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STATEMENT OF  
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BEFORE THE  
SUBCOMMITTEE ON TELECOMMUNICATIONS, CONSUMER PROTECTION,  
AND FINANCE  
COMMITTEE ON ENERGY AND COMMERCE  
UNITED STATES HOUSE OF REPRESENTATIVES  
ON THE  
SECURITIES AND EXCHANGE COMMISSION'S  
OVERSIGHT OF SECURITIES INDUSTRY SELF-REGULATORY ORGANIZATIONS



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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our work involving the Securities and Exchange Commission's oversight of self-regulatory organizations. You asked us to evaluate how effectively the Commission oversees securities industry self-regulatory organizations (SROs), such as the New York Stock Exchange and the National Association of Securities Dealers. At the outset, it should be recognized that the scope of our evaluation was constrained by the fact that we do not have the statutory access to books and records at SROs and broker-dealers that we have at federal agencies. Thus, we relied on information that was available from SEC which left us one step removed from the SROs themselves.

Despite this constraint, we were still able to develop a picture of SEC's oversight of SROs and to form an opinion on its effectiveness. Thus, although our evaluation results are still tentative, we are finding that the Commission accomplishes important oversight objectives by

- improving SRO operations through its inspection program, with improvements taking varying amounts of time;
- effectively reviewing and approving changes to SRO rules;
- and
- uncovering violations of varying severity that were missed in SRO examinations, though the Commission does not consistently identify the causes of the omissions.

In recent years, however, concerns have been raised about the Commission's continued ability to perform its job effectively because the securities market is growing in both size and complexity while the Commission's resources have remained relatively stable. The results of Commission efforts to deal with these developments are still uncertain, and the question of how intrusive the Commission should be in its conduct of industry oversight remains undecided.

The work I am here to discuss today is part of our work on various aspects of the Commission's operations that is being done for you and Chairman Dingell of the Subcommittee on Oversight and Investigations. In addition, we have undertaken a series of studies assessing regulatory alternatives to the largely unregulated Treasury securities market at the request of Chairman Fauntroy of the Subcommittee on Domestic Monetary Policy of the House Banking, Finance, and Urban Affairs Committee.

#### SCOPE OF REVIEW

We defined Commission "effectiveness" to mean the accomplishment of certain program objectives in three areas:

- broker-dealer examinations,
- inspections of SROs, and
- reviews of SRO-proposed rules.

We measured effectiveness by pursuing three principal lines of inquiry. First, we analyzed the extent to which the Commission, through its broker-dealer examination program,

identified violations of securities laws and regulations missed by SRO examiners, identified the reasons for the omissions, and acted on those reasons. Second, we reviewed the disposition of findings uncovered in Commission inspections of SROs. Third, we assessed the Commission's compliance in its review of SRO-proposed rules with procedures specified in the Securities Exchange Act. In conducting this work, we reviewed Commission examination and inspection reports and information relating to the review of SRO proposals.

We performed most of our work at the Commission's headquarters in Washington, D.C., and at its Washington, D.C., New York, and Chicago regional offices. These three regional offices performed more than half of the Commission's broker-dealer examinations and were located near the nation's major SROs. The SROs where we had the most extensive discussions were the National Association of Securities Dealers, the New York Stock Exchange, the American Stock Exchange, and the Chicago Board Options Exchange. In 1984 these SROs accounted for all over-the-counter trading, about 88 percent of stock share sales at exchanges, and about 77 percent of options activity.

#### THE CONCEPT OF SELF-REGULATION

Self-regulation in the securities industry entails SROs directly regulating their member brokers and dealers and the Commission overseeing that process. SROs regulate their members by writing rules governing their conduct, examining them to

detect violations of law or of Commission or SRO rules, and disciplining them for improper behavior. The Commission oversees this direct regulation by, among other things, inspecting SROs, reviewing SRO-proposed rule changes, and reexamining broker-dealers that the SROs have already examined. The Commission also performs some direct regulatory tasks, such as examining broker-dealers under specified circumstances.

Although self-regulation offers benefits such as reduced government involvement and expenditures, it also carries risks. The primary danger is that self-regulators--groups of industry professionals--might be less diligent than might be desired because they are regulating their own industry.

A key question concerning self-regulation has centered on the proper balance between self-regulatory autonomy and the protection of the public interest through government intervention. The balancing of regulatory responsibilities between the Commission and the SROs has evolved over time, subject to interpretation by industry participants and the Congress. In 1975 the balance tipped somewhat toward an increased federal role when the Congress gave the Commission additional tools to use against SROs to ensure compliance with laws, regulations, and rules.

#### COMMISSION OVERSIGHT EFFECTIVENESS

In the remainder of my testimony I would like to expand on the results of our work by pursuing two main themes:

- the conduct of the Commission's oversight program to date and

--the changes that are occurring in the securities industry and the Commission's response to those changes.

