A FAIR EXCHANGE

In the new market structure, can exchanges be trusted with a self-regulatory function?

By Sherree DeCovny

Historically, exchanges had a dual persona. They were member-owned utilities that functioned as trading venues *and* regulators of their own activities. In the US, this tradition dates back to 1817 when the New York Stock Exchange's constitution was adopted and the financial responsibility rules and trading conventions were created.

Listing and financial reporting rules were first codified into US federal law in the Exchange Act of 1934, and they have been amended since then. The National Association of Securities Dealers, which is the precursor to the Financial Industry Regulatory Authority (FINRA), was created by the Maloney Act in 1938. That legislation established the concept of a national securities association with mandatory membership and laid the groundwork for self-regulation.

The US Congress has supported self-regulation over many decades, taking the view that self-regulatory organizations (SROs) have the expertise to perform the supervisory, surveillance, rule-making, and enforcement functions much more efficiently and cost effectively than a government bureaucracy could.

As the external environment has changed, however, the self-regulatory model has come under review by the US Securities and Exchange Commission (SEC) and other government regulators worldwide. The markets have become more complex, with increased globalization and the proliferation of electronic communications networks and trading venues. New technologies have sparked public concerns. Moreover, when exchanges became publicly traded, for-profit companies and assumed a fiduciary duty to their shareholders, questions arose about the quality of self-regulation. This conflict of interest has become even more apparent as exchanges have had to compete with trading venues that do not have the same level of regulatory responsibilities.

DIFFERENT FLAVORS OF SROS

Before companies can begin trading their shares on an exchange, they must meet certain initial requirements or listing standards. In the US and Canada, the exchanges set their own standards for listing and continuing to trade a stock, but they are subject to congressional or parliamentary legislation. In the US, for example, listings must comply with the Sarbanes–Oxley Act of 2002 and the Dodd–Frank Act of 2010. The passage of the JOBS Act in 2012 exempted smaller, emerging companies from some listing standards imposed on larger companies.

FINRA and the Investment Industry Regulatory Organization of Canada (IIROC) have a unique role in the world's financial markets. Funded by the broker/dealers, they are independent SROs with regulatory responsibility for the equities markets in the US and Canada, respectively. The exchanges outsource such functions as market surveillance and enforcement to these entities. Oversight for the derivatives markets is done separately by exchanges that list those contracts and other organizations.

By statute, US equities exchanges can outsource certain functions to FINRA, but they cannot delegate their responsibility as SROs. Each exchange has a regulatory committee to oversee FINRA's activities, and the SEC holds FINRA accountable for fulfilling the functions it serves.

Europe's financial markets are competitive, like exchanges in the US and Canada, but are generally going down a different route. Supervisory functions are being taken away from the exchanges and given to the European Securities and Markets Authority (ESMA) as the universal regulator.

Niki Beattie, CEO of Market Structure Partners in the UK, points out that in a developing country where there is no competition, the incumbent exchange SRO has the most expertise to enforce rules. But the complexion changes once competition comes into the market. "It just doesn't seem right to have an exchange setting certain marketwide regulations and enforcing those when in fact it's got competitors out there," she says.

Yet each European country is different. The concept of competitive markets is well ingrained in the UK, and the authorities in that country regulate multiple marketplaces. Recently, the government regulator was split into two bodies, with the Prudential Regulatory Authority supervising the banks and the Financial Conduct Authority (FCA) as the primary regulator for the financial markets and the securities listing authority. Other European markets, such as France, Italy, and Spain, have less competition. In those markets, the incumbent exchange is still the primary market (at least conceptually) and is therefore expected to take a greater role in regulating the market.

