, and the processes that make management accountable for its performance."[15]

One of the most critical issues to be addressed in any proposed restructuring of the SRO system is the ownership and governance of the SROs. Corporate governance is critical because the composition of the board of directors determines how all major decisions will be made, including selection of management, corporate strategy and policy, adoption of rules, approach to supervision programs and enforcement, and so on.

Following several decades of evolution, international best practice in developed markets is for SROs to have a majority of independent directors. In an independent SRO, this model ensures strong representation of regulated

[15] IOSCO CSD Report

firms – which is integral to the concept of self-regulation – while ensuring that conflicts of interest are minimized and the interests of all stakeholders in the capital markets are represented.

Governance of demutualized Exchange SROs is more complicated, especially for listed Exchanges. Their boards are shareholder-based, so often have a minimal number of directors representing regulated firms. While a majority of directors may be independent, in practice it is difficult to ensure full independence given that these directors are nominated by the shareholders. Here regulatory oversight and veto power of the nominations (stopping short of actually nominating directors) for appointments to the Boards of SROs would help in further addressing the conflict.

In the case of an independent SRO ownership may not, in and of itself, be significant because in a properly designed "pure SRO" ownership would not carry any rights except the right to vote for a certain number of directors. Nevertheless, the ownership structure can influence the selection of member directors in particular, and ownership is important for funding because the member fees are expected to finance the SRO. In the case of an Exchange SRO ownership is quite important if it is investor-owned because the shareholders elect the board.

The governance structure that is suitable for a demutualized Exchange, a member-owned Exchange and an independent SRO varies significantly because they have different owners and mandates. Therefore regulators have developed a flexible approach to corporate governance of SROs which enables governance requirements to be tailored for each type of institution.

Box 2.2 International Experience in designing governance structures for SROs

The UK Financial Services Authority's (FSA) REC Handbook sets out general governance requirements for recognized investment Exchanges and clearing houses, but does not mandate a specific approach. It lists a number of broadly-worded factors relating to corporate governance that will be considered by the FSA in assessing whether an applicant for recognition is "fit and proper".[16] In 2004, the FSA also issued a letter to recognized bodies that expanded on its views on sound corporate governance of recognized bodies.[17]

Following an extensive review of the corporate governance of SROs, **the US SEC has proposed extensive new governance and ownership rules** for securities Exchanges and securities associations such as NASD. As a first step the SEC proposed new rules to strengthen SRO governance and the SEC's oversight of SROs.[18] So far these proposals have not been implemented universally, although these have largely implemented, in connection with Nasdaq-NASD and NYSE whose revised governance structures had to be approved by and were impacted by SEC views. The proposals minimum standards require greater transparency and disclosure of important governance information, set requirements for independent directors and require fully independent board committees for oversight of SRO

[16] Financial Services Authority Handbook, REC Handbook – Recognized Investment Exchanges and Recognized Clearing Houses

[17] FSA Markets Division letter to Chief Executives of all Recognized Bodies re Corporate Governance of Recognised Bodies, March 31, 2004.

[18] Securities Exchange Act release No. 50699 (Nov. 18, 2004), *SRO Governance Rulemaking, available at* <http://www.sec.gov/rules/proposed/34-50699.htm>.

functions. The proposed rules also would require any subsidiary that provides regulatory services to a SRO to observe the same standards of governance.

For demutualized Exchanges, especially listed companies, the concept of public directors has been supplanted by independent directors in most jurisdictions. This is more suitable for a business corporation as the concept of a "public director" is arguably foreign to a commercial company where directors represent the shareholders. But Hong Kong, Singapore and India have retained the category of public interest directors appointed by Government or the regulator even after demutualization and listing; in recognition of the Exchanges' express public interest obligations. It is a possibility though that these 'public interest directors' who are professionals, academics etc may not be entirely independent (since they may have an opinion or interest in the markets) but are persons of high standing and qualifications.

The US, UK, Australia and Canada do not require public directors for listed Exchanges, but do require independent directors as broadly defined. Independent directors are defined as persons who are independent of both the Exchange and its participants. They do not represent investors or the public -- their primary duty is the same as any director's: to act in the best interests of the corporation in accordance with corporate law norms.

Independent SROs still have public directors in the traditional sense; ie. non-member directors who represent the "public interest". For example, the new SRO being created by NASD and NYSE has a specified number of "public governors".

The other key issues which impinge on the governance arrangements relate to: the mandate of SRO boards and balancing roles and responsibilities[19], and Committees to support the Board of Directors in carrying out their responsibilities. A SRO board has a duty to ensure that the institution meets its public interest and regulatory responsibilities. Striking an appropriate balance among an SRO's duties to its owners, members or users, the public and other stakeholders is a major challenge in the governance of an SRO.

2.3.2 SRO Responsibilities

Any proposal to restructure the SRO system should define the terms Market Regulation and Member Regulation with some precision. The definitions will summarize the main functions that SROs may appropriately be responsible for. **Responsibilities for each area of regulation are generally shared between regulators and SROs.** It is important to examine the specific activities that each regulator is usually responsible for. For example, in market regulation several levels of regulation can be identified – see Table 2.1 below. In general terms, government regulators are usually responsible for most higher level activities (levels 1 and 2), and SROs are usually responsible for most front-line activities (levels 3 and 4).

Table 2.1

Level of Regulation	*Responsibilities*	*Regulatory Activities*
1. Overall Market Regulation	Overall supervision of markets and intermediaries' market conduct and trading practices	▪ Rulemaking ▪ Supervision ▪ Enforcement

[19] A SRO board has a duty to ensure that the institution meets its public interest and regulatory responsibilities. Striking an appropriate balance among an SRO's duties to its owners, members or users, the public and other stakeholders is a major challenge in the governance of an SRO.

2. Market conduct standards	Principles of fair dealing, insider trading, deceptive and manipulative trading	▪ Rulemaking ▪ Supervision ▪ Enforcement
3. Exchange trading rules	Market integrity rules and practices for each marketplace	▪ Rulemaking ▪ Supervision ▪ Enforcement
4. Market surveillance	Monitoring of trading in each marketplace for compliance with rules	▪ Supervision (market surveillance, trading analysis) ▪ Investigations and enforcement

Regardless of the structural option selected, the current division of responsibilities between SEBI and SROs should be revisited to ensure a clear and efficient division of functions based on which body is best equipped to perform a given function. If one or more new SROs are created, this will require transferring responsibilities from the Exchanges. It may also involve realigning the division of responsibilities between SEBI and the SROs.

Any changes in responsibilities in the new structure will likely require 1) transfer of rules from one body's Rulebook to another's, 2) transfer of responsibility for supervision programs, 3) transfer of experienced managers and staff, and 4) transfer of infrastructure, including IT systems and tools. Agreement will need to be reached on the precise line of division of responsibilities, and documented in legal agreements or MOUs. Suitable arrangements will need to be agreed for the transfers of these responsibilities and assets.

2.3.3 Oversight

IOSCO emphasizes the need for effective oversight of an SRO, which should include processes such as periodic reviews or inspections of the SRO, reporting requirements, review of corporate governance arrangements and review of SRO rules.[20] IOSCO states that the professional standards for an SRO should be similar to those of a regulator. The level and strength of an oversight program depend on the scope of the Exchange's or SRO's regulatory responsibilities and other factors such as the types of conflicts of interest it may be subject to. There is increasing convergence in global regulatory standards, which has produced a clear set of best practices for the organization, operation and oversight of SROs. Of course, oversight should not extend to interfering in the management or operations of an SRO, absent a regulatory failure. An SRO is owned, governed and managed independently from its supervising regulator-and is not the arm of the government regulator.

Elements of oversight program: Table 2.2 below sets out the main tools or processes that regulators employ in oversight programs and the purposes of each process.

Table 2.2 Elements of oversight program

[20] IOSCO Implementation Report, p. 32.

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

Most regulators have strengthened oversight of Exchanges and SROs in the last decade, in part because of the commercial nature of Exchanges today. Oversight programs now require a significant level of resources at both the regulator and SRO levels to support them. Some SROs believe that the level of scrutiny has become excessive and amounts to continuous monitoring of the SRO's performance of its functions, rather than oversight. In some countries the regulator has the power to recommend, or to require a SRO to adopt, specific rules. But use of such powers is rare; instead government regulators and SROs discuss regulatory initiatives on a regular basis. If a regulator believes that a SRO should take a specific action or adopt a certain rule, it usually advises the SRO of its views informally. The institutions often discuss what the most effective approach to an issue is and try to reach agreement on a common view.

2.3.4 **Exchanges' Roles**

Even if most regulation responsibilities of Exchanges are transferred to a new entity, Exchanges would remain responsible for administering their own membership rules (which would be limited to qualifications to become a participant), trading rules (which would be mainly operational) as well as Listing and clearing rules, as noted below. Similarly, Depositories would remain responsible for administering the operating rules for participants. As licensed industry bodies, Exchanges and Depositories would remain subject to SEBI oversight in performing these and other functions.

- **Market Regulation**

  There are various scenarios on market regulation depending on how the scope and responsibility for market regulation is decided upon.

  If the present scenario is maintained (i.e. SEBI retains a significant role in market surveillance and investigation of market conduct issues) and if SROs are to continue to play an important role in market surveillance, it is important to clearly divide the responsibilities of SEBI and the SROs in this area.

  Many countries rely mainly on Exchanges or SROs to perform front-line surveillance or market monitoring, while the regulator focuses on reviewing problems identified by the SROs and follow-up investigations. If the Exchanges continue as the Market Regulation SROs, logically their purview would be restricted to products traded on their markets. This includes equities, options, futures, proprietary products like Exchange Traded Funds and some debt instruments.

  The Exchanges could also contract with other bodies to perform market regulation for other securities trading, for a fee. The Exchanges should not be expected to subsidize other markets by supervising their trading. For example, the Exchanges must maintain a trade reporting platform for corporate debt securities that may not be traded on their markets. The monitoring and supervision of this segment should ideally be done by the Exchanges as part of their market regulation functions for a fee.

  If the Market Regulation SRO is an independent organization, logically it could assume responsibility for regulating trading in any securities that are publicly traded (on an Exchange or OTC) subject to resolving any jurisdiction issues with RBI and others. Of course the approach to market regulation will vary for different securities based on the types of issues that arise, the available surveillance tools and the type of market data that is available. The program should have special teams or divisions for supervision of each type of security: equities, options, futures, debt and specialized securities.

  It is desirable to craft a solution that centralizes market surveillance and regulation in one entity in order to address the problems with fragmented supervision, especially since most significant issuers are listed on both NSE and BSE and most major brokers are participants on both. This is a

bigger issue if regional Exchanges become active (Delhi Exchange has announced it will resume trading). On the other hand, if SEBI plays the lead role in market surveillance and examining market-wide issues through the recently instituted Integrated Surveillance System[21], centralized SRO market regulation is less important.

- **Member Regulation**

  Consolidation of all member regulation functions in one entity is strongly preferred. The main benefits are 1) uniform rules for all member firms, 2) uniform standards for inspections and supervision, 3) uniform approach to enforcement, and 4) more cost-effective regulation by eliminating duplication.

  In India there is a strong argument for consolidating member regulation (supervision of brokers) since there is considerable overlap in membership between the two Exchanges. The case for an independent SRO is also strengthened when one considers that brokers also engage in many segments of the securities market outside the Exchanges, such as providing depository services, portfolio management, mutual fund distribution, and in a few cases also have licenses for investment banking and primary dealership in the government securities market.

  Sub-brokers

  The large number of unregistered sub-brokers[22] (estimated to run in tens of thousands) operating in the Indian capital market was a big area of concern for the regulators and Exchanges due to the risks they posed in terms of market safety and investor protection. It appears that the issue of regulation of sub-brokers has largely been addressed by changes in SEBI regulations that require a sub-broker to deal through only one member broker of an Exchange. The member broker carries the sub-broker's client accounts and is responsible for handling all cash and securities.

  If the member broker is responsible for the operations of its sub-brokers under the regulations, in our view it is not necessary to require sub-brokers to become members of a SRO. Sub-brokers will be treated like a branch office of the member broker under the rules. The SRO would have the right to inspect a sub-broker's operations, as part of its examination of the member broker, or as required for a specific investigation or enquiry. In addition, as sales representatives become subject to certification and registration by a SRO in the future, the requirements would apply to sub-broker representatives too.

- **Listing and Issuer Regulation**

  As with other regulatory responsibilities, Exchanges around the world face increasing conflicts of interest in regulating listed companies. Exchanges

[21] The integrated surveillance system that has been recently acquired by SEBI provides the regulator with close to real-time information on all market trades through a replica of the Exchanges trading servers.
[22] Sub-brokers act as introducing brokers but are not themselves members of an Exchange.

have incentives to increase listings and maintain good relationships with listing customers, and these incentives are stronger for for-profit exchanges. As exchanges demutualize and become increasingly commercial, regulators have become more cautious in delegating regulatory powers and functions to exchanges.

In some countries, Exchanges' roles in setting "continued listing obligations" and regulating listed companies have been diminished in light of increasing attention on the conflicts involved. In addition, many Exchanges have taken steps to improve conflict management by formally separating the administration of Listing rules from business operations. Examples include the ASX (Australia), NYSE (US), HKEx (Hong Kong) and OMX Exchanges (Scandinavia). The most extreme form of separation is in the UK, where the Government transferred the "Listing Authority" function from the LSE to the FSA because it did not believe that an exchange that competes with other exchanges for listings should have authority to establish general standards for listing. This model will prevail across the European Union once the Investment Services Directive (MiFID) is fully implemented.

The division of responsibilities between the statutory regulator and the Exchange in setting Listing standards and regulating issuers varies around the world. Almost all Exchanges set their own listing standards (the LSE is a notable exception) but statutory regulators have assumed the primary role for regulating public issuers. Minimum disclosure standards are generally set by the regulator and Exchanges' roles in this area are secondary (if any). In some countries Exchanges traditionally performed the job of approving prospectuses too, but this function has moved to regulators around the world. Many Exchanges still have an important role in setting corporate governance standards.

See Annex 3 for a description of exchanges' and regulators' roles in Listing and issuer regulation in select jurisdictions.

In India the Listing Agreement is comprehensive and the Exchanges play a strong role in setting standards for listed issuers, partly due to legal constraints on SEBI's powers. Therefore the potential for conflicts of interest to arise is high, especially when one considers the degree of competition amongst the Exchanges. This suggests that Listing is an area that should be considered in addressing the Exchanges' regulatory roles going forward, as well as in discussing changes to Exchanges organizational and governance structures that might be needed to improve conflict management.

However, responsibility for Listings functions was not an issue raised in our discussions with stakeholders about self-regulation. This is probably because the issue of responsibility for Listing standards and Listing Rules is a related but separate issue from self-regulation of intermediaries. In many respects, Listing is not a self-regulatory function because Listing

rules are simply based on a contract between an Exchange and the company. Internationally, exchanges do not assume the same supervision and enforcement functions over listed companies that they do over members or trading participants. Responsibility for Listings and policy on managing the conflicts involved are issues to be decided between the Exchanges and SEBI. Listing rules cannot be transferred to an independent SRO, since a member-based SRO has no basis for jurisdiction over listed companies.

A detailed examination of the Listings responsibilities and issuer regulation is beyond the scope of this Note. This may be an area that the authorities would like to analyze further in considering proposed changes to the Exchanges' regulatory roles. The Bank prepared a Policy Note on Listings regulation in India in 2004[23] which considered some of these issues, and should there be interest, this work could be updated in a future assignment.

2.3.5 **OTC Trading**

A decision should be made on what form of regulation and supervision is needed in OTC markets, including both equity and debt markets, and what role a SRO can play in this area. For a more thorough treatment of this issues, see the discussion of OTC debt trading in Chapter 4 below.

2.4 Transitional Issues

2.4.1 **Scope of SRO Regulation**

It may be too ambitious to develop an all-encompassing solution to self-regulation of all segments of the capital markets (see *Risks of Change* below) in one step. Creating a new "super SRO", as has been proposed by some quarters in the Indian securities market, to assume responsibility for regulating a range of investment industry sectors from mutual funds to merchant banks to investment advisors is arguably quite ambitious. Only the core securities markets are currently self-regulated. In the other areas, no rules, programs, skilled people or infrastructure exists. It would all have to be built from scratch. Furthermore, the issues, the rules, and the kind of supervision required would vary significantly by sector. The risk of the organization losing focus and being torn among different priorities in different sectors is high. One of the hallmarks of self-regulation is specialized expertise in a specific field. This benefit could be lost if the same organization covers too many fields.

