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SECURITIES REGULATION

Securities and Exchange Commission Oversight of Self-Regulation

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The Honorable Timothy E. Wirth
Chairman, Subcommittee on Telecommunications,
Consumer Protection, and Finance
Committee on Energy and Commerce
House of Representatives

Dear Mr. Chairman:

In response to your June 9, 1983, request, we are sending you our report entitled Securities Regulation: Securities and Exchange Commission Oversight of Self-Regulation. This report contains our analysis of the Securities and Exchange Commission's oversight of securities industry self-regulatory organizations, such as stock exchanges and the National Association of Securities Dealers. As agreed with your office, chapter 6 of the report contains material responding to the October 30, 1985, request of Chairman Dingell that we review the Securities and Exchange Commission's budget and its effects on the Commission's operations.

As arranged with your office, we are sending copies of this report to Rep. John D. Dingell and the Chairman of the Securities and Exchange Commission. Copies will also be available to other interested parties who request them.

Sincerely yours,

W. J. Anderson

William J. Anderson
Assistant Comptroller General

Executive Summary

Purpose

Each year, the United States' capital markets raise hundreds of billions of dollars to finance both government programs and private enterprises. The ability of these entities to attract investors depends on the existence of liquid markets in which securities can be purchased and sold. In adopting the Securities and Exchange Act of 1934 the Congress recognized that the proper functioning of those markets depends on public confidence in their integrity. In order to maintain that integrity, the Congress advanced a process combining direct industry self-regulation with oversight by the Securities and Exchange Commission (Commission).

The Chairman of the House Subcommittee on Telecommunications, Consumer Protection, and Finance, Committee on Energy and Commerce, reflecting concern for the continued effectiveness of the Commission's oversight, asked GAO to evaluate it. Later, the Chairman of the Subcommittee on Oversight and Investigations of the same committee asked GAO to evaluate the impact on Commission operations of the Commission's budget, which reflected reduced oversight staff resources. Accordingly, GAO analyzed specific aspects of how the Commission carries out its oversight of industry self-regulatory organizations (SROs). GAO also looked at Commission efforts to maintain adequate oversight with limited staff resources. However, because of legal restrictions GAO did not itself evaluate SROs' direct regulation of industry participants, which is a critical element to ensuring adequate investor protection.

Background

SROs, which include 10 exchanges and the National Association of Securities Dealers, regulate member broker-dealers by writing rules governing their conduct, examining them to detect violations of law or Commission or SRO rules, and disciplining them for improper behavior. The Commission seeks to ensure that the SROs effectively fulfill their responsibilities 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.

The relationship between the Commission and the SROs has evolved over the years, and the level of forcefulness employed by the Commission has varied. Although the Congress in 1975 gave the Commission more sanctions to use, the Commission has not generally used them, preferring a negotiating process to resolve problems, a process that can take varying amounts of time.

In recent years the markets have grown significantly in both size and complexity, while staff resources at the Commission for conducting SRO oversight have decreased. For example, the number of registered broker-dealers increased by 54 percent between 1980 and 1984, while the Commission's staff involved in the oversight program decreased by 9 percent. Such trends have caused some industry experts and members of Congress to be concerned that Commission oversight could become less effective.

Results in Brief

The Commission found hundreds of violations in fiscal years 1982 through 1984 that the SROs had missed (see p. 21). Most were not serious and the SROs have taken steps to reduce the number missed. Similarly, when the Commission finds that SROs are not complying with their own rules, with Commission regulations, or with securities laws, the Commission in most cases has reached agreement on corrective actions (see p. 32). The Commission also has achieved improvements in the way SROs monitor market activity (see p. 42). Finally, the Commission effectively reviews and approves changes to SRO rules (see p. 48).

However, in order to maintain adequate oversight of the industry in light of growing markets and declining Commission staff resources devoted to oversight, the Commission has been shifting more responsibility to SROs for conducting some kinds of examinations. Considering past shortcomings perceived by the Commission, Commission staff have some reservations about how successfully the SROs can fulfill these responsibilities (see p. 61).

GAO Analysis

Oversight Objectives Accomplished

The Commission evaluates the effectiveness of SRO broker-dealer examinations by examining some broker-dealers itself and comparing its results with those of the SRO examiners. Though GAO did not ascertain the total number of violations found by all the SROs, the Commission found over 2,000 violations each year in fiscal years 1982, 1983, and 1984. The SROs could not have found some of those violations because they did not inspect all the same broker-dealers for the same time periods, but the Commission found hundreds each year that the SROs could have caught but did not. The Commission found 375 of the latter type of violations in fiscal year 1982, 551 in 1983, and 528 in 1984.

Commission officials told GAO that while most of the missed violations were not serious, some were, and that the SROs have taken steps to reduce the number missed. For instance, one SRO has assigned more persons to each examination, hired former Commission employees, and initiated new programs to improve examinations.

The Commission's regional offices, which conduct the broker-dealer examinations, did not uniformly identify causes of SROs missing violations. However, a reemphasis on identifying causes initiated by the Commission in 1986 should assure that causes are more consistently identified in the future, thereby assuring proper corrective action.

In the Commission's oversight inspections of SROs' regulatory programs to ascertain if they are assuring compliance with their own rules, with Commission regulations, and with securities laws, GAO counted 79 deficiencies cited in the 14 reports sent to SROs from 1980 through 1984. A Commission official considered 57 of them (72 percent) to have been resolved as of May through July 1985.

In its program of overseeing how well SROs conduct surveillance of market activities, the Commission had cited 275 deficiencies in the 40 inspection reports sent from 1980 through 1984 that GAO reviewed; 259, or 94 percent, were considered resolved, and less than 2 percent had been resisted by SROs.

Rule Reviews Effective

The Commission reviews changes proposed by the SROs to their own rules, which cover many topics, such as membership requirements, listing requirements, and business conduct. Its process for reviewing the proposals and either approving or denying their implementation appears to be working well. SRO officials told GAO the guidance they receive and the quality of Commission staff review are adequate. The changes were published for comment as required by the Securities Exchange Act, and the time frames for review were reasonable, 75 percent being within 43 days of the date the change was published for comment.

Shifting Responsibilities and Improving Productivity

Shifting more regulatory responsibility to SROs may help ease the Commission's resource situation, but Commission staff members are concerned that the SROs may not be able to assume the additional burden, even though the SROs maintain that they can. In the past, SROs have not always been able to meet their own examination schedules. Moreover,

Commission staff are always concerned that an SRO might show less aggressiveness than might be desired in disciplining a member firm. Giving SROs even more responsibility to investigate problems with members requires monitoring by the Commission to make sure that referred matters are handled properly.