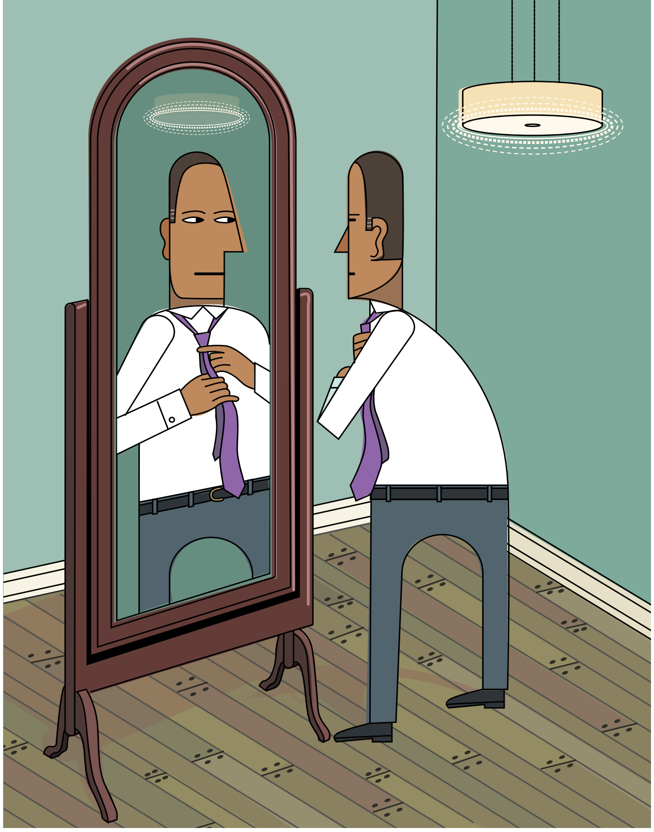

Illustration by Robert Meganck

Australia's incumbent exchange, ASX, traditionally has had SRO responsibility, including the responsibility to enforce disclosure rules. Now that competition is allowed, regulation is migrating to the primary government regulator, the Australian Securities and Investments Commission (ASIC).

Responsibilities are shifting in many markets, posing a challenge for the industry. "There is a time lag between the regulators understanding what they have to take on and having the experience and the capability to take on that role," says Beattie. "It's a bit of a black hole where the exchange isn't really doing it anymore, but the regulator hasn't quite got up to speed."

CONFLICTS OF INTEREST

Exchange SROs always had to balance their regulatory arm and their operational arm. The operational arm wants to attract order flow, but there is a risk that certain members will have undue influence over how the exchange operates. FINRA maintains that it avoids industry capture in the US by requiring that its board

WHEN EXCHANGES BECAME PUBLICLY TRADED, FOR-PROFIT COMPANIES AND ASSUMED A FIDUCIARY DUTY TO THEIR SHAREHOLDERS, QUESTIONS AROSE ABOUT THE QUALITY OF SELF-REGULATION. THIS CONFLICT OF INTEREST HAS BECOME EVEN MORE APPARENT AS EXCHANGES HAVE HAD TO COMPETE WITH TRADING VENUES THAT DO NOT HAVE THE SAME LEVEL OF REGULATORY RESPONSIBILITIES.

Self-Regulation in the Financial Markets

By Jason Voss, CFA

In the aftermath of the global financial crisis, many finance industry commentators have scrutinized the role of regulators in contributing to the crisis. Particular scrutiny has fallen on self-regulatory organizations (SROs). To help shape a better future for the financial industry, CFA Institute published the report *Self-Regulation in the Securities Markets: Transitions and New Possibilities* (available at www.cfainstitute.org and www.cfapubs.org). The report, which builds on earlier CFA Institute research on self-regulation, concludes, "We believe … that despite differences in the securities regulatory landscape that existed when they were first created, SROs and the market expertise they offer are now more important than ever. In fact, the ever-evolving complexities of the securities markets argue for more, rather than fewer, uses of SROs, if only to take advantage of their understanding of market practices."

In support of this conclusion and in the interest of moving the SRO reform agenda forward, CFA Institute recently hosted an event in Washington, DC, under the auspices of the Future of Finance initiative. As part of the event titled "Self-Regulation in the Financial Markets: Exchange Issues, Market Structure, and Investor Protections," a panel of current and former senior regulators, practitioners, and law professors (including Mary Schapiro, former chair of the US SEC) discussed a range of topics, from security exchange issues and market structure to investor protections, global financial market interconnections, and both the strengths of SROs and areas of needed reform.

Mary Schapiro

All panelists, including those from traditional regulators and the legal profession, felt that SROs are an important part of the global regulatory framework. Still, the panelists identified many ongoing challenges. In opening remarks, for example, Schapiro contended that SROs can be a highly effective enforcer and can complement the role of governments, especially in an environment where traditional regulators are underfunded. However, she argued, this is only true if the following conditions are met: SROs are well-funded; they are technologically advanced; there is government oversight; they are held accountable; they act within their authority; and they are structured to avoid conflicts of interest.

Jason Voss, CFA, is a content director at CFA Institute. This sidebar is an excerpt from a post that originally appeared on the *Market Integrity Insights* blog. For full details, including summaries of the panel presentations at the event, read the complete post "Self-Regulation in the Financial Markets" (24 June 2014) at http://blogs.cfainstitute.org/marketintegrity.

consist mostly of public governors, who are not elected by the broker/dealer members.

Over the past 15 years, the SEC has taken disciplinary actions against exchange SROs for failure to discipline or investigate certain activity within their area of responsibility. Examples include unlawful proprietary trading, failure to enforce order-handling rules, failure to implement proper controls for a system outage, or giving improper trading advantage to one member over another.

According to Sayena Mostowfi, senior analyst at Tabb Group, potential conflicts of interest between exchanges, broker/dealers, and investors are not new. Each stakeholder group has always had certain advantages and disadvantages, but conflicts are coming to a head now as the industry evolves and trading becomes more electronic. "You can't look at one [stakeholder group] in isolation from the other," she says.

