

June 2, 2006

Mr. Philippe Richard  
IOSCO Secretary General  
Oquendo 12  
28006 Madrid  
Spain

**Re: Public Comment on *Regulatory Issues Arising From Exchange Evolution***

Dear Mr. Richard:

In my capacity as Chairman of the Working Group on Self-Regulation of the International Council of Securities Associations (ICSA),<sup>1</sup> I would like to comment on the consultation report entitled, *Regulatory Issues Arising from Exchange Evolution* prepared by IOSCO's Technical Committee's Standing Committee on the Regulation of Secondary Markets (SC2). This is an extremely complicated issue and the members of the Standing Committee are to be congratulated for the excellent report that they have produced.<sup>2</sup>

I will start with some observations arising from an ongoing study being carried out by the ICSA Working Group on Self-Regulation regarding the evolution of self-regulation in financial markets. The study itself has not yet been concluded and therefore cannot be distributed at this point, although we look forward to distributing the completed study to IOSCO members within the next few months. As part of this project, the Working Group has conducted a survey of SROs in order to identify the core or defining features that

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1. ICSA is composed of trade associations and self-regulatory associations for the capital market in broad range of jurisdictions as well as a number of international trade associations. ICSA members represent and/or regulate the firms that carry out the bulk of the activity on the world's equity, bond and derivatives markets. A list of ICSA members is attached to this letter.

2 A separate ICSA Working Group will be commenting on other issues raised in the IOSCO report.

characterize SROs across national boundaries. This was seen as important since, while the benefits of and limits to self-regulation in financial markets have attracted a great deal of attention over the past several years, there is no agreed upon definition of SROs that is valid on an international basis. Without a common vocabulary, it is difficult if not impossible to understand the various ways that SROs are evolving in response to the continuing changes in financial markets.

The survey included both exchange SROs and member regulation SROs and consequently, was more inclusive than previous studies on this issue, which have focused solely on the exchange SROs.<sup>3</sup> The results from this study shows 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;<sup>4</sup> (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.<sup>5</sup>

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3 Although the sample size of this survey was relatively small, comprising only ten SROs, those SROs included in the survey represent many of the largest exchanges operating in the world today as well as member SROs that operate independently of an exchange or market. The participants in the survey were the Australian Stock Exchange (ASX); Bond Exchange of South Africa (BESA); International Capital Market Association (ICMA); Investment Dealers Association of Canada (IDA); Japan Securities Dealers Association (JSDA); Korea Securities Dealers Association (KSDA); NASD; National Futures Association (NFA); New York Stock Exchange (NYSE); and the Tokyo Stock Exchange (TSE)

4 Surveillance is defined as the timely review of trading activity conducted on an exchange or market.

5 Along with the core characteristics outlined above, many SROs carry out a variety of other activities that are consistent with their mandate to enhance market integrity, market efficiency and investor protection. These activities include: (1) the provision of consumer redress/dispute resolution services; (2) the provision of investor education for consumers and educational services for market professionals; and (3) the provision of market data for member firms and other market participants.

I would like to emphasize that this list of core or defining characteristics is based on survey results and is not intended as a normative statement about how SROs should conduct their activities.<sup>6</sup> At the same time, however, the members of the ICSA Working Group believe that this list of core characteristics can help to illuminate the changes that are taking place within SROs in general, and within exchange SROs in particular.

The members of the Working Group on Self-Regulation believe that this list of core characteristics is particularly useful when examining the changes that have taken place in the regulatory operations of demutualized exchanges. One of the results of the ongoing wave of demutualization among exchanges has been the emergence of a variety of models to deal with conflicts of interest between the exchanges regulatory and commercial activities. In addition, some demutualized exchanges continue to operate as SROs, although in most cases additional arrangements have been made to separate the exchanges' regulatory activities from their commercial activities. In other cases, however, the bulk of the exchange's regulatory activities have been either contracted out to a third party SRO or taken over by the government regulator. In those cases the exchanges usually continue to set rules related directly to the functioning of their markets and serve as the front-line monitors of market activity but do not perform any other regulatory activities.