Conduct of the Oversight Program to Date

The Commission oversees the quality of SRO regulation by directly examining broker-dealers, inspecting the SROs, and reviewing proposed changes to SRO rules. With regard to its broker-dealer examination program, the Commission reexamines broker-dealers for compliance with various laws and regulations after the SROs have conducted their exams. In reexaminations, the Commission is supposed to identify deficiencies at the broker-dealers and evaluate the quality of work done by the SROs at the broker-dealers. An SRO's examination performance is judged to a great extent by determining whether violations existed at a firm but were not detected by the SRO and, if so, why they were not detected. Commission examiners also determine if the scope of an SRO's examination was adequate and if actions taken by SROs to remedy deficiencies were appropriate and effective.

Between fiscal years 1982 and 1984 the Commission found hundreds of violations each year of varying severity that had been missed by SROs in the course of conducting their examinations. One of our primary concerns with such missed

violations was whether or not they had contributed to the subsequent failure of a broker-dealer. We found that, with the exception of the case involving an SRO's failure to discover fraudulent activity that was cited in the Commission's 1983 annual report, this has not been a problem. Of the 16 broker-dealers entering Securities Investor Protection Corporation liquidation proceedings in 1983 and 1984, there was no other case in which the SEC's discovery of violations missed by an SRO led to a firm closing immediately afterwards.

In general, where missed violations were found, the Commission communicated with the SROs. And, SROs took steps to improve their examination programs, steps that the Commission believes should in the future reduce the number of violations missed. For example, one SRO has assigned more persons to each examination, hired ex-Commission employees, and initiated new programs.

While the Commission found numerous missed violations and communicated with the SROs, not all regional office reports identified the reasons why the SROs missed the violations. Thus, we could not always determine why the SROs were missing violations. Reasons we did see in reports included: weaknesses in examination procedures, misapplication or apparent unfamiliarity with rules, and errors by individual examiners. In 1982 the Commission emphasized the importance of identifying

causes for missed violations in written guidance issued to its regional offices. However, of the 132 examination reports we reviewed in three regions (59 completed by the Commission before the 1982 guidance was issued, and 73 afterwards), most did not contain any information on causes of missed violations. We believe that identifying the reasons why SROs miss violations, particularly those that are serious, is an important component of any effort to improve the quality of broker-dealer examinations. It therefore is important that, as an integral part of its oversight of the quality of SRO examination procedures, the Commission reemphasize that reports on missed violations should identify cause.

The second area of Commission oversight that we reviewed involved regulatory compliance and surveillance inspections of the SROs. These inspections are conducted to assure that the SROs are complying with securities laws and regulations and providing adequate mechanisms for detecting price and other forms of market manipulation by members. We reviewed 14 regulatory compliance inspections that identified 79 deficiencies and we also reviewed 40 surveillance inspections that identified 276 deficiencies. These inspection reports were sent to the SROs between calendar years 1980 and 1984. In general, the Commission was satisfied that identified problems had been resolved. Perhaps most noteworthy is the fact that the Commission has encouraged SROs to make the investments necessary to update, refine, or modernize systems for collecting trading information to better monitor market activity and broker-dealer



trading and, for the most part, these systems are in place. However, in some instances, the Commission has not been completely satisfied with progress made in the area of SRO disciplinary measures.

Though securities laws give the Commission authority to use formal remedies, such as censuring SROs or their officers and limiting their business to get them to resolve deficiencies, the Commission prefers a give-and-take negotiating process. Because of this, it can take a very long time to resolve highly complex or controversial problems. As an extreme example, since 1963 the Commission has been trying to get the New York Stock Exchange to develop an accurate automated system to record securities transaction data. While the system was in place as of 1984, accuracy problems still existed. At the other extreme, SROs have resolved relatively minor deficiencies very quickly, even before receiving the Commission's inspection report.

It is difficult to say how long it should take to correct deficiencies identified in SRO inspections. Within the Commission there is a general belief that, if SROs can be persuaded of the need for a corrective action, they are more likely to take it. The question is how long should it take to resolve differences of opinion over the existence of identified problems or proposed solutions.

Our final area of inquiry was the Commission's rule review process. The Commission has broad authority to review and either approve or deny SRO-proposed rule changes covering such areas as membership requirements, securities listing

requirements, and business conduct. The purpose of the rule review process is to assure that proposed rule changes conform with the intent of securities laws and applicable rules and regulations. During its review the Commission must comply with procedures and requirements designed to provide for public comment on, and timely review of, proposed rule changes.

We reviewed 306 proposed rule changes that were submitted to the Commission and approved during 1984. In general, we found that

- rule changes were acted upon by the Commission within reasonable timeframes and
- the opportunity for public comment was adequately provided for.

One-half of all proposed rules were published for comment within 22 days and one-half of all rules were acted upon within 36 days of their publication. Proposed rules were published in the Federal Register; comments were sought and public files were maintained.

In addition, we found that

- SROs viewed favorably the Commission's guidance on submission of proposed rule changes and
- SROs also viewed favorably the quality of Commission staff review of proposed rule changes.