The first step could be to address the priority regulatory issues or risks in the current SRO system, building on existing self-regulatory capacity at NSE and BSE. Under this approach, initially a new SRO structure would be limited to regulating the securities markets – i.e. brokers' business conduct and trading

[23] The World Bank, Modernising India's Listing Agreement and Improving Issuer Compliance, April 2004.

in the markets. This includes dealing in equities, derivatives and bonds and related business conduct and sales compliance issues. See Part III for comments on how other segments of the industry could be addressed.

2.4.2 **Risks of Change**

The authorities should articulate the key drivers for changing the current approach to self-regulation in India, and assess the importance of achieving the objectives of reforming the system. These objectives should be compared to the risks involved in making any proposed changes to the system. Any major changes carry risk, and the broader the scope of the planned changes, the greater the risk of failure. The major risks include:

- Capture of the SRO system by regulated firms or one segment of the industry;
- Inadequate corporate governance or management;
- Disruption to standards of regulation and supervision during the transition period;
- Reduced standards of regulation and supervision under the new system;
- Failure to build effective and capable new organizations;
- Overloading the SRO system with new responsibilities that it does not have time to build the capacity to address;
- Excessive interference by the statutory regulator in the governance and operation of SROs;
- A new system is not designed properly, leading to excessive duplication of activities and cost.

If major changes are contemplated, the industry and the authorities might consider taking an evolutionary approach to implementation in order to minimize the transitional risks involved. In addition, the approach to reforming the SRO system should be designed to mitigate these risks. For example, if maintaining high standards of regulation during the transition is considered to be a big risk, the approach should be designed to minimize the risk.

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

2.4.3 **Resources and Costs of Implementing Self-Regulation**

How adequate are the resources available to the statutory regulator and at the SRO level, including financing, infrastructure and human resources? SEBI's resources are limited relative to the scale of regulation and supervision needed in India. The regulator seems to be concerned about the growth of the industry and their capacity to deal with all of the activity without a more robust framework of self-regulation.

On the other hand, international experience shows that in making changes in SRO systems, the budget for the SROs and the funding formula are

contentious issues. A range of options for calculating fees to regulated persons exists. They include fees based on trading activity, revenues and assets. Also if the Exchanges relinquish any responsibilities for regulating their markets, whether they should contribute to the costs involved is an issue to be considered. In order to have an efficient system of self-regulation, the costs to the regulated entities needs to be devised through a consensus within the industry.

2.4.4 **Consensus on Approach**

There is a need to build consensus amongst the stakeholders on a ***'common vision'*** to a reformed regulatory structure. The industry and the authorities should consider plans to develop a consensus on any planned changes to the SRO system among industry participants and other stakeholders. We suggest the formation of a working group of key stakeholders, whose task would be to develop a detailed proposal. These stakeholders should include Ministry of Finance, SEBI, RBI, NSE, BSE, ANMI, FIMMDA, and potentially other groups/industry associations.

2.4.5 Approvals

The plan must identify the legal and regulatory approvals that are needed. SEBI should establish a formal process to consider applications for approval by a new SRO, and / or for proposed changes to the Exchanges' responsibilities. This would include terms and conditions for approval of a SRO. There are international precedents for licensing conditions, including a framework suggested by IOSCO. The top priorities are for the applicant to demonstrate that there are potential benefits in its establishing the SRO to the marketplace, its participants and its regulators; and it has, or is capable of putting in place, a sound corporate governance system, effective management and the institutional capacity to fulfill its regulatory responsibilities.

A group that proposes to organize a new SRO must develop a formal proposal and implementation plan, and file an application for approval with SEBI. This group could include the Exchanges. Sometimes creative solutions can resolve legal obstacles – for example contracting out of regulation functions from one body to another.

2.4.6 **Transitional Arrangements**

Whenever structural changes are made to a regulatory system, important transitional issues must be addressed. These include ensuring that:

- Regulatory processes continue uninterrupted, especially supervision of markets and intermediaries,
- Regulated persons remain within the legal jurisdiction of a regulator at all times,
- Open files and cases are transferred to new bodies without loss of jurisdiction,
- The transition to new management and governance is as seamless as possible,
- HR issues are addressed, including the contractual rights of any staff members who are transferred,
- Dispute resolution mechanisms are agreed to address any unforeseen issues that arise during the transition period.

3. Options for Securities Market Self-Regulation in India

3.1 Basic Models of Self-regulation

Based on international experience, there are four basic alternative approaches to using self-regulation. The models are theoretical and illustrate a continuum of options in relying on self-regulation. The approach in specific countries may lie somewhere in between two of the models.

In the context of reliance on self-regulation, the four basic models are:

A. **Government (Statutory) Model**
Regulation is performed by a public authority. Formal SROs do not exist. Exchanges are responsible for very limited supervision of their markets. *Examples:* UK (FSA), France (AMF), most EU countries.

B. **Limited Exchange SRO Model**
A public authority is the primary regulator; it relies on Exchange(s) to perform certain regulatory functions tied to operation of its market. *Examples:* Hong Kong, Singapore, Dubai, Sweden

C. **Strong Exchange SRO Model**
A public authority is the primary regulator; it relies on Exchange(s) to perform extensive regulatory functions that extend beyond its market operations, including regulating members' business conduct. *Examples:* US (NYSE[24], CME), Australia (ASX), Japan (TSE, OSE), Malaysia (Bursa Malaysia)

D. **Independent SRO Model**
A public authority is the primary regulator; it relies extensively on an independent SRO (a member organization that is not a market operator) to perform extensive regulatory functions. *Examples:* US (NASD & NFA), Canada (IDA & MFDA), Japan (JSDA), Colombia (AMV)

While there is no single 'right' approach, the last three models described above that employ SROs are realistic options for India. The government regulation model (for example, the UK approach), may not be consistent with the immediate priorities of Indian authorities.

3.2 Four Options in the Indian Context

Option 1: Restructure Existing Exchange SRO Model

This model is based on the view that an Exchange operating as a business has strong incentives to maintain sound regulatory standards, and that the conflicts of interest can be managed. It still prevails in many countries. In this model the statutory regulator relies on an Exchange to perform a wide variety of regulatory functions. However, given the trend towards increasing commercialization of Exchanges and potential listing, this

[24] The NYSE will cease to be a "strong SRO model" after member regulation is centralized in the new SRO that NYSE and NASD have agreed to create, as discussed above.

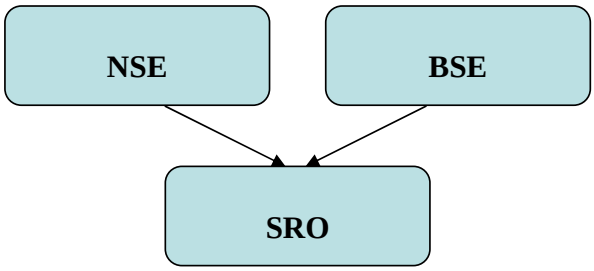
model poses conflict of interests issues that need to be managed through appropriate reforms in the governance and oversight arrangements.

In this model, India would continue to rely on the Exchanges – mainly NSE and BSE – as SROs. At a minimum, the Exchanges should be required to reform the organization structure, corporate governance and management of their SRO functions to address the conflicts of interests involved. Based on international precedents, a number of alternatives exist in these areas to address conflicts, but the key is to ensure sufficient independence of SRO operations. *(See Annex 4)*

While NSE and BSE could continue to perform SRO functions separately, a superior approach would be to encourage the Exchanges to create a joint SRO subsidiary. We acknowledge that it might be difficult for NSE and BSE to agree on this, but centralizing self-regulation functions is preferable for many reasons, especially in India where the two Exchanges share many common members, traded securities and regulatory standards. The benefits include:

- Uniform rules and policies for all members
- Integrated market surveillance across markets and a cleaner division of responsibilities and accountability between the SRO and SEBI
- Uniform broker inspection programs
- Uniform standards of conduct for sales representatives
- One SRO is better able to set standards for regulating new products across the industry
- Consistent approach to enforcement
- The SRO sees the full picture of both market issues and member firm activities, so can assess risk in a holistic way
- Minimizes duplication and gaps in regulation and SRO infrastructure
- Simple and cost-efficient
- Centralizes management and staff expertise
- Easier for investors to understand and deal with and
- Easier for the statutory regulator to supervise

Figure 3.1– Joint subsidiary of the Exchanges



If this structure is adopted, then it is important for the SRO subsidiary to be governed by its own board of directors, with a majority of directors who are independent of the Exchanges and of regulated brokers. This would ensure operational independence from

the Exchanges, which is important to address the conflicts of interest as well as to ensure the SRO operates effectively as an independent entity.

Many feel that this model is not practical because NSE and BSE have historically had minimal cooperation. However, conceptually this model should be considered. Regulation is a field where the Exchanges have strong incentives to cooperate, and where competing arguably has more disadvantages than benefits. In many respects regulation is a utility function that should be performed on a neutral basis to a common standard. Furthermore, both NSE and BSE would benefit by supporting a proposal that would enable them to reduce their regulatory responsibilities while ensuring that strong self-regulation continues to support the markets.

Although there may not be any exact precedents for this model in international markets, competing Exchanges have and continue to cooperate in establishing common infrastructure in other countries. Most notably, the NYSE and NASD recently agreed to merge their member regulation functions to create a new SRO in the US. Also in the US, Exchanges have cooperated to form a common industry technology services entity (Securities Industry Automation Corp.), a common clearing organization for options (Options Clearing Corporation) and a body to coordinate market surveillance (Intermarket Surveillance Group). In Canada, competing marketplaces have agreed to outsource market regulation to a central SRO, Market Regulation Services Inc. (RS). Recently RS and the IDA have agreed to merge to establish a new central SRO for both member and market regulation.

However, it is important to recognize that given the complexities of these types of arrangements, the role of government in facilitating solutions to restructure existing models could be crucial. For example, in the agreement between NYSE and NASD the SEC's involvement was decisive on how expedient this process was.

In India, a joint subsidiary of the Exchanges could be responsible for both Member Regulation and Market Regulation programs. This option could be considered a transitional stage to developing an independent SRO, as described below in Section 3.3 under *Phased approaches to a new structure*.

The advantages of this model are:

- The Exchanges provide an existing platform for SRO functions that works reasonably well. Many countries continue to use the Exchange SRO model because it is very difficult to develop new regulatory bodies from the ground up. This platform includes a governance structure, professional management, experienced staff, documented programs and procedures, and IT tools.
- It minimizes the risks involved in structural change.
- Other jurisdictions have developed ways to manage the conflicts of interest. Strict separation of the governance and management of SRO and business functions has emerged as a best practice. This approach could work in India.

The disadvantages of this model are:

- This option raises all of the issues on conflicts of interest at Exchange SROs. (As noted above, conflicts can be mitigated with reforms in organizational structure and corporate governance.)

- As business entities, Exchanges have little incentive to maintain and invest in broad regulatory responsibilities, especially in areas such as member regulation that are not directly tied to market operations. These conflicts exist now and will be exacerbated if / when the Exchanges become listed companies.
- Exchanges should be positioned to focus on market development, innovation and on increasing the competitiveness of India's capital markets. Major regulation roles detract from this focus.
- If a SRO with broader responsibilities is needed, Exchange SROs do not provide a logical solution for supervision of OTC trading, merchant banks etc.

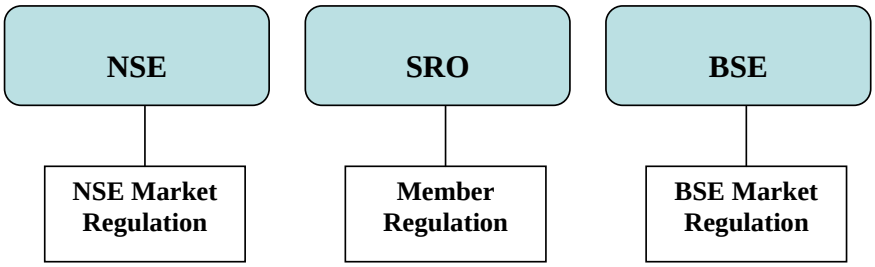
Option 2: Hybrid Model – Independent SRO for Member Regulation and Exchanges for Market Regulation

Under this option a new independent SRO would be created for member regulation functions. The Exchanges would continue to regulate trading on their own markets. This model is similar to the American approach adopted under the recent NASD – NYSE agreement to consolidate their member regulation programs. It is based on the idea that supervising members is best done through a centralized entity, but that regulating its own market is essential to an Exchange's market quality and brand. In this model, the statutory regulator relies extensively on an independent SRO instead of an Exchange to carry out regulatory functions. An independent SRO is a member-owned organization that is purely a regulatory body – it does not operate markets *(See Annex 1 for a description of the US model)*

This option is very similar to the proposal being mooted by the Association of National Stock Exchange Members of India (ANMI) to create a member-based SRO. ANMI's proposal envisages retaining its trade association role albeit in an insulated manner from the member regulation role. However, international best practice suggests that the SRO should not be based on a trade association because of the significant conflicts of interest between acting as an advocate for member firms and regulating those firms. A trade association's activities are important, but should be carried on by a separate organization.

Member brokers, represented by organizations such as ANMI, could sponsor a new SRO for member regulation. Alternatively, the SRO could be jointly sponsored by the Exchanges (who must transfer their SRO assets to it) and by member brokers, which would broaden the platform of the new organization and require the Exchanges to participate in its development and in the transition stage.

Figure 3.2–Hybrid Model



A variation on this model would see the Exchanges combine their market regulation functions as outlined under option 1. This would result in two SROs instead of three as would result from the hybrid model.

The advantages of this model are:

- Exchanges have incentives to perform market regulation for products traded on their markets. The arguments for combining all member / intermediary regulation in one body are stronger than for consolidating Market Regulation.
- It is less difficult to create a new SRO for member regulation only. If the Exchanges keep market regulation, the risks are lower than in creating a new "super SRO" from scratch.
- Independent member SRO could potentially accept financial institutions other than brokers as members.
- It is easier for an independent SRO to become responsible for the supervision of the OTC markets (bonds and equity)

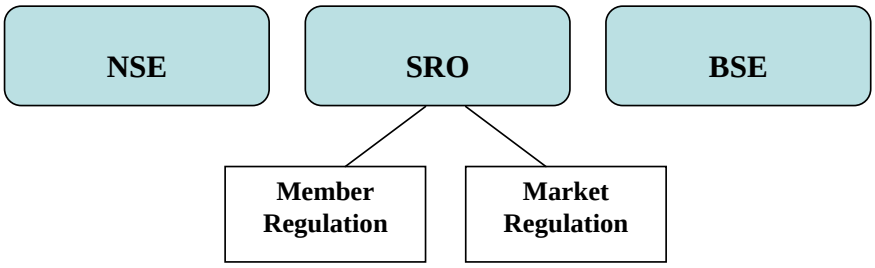
The disadvantages of this model are:

- If the Exchanges each regulate their own markets, market supervision will continue to be fragmented and less effective. Coordinating mechanisms such as the Intermarket Surveillance Group (ISG) and the SEBI / NSE / BSE committee are needed, but they have flaws. Centralized supervision is more efficient and effective.
- Conflicts of interest still exist for Exchange SROs in market regulation.
- Exchange SROs may not be suitable supervisors of OTC trading, not to mention trading on competing platforms such as regional Exchanges.

Option 3: New Central Independent SRO Model

Under this option a new central SRO would be created for both Member Regulation and Market Regulation. This model is currently being implemented in Canada through the merger of two independent SROs. The new SRO created by the recent NASD-NYSE agreement is also similar in many respects because the NASD also regulates trading on Nasdaq and several other markets under agreements signed with the markets. *(See Annex 1 for country examples.)*

Figure 3.3– New Central Independent SRO Model



As with option 2, member brokers, represented by organizations such as ANMI, could sponsor this new SRO. Alternatively the SRO could be sponsored jointly by the Exchanges (who must transfer their SRO assets to it) and by member brokers.

