

ICSA International Council of Securities Associations

Self-Regulation in Financial Markets:

An Exploratory Survey

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This report is a product of the ICSA Working Group on Self-Regulation in Financial Markets, under the chairmanship of Joe Oliver, President and CEO of the Investment Dealers Association (IDA). The members of the Working Group and their affiliations are: Paul Bourque, Investment Dealers Association (IDA), Richard Britton, International Capital Markets Association (ICMA), Garth Gruebel, Bond Exchange of South Africa (BESA), Marjorie Gross, Bond Market Association (BMA), Koichi Ishikura, Japan Securities Dealers Association (JSDA), George Kramer, Securities Industry Association (SIA), David Lynch, Australian Financial Markets Association (AFMA) and Dan Sibears, NASD. The report also benefited from discussions with Karen Wuertz of NFA and Elisabeth Roegele of BaFin. Marilyn Skiles, Executive Director of ICSA, was the principal author of the report. Any errors in the report are those of the principal author.

**SELF-REGULATION IN FINANCIAL MARKETS :
RESULTS OF AN EXPLORATORY SURVEY**

Abstract

The benefits of and limits to self-regulation in financial markets have attracted a great deal of attention over the past several years, focusing principally on the role played by self-regulatory organizations (SROs). However, one difficulty in this debate is that there is no internationally agreed upon definition of SROs. Therefore, in an effort to provide the basis for a more informed discussion about self-regulation, ICSA has carried out a survey in order to determine how self-regulation is actually practiced at SROs. On the basis of this survey, 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 government regulators; (3) have statutory regulatory authority and/or authority delegated by the government regulator(s); (4) establish rules and regulations for firms and individuals subject to their regulatory authority; (5) monitor compliance with those rules and regulations; (6) have the authority to discipline firms and individuals that violate their rules and regulations; (7) include industry representatives on their Boards or otherwise ensure that industry representatives have a meaningful role in governance; and (8) maintain structures, policies and procedures intended to ensure that conflicts of interest between their commercial and regulatory activities are appropriately managed. These core characteristics have been found to apply to all SROs in the survey, regardless of their jurisdiction.

SELF-REGULATION IN FINANCIAL MARKETS : RESULTS OF AN EXPLORATORY SURVEY

Introduction

The benefits of and limits to self-regulation in financial markets have attracted a great deal of attention over the past several years. Proponents argue that self-regulation contributes to greater efficiency in financial markets as it provides a mechanism for the expertise and practical experience of the industry to contribute to the development of regulatory policy. In addition, rules that are informed by industry expertise will obtain greater industry buy-in and result in a higher level of voluntary compliance. Much of the concern about self-regulation, on the other hand, has focused on the perception that the self-regulatory bodies are unduly influenced by the industry in the formation of regulatory policy and are often subject to conflicts of interest between their regulatory responsibilities and their business operations. At the same time, public expectations regarding the need for vigorous and effective regulation to ensure that retail investors are adequately protected have increased over the past several years. Largely in response to these concerns, governments and regulators in a number of jurisdictions are examining the role of self-regulation in financial markets.

In an effort to bring greater clarity to the debate over the role of self-regulation in financial markets, ICSA has carried out a survey of self-regulatory organizations (SROs) in order to examine how self-regulation is actually practiced in today's financial markets. The objective of the survey was to arrive at a better understanding of the core responsibilities and activities that characterize SROs across national boundaries. Specifically, the survey looked at the sources of SROs' regulatory authority, their regulatory and other activities, and their relationships with their members and with government regulators. The results of the survey, which are summarized in this paper, may serve as the basis for an internationally agreed upon set of "best practices" or principles for the responsibilities and activities of SROs operating in different jurisdictions.

A. Self Regulation in Financial Markets

Self-regulation has a long and varied history in financial markets. The first form of active self-regulation appeared at the precursor to the London Stock Exchange, which was established as The Stock Exchange in the early 1800s with specific rules intended to prevent “disorderly action” and thereby improve the reputation of its members. The exchange, which issued its first rulebook in 1812, had the ability to impose fines on members that were not in compliance with its rules and bar from its premises anyone who was not a member. Shortly afterwards the New York Stock and Exchange Board – the precursor to the New York Stock Exchange – was established with a set of rules that governed trading, the admission of new members and the resolution of disputes between members.¹ By 1820, the New York Stock and Exchange Board had adopted a detailed set of by-laws along with a range of rules governing its members and listed companies, including member financial responsibility rules, listed company registration and financial reporting rules.

As other stock exchanges developed in other parts of the world, most adopted some form of self-regulation. However, the extent and form of self-regulation has varied widely among exchanges, reflecting the legal and cultural framework in which the exchanges were embedded.² In many jurisdictions, exchanges have exercised their regulatory authority solely on the basis of contracts with their members. In other jurisdictions, however,

¹ Self-regulation among “stock-jobbers” was important in both England and New York State in the 19th century because of legal prohibitions in both jurisdictions against some of the transactions that were then common at the stock exchanges. For that reason, the rules resolving disputes between members at The Stock Exchange in London and at New York Stock and Exchange Board were important since they provided the only dispute resolution mechanisms available for the enforcement of such transactions. See Stuart Banner, *Anglo-American Securities Regulation: Cultural and Political Roots, 1690-1860*, New York: Cambridge University Press, 1998. See also John Coffee, Jr., “The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control”, Columbia Law School Center for Law and Economic Studies (January 2001).

² For example, while both the Stock Exchange in London and the New York Stock and Exchange Board were private entities owned by their members, the Paris Bourse was historically a state chartered monopoly run under close governmental supervision. Stockbrokers at the Bourse were effectively civil servants that were appointed to their position by the Minister of Finance after having passed an exam. Unlike the situation in London and New York, brokers at the Paris Bourse did not own their seats nor control the commission rates charged on stock transaction and, as a result, had neither the incentive nor the ability to develop a self-regulatory structure during the exchange’s early history. See Coffee, op. cit.

exchanges have statutory regulatory authority and/or authority that has been delegated to them from government regulators. These additional regulatory powers have been seen as necessary in order for the exchanges to effectively enforce their rules and regulations.

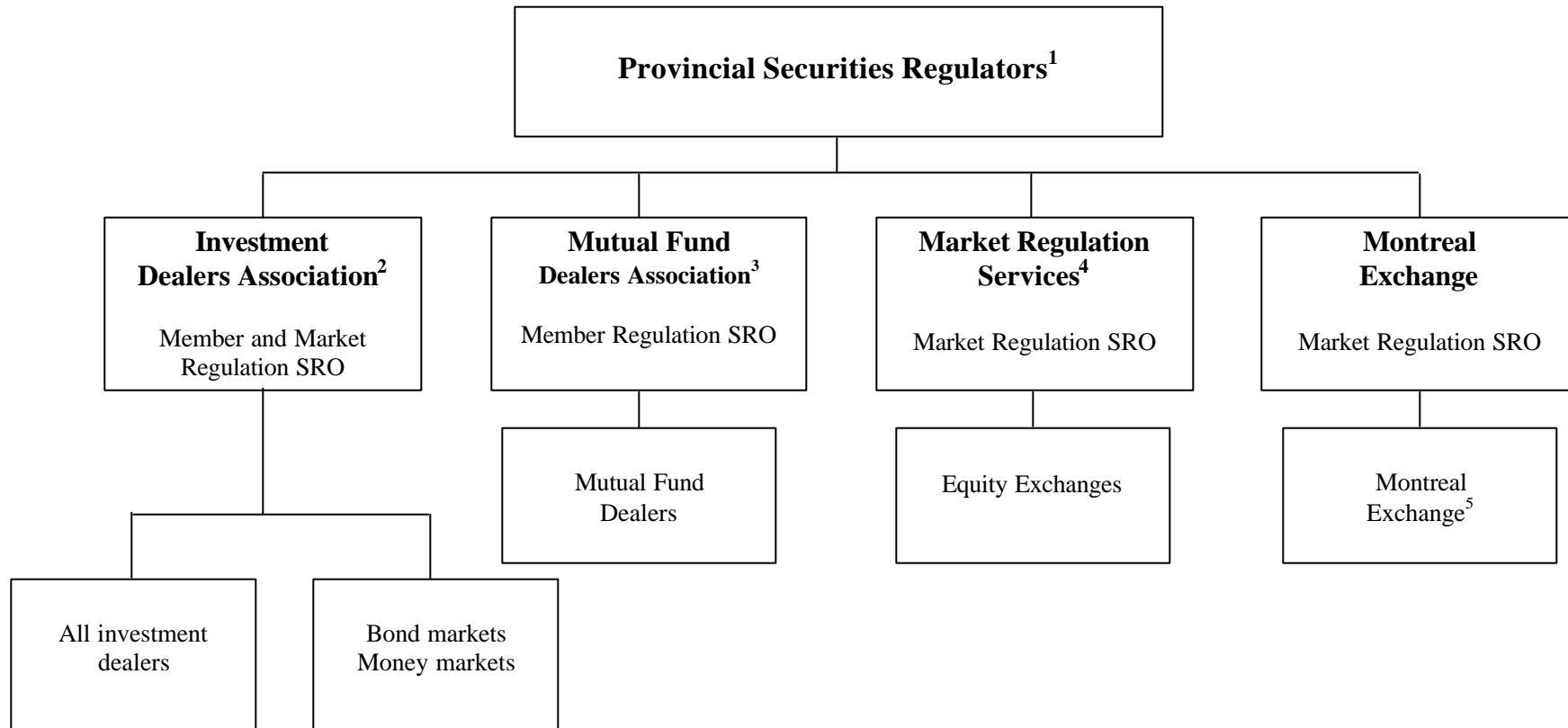
Along with the regulation exercised at the level of the exchanges, nationwide self-regulatory bodies that regulate a broad number of market participants have developed in a number of jurisdictions.³ In some cases these organizations regulate markets as well as market participants, but do not own or operate an exchange or market. In other cases these organizations both regulate markets and a broad number of market participants and also own or operate an individual exchange or market. Some of the nationwide self-regulatory bodies also function as trade associations, and in that capacity represent the industry.