In addition to the shifting of oversight responsibilities, attempts are being made to enhance the productivity of examiners and inspectors through the use of portable computers. Though pilot testing of automated techniques showed some promise, funding limitations have curtailed the early expansion of this initiative.

Because of Commission staff concern about examination referrals and because funding levels have limited productivity enhancements, the degree to which the initiatives will work is uncertain.

Agency Comments

GAO received comments from the Securities and Exchange Commission's Division of Market Regulation, the New York Stock Exchange, and the American Stock Exchange. GAO made some technical changes at the Division's request and some wording changes, where appropriate, based on comments by the New York Stock Exchange. (See GAO comments in apps. X, XI, and XII.)

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Abbreviations

CBOE	Chicago Board Options Exchange
CBT	Chicago Board of Trade
GAO	General Accounting Office
NASD	National Association of Securities Dealers
NYSE	New York Stock Exchange
SECO	Securities and Exchange Commission Only
SIPC	Securities Investor Protection Corporation
SRO	Self-Regulatory Organization

Chapter 1

Introduction

The economic health of the United States depends on maintaining continuously available investment capital and efficient secondary trading markets in securities. Every year hundreds of billions of dollars are raised in the capital markets to finance government programs and private enterprise. A key to achieving the objectives of liquidity and efficiency is maintaining the confidence of investors in the integrity of the capital markets.

In order to maintain this confidence, the securities industry is governed by the principle of self-regulation. According to this principle, the industry regulates itself through various self-regulatory organizations (SROs) overseen by the Securities and Exchange Commission (Commission).[1] SROs are groups of industry professionals with quasi-governmental powers to adopt and enforce standards of conduct for their members. They include the 10 securities exchanges, such as the New York Stock Exchange (NYSE), which regulate their marketplaces, and the National Association of Securities Dealers (NASD), which regulates the over-the-counter market. They also include clearing agencies, which provide services necessary to settle securities transactions, and the Municipal Securities Rulemaking Board which issues rules governing municipal securities. All of these SROs operate under Commission supervision.

In a March 11, 1983, letter to the Commission, Chairman Timothy E. Wirth of the Subcommittee on Telecommunications, Consumer Protection, and Finance, House Committee on Energy and Commerce, noted that the "worst setback to industry self-regulation would be a scandal resulting from either inaction of the SROs to adequately police their members or ineffective oversight of the SROs by the Commission." He commented on the need for vigorous Commission oversight of SRO activities and on the importance of a firm Commission commitment to step in wherever SRO resolution may be lacking.

Following the expression of these concerns, on June 9, 1983, Chairman Wirth asked us to evaluate the effectiveness of the Commission's oversight of the SROs. We agreed with the Chairman's office to respond to this request in two stages. We have issued a staff study (Securities and Futures: How the Markets Developed and How They Are Regulated [GAO/GGD-86-26, May 15, 1986]) tracing the historical development of

[1] In this report we will use the term "Commission" to refer to the agency known as the Securities and Exchange Commission. The term "commissioners" will describe the five Commission members appointed by the President.

both securities and futures markets and explaining how self-regulation in the securities and futures industries works. This report specifically addresses the Chairman's request.

While we were doing our work for Chairman Wirth, we received on October 30, 1985, a request from Chairman John D. Dingell of the Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce. In that request, the Chairman asked us to review the Commission's budget and its effects on the Commission's operations. We arranged with Chairman Dingell's staff and Chairman Wirth's staff to incorporate a discussion of the portion of the Commission's budget allocated to its SRO oversight into chapter 6 of this report.

On March 5, 1986, we conveyed our preliminary findings on the Commission's oversight program in testimony before Chairman Wirth's subcommittee.

The Development and Nature of Securities Self-Regulation

Before the stock market crash of 1929, U.S. securities exchanges operated in many respects as private business clubs. While the exchanges did have some internal rules and requirements, government studies in the early 1900s concluded that the exchanges placed member broker-dealers' interests above those of the investing public. The chaos of 1929 created a demand for federal intervention to regulate the markets and thereby restore public confidence in them.

The Securities Exchange Act of 1934 and subsequent amendments were passed to prevent unfair practices on regulated securities exchanges and over-the-counter markets. In supervising and regulating the securities area, the Commission, created by the 1934 act, is charged with establishing and maintaining trading standards conducive to fair, orderly, and efficient markets.

The Commission's main method of ensuring fair dealing and investor protection is through the SROs. Under the industry self-regulation concept promoted by the Securities Exchange Act, the SROs are delegated government power to enforce compliance with legal and ethical standards in the securities industry. While a fundamental principle of securities industry regulation is that the industry regulates itself, as the then Commission Chairman William O. Douglas said in the late 1930s, government "would keep the shotgun, so to speak, behind the door, loaded, well-oiled, cleaned, ready for use but with the hope it would never have

to be used."[2] In other words, government authority was to be held in reserve to assure that regulatory needs were met fully and effectively.

Although conceptually self-regulation entails benefits such as foregoing excessive government involvement, it also carries potential risks. One danger is that self-regulators—groups of industry professionals—may be less diligent than might be desired because they are regulating their own industry. Another theoretical risk is that SROs will use self-regulatory powers to impair competition in order to satisfy private interests rather than regulatory needs.

The defined relationship between the Commission and the SROs allows room for interpretation as to how strong the Commission should be in exercising its oversight responsibilities. Thus, historical shifts in the balance of power can be observed. Even in the day-to-day operations of self-regulation and oversight, a give-and-take ensues that allows for flexibility in the Commission/SRO balance of power.

1975 Shift Toward Greater Federal Oversight

In 1975 the Congress amended the 1934 Exchange Act with the expectation that the Commission would exert stronger influence over the industry. Prompted by severe late 1960s recordkeeping problems and brokerage firm failures, the amendments reflected congressional endorsement of self-regulation but increased the Commission's authority. For instance, the already existing requirement that the Commission review NASD disciplinary actions grew to a requirement that the Commission review disciplinary actions taken by securities exchanges as well. The amendments afforded the opportunity for public comment on SRO-proposed rules and required the Commission to specifically approve SRO rules as opposed to merely not objecting to them. The amendments added specific disciplinary actions that the Commission could take against SROs and gave the Commission the authority to enforce SRO rules when an SRO was unable or unwilling to act or when Commission action was otherwise appropriate. In addition, the amendments extended Commission oversight authority to clearing agencies and the Municipal Securities Rulemaking Board.

[2]William O. Douglas, Democracy and Finance, J. Allen, ed. (New Haven: Yale University Press, 1940), pp. 64-65.

