

MODEL FOR EFFECTIVE REGULATION



**Report of the SRO Consultative Committee
of the
International Organization of Securities Commissions**

May 2000

Preface

The International Organization of Securities Commissions (“IOSCO”) SRO Consultative Committee undertook a new project regarding the effectiveness of self-regulation. Conseil des Marchés Financiers and National Futures Association agreed to be the co-chairs of a subcommittee to develop a formal paper that would set forth the general principles for self-regulation and why self-regulation should be incorporated into regulatory frameworks. The subcommittee included a cross-section of self-regulatory organizations, in terms of geographic location, type of market and type of self-regulatory organization.

The subcommittee held a meeting in London to discuss the content material for the paper and to discuss important issues impacting the various marketplaces around the globe. The subcommittee also reviewed a large amount of material written on the topic of self-regulation. In order to obtain more detailed data regarding the activities of the SRO Consultative Committee members, a questionnaire was distributed to solicit specific information regarding the activities of each organization. Attached as Appendix A is a list of the organizations who contributed to the development of this paper. This paper was presented at the IOSCO annual meeting in May 2000. The purpose of this paper is to advocate the use, value and efficiencies of self-regulation as part of the overall regulatory structure in the financial services industry.

Introduction

Self-regulation, typically involving a unique combination of private interests with government oversight, is an effective and efficient form of regulation for the complex, dynamic and ever-changing financial services industry. As stated in IOSCO’s seminal report on Objectives and Principles of Securities Regulation, “self-regulatory organizations (“SROs”) can be a valuable component to the regulator in achieving the objectives of securities regulation.”¹

This paper describes the general elements that have served to make self-regulation successful. These general elements transcend distinctions based on type of financial instrument (e.g., securities, derivatives); market structure (electronic versus physical on-floor auction markets); nature of market users (e.g., institutional, retail); nature of transactions (principal, agency or both); and SRO structure. Specific elements must be tailored to the goals, objectives

¹ See page i. This report, published in September 1998, was prepared by the government regulators that belong to IOSCO. The report states that the words “securities markets” are used, where the context permits, to refer to the various market sectors. In particular, where the context permits they should be understood to include reference to the derivatives markets. The same applies to the use of the words “securities regulation.” (See IOSCO By-Laws, Explanatory Memorandum.)

and needs of each particular market and regulatory regime.² Indeed, the flexibility of design of self-regulatory programs is one of the hallmarks of self-regulation.

Building upon the identified elements for effective self-regulation, this paper proposes a general template of functions as an aid for developing an SRO structure that is appropriate for the characteristics of the marketplace and any applicable government oversight framework. The paper also addresses the relationship of the SRO to the government regulator, advocating deference to SROs as “frontline” regulators, subject to government oversight under general performance standards.

As a result of advances in technology and telecommunications, financial markets are increasingly global and trade without regard to national boundaries. Additionally, the market sectors are increasingly integrated through market users, market intermediaries and payment systems, and distinctions between exchange and over-the-counter (“OTC”) market structures are blurring. In light of these developments, the regulatory approach must be flexible, effective and efficient to provide the necessary protections in today’s ever-changing global marketplace. The regulatory framework must be continuously evaluated in light of the changes that are occurring and will occur. The regulatory framework cannot lag behind or act as impediments to market innovations.

It may be appropriate for established SROs, as well, to reevaluate their overall structures, as market innovations force rethinking of the traditional roles of exchanges and market intermediaries. This process of reevaluation is occurring at a number of securities and futures exchanges around the world as they consider whether demutualized, for-profit structures may allow them to be more responsive to the needs of their market users through competitive forces.

Definition, Role and Current Assessment of Self-Regulation

The role of self-regulation and, indeed, its very existence differs country to country, across market sectors and across the developed and emerging markets. Where its role is significant, it almost invariably derives from a long track record of responsible behavior, under the oversight of statutory regulators. That relationship has permitted SROs to contribute to the quality of regulation and to the content of policy in the public interest.