The advantages of this model are:

- A single independent SRO is theoretically a cleaner, efficient and more effective solution. It eliminates inconsistent standards or "non-level playing fields" and therefore promotes high standards of conduct and a professional approach.
- No regulatory arbitrage or, on the other hand, competition among SROs.
- It also best addresses conflicts of interest, especially if the SRO covers several segments of the industry, preventing any individual group from dominating its affairs.
- Independent member SRO could potentially accept financial institutions other than brokers as members.
- It is easier for an independent SRO to become responsible for the supervision of the OTC markets (bonds and equity)

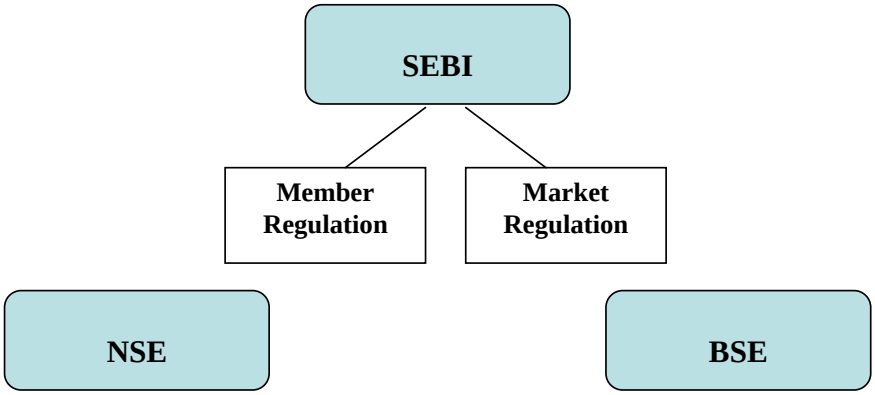
The disadvantages of this model are:

- The model is theoretically attractive but is difficult to develop. It took decades to put in place in North America. It requires a strong consensus among a wide range of stakeholders to implement successfully.
- The more responsibilities and segments of the capital markets that it covers, the greater the challenges for the SRO to succeed. The organization will require huge resources and could take years to build and fully implement.
- A wide-ranging SRO would require very strong leadership and governance, including an ability to set clear and limited priorities.
- Even if its scope is limited to the securities arena, the challenges involved in building a new "super agency" from scratch should not be under-estimated. The regulators', investors' and the industry's expectations of the new agency might prove impossible to meet. It might be more practical to adopt a less challenging model and see how it evolves.
- This agency has the potential to become a "political football" that invites intervention from SEBI and Government.

Option 4: Government model

Under this approach regulation functions are centralized in the statutory regulator. Most SRO functions would be transferred from the Exchanges to SEBI, with the exception of Exchange trading rules, Listing functions and perhaps basic front-line market monitoring. This model is employed where governments believe that it is not appropriate or efficient to rely on private bodies to carry out regulation, which is by nature a public function. The UK is a primary example of this model. *(See Annex-1 for details on country examples)*

Figure 3.4– Government Model



The advantages of this model are:

- SEBI has a broader regulatory mandate and wider powers than a SRO, and thus could be more effective.
- A single-tier regulatory structure could be simpler and more efficient, if SEBI could obtain sufficient resources to perform all functions.

The disadvantages of this model are:

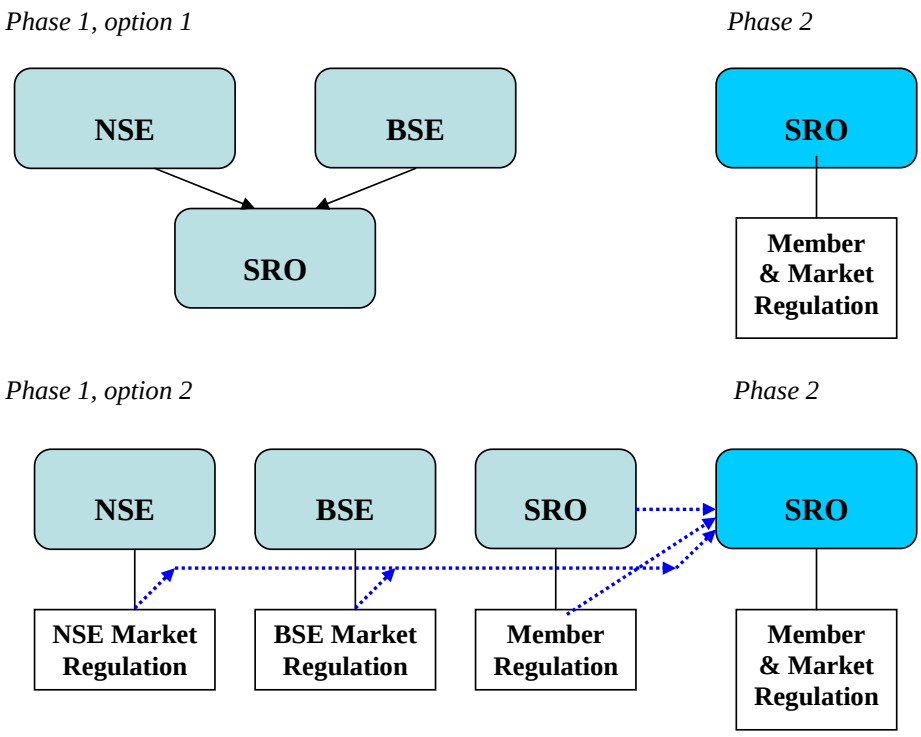
- The model is inconsistent with the current approach articulated by the Indian government and promoted by SEBI.
- The model does not appear to make sense in India because the markets are large (and growing rapidly), complex and diverse. SEBI probably could not effectively assume all regulatory responsibilities directly, due to constraints on its resources and capacity. **This model requires the Government regulator to obtain significant resources** in order to cover the full spectrum of regulatory responsibilities. A system that employs SROs is more likely to have greater overall levels of regulatory resources and expertise. Even with generous funding, the government regulator may not have the technical capacity or expertise to deal with all of the detailed and technical rules and programs required to govern complex markets, investment products and a wide range of financial intermediaries. A statutory regulator may not be able to attract people with market experience, or be able consult with participants as closely as a SRO can.
- The advantages of using industry knowledge in the supervision of the markets may be lost. This is why the UK and other European regulators are currently exploring greater involvement of the industry in supporting regulation, without using formal SROs.
- Another potential disadvantage of this single Government regulator may become too powerful or bureaucratic, and less responsive to the needs of the industry. An SRO system provides some checks and balances in the regulatory system and provides a voice for the members of the SRO in regulatory policy.

3.3 Phased approaches to a new structure

If the authorities decide to create a new central, independent SRO along the lines of option # 3 above, then they could consider moving from the current SRO system based on NSE and BSE to the new model in phases. A phased approach to change would mitigate the risks involved in making major changes in the self-regulatory system. Creating a new independent SRO from scratch would be a formidable challenge. Significant risks arise if the project runs into problems during the complex tasks of obtaining agreement on and approval of a plan, implementing all facets of the plan, and building the new institution.

A phased approach would leverage the NSE's and BSE's existing SRO programs and encourage the Exchanges to be actively involved in implementing the new system. Phase 1 could be based on either option # 1 or # 2 above. The former would be mainly Exchange-driven; the latter would be mainly Government-driven. For instance, if the Exchanges cannot agree to create a joint SRO subsidiary, then phase 1 could be based on option 2.

Figure 3.5– Phased approach



Note: ····▸ *represents transition to Phase 2 which is Option 2 described earlier*

The basic steps involved in implementing a phased approach based on option 1 are set out below.

1. NSE and BSE agree to create a joint subsidiary company, with its own board of directors, to perform their SRO responsibilities. (This would not include their Listing Departments.) See description of option # 1 above.

2. NSE and BSE transfer their regulatory staff, programs and tools to the subsidiary. NSE and BSE provide services and support to the sub in areas such as HR, IT systems and databases, and finance. The sub could be financed partly by the Exchanges and partly by regulatory fees charged to members. NSE and BSE would lower their fees to reflect lower costs due to transfer of regulation functions.

3. NSE and BSE regulation programs are merged within the new SRO unit. Where rules, policies, procedures and tools differ, management would be expected to adopt the best practice or highest standard.

4. NSE and BSE monitor the performance of the subsidiary to ensure that it meets high standards of regulation and performs effectively. NSE and BSE will remain accountable to SEBI for performance of the subsidiary.

5. After a 2 to 3 year transition period, an assessment is made to determine if the SRO subsidiary is ready to be spun off by NSE and BSE and become an independent organization. At this stage, the subsidiary should have completed the implementation phase covering its governance, management, strategy, organizational structure and regulation program. Its governance, regulation functions, financial position and related operations (including IT) must be stable and working effectively. NSE, BSE and SEBI must agree that the SRO is on a sound footing and is ready to become an independent entity. The industry (regulated firms) should also be consulted.

6. The SRO is spun off from the Exchanges and obtains SEBI approval as an independent entity. A new "ownership" is agreed but continuity is maintained in all other aspects, especially the composition of the board of directors and management.

Benefits of following the phased approach:

- NSE and BSE, as the existing professionally managed SROs, sponsor creation and development of the new entity and remain accountable for self-regulatory standards.
- NSE and BSE foster the new unit's development through provision of advice, services and support as well as transfer of existing regulatory HR, infrastructure and tools. This includes IT services provided by the parent companies.
- NSE and BSE ensure that the new unit has effective corporate governance and independence from regulated firms by selecting credible, highly qualified individuals to sit on the board.
- NSE and BSE oversee the new unit to ensure that it is working effectively. The Exchanges will help to resolve any problems that arise and, if necessary,/ will contribute funds to address issues.

- The Exchanges will be permitted to relinquish their SRO responsibilities only when it is demonstrated that the SRO unit is capable of operating effectively on a fully independent basis. The timing is flexible, so an independent SRO is created only when the Exchanges, SEBI and the industry agree that the organization is ready to become independent.
- This transition plan significantly minimizes the risks involved in creating a new institution by ensuring that the new organization is built on an existing, proven platform.
- This option could be the fastest to implement, with lower risks in its implementation.

Challenges in achieving this phased approach:

- It is recognized that NSE and BSE may not be able to reach agreement on creating a joint SRO subsidiary. NSE has a bigger market share and this will be a factor.
- However, both Exchanges should recognize that building an effective, independent SRO is clearly in their respective business interests. As fully demutualized, commercial entities, it does not make sense for the Exchanges to continue their full-fledged SRO roles, either from a business standpoint or a regulatory / public policy standpoint. The proposal provides an exit strategy from SRO responsibilities for the Exchanges that minimizes the risk to the public, the market and their own businesses.
- The phased plan provides a means for the Exchanges to relinquish most of their regulation functions while minimizing the risk of lower regulatory standards, gaps or other problems arising. The ExchangesExchanges have a very strong business interest in maintaining, and in fact raising, sound standards in SRO regulation.
- Furthermore, consolidating their regulation functions in one new organization is clearly a more effective and cost-efficient approach to self-regulation. Effective and efficient regulation will better support both NSE's and BSE's businesses going forward, not to mention supporting market development in Indian capital markets. A central SRO unit will reduce cost for the industry while being more professional and easier for SEBI to oversee.
- While creating SRO subsidiaries at each Exchange is an alternative, it is a much less desirable alternative because it would perpetrate conflicts and competition between the two Exchange's subs that could prove fatal to any planned consolidation in the future.

4. Depositories, Marketplaces and Industry Associations

Many forms of self regulation currently exist for financial markets to achieve the objectives of self-regulation as defined by IOSCO[25]. There are industry self-regulatory organizations, Exchange self-regulatory organizations and private associations that define and encourage adherence to standards of best practice among its participants. As discussed earlier, in its most complete form, self-regulation would entail the authority to create, amend, implement and enforce rules of conduct with respect to entities in the SRO's jurisdiction[26]. This authority is usually derived from formal legislation or delegation of power by statutory authorities. On the other hand, there are number of organizations that provide valuable industry input in terms of codes of good conduct and master agreements and perform important roles in the standardization of common practices without any formal regulatory status.

In India, besides a solution for securities market self-regulation, currently there seems to be a debate on how best to supervise and regulate participants in other industry bodies such as depositories, clearing agencies etc. While not SROs, they must be licensed and overseen by SEBI in accordance with international standards, including IOSCO principles. Secondly, the question of how to regulate other segments of the capital markets arises, including mutual funds, merchant banks and investment advisors. The primary issue for these segments being debated is whether they should be formally self-regulated today, and if so, by a dedicated SRO for the segment, or by a central, independent SRO along the lines mentioned in Chapter 3 above.

As an alternative to formal self-regulation, another option is to ask industry associations to play a standard-setting role; including setting a code of conduct as is done in other jurisdictions. This might be considered as a less challenging alternative to establishing several SROs simultaneously, or requiring a single new SRO to take on regulation of all of these segments. It could be useful to follow the initiatives of the UK, France and some European securities regulators to use industry trade associations to become more involved in supporting implementation of standards set by the regulators. In a recently issued document for discussion the AFEI (French Association of Investment Firms) is seeking "a form of self-regulation" that can tentatively be defined as "the possibility for industry associations, professional bodies and other representative organisations to define for their members, rules or guidelines, appropriately embedded in the legal environment, that are aimed at promoting one or all of investor protection, market integrity and market efficiency":[27] It is a renewed approach that will probably focus on wholesale markets and will not involve enforcement activities, but rely on the statutory regulator for those matters.

Comment [w1]: Clemente, could we please redraft this paragraph as I am not sure I understand the import of this document. Also when we say 'renewed' effort in the last line in this paragraph, what exactly do we mean?

[25] The IOSCO Objectives and Principles of Securities Regulation define the broad objectives of self-regulation as follows: to preserve market integrity (fair, efficient and transparent markets), to preserve financial integrity (reduce systemic risk) and to protect investors.

[26] Usually, unless an organization has the power and legal authority to impose rules that persons within its jurisdiction are obligated to comply with, and to enforce its rules by taking disciplinary action, it is not a SRO. Furthermore, a SRO is licensed or "recognized" by a supervising regulator that is responsible for oversight of the SRO's operations.

[27] "The new role of self –regulation in European securities markets", document for discussion, Afei, June 6th 2007.

One of the main issues that needs to be highlighted in the Indian context is that the recognition that each industry body or segment could be properly categorized as 1) a SRO; 2) another form of recognized or licensed body by SEBI; or 3) a private industry association that sets standards and best practices but has no official status. All these forms of industry participants can co-exist effectively and contribute to the objective of self-regulation without having to have all of them function as SROs or members of SROs. In this section, the note will provide a conceptual framework for the practices of self-regulation as these apply or could apply to (A) industry bodies (depositories, clearing agencies); (B) other segments/associations (mutual funds, merchant bankers, registrar and share transfer agents, investment advisors); (C) Marketplaces; and (D) market structure (OTC trading of bonds).

A. Industry Bodies

4.1 Depositories

It is well established internationally and in IOSCO principles that Central Securities Depositories (CSDs) should be officially licensed or recognized bodies subject to regulatory oversight. This includes establishing standards for their governance, admission of participants, rules and risk management policies. Whether categorized as SROs or not, CSDs should be subject to many of the same disciplines as a SRO. They have a limited form of regulatory authority in administering rules for participants. However their rules only cover how a participant uses clearing and settlement services, and *do not* extend to setting requirements for business conduct or other areas.

As a part of its on-going market reforms, the Government of India enacted the Depositories Act in 1996 followed by the Depositories and Participants Regulations. Following the enactment, the first depository National Securities Depository Ltd. (NSDL) was setup in November 1996 and the second depository Central Securities Depository was setup in 1999. The Depositories Act provides for dematerialization to enable book entry based transfer of securities and settlement of securities traded.

The depositories undertake certain regulatory functions such as rulemaking, supervision and enforcement in the context of the depository participants. The Byelaws issued by the depository under the Depositories Act are approved by SEBI and define the scope of the functioning of the depositories and their business partners (depository participants). Under the regulations, a depository is expected to certify the eligibility of a depository participant as per its bye-laws and offer recommendations to the regulator at the time of registration[28]. The Business Rules issued by the depositories outline the operational procedures to be followed by the depository and it's "Business Partners." In addition, the depository can also carry out inspections of the depository participants relating to operational issues. The functions and regulatory responsibilities of the depositories have come into question lately as illustrated in the Box 4.1 below.

Box 4.1: IPO Scam and the role of the depositories

[28] A majority of the depository participants in India are stock brokers followed by banks.