SRO and Commission Roles

In balancing industry and government roles in securities regulation, the SROs and the Commission have assumed different duties. As mentioned earlier, the SROs' general role has been to enforce at the SROs' own initiative the securities industry's compliance with the Securities Exchange Act's legal requirements and with more far-reaching ethical standards. Specifically, the securities exchanges and the NASD operate and regulate market facilities, write rules governing member conduct, examine members for violations of law or Commission or SRO rules, and discipline errant members.

The Commission, on the other hand, supervises the SROs' exercise of their regulatory power. It assures that this power is used effectively to fulfill SRO responsibilities and not used in ways adverse to either public or private interests. It performs oversight by reviewing SRO rules, disciplinary actions, and various other activities. The Commission also inspects SROs to assure compliance with their Exchange Act responsibilities, especially as to whether SRO examination and enforcement programs are adequate to guarantee observance of statutory and regulatory requirements by SRO members. Although under the self-regulatory concept the Commission relies on the SROs to conduct most broker-dealer examinations, the Commission also examines broker-dealers on its own as an important check on the adequacy of SRO activities.

Commission Management of Its Oversight Role

The Commission conducts its oversight activities from both its headquarters and regional offices. In its Washington, D.C., headquarters the Division of Market Regulation has two offices—Self-Regulatory Oversight and Market Structure, and Inspections and Financial Responsibility—which perform or lead oversight. The Office of Self-Regulatory Oversight and Market Structure, among other duties, reviews SRO-proposed rule changes. The Office of Inspections and Financial Responsibility inspects SROs and guides the oversight work of nine Commission regional offices which conduct some inspections of SROs and do all of the Commission examinations of broker-dealers.

Objectives, Scope, and Methodology

This report's overall objectives are to

- inform cognizant Members of Congress and their staffs about the operations of the Commission's program to supervise and oversee SROs,
- evaluate the effectiveness of key parts of the program, and

- make observations about the Commission's plans to maintain sufficient oversight of markets that are growing while the Commission's staff resources for oversight are limited.

In proceeding toward these objectives, we first reviewed the design and implementation of Commission procedures for overseeing SROs. We then agreed with Chairman Wirth's office to focus our attention in assessing the Commission's oversight effectiveness on three areas—(1) broker-dealer examinations, (2) inspections of SROs, and (3) reviews of SRO-proposed rules. We selected these topics because we and/or the Wirth subcommittee had heard complaints that some broker-dealers had failed shortly after receiving a clean bill of health in an SRO examination, that the Commission had not been diligent in following up its inspection findings, and that the Commission took too long to approve SRO rule changes.[3]

In order to evaluate the Commission's effectiveness in these three areas, we reviewed results achieved in each one. In the broker-dealer examination area, we analyzed how the Commission, through its broker-dealer examination program, discovered and dealt with violations of securities laws and regulations missed by SRO examiners. To evaluate the Commission's inspections of SROs, we reviewed the disposition of findings it uncovered. Finally, we measured the Commission's compliance with procedural requirements of the Securities Exchange Act in its review of SRO-proposed rules.

To analyze the broker-dealer examination program, we first ascertained how the number and type of Commission examinations changed between 1982 and 1984. Since the Commission was turning more of the responsibility for cause examinations over to SROs, we tried to determine the extent to which the major examining SROs—NASD and NYSE—had or had not met their own projections for routine examinations. We did this to analyze the potential implications of transferring more responsibility to the SROs, an approach that enabled us to address the requests of both Chairman Wirth and Chairman Dingell. For Chairman Dingell, we also obtained information on Commission efforts to enhance examiner productivity.

For Chairman Wirth, we analyzed the extent to which the Commission discovered violations of securities laws and regulations missed by SRO

[3]We also agreed with Chairman Wirth's office to supply statistical information on the Commission's review of appealed SRO disciplinary actions. This information appears in appendix I.

examiners, identified the causes for the omissions, acted on those causes, and noted other problems with SRO examinations. We did this by deriving statistics from examination reports and corresponding memoranda sent to SROs noting missed violations, and by reviewing memoranda of meetings between Commission regional offices and SROs. In addition, we interviewed various Commission officials about what the major causes of the SROs' missing violations might have been.

We selected examination reports for review from the 894 and 630 reports issued by the Commission in fiscal years 1982 and 1984, respectively. Over half of the reports issued in each year, or 469 and 334, were prepared by the three Commission regional offices we studied—New York, Chicago, and Washington. Of the reports prepared in these regions, we reviewed 59 from fiscal year 1982 and 73 from 1984. We selected these reports for review because they were the ones which we believed might contain the most critical comments of the SROs doing the most broker-dealer examinations, that is, the NYSE and the NASD. These were the reports which described broker-dealer deficiencies overlooked by the SROs. We did not analyze reports citing no broker-dealer deficiencies or citing only SRO-found deficiencies confirmed by the Commission and/or Commission-found violations that the SROs could not have found due to differences in scope. For the three regions we studied, we focused on the SRO entities for which the Commission found the most missed violations, that is, the NYSE and the New York, Chicago, and Philadelphia district offices of the NASD. We focused on specific SROs and on 2 specific years so we could analyze for constant and changing problems over time.

We also analyzed on a limited basis examination reports and other documents pertaining to the 16 broker-dealer failures (out of about 8,000-10,000 broker-dealers) for which the Securities Investor Protection Corporation (SIPC) was appointed trustee in calendar year 1983 or 1984. Our goal was to see from these documents why the broker-dealers failed and what part, if any, SRO-missed violations or other SRO shortcomings detected by the Commission might have played in the failures.

The Commission conducts two broad types of inspections of SROs—self-regulatory and surveillance—and we evaluated them by determining how well the Commission assures that its inspection findings are resolved. This method appeared to us to have the best potential for revealing the effectiveness of the Commission's inspections, and Chairman Wirth was particularly concerned about the Commission's commitment to resolving deficiencies found at SROs. We also ascertained

how the frequency and scope of Commission inspections might have changed over time.

We followed up Commission findings by analyzing the 40 surveillance inspection reports sent by Commission headquarters to the SROs from calendar years 1980 through 1984 and the 14 self-regulatory inspection reports. We used a 5-year period because the House Subcommittee on Telecommunications, Consumer Protection, and Finance used an earlier 5-year span in its questions about inspections in 1983 authorization hearings. For each inspection report, we examined the follow-up to all findings by reviewing SRO responses, later Commission reports, and formal and informal Commission internal documents. Where we had questions about the follow-up, we conferred with Commission and/or SRO officials. We also reviewed inspection reports outside the time frame mentioned above to enhance our understanding of particular subjects. We did not include in our analysis inspections led by Commission regional offices because resulting reports were not always transmitted formally to SROs and because inspections have not been a mandatory part of regional programs.

To gain an understanding of the frequency and scope of inspections, we determined what inspection cycle the Commission has followed over time and whether the Commission has periodically inspected the major components of all SROs.