When US exchanges want to introduce or change a rule—whether it has to do with capital requirements, order types, systems, or any other issue—they must file a proposal with the SEC. The proposal is then opened up to the public for comment. During the comment period and approval processes, exchanges' operations are affected. If they want to make a systems change, for example, their competitors are entitled to provide input on the proposed functionality or even copy it. Alternative trading systems (ATSs) are not required to file changes publicly.

Exchanges are obligated to operate a fair and orderly market, and they cannot discriminate between their members. Broker/dealers are obligated to provide customers the best execution possible across the industry—both on and off exchange. But unless ATSs reach a certain threshold, broker/dealers do not have fair-access requirements and can discriminate between customers by charging different fees or providing a different execution quality. Exchanges have limited liability for such problems as a botched IPO caused by a systems glitch. Broker/dealers are fully liable for an array of faults.

Exchanges in the US collect market data revenue from broker/dealers. The securities information processors (SIPs) consolidate quote and trade data for US stocks. Revenue from the SIPs is divided among all the exchanges through a formula that weights the volume of quotes and trades. FINRA also receives a portion of the income. Canada has a pass-through model for market data. In addition to the distribution fee, market-data fees and the data policies of the contributing marketplaces are passed through to the client.

Buy-Side Effects

Because buy-side firms are not members of exchanges, they are one step removed from SRO responsibilities and conflicts of interest. But that is not to say that they are not affected by them. After all, investor protection is an important function of an SRO.

Tabb Group surveyed 108 buy-side traders in the US and found their main concern is execution quality—specifically, information leakage, timeliness of the execution, and execution price. Not all broker/dealers automatically disclose where their customers' orders are being executed, who is executing them, and how they are routed, and buy-side firms do not necessarily ask. When the survey participants were asked whether there is a difference between on- or off-exchange execution, the researchers found that most respondents distrust exchanges and broker/dealers equally.

Despite some detachment, responsibility for market surveillance has come onto buy-side firms' radar screen, especially since the flash crash of 6 May 2010. Critics say it took too long for the SEC and the CFTC to do forensic analysis and figure out exactly what happened that day. Since then, the government has allocated billions of dollars to build systems to improve transparency. The SEC built the Market Information Data Analytics System (MIDAS) and is building the Consolidated Audit Trail (CAT).

In Europe, market surveillance is still completely disjointed. Exchanges are responsible for monitoring their own marketplace but not any other part of the market.

"We've got this jigsaw puzzle of surveillance going on, but nobody's actually putting all the pieces together," says Beattie.

The proliferation of high-frequency trading and the debate over whether it is good or bad has pushed this issue into the limelight. Buy-side firms in Europe have no way of knowing whether they are being gamed across multiple exchanges because no single authority has enough information to be able to tell for sure.

"The incumbent exchanges often complain that their role as SRO gives them an unfair disadvantage, as they have to incur extra costs in order to fulfill their regulatory function and new competitors do not have to worry about these costs," says Beattie. "It seems no one is really happy, and the transition path is usually unclear for all parties."

Yet Mostowfi points to the practical benefits of making changes. "I don't think you can say, 'OK, from now on exchanges don't have any regulatory authority, and broker/dealers have to disclose all of their operations in a public manner,'" she says. "You don't want to end up in a scenario where you have unintended consequences."

SHOULD EXCHANGES BE SROS?

Roberta Karmel, Centennial Professor of Law at Brooklyn Law School and former SEC commissioner, blames the industry for losing some of its self-regulatory control. Speaking at a CFA Institute conference on SROs, market structure, and investor protections, held in Washington, DC, in June 2014, she noted that fragmentation and the destruction of the exchange model of trading have undermined the SRO system. Moreover, the 2008 meltdown indicates that members did not feel any obligation to the system or the securities industry as a whole. [For further details about the conference and CFA Institute's engagement with the topic of self-regulatory organizations, see the sidebar "Self-Regulation in the Financial Markets" on page 34.]

"Some of them had to know that some of the developments in the market were going to lead to disaster, but they did nothing to put a stop to it," she said. "To me, that is what was lost—the sense of obligation to a community that to some extent existed in the old self-regulatory system."

She pointed out that the US has no choice but to continue with the self-regulatory system that is in place. Change will not come until the SEC becomes a self-funded organization and has a much bigger budget than Congress has allocated and until the SEC merges with the CFTC, providing the latter entity with more resources.

Although Karmel was complimentary about FINRA's performance, she also argued that the future of exchange SROs must be viewed in light of the fragmented market and the volume of trading that occurs off exchange. "Unless some kind of regulation comes into effect to unify all of these marketplaces, I don't think it makes that much sense for the exchanges to be self-regulatory organizations," she said at the conference. "As a practical matter, I don't know that they really are since so much has been given over to FINRA."

Given the nature of the business, exchanges likely will have certain public responsibilities, such as upholding market integrity by designing sound trading rules, ensuring transparency, and protecting investors (even if they delegate other activities). But in the near term, the role of exchange SROs and whether they should be SROs at all will continue to be a topic for debate.

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