Following a recent scam in late-2005 in the initial public offering market in India, there has been greater scrutiny of the role of the depository in overseeing activities of depository participants. The scam involved opening of thousands of share trading accounts with depository participants and bank accounts in fictitious names by several individuals in order to corner shares issued through IPOs under quotas that are reserved for retail investors. SEBI ordered an independent audit of the operations of the National Securities Depository Ltd. following the IPO scam. The audit report pointed out inadequate controls, systems and procedures of NSDL for monitoring and evaluating compliance with statutory requirements and supervision of Depository Participants (DPs) especially with 'know-your-client' requirements. Subsequent to this, SEBI had in its ruling in November 2006, found the depository (NSDL) and some of the depository participants negligent in carrying out their responsibilities and functions. The depository and some of the depository participants were held jointly and severally liable for not containing the IPO scam and have been required to disgorge about $ 26 million that was estimated to have been the cost of this scam to retail investors. There has been a great deal of legal and media attention on this case as this has been the first order of disgorgement in the Indian securities market. However, whether the action taken by SEBI qualifies as a disgorgement as opposed to being a penal order is being widely debated. SEBI's order was subsequently overruled by the Securities Appellate Tribunal stating that the issues involved in the appeal require a detailed consideration. The fallout of this scam has led to the policy makers questioning whether the depositories should be included as part of any new design that will be put in place for the SRO system.

International best practice indicates that the Depositories should remain independent, recognized bodies overseen by SEBI rather than be incorporated into a new SRO. Depositories should continue to administer their own procedural rules and risk management policies for participants directly because of the unique technical and risk management issues involved in their operations. A CSD usually has greater industry representation in its governance than would be the case with an Exchange or an independent SRO. Incorporating Depositories into an SRO would complicate the SRO's membership requirements, governance and operations.

If depository participants need to be regulated by a SRO – for example to ensure that they comply with rules on capital requirements and conduct of business – then all participants should be required to become members of the SRO responsible for member regulation functions. The Depositories should enter into information sharing MOUs with the SROs to ensure that the SROs can obtain information about member and client deposit activity as needed for investigating members' compliance with SRO rules.

B. Other Industry Segments

4.2 Mutual Funds

Government regulators usually regulate the creation and operation of mutual funds by mutual fund companies. However many mutual fund industry associations establish codes of conduct, guidelines on best practices and so on. In India as well the Association of Mutual Funds of India (AMFI) plays this role. AMFI, the apex body of all the registered Asset Management Companies was incorporated in 1995 as a non-profit organization and has as its members all the 29 Asset Management companies in India that have launched mutual fund schemes.

As a trade association, one of AMFI's primary objectives is to represent the interests of its members to the regulators. In addition, it also has been instrumental in defining business practices and codes of conduct for its members. As the sale of mutual funds by its members grew, AMFI has also taken on the responsibility of implementing a

program of training and certification for all intermediaries and other engaged on the sales/distribution side of the mutual fund industry[29]. However, AMFI has been reluctant to take the mantle of an SRO for the industry as it feels it will lose its flexibility and member focus. Internationally, we are not aware of any, mutual fund industry association becoming an SRO (for example, the Investment Company Institute, is the industry association for the mutual fund industry in the United States and is not an SRO).

While mutual funds are not usually organized as SROs, in jurisdictions where existing SROs regulate sales of securities, they are also responsible for regulating the sale of mutual funds by their members. In Canada, a new SRO called the Mutual Fund Dealers Association of Canada (MFDA) was created five years ago specifically to regulate specialized dealers in mutual funds. There are separate self-regulatory structures for mutual fund dealers and for securities dealers that handle a wider range of securities and financial products, but many observors feel the system creates unnecessary duplication. Some have proposed that the MFDA should regulate the mutual fund operators as well. In the US, the NASD permits more limited qualification standards for firms that only sell mutual funds, so only one SRO is needed.

4.3 Industry Associations

Industry associations, such as those for merchant bankers, bond dealers and other types of intermediaries, can play a useful role in raising market standards, providing basic infrastructure such as trade reporting systems and defining standard rules of practice and conduct. The Fixed Income Money Market and Derivatives Association (an association of Commercial Banks, Financial Institutions and Primary Dealers, incorporated as a not-for-profit company in 1998) is an example of such an industry association. The roles performed by such industry associations do not necessarily require becoming a full-fledged SRO which would then be subject to all of the terms, conditions and oversight arrangements associated with stock exchanges.

Most regulators can achieve a great deal by using “moral suasion” to persuade industry bodies to take on issues. This might be a practical starting point for industry associations in India as well. It is also important to consider whether SEBI would have the capacity at this stage to shepherd along a number of new SROs, establish terms and conditions for their approval, and oversee them all continuously.

4.4 Investment Advisors

The USAID has prepared a draft report dated April 2007 entitled *Developing a Road Map for Investment Advice Regulation* which covers the topic in great depth. In light of this report, this Note does not discuss regulation of investment advisors in detail. On a brief review,, the Bank team is in general agreement with the report’s analysis and recommendations. In this section the analysis focuses on how the regulatory

[29] The Securities and Exchange Board of India (SEBI) has made mandatory for any entity / person engaged in marketing and selling of mutual fund products to pass AMFI certification test (Advisors Module) and obtain registration number from AMFI.

structure recommended in USAID's report can be integrated with the SRO structures suggested in this Note.

In its recent discussion paper on 'Investment Advisors' posted on its website, SEBI has proposed introduction of a 'private sector self-financing regulatory organization'. SEBI's proposal is consistent with the structure recommended by USAID.

Box 4.3 Experience with regulating investment advisors in other jurisdictions

Comment [JC2]: Do you want to keep this box in light of the USAID Report?

YES we could retain this.

In the US different standards of regulation apply for advisors with regulated member firms of NASD than apply outside of regulated securities business. "Investment advisors" (also known as "brokers" or registered representatives (RRs)) that work for broker-dealers are regulated as employees of NASD members. The primary focus of regulation of this group is "sales compliance", meaning dealings with customers. This is a joint responsibility of the RRs and their firms. Firms have a responsibility to supervise RRs to ensure compliance and fair treatment of clients. Firms must carry out reviews of client trading on a daily and monthly basis for this purpose. Usually such reviews are facilitated by automated tools that identify anomolous or risky trading. The system is the same in Canada.

The main rules involved are the 'know your client' and suitability rules. Basically, investment recommendations and advice must be suitable for the client based on his financial needs and circumstances, as documented in the KYC process. (Of course this does not apply to "discount brokerage" or on-line trading directed by clients.) In addition, there are general standards of conduct that apply; for example a duty to act in the best interests of clients, to avoid conflicts of interest and to act fairly, honestly and in good faith.

Today, sales compliance is the biggest area of NASD operations. This is not surprising one considers the total number of individual RRs and client investors. This is why member regulation is a much bigger area of operations than market regulation. In addition to SEC and SRO regulation, arbitration (administered by the NASD) and lawsuits are a common tool used by clients for complaints about suitability and other compliance failures.

Outside of regulated securities firms (i.e. firms that are not members of a SRO like the NASD) financial advisors, financial planners and the like are not formally regulated. Under securities laws, strictly speaking they are not supposed to provide advice on investing in specific securities. Although these persons are not regulated, they are still subject to statutory and common law, and state-level regulation may provide some protection. In addition, industry associations exist for planners which usually would set codes of conduct (but they are not enforceable).

Advertising by securities dealers is regulated by specific rules, which are quite complicated. All firms must have internal policies and procedures governing marketing and advertising. In Canada firms' policies must be approved by the IDA. All marketing communications from investment advisors / RRs must be approved internally by an appointed supervisor before use. This includes emails to multiple clients. All emails must be stored and available to regulators.

Media is not regulated. The key point is that media journalists do not offer specific advice although they do comment on product features and risks. (Again, by law only registered persons can provide advice on specific securities.) Recommendations on specific securities are only provided through the media when a journalist quotes research material or investment analysts who are employed by regulated securities dealers (or a TV journalist interviews such a person).

In the UK, investment advice is an 'authorisable' activity in its own right and therefore investment advisors must be licensed by the FSA. That has not necessarily been the case across Europe but will be when MiFID comes into force in November 2007. In the UK, there is no SRO involvement in regulation of investment advisors. SROs were abolished in 1999. (Exchanges perform limited market monitoring as recognized bodies). Investment advisors may or may not be affiliated to other registered firms such as (stock) brokers or banks, although brokers and bankers who give investment advice are covered by their firm's license if it includes giving investment advice. There is also a group of 'tied agents' who advise on the products of only one originator (insurance company or fund manager) and

for whom the originator takes responsibility. These companies do not require their own authorization. A similar regime operates in Germany.

Given the huge universe of investment advisors there is potentially a large burden of supervision involved for the FSA. However, FSA does not supervise them individually, but uses select examinations of firms to investigate specific issues and operates a help line for them. As in North America, the primary onus for ensuring advisors' compliance is on the firm.

It is important for Indian markets to achieve international standards of licensing and supervision of investment advisors, including both 'salespersons' employed by brokers and those employed by other securities distributors. The USAID report identifies a gap in regulation of investment advisors because securities distributors (SDs) provide investment advice but are not regulated as Exchange brokers are. The USAID report rightly concludes that:

- "We do not think that it is possible to consider any regulatory scheme for investment advice regulation without coverage of IAs/SDs. Securities market regulation will be incomplete and ineffective if it does not cover all those who interface with customers providing investment advice and distributing securities products to them."

- "Ideally investment advice should be regulated by one regulator across all retail financial products. The same IAs and SDs distribute and advise on multiple products. Separate regulatory regimes are confusing to the industry and to investors and provide avenue for regulatory arbitrage."

The report also makes a proposal to establish an independent SRO overseen by SEBI to regulate investment advisors. The report suggests starting with the securities sector. Both of these proposals are consistent with the proposals for a new SRO structure discussed in this Note.

Since the USAID report focuses on regulating investment advisors, it proposes creating a new private sector regulator to perform this function. However, a preferred approach would be to assign this function to a new securities SRO that is responsible for overall Member Regulation. It would not be practical or efficient to establish a separate SRO simply to regulate investment advisors; i.e. to set certification and licensing standards, to set rules on "sales compliance" or dealings with customers, and to supervise compliance with regulations through inspections of member firms. These areas of regulation are all important elements of Member Regulation, as the term is used in this Note. There are many synergies between regulation of investment advisors and other areas of regulating member firms' business conduct. Therefore, the most effective approach would be to centralize these functions into a SRO that has overall responsibility for regulating securities firms.

In implementing a new regulatory regime for investment advisors in conjunction with establishing a new SRO system, a fundamental issue is *when* the new regime should be adopted. The issues involved in regulating investment advisors are complex, including defining what persons will be regulated, deciding and establishing new education, certification and licensing standards, and determining the specific rules on dealings with customers that will be adopted. Once these rules and standards are decided, implementing them across all of the firms and investment advisors covered by the system will be a huge task.

Introducing full-fledged self-regulation of investment advisors might be ambitious in the near term, in particular given other priorities discussed in this Note and the larger questions of financial regulatory architecture that this would raise. It would be a prerequisite for all securities distributors to become members of the SRO, while the proposals in this Note are based on starting with regulation of Exchange brokers since they are currently within a self-regulatory environment.

In implementing a new regulatory regime for investment advisors two basic approaches are viable:

(1) If a new SRO is established, it could introduce a basic investment advisor regulation program within its Member Regulation program within the first few years of the SRO's launch. This assumes that agreement can be reached on conditions of membership for securities distributors. A basic program might cover training, certification and licensing of salespersons in core securities markets, and introducing basic rules on dealings with clients. Once this program is created, the next step would be to introduce SRO inspections of members' compliance with these rules. Over time, this program could be developed by introducing more comprehensive standards, rules and inspections, with the goal of achieving international standards.

The USAID report recognizes the need to phase in a new regime for investment advisors. It states:

> "The timing of implementation phases is discretionary and may be determined by consensus or by the sense of urgency regulators have for each market segment. Regulation may begin with stock advisers and mutual fund advisers then extend to financial planners and portfolio managers. Regulation of advice about other products can then be included."

(2) A new SRO's involvement in regulating advisors could be delayed for several years until the SRO's programs covering existing areas of self-regulation are fully established. In the meantime, SEBI could encourage industry associations for investment advisors (such as the Financial Planning Standards Board) and Exchange brokers' associations to take a stronger role in establishing standards and codes of practice.

Regulation of sales practices is fundamental to investor protection. On one hand, creation of a new SRO presents an opportunity to develop a set of consistent, industry-wide policies and requirements on certification, licensing and client dealings based on international standards. If left to industry associations, they could develop a range of inconsistent policies and requirements. It could be difficult to reconcile these later. On the other hand, requiring a new SRO to assume responsibility for organizing a new licensing and regulatory regime for all investment advisors in its start-up phase could prove to be too difficult a task to deal with.

In regulating both investment advisors and broker sales representatives in India, the approach adopted should stress making firms (brokers and securities distributors) accountable for their own operations. Given the sheer numbers it would not be possible for the regulator or SRO to fully monitor for compliance. In order to ensure

effective supervision, Member firms should be responsible for supervising their own business operations, including investment advisors' conduct. Sound standards of internal supervision and compliance are integral to the governance, management and operation of a regulated securities dealer. This approach is consistent with international standards.

For example, in Canada the focus of SRO examinations of members is on firms' supervisory and compliance policies and procedures. Firms must have written internal supervision policies and procedures, and their own internal market surveillance and broker monitoring programs. Firms are expected to identify and catch regulatory compliance issues, and deal with them. In this manner the regulator and the SRO share the burden of regulation by keeping the onus of compliance with regulatory requirements an internal controls process. This also in large part explains the reason why securities firms in developed markets have large, professional compliance staffs.

C. Marketplaces

If Exchanges cease to be SROs, once they relinquish their regulatory responsibilities to the SRO, they still must be licensed / recognized and subject to regulatory oversight, in the same manner as CSDs. Again, this is well established internationally and in IOSCO principles. There are many precedents on the standards that marketplaces must meet and on oversight programs.

To the extent that an Exchange is relying on a SRO to license and regulate its participants, all participants would have to become SRO members in order to qualify as a trading participant in the Exchange. Also, all the requirements in question would have to be in the SRO Rulebook (or incorporated by reference).

D. Regulating OTC Bond Trading

The authorities aim to develop the corporate bond market in India. The plan includes developing a trade reporting system for OTC bond trading to complement reporting of trades on the Exchanges. The availability of comprehensive trading information for bonds raises the question of how the information should be used for regulatory purposes, including surveillance of the debt markets. This issue could also extend to trading in government bonds.

The mandates of SEBI and RBI in supervision of OTC debt market activity need to be clarified. While SEBI has legal jurisdiction over the securities markets, including the OTC markets, it would be helpful to agree on how SEBI and / or the SROs will access OTC bond trading information, and what types of supervision programs should be in place. The answer should be based on a regulatory risk assessment relating to important regulatory or investor protection issues exist in the bond markets.

If the bonds are publicly offered, registered with SEBI but traded in the OTC, it seems natural that trading should be monitored by the regulator and the SRO. The complexity arises if the parties involved in the trade are not registered with SEBI.

For example in the USA, the NASD monitors trading in corporate bonds, and banks can only trade corporate bonds through their broker dealer subsidiaries, not directly. (The exception is the government bond market where banks are allowed to trade directly.)

If SEBI's role is clarified, the next step is to decide on the role of the SROs in regulating OTC bond trading. This could have an impact on the preferred structure for self-regulation. For example, NSE and BSE are not best positioned to regulate off-Exchange trading. Although all trade reports for corporate bonds could be merged, and market surveillance could be outsourced to the Exchanges by contractual agreement, Exchanges do not have jurisdiction over non-member intermediaries. An independent SRO would probably be a more logical regulator of OTC markets. Since banks are major players in the OTC bond markets, one possibility is that banks could become limited-purpose members of an independent SRO for purposes of supervision of their OTC securities trading.

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Annex 1 International Trends on Reliance on Self-Regulation

There is a clear international trend to vesting greater authority in public regulatory bodies and reducing reliance on SROs. In many parts of the world the value of self-regulation has increasingly been questioned, and the authorities have reduced reliance on self-regulation. This trend affects Exchange SROs in particular because the most significant reason for the trend is demutualization (or commercialization) of Exchanges. A large majority of SROs around the world are Exchanges and the commercial model for Exchanges is now the preferred model. The great majority of Exchanges in developed markets are demutualized, as well as in a large number of emerging markets. A significant number are now public, listed companies with widespread investor ownership. The industry has experienced significant consolidation which is now occurring cross-border as international mergers gain acceptance. The commercialization of the Exchange industry has posed significant challenges for self-regulation and led to major changes in Exchanges' SRO roles in many countries.