We conducted our analysis of the Commission's rule reviews by checking for Commission compliance with procedural requirements established by the 1975 amendments to the Securities Exchange Act and by reviewing the effectiveness of program management. In order to review the Commission's compliance with the procedural requirements of the act, we inspected the Commission's public files and its published proposed rule changes soliciting public comment.

In analyzing the Commission's compliance with statutorily established procedures, we paid particular attention to the issue of timeliness, since a few SROs had complained that the Commission occasionally took a long time to act upon certain proposed rule changes, adversely affecting SRO operations. We interviewed Commission and SRO officials about delays in publication for comment and the timeliness of Commission review once the rule proposals were published. We also analyzed all proposed rule changes approved in 1984 and published in the Federal Register to see how long review and approval took. We analyzed only 1984 information because it contained rules proposed in previous years, and we were told

by Commission officials that 1984 was a typical year in the number and substance of rules involved.

In addition to these analyses, we examined 2 filings that were at least 1 year old and were approved in 1984 and 45 filings that had been open for at least 1 year as of December 31, 1984. Our purpose was to determine why the Commission required an extended period of time to act on these proposed rule changes. We collected our information by meeting with both Commission and SRO officials to obtain their perspectives on the history and status of those individual filings.

In order to analyze the effectiveness of rule review program management, we asked further questions of the officials from the Commission and the SROs. We gathered opinions on the adequacy of Commission guidance to SROs and on the quality of staff review.

In all of our rule-related work, we held discussions with Commission headquarters officials and officials representing the following SROs: American Stock Exchange, Chicago Board Options Exchange, Depository Trust Company, Midwest Clearing Corporation, Midwest Securities Trust Company, Midwest Stock Exchange, NASD, National Securities Clearing Corporation, NYSE, and the Options Clearing Corporation. These SROs had accounted for about 65 percent of the entries related to rule proposals in the 1984 Federal Register.

The bulk of our Commission work was done at Commission headquarters in Washington and at the Washington, 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 major SROs. These SROs, with whom we had more extensive discussions than with others, were the NASD, the NYSE, 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. We do not attribute facts not in the public domain to identified SROs, locations, or broker-dealers because of the Commission's preference that such information be treated as sensitive.

The major limitation on our work was that we have no statutory authority to evaluate directly the operations of the SROs. Although the SROs we contacted were very cooperative, we relied primarily on Commission records and evaluations of SRO performance and operations. Except for that limitation, our work was performed in accordance with

generally accepted government auditing standards. It was performed between September 1984 and January 1986.

Comments From Commission and SROs

Copies of the draft of this report were sent to the Commission's Division of Market Regulation, the American Stock Exchange, the Chicago Board Options Exchange, the National Association of Securities Dealers, and the New York Stock Exchange. Comments on the draft were received from the Commission (see app. X), the American Stock Exchange (see app. XII), and the New York Stock Exchange (see app. XI).

Broker-Dealer Examination Program: Results to Date

Industry self-regulatory organizations examine broker-dealers who trade securities for themselves and for customers. The purpose of these examinations is to make sure that the broker-dealers comply with federal securities laws and Commission and SRO requirements. The Commission evaluates the examination operations and capabilities of the SROs by conducting its own broker-dealer examinations and comparing results to the SROs'.

The Commission examiners find hundreds of violations at broker-dealers each year that were missed by SROs. According to Commission officials, most of the violations were minor, but some were not. The Commission has worked with SROs to improve their broker-dealer examinations, but we found that the Commission's examiners did not consistently disclose in their reports why the violations had been missed. Thus, we had no way to evaluate how well those causes were being analyzed and resolved. Since that time, the Commission has reemphasized an approach of consistently identifying and documenting the causes.

Description of the Broker-Dealer Examination Program

According to the Securities Exchange Act of 1934, the Commission is responsible for assuring that the SROs enforce their members' compliance with the act and related rules and regulations. The act also gives the Commission the right to examine broker-dealers' business operations and comment on SRO regulatory and enforcement programs.

The Commission performs various tasks to ensure that SRO examinations of broker-dealers are appropriately conducted. These tasks include targeting SRO-examined firms to be reexamined directly by the Commission, reviewing the quality of the SRO examinations themselves, and meeting with the SROs to discuss Commission examination results.

The Commission performs two types of examinations: oversight and cause. Oversight examinations are conducted at broker-dealer firms after the SRO has conducted its own examinations. The Commission then evaluates the quality of SRO examination programs and provides feedback to the SROs. Cause examinations, on the other hand, respond to specific, identified or suspected problems at broker-dealers. The Commission performs cause examinations when customer complaints or other leads indicate potential violations of securities laws or regulations.

The Commission implements its broker-dealer examination program through its Division of Market Regulation and its nine regional offices. The Division sets program goals and objectives, provides guidance to the

regions on how to conduct examinations, and monitors regional activity. The regional offices conduct the examinations of the firms located in their jurisdictions. Although the Division provides guidance, the regional offices exercise discretion throughout the entire examination process, actually selecting the firms to examine and specific examination procedures to follow. However, each year the Division formally evaluates each region's examination program, analyzing such areas as the region's selection of firms to examine, the thoroughness of field work, and the quality and timeliness of examination reports.

A fuller description of the broker-dealer examination program may be found in appendix II.

The Commission Finds Many Missed Violations, Some of Which Are Considered to Be Serious

In its own direct broker-dealer examinations, the Commission found many violations that had been missed by SRO examiners. Most of these violations the Commission did not consider to be serious, but some were. While some of the violations were missed for understandable reasons such as violations missed through human error, some were caused by more disturbing reasons such as inadequate SRO procedures. Overall it was difficult for us to evaluate the causes or their implications because Commission examiners did not consistently identify them in their reports. However, the Commission is working with the SROs to reduce the chance that serious violations would be missed.

In 1983 authorization hearings, the Commission told the Congress that in 1982 it had found about 350 securities law violations committed by broker-dealers but not detected by SROs. Our review disclosed that this number has increased. Table 2.1 shows that after fiscal year 1982 the Commission continued to find hundreds of missed violations each year.

Table 2.1: Number of SRO-Missed Violations and Commission Examinations for Fiscal Years 1982, 1983, and 1984

	1982	1983	1984
Number of SRO-missed violations[a]	375	551	528
Number of Commission oversight examinations	249	324	389
Number of Commission non-SECO examinations[b]	634	535	609

[a]We did not ascertain the number of violations found by SROs. The Commission found more than 2,000 violations by broker-dealers each year, but this number includes some the SROs had found as well as others the SROs could not have found. SROs could not have found certain Commission-found violations because, for example, they examined broker-dealers at time periods that differed from the Commission's or were not required to examine particular broker-dealers at all.

