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The International Organization of Securities Commissions
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Good morning. I'm delighted to address the IOSCO Annual Conference. I am Dan Sibears with NASD Regulation in Washington DC. At NASD Regulation I serve as Senior Vice President and Deputy of Member Regulation. Mary Schapiro, the President of NASD Regulation, regrets that an irreconcilable schedule conflict precluded her from attending this conference.

Today we have an opportunity for an in depth discussion of trends in the market, such as demutualization, the growth of electronic markets, and the relationship between the markets and the regulators.

Not surprisingly, the topic that I would like to discuss is the value and future of self-regulation in the securities markets. This topic has been on and off the radar screen since markets first set out to police their own conduct, but never has it been more important or more timely than it is today.

The future of self-regulation, whether it will continue to exist, and, if so, in what structure, will be determined by how the self-regulatory community responds to rapidly evolving and changing market structure, how we design and implement technology enabled regulatory programs, and how we proactively discharge our investor protection mission in this ever increasing, ever present, on-line world.

Nasdaq, the major market regulated by NASD Regulation, is a good example of the change that is now occurring in the markets. Based on a recent member vote, Nasdaq is now positioned to move from non-profit to a for profit status. This type of action by a traditional market is driven, in part, by the evolution and competition of Electronic Communications Networks, trading systems that simply could not have emerged just several years ago. The proliferation of new trading systems and their competition with traditional markets raises head on the conflicts of interest question presented by a structure where a single entity both runs and regulates a market. How self-regulators respond to this question may well determine whether we save or lose the self-regulatory structure and the benefits it provides.

Self-regulation has a history that may help put this critical issue

in perspective. The extensive network of U.S. federal legislation in the 1930s partly grew out of the perceived failure of self-regulation by stock exchanges. The legislative history of the Securities Exchange Act of 1934 is replete with examples of self-dealing, manipulation, and other misconduct that gave rise to the current federal oversight role in the U.S. Although federal regulation is dominant, it depends on the markets to guide and police their own conduct. Indeed, the NASD was born out of the need to create a structure that would centralize the task of regulating the loose network of over-the-counter trading. And even though the NASD and other self-regulators have fundamentally discharged their duties, self-regulation has never been more challenged and at risk than it is today.

One reason for this is technology. Technology has literally transformed the markets by breaking down barriers and permitting new trading systems and even new registered exchanges to emerge. It is interesting to note that in 1963, a special study of the U.S. securities markets commented on the technological changes that would come to transform the over-the-counter markets and radically affect the role of the NASD. The study noted that: "There is on the horizon the likelihood of a computer system that would

assemble all inter-dealer quotations and instantaneously determine and communicate best quotations for particular securities at any time. If such a system were established, the further possibility of using it in connection with executions and to compile actual price and volume data for over-the-counter transactions would exist. Any such automated system would clearly be affected with a public interest and should be under regulatory supervision." An incredible vision for 1963.

Of course, it would be many years before that vision was fully realized. But we did get there. In the nearly 40 years since that special study, paper lists of quotations and telephones as the sole communications vehicle have pretty much disappeared as the way of doing business. Today, Nasdaq and other markets represent sophisticated trading systems, capable of routing orders to other participants, executing trades, and providing last sale reports of prices and volume virtually instantaneously. Ongoing capacity upgrades permit more and more quotes and trades to be entered and executed more rapidly and in full view of investors around the world.

As the markets evolved so did the rules designed to make markets more efficient and transparent for the protection of

investors. For example, in the U.S., firms must achieve best execution by assessing prices quoted in competing markets prior to executing trades. There are also new order handling rules that track the life of a trade from the time received through execution. And, new rules make it more practical for entities to register as exchanges or to operate as quasi-exchanges. We have just witnessed, for example, the approval of the International Securities Exchange, the first new exchange in nearly 30 years. As one might suspect, the International Securities Exchange is not a floor based, paper driven market. It is an all electronic U.S options exchange.