Importantly, these nationwide self-regulatory bodies can be found in countries with widely different regulatory structures. Canada, for example, has several nationwide self-regulatory bodies active in the securities market but does not have a national government securities regulator, relying instead on government securities regulators at the provincial level to establish the country's regulatory policies (Chart 1). Japan, on the other hand, has a unitary national government regulator that is responsible for regulating the entire financial sector along with a number of self-regulatory bodies for the securities industry (Chart 2). Finally, the U.S. has separate government regulators for the securities and futures markets and a number of self-regulatory bodies for both of those industries (Chart 3).

³ In some cases the nationwide self-regulatory bodies emerged out of the activities of trade associations that developed codes and rules of conduct for their members. This was the case in Canada, where the Investment Dealers Association of Canada (IDA) – then known as the Bond Market Association of the Toronto Board of Trade – began regulating in 1923 with the creation of a “Vigilance Committee”. In a number of countries, however, the government and/or government regulator played a key role in the formation of self-regulatory bodies for the securities market. This was the case in Japan, for example, where the government stipulated that securities companies had to form one association in every prefecture in 1940 in order to facilitate wartime control of the securities markets. These individual associations were merged with one another in phases and the Japan Securities Dealers Association was established as a single entity in 1973. Finally, the Roosevelt administration and the SEC in the U.S. played a key role in the formation of the NASD in the 1930s. For the U.S., see Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance*, Boston, Massachusetts: Houghton Mifflin Company, 1982.

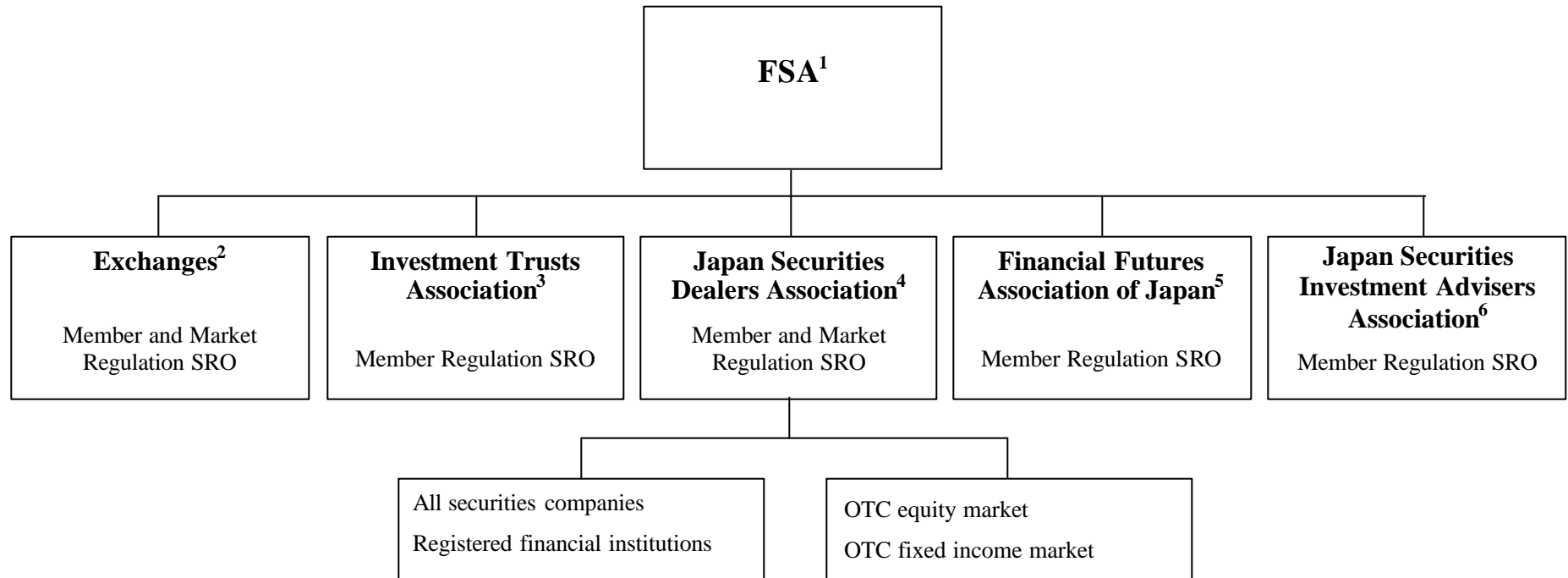
CHART 1

Regulatory Structure for Canada's Securities Market



1. Canada does not have a national regulator for the securities market. Instead, securities regulators from each province and territory in Canada regulate the securities markets in their jurisdictions. Through their participation in the Canadian Securities Administrators (CSA), these regulators are working to develop a harmonized approach to securities regulation across Canada.
2. The Investment Dealers Association of Canada (IDA) is the main self-regulatory organization for Canada's securities markets. In that capacity, IDA regulates all investment dealers and monitors trading activity in the bond and money markets.
3. The Mutual Fund Dealers Association is the self-regulatory organization responsible for regulating mutual fund dealers.
4. Market Regulation Services (RS) is the independent regulation services provider for Canada's equity markets. RS is responsible for developing and implementing the Universal Market Integrity Rules (UMIR), a common set of rules for equities trading across Canada, and monitors and enforces compliance with the UMIR.
5. The Montreal Exchange specializes in financial derivatives.

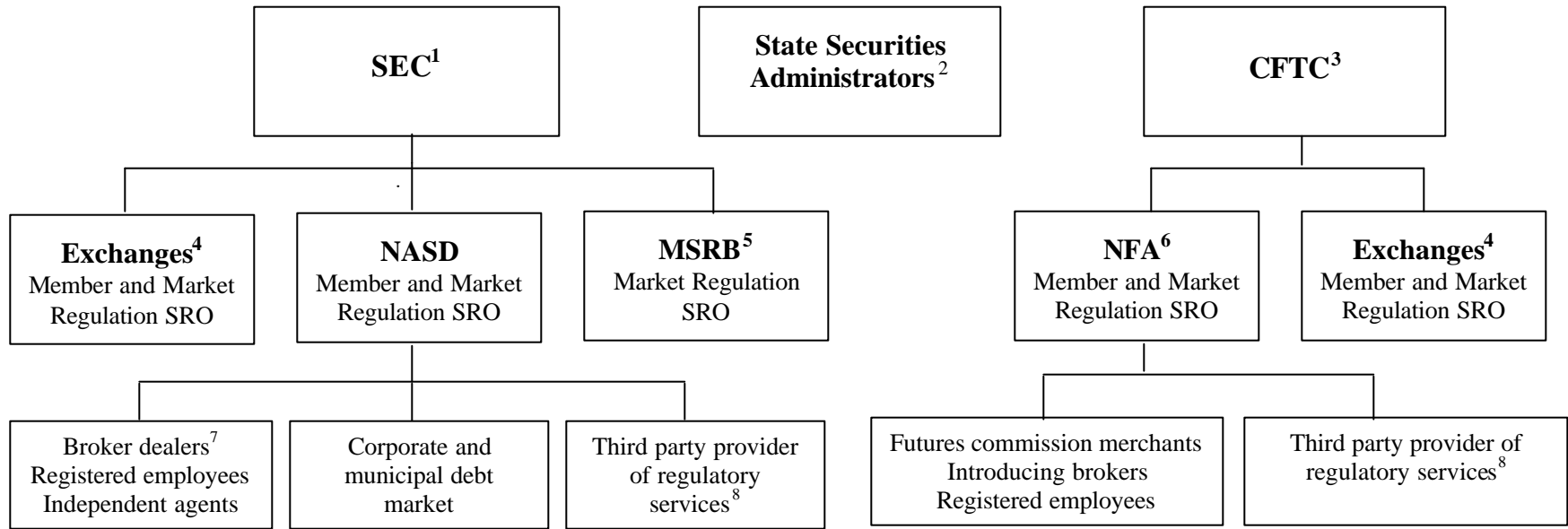
CHART 2
Regulatory Structure for Japan's Securities Market



1. The Financial Services Agency (FSA) is responsible for regulating all financial market participants in Japan. In the securities market, the FSA regulates the SROs and other market participants such as broker-dealers, investment banks and investment trust companies. The FSA also oversees the disclosure of financial information by listed companies.
2. Exchanges have the authority to regulate their own markets, as well as companies listed on those markets and broker-dealers active on those markets.
3. Investment Trusts Association regulates investment trust companies and broker-dealers in the investment trust industry.
4. Japan Securities Dealers Association (JSDA) regulates all securities companies operating in Japan as well as registered financial institutions, which are banks and other financial companies authorized by the government to engage in certain securities transactions. JSDA also regulates the over-the-counter equity and fixed income markets.
5. Financial Futures Association of Japan (FFAJ) regulates broker-dealers in the financial futures industry.
6. Japan Securities Investment Advisers Association (JSIAA) regulates investment advisers.

CHART 3

Regulatory Structure for the Securities and Futures Markets in the U.S.



1. The Securities and Exchange Commission (SEC) regulates the securities market. This includes: (1) regulating the major securities market participants, including broker-dealers and SROs; (2) regulating the investment management industry, including investment companies and investment advisers; and (3) overseeing the disclosure of financial information by publicly-held companies. In addition to the exchanges, NASD and the MSRB, registered clearing agencies and the Public Company Accounting Oversight Board are also SROs that are regulated by the SEC.
2. State securities administrators license securities firms and investment professionals active in their states, register certain securities offerings, review financial offerings of small companies, audit branch office sales practices and record-keeping, and enforce state securities laws.
3. The Commodity Futures Trading Commission (CFTC) regulates the futures and options on futures markets. This includes regulating participants on the futures market including SROs, futures commission merchants, introducing brokers, commodity pool operators and commodity trading advisors. In addition to the exchanges and NFA, designated clearing organizations are also SROs that are regulated by the CFTC.
4. Exchanges regulate their own markets, either directly or through a contractual agreement with another SRO. Exchanges also regulate, either directly or through a contractual agreement with another SRO, the companies that list on their markets and broker-dealers that are active on their markets.
5. The Municipal Securities Rulemaking Board (MSRB) is the rulemaking SRO that establishes regulations for broker dealers and banks dealing in municipal bonds, notes and other municipal securities. The SEC, NASD, Federal Reserve, FDIC and OCC enforce the MSRB's rules.
6. National Futures Association (NFA) is the industry-wide SRO for the futures industry. NFA regulates all futures commission merchants, introducing brokers, commodity pool operators and commodity trading advisors along with the registered employees of all of those entities
7. NASD is the industry-wide SRO for the securities market and regulates broker-dealers and associated persons (registered and non-registered) of broker-dealers with respect to equity and fixed income markets, interactions with investors, corporate financing and advertising.
8. NASD and NFA provide market and member regulation services for exchanges on a contractual basis.