## Changes in the Regulatory Environment and Resulting Commission Actions

I indicated at the beginning of my statement that changes in securities markets over the past few years have created new challenges for the Commission in continuing to oversee their operations. The crux of the dilemma is that, while the market has grown both in size and in complexity, the Commission's personnel resources have remained stable or even declined in some areas. I know that this Subcommittee and Chairman Dingell of the House Committee on Energy and Commerce have expressed concern about this in past oversight hearings. According to the Commission's fiscal year 1986 budget estimate, staff resources devoted to market oversight have declined by 9 percent since 1980; now, we see increased emphasis on deficit reduction measures keynoted by the Gramm-Rudman-Hollings legislation.

While it is not possible to predict precisely how market integrity may be affected by this dilemma, I would like to offer some observations on the nature of the market changes and on the Commission's attempts to deal with them while keeping within its desired or imposed resource levels.

Between 1980 and 1984, the volume of trading on exchanges and on the over-the-counter market more than doubled and it is still growing. The number of broker-dealer firms increased by over 50 percent and the increase in branch offices was even higher. Overall employment in the industry increased by nearly 70 percent between 1980 and 1984. In other words, there is a

lot more going on in securities markets today than there was just five years ago and, consequently, there is a need for increased coverage of oversight.

The growing interdependence of business relationships between financial services industry participants has caused an increased vulnerability of markets to widespread disruption. As ESM clearly demonstrated, it does not take much of an incident in today's environment to severely disrupt financial markets and erode public confidence in them. A few years ago, the ESM debacle might have been a more isolated incident. Thus, there would appear to be a need for increased thoroughness in the oversight of the activities of market participants.

In addition to these phenomena, there has been a proliferation of new product offerings and other trends in the market that have resulted in increased Commission responsibilities. For example, the Commission has received the responsibility of reviewing proposals to trade futures contracts on stock indices. It must also address regulatory issues related to trends toward greater numbers of foreign transactions in U.S. equities and greater holdings of foreign stocks by U.S. institutions.

Despite these developments, the Commission's personnel levels have remained relatively stable over the last 5 years, although there has been some growth in the size of its budget. Indeed, in the areas of oversight we reviewed, the number of people has actually declined since 1980. Coupled with this, we are entering a period of severe budget austerity, and the option

of devoting more federal resources (personnel or otherwise) to oversight of securities markets may not be a realistic one. The Commission needs to seek more efficient ways of regulating and overseeing financial services industry participants. Regardless of the means chosen, it is important that the trust that investors place in the workings of these markets or the integrity of their participants not be compromised.

The Commission is trying several means to manage its expanding workload with limited resources. The Commission has dealt with its expanding workload by turning more regulatory responsibility over to the SROs, and it has tried to increase the efficiency of its examination workforce. The outcome of these approaches is as yet uncertain.

With regard to increasing SRO responsibilities, the Commission has turned over Securities and Exchange Commission Only (SECO) exams to the SROs. Under the SECO program, the Commission had directly regulated and examined broker-dealers that did not belong to an SRO. In addition the Commission has transferred more responsibility for cause exams (those that are based on customer complaints or other intelligence information) over to the SROs. As a result of these actions, the Commission has increased the number of oversight exams it conducts. But, as yet, we have not seen a corresponding increase in the number of cause exams by SROs.

In the course of our work, Commission staff expressed concern about the willingness and ability of SROs to investigate and prosecute complicated alleged sales practice violations.

They were also concerned about the SROs' ability to conduct an increased number of exams. Our data indicate that SROs have not always been able to meet their exam schedules and that the number of complaints pending investigation by one major SRO has risen.

SRO officials believe they can handle their increased responsibilities, and in some cases SROs have increased their staffing to deal with the situation. Nevertheless, we are unsure at this point how the Commission's actions will affect the broker-dealer examination program; it is simply too soon to tell.

This transfer of Commission responsibilities will need close scrutiny in the future to determine how well it is working. In our opinion monitoring workload and backlog statistics is relatively straightforward. However, ascertaining the extent to which sales practice violations are fairly and effectively dealt with by SROs involves considerable judgment and will therefore prove considerably more difficult.

One of the other ways in which the Commission has planned to cope with the increased workload is through increased use of automation. According to SEC officials, the Commission is using or plans to use automated data processing technology to improve its ability to monitor the referral program and to improve the efficiency with which oversight exams are conducted. For example, in 1985 the Commission pilot tested a program that fully automated key portions of broker-dealer exams, such as

schedule preparation, and found that time savings were significant. But according to Commission officials, full implementation of this program may be jeopardized by lack of funds for acquiring computers.

We have not studied the efficiency gains that might be expected from the use of microcomputers in on-site examinations of broker-dealers. But if their application does result in significant reductions in the labor intensity of examinations, then use of automation may be one effective means of dealing with growing oversight demands.

Mr. Chairman, this concludes my prepared statement. I will be happy to respond to any questions you or other members of the Subcommittee may have.

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