

## **Best Practices for Self-Regulatory Organizations**

ICSA members consider self-regulation of financial markets to be a valuable element of regulatory systems around the world, as it provides a mechanism whereby the expertise and practical experience of the industry contributes to the development and implementation of regulatory policy.<sup>1</sup> Self-regulation is particularly important when regulators are dealing with market issues and the conduct of market participants, since self-regulatory organizations (SROs) are close to the market and therefore can be flexible and responsive to market developments.<sup>2</sup> Self-regulation can also contribute to increased market efficiency because it expands regulatory resources at a lower cost to taxpayers than other forms of regulation while also giving due consideration to both protection concerns and the need for efficiency and competitiveness.

Self-regulation in securities markets, which predates the establishment of government regulation in many jurisdictions, takes a large variety of forms. At an informal level, almost all trade associations that represent firms active in the securities market develop codes of conduct and other forms of guidance for their members, although generally this guidance is not binding. At a formal or official level, almost all exchanges exercise some regulatory authority over their markets and member firms, although the nature of that authority has changed significantly over the past several years in response to

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<sup>1</sup> The members of the International Council of Securities Associations (ICSA) represent and/or regulate the overwhelming majority of the world's equity, bond and derivatives markets. ICSA's objectives are: (1) to encourage the sound growth of the international securities markets by promoting harmonization in the procedures and regulation of those markets; and (2) to promote mutual understanding and the exchange of information among ICSA members. A list of ICSA members is attached to this document.

<sup>2</sup> The ICSA *Best Practices for SROs* are intended for organizations that are regarded as self-regulatory organizations (SROs) by the relevant regulatory authority or authorities in the jurisdiction(s) in which they are active.

demutualization and other developments.<sup>3</sup> In addition, SROs that regulate the vast majority of market participants have developed in several jurisdictions including Canada, Japan, Korea, and the U.S. In some cases, these SROs regulate markets as well as market participants, but do not own or operate an exchange or marketplace. In other cases, these SROs regulate markets and market participants and also own and/or operate an exchange or marketplace. Finally, in some countries, these SROs also function as trade associations and, in that capacity, advocate on behalf of the industry.<sup>4</sup>

In the context of these different structures and responsibilities, recent changes in financial markets have raised concerns about conflicts of interest at SROs. This is particularly the case for SROs affiliated with exchanges, since demutualization and changing business models have raised concerns about the potential for greater conflicts of interest between an exchange's self-regulatory responsibilities and its commercial activities.<sup>5</sup> Concerns have also been raised about potential conflicts of interest at the SROs that regulate the vast majority of market participants in some jurisdictions, particularly those that also operate as trade associations for the securities industry and/or are affiliated with an exchange or market.

SROs have a strong incentive to ensure that public confidence in the self-regulatory system is maintained.<sup>6</sup> Therefore, over the past few years SROs in many jurisdictions have implemented measures to increase their regulatory responsibilities and resources

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<sup>3</sup> For a discussion of these developments, see IOSCO Technical Committee, "Regulatory Issues Arising from Exchange Evolution", Consultation Report (March 2006).

<sup>4</sup> For a more detailed description of the distinction between the different types of SROs see ICSA Secretariat, "Self-Regulation in Financial Markets: An Exploratory Survey", September 2006.

<sup>5</sup> This issue is being examined in many of the jurisdictions where nationwide SROs function. In the U.S., for example, the SEC proposed a number of alternatives to the current system of SROs. See the SEC, "Concept Release Concerning Self-Regulation", Release No. 34-50700 (March 8, 2005).