For a variety of reasons, the self-regulatory systems existing in many countries have come under intense scrutiny during the past few years. This has been particularly true for exchanges, where concerns have been raised about the potential for greater conflicts of interest between the exchanges' self-regulatory operations and their commercial activities due to demutualization and the changing business models at many exchanges.⁴ Regulators, exchanges and other market participants have responded to these concerns in a variety of ways, resulting in the emergence of different models for managing conflicts of interest at demutualized exchanges.⁵ In general these changes have resulted in either a strengthening of the regulatory operations at exchanges or the assumption by the government regulator of many of the exchanges' regulatory powers. These models and some of the exchanges that have adopted each model can be summarized as follows:⁶

1. Exchange functions as a SRO with regulatory powers – CME, CBOT⁷, TSE
2. Exchange creates separate entity to carry out regulation – NYSE, ASX
3. Exchange's regulatory activities take place in a quasi-public entity that is completely separate from the commercial operations of the exchange – FSE
4. Exchange contracts with third party supplier of regulatory services – NASDAQ, TSX
5. Government regulator has responsibility for most regulatory activities and exchange has limited regulatory authority – LSE, HKEx, Euronext Paris

⁴ See IOSCO, "Regulatory Issues Arising from Exchange Evolution", Consultation Report (March 2006).

⁵ See the Appendix to this document for a more detailed discussion.

⁶ Modified and adapted from John Carson, "Conflicts of Interest in Self-Regulation: Can Demutualized Exchanges Successfully Manage Them?" The World Bank, (December 2003).

⁷ The Commodity Futures Trading Commission (CFTC) recently issued a set of proposed "Acceptable Practices" for exchanges under its jurisdiction, which includes the Chicago Board of Trade (CBOT) and the Chicago Mercantile Exchange (CME). Among other measures, exchanges are now expected to establish independent, board-level Regulatory Oversight Committees (ROCs) composed solely of public directors that are directly responsible for overseeing the exchanges' regulatory functions. See CFTC, "Conflicts of Interest in Self-Regulation and Self-Regulatory Organizations: Proposed Rule", 17 CFR Part 38, Federal Register Vol. 71, Number 130 (July 7, 2006). For additional information see the Appendix to this document.

In addition to the exchanges, the role of the nationwide self-regulatory bodies has also been called into question in some jurisdictions.⁸ Similar to the exchanges, these organizations have been under scrutiny in part because of concerns over possible conflicts of interests. In addition, the nationwide self-regulatory bodies have been criticized in some jurisdictions because of excessive and costly duplication between their regulations and the regulations imposed on market participants by the exchanges.

The nationwide self-regulatory bodies have responded in different ways to these concerns over the past several years. In Canada, the Investment Dealers Association (IDA) had functioned for decades as both a trade association and a self-regulatory organization. However, due in part to the perception that it could not adequately protect the public's interest if it continued to function as a trade association, IDA became solely a SRO in early 2006.⁹ As a result of this change, IDA is now actively engaged in merger discussions with RS Inc., the SRO that regulates Canada's equity exchanges.¹⁰

In Japan, the Japan Securities Dealers Association (JSDA) continues to function as both a trade association and a self-regulatory body for the national securities market. In order to reduce concerns about a conflict of interest between JSDA's trade association activities and its self-regulatory activities, the JSDA changed its governance structure in July 2004. As a result, the operations of the trade association are now completely separate from those of the SRO and an independent board that includes public representatives now oversees JSDA's self-regulatory operations.

⁸ In the U.S., for example, the SEC suggested a number of alternatives to the current regulatory system in a concept release that it published in early 2005. These included: (1) the abolition of all of existing SROs in favor of direct regulation by the SEC; (2) the abolition of all existing SROs and the establishment of a universal industry SRO; and (3) the abolition of all existing SROs and the establishment of a non-industry SRO. See SEC, "Concept Release Concerning Self-Regulation", Release No. 34-50700 (March 8, 2005).

⁹ A new trade association for Canada's securities market, the Investment Industry Association of Canada, was established at the same time.

¹⁰ If that merger is formally approved, as is expected, one single member- and market-regulation SRO will regulate all investment dealers in Canada as well as the country's equity, bond and money markets.

In the U.S., following the price collusion scandal on the NASDAQ market in the mid-1990s, NASD has substantially strengthened its regulatory operations, sold off its entire interest in NASDAQ and, more recently, has suggested that it should merge its regulatory operations with those of the NYSE in order to eliminate the duplicative regulatory requirements that have been a source of discontent for much of the industry. NASD has also endorsed a proposal made by the Securities Industry Association (SIA), the main trade association for the securities industry in the U.S., for the establishment of a single member SRO that would carry out all regulation for broker-dealers in the U.S. Under this so-called “hybrid” model, the exchanges would retain the responsibility for regulating their specific markets – including all aspects of trading, markets and listing requirements – but would not regulate the broker-dealers active on those markets.

In effect, similar to the changes taking place in many exchanges on a global basis, nationwide self-regulatory bodies in various jurisdictions have moved over the past several years to eliminate concerns about potential conflicts of interest and to strengthen their regulatory operations. In some jurisdictions, in addition, steps are being taken to consolidate the self-regulatory structure and thereby reduce the cost of duplicate regulations. The result of these changes should be to strengthen the system of self-regulation in those jurisdictions where it exists.

As is clear from this brief review, self-regulation continues to be an important and evolving component of the regulatory system in a variety of jurisdictions.¹¹ This includes self-regulation by exchanges and by nationwide self-regulatory bodies, where they exist. Because self-regulation is such an important component of the regulatory structures in a large number of countries, the remainder of this paper will review the results of a recent survey of self-regulatory organizations (SROs), which are a key element of almost any regulatory system based on self-regulation.

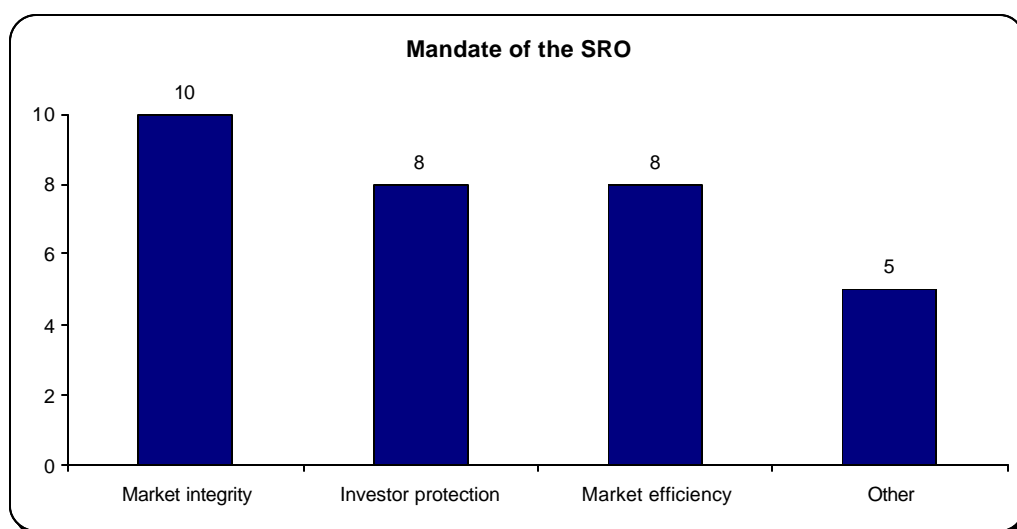
¹¹ Precisely because it is not bound to a single jurisdiction, has a contractual relationship with its members and can be responsive to both government regulators and industry participants, some form of self-regulation may become an important component of a regulatory system that is established for global exchanges, if those are formed.

B. Survey on SROs

The objective of the ICSA survey of self-regulatory organizations, which was carried out in early 2006, was to arrive at a better understanding of the core responsibilities and activities that characterize SROs across national boundaries.¹² The survey examined the sources of SROs' regulatory authority, their regulatory and other activities, relationships with their members and with government regulators and mechanisms for controlling conflicts of interest. The results of the survey are summarized below.

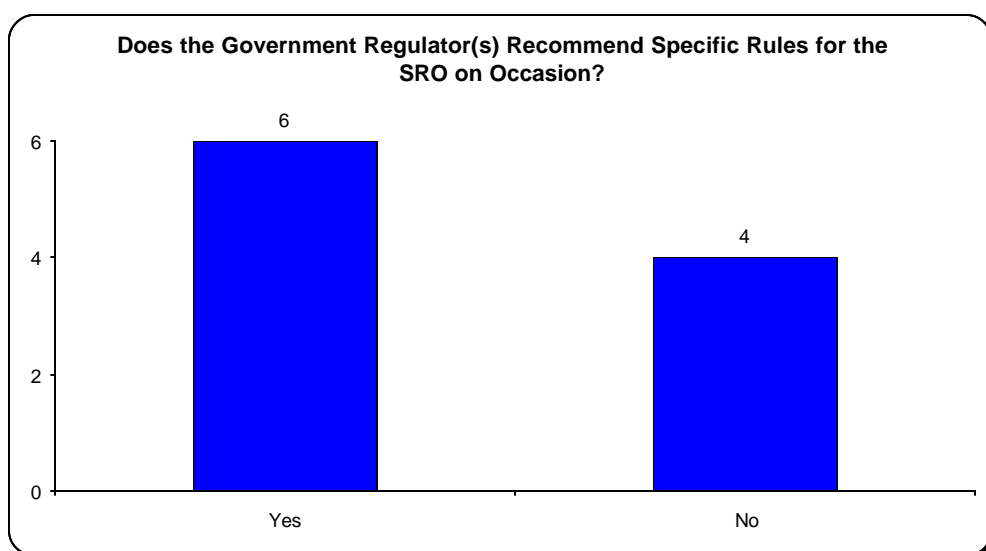
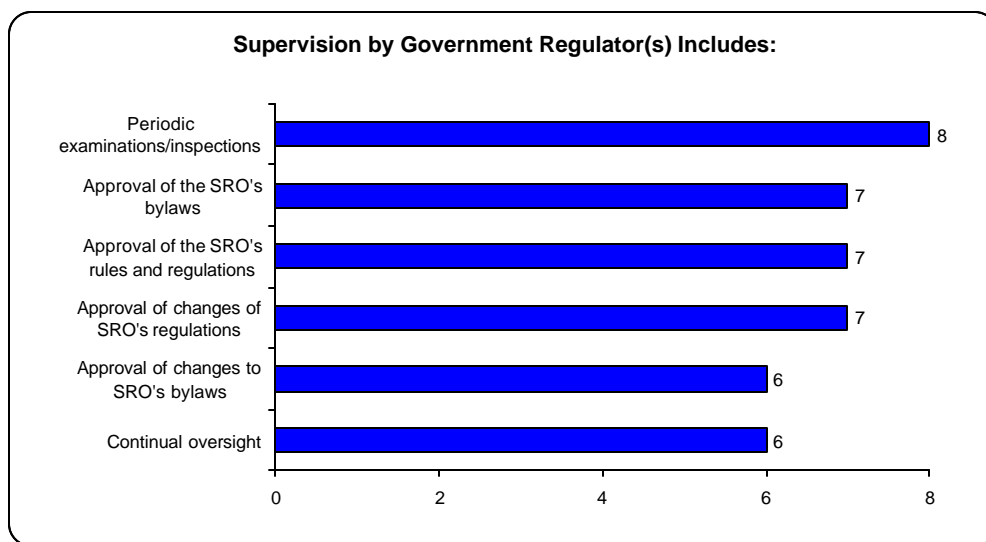
1. Mandate and Sources of Regulatory Authority