The broad objectives of self-regulation are the same as those identified for government regulation of financial markets in the IOSCO Objectives and Principles of Securities Regulation: to preserve market integrity (fair, efficient and transparent markets), to preserve financial integrity (reduce systemic risk) and to protect investors. Many different forms of self-regulation currently exist for financial markets to achieve these objectives. There are industry self-regulatory organizations, exchange self-regulatory frameworks and private associations that define and encourage adherence to standards of best practice among its participants. Self-

² It is beyond the scope of this project to try to reconcile differences in regulatory principles that exist across countries or across different financial markets’ regulatory regimes within a country.

regulation typically focuses on oversight of the market itself, qualification standards for market intermediation and oversight of the business conduct of intermediaries including their relationship with their client market-users. These areas of responsibility may be performed by a single SRO or they may be divided or shared among SROs within a given country or market sector.

In its most complete form, self-regulation encompasses the authority to create, amend, implement and enforce rules of conduct with respect to the entities subject to the SRO's jurisdiction and to resolve disputes through arbitration or other means. Typically, this authority is derived from a statutory delegation of power to a non-governmental entity. In some jurisdictions, the SRO role may be more narrowly proscribed. There are a number of organizations on the IOSCO Consultative Committee 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 several jurisdictions around the world, effective self-regulation existed before statutory regulation. As markets developed, market participants recognized that regulation was necessary in order to protect the integrity of the market. Industry participants recognized that those who were most familiar with the customs and practices of a particular trade were best suited to create rules related to that trade, to enforce those rules and to resolve the disputes that arose from those rules. Moreover, the familiarity with the concepts involved ensured that such disputes were quickly resolved and that the rules for commerce in that particular market continually and quickly adapted to the evolutions in the manner in which trade was conducted.

Self-regulation has proven to be efficient regulation. SROs by their very nature have greater flexibility to adapt regulatory requirements to a rapidly changing business environment. One of the biggest challenges that government faces in devising and administering a statutory oversight framework is to provide an appropriate level of government oversight of SRO activities without encumbering or usurping an SRO's ability to respond quickly and flexibly to changing market conditions and business needs. Self-regulation has also proven to be effective regulation. In self-regulation, the rules are drafted by market participants with an intimate knowledge of the market who know how to maximize the regulatory benefits (e.g., orderly markets, customer protection, reduction of systemic risk) while minimizing the business costs. This intimate knowledge of the market is essential for creating a self-regulatory framework, which is perceived as appropriate and reasonable by the regulated individuals and entities. This perception will in turn result in a tighter degree of compliance by the market participants operating within the self-regulatory framework.

Industry representation and self-regulation continue to be integral parts of most regulatory schemes. Even in the recent transformations of a few regulatory models, many aspects of self-regulation have been reincorporated into the statutory regulatory framework.

In fact, in its report on Objectives and Principles of Securities Regulation, IOSCO has endorsed the use of SROs within statutory oversight frameworks for financial markets, as part of a broader set of thirty principles. The report recommends appropriate use of SROs with direct responsibilities in their areas of competency, to the extent appropriate to the size and

complexity of the markets, to assist regulators in meeting their regulatory objectives of investor protection: fair, efficient and transparent markets and reduction of systemic risk.

Elements of Effective Self-Regulation

This section of the paper describes the important elements that contribute to the effectiveness of the self-regulatory model.

- **Industry Specialized Knowledge**

Financial markets are becoming more and more complex. Self-regulatory bodies have a keen interest in and a thorough knowledge of this industry and the regulatory framework within which they operate. In an environment characterized by a variety of different markets and different types of participants, a specialized and thorough knowledge is very beneficial. This is an invaluable source of expertise to which statutory regulators can turn and provides several benefits. For example, SROs and their members should be involved in any and all rule development discussions affecting their industry. An SRO typically adopts, updates and enforces its own procedural rules and rules of conduct*, using large volunteer networks of market professionals to provide direct market experience. Thus, SROs have the expertise and direct market contact needed to stay abreast of rapid changes in a complex industry and continue their regulatory effectiveness. This experience can greatly enhance the effectiveness and efficiency of an SRO's rule development, monitoring and enforcement programs.

An SRO's expertise, experience, authority and commitment also will allow it to design, implement and evaluate the compliance programs necessary to be effective. An SRO needs a qualified staff to accomplish this task, and additional financial resources may be required in order to recruit, train and retain this kind of knowledgeable staffing. However, it will generally be more efficient to rely on an SRO's extensive knowledge, experience and expertise rather than trying to reproduce it within the statutory regulator.