[b]These numbers include both oversight and cause examinations. Although cause examinations are not necessarily designed to detect missed violations, they sometimes do. The numbers do not include Commission examinations of broker-dealers who were not members of SROs at the time of examination. These examinations were called SECO, or Securities and Exchange Commission Only, examinations.

To determine what types of violations the SROs most often missed, we analyzed the 42 categories of violations in the Commission's examination activity tracking system. According to our analysis, the four specifically defined categories with the most missed violations during fiscal years 1982 through 1984 all related to the financial and operational aspect of broker-dealer firms rather than to the sales practice side (how the firm deals with customers). These categories were recordkeeping, net capital computations, miscellaneous provisions of the customer protection rule, and financial reporting.[1] Violations in these categories comprised between 30 and 46 percent of all the missed violations in the 3 years. Commission officials explained that errors frequently occurred in these areas because of the technical and interpretive nature of the rules.

Because the Commission's examination tracking system does not categorize the severity of missed violations, each violation category could encompass a wide variety of problems. Nonserious problems[2] are lumped together with serious ones. Examiners in various parts of the Commission were not encouraged to determine the seriousness of missed violations because their views would be subjective. The seriousness of each violation would have to be related to the broker-dealer's size and history. Regional offices distinguish degrees of seriousness of particular

[1]The net capital rule protects customers by requiring that broker-dealers maintain enough liquid assets to meet their current indebtedness. The customer protection rule requires, among other things, that broker-dealers deposit in special accounts the difference between obligations to customers and customer obligations to them. Financial reporting refers to certain broker-dealer financial reports filed with the Commission and the SROs to serve the public interest or protect investors.

[2]From one SRO's viewpoint, an example of a nonserious violation was a broker-dealer not displaying a logo informing its customers of its membership in the Securities Investor Protection Corporation (SIPC). SIPC protects customers in the event of a broker-dealer failure.

violations when they decide what action to take against violators, and Commission headquarters is apprised of the seriousness of the violations on the examination report.

Although much subjectivity was involved, officials in one region did point out to us 32 "very serious" missed violations in fiscal years 1982 and 1984. They were able to do this because, on their own initiative, for fiscal year 1985 they devised a system for subjectively categorizing the severity of violations as "not serious," "serious," and "very serious." They implemented the system to help them identify the more serious violations, quantify materiality, and plan examinations. We asked the officials to use their system to rank the severity of the 1982 and 1984 missed violations in our sample that were committed by the 13 firms in their region who were referred to the SROs or the Commission's enforcement arm for further investigation. Examples of the 32 very serious missed violations they identified included

- using intensive personal sales presentations on unsophisticated customers to induce them to sell their currently owned securities and then purchase similar ones;
- allowing the commingling of customer-owned securities with other securities that were serving as collateral for a loan to the broker-dealer;
- charging excessive markups on Treasury security sales; and
- erroneously computing a deposit that needed to be made into a special bank account for the exclusive benefit of customers, resulting in a $3 million deficiency in the account.

Officials in this regional office as well as in other parts of the Commission told us that serious violations like these were in the minority. They said most missed violations were not considered serious.

Regardless of the relative seriousness of the violations, Commission officials offered various explanations for why hundreds of missed violations continued to be found each year. One explanation was that the Commission has been more effectively targeting the firms selected for oversight examinations. More effective targeting allowed the regions to examine firms with the highest potential for violative conduct. A Commission official also said the Commission is spending more time on reviews, discovering additional missed violations. A third explanation was that violations found recently related to new products and rule changes and therefore differed from those found before. One regional official attributed the continuation of missed violations to such factors as the presence of inexperienced and low-paid SRO examiners and SROs'

failure to expand the examination scope when warranted. Inexperienced examiners and relatively low salary levels at SROs were also cited by the Commission in 1983 as serious problems affecting SROs' regulation of their members.

Although hundreds of missed violations are still found annually, SROs do make changes to improve the work of their examiners and thus reduce the number of missed violations. For example, one SRO initiated new examination programs, assigned a minimum of two examiners to each examination as opposed to one, hired former Commission officials and other individuals to solve identified problems, established a department to review regulatory operations, and ran an extensive training program to teach new procedures and reinforce a more questioning attitude among examiners.

During our review, Division officials told us of a change they plan to make in analyzing missed violations. The Commission's examination activity tracking system was established in 1981 to provide the Division with the capability of monitoring trends in regional office performance. According to a Commission official, the Division used the data on missed violations to identify which regions were finding the most and the least SRO-missed violations and to determine whether the SRO-missed violations were in the financial and operational or in the sales practice areas. However, the Commission had not compiled information over time as we did on what specific violations were most often missed by SROs. During our review, Commission staff told us of plans to expand their analysis of missed violations. This would enable them to refine their monitoring of regional office performance, analyze specific violations not detected by SROs, and improve SRO responses to overlooked violations. According to a Commission official, data will be ready for analysis toward the end of calendar year 1986.

Causes of SRO-Missed Violations Have Not Been Reported Consistently

According to the Division of Market Regulation's 1982 broker-dealer examination guidance sent to the Commission's regional offices, while conducting oversight examinations the Commission should, among other things, identify "whether (and why)" an SRO examination did not discover a violation detected by the Commission. In our opinion, identifying the reasons why violations were missed helps the Division obtain as much information as possible from the regions on how the SROs' procedures should be improved. The guidelines provided examples of the types of questions examiners should answer when an SRO-missed violation is detected. These questions dealt with whether SRO procedures

were adequate, whether they were followed, and whether examiners had enough experience or training. The guidance further stated that examination reports should carefully identify perceived SRO shortcomings. Causes that we have seen identified and that we believe lay the groundwork for SROs addressing their problems included weaknesses in examination procedures, misapplication or apparent unfamiliarity with rules, and errors by individual examiners.

In the examination reports we reviewed in three regional offices, the regions were not consistently reporting causes for SRO-missed violations either in 1982, before the 1982 guidance was issued, or in 1984. Specifically, of the 132 reports in our sample, examiners included causes in 21. Most of these causes (14 out of the 21) were cited in one regional office. Officials in that region believed that where an inordinate amount of time is not involved, cause identification by examiners helps the region identify SRO examination weaknesses and draw overall conclusions about examination programs.

Officials in the other two regions we reviewed were concerned that examiners would have to speculate or would lack the proper perspective, knowledge, or access to all the relevant information. We were told in one of the regions that the local responsibility was not to identify causes but to inform the Division and SROs of the missed violations and allow them to identify the causes, particularly since most of the SRO-missed violations were not material. Consequently, even for the 32 missed violations identified to us by the region as being very serious, the region could not give us the reasons behind the omissions or cite what specific corrective action, if any, the SROs took to eliminate the causes. Although memoranda of regional meetings with SROs at times discussed causes of missed violations, this regional office could not provide us with memoranda of meetings from fiscal years 1982 through 1984. Officials in the other region deemphasizing cause identification provided us with two memoranda documenting meetings with SROs, but only one referred to causes. Commission officials in Washington, D.C., told us that although regional offices may not always be documenting the causes for missed violations, they do discuss them with the SROs.