The SROs in the survey share a number of important characteristics. First of all, their mandates emphasize public interest objectives, including the enhancement of market integrity, investor protection and market efficiency. Some of the SROs in the survey note that their mandates also include additional public interest objectives, such as improving the competitiveness of their capital markets and market infrastructures, providing education for market professionals and the general public, and increasing and/or maintaining investor confidence.

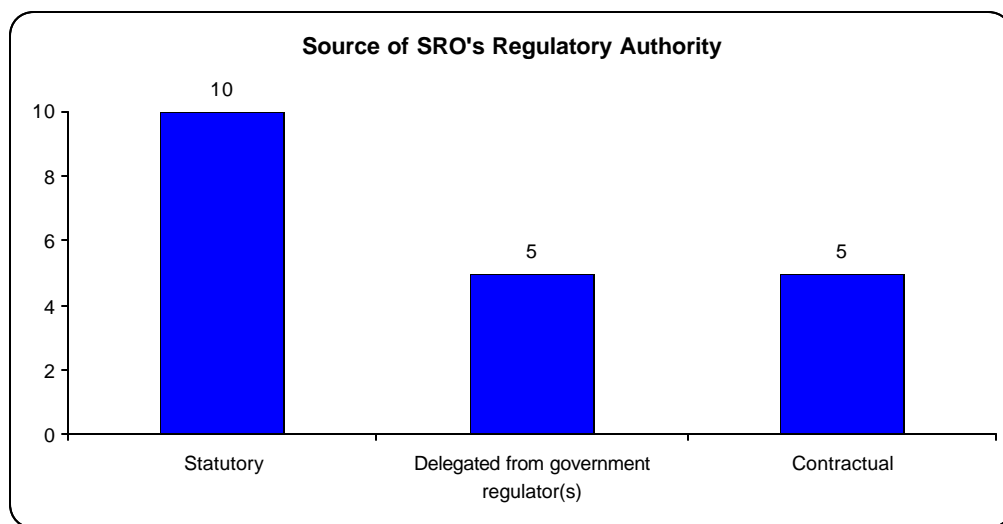


¹² A list of respondents to the survey is on page 27 of this document..

Government regulators actively supervise all of the SROs in the survey. This supervision is carried out primarily through periodic examinations and/or inspections, although more than half of the SROs in the survey report that government regulators exercise continual oversight over their operations. In addition, in most cases government regulators must approve SROs' bylaws, rules and regulations and any changes to those bylaws and regulations. Along with the formal supervision of SROs, government regulators are able to initiate rulemaking for more than half of the SROs in the survey.



Finally, all of the SROs in the study have statutory authority for their regulatory activities and half also have authority that is delegated from the government regulator(s). Historically SROs have relied on contracts with their members as the principal, and in many cases the sole, source of authority for their regulatory activities. However, none of the SROs in the survey reply exclusively on contractual authority with their members, which is an indication of the important shifts that have taken place within SROs over the recent past.

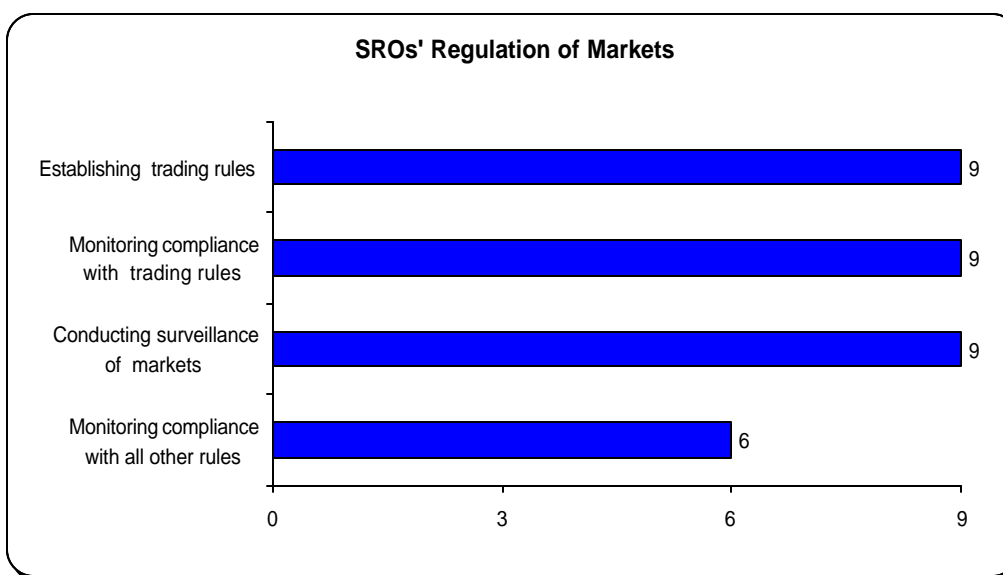
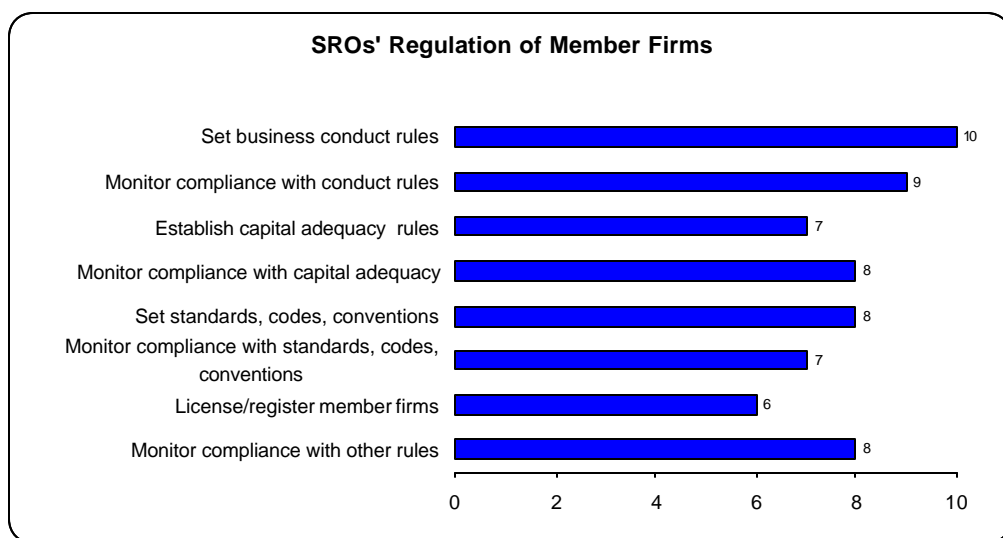


2. Regulatory and Related Activities of SROs

All of the SROs in the survey carry out their regulatory activities by: (1) establishing rules and regulations for firms and individuals subject to their regulatory authority; (2) monitoring compliance with those rules and regulations; and (3) disciplining firms and individuals that violate their rules and regulations. The extent to which each of the individual SRO carries out these activities, however, depends on its regulatory “reach”.

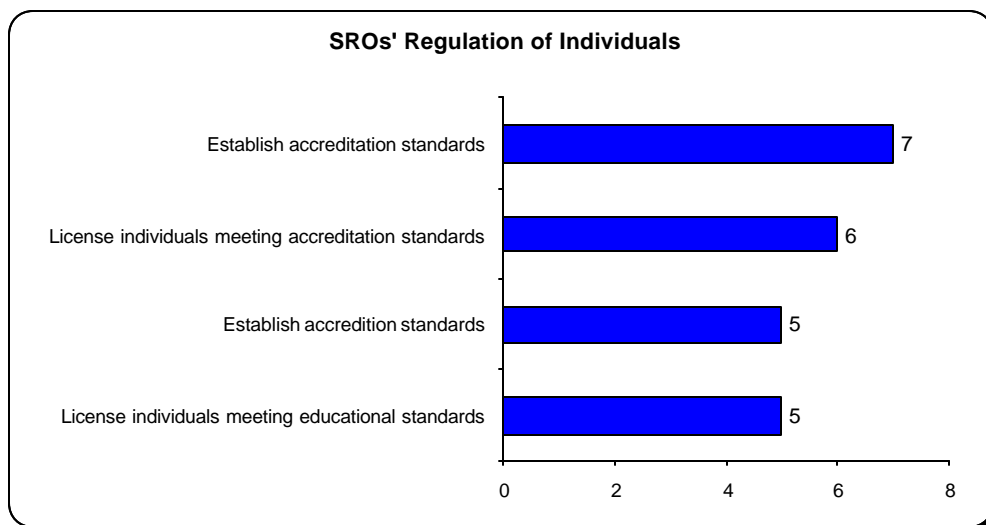
All of the SROs surveyed have the authority to regulate member firms (see next page). This is done first and foremost through the establishment of and monitoring compliance with sales practice/business conduct rules. The SROs in the survey also establish and monitor compliance with capital adequacy standards and standards, codes and conventions, license or register member firms, and monitor compliance with all other

rules and regulations, such as anti-money laundering and customer identification requirements. Almost all of the SROs participating in the survey also regulate markets, principally by establishing and monitoring compliance with trading rules and conducting surveillance of trading activities.¹³ The SROs that regulate markets also monitor compliance with all other relevant rules and regulations.