Another integral element of most regulatory schemes, including many statutory regulatory bodies, is industry representation. Both statutory regulators and SROs recognize that industry representation provides each regulator the capacity to react quickly to changes in the marketplace. Industry representation provides the knowledge and the institutional background so that both can identify trends and determine the regulatory implications of those trends. Industry representation can also provide the knowledge and assistance to react to emergency situations quickly and effectively. IOSCO's Objectives and Principles of Securities Regulation correctly highlights that SROs may offer considerable depth and expertise regarding market operations and practices, and may be able to respond more quickly and flexibly than the government authority to changing market conditions.

*An SRO may also be required to incorporate certain minimum features into its own rules pursuant to statutory provisions or the rules of the statutory regulator. An SRO may also be responsible for enforcing the rules of the regulator separate and apart from enforcing its own distinct rules.

- **Industry Motivation**

Self-policing systems and the general concept of self-regulation work because of the business incentive to operate a fair, financially sound and competitive marketplace. Reputation and competition are powerful motivating forces for sustained proper behavior, especially in today's global environment where market participants have virtually immediate, 24-hour access to a range of competing markets and products.

To realize the concept of "self" in self-regulation, SROs should encourage market participants and their professional trade associations to contribute to the development of industry best practices and standards. It is common for SROs to work with the industry to develop appropriate codes of conduct, and where appropriate, ensure compliance with these codes. From a government oversight perspective, government should consider applying general performance standards to SROs to ensure that they have the flexibility they need to develop appropriate rules of conduct and compliance and enforcement programs through their direct interaction with industry participants. This approach is more cost effective both for the SRO and the government regulator. It also has the benefit of contributing to a strong compliance culture within the firms that participate in the development of industry best practices and standards.

Incorporating self-regulation into the regulatory framework will result in better regulation because the statutory regulator's statute and rules are supplemented and enforced by those entities directly involved in the regulated activity, which will have more detailed knowledge of the operational or technical aspects of the activity. Additionally, self-regulation may result in better compliance with rules because it may be more easily accepted by the regulated parties.

One way an industry can demonstrate its commitment to self-regulation is by demonstrating its willingness to pay for self-regulation. In the United States, for example, National Futures Association is funded entirely by the futures industry. No federal, state or city taxes are used to finance the Association.

Industry financing should be a major source of an SRO's overall funding thereby reducing the amount of government funding needed to support the regulatory framework for financial markets. For example, in a CFTC Report, it was estimated that National Futures Association's operations during its formative years during the 1980s resulted in \$3.5 million in direct savings by the government agency and \$16.2 million in avoided additional costs over a three year period.

- **Contractual Relationship**

The contractual relationship that an SRO has with the individuals and entities it regulates can be powerful. It can have a global reach, crossing national boundaries; it can reach where statutory powers may not. IOSCO's Objectives and Principles of Securities Regulation state that SROs may require the observance of ethical standards, which go beyond government regulations. The contractual relationship also provides more flexibility and it allows SROs to

react more quickly because it is based on the SRO's rulebook and the agreement by the SRO's members that they will comply with the requirements of the SRO's rulebook. The process of revising the SRO contractual agreement can be a less cumbersome process than having to change statutory laws through legislative acts.

- **Transparency and Accountability**

Self-regulation does not mean self-interest. With very few isolated examples, all members of an SRO want to be seen as well regulated. Any regulatory body, whether a statutory regulator or an SRO, is subject to pressure from the very industry it regulates. A statutory regulator is not necessarily more immune from outside pressure than an SRO.

An SRO's compliance programs should be transparent and accountable to ensure that SROs follow professional standards of behavior on matters including confidentiality and procedural fairness. Such transparency can occur in different ways, including making SRO rules accessible to the public in printed form or over the Internet, publicizing significant disciplinary actions taken by an SRO and through educational outreach programs. The inclusion of both public representatives and industry professionals on an SRO's governing body and public participation in deliberations pertaining to regulatory policy and rulemaking, can also provide the foundation for an open organization. In some jurisdictions, SROs prepare regulatory plans that are submitted to their statutory regulator and made available to the public. These regulatory plans describe the SRO's regulatory objectives, what the SRO intends to do in the next year, how it will do it and what it will cost. The SRO's plans should take into account a cost-benefit analysis.