<sup>6</sup> SROs have an incentive to ensure that public confidence in the self-regulatory system is maintained since a breakdown of public confidence could compel government regulators to take actions that might threaten the SRO's autonomy or even its continued existence.

and, in many cases, separate their regulatory activities and from their commercial and/or advocacy activities.<sup>7</sup>

In the absence of an international code or set of best practices, ICSA members have developed a set of *Best Practices for SROs* that incorporates many of these measures and is intended to help SROs appropriately manage conflicts of interest regardless of their structure.<sup>8</sup> Accordingly, ICSA members agree that:

1. *A SRO is a private, non-governmental organization that should be dedicated to the public interest objectives of enhancing market integrity, investor protection and market efficiency.*

The SRO should always put the public interest first where there may be a conflict between the commercial and other interests of their members and the public interest. The SRO can achieve this objective through its rules and regulations as well as through its compliance and disciplinary activities. The SRO may also accomplish its public interest objective through the provision of: (a) educational services for market professionals; (b) resolution services for its members; (c) consumer redress services for retail investors; and (d) investor education services for retail investors. It is recommended that all SROs emphasize their public interest mandate in their mission statements.

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<sup>7</sup> The extent of the separation between the SRO's regulatory and commercial/advocacy activities has varied considerably between jurisdictions and between individual SROs. The main exception is found at a number of exchanges in Europe and Asia, where the government regulator has assumed some portion of the regulatory responsibilities that had been previously exercised by the exchange. For a description of the recent structural changes that have taken place at SROs see ICSA Secretariat, op. cit.

<sup>8</sup> The ICSA *Best Practices for SROs* are intended as a complement to and amplification of the principles set out in IOSCO's *Principles and Objectives of Securities Regulation* (2002) as well as the standards proposed in the report issued by IOSCO's SRO Consultative Committee, *Model for Effective Self-Regulation* (2000). For the sake of brevity, some intrinsic characteristics of SROs have not been included in the ICSA *Best Practices for SROs*, since they are already included in the IOSCO and SRO CC documents.

2. *A SRO should establish rules and regulations that effectively promote market integrity, market efficiency and enhance investor protection.*

All SROs promulgate rules and regulations for market participants subject to their jurisdiction. These may include: (a) membership requirements; (b) business conduct rules/sales compliance rules; (c) capital adequacy rules; and (d) accreditation/proficiency standards. SROs may also license and/or register market participants subject to their regulatory authority. In addition, SROs that regulate markets may establish market conduct trading and quality rules. The SRO should ensure that its rules and regulations treat all market participants in a fair and equitable manner, do not distort the market mechanism or impose an excessive burden on regulated firms and individuals.<sup>9</sup>

3. *A SRO should monitor and enforce compliance with its rules and regulations and, where applicable, with other relevant governing regulations.*

In order to ensure compliance with its rules and regulations, the SRO conducts investigations, inspections and surveillance activities on a regular basis including, when necessary, onsite visits. All investigations, inspections and surveillance activities conducted by the SRO should be carried out independently by the SRO's staff and separated by effective firewalls from the SRO's non-regulatory activities. The SRO should also ensure that its monitoring and disciplinary procedures are applied in a fair and consistent manner to all market participants. Some SROs accomplish this goal by having public representatives serve on the SRO's disciplinary bodies along with market participants, taking care to ensure that an

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<sup>9</sup> This can be accomplished by: (1) establishing that there is an actual market failure that can be effectively remedied by a new rule or regulation; (2) considering the full range of possible policy responses; (3) employing rigorous analysis, using cost-benefit techniques to the extent possible, to determine whether the benefits of new rules or regulations would outweigh the costs; and (4) ensuring that new rules and regulations are no more complex or wide-ranging than the problems that are to be mitigated. The SRO should also review existing regulations from time to time to determine whether they are still relevant and whether the existing measures should be amended, simplified or abolished. For a comprehensive explanation see ICSA *Principles for Better Regulation* (2006).

appropriate balance between market participants and public representatives is maintained. In addition, the SRO should advise the public and media of material disciplinary actions and/or disclose the terms of settlement agreements, to the extent permitted by privacy rights.

4. *A SRO should have statutory regulatory authority and/or regulatory authority that is delegated to it by the government regulator(s).*

As a result of ongoing market developments, including the emergence of new and highly diversified market participants and increased public expectations for investor protection, the regulatory responsibilities at SROs have increased over the past several years. As a result, regulatory authority based solely on contract may no longer be adequate. Therefore, it is important that the SRO have statutory regulatory authority and/or regulatory authority delegated to it by the government regulator(s), whenever possible. These enhanced regulatory powers will help to ensure that the SRO can adequately enforce its own rules and regulations and, where applicable, relevant government rules and regulations.