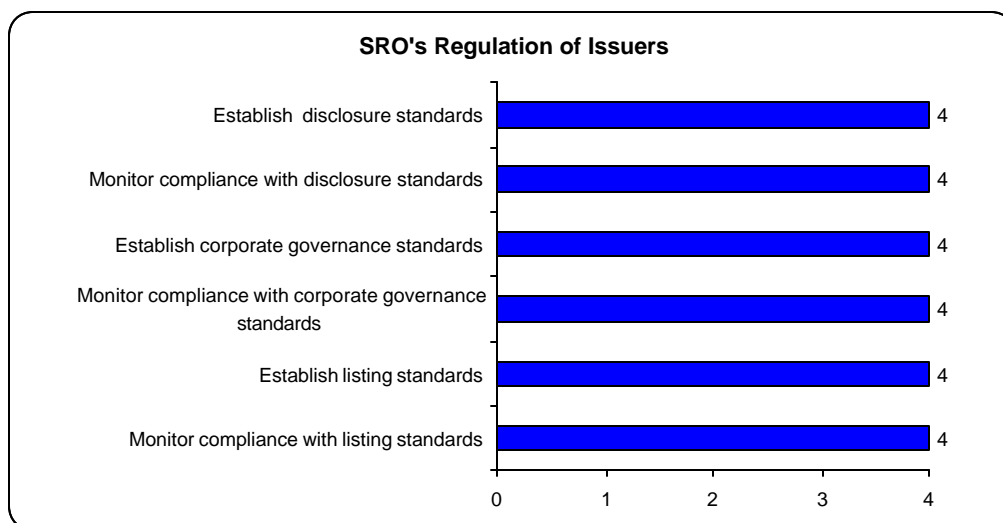


¹³ Surveillance is defined as the timely review of trading activity conducted on an exchange or market.

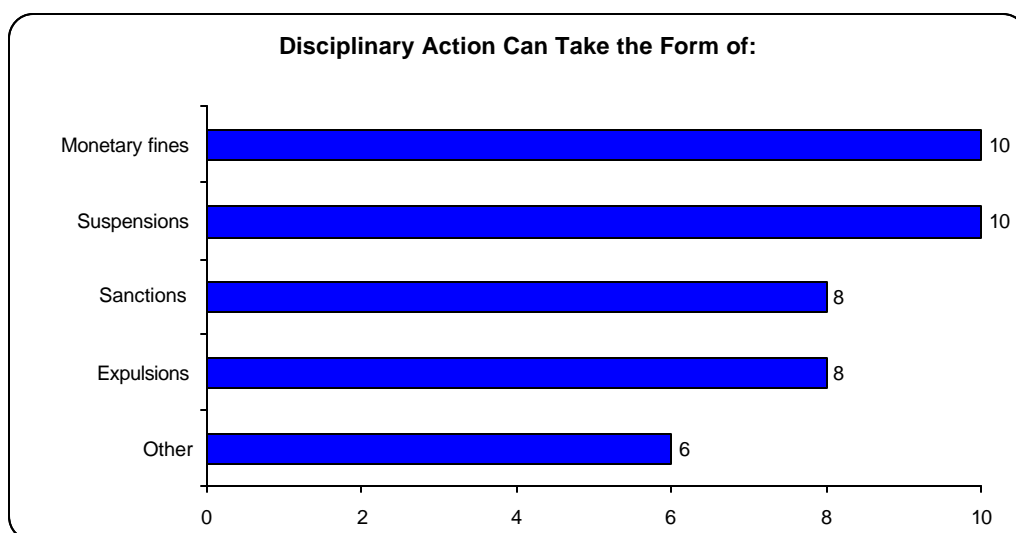
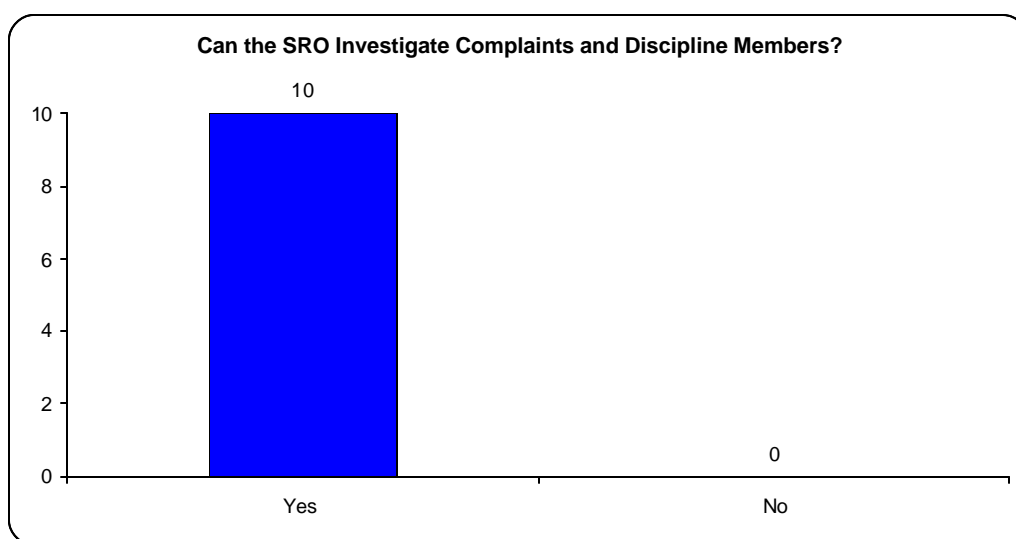
Most of the SROs in the survey also regulate employees of member firms and, in some jurisdictions, independent contractors that are active in the markets they regulate. SROs regulate individuals primarily through setting accreditation/proficiency standards and licensing or registering the individuals that meet those standards. A large percentage of the SROs that regulate individuals also set educational standards for the individuals that they regulate and license or register the individuals who meet their educational standards.



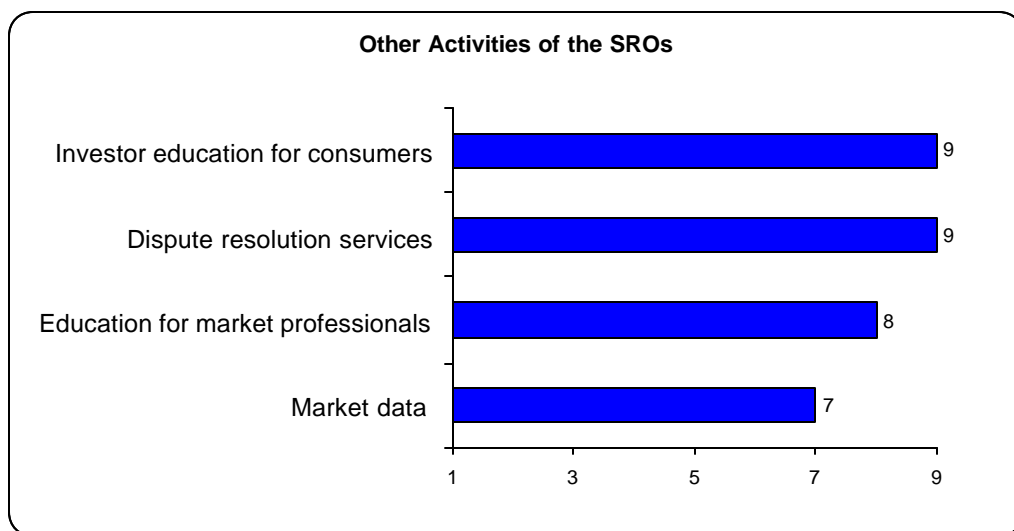
A relatively small number of SROs in the survey also regulate issuers. All of the SROs that regulate issuers do so by establishing and monitoring compliance with disclosure, listing and corporate governance standards.



In addition to establishing rules and regulations for their members and monitoring compliance with those rules and regulations, all of the SROs in the survey have the authority to investigate complaints against the firms and individuals that are subject to their authority and to take disciplinary action against firms and individuals that are found to have violated their rules and regulations. The disciplinary actions by SROs most commonly takes the form of monetary fines, suspensions and sanctions. Most of the SROs in the survey can also expel members and force the disgorgement of profits, among other actions, as a way to discipline firms and individuals.

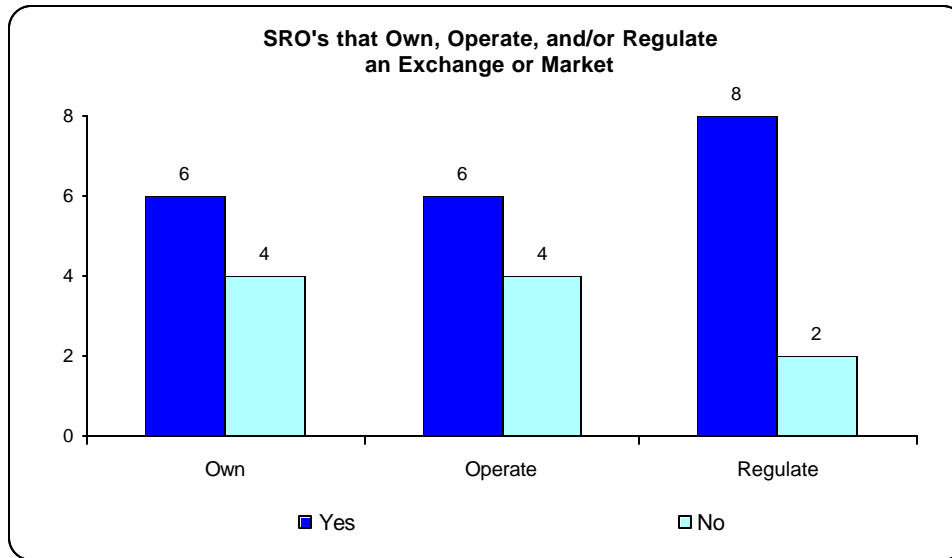


Finally, almost all of the SROs in the survey also carry out a variety of non-regulatory activities. These activities may include the provision of investor education for consumers, the provision of dispute resolution services for members, and the provision of educational services for market professionals. A number of SROs also carry out certain commercial activities, such as the provision of detailed market data. All of these activities are consistent with the SROs' public policy mandate to strengthen market integrity, market efficiency and investor protection.