- **Flexible SRO Compliance Programs**

Self-regulation allows for more diversity in methods of compliance with rules and regulations than may be possible for a statutory regulator to provide. The regulatory framework should be sufficiently flexible to permit market participants to respond to inevitable change in an innovative, timely and sensitive manner.

A product of the experience and expertise of self-regulatory bodies is their ability to modify their rules in response to changes taking place in the industry more readily than government agencies. In many jurisdictions, the more rigid requirements typically imposed on the rulemaking process of statutory regulators does not allow the statutory regulators to react as quickly to changes taking place in the financial services industry. The benefit of prompt and flexible SRO rulemaking may be lost if the SRO is required to follow rigid agency review and approval processes.

In addition to flexibility, an SRO's regulatory programs must have clear guidelines that can be objectively applied. The SRO Consultative Committee of IOSCO conducted a survey regarding each SRO's regulatory obligations and the methods used in fulfilling those obligations. The survey indicated common regulatory practices and objectives that include:

- Enforcing rules and regulations through investigations and disciplinary action;

- Conducting financial/operations and sales practice examinations;
- Conducting fitness screening for access to marketplace;
- Handling customer complaints;
- Having surveillance programs to detect violative conduct;
- Sharing information and cooperating with other SROs; and
- Providing a dispute resolution forum.

An integral component of many SRO compliance programs is the development of guidebooks and other educational materials to help their members meet their regulatory responsibilities.

- **Coordination and Information Sharing**

Obviously as the markets become more globalized, coordination of market oversight becomes more important. Coordination does occur among SROs and SROs and regulators. SROs are an excellent forum for bringing together different interests on regulatory issues. With the elimination or decrease in boundaries, regulatory arbitrage in which regulated parties may gravitate to less expensive regulatory environments could become more prevalent. An identical approach among international regulators, however, is an unrealistic goal. Although the instruments being regulated by the different international regulators may be very similar, the priorities and cultures of each country are not. Coordination and information sharing must be a priority among markets in order to address cross-market issues. A coordinated approach is a necessity to address potential market abuse or systemic risk concerns that may impact more than one market.

At this time, one way to work towards coordination of market oversight is to support efforts to define “best practices” by organizations such as IOSCO. Organizations such as IOSCO can play a valuable role in bringing about harmonization, through developing general principles and promoting understanding of regulatory differences that may exist across countries. IOSCO continues to increase in importance to local statutory bodies and SROs because of the global aspects of regulation. It is important, to solicit industry participation in international standards setting projects to ensure that the standards adequately reflect legitimate business considerations. All countries and marketplaces should be more open-minded toward other regulators’ structures. There may be instances where certain facets of another regulatory structure could be adopted and integrated into a current structure.

Proactive, ongoing international cooperation should continue to move forward, with meaningful industry input. Fortunately, the development of advanced communication technologies has and should continue to improve the quality, amount, and timeliness of information. Cooperation by national regulators and SROs in an increasingly global financial

environment is not an option—it is a necessity. It should not just be coordination and cooperation after a problem occurs. Coordination and communication should be structured to address potential problems before they happen.

Regulatory Oversight of SRO Functions and the Associated Relationship between Regulator and SRO

Effective self-regulation must be defined within the context of government oversight. Government oversight is an essential element in the self-regulatory structure.* Government oversight of SRO activities ensures that, among other things, all interests are given the proper consideration and voice in all regulatory activities. This oversight provides a system of checks and balances.

The governing statute should clearly delineate the respective roles of the statutory regulators and the SROs. To take full advantage of the benefits and cost efficiencies of self-regulation, this paper recommends giving SROs the clear authority to act as self-regulating bodies, with the power to make and enforce their own rules. To ensure that SROs have the flexibility to adapt quickly to market innovations, they should be held to general performance standards that recognize and, as appropriate, encourage the elements described in the preceding section that provide for effective self-regulation.