In response to our concern about the inconsistent reporting of causes for SROs missing violations, the Division of Market Regulation sent a memorandum dated March 13, 1986, to Commission regional offices. The memorandum instructed the regional offices to include in their examination reports their assessments of why violations were missed, including

deficiencies in SRO procedures and SRO examiners not following procedures. If the regional office could not definitely state why an examiner failed to discover a violation, it was to request a written explanation from the SRO.

Missed Violations Were Generally Not a Significant Factor in Broker-Dealer Failures

One reason we focused on SRO-missed violations and on those considered serious was to ascertain whether the missed violations might have directly related to subsequent broker-dealer failures. Based on our review of 16 recent failures, we found that missed violations were generally not a significant factor in the failures.

According to the Commission's 1983 annual report, one Commission oversight examination of a particular firm found that an SRO failed to discover fraudulent activities involving about $40 million. Upon the Commission's discovery of the fraud, the Securities Investor Protection Corporation (SIPC) was notified, and a trustee was appointed to supervise the firm's liquidation.

To see if this was an isolated case or an indication of a broader trend, we performed a limited analysis of the files of the 16 broker-dealer firms that entered SIPC liquidation proceedings in calendar years 1983 and 1984.[3] According to our analysis, in 5 of the 16 cases—including the one mentioned in the annual report—the Commission had noted SRO-missed violations during oversight examinations within the year before referral to SIPC for liquidation.[4]

The situation described in the annual report was the only one we saw in which the firm failed directly after the Commission's detection of missed violations. The Commission found that the SRO had missed violations which resulted from efforts to conceal fraud and also missed the fact that the broker-dealer was already insolvent. According to the Commission, the SRO probably would have discovered the violations and the fraud causing the failure if it had verified the authenticity of certain documents.

[3]To place the number and cost of broker-dealer failures in proper perspective, about 8,000 to 10,000 broker-dealers were in existence in 1983 and 1984. Through 1984, SIPC advances to satisfy customer claims against the 16 firms amounted to about $54.4 million, including the case cited in the annual report.

[4]In another 9 of the 16 cases, the Commission had conducted at least one cause examination within 2 years of referral to SIPC, but no missed violations had been cited. In the remaining two cases, the Commission conducted oversight examinations but noted no missed violations.

In the other four cases with missed violations, the relationship between the violations and the firms' ultimate failures was not so clear-cut. The examination discovering the missed violations preceded the referral to SIPC for liquidation by between 3 and 11 months, not a matter of days as in the case above. Also unlike the above case, in none of the four cases did the Commission's discovery of SRO-missed violations in and of itself reveal a firm to be insolvent.

Regarding the four individual cases, Commission officials told us the missed violations either were not related to the failures, or were related in varying degrees. For instance, in one case the missed violations were not related at all. At the time the missed violations were discovered, this firm was very profitable. In another case, according to a Commission official, "there was no direct causal connection between the missed violations and the failure." However, the missed violations were related to the extent that they were part of a long string of violations preceding the failure. In still another case, the missed violations together with SRO-found violations were an indication of serious recordkeeping problems at the firm. Recordkeeping violations were related to the failure in that the firm was unable to determine its financial position, but they were not the cause of the failure. The firm failed because of a large operating loss.

The 1983 case cited in the annual report was so severe that it specifically resulted in SRO and Commission systemic action. In the aftermath of the broker-dealer failure, the SRO retained a consulting firm to help improve its examination process. The SRO together with the consulting firm developed new programs, including a risk assessment profile, a planning document for examinations, and a supervision and review program for examiners' workpapers and findings. The Commission responded to this failure as well as to another by proposing changes in its customer protection rules. According to a Commission official, the proposed changes would not necessarily prevent a fraud such as that missed by the SRO but would make circumvention of the rules more difficult.[5]

In addition to analyzing whether the SRO-missed violations noted by the Commission played a large part in ultimate broker-dealer failures, we were interested in whether the SROs— the first line of regulatory defense—or the Commission first became aware of serious broker-dealer

[5]Fraud was only one of the causes of broker-dealer failures in 1983 and 1984. For a discussion of others, see appendix III.

financial difficulties. Out of the 16 cases we reviewed, 13 files indicated that the SRO became aware of the difficulties either before or at the same time as the Commission. Problems came to light through an early warning/financial reporting system, SRO or joint Commission/SRO examinations, and customer complaints. The Commission became aware of the other three cases through its own examinations or pursuit of complaints. One of these three firms was under the Commission's direct oversight following its expulsion from membership in an SRO, so the SRO could not have discovered problems first.

Commission Examinations Note Continuing Violations

In addition to noting SRO-missed violations, Commission examiners ascertained whether violations that the SROs had found still existed when the Commission conducted its examination. We found continuing violations mentioned in 14 percent of the reports. We also found that the Commission was beginning to assemble more comprehensive information on the extent of continuing violations.

Out of the 132 Commission examination reports for fiscal years 1982 and 1984 that we reviewed, 18 (9 in each year) contained evidence that at least 1 previously found violation still remained (26 remained in total). Of the 18 examinations, 13 were in one of the three regions we studied, and 8 of those 13 were in 1982.

Officials in the two regions whose reports contained less evidence of continuing violations had positive comments about the SROs in their regions. Officials in the region with the most reports showing continuing violations—eight in 1982 and five in 1984—stated that one reason for continuing violations was that SRO actions were not severe enough to deter them. However, this was tempered by the belief that some broker-dealers will continue to repeat violations in spite of all SRO efforts. According to the officials, some broker-dealers just do not take SRO actions seriously. One regional official did say, though, that the decrease in the number of continuing violations from eight in 1982 to five in 1984 pointed to an increasing deterrent effect of the Commission's oversight. The Commission has pointed out this region's problem with continuing violations to the cognizant SRO.

During our review, the Commission devised a new categorization of violations to capture in computerized fashion how many continuing violations it noted and more easily pinpoint where continuing violations were a problem.

Conclusions

The Commission's broker-dealer examination program has uncovered violations missed by SROs and helped correct some SRO examination procedures. We believe, in addition, that the Commission's recent emphasis on identifying the reasons for missed violations in examination reports will improve the examination program. It better assures the Division of Market Regulation of obtaining as much input as possible from the regions so that problems of national concern may be corrected.