In some ways, these changes are driven as much by institutional and individual investors as by technology. We have in fact witnessed a democratization of the markets and this fundamental power shift has caused investors to have as much influence in the market structure debate as intermediaries. This is very positive development.

Like everyone else, I don’t have the crystal ball that provides a glimpse of the future or tells me where all of these changes and progress will lead. However, it seems reasonable that despite what might be viewed at this juncture as a trend toward fragmentation of the markets, that all significant trading activity will move toward a

center that provides clear and timely information to investors. It also seems reasonable that trading networks and established markets will continue to evolve, change form, and change ownership. All of these developments point to immense challenges for self-regulators.

In fact, where better to observe the significant changes moving through the securities industry and markets than the NASD itself. As already referenced, just last month, the NASD membership cast their ballots in favor of a proposal to restructure the ownership of the Nasdaq market. With a majority of the members approving that proposal, Nasdaq is now positioned to move to a separately owned and operated enterprise. This anticipated move by Nasdaq, and potentially others, solidifies the view that to survive commercially the major markets must be poised to compete as commercial ventures.

Clearly, as markets are created, change form, consolidate, and generally reshape themselves, self-regulation must be positioned to respond and to effectively deal with the conflicts of interest that only get worse. In 1996, the NASD began to address this issue by creating a separate regulatory organization. Although the new organization was a temporary fix to specific issues, it has led to greater public trust since it clearly places investor protection and the public interest as the central priority of the separate self-regulatory

body.

But just four years ago when NASD Regulation was created we did not foresee the rapid evolution of new trading systems and registered exchanges. Still, other markets continue to play dual market/regulatory roles, switching between their regulatory and market hats even as they look for ways to compete with leaner players. On top of this problematic structural issue is the fact that the major SROs continue to face enormous strains in terms of regulatory responsibilities.

All of these factors require that we revisit self-regulation as a concept and the manner in which it is structured, financed, and implemented.

The SIA recently issued two reports worth discussing. One report provides a starting point for exploring the structural possibilities of self-regulatory organizations. It does not advocate a single solution but considers six alternative models and discusses the advantages and disadvantages of each. Let me touch on just some of the proposals.

Specifically, two of the alternatives discussed in the SIA paper are quite undesirable. One would retain the current system but designate one SRO as the sole authority responsible for examination

of broker-dealers that are members of more than one SRO. This model would, among other things, require that each self-regulatory organization enforce compliance with the rules of another. That poses a number of inherent difficulties and conflicts. Yet another proposal would abandon self-regulation altogether and grant to the SEC the authority to perform all the functions now performed by the SROs. This poses serious resource issues and removes from the industry the ability for the business people to regularly and effectively participate in the regulatory process. Mary Schapiro recently commented that: “The integrity of any system of rules is stronger when those who must follow them are involved in their creation and in seeing them carried out.” In short, abandoning self-regulation is a step backward.

So how do we deal with the issues if the status quo cannot remain a viable model? What do we do to address and eliminate the conflict that exists between running a market in a competitive environment and regulating the same market. These are questions that must be asked and issues that must be addressed even though there are no improper motives or lack of professionalism in the current model. The fact remains that even the utmost professionalism does not eliminate the perceived conflicts that arise

when a self-regulator is deciding where to allocate resources, what types of violations to pursue on a priority basis, and whether to implement new rules that may impact some but not all markets. Again, the situation grows all the more critical as an increasing number of market competitors spring up.

In any scenario, the challenge is to see that regulatory oversight is broad, evenhanded, and flexible enough to cope with continuing changes in the industry. The self-regulators must demonstrate to all market competitors that they are being treated fairly.

In this regard, the SIA presented two options in its report that revolve around the concept of a single regulator. At NASD Regulation, we recognize that a single self-regulator may not emerge, but we feel that we will end up with some consolidation of regulatory functions over time. Implemented correctly, an integrated organization with diverse member participation would be more adaptable than several small self-regulators that cannot reasonably respond through resources, technology, or human expertise, to rapidly changing market conditions. As we wait for the new self-regulatory structure to evolve it seems that the best approach is the separating of regulation and market operations. The longer term

solution will take shape as we continue to move into the future.