In many countries this metamorphosis in the global Exchange industry has led to the transfer of some regulatory powers and responsibilities from Exchanges to statutory authorities. In other countries, Exchanges have transferred or contracted regulatory activities to independent SROs. The ICSA Working Group on Self-Regulation states that organizational separation of Exchanges' SRO units and the transfer of regulation responsibilities are the two main identifiable trends affecting the regulatory activities of demutualized Exchanges.[30]

Both regulators and Exchanges continue to reconsider the self-regulatory roles of Exchanges in light of their focus on business and market development. Governments and regulators have questioned whether a for-profit Exchange can effectively perform regulatory responsibilities. The prevailing view is that an Exchange's primary role is to operate an efficient market platform, and it should be positioned to compete successfully in international markets. As Exchanges focus on business development, they are increasingly seeking to narrow their regulatory functions to areas that are directly tied to business operations, such as trading supervision.

Demutualization heightens concerns about conflicts of interest. A global debate continues on the question of whether Exchanges can successfully balance their public interest and regulatory responsibilities with their business mandates. The jury is still out on this complex issue. Although most regulators and Exchanges believe they can reconcile the two, there is a trend towards scaling back Exchanges' regulatory responsibilities. See Annex 4 for more details on conflicts of interest.

Demutualization triggers changes in Exchanges' strategies and priorities that inevitably impact their regulatory roles[31]. This affects both the *scope of regulatory functions* and the *approach to regulation* and enforcement. Exchanges are asking which functions are core to their business and add value to their products and services. They also seek to eliminate duplication and overlap with government regulators' activities.

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[30] *Self-Regulation in Financial Markets: An Exploratory Study*, Working Group on Self-Regulation of the International Council of Securities Associations (ICSA), September 2006, http://www.icsa.bz/pdf/Self-RegulationFinancialMarkets.pdf

[31] Carson, John – Conflicts of Interest in Self-regulation: Can Demutualized Exchanges Successfully Manage Them?, World Bank Policy Research Working Paper 3183 (2003).

As a practical matterr, a demutualized Exchange ceases to be a self-regulatory body as traditionally defined when member firms no longer own the Exchange. The concept of self-regulation requires that members have a significant degree of control and influence over the rules, policies and operations of the organization. Most Exchanges today are really private regulators, not self-regulators (although they often are SROs under securities laws). Exchanges are increasingly described as *front-line regulators* for this reason. Since self-regulation of broker-dealers is an activity that extends well beyond Exchange markets and products, this is another factor in Exchanges narrowing their regulatory roles.

In spite of these concerns, most Exchanges continue to be responsible for important regulatory functions. Many jurisdictions require a regulated market to maintain self-regulatory responsibilities and mandate a public interest role for Exchanges in the law or regulations. Also, statutory regulators in many countries benefit from the resources and specialized expertise that an Exchange or SRO can contribute to effective regulation of the market. These factors can be especially important in emerging markets where budgets of statutory regulators are limited.

Exchanges' regulation roles are still evolving and it is not yet clear where the trend to reduced regulatory roles will lead. One view is that Exchanges as market operators will become just another category of licensed financial intermediary, similar to a bank or broker. On the other hand, many Exchanges believe that regulation is central to the quality of their services, and hence to their "brand". Almost all Exchange SROs retain control over the quality of supervision of their markets and listing standards, which benefits their businesses. Exchanges also have specialized expertise in the trading rules and operations of their own markets, which may enable them to do a better job of surveillance and compliance.

In countries that want to promote competition among Exchanges or markets, moving regulatory authority to public authorities fosters competition. All Exchanges operate in accordance with a uniform set of rules established by an independent regulator. Exchanges cannot use self-regulatory powers to impose rules that impede competition. This result can also be achieved by transferring SRO functions to an independent SRO that is not a market operator.

Transferring regulation responsibilities from Exchange SROs to independent SROs is an alternative to centralizing functions in a statutory regulator. Arguably traditional member-based self-regulation can only be preserved if alternative member-owned organizations, namely independent SROs like the NASD, assume Exchanges' regulation functions. On the other hand, some believe the most important principle is to maintain front-line regulation by private organizations in the market, not self-regulation by member firms. This approach is being taken in jurisdictions where statutory regulators do not want to assume the full regulatory burden as Exchanges become business corporations. Others, especially regulated firms, may consider active participation by members in policy development and governance to be fundamental.

The US and Canada rely extensively on independent SROs, and in both countries the role of independent SROs has expanded as Exchanges shed regulation responsibilities. The recent agreement between the NYSE and NASD to consolidate all of their member regulation functions in one SRO has given significant impetus to this approach.

Apart from the role of Exchanges, **self-regulation is also being diminished because a number of countries have adopted, or are considering, the UK model of a universal, statutory financial regulator.** The UK Financial Services Authority (FSA) is a quasi-independent body with statutory powers that reports to the Government. This model is designed to streamline the regulatory system by consolidating all regulation of the financial services industry in one organization. It eliminates the additional layer of regulation that SROs create. The model is discussed in more detail below.

Even where a specialized securities regulator continues to exist **many governments have concluded that it is not appropriate to assign public regulation functions to a private body** and especially not to a commercial company such as an Exchange. This is particularly true throughout the European Union. It also applies to a number of countries in Asia and the Middle East, where countries now aim to create a strong, efficient statutory regulator alongside a competitive, innovative Exchange. In countries with small markets it is difficult to justify several layers of regulation. Furthermore, countries that have limited experience with self-regulation take the view that better regulation and standards will result if regulation functions are centralized in a statutory body, especially if an SRO could be "captured" by the industry.

Finally, securities markets regulation has become stronger and more complex around the world as pressure to increase standards of conduct rises. This trend has reinforced the expansion of the role and authority of public regulators because they have much broader jurisdiction and powers than SROs, and are seen as stronger, more effective regulators. Public regulators are expected to impose higher and more consistent national standards of regulation.

The trends described above have led to extensive "co-operative regulation" in many markets. Both statutory regulators and SROs are often active in the same areas. For example, in the US most areas of regulation involve both the SEC and the SROs and many initiatives are joint undertakings. The WFE survey shows extensive use of cooperative or shared regulation instead of a clear division of responsibilities. Sharing of responsibilities can be beneficial as there is a clear role for both government regulators and SROs based on their respective expertise and powers (e.g. market surveillance). But the lack of a clear definition of roles often leads to unnecessary duplication, conflict and even competition over roles. The regulators also must devote a lot of time to coordinating their activities. Cooperative regulation can be confusing for investors and market participants too because it may not be clear who has responsibility for what.

For further discussion of what is driving the trend to reduced reliance on self-regulation see Appendix A. In summary, it is fair to say that the future of self-regulation in international markets is in question.

Reliance on Self-Regulation – Country Examples

European jurisdictions are leading the move towards consolidation of regulatory and supervision functions in government authorities. The consensus in Europe is that regulation is a public function that should not be performed by a private organization, especially for-profit business organizations. The European Commission stated: "It is no longer appropriate for Exchanges to carry out regulatory roles since they are commercial entities".

Furthermore, EU directives implemented under the Financial Services Action Plan mandate that a public "Competent Authority" in each country to supervise securities markets, which will support harmonization of rules and regulatory structures across the EU. This has led to many regulatory functions that were formerly delegated to Exchanges being curtailed or assumed by the government regulators. Specifically:

- The Market Abuse Directive transferred the primary responsibility for addressing market abuse to Competent Authorities.
- The Prospectus Directive shifted responsibility for approving prospectuses and many "listing" functions to Competent Authorities.
- The Markets in Financial Instruments Directive established a common framework for the regulation of Exchange members and Exchanges.

Consistent with their EU counterparts, the UK's view is that commercial Exchanges should not assume public mandates, including regulation of participating firms. In the late 1990s the UK Government created the FSA as a universal financial regulator and transferred all of the

significant powers of the former SROs to the FSA. The new regime represented a wholesale departure from the historical reliance on self-regulation in the City's financial markets.

Fostering competition amongst market operators was a major impetus for the UK's reforms. Exchanges' SRO roles could impede competition among Exchanges. For example, the Government transferred the London Stock Exchange's (LSE) former role as "competent authority for listing" (a public role defined in law that includes clearing prospectuses) to the FSA because the LSE competes for listings with other UK Exchanges. The LSE's Listings Department was transferred intact to the FSA.

In 2000 the FSA stated in a submission to an EU Committee[32]:

> "We do not think that it would be appropriate to leave the setting, monitoring and enforcement of EU legislative requirements to one or more self-regulatory organisations. Today's markets require a more independent regulatory authority to provide all participants with a more objective approach to regulation."

However some vestiges of self-regulation remain in the UK. Regulated investment Exchanges (RIEs) such as the LSE and LIFFE remain responsible for limited market monitoring functions, subject to FSA supervision, under the law. The LSE has its own trading rules, and is responsible for ensuring members comply with them. (This is consistent with the supervisory roles retained by European Exchanges.)

The FSA also looks to industry bodies to develop guidance on implementation and compliance with rules. In November 2006 the FSA released plans to encourage greater use of industry guidance as it moves towards a more principles-based approach to regulation.[33] The FSA stated:

> Industry Guidance includes Codes of Practice and similar Statements generated by trade associations and professional bodies to help their members understand and follow good practice in meeting regulatory requirements.

The FSA made it clear that industry guidance will supplement FSA rules, not replace them. The plan sets out a standard process for the FSA to "recognize" industry guidance, which will give industry guidance semi-official status. The FSA's approach, where the regulator establishes higher-level rules and the industry provides guidance or standards of practice on how to implement them, has parallels to the concept of self-regulation as it applies in other jurisdictions.

In France the Government decided over a decade ago that the EU single market would intensify inter-Exchange competition and require Exchanges to become commercial entities. In order to position the French market for competition, the former Paris Bourse was set up as market operator, and regulation was centralized in two government authorities. These regulators recently merged to form the AMF (Financial Market Authority). Although Euronext Paris still performs limited market surveillance functions for its markets based on its own trading rules, it is not a SRO.[34] The AMF is responsible for all regulating and monitoring market conduct, and it regulates all financial intermediaries directly.

The UK or French model will prevail in Europe by the end of the decade based on EU regulations designed to foster a single financial market with harmonized regulation. In general European

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[32] Response by the UK Financial Services Authority to the Committee of Wise Men on the Regulation of Securities Markets, September 2000.

[33] FSA/PN110/2006 – "The Financial Services Authority today set out plans to encourage greater use of Industry Guidance as it moves towards a more principles-based approach to regulation.", November 1, 2006.

[34] Euronext also performs limited listing functions, including setting basic listing rules and approving listing of securities.

Exchanges were never responsible for member / intermediary regulation, which was always considered a government function in civil law jurisdictions.

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

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

In spite of the broader trend, reliance on self-regulation remains strong in some jurisdictions, including the US, Australia, Canada and Japan.

In Australia, the Australian Stock Exchange (ASX) maintains broad SRO responsibilities by law. In order to better address conflicts of interest, the ASX has restructured its regulation functions by placing them in a separate department. To increase the efficiency its SRO functions the Exchange seeks to eliminate areas of overlap with the Commission's rules and processes.

In Canada and the US, the SROs have become stronger and more significant than ever in some respects. In Canada the SRO system has seen significant consolidation and a shift from Exchange SROs to independent SROs[35]. The TSX transferred responsibility for member regulation to the Investment Dealers Association (IDA) in 1997 and, following demutualization, created a new SRO, Market Regulation Services (RS), to perform market regulation in 2001. Canada will soon have one national SRO for the securities industry as a merger of the IDA and RS will be completed in mid-2007. In addition a new SRO was created 5 years ago to regulate mutual fund dealers.

In the US the SRO system has long been fragmented as the numerous securities and futures Exchanges are all SROs by law. In addition independent SROs such as National Association of Securities Dealers (NASD) and the National Futures Association (NFA) are important regulators. All securities firms must be members of the NASD in order to carry on securities business. Most of the concerns about self-regulation in the US have focused on the inefficiency of the system's structure, as opposed to the merits of self-regulation. The consensus has been that the shortcomings of the system can be corrected if its fragmented structure is addressed.

In December 2006 the NYSE Group and NASD announced the consolidation of their member regulation operations to create a new national SRO. This move will significantly reduce fragmentation in the self-regulatory system for the securities industry. Currently, NASD regulates more than 5,100 securities firms. About 200 firms, including most of the biggest, are

[35] The TSX transferred its member regulation functions to an independent regulator, the Investment Dealers Association (IDA), in 1997 and then, following demutualization, it transferred market regulation to a new independent SRO. Other Exchanges have been consolidated into TSX, except for the Montreal Exchange which specializes in derivatives products. In addition the securities commissions have assumed more responsibility from the Exchanges in the area of issuer disclosure and corporate governance.

also members of NYSE and are regulated by both organizations. The new SRO will be the private sector regulator for all securities brokers and dealers doing business with the public in the US. According to the NYSE and NASD, the plan will increase the efficiency and consistency of securities industry supervision, and is also expected to reduce regulatory costs by millions per year.

The new SRO will be responsible for:

- all member firm business conduct and financial regulation and enforcement;
- all member firm compliance and financial examinations;
- investor arbitration and mediation functions;
- professional training, testing and licensing of registered representatives;
- all other current NASD responsibilities, including market regulation by contract for Nasdaq, the American Stock Exchange (Amex) and the International Securities Exchange (ISE).

NYSE Regulation will remain responsible for market regulation of the NYSE market, as well as regulation of its listed companies. All other US securities Exchanges remain SROs; their primary function will be market regulation of their own market (which may be contracted out as Amex and ISE have done). The deal does not affect the futures industry or Exchanges.

The NYSE – NASD announcement follows the US SEC's release of proposed alternative structures to the current SRO system in a 2005 concept release. The release canvassed the pros and cons of options ranging from abolishing SROs to creating one universal SRO.[36] One of the options, dubbed the "hybrid approach", is reflected in the NYSE – NASD agreement – to establish a single SRO to perform all member regulation functions, while each Exchange would remain responsible for regulating its own market. The securities industry is very supportive of the new SRO, as for many years it pushed for integrating the NYSE and NASD member regulation programs into a central SRO.

Ongoing demutualization of Exchanges and the consolidation of Exchanges and competing markets such as ATSs will produce more changes in the American SRO system. The consolidation of markets will lead to further consolidation of SROs. For example the recent merger of CME and CBOT will create one dominant Exchange and SRO in the futures arena. Exchanges are likely to contract out more regulation functions too.

Japan also has both Exchange SROs and independent SROs. Japanese Exchanges (primarily the Tokyo and Osaka Exchanges) regulate their own markets, securities dealers that trade on the Exchange, and companies listed on the Exchange. The Japan Securities Dealers Association (JSDA) regulates all securities dealers and financial institutions that trade in securities, as well as over-the-counter equity and debt markets. The JSDA is both a trade association and a SRO. Japan also has another independent SRO, the Financial Futures Association of Japan (FFAJ), which regulates broker-dealers in the financial futures industry.

Colombia established a new independent SRO in 2006 to provide central regulation of trading by all market intermediaries. Colombia's Exchanges (now consolidated into one Exchange) have a long history of self-regulation of brokers, but an independent SRO was needed to persuade other

[36] SEC, *Concept Release Concerning Self-Regulation*, Release No. 34-50700, March 8, 2005.

financial institutions to participate in the system. This is a novel approach in an emerging market, especially since Latin America has historically made limited use of self-regulation.

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

Annex 2 National Association of Securities Dealers as a Self-Regulatory Organization (SRO)

1. Introduction[37]

The purpose of this paper is to present the concept of self-regulatory organizations (SRO) using the experience of the National Association of Securities Dealers, Inc. (NASD) as a case study. NASD is one of many SROs in the United States, but the only National Securities Association and is by far the largest SRO in terms of number of members and staff.

The merits of self-regulation have been articulated in detail elsewhere and NASD certainly subscribes to the benefits of these. It is not the purpose of this paper to provide a theoretical exposition of these merits, however, but rather to show how an SRO can work in practice. In addition to their merits, there are also concerns about SROs, in particular potential conflicts of interests; again, we do not address these at the conceptual level here, but do discuss how NASD has handled conflicts in its structure and operations. (For a brief summary of the arguments regarding the merits and limitations of SROs, please see Box 1.)