Self-Regulatory Inspections Improve SRO Compliance Regulation of Broker-Dealers

The broker-dealer examination program, described in chapter 2, and the self-regulatory inspection program, to be described in this chapter, together comprise the Division of Market Regulation's two-part approach to ensuring that SROs assure compliance by their member broker-dealers with the SROs' own rules, with the 1934 act, and with Commission regulations. The first part, the Commission's program for examining particular broker-dealers, specifically checks on SROs' conduct of individual broker-dealer examinations by going to the broker-dealers themselves. The second part, the Commission's self-regulatory inspections, is conducted at the SROs.

The Commission carries out the self-regulatory inspection program both by routinely receiving and examining SRO documents and by visiting the SROs themselves. More specifically, it evaluates how well SROs

- examine member firm sales practices and financial and operational procedures;
- investigate customers' complaints, terminations of registered representatives for violations of rules or statutes, and cases of disciplinary actions taken by the firms against a registered representative; and
- discipline broker-dealers for improper behavior.

Though some of these same subjects are addressed in the broker-dealer examinations described in the previous chapter, the self-regulatory program described here covers SRO operations as reviewed at their own offices.

As described more fully in chapter 1, GAO's objectives in evaluating Commission self-regulatory inspections were to analyze the frequency and scope of the inspections and the disposition of inspection findings. In conducting its oversight of SRO programs, the Commission is generally satisfied that the SROs make changes to address deficiencies it noted. Some of the changes involved comprehensive SRO policy modifications.

In suggesting changes, the Commission prefers maintaining cooperative, give-and-take relationships with the SROs rather than taking an aggressive approach. Although the Commission has influenced SROs to improve, its approach leaves open the possibility that SROs can resist Commission recommendations and lengthen the time needed for problem resolution. In addition, the staffing situation at the Commission, including the number of staff and the degree of turnover, has affected the self-regulatory inspection work performed.

Description of the Commission's Oversight of SRO Compliance Programs

The Commission oversees and evaluates SRO activities to ensure member compliance by ascertaining whether adequate procedures exist for these activities and whether they are consistently implemented. The Commission bases its evaluation on information obtained through periodic on-site inspections at SROs and through the monitoring of information routinely provided by SROs.

Section 17(b) of the Securities Exchange Act of 1934 provides the SEC with the authority to conduct "at any time, or from time to time . . . such reasonable periodic, special, or other examinations . . . as the Commission . . . deems necessary or appropriate in the public interest, for the protection of investors, or otherwise. . . ." Periodic, on-site inspections are conducted both routinely and when warranted by special circumstances and are referred to as oversight and special inspections, respectively. In evaluating specific SRO regulatory activities, Commission inspectors may also evaluate such managerial matters as the quality of internal SRO staff supervision, the SRO's level of staff resources, the possibility of examiner conflict-of-interest, and the adequacy of the documentation of examination results. For more details about the Commission's self-regulatory inspections, see appendix IV.

The second way the Commission evaluates SRO procedures is through the routine monitoring of SRO reports and numerous telephone calls to SRO officials. In this way, the Commission staff is able to detect potential deficiencies, to determine whether previously identified deficiencies have been corrected, to see if the SRO is on schedule for completing broker-dealer examinations and cause investigations, and to better target resources for on-site inspections. Reports sent to the Commission include

- statistical summaries of NASD districts' activities, including such items as the number of broker-dealer examinations completed and the number of cause matters received and resolved;
- minutes of NASD/District Business Conduct Committees who decide whether to take disciplinary actions against broker-dealers;
- monthly listings of violations of rules and regulations found in exchange examinations of broker-dealers and corresponding actions taken by the exchange;
- early warning lists of firms experiencing financial difficulties; and
- lists of current personnel and personnel changes, including people hired, fired, and reassigned.

The Commission routinely receives and analyzes this information. If Commission staff members were to learn of problems and inconsistencies during their review, a Commission official told us they would probably call the SRO. If the problem were persistent or part of a pattern, the Commission might schedule the SRO for an on-site inspection.

The Commission Is Satisfied That Cited Deficiencies Are Generally Resolved

A key measure of whether the Commission self-regulatory inspection program is effective is the extent to which Commission-discovered deficiencies in SRO programs are followed up and eventually resolved. Based on our analysis of inspection findings and our discussions with Commission staff, Commission-identified deficiencies generally have been resolved. Commission staff believe they have developed cooperative working relationships with the SROs, and the Commission has negotiated and urged the SROs to make changes to their programs.

During calendar years 1980 through 1984, the results of 14 on-site inspections involving Commission headquarters staff were formally communicated by letter to SROs. We reviewed the letters, extracted the deficiencies cited by Commission staff, and discussed the dispositions of each with the chief of the Commission's Self-Regulatory Inspection Branch.

The branch chief was satisfied that 72 percent, or 57 of the 79 deficiencies we counted in the 14 inspection letters, were resolved as of the May through July 1985 dates of our discussions. ("Resolved" was defined to us as indicating that symptoms of the deficiency seem to have disappeared.) In some instances, the Commission was able to provide us with revised or newly-established SRO policy statements or other documentation which indicated resolution of the deficiency. In other instances, we were told that the Commission had not seen recurrences of the deficiency, but no documentation was available for us to review.

Although measures had been taken to lessen the likelihood a deficiency would recur, they did not preclude the possibility of recurrence. For example, although an SRO might establish procedures to address a particular program deficiency, this does not necessarily ensure consistent implementation of these procedures.

According to the branch chief, the remaining 28 percent of the deficiencies—those that had not been resolved—were either still being negotiated (27 percent) or had been successfully refuted by the SRO (1 percent). The 27 percent still being negotiated could be separated into

two categories. The first category contains deficiencies for which the solution is an ongoing point of discussion. For example, the Commission and SROs frequently discuss the reasons why SROs fall behind in their broker-dealer examination programs. Although an SRO may become up-to-date in its examination program, delays can recur with little or no warning. Therefore, the problem is classified as ongoing. One reason is that in the event of a financial crisis, such as a firm in danger of SIPC liquidation, SROs will divert resources away from the routine examination of broker-dealers and attend to the crisis. Consequently, the conduct of broker-dealer examinations is periodically delayed. Commission and SRO officials will then try to agree on the steps needed to correct or mitigate the effects of these delays. Ten percent of the deficiencies fell into this category of ongoing discussion. The second category included deficiencies cited by the Commission but not yet acknowledged by the SRO. About 16.5 percent of the deficiencies fell into this category. For both these categories, negotiation was continuing.