The second SIA paper I referenced, discusses fair and transparent regulation. A review of the document shows that its focus includes investor protection and fair markets. The fundamental regulatory principles and practices that are advanced to achieve a fair and level playing field for market participants include fair and non-discriminatory enforcement of regulations, clear regulations, an open rule making process, reasonably frequent qualifications examinations where such exams are required, a protocol for inspections and investigations, and an opportunity to be heard in connection with regulatory proceedings.

Of course, each of the proposals in this discussion document contains a good amount of detail and each must be explored in depth. As a general matter, however the final structure of the self-regulatory community shapes up in the face of the dramatic market changes, the referenced attributes are important components.

Let me close with some thoughts on the ability of self-regulators to effectively deploy technology. Historically, the self-regulators centered their operations on examination and market surveillance programs. These regulatory functions will continue to add value only through the use of cutting edge technology. It simply

is not feasible or acceptable in today's markets to look at past practices and take small samples from which to judge compliance. Rather, real time and near real time transactions must be monitored, and surveillance of trading activity must cover up to the entire universe of trades.

At NASD Regulation, we are responding to available technologies in a variety of ways, including the launch of a world class examination program which will further investor protection, result in value added examinations, deliver sophisticated training for our staff, and position our own oversight authority, the SEC, to conduct less oversight examinations. This initiative will position NASDR to meet and resolve the challenges posed by new, more complex market structures and regulatory mandates.

To fully appreciate the impact our new, technologically enabled examination program will have on the broker-dealers that make up the NASD membership, first consider that our Member Regulation examination program alone accounts for over 12,000 cycle and cause examinations annually.

The technology driving the surveillance and monitoring aspect of the new program represents a breakthrough in the collection and use of electronic information. Specifically, we will integrate clearing

firm information into our traditional risk assessment models. For the first time on an automated basis we will capture clearing data, such as the number of trades, cancellations and re-bills, the dollar volume and positions of low-priced equity securities, financial data, and secured/unsecured debit balances.

New applications will then permit us to combine this clearing data with internal regulatory intelligence. The result is exception reports for specific firms generated through the use of data mining and visualization techniques, statistical analysis, and population and risk criteria assessment.

Evolving to technology enabled regulatory programs not only helps us as self-regulators do our jobs better, but assists the industry through value added services, and better protects the public through ongoing, rather than periodic, regulatory oversight. In this regard, the new program will deliver a "report card" for each member that discloses patterns and trends within a single firm and against each firm's peer group. This approach will allow a broker-dealer to quickly assess, for example, whether its complaints per rep are on the rise and whether the broker-dealer's customer complaint trend is consistent with or unusual for that firm's peer group. In this regard, NASDR will supply broker-dealers with the tools to serve,

appropriately, as the first line of defense for potential regulatory and compliance issues.

There are many other exciting technology solutions that are furthering our regulatory programs, including new technologies in Market Surveillance, testing and qualification programs, and debt instrument transactions, to name just a few. These and other new technologies will help us do a better, more sophisticated job with respect to our traditional programs, while permitting us to handle the e-commerce world. Consider, for example, the challenges posed by the misrepresentations and manipulations that are now occurring through some anonymous chat rooms. This is an entirely new area in need of customized regulatory programs and we must use technology to detect and protect violations and ensure adequate enforcement. On the other hand, this same medium and the Internet in general can be used to deliver the most comprehensive and consistent investor education programs possible.

In short, we must ensure that self-regulation adapts properly to the new age e-investor.

In the final analysis, the self-regulatory structure must be designed in a manner that maintains the confidence of the public in

the industry, and ensures that the industry and markets operate in an environment defined by real and perceived fairness.

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