In broad terms, NASD is responsible for developing rules, monitoring its members' compliance with those rules, as well as Federal Securities Laws, investigating possible breaches of rules, and disciplining members who are found in breach. NASD's jurisdiction extends to its roughly 5,075 member firms and those employees of these firms who are required to register with NASD. There are currently more than 662,000 individuals licensed with NASD as registered representatives. Federal statute makes membership in NASD mandatory for most securities firms. NASD has a professional staff of more than 2,300 and an annual budget of nearly $600 million and is structured as a not-for-profit corporation. NASD is governed by a Board of Governors made up of a majority of non-industry members. NASD's members vote on Board membership, but do not exercise an economic ownership interest in the organization.

NASD has evolved significantly since its inception in 1939. From its early days with a small, largely volunteer staff, NASD has expanded both the range and depth of its activities. NASD has demonstrated versatility in its ability to respond to the demands of the industry as well as the marketplace, most recently evidenced with the announcement of the proposed regulatory consolidation with the New York Stock Exchange (NYSE).

This summary describes the evolution in the United States of SROs, and NASD in particular, and explains NASD's commitment to its special role as a central regulator in the U.S. securities markets.

Box A1: Arguments on the merits and limitations of SROs

The benefits that are typically ascribed to an SRO include the following:

- SROs are closer to the industry, and are able to anticipate or respond to industry trends more rapidly than a government agency such as the SEC.
- SROs place a large measure of the cost of regulation on the users of industry services, and not on the general taxpayer.
- SROs can set and enforce higher ethical standards than exist in federal law and regulations.
- SROs are often able to secure greater acceptance and support for regulatory initiatives due to the opportunity for member input.

The concerns that are raised regarding SROs include the following:

- SROs may become subject to regulatory capture by their members, or a sub-set of powerful

[37] This note has been prepared by staff at the NASD

members, and thus fail to perform their regulatory responsibilities effectively;
- SROs may discriminate against some members (or non-members) on behalf of powerful members; and
- SROs that operate and regulate a market may face conflicts of interest between the objectives of both activities, particularly if the market is run on as a for-profit entity.

2. NASD: From Origin to Present Day

2.1 Origins

The concept of self-regulation has deep, historical roots in the United States. Long before a governmental regulator was established, stock Exchanges regulated the activities of their members. The Exchanges were mutual organizations; they were member-funded and operated on a not-for-profit basis. From an oversight and enforcement perspective, the members acted on what might be considered a peer-review basis. During that period of time, no central governmental body provided any oversight of the Exchanges.

The stock market crash of 1929 changed the course of securities regulation in the United States. In direct response to the crash, Congress passed new laws to strengthen and regulate the market and stock Exchanges, including the Securities Exchange Act of 1934 (Securities Exchange Act). This statute gave birth to the Securities and Exchange Commission (SEC), and formalized the role of Exchanges as SROs subject to SEC oversight as well as the SROs' roles and responsibilities in regulating their members. The Act did not, however, address regulation of the over-the-counter (OTC) market and thus left many brokers and/or dealers who were not members of an Exchange without an SRO regulator. This was a conscious omission that reflected the Congress' uncertainty over how the OTC market should best be regulated.

In 1938, Congress amended the Securities Exchange Act to require that *all* brokers and dealers that effect transactions in, or induce or attempt to induce purchases or sales of, securities with the public must be a member of a registered national securities association. In essence, under the new law, brokers and dealers who were not members of Exchanges, and, instead, traded in the over-the-counter (OTC) market, had to belong to a registered national securities association.

In 1939, a group of brokers and dealers established NASD as a not-for-profit corporation, and NASD became the only registered national securities association in the United States.

2.2 Role of NASD in the US Securities Market

NASD is responsible for regulating the activities of its members and, in general, upholding high standards for ethics and business practices. Its critical duties and responsibilities, which stem from its registration as a national securities association, include:

- Registering member firms and their representatives;
- Writing rules to govern behavior in the financial markets;
- Inspecting brokerage operations for compliance;
- Monitoring capital markets for fraudulent and inappropriate trading;
- Disciplining individuals and firms; and
- Overseeing and regulating trading activity in the over-the-counter markets.

In addition, to assist in fulfilling its regulatory mission, NASD also:

- Provides education to industry professionals and investors;
- Provides services to members to support their compliance efforts; and
- Operates the largest securities dispute resolution forum in the world.

2.2.1 Duties and Responsibilities of NASD:

- *Registering member firms and their representatives*
  NASD serves as the gatekeeper for entry into the securities industry in the United States for both brokerage firms and their employees. Firms seeking to enter the industry and/or change their business must obtain prior NASD approval. To this end, NASD operates a "Membership Application Program" that conducts a thorough review of an applicant's business plan, credentials and experience of owners and high level managers, financial condition and supervisory structures. In addition, if a firm wishes to change its mix of business activities – e.g., to begin selling options products to investors or to change its method of clearing securities transactions – the firm must obtain NASD's prior written approval.

  With respect to qualifying individuals, NASD plays two central roles in the industry. In the first instance, NASD administers the qualifications exams that individuals must take to assume a position in an NASD member that involves interaction with customers or management of those individuals. These exams – e.g., the Series 7 and Series 23 – help ensure that employees of NASD members are familiar with both the financial products they sell as well as the rules governing those products.

  Second, NASD members and their employees must fulfill continuing education requirements to ensure that employees remain current on industry and product line issues as well as other matters of regulatory significance. Under NASD rules, member firms are obligated to develop a continuing education program for their employees that reflects the firm's business. In addition, NASD delivers course materials that individuals must take in order to maintain their qualification. This data plays an integral role in NASD's regulatory oversight of firms, including in NASD's inspection program, described below.

  In addition to administering the qualifications exams for individuals, NASD also operates a central database of member firms and individuals associated with member firms. The Central Registration Depository, or CRD, catalogs data on market participants. With regard to securities firms, this database maintains information ranging from the addresses and telephone numbers of business locations and branches to details regarding approved business lines and schedules of firm ownership interests. For individuals, CRD tracks approved licenses held by broker-dealers, licensing examination scores, continuing education status, and other personal information. For both firms and individuals, the CRD is a primary resource for maintaining data on regulatory histories including disciplinary history and other disclosure items.

- *Writing rules to govern behavior in the financial market*
  NASD is responsible for the creation of a set of rules and regulations to ensure the fair and efficient operation of the market and just and equitable principles of trade. NASD drafts rules that address many areas of securities sales practices, market operations, trade reporting, disclosure and order handling.

  The process by which these rules are drafted and/or amended reflects both the self-regulatory structure of the industry as well as the role of the SEC as overseer of both industry participants as well as NASD as an SRO. For its part, NASD seeks to maximize opportunity for member input on rule filings in two ways. First, NASD utilizes relevant member committees (see box 2) to provide comment on proposed rules during the drafting stage. Second, once a rule has been drafted, NASD submits the rule to its members for comment. Once the comment period is complete, NASD may send the draft rule as written to the SEC for approval, modify the rule to address some or all of the comments received and submit the rule to the SEC, or redraft the rule and re-submit it to members for further comment.

Ultimately, the SEC must approve NASD rules and, typically, NASD rule filings are published in *The Federal Register* for public comment (as opposed to the member comment review period at NASD) before the SEC approves a rule. The SEC has the power to accept, modify, or reject proposed NASD rules.

Box A2: The role of member committees
NASD member committees play a critical role in the functioning of the organization as an SRO. Member committees are one of the principal vehicles for soliciting industry input on NASD rules (and regulatory initiatives). The Committees are made up of a cross section of industry representatives and NASD staff and are structured to address topic, product, or firm-type-specific issues. NASD's member committees include:

- Chairman's Advisory Council
- Economic Advisory Board
- Legal Advisory Board
- Operation Advisory Committee
- Small Firm Advisory Board
- Technology Advisory Committee
- Bond Transaction Reporting Committee
- Corporate Financing Committee
- E-Brokerage Committee
- Financial Responsibility Committee
- Fixed Income Committee
- Independent Dealer/Insurance Affiliate Committee
- Investment Companies Committee
- Market Regulation Committee
- Membership Committee
- National Arbitration and Mediation Committee
- Uniform Practice Code Committee
- Variable Insurance Products Committee

- *Inspecting brokerage operations for compliance*

  NASD is responsible for the regulatory inspection of all member firms engaging in securities business with public customers. These on-site inspections (or examinations) involve rigorous review of administrative and operational data as well as a detailed audit of a member's financial statements and levels of capitalization. In carrying out this inspection process, NASD looks to enforce its rules as well as SEC rules and the rules of the Municipal Securities Rulemaking Board, where applicable. A key component to the inspection process involves an assessment of the supervisory and compliance control processes in place at a member firm. Where NASD staff identifies compliance breaches, it has the power to take disciplinary action including the imposition of suspensions, bars and monetary sanctions through its Enforcement Department.

  In addition to the on-site inspection of its member firms, NASD also performs off-site financial surveillance to monitor members' compliance with SEC financial soundness (net capital) rules. This financial surveillance forms a critical component of NASD's oversight to protect investors and the information from this oversight also supports NASD's on-site inspection by, for example, through the identification of major sources of (or changes in) revenue from a member's business.

  Beyond the routine or scheduled inspections, NASD will also inspect a member if it believes there is a specific problem or potential rule violation. These examinations – known as cause examinations – may be triggered by a variety of events including the receipt of a customer complaint, a regulatory tip or the termination of an employee at a member. These inspections may involve an on-site visit to the firm, but may also be addressed through telephone calls and/or correspondence.

- *Monitoring capital markets for fraudulent and inappropriate trading*
  NASD conducts post-trade surveillance of activity on the NASDAQ Stock Exchange as well as the OTC markets on a daily basis. This surveillance relies heavily on sophisticated automated detection systems to identify possible instances of aberrant behavior (e.g., insider trading, market manipulation, and other prohibited acts) among the millions of quotes, orders, and trades that are entered on a daily basis. NASD's market surveillance staff then investigates alerts produced by the surveillance system to determine the validity of the automated alert and, if warranted, pursues further investigation and disciplinary action.

- *Disciplining individuals and firms*
  The NASD disciplinary process is one of the most important and sensitive areas of the NASD's activities as an SRO, and this is reflected in the procedural and organizational safeguards built into the process. Cases are initiated by either the Enforcement or Market Regulation Departments which prosecute cases. The Office of Disciplinary Affairs (ODA), which is separate from the two prosecuting departments, must approve both the initiation of a case as well as any settlement. The Office of Hearing Officers (OHO), also separated from the prosecuting departments with information barriers, administers the formal NASD internal adjudicative process. Finally, decisions of a hearing panel may be heard by an internal appeals body, these decisions can be appealed to the SEC and from there to the Federal appellate process.

  Enforcement actions may be resolved through a settlement, the course of action taken in about 80 percent of the actions pursued, while the remaining 20 percent are heard by an NASD hearing panel. NASD hearing panels are the organization's internal adjudicative body and consist of three judges, a presiding officer who is an NASD employee and two additional panelists who are members of the industry. The NASD hearing officer is selected from the Office of Hearing Officers. These panelists are selected by the NASD presiding officer from a roster of approved individuals. Cases are decided by a majority vote of the panelists who apply a preponderance of the evidence standard in assessing guilt or innocence. Preponderance of the evidence means that, based on the evidence presented, it is more likely than not that the firm or individual engaged in the activities alleged. (It is important to remember that NASD only exercises jurisdiction over its members and their employees.) Punishment decisions are based on NASD's Sanction Guidelines which are published and available online to NASD member firms as well as the general public. NASD's disciplinary remedies include: fines, ordering restitution to customers, disgorgement of gains, remedial actions, as well as suspensions or expulsions of member firms or individuals operating within them.

  Appeals are heard by the National Adjudicatory Council (NAC), a body made up of NASD members. As noted earlier, decisions by the NAC may be appealed to the SEC.

2.2.2 NASD Corporate Structure

Having completed the divestiture of its for-profit businesses, NASD consolidated all aspects of its regulatory services under one corporate umbrella. Regulatory operations, regulatory policy and dispute resolution areas all report to a single Chairman and CEO in order to facilitate collaboration amongst business units in working toward the common mission of customer protection and maintaining the integrity of markets. Further, the regulatory operations group includes member regulation, market regulation and enforcement functions reporting to a single individual who reports to the CEO. These three departments are some of the largest in NASD. At 800 plus people, the Member Regulation department is largest single department in the organization. Over 520 of these staff members are inspectors who work in NASD's 15 district offices around the country

and carry out NASD's on-site inspection of its members. The Market Regulation and Enforcement departments each employ over 200 staff to carry out their responsibilities.

2.2.3 NASD Funding

NASD is funded by its members through fees and assessments that ensure that members are contributing amounts proportionate to their sizes and roles in the market place. In broad terms, NASD funding is derived from three primary sources: Trading Activity Fees, a Personnel Assessment and a Gross Income Assessment. The Trading Activity Fee (TAF) generates revenues based on a firm's trading activity regardless of the location of execution. In the past, transaction-based assessments were focused on trades executed on NASDAQ and as such may have influenced trade execution decisions. The Personnel Assessment is a per-person assessment based on the number of registered representatives and registered principals licensed with each member. The Gross Income Assessment is based on the greater of a base rate or a sliding revenue-based schedule.

In addition, NASD members pay fees to cover the cost of various regulatory systems and services provided by NASD. For example, the NASD Advertising Department is responsible for reviewing members' advertisements to ensure that they comply with NASD rules and there is a fee associated with the submission of advertisements for review (note that member who advertise must submit advertisements for review). Similarly, there are fees to use NASD's TRACE system, a transaction reporting system for trades in corporate debt securities.

NASD's fees are overseen by both the NASD Board and the SEC. In the first instance, NASD's Board, which includes representatives from NASD's membership, must approve NASD's budget. In addition, any proposed changes to NASD's fee structure must be submitted to the SEC for approval as a rule change and, as part of this process, is subject to public comment.

This fee assessment structure ensures that members are contributing to the funding of NASD commensurate with the size and scope of their business and the related cost of regulation. NASD does not use the proceeds from Enforcement actions (e.g. fines) to fund its member regulatory activities, nor are fines included in NASD's annual budget. These monies are put toward continuing investor awareness and education efforts.

2.2.4 What NASD is not

As an SRO, it is critical to note that NASD is not a trade association. NASD neither represents, nor advocates on behalf of, its members before Congress or the SEC. The industry organization for this purpose is the Securities Industry Financial Markets Association (SIFMA). (SIFMA was created out of the merger of the Securities Industry Association and the Bond Market Association.)

Box A3: NASD and NASDAQ

NASD and NASDAQ are often confused and assumed to be part of the same organization. This is assumption is not correct. Although NASD created NASDAQ, the two are now separate organizations. NASDAQ arose out of NASD's responsibility to oversee the over-the- counter markets. In 1971, as part of its oversight these markets, NASD created a wholly owned subsidiary, NASDAQ, Inc., which established NASDAQ (NASD Automated Quotation System). NASDAQ, Inc. was solely responsible for the operation and maintenance of the NASDAQ system. NASDAQ initially was a computer bulletin board system and did not actually connect buyers and sellers. The addition of trade reporting and routing facilities in the 1980s led to the creation of a second subsidiary, Market Services, Inc., which operated those functionalities. NASDAQ, Inc. continued to administer only the quote-related functionality. In the early 1990s, the two subsidiaries were merged to form the NASDAQ Stock Market, Inc., a for-profit entity, but

still a wholly owned NASD subsidiary. As a consequence of the merger, NASDAQ, Inc. relinquished its not-for-profit status, since Market Services, Inc. was already a for-profit entity. Consequently, NASD was then the owner, operator, and regulator of NASDAQ.
In 2000, NASD began selling its interest in NASDAQ, because it recognized the increasing conflicts of interest between being an owner and a regulator of a market. By 2002, NASD and NASDAQ became operationally separate and NASD had sold most of its interest in NASDAQ. In 2006, the SEC approved NASDAQ as a national securities Exchange (a change in legal status), and NASD completed the sale of its remaining interest in NASDAQ.

2.2.5 Summary of NASD 2005 activities

Box 4 contains a summary, end-of-year press release for calendar year 2005 that describes NASD's activities during the year. This press release provides a further sense of the range of activities that NASD performs and the issues that were of particular regulatory focus during 2005. Table A1 provides a summary of various statistics relevant to NASD's operations.