Through its self-regulatory inspection program, the Commission has been instrumental in effecting changes at the SROs. In certain cases, comprehensive policy changes made by an SRO directly addressed Commission-identified deficiencies. For example, in various inspections the Commission suggested that one SRO adopt standardized workpaper formats. Without complete documentation of the SRO's examinations, a Commission official believed the Commission could not effectively evaluate examination performance. The SRO issued an educational circular which resolved the workpaper deficiency to the Commission's satisfaction. Other examples of changes made after Commission suggestions included SROs developing a supervisory review form; providing more disclosure of discipline-related information to disciplinary panels; and changing their staffing levels, allocation of staff, and compensation arrangements.

Problems Generally Resolved Through Negotiation

While the Commission was satisfied that deficiencies noted in its self-regulatory inspections were generally resolved, the give-and-take relationship existing between the Commission and the SROs leaves the possibility that SROs may resist Commission findings. If a Commission inspection of an SRO finds SRO shortcomings, the Commission has various statutory remedies it can institute. The Commission's approach has been to use these powers sparingly and rely instead on maintaining cooperative, give-and-take working relationships with the SROs and urging the SROs to improve.

The Commission's Sanctioning Authority

Sections 19 and 21 of the act provide the Commission with certain sanctioning authority to deal with the SRO shortcomings it finds. However, the original 1934 act authorized the Commission to take only the most extreme actions against an SRO. The Commission's authority was limited to suspending an SRO for up to 12 months or revoking its registration.

The 1975 amendments to the 1934 act significantly increased the regulatory options available to the Commission. In these amendments, the Congress authorized the Commission to censure an SRO or place limitations on its activities, functions, and operations. The amendments also expanded the grounds on which the Commission could sanction an SRO and enabled the Commission to take appropriate action upon finding that an SRO had failed to enforce its own rules, the 1934 act, or the rules and regulations implementing the act. In addition, the amendments authorized the Commission to censure or remove from office any officer or director of an SRO who had willfully failed to enforce compliance with the 1934 act or corresponding rules. Finally, the amendments empowered the Commission to apply to a federal court for an order to: 1) enjoin the violation of the rules of the SRO, 2) command a member of an SRO to comply with SRO rules, or 3) order an SRO to enforce compliance by its members with the 1934 act and corresponding rules.

In expanding the Commission's formal disciplinary powers, the Senate Committee on Banking, Housing, and Urban Affairs explicitly noted that it intended the Commission to be more willing to use its powers than in the past. As described in this chapter and in chapter 4, the Commission has used these powers rarely but has induced changes nonetheless. According to a Commission official, just having the proverbial "shotgun behind the door" is useful in the self-regulatory process.

The Commission's Approach to Oversight

Instead of using its statutory powers extensively, the Commission prefers to persuade the SROs of the need to adopt its recommendations. The Commission believes that more effective regulation of member firms can be achieved by maintaining a cooperative rather than an adversarial working relationship with SROs. According to one Commission official, routinely and publicly forcing an SRO to change would undermine investor trust in the business community and therefore would not be in the public interest.

Still, the Commission has taken more forceful action on a few occasions. For instance, a 1980 inspection of the Philadelphia Stock Exchange disclosed deficiencies of such severity that the exchange was ultimately

induced by the Commission to voluntarily relinquish examination and financial surveillance responsibilities for all members except those few which were members solely of that exchange. In October 1981 these examination and financial surveillance responsibilities were assumed by the NASD. Other examples of relatively forceful action include the publication of information surrounding NYSE's investigation of the 1980 silver crisis and the public censuring of the Boston Stock Exchange for failure to enforce compliance with its own rules.

SRO Resistance to Commission Findings

The fact that the Commission prefers a give-and-take negotiating process to more forceful action leaves open the possibility of strong SRO resistance to Commission suggestions. Because the Commission and the SROs may differ in their views on how broker-dealers should be regulated, Commission criticisms of, and recommendations to, SROs may be met with resistance, and changes may not be immediate. It is hard to say how much time is appropriate to overcome resistance or clear up any misunderstandings because the amount of time depends on the nature and the severity of the criticism. For example, policy changes with widespread implications take longer to implement than do minor, technical changes.

An April-May 1981 inspection of a program at one SRO clearly demonstrates the resistant nature of the give-and-take which may exist between the Commission and an SRO. In a March 1982 memorandum prepared for the commissioners, the Division of Market Regulation called the SRO program "seriously deficient." According to a July 1983 Commission letter to the SRO, although several Commission/SRO meetings had been held, no agreement could be reached as to the disposition of the findings. The letter said that to the best of the Commission's knowledge, the deficiencies noted in the inspection—including failures to open and properly pursue investigations of possible violations of securities laws—still existed. SRO officials told us that they did not and do not agree with the Commission's findings in this case. They believed that because the SRO needs to exercise discretion in its work, the Commission's criticisms were unjustified. Furthermore, the officials believed the report message was unbalanced and created the unwarranted impression that the SRO was doing a less than adequate job. The Commission's letter to the SRO summarized its position and related the difficulties the Commission had experienced in working with SRO officials. In September 1983 the SRO officially responded to the Commission that it would increase its personnel budget as well as enhance its computer support for regulatory programs.

This case depicts a somewhat extreme example of SRO resistance and is not typical of all inspections, although we did see elements of resistance at other SROs. Both the SRO and the Commission in this example have affirmed that the relationship between the two organizations has improved. In 1985 the Commission again reviewed this SRO program, but as of April 8, 1986, the findings from this inspection were not yet available for our review. In any case, this example shows the resistance that can occur between an SRO and the Commission as part of the give-and-take of the self-regulatory process.

Resource Limitations Cause Careful Allocation of Staff, More Reliance on SROs

Given the number of staff available, varying staff experience levels, and the degree of staff turnover, Commission officials felt the need to allocate self-regulatory oversight resources carefully. Commission personnel turnover, short-term delays in report review, and short-term differences over the quality of inspection work performed affected what the Division of Market Regulation has been able to accomplish.

According to Commission officials, the Self-Regulatory Inspection Branch has been unable to conduct inspections of each SRO every year as it would have liked because its staff was limited (never numbering more than 5 in the 1980s) and relatively inexperienced. In the early 1980s the Commission was not able to do all the self-regulatory inspections it planned. Needing to inspect NASD district offices and the NYSE, the Commission chose to inspect each NASD district first. The Commission completed those inspections by 1981. It then told the House Appropriations Committee in 1981 that due to its limited resources and the NYSE's large size, the Commission would not completely review all facets of NYSE's operational, financial, and sales practice compliance programs until the end of fiscal year 1982.

As it turned out, the Commission was able to perform and formally communicate a routine evaluative inspection of only one NYSE program from 1981 through 1984. According to a Commission official, the branch spent 1982 and 1983 further developing a core of knowledge about NYSE. This investment of time was needed because branch staff were leaving the Commission in 1982 