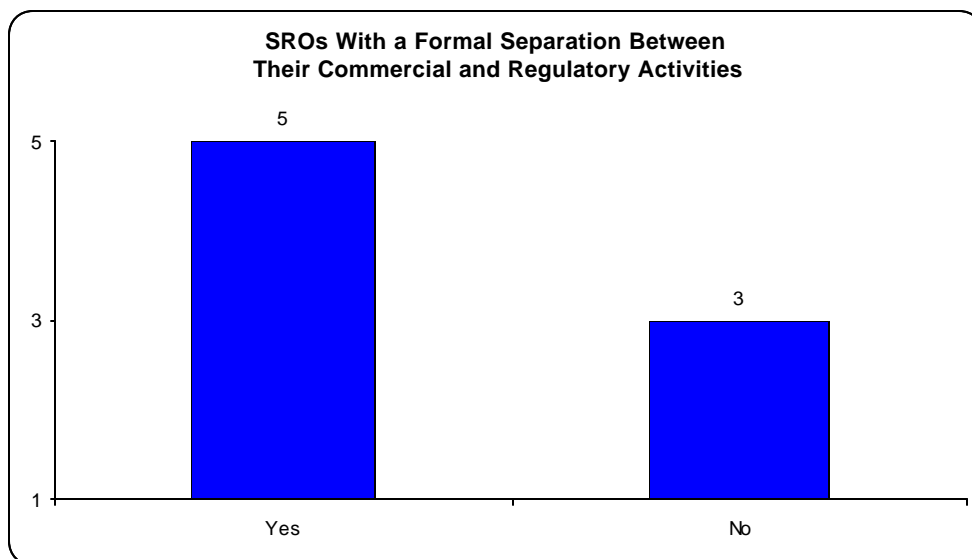


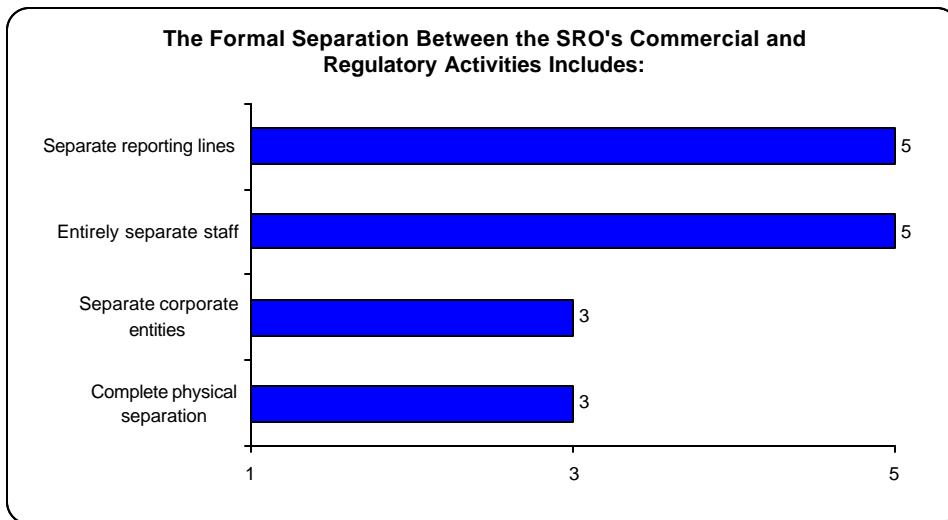
3. Dealing with Potential Conflicts of Interest

Ongoing demutualization among exchanges over the past decade has raised significant concerns about potential conflicts of interest between the exchanges regulatory activities and their commercial operations. In light of these concerns, it is interesting to note that slightly more than half of the SROs in the survey own or operate an exchange or market that they also regulate (see next page). In addition, two of the SROs in the survey function as third party suppliers of regulatory services, as they regulate exchanges that they do not own or operate. Finally, two SROs do not regulate exchanges or markets at all.

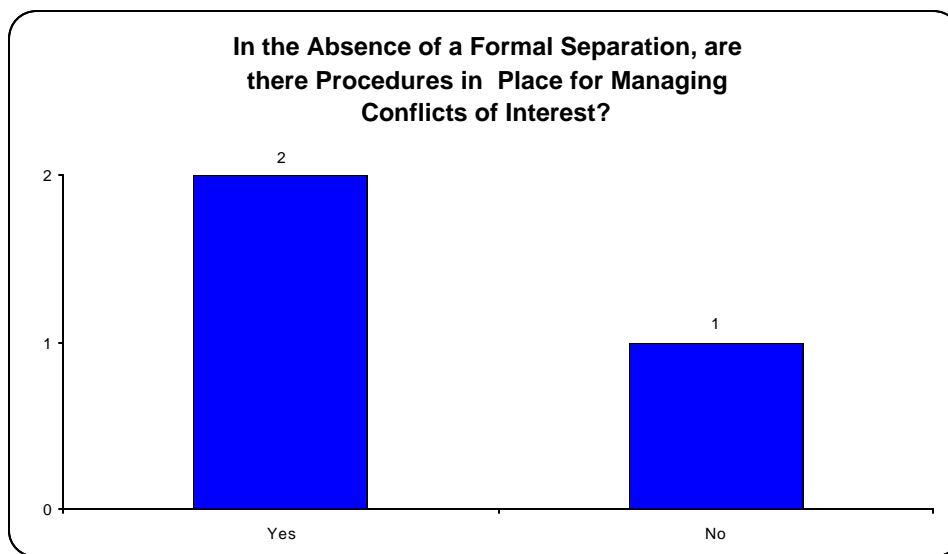


The majority of SROs in the survey that regulate an exchange or market that they also own or operate maintain a formal separation between their regulatory and commercial activities. In all cases, these separations include separate reporting lines and completely separate staff for the SRO's regulatory and commercial activities. In addition, three of the five SROs that have a formal separation between their commercial and regulatory activities have established completely separate corporate entities for their regulatory activities.





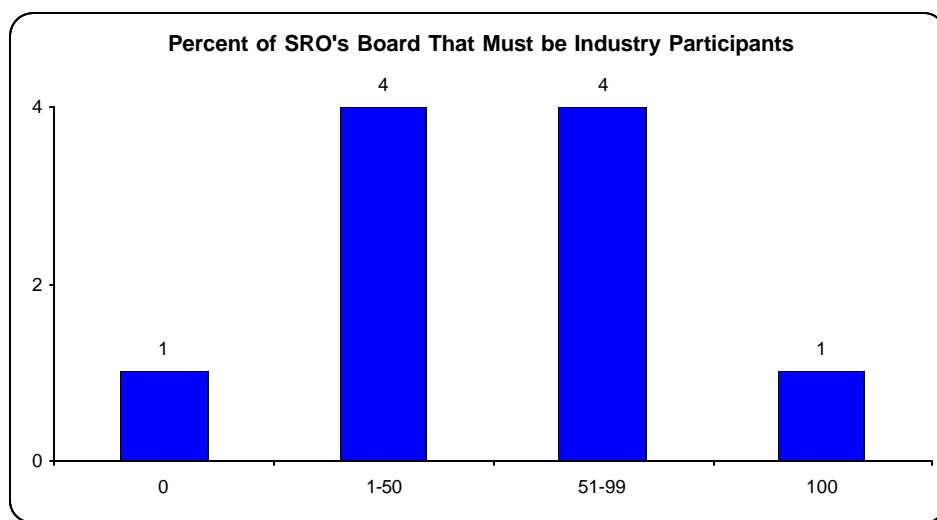
Three of the SROs in the survey that regulate an exchange or market that they own and/or operate do not have a formal separation between their regulatory and commercial activities. However, two of those SROs have formal policies and procedures in place for managing potential conflicts of interest, when they arise, and the relevant government regulators have reviewed these policies and procedures.



4. Governance Arrangements and the Role of SROs' Members

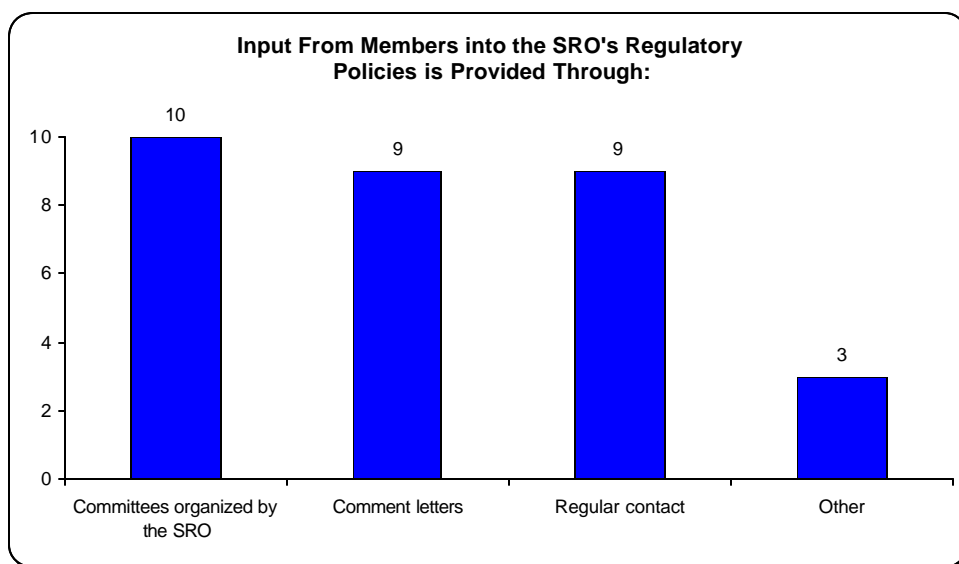
The role that members play in influencing the direction of SROs' activities has changed significantly over the past decades, due in part to market developments as well as the growth of a professional and increasingly sophisticated staff at most SROs. In addition, many SROs have responded to concerns about potential conflicts of interest by incorporating a larger percentage of independent directors on their boards, which has also had the effect of reducing the role and importance of industry participants. Finally, government regulators have become more involved in SRO rulemaking, both directly and indirectly. Therefore, although members continue to play an important role at all SROs, in general their role and influence has declined relative to what it was in the past.