Box-A4 Extract from a News Release: NASD – 2005 in Review
This last year saw NASD intensify its regulatory focus on sales of mutual funds, variable annuities and 529 College Savings Plans by bringing significant enforcement actions, advocating enhanced point-of-sale transparency and creating tools for investors aimed at better understanding these products. In total for 2005, NASD set records for the number of new enforcement actions brought and the amount of fines collected.
NASD dramatically increased transparency in the corporate debt market with full implementation of NASD's TRACE (Trade Reporting and Compliance Engine). In February of this year, TRACE began disseminating publicly, in real-time, price data for 99 percent of corporate bond trades, and in September NASD submitted a rule proposal to the Securities and Exchange Commission (SEC) to allow real-time public dissemination of the remaining one percent of trades. On average, information is available daily on TRACE on 22,000 transactions representing approximately $18 billion in par value.

As part of its ongoing efforts to demystify the corporate, municipal and government bond markets for retail investors, NASD introduced a comprehensive, on-line learning center called Smart Bond Investing . NASD also introduced two major tools for mutual fund investing - a new and improved Mutual Fund Expense Analyzer that delivers fee and expense information to investors for virtually all of the more than 18,000 mutual funds and 160 Exchange Traded Funds (ETFs). Among other things, the analyzer will compare the expenses of up to three ETFs, mutual funds or share classes of the same mutual fund simultaneously. The new analyzers automatically populate fee and expense data, saving investors from the task of searching through the prospectus and sales materials and manually inputting the information. NASD's new Mutual Fund Breakpoint Search Tool offers users a groundbreaking way to research eligibility for breakpoint discounts. Investors and brokers can look up breakpoint schedules and linkage rules for mutual funds with front-end sales charges, most commonly A shares.
NASD continued to bolster its investor education initiatives by issuing a variety of Investor Alerts on topics ranging from identifying bogus stock tips on cell phones to protecting online brokerage accounts from identity thieves. The NASD Investor Education Foundation completed three grant cycles and awarded more than $3.7 million to organizations for educational programs and research projects targeting the underserved segments of the population.

NASD Dispute Resolution saw close to 6,000 new arbitration claims and 1,250 mediation claims filed in 2005. And, 9,150 arbitration cases and 1,700 mediation cases were closed during the year. NASD completed its arbitration and mediation hearing location expansion project in 2005 - and now has 68 hearing locations, at least one in each state, Puerto Rico and London. Also in 2005, NASD filed a rule proposal with the SEC to further tighten the definition of who may serve as a public arbitrator in its Dispute Resolution forum, and is close to finalizing its new Code of Arbitration Procedure, a plain-English document that will enhance investor accessibility to the forum. NASD pushed for improvements in point of sale disclosure to mutual fund investors by proposing Internet disclosure of a new "Profile Plus " - a two-page document providing basic information about a mutual fund, including its investment objectives, risks, performance, fees and expenses and

information about potential conflicts of interest. NASD also recommended that every broker-dealer be required to post a Profile Plus for each mutual fund it sells on its website, with hyperlinks to the fund's prospectus. Profile Plus is the chief recommendation of NASD's Mutual Fund Task Force in its second and final report to the SEC, *Mutual Fund Distribution*.

Also in 2005, NASD submitted a number of rule proposals to the SEC - including one that would impose more formal procedures for issuing fairness opinions and require broker-dealers to disclose potential conflicts of interest in the fairness opinions they write. NASD has also been working with the Municipal Securities Rulemaking Board (MSRB) to harmonize the rules for sales of 529 Plans (which are municipal securities) and mutual funds.

Mutual Fund Sales and Trading Practices
NASD intensified its focus on mutual fund sales and trading issues, bringing more than 120 disciplinary actions involving deceptive market timing, late trading, unsuitable sales of Class B and Class C mutual fund shares and impermissible revenue sharing. This year's actions bring to more than 400 the number of cases NASD has taken in the mutual fund area since 2000.

NASD fined six major firms - Citigroup Global Markets, American Express Financial Advisors (now known as Ameriprise Financial Services), Chase Investment Services , Merrill Lynch, Wells Fargo and Linsco/Private Ledger a total of more than $40 million for unsuitable B share and C share sales. NASD ordered the firms to offer customer remediation on more than 400,000 mutual fund transactions made by more than 79,000 households, at a cost potentially greater than the amount of the fines.

In the area of directed brokerage and impermissible revenue sharing, NASD settled 27 cases against retail firms for providing preferential treatment to select mutual funds in Exchange for brokerage business, in violation of NASD's Anti-Reciprocal Rule. In the largest settled case, Ameriprise Financial Services was fined $12.3 million. In total, the 26 firms paid nearly $55 million in fines.

NASD brought 11 cases against firms for facilitating deceptive market timing in mutual funds or variable annuity sub-accounts, and for failing to have procedures in place to prevent late trading of mutual funds. Two of the largest cases involved a $1.5 million fine against ING Fund Distributors and a $1.2 million fine against Janney Montgomery Scott . ING Fund distributors was ordered to pay $1.4 million in restitution to the affected mutual funds, while Janney Montgomery Scott paid nearly $1 million in restitution.

Variable Annuities
NASD's continued focus on the sale of variable annuities and variable life products resulted in the filing of 88 cases in 2005. NASD settled a major enforcement action against Waddell & Reed , in which the firm agreed to pay a $5 million fine and $11 million in restitution to injured customers for engaging in a campaign to Exchange the variable annuity contracts of thousands of customers without regard to the suitability of those switches.

Corporate Bonds and Trade Reporting
NASD continued its vigorous enforcement of rules prohibiting excessive markups and markdowns in bond transactions. S.G. Americas, RBC Capital Markets and RBC Dain Rauscher paid a total of $6.75 million in fines for excessive markups, inadequate supervision and faulty books and records. A fourth firm, Debt Traders, was expelled from the securities industry for similar violations. The four firms were also ordered to pay a total of $1.12 million in restitution to customers.

A number of 2005's cases concerned the failure of firms to promptly and accurately report corporate bond transactions to NASD and/or municipal bond transactions to the Municipal Securities Rulemaking Board (MSRB). NASD settled charges against 20 firms for late and/or inaccurate reporting of tens of thousand of municipal securities transactions to the MSRB, imposing fines totaling $1.65 million. Municipal and corporate bond trade reporting failures led to a record-breaking settlement with State Street Global Markets , which paid a $1.4 million fine. Edward D. Jones was fined $300,000 for failing to disclose municipal bond yields on more than 86,000 municipal customer sales confirmations. And NASD charged Oppenheimer & Co. (formerly known as Fahnestock & Co.) with failing to report municipal bond transactions, reporting others that were

never effected and reporting thousands of other trades late and inaccurately - and with attempting to thwart NASD's investigation of that misconduct.

Private Investment in a Public Equity (PIPES)
Abuses in PIPE transactions were a new area of focus for NASD investigators in 2005. A PIPE (Private Investment in a Public Equity) is a private offering in which accredited investors agree to purchase restricted, unregistered securities of public companies. Hilary L. Shane , a hedge fund manager formerly registered with First New York Securities, was permanently barred and paid more than $1.45 million to settle NASD and SEC charges of fraud and insider trading arising from her purchase and sale of shares in a PIPE transaction. John F. Mangan, Jr. , a former broker and hedge fund manager formerly registered with Friedman, Billings Ramsey & Co., was permanently barred and paid a $125,000 fine to settle NASD charges that he deceptively obtained shares in the same PIPE offering, improperly sold the sales short and secretly shared in the profits from the those sales. Additional investigations are continuing.

Equity Trading
NASD filed a complaint against Kenneth Pasternak , former CEO of Knight Securities and John Leighton , former head of the firm's Institutional Sales Desk, charging them with supervisory violations in connection with fraudulent sales to institutional customers in 1999 and 2000. Knight's former lead institutional sales trader, Joseph Leighton , agreed to a permanent bar and paid $4 million to settle NASD and SEC charges related to those fraudulent trades. In late 2004, NASD and the SEC sanctioned Knight Securities $79 million in connection with the same misconduct.

Instinet and INET ATS paid a $1.475 million fine to settle NASD charges of publishing inaccurate reports on order execution quality, backing away from posted quotes, failure to report orders, improper "last sale" or trade reporting and supervision violations. INET's and Instinet's flawed reports compromised the ability of investors and other market participants to accurately assess execution quality and compare venues for execution.

Fee-Based Accounts
While fee-based brokerage accounts have become increasingly popular over the past several years, NASD brought two cases in which firms failed to institute appropriate supervisory procedures for fee-based business, to the detriment of their customers. NASD fined Morgan Stanley DW, Inc. $1.5 million and ordered the firm to pay more than $4.6 million in restitution to 3,500 customers for failing to adequately supervise its fee-based brokerage business. In addition, NASD censured and fined Raymond James & Associates and Raymond James Financial Services $750,000 for violations relating to the firms' fee-based brokerage business and ordered to pay restitution totaling $138,000. The firms also violated NASD rules by recommending and opening fee-based brokerage accounts for customers without first determining whether these accounts were appropriate and by allowing fee-based accounts to remain open without determining whether they continued to be appropriate for customers.

Research Analyst Rules
Enforcement of NASD's research analyst rules remained a high priority in 2005. Over the last 18 months, NASD has brought more than 30 cases in this area. Among 2005's notable cases were: a six-month suspension and $130,000 fine against Jesup & Lamont Securities Corporation research analyst Gary Davis for trading contrary to the recommendations in his research reports and other violations; formal charges against the firm and its chief compliance officer, Robert Strong, for failing to detect and prevent the illegal trading activity by Davis and for other violations relating to research reports published by the firm; a $75,000 fine against Fulcrum Global Partners research analyst Walter Piecyk for circulating a false rumor about RF Micro Devices, Inc. while selling short 3,000 shares of that company and earning a profit of $7,815; and, a $100,000 fine against SunTrust Capital Markets and a $150,000 fine against Green Street Advisors for failing to qualify and register their research analysts under new NASD rules.

529 College Savings Plans
Another area of focus in 2005 was sales of 529 College Savings Plans. In the first action of its kind, NASD fined Ameriprise Financial Services (formerly American Express Financial Advisors) $500,000, and ordered it to pay approximately $750,000 to compensate more than 500 disadvantaged customer accounts - for failing to adequately supervise the firm's sales of 529 Plans.

As a result of those failures, Ameriprise had no procedures in place to ensure that sales recommendations took into account available state tax benefits for in-state 529 Plans. NASD's investigations into 529 Plan sales are continuing.

NASD is the leading private-sector provider of financial regulatory services, dedicated to investor protection and market integrity through effective and efficient regulation and complementary compliance and technology-based services. NASD touches virtually every aspect of the securities business - from registering and educating all industry participants, to examining securities firms, enforcing both NASD rules and the federal securities laws, and administering the largest dispute resolution forum for investors and registered firms. For more information, please visit our Web site at www.nasd.com .

Table A1: NASD – 2005 Year End Statistics*

	2005	2004	2003	2002
New Disciplinary Actions Filed	1,412	1,396	1,410	1,271
Formal Actions Resolved	1,296	1,336	1,324	1,129
Firms Expelled From Membership	14	22	30	25
Individuals Barred From The Industry	381	454	494	440
Firms Suspended From Membership	3	4	7	5
Individuals Suspended	356	379	333	374
Disciplinary Fines Collected (millions)	$125.4	$103.9	$33.3	$68.2
Firms	5,144	5,222	5,272	5,392
Branches	106,449	97,250	92,861	91,473
Registered Representatives	662,938	667,751	653,887	662,311
Customer Complaints Received	4,800	4,687	4,843	4,495
Customer Complaints Resolved	4,500	4,730	5,686	4,611
Firm Examinations Initiated	2,284	2,351	2,645	2,662
Firm Examinations Completed	1,925	2,174	2,787	2,480
Terminations For Cause Initiated	8,600	12,081	6,510	4,438
Terminations For Cause Resolved	8,500	12,421	7,359	4,448
Examinations For Cause Initiated	6,600	10,658	3,384	2,100
Examinations For Cause Resolved	6,500	10,258	3,453	1,950
Advertisements and Sales Communications Reviewed	88,000	88,301	85,735	87,855
Arbitration Claims Filed	6,000	8,201	8,945	7,704
Arbitration Cases Closed	9,150	9,209	7,278	5,957
Mediation Claims Filed	1,250	1,217	1,200	936
Mediation Cases Closed	1,700	2,063	1,889	1,360
BrokerCheck Searches and Reports	4,086,451	3,815,961	2,956,974	2,329,307

The data provided is preliminary. Final numbers may vary slightly.

3. The SEC and the SROs

3.1 Overview

Congress did not create the SEC in 1934 to replace the then-existing 21 Exchanges. Rather, Congress intended the SEC to oversee the regulatory functions of those Exchanges to ensure that they were properly executed. The relationship between the SEC and SROs is complex, dynamic and occurs through both formal and informal channels.

In the first instance, the SEC is both gatekeeper and overseer, i.e., the SEC must approve the establishment of an SRO and is responsible for overseeing the SROs' continuing operations to ensure that they perform their responsibilities effectively and fairly. The SEC is involved in the approval of SRO rules and may act as a mediator in instances where conflicts exist between SRO rules. Beyond this, the SEC and SROs often work cooperatively in performing oversight of broker/dealers. An example of this collaboration can be found in recent joint efforts between the SEC and NASD to review the application of mutual fund sales charge breakpoints. These efforts led to sales charge

refunds to investors where breakpoints had not been properly applied. In addition, if examination or surveillance activities lead to suggestions of possible wrong-doing, SROs may refer cases to the SEC for handling in instances where alleged participants lie beyond the jurisdiction of the SRO. Insider trading is one example of a type of investigation that may frequently lead to a person or entity that is not subject to an SRO's jurisdiction. (SROs may also refer cases to the Justice Department if they have reason to believe that criminal violations have occurred.) Typically, the SEC looks to the SROs to discipline their members, but the SEC may take concurrent action against a broker if it deems a case sufficiently important to warrant SEC involvement as well.

These formal relationships are supported by staff relationships between the SROs and the SEC that develop over time. These channels of communication enable discussions of issues of regulatory concern between the SEC and SROs in a manner that facilitates sharing of information and collaboration on member and market oversight. In addition, there is staff movement between the SEC and SROs. Senior officials in a number of SROs have worked previously at the SEC and some staff leave SROs to work at the SEC.

As noted above, the SEC's fundamental obligation vis-à-vis the SROs is to act as gatekeeper and overseer. In 1934, as well as today, the SEC conditions its approval of the registration of an SRO on the SRO's ability to demonstrate that it:

- Has the organization and capacity to enforce compliance with federal laws and an SRO's own rules;
- Prohibits fraudulent and manipulative practices;
- Has an appropriate disciplinary mechanism to enforce its rules; and
- Cooperates with other regulators to protect investors and the public interest.

The responsibilities of SROs flow from their registration with the SEC. Once an organization registers as an SRO, the SEC provides ongoing oversight, including:

- Approval of all SRO rules, including the right to amend, modify, abrogate, and adopt rules;
- Inspection of SROs and oversight of the SROs' inspections of their own members with the authority to conduct examinations directly;
- Review of SRO disciplinary proceedings and membership application denials;
- Direct enforcement of SEC and SRO rules if the SRO is not adequately or is unwilling to take appropriate actions; and
- Review of record keeping and reporting requirements.

3.2 Examples of SEC Oversight of an SRO

As noted above, the SEC has the authority to oversee all aspects of an SRO's activities. This oversight is intended to ensure, among other things, that the SRO is effectively implementing its responsibilities and that it is doing so in a non-discriminatory manner.

3.2.1 Oversight of NASD's member firm inspection program

- Completed inspections of member firms are sent to the SEC for informational purposes, not approval;
- NASD's inspection procedures/protocols are subject to SEC review and comment;
- NASD's sampling protocols are subject to SEC approval (not through a rule filing process, but through the SEC's routine oversight)
- Typically NASD can expect that the SEC will review inspections conducted by regional offices every two to three years
- The SEC will, in some instances, conduct an inspection of a broker that was recently inspected by NASD to see if the SEC's inspection produces similar results. If it does not, the SEC will attempt to reconcile the differences to

determine if NASD is applying its inspection procedures correctly and/or whether these are adequate to the task.

3.2.2 Oversight of NASD's market surveillance activities

- NASD's automated surveillance systems and algorithms are subject to SEC oversight, including alert thresholds;
- NASD's surveillance systems maintain logs of all alerts, including their status, and, if work is complete, disposition (NASD's systems generates thousands of alerts each year); the SEC in its oversight exams may select, randomly or otherwise, sets of alerts and ask NASD to explain and justify the disposition of each alert.