5. *A SRO should be effectively supervised by the relevant government regulator(s).*

Ongoing supervision of the SRO by the relevant government regulator(s) is fundamental in order to achieve accountability and to alleviate concerns about conflicts of interest. Oversight should be sufficiently comprehensive and frequent to ensure that the SRO discharges its responsibilities diligently and fairly and puts the public interest first. At the same time, oversight should not extend to managing the SRO or taking over the self-regulatory policy development process, as that would undermine the SRO's ability to add value to the regulatory process.

6. *A SRO should have a stable and adequate funding base for its regulatory activities while also maintaining financial accountability and transparency.*

In order to carry out its regulatory and other responsibilities in a timely manner and operate independently from the market participants it regulates, the SRO should have a stable and reliable funding base. The SRO's revenue may come from a variety of sources, including income from member dues, trading and reporting fees, the provision of educational and/or other services, and regulatory fines. Revenue generated from regulatory fines should be used exclusively for regulatory activities or activities that relate exclusively to the SRO's public interest mandate, such as the provision of educational services. In addition, to promote accountability and transparency, the SRO should publish an audited financial statement of its revenues and expenditures on an annual basis.

7. *A SRO should have a professional staff with the appropriate training and resources.*

A professional and well-trained staff dedicated to the objectives and mission of the SRO will help ensure the SRO's independence from the market participants that it regulates and thereby reduce concerns about conflicts of interest. Moreover, since the SRO's staff is responsible for designing and implementing complex regulatory policies and rules, it is critical that the SRO hire competent staff that participates regularly in training programs and other forms of continuing education.

8. *A SRO should ensure that market participants and qualified independent directors have a meaningful role in its governance.*

Given its self-regulatory status and public interest mandate, the governing board of the SRO should normally have adequate representation by both qualified independent and industry directors. If the SRO's governing body is composed

entirely of independent directors, arrangements should be in place to ensure that market participants have an effective voice in the SRO's governance and the development of its regulatory policies. Alternatively, if the SRO's governing body is composed entirely of market participants, arrangements should be in place to ensure that qualified independent representatives have an effective voice in the SRO's governance and the development of its regulatory policies.

9. *A SRO should establish and maintain an effective consultation program in order to ensure that market participants and, when appropriate, members of the public have input into the design and implementation of regulatory policies.*

An effective consultation program helps to ensure that the SRO's policy development process is transparent and has adequate input from market participants and, when appropriate, from members of the public.<sup>10</sup> To achieve these objectives, the SRO should: (a) begin consultations as early as possible; (b) consult widely with relevant constituents; (c) give due consideration to the responses that have been received; and (d) consult for a second time if the response to the first consultation reveals significant problems, or where revised proposals are substantively different from the original proposals.

10. *A SRO should establish and maintain appropriate structures, policies and procedures to ensure that potential conflicts of interest between its regulatory and commercial and/or advocacy activities are appropriately managed.*

Some SROs will need to implement specific procedures to manage potential conflicts of interest between their regulatory and other activities. This is particularly pertinent for SROs that own or operate an exchange or marketplace and for SROs that also function as trade associations. A variety of mechanisms

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<sup>10</sup> For a comprehensive overview of the various elements of an effective consultation policy, see ICSA *Statement on Regulatory and Self-Regulation Consultation Practices (2004)*. Typically, public input occurs during a period for public comment provided by the government regulator as part of its formal approval process of SRO rules.

can be used for this purpose, such as the establishment of firewalls separating the SRO's regulatory activities from its commercial and/or advocacy operations and the creation of a separate governing body responsible for overseeing the SRO's regulatory activities. Alternatively, the SRO may contract with an unaffiliated SRO that will carry out all or a portion of its regulatory responsibilities or may establish separate structures for its commercial and regulatory activities, including different corporate entities with separate staffs and/or a complete physical separation. Where a formal separation is not established, the SRO should establish appropriate procedures for managing potential conflicts of interest. Those procedures would normally be approved by the relevant government regulator(s).