The statutory regulator's role should truly be an oversight role. The statutory regulator should be able to rely on the work performed by the SRO in light of the strong incentives that exist to encourage SROs to act responsibly in performing their self-regulatory functions, including the powerful motivating forces of reputation and competition described above. (In the absence of the natural checks and balances of market forces, the oversight framework may need to address the potential for conflicts of interest to occur where industry participants may favor their interests over those of the investing public.) In addition, the statutory regulator can verify that the processes and programs executed by the SROs are, in fact, effective in meeting the established regulatory objectives through spot-checking or other types of periodic review. In most cases, statutory regulators perform inspections of SROs and evaluate how the SROs are performing their regulatory responsibilities. SROs may be required to report regularly on compliance with the statutory requirements and SROs may be required to provide special reports at any time. Because government regulators ultimately retain jurisdiction over the activities of an SRO, statutory regulators should be encouraged and willing to delegate more responsibilities to SROs.

In some jurisdictions, SROs submit new rules and rule changes to the statutory regulator to ensure they are consistent with the protection of investors, as well as other standards. SROs, with an established track record of successes, should be given both the authority and the responsibility to determine and evaluate what rules are appropriate to govern the conduct of their

* Although most of the SROs who completed the survey expressed this view, some expressed a modified view.

members. The statutory regulator should step in only if a self-regulatory organization shirks its responsibilities and allows its members to endanger customer funds or engage in fraud, manipulation and other illegal conduct. This would allow the statutory regulator to focus its limited resources where there is the most risk, rather than creating an unnecessary layer of review and regulation.

Defining the statutory regulator's role as a pure oversight role would not diminish the effectiveness of self-regulation. For example, the U.S. futures and securities exchanges were the first regulators in the industry, long before the federal government required them to regulate themselves. These futures and securities exchange markets have a long history of voluntary regulation. The exchanges adopted rules of conduct governing members and member organizations and recognized from the beginning that self-regulation was in their own best interest in order to maintain orderly markets and promote public confidence in those markets. Self-regulation also seeks to ensure the financial integrity of exchange markets and the participants in those markets. SROs would not act against those interests and jeopardize the viability of the markets if the statutory regulator's role was an oversight role.

A potential problem that needs to be addressed through more communication and better relationships between SROs and their government oversight bodies is to avoid potential broadening of the government regulator's role from oversight to supervision, direction and policy making. For example, when a government regulator instructs an SRO to carry out policies that an SRO reasonably concludes are not in the interests of the market it represents, the SRO risks becoming an agent of government policy at the expense of being an effective SRO. The statutory regulator should oversee and support the regulatory framework including the effectiveness of the SRO.

An effective regulatory framework should ensure that there is little to no duplication of the regulatory work performed by SROs and the statutory regulators. Efforts need to be made between the self-regulators and the government regulators to reduce and/or eliminate the duplication of work and the proliferation of rulebooks with overlapping and potentially conflicting rules. In order to eliminate and/or reduce duplication of efforts, some jurisdictions have developed and signed memoranda of understanding ("MOU") between the statutory regulators and the SROs. These MOUs delineate the responsibilities between the front-line regulator and the oversight body. These agreements provide for a separation of functions.

SROs are an easy focus of regulatory attention because they operate in the public spotlight as organizations with self-regulatory responsibilities. Because SROs are easy to regulate, that does not mean that they should be subject to more regulation and more oversight. It is recommended that government regulators recognize that SROs have the same primary objectives as statutory regulators (i.e., protect investors, ensure fair and efficient markets and reduce systemic risk) and rely on the SROs to execute their responsibilities accurately, completely, effectively and efficiently in accordance with their governing documents or delegation orders.

Government oversight may provide an additional level of confidence that the regulatory functions are being exercised conscientiously by the SROs. Government oversight at the policy level can also promote a level playing field across all markets, help prevent fragmentation and promote consistent regulation. Consistency and uniformity across markets can benefit the investing public. However, at the level of day-to-day administration of the markets, government oversight should not extend to the detail. Rather, the SRO should be permitted autonomy to ensure the maintenance of a fair and orderly market and to achieve its other self-regulatory goals.

Application of a Self-Regulatory Model

The material in this paper could be used to develop a model template of the elements for an effective SRO. A model template for an effective SRO could also address the common regulatory practices incorporated into an SRO's regulatory program. The template should be flexible and diverse in order to take into consideration the different characteristics and environments of each marketplace. Because SROs have varying organization structures, the template should be recognized as a menu of options and not a rigid format. The following is a list of basic areas to be considered in the template:

- Internal rulemaking procedures;
- Authorization and access to marketplace, including fitness/qualification standards for market intermediaries;
- Establishment and enforcement of financial, operational and sales practice standards;
- Surveillance of market activity;
- Investigation, prosecution and adjudication of rule violations;
- Administration of a dispute resolution forum;
- Development and implementation of education programs for market participants and public investors; and
- Sharing information and cooperating with other SROs and statutory regulators.