3.2.3 Oversight of broker activities

- The SEC will conduct periodic inspections of broker-dealers exclusive of SRO oversight functions. The SEC will forward the findings of these inspections to NASD's regional offices in an informational context.
- The SEC may choose to refer specific findings from these inspections to NASD for further review.

3.2.4 Appeals process

- The decisions of NASD's internal disciplinary bodies may be appealed to the SEC for review.
- The SEC conducts a review of cases
- Decisions by the SEC may be appealed to a Federal appellate case.

3.3 SEC's 21(a) Report

In addition to the specific oversight activities by the SEC described above, SROs can be targeted for broader oversight and sanction if the SEC believes that the SRO demonstrates significant failings in executing its regulatory responsibilities. In the mid-1990s, the SEC became concerned that NASD was neither providing sufficient oversight of its member's activities on The NASDAQ Stock Market nor sanctioning such members in a meaningful way if they were subject to disciplinary proceedings.

In 1996, the SEC issued a report requiring remediation of these problems by NASD and NASDAQ. The report is commonly known as the "21(a) Report" because the SEC conducted an investigation under Section 21(a) of the Securities Exchange Act. The 21(a) Report cited a breakdown by NASD in bringing enforcement actions against large market participants. The SEC maintained that large firms made up a substantial proportion of NASD's board and had too great an influence over the disciplinary process because of their strong representation on committees that decided which cases to bring forward. The SEC also found that NASDAQ market makers influenced NASD's affairs through their dominant role in its governance, the administration of NASD's disciplinary process, and the operation of NASDAQ. In addition, according to the SEC, other smaller constituencies, such as retail and institutional investors and small broker/dealers, did not have comparable representation on the key NASD boards and committees.

As the SEC prepared the 21(a) Report, it engaged in discussions with NASD to resolve administrative proceedings it was instituting against NASD concerning misconduct in the NASDAQ Stock Market, and NASD's performance as an SRO. Therefore, at the time of the release of the 21(a) Report, the SEC also issued an order to which NASD agreed, requiring NASD to comply with a series of undertakings, and these are described below.

- *Corporate Governance*
  NASD's Board of Governors and all key committees became more balanced. The number of public and non-industry governors equals or exceeds the number of industry governors. In addition, the regulatory arm of NASD – NASD Regulation, Inc. – became a separate subsidiary. An independent internal audit staff, which reports to NASD's chairman, reviews all aspects of NASD (including the regulatory function and the disciplinary process). Finally, NASD voluntarily subscribes to the Sarbanes-Oxley requirements, under which the NASD chief executive officer certifies NASD financial statements.

- *Disciplinary Process*
  With respect to changes in the disciplinary process, NASD Regulation staff became autonomous and independent from NASD members. Accordingly, the disciplinary and member application processes are almost entirely staff driven. The staff has the sole discretion as to which matters to investigate and prosecute, and as to the approval or denial of applications for membership. A separate Office of Disciplinary Affairs must authorize the staff to issue all complaints and to execute all settlements. NASD staff also now includes professional hearing officers (attorneys with appropriate experience and training) to preside over disciplinary proceedings. Still, the three-person hearing panels also include representatives of the securities industry, to help ensure that business interests are appropriately recognized. In addition, the NASD appellate body also consists of persons with experience in the capital markets.

- *Rulemaking*
  The staff prepares rule proposals, rule interpretations, and other policy matters after consultations with interested NASD constituencies. Nonetheless, while the rulemaking process involves member committees, the staff still has the ability to bring proposals to NASD's Board of Governors, irrespective of committee views. Moreover, the NASD Board must approve all NASD rule proposals before NASD submits them to the SEC. In this way, the Board, which represents various stakeholders, oversees NASD rulemaking initiatives.

4. SEC Concept Release

In late 2004, the SEC issued a Concept Release, requesting comments on options for changing SRO regulation. Among the SEC's concerns were real and perceived problems with duplicative and potentially conflicting regulations and inspection regimes among the various SROs. In addition, in the SEC's view, SRO demutualization introduced potential new conflicts of interest and issues of regulatory incentives.

The Concept Release set forth seven potential options to change the SRO structure in the United States:

- Enhancement of the current SRO system, by improving transparency and governance;
- Independent regulatory model and market corporate subsidiary model, in which the SROs would establish independent regulatory subsidiaries;
- A hybrid approach, in which there would be one SRO for firm regulation, and Exchanges would continue to carry out market regulation;
- A competing hybrid model, involving competing SROs for firm regulation and Exchanges continue to carry out market regulation;
- Universal self-regulator model, in which there would be one industry SRO for both market and member regulation;
- Universal non-industry regulator model, in which there would be a non-industry SRO for both market and member regulation; and

- Direct SEC regulation of the securities industry.

NASD has endorsed the third option. Under this hybrid approach, a single SRO for firm regulation, unaffiliated with any one market, would be solely responsible for regulating all SRO member firms. The single member SRO would promulgate both membership and conduct rules, inspect members for compliance with those rules, and take enforcement action against members that fail to comply. This hybrid model could improve upon the current SRO system in a variety of respects. For instance, because the single member SRO would not be affiliated with a particular market, this would eliminate inherent conflicts of interest that currently exist between the regulatory function and market operation of an SRO. Moreover, because each trading market would have control over enforcement of its own trading rules, this approach would preserve the value of having market regulatory staff embedded within the market SROs. The hybrid approach also would eliminate duplicative regulation with respect to membership and conduct rules. Among other things, the single firm SRO would reduce or eliminate the duplication of inspections, inspection reports, surveillance, and other areas of overlapping jurisdiction; the need for maintaining and staffing multiple SROs; and the ineffectiveness and inefficiency of a firm having to respond to requests from two or more SROs.

In late November 2006, with the endorsement of the SEC, NASD and the New York Stock Exchange announced the signing of a letter of intent to consolidate their member regulation operations into a new SRO. This SRO will be the private sector regulator for all securities brokers and dealers doing business with the public in the United States. The consolidation thus embraces the hybrid approach, described above. By streamlining broker-dealer regulation, the plan should increase the efficiency and consistency of securities industry oversight and should reduce overall regulatory costs to the industry.

5. Conclusion

While the self-regulatory system has undergone numerous changes in the United States as Congress and the SEC have made periodic adjustments to account for changing circumstances, the basic concept that 'self-regulation is preferable to direct government regulation' remains intact. The history of NASD as an SRO is unique, but this history has lessons, both positive and negative, for other SROs and their regulators, as well as entities considering becoming SROs.

Annex 3: SRO Responsibilities

This Annex outlines the basic responsibilities that SROs typically perform, and summarizes the responsibilities of SROs in six major jurisdictions.

A. Outline of Responsibilities

Exchanges usually have responsibilities to investors, issuers and the public imposed on them that are over and above their responsibilities to shareholders or members. These include 1) maintaining a fair, efficient, and reputable public market, 2) ensuring compliance with their rules and securities regulations, and 3) enhancing market integrity and investor confidence by imposing standards of conduct that protect investors and promote quality markets.

Self-regulatory functions contribute to meeting these public responsibilities. The functions traditionally covered by Exchange SROs cover four areas:

1. **Member (Broker-Dealer) Regulation**
   1.1 Membership or registration of Members or Participants
   1.2 Licensing or registration of individuals
   1.3 Compliance, supervisory and internal control policies and procedures
   1.4 Capital adequacy regulations (net capital and margin requirements)
   1.5 Financial examinations
   1.6 Books, records and accounts requirements
   1.7 Business conduct and sales compliance rules
   1.8 Duties to clients
   1.9 Compliance examinations

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

3. **Listings Standards and Rules**
   3.1 New listing standards
   3.2 Continued listing rules
   3.3 Corporate disclosure rules
   3.4 Corporate governance rules
   3.4 Shareholder protection rules (for transactions that affect public or minority shareholders)
   3.5 Reporting requirements

4. **Enforcement**
   4.1 Formal investigations
   4.2 Emergency powers
   4.3 Disciplinary procedures

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

As noted above, increasingly Exchanges' regulatory functions are being limited to activities that directly support and add value to its core business operations of administering trading markets, facilitating the trading of a range of products and listing securities for trading.

B. Division of Responsibilities between Regulators and SROs

Two recent international surveys have examined the division of responsibilities between government regulators and SROs. In 2002 the World Federation of Exchanges surveyed its members on their regulation responsibilities.[38] The Survey showed that a large majority of Exchanges perform at least some market regulation. Many regulate trading members and supervise clearing and settlement activities. Many perform a Listings role, and have some responsibility for listed company disclosure and corporate governance. The results show that regulatory roles are usually shared with the government regulator.

In 2006 ICSA conducted a survey of 10 major Exchange and independent SROs.[39] All the SROs surveyed regulate member firms. Almost all regulate markets, either Exchange or OTC. The Exchange SROs also regulate issuers. In addition, almost all SROs performed other activities, for example dispute resolution services, investor education and education of market professionals. Of course the scope of regulation that any given SRO is responsible for in each area differed by jurisdiction.

Rulemaking is a function at several levels of regulation, so it is usually shared between an SRO and the regulator. In market regulation, regulators are usually responsible for the overall standards of market conduct and Exchanges normally set their operating rules and more detailed rules of trading conduct.

C. Country Examples

The following table describes the division of regulatory responsibilities between the regulators and SROs in 6 developed markets. The table focuses on 6 key responsibilities that are performed by SROs in many countries.

The boxes are highlighted for areas where SROs have significant responsibilities.

	US	Canada	Hong Kong
Market Regulation	Exchanges are primary regulators of their securities and futures markets. Nasdaq contracted NASD to perform most functions. NASD and NFA regulate some markets by contract. SEC sets high level anti-fraud rules. Several authorities regulate debt markets.	New merged independent SRO does market surveillance & sets market conduct rules for all equities markets. Markets must contract with SRO for regulation services. The SRO is also the main regulator of debt markets. MX regulates its own derivatives market. Commissions set high-level principles.	SFC is primarily responsible for market conduct. HKEx monitors its securities and futures markets for compliance with Exchange trading rules. HKEx lists corporate bonds.

[38] Regulation of Markets Survey 2004, World Federation of Exchanges (January 2005).
[39] Self-Regulation in Financial Markets: An Exploratory Survey, International Council of Securities Associations (September 2006).

Listings	Exchanges (mainly NYSE, Nasdaq & Amex) set listing requirements and approve listing. Set some Listing Rules (ongoing obligations of listed companies). Issuer regulation shared with SEC.	TSX sets listing requirements and approves listing, and also sets many Listing Rules. Issuer regulation is shared with Commissions.	HKEx sets listing requirements and approves listing. Sets many Listing Rules. Issuer regulation shared with SFC.
Issuer Disclosure & Governance	SEC sets disclosure requirements. Exchanges monitor compliance with timely disclosure. CG standards shared.	Commissions set disclosure and CG standards. SRO monitors compliance with timely disclosure.	HKEx and SFC share responsibility.
Member / Intermediary Regulation	New SRO[40] will be primarily responsible for rules and compliance inspections. In futures industry NFA and Exchange SROs share responsibility.	SROs (IDA and MFDA) are primarily responsible for rules and compliance inspections of members. MFDA (SRO) for fund dealers.	SFC is primarily responsible for regulation of securities dealers.
Enforcement	SROs for SRO rules. SROs can also enforce members' compliance with securities laws.	SROs for SRO rules.	HKEx for its rules.
CSD Regulation	Independent CSD	Independent CSD	HKEx regulates its own clearing houses.

	UK	**France**	**Australia**
Market Regulation	FSA is mainly responsible for market conduct and surveillance in all markets. Exchanges monitor trading on their markets for compliance with their trading rules. LSE lists all types of bonds. .	AMF is mainly responsible market conduct and surveillance. Exchanges monitor trading on their markets for compliance with their trading rules. Euronext acquired 51% of Euro MTS debt trading system in 2005.	ASX sets most market conduct and trading rules for securities and futures markets (ASX merged with SFE in 2006.) Full market surveillance responsibility for ASX rules and for identifying breaches of law. Debt is not traded on ASX and is not a SRO responsibility.
Listings	FSA sets listing rules and approves listing. LSE has admission to trading standards.	Euronext sets listing requirements and approves listing. Euronext sets some basic Listing Rules. Issuer regulation is primarily AMF.	ASX sets listing requirements and approves listing. Sets Listing Rules.

[40] See description in Annex 1 of NYSE Group – NASD agreement to consolidate member regulation in a new central SRO.

	UK	France	Australia
Issuer Disclosure & Governance	FSA	AMF	ASX shares role with ASIC. ASX sets some rules and monitors compliance with timely disclosure.
Member / Intermediary Regulation	FSA has full responsibility.	AMF has full responsibility.	ASX shares role with ASIC.
Enforcement	FSA. Exchanges have limited role.	AMF. Exchange has limited role.	ASX for breaches of ASX rules.
CSD Regulation	Independent CSD	Independent CSD	ASX subsidiary sets rules

Annex 4- Responses to Conflicts of Interest

A wide range of approaches to managing conflicts of interest are employed by SROs and their supervising regulators. International experience demonstrates that there is no clear right or wrong answer to the conflict issue. A range of responses to conflicts are still being tested. Most demutualized Exchanges are still transforming to a fully commercial orientation. Nevertheless some international convergence on approaches to managing conflicts has emerged.

The organizational separation of the regulatory and the business operations of an Exchange is now established as a best practice. Some Exchanges have established separate entities with their own boards to house SRO operations, including the NYSE.

Many Exchanges have reinforced the independence of their regulatory units. For example, in 2006, ASX established a separate subsidiary for its regulatory operations called ASX Markets Supervision. It is governed by a separate board and is headed by a Chief Supervision Officer who reports to the Board of the subsidiary and to the Board of ASX. OMX, the operator of several Nordic Exchanges, established an independent committee to oversee its surveillance and listings functions.

T**ransfer of regulatory responsibilities from for-profit Exchanges to alternative regulators** is also a well-established trend. Usually functions are transferred to the government regulator but independent SROs have assumed responsibilities from Exchanges in Canada, the US and Colombia.

Several independent SROs have organizationally separated their regulatory and trade association operations. In Canada the IDA became a pure SRO in 2006 after splitting off its trade association arm into a new organization. In Japan the JSDA remains a dual-purpose institution, but recently adopted a new organizational structure to separate the governance of its SRO operations. An independent Self-Regulation Board is entrusted with decision-making on SRO matters.

Corporate governance policies are of critical importance in responding to conflicts.
Directors should be trained on the meaning and interpretation of the SRO's public interest role and how individual directors and the board as a whole should address public interest issues and ensure that the organization meets its public interest responsibilities. This would typically include concrete procedures to be followed in considering issues, making policy decisions and adopting proposed rules.

Use of special Board committees to address conflicts of interest is in favour. Several Exchanges have created Conflicts Committees to address conflicts of interest, including Toronto, Hong Kong and Singapore, in particular conflicts with other listed companies. The issues that the Committees deal with are reviewed by the supervising regulator. In the EU, the Markets in Financial Instruments Directive will require all regulated markets to have governance arrangements in place to identify and manage the consequences of any conflict of interest between the regulated market, its owners or its operators and the sound functioning of the market.[41]

Creating Board-level Regulatory Oversight Committees is an emerging best practice of SROs. Their mandate is to oversee regulatory plans and programs for the purpose of ensuring that they operate independently of the business and perform effectively. licts of interest noted

[41] IOSCO Technical Committee – Consultation Report on Regulatory Issues arising from Exchange Evolution, March 2006

above. Several US Exchanges, including the NYSE and CME, have established such committees, as has the IDA in Canada. For example the mandate of the NYSE's Regulatory Oversight & Regulatory Budget Committee is to ensure the "effectiveness, vigour and professionalism" of the Exchange's regulatory program; to oversee the budgets for all regulatory operations; to determine the annual regulatory plan and budget; and to assess regulatory performance.[42]

Stronger supervision of SROs by government regulators has been an almost universal response to greater conflicts at Exchange SROs, with a particular focus on reviewing how Exchanges manage conflicts of interest. This includes both the policies and procedures adopted to address conflicts and how specific cases of conflict are handled. Since regulators have ramped up their overall oversight programs for SROs, including non-Exchange SROs where relevant, stronger oversight is not attributable only to addressing conflicts of interest.

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

[42] NYSE Regulatory Oversight Committee Charter, www.nyse.com/pdfs/regoversightcharter.pdf.