The changing role of industry participants is reflected in governance arrangements at SROs. Half of the SROs in the survey report that industry participants account for less than half of their board members while the other half of the SROs in the survey report that industry participants account for the majority of their board members.¹⁶

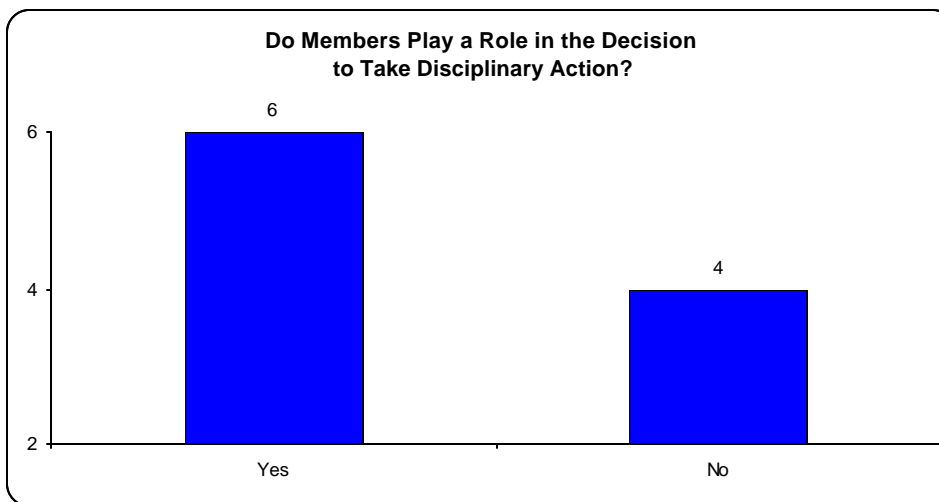
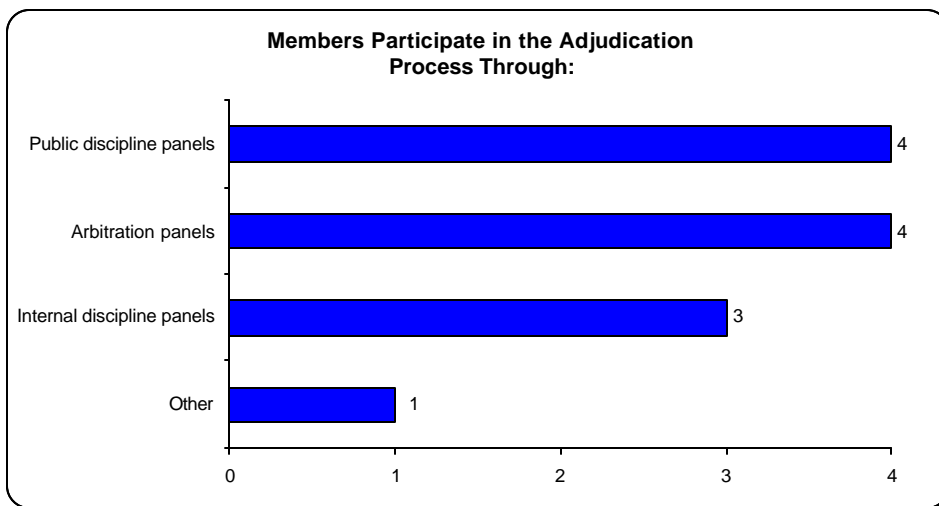
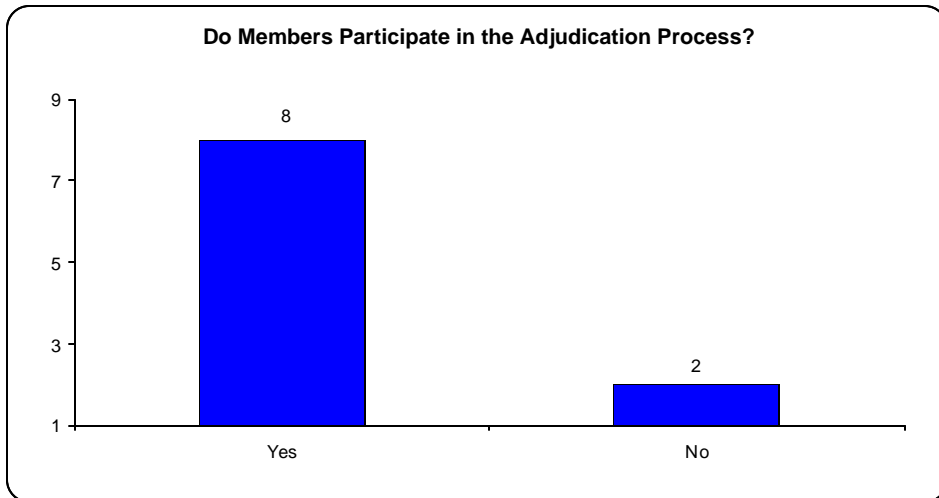


¹⁶ The remaining board members are independent directors plus, in almost all cases, the CEO. In almost all cases, independent directors are defined to be individuals that have no material relationship with the SRO or its subsidiaries or members of the SRO or, in the case of SROs that regulate markets, with listed firms.

It is difficult to determine the actual role that members play in influencing regulatory policy. All of the SROs in the survey report that members play an important role in the development of the SRO's regulatory policies, primarily through committees organized by the SRO, comment letters and regular contact with the SRO. However, in a previous survey carried out by ICSA all SROs reported that they also rely extensively on analysis by their own staffs and on developments in other jurisdiction when formulating new regulatory policies.



On the other hand, members play an important role in the enforcement process at most SROs in the survey (see next page). Most SROs report that their members are not involved in the initial decision to investigate a complaint against another member. However, once the SRO has made a decision to investigate a member firm or individual, almost all of the SROs report that their members play a role in the adjudication process. In general, members participate in the adjudication process through public or private discipline panels and on arbitration panels. Slightly more than half of the SROs in the survey also report that members play a role in the decision to take disciplinary action against member firms or individuals that have been found to have violated the SRO's rules and regulations.



5. Core Characteristics of SROs

The results of this survey show that it is possible to construct a definition of SROs that describes the core characteristics that are common among SROs in all jurisdictions. Specifically, based on the results of this survey, SROs could be defined as non-governmental organizations that:

1. Share a common set of public interest 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
4. Establish rules and regulations for firms and individuals that are subject to their regulatory authority;
5. Monitor members' compliance with applicable rules and regulations and, in the case of SROs that regulate trading markets, conduct surveillance of those 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.

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 services; (2) the provision of dispute resolution services for their members; (3) the provision of investor education for consumers and educational services for market professionals; and (4) the provision of market data for member firms and other market participants.

Summary

This study is based on the understanding that the process of self-regulation in financial markets is a continuum that includes the activities of individuals, firms, trade associations and SROs. Within that broad continuum, SROs occupy a unique position because of their regulatory authority, relationship with government regulators and their members, and the regulatory activities that they carry out. However, despite the important role played by SROs in a large number of jurisdictions, until now there has been no internationally accepted definition of SROs.

The definition presented here, which describes the core characteristics of SROs regardless of their jurisdiction, is intended to provide the basis for an informed discussion about the process of self-regulation in financial markets. It should be noted that this definition is based on survey results and is not intended as a normative statement about how SROs should conduct their activities. Going forward, just as IOSCO has developed its *Objectives and Principles of Securities Regulation*, which serves as a common handbook for government securities regulators, it may be useful for SROs as a group to develop their own handbook outlining the objectives and principles of self-regulation in financial markets.

Participants in the ICSA Survey on Self-Regulation in Financial Markets:

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)

Tokyo Stock Exchange (TSE)

* Indicates that survey participant is an ICSA member.

Appendix

The chart on the following pages contains information about the procedures that have been developed at a variety of exchanges to manage potential conflicts of interest. The information contained in the chart is based on published sources, and therefore is as factually accurate as those sources.

Procedures for Managing Conflicts of Interest at Selected Exchanges

Stock Market	Public Listed/ Mutual	Government Regulatory Authority	How Regulation is Handled:	Listing Power?
Australian Stock Exchange (ASX)	Public and Listed	Australian Securities and Investment Commission (ASIC)	There is no legal definition of a SRO under Australian law. However, as a market licensee under the Corporations Act, ASX has the power to establish rules and standards for listed entities and market participants, monitor compliance with those rules and standards and impose disciplinary actions. In July 2006, ASX established a separate subsidiary for its market supervisory operations called ASX Markets Supervision. The subsidiary, which will carry out all of ASX's supervisory operations, has its own board and is headed by a Chief Supervision Officer who reports to the Board of the subsidiary and to the Board of ASX. ASIC and ASX Supervisory Review provide oversight to ASX Markets Supervision. ¹	Yes
Chicago Board of Trade (CBOT)	Public and Listed	Securities and Exchange Commission (SEC)	CBOT's Office of Investigations and Audits (OIA) performs the self-regulatory functions of the exchange. Among other activities, the OIA audits firms and requires them to meet minimum capital requirements, monitors actual trading activity, and oversees contracts as they move closer to expiration.	Yes
Chicago Mercantile Exchange (CME)	Public and Listed	Securities and Exchange Commission (SEC)	In early 2004, the CME created the Market Regulation Oversight Committee, a separate and independent board level committee composed solely of independent directors that has direct oversight responsibility for all of the regulatory functions at the exchange, including market regulation, market surveillance, audit and financial supervision. ²	Yes
Euronext Paris	Owned by Euronext NV, which is publicly listed	Autorité des marchés financiers (AMF) and Commission Bancaire (for prudential issues)	The AMF defines the rules that Euronext uses for public offerings, disclosure and reporting obligations of issuers, and market manipulation for dealing with investment services providers. ³ Although Euronext Paris defines some membership rules, trading rules and some rules of conduct, most of those rules either strengthen or provide additional detail to the AMF provisions, save for the conditions for admission to trading of securities where Euronext Paris retains the primary competence. Euronext's limited regulatory functions are located in the exchange's Legal Regulatory Compliance Department, which reports directly to the board. The head of that department and the persons responsible for trading surveillance and member regulation are required to hold a professional license, which is issued by the AMF on application by the exchange. Among other responsibilities, they must all complete an annual regulatory report for the AMF. Direct enforcement actions by Euronext Paris are limited and conducted on contractual basis.	No