The template could then be used as a model for developing SROs to aid in the design and development of their regulatory objectives and programs. The template could also be used by existing SROs to review and evaluate their regulatory programs, especially in the face of the structural changes occurring in the markets due to technology and telecommunications. The template approach highlights that SRO activities can be broken down into discrete components that allow flexibility in the design of SRO structures including sharing or outsourcing arrangements by and among SROs.

The development of a template could lead to a process in which SROs regularly exchange “best practice” information as a means of continuously improving the effectiveness of self-regulation in the regulatory framework. The regulatory structure and SRO structures each should be responsive to the ever-changing financial markets industry.

As international competition increases, statutory regulators and SROs should ensure that excessive regulation does not unnecessarily export jobs and market share from the home jurisdiction to foreign jurisdictions. Ideally, a regulatory approach which minimizes cost burdens while maximizing investor confidence and fairness in the market and contributes to the reduction of systemic risk should be the ultimate goal of any regulatory structure. Striking that optimum balance requires a thoughtful cost-benefit analysis of existing and proposed regulations. If the costs of regulation outweigh the benefits, business will migrate to the markets with lower regulatory cost. As United States Federal Reserve Chairman Alan Greenspan has admonished:

“Migration of activity from government-regulated to privately regulated markets sends a signal to government regulators that the many transactors believe the costs of regulation exceed the benefits. When such a migration occurs, government regulators should consider carefully whether less regulation or different regulation would provide a better cost-benefit tradeoff without compromising public policy objectives.”³

No regulatory structure can completely guard against systemic risk and attempting to do so through over-regulation poses other risks to the health of the markets that outweigh the regulatory benefit. If regulatory authorities overreact and develop regulations with costs that outweigh their benefits, the market will become less efficient. Since capital will ultimately flow to the most efficient markets, implementing regulations that do not provide any real benefit will result in capital going to other markets.

The successful implementation of all or some of the elements of self-regulation may vary depending on the maturity and sophistication of the marketplace and its existing regulatory environment. In a less mature and less sophisticated market, resources will be needed to educate statutory regulators and market participants about the benefits of self-regulation. This paper demonstrates that the establishment of self-regulation in the regulatory framework has a long and successful track record around the world. These substantial efforts to demonstrate the benefits of self-regulation should lead to the transfer or delegation of certain regulatory responsibilities to the SRO. A successful self-regulatory program can be implemented over time as an SRO demonstrates its effectiveness to the marketplace and to the statutory regulators. A statutory regulator and market participants will delegate more responsibilities to an SRO once an SRO has a demonstrated track record of carrying out its current responsibilities efficiently and effectively. This process requires substantial efforts by an SRO that is both willing and capable of taking on new regulatory responsibilities.

³ Chairman Alan Greenspan, remarks at the Financial Conference of the Federal Reserve Bank of Atlanta, Coral Gables, Florida (Feb. 21, 1997).

Conclusion: Why Incorporate Self-Regulation into Regulatory Frameworks

- **Self-regulation has a long history of working effectively**

SROs are motivated to act responsibly developing best practices and monitoring their markets out of economic, reputational and regulatory self-interest. If SROs do not police their markets effectively, they will lose business, especially in today's competitive environment where investors have a range of products and markets to choose from for their risk management or investment needs.

- **SROs possess flexibility to adapt to regulatory requirements of a rapidly changing business environment**

SROs are close to their markets and market users and can tailor their rules and surveillance techniques to the specific characteristics of their markets. They can also modify them quickly to respond to market changes. Given the procedural requirements imposed on agencies, a government regulator's response may lag behind market changes.

- **SRO contractual relationships can reach across international boundaries**

SROs are effective in dealing with global issues because self-regulation is defined by contract—the rulebook—versus national legislative act. This is important in today's environment where markets operate without regard to national boundaries and where large, multi-national financial institutions dominate the markets.

- **Industry input and representation contribute to a strong and effective compliance culture**

Since SROs are close to their markets and market users, they are also in a good position to balance the benefits of their regulation relative to the costs and avoid unnecessary regulatory costs.