At a relatively high level of abstraction these different models – and some exchanges that have adopted each model – could be summarized as follows:

1. Exchange continues to function as a SRO – CME, CBOT, TSE
2. Exchange creates separate corporate entity to carry out regulation – NYSE, ASX
3. Exchange retains self-regulatory function but contracts with third party supplier of regulatory services to carry out some of its regulatory activities – Nasdaq, TSX
4. Regulatory activities of the exchange are conducted in a quasi-public entity that is completely separate from the commercial operator of the exchange – FSE
5. Government regulator assumes responsibility for most regulatory activities and exchange retains only limited regulatory authority – LSE, HKEx, Euronext Paris

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<sup>6</sup> Principle 7 of IOSCO's *Objectives and Principles of Securities Regulation* contains a similar list of attributes for SROs, although they are presented in a more normative framework.

This particular point was discussed in IOSCO's consultation document, specifically with respect to the separation of functions within an exchange and the transfer/removal of regulatory functions from a demutualized exchange. However, the members of the ICSA Working Group on Self-Regulation believe that this issue needs to be stressed more as it appears to be the main identifiable trend affecting the regulatory activities of demutualized exchanges. In that respect, there is a degree of international convergence taking place regarding the mechanisms used to manage conflict of interest at demutualized exchanges, although the specifics differ greatly between different exchanges and different jurisdictions.

In addition to the already existing models for managing conflicts of interest at demutualized exchanges, it is likely that additional models will emerge over time. In particular, it is possible that a single, nationwide member regulation SRO will be established in one or more jurisdictions that would carry out all regulation of broker-dealers while the exchanges in that jurisdiction would retain responsibility for regulating their specific markets. An alternative model would involve the establishment of a single, nationwide SRO that would carry out almost all market regulation as well as member regulation for broker dealers. In both cases, the SRO would not own or operate any exchange or market, thereby completely eliminating the potential for conflicts of interest.

Given the variety of approaches that the exchanges – and regulators – have adopted in order to manage conflicts of interest at demutualized exchanges, it is still not clear which are the most efficient and therefore appropriate regulatory models. And, as more exchanges consolidate on a cross-border basis, what should be the regulatory framework for those exchanges? This is a very relevant concern, since it appears to be only a matter of time before one or more exchange consolidates on a truly global basis. Therefore, it could be extremely useful for IOSCO, possibly in conjunction with private sector representatives, to examine this issue more in depth. Such an examination could include, for example, an in-depth analysis of the advantages and disadvantages of the various models for managing conflicts of interest that have been adopted at demutualized exchanges.

In addition, it might be useful to evaluate the feasibility of the formation of a global SRO that could provide third party regulatory services to global exchanges. Since SROs are not as bound to the political jurisdictions in which they are domiciled as are government regulators, this could be one solution to the problem posed by the formation of exchanges that span geographical – and regulatory – boundaries. In this case, the SRO would be closely supervised by the relevant government regulator in each jurisdiction where the exchange was located. However, regulation of the exchange by the SRO would take place within one organization, thereby minimizing coordination problems that could arise if the exchange were regulated individually by different government regulators.

In closing, I would like to emphasize once again the importance of the Standing Committee's report on *Regulatory Issues Arising from Exchange Evolution* and thank IOSCO for allowing us the opportunity to comment upon it. This is very timely study that incorporates an extensive amount of information about individual exchanges, as well as about general trends among demutualized exchanges. We look forward to engaging in further dialogue with IOSCO members on this very important issue.

Sincerely,

Joe Oliver, CEO and President  
Investment Dealers Association of Canada  
and Chairman, ICSA Working Group on  
Self-Regulation in Financial Markets

*The members of ICSA are as follows:*

Association of Capital Market Intermediary Institutions of Turkey (TSPAKB)

Australian Financial Markets Association (AFMA)

Bond Exchange of South Africa (BESA)

Bond Market Association (TBMA)

French Association of Investment Firms (AFEI)

International Capital Market Association (ICMA)

Investment Dealers Association of Canada (IDA)

Italian Association of Financial Intermediaries (Assosim)

Japan Securities Dealers Association (JSDA)

Korea Securities Dealers Association (KSDA)

London Investment Banking Association (LIBA)

NASD

Securities Industry Association (SIA)

Swedish Securities Dealers Association (SSDA)

Taiwan Securities Association (TSA)