Frankfurt Stock Exchange (FSE)	Operated by Deutsche Börse AG, which is publicly listed	German Federal Financial Supervisory Authority (BaFin) and the Exchange Supervisory Authority (ESA) of Hesse, which is part of the Hessian Ministry for Economics, Transport and Regional Development	Regulation of securities trading is shared in Germany between BaFin, the provincial exchange supervisory authorities and the exchange itself. The German model is unique in requiring separate legal and governance structures for the exchange and for the entity that operates the exchange. While exchanges are public entities under administrative law the operators of exchanges are private entities. Each exchange must establish five sovereign bodies – the Exchange Council, a Board of Management, a Listing Office, a Trading Surveillance Office and a Disciplinary Board – all of which are required by law to act solely in the public interest. The Exchange Council is composed of members, issuers and investors and governs the exchange by setting rules and regulations, deciding on all important strategic issues and appointing the Board of Management. The Board of Management manages the daily business of the exchange while the Listing Office is responsible for the admission of securities. The Trading Surveillance Office monitors trading activities and the settlement of trades and has full investigative powers. Any violations of regulations found by the Trading Surveillance Office are reported to the ESA and to the exchange’s Board of Management, which may issue appropriate orders to ensure the orderly conduct of exchange trading and the settlement of exchange transactions. If the violations are confirmed, the ESA and/or the Trading Surveillance Office will notify the exchange’s Disciplinary Board, which has the authority to sanction members and issue suspensions. The Trading Supervisory Office is also required to inform BaFin of any information which BaFin needs in order to fulfil its duties. The operator of the exchange is completely separate from these five sovereign bodies and may be a private corporate entity. The operator of the Frankfurt Stock Exchange, the largest exchange in Germany, is Deutsche Börse. The operating institution of the exchange is obliged to provide the exchange with the financial resources, the staff and the facilities required for the conduct and adequate development of the exchange.	Yes
Stock Exchange of Hong Kong (SEHK)	Public and Listed	Securities and Futures Commission (SFC)	Hong Kong Exchange and Clearing (HKEx) is the holding company that owns and operates the stock and futures exchanges in Hong Kong and their related clearing houses. Since SEHK demutualized in 2000, the SFC has assumed many of the regulatory responsibilities for the stock exchange. Specifically, the SFC is the front-line regulator for listed companies and in that capacity carries out market surveillance, investigates and punishes all breaches of law and is the statutory regulator for listed company disclosure. The SFC is also responsible for member regulation and carries out routine inspections, monitors compliance with business conduct and financial resources rules and investigates and punishes all breaches of applicable rules and regulations. The exchange remains responsible for front-line monitoring of compliance with its trading and clearing rules and the maintenance of market transparency on a contractual basis.	Yes

London Stock Exchange (LSE)	Public and Listed	Financial Services Authority (FSA)	The LSE's listing activities were transferred to FSA in 2001, in part because the government was concerned that competition between exchanges would continue to increase and that it would not be appropriate for the LSE, which had been designated as the UK Listing Authority, to act as the gatekeeper for all other exchanges. As a result of this and subsequent changes, the FSA now regulates all securities trading in the UK and is also the listing authority for the UK. The LSE continues to maintain a rulebook for trading firms and, as the frontline monitor of market behavior, conducts surveillance of trading activities. ⁵	No
NASDAQ	Public and Listed	Securities and Exchange Commission (SEC)	NASDAQ is responsible for regulating its market but has contracted for the day-to-day administration of market regulation, including the investigation and prosecution of disciplinary actions, to NASD.	Yes
New York Stock Exchange (NYSE)	Public and Listed	Securities and Exchange Commission (SEC)	After its demutualization in March 2006, NYSE's business and assets were separated into three entities affiliated with NYSE Group – NYSE LLC, NYSE Market and NYSE Regulation. NYSE LLC is a wholly owned subsidiary of NYSE Group and has assumed NYSE's registration as a national securities exchange. NYSE LLC has delegated the performance of its market and self-regulatory functions to two wholly owned subsidiaries, NYSE Market and NYSE Regulation. NYSE Market operates the exchange trading market and issues trading licenses to market participants. NYSE Regulation, a not-for-profit corporation, performs the regulatory functions of NYSE LLC. The NYSE Regulation CEO reports directly to the NYSE Regulation board, a majority of which are independent directors that are not NYSE Group directors. The remaining members of the NYSE Regulation board are also NYSE Group independent directors.	Yes
Stockholm Stock Exchange (SSE)	Owned by OMX AB, which is publicly listed	Finansinspektionen (FE)	OMX AB, a Swedish financial services company formed in 2003, owns and operates six stock exchanges in the Nordic and Baltic countries; the largest of which is the Stockholm Stock Exchange. The Swedish regulator (Finansinspektionen or FE) sets listing standards for the Stockholm Exchange and establishes rules regarding trading practices, compliance with insider trading rules and information disclosure requirements. In addition, since the Stockholm Stock Exchange is an authorized exchange under the Swedish Exchange Act, it is also required to establish extensive rules and regulations for both members and listed companies and monitor the market to ensure compliance with its trading rules. In addition, the exchange has a disciplinary committee comprised of Supreme Court judges as well as senior people with securities market experience that handles any breach of its contractual regulation.	No

Tokyo Stock Exchange (TSE)	A joint stock company; Not listed	Financial Services Authority (FSA)	The Tokyo Stock Exchange has statutory authority as a SRO and, in that capacity is responsible for maintaining a transparent, equitable and reliable market. To fulfill that objective, TSE establishes rules and regulations for member firms and listed companies, continuously monitors member firms and listed companies in order to ensure that they comply with the TSE's rules and regulations, and carries out enforcement actions when violations are found to have occurred. TSE also establishes rules for the listing of securities and conducts surveillance of trading activities.	Yes
Toronto Stock Exchange (TSX)	Public and Listed	Ontario Securities Commission (OSC)	The Toronto Stock Exchange is responsible for regulating its market but has contracted with Market Regulation Services (RS), a national third-party provider of regulatory services, to carry out most of that regulation, including surveillance and investigations. RS carries out the following activities: (1) develops and administers trading rules applicable to all marketplaces in Canada, referred to as the Universal Market Integrity Rules (UMIR); (2) monitors each and every trade every day made in Canada in real time to ensure strict compliance with the UMIR; (3) conducts investigations into trading activities in response to complaints or any market activity identified during its market surveillance that could be construed as violating securities trading rules, policies and statutes; and, (4) enforces the proper and fair conduct of regulated individuals and firms, and can impose fines of up to \$1 million per violation depending on the severity of the violation and can suspend or ban individuals from access to the market. RS also regulates trading on the TSX Venture Exchange (TSX V), Canadian Trading and Quotation System (CNQ), Bloomberg Tradebook Canada Company (Bloomberg), Liquidnet Canada and Markets Securities Inc. ⁵	Yes

Endnotes

1. In 2001, two years after it became a for-profit entity, ASX established ASX Supervisory Review (ASXSR), an independent operating subsidiary of ASX that is tasked with assessing if the ASX Group adequately complies with its obligations as a market operator and clearing house operator, is conducting its supervisory activities ethically and responsibly, funding those activities adequately and maintaining appropriate controls concerning employee and commercial conflicts of interest. ASXSR also has an important role where an actual or perceived commercial conflict exists concerning the ASX Group and a listed entity, or trading participant or clearing participant. In such cases ASXSR can offer an independent layer of scrutiny of the actions of ASX. ASXSR has its own board that is made up of a majority of independent directors who have not had any material relationship with ASX for at least two years. ASIC (the government regulator) has the power to veto the nomination of any ASXSR board member and to force the removal of any board member prior to the expiration of their term of office.
2. After a lengthy and comprehensive investigation into the operations of SROs in the U.S. futures industry, the CFTC recently issued a set of proposed “Acceptable Practices” intended to improve corporate governance practices at the exchanges under its jurisdiction. Among other measures, the proposed “Acceptable Practices” recommend that the exchanges appoint a Chief Regulatory Officer who will be responsible for the supervision of day-to-day regulatory operations at the exchanges and will report directly to an independent, board-level Regulatory Oversight Committee (ROCs). The Regulatory Oversight Committee, in turn, is to be composed solely of public directors and will have oversight responsibilities for all facets of the exchange’s regulatory activities. This includes broad authority to oversee: (a) trade practice surveillance; (b) market surveillance; (c) audits, examinations, and other regulatory responsibilities with member firms; (d) the conduct of investigations; (e) the size and allocation of regulatory budgets and resources; (f) the number of regulatory offices and staff; (g) the compensation of regulatory officers and staff; (h) the hiring and termination of regulatory officers and staff; and (i) the oversight of disciplinary committees and panels. See CFTC, “Conflicts of Interest in Self-Regulation and Self-Regulatory Organizations: Proposed Rule”, 17 CFR Part 38, Federal Register Vol. 71, Number 130 (July 7, 2006). The structure of the ROC proposed by the CFTC is similar to the one that was established at the CME in 2004.
3. Euronext was formed as a result of the consolidation of local stock exchanges in Paris, Amsterdam, Brussels and Lisbon, which joined forces under the Netherlands holding company Euronext NV, a public company whose shares are listed on the primary market of Euronext Paris. For regulatory oversight, Euronext NV’s exchange subsidiaries are licensed locally in each participating country.
4. In addition, in certain circumstances the LSE can suspend trading and delete companies from exchange regulated markets.
5. Regulation Services, Inc., is jointly owned by the Toronto Stock Exchange and the Investment Dealers Association of Canada (IDA), the main member- and market-regulation SRO for Canada’s securities market. IDA and RS recently announced that they were discussing a merger that would result in the formation of a single national member and market SRO in Canada. That merger is still subject to regulatory approval.

Sources:

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