- **Self-regulation generally imposes fewer costs than government regulation**

Self-regulation can result in substantial cost savings to the government, because those regulatory costs are largely shifted to the regulated industry.

Properly implemented and monitored, a program of self-regulation will effectively advance the statutory objectives consistent with the public interest and the interests of the regulated entities at a lower cost than statutory regulation. Incorporating self-regulation into the regulatory regime should diminish the need for tax dollar financing, provided that SROs and government regulators cooperate and coordinate with one another to avoid duplicating activities.

- **SROs provide an intimate knowledge of the markets and products**

SROs have the experience, resources and commitment to play a constructive role in assisting statutory regulators to examine issues and to arrive at creative and effective solutions which enhance the health of the financial markets and the protection of customers.

Recommendation

Overall, self-regulation fosters integrity in the marketplace and among participants. Moreover, it is an effective method of regulation because self-regulatory organizations are familiar with the increasingly complex nature of the industry as well as the products developed and marketed by members and member organizations. SROs, therefore, have the specific knowledge and ability to effectively implement and conduct efficient and cost-effective regulatory programs.

Because of the large diversity in the size, market conditions and types of marketplaces intended to be covered by this document, it is difficult to provide one recommendation for every marketplace. However, statutory regulators should consider self-regulation as a regulatory technique when designing, revising or re-evaluating regulatory programs. SRO functions should be developed, retained and maximized to the greatest extent practicable, subject to appropriate accountability mechanisms to ensure that regulatory responsibilities are discharged properly and that the regulated markets operate in accordance with general performance standards in the public interest. When properly implemented, self-regulation can lead to efficient rules, wide compliance with and acceptance of those rules, timely adjustment of rules to meet changing conditions, and flexible and effective enforcement of rules. Furthermore, self-regulation can lead to significant cost savings for governments by shifting the costs of regulation to the regulated bodies. Self-regulation is not a form of “deregulation” it is an important part of a model of efficient and broad-based regulation.

IOSCO Committees and their respective working groups should therefore consider, recognize and incorporate self-regulatory approaches in the guidelines or standards they develop for the specific regulatory issues they examine.

Appendix A

Model for Effective Self Regulation Participants

<u>Country</u>	<u>Organization</u>	<u>Codes</u>
Australia	Sydney Futures Exchange	1,3
Belgium	European Association of Securities Dealers Automated Quotation	3
Brazil	Sao Paulo Stock Exchange (Bovespa)	1,3,4
Canada	Investment Dealers Association	1,4
Canada	Vancouver Stock Exchange	1
France	Conseil des Marches Financiers	1,2,3,4
Hong Kong	The Stock Exchange of Hong Kong, Limited	1,3,4
Indonesia	Jakarta Stock Exchange	1
Indonesia	Surabaya Stock Exchange	1
Japan	Japan Securities Dealers Association	1,3,4
Malaysia	Kuala Lumpur Stock Exchange	3,4
Philippines	Asian Development Bank	4
Poland	National Depository for Securities	3
Portugal	Bolsa de Derivados de Porto	4
Spain	Bolsa de Madrid	3
Switzerland	International Securities Markets Association	1,3,4
Switzerland	Swiss Exchange	1,3,4
Taiwan	Taiwan Stock Exchange	3
Thailand	The Stock Exchange of Thailand	3
Turkey	Istanbul Stock Exchange	3
United Arab Emirates	Arab Monetary Fund	3
United Kingdom	The Financial Services Authority	1
United Kingdom	London International Financial Futures and Options Exchange	1,3,4
United Kingdom	The London Stock Exchange	1
USA	Board of Trade Clearing Corporation	1,3,4
USA	Chicago Board of Trade	1,3,4
USA	Chicago Board Options Exchange	3
USA	Chicago Mercantile Exchange	1,4
USA	International Finance Corporation	3
USA	NASD Regulation, Inc.	1,3
USA	National Futures Association	1,2,3,4
USA	New York Stock Exchange	1,3

Codes:

1 – Subcommittee Member

2 – Co-Chair of Project

3 – Provided Response to Questionnaire (Copies of these questionnaires are available as supplemental material by contacting Karen Wuertz at National Futures Association at kwuertz@nfa.futures.org)

4 – Provided Comments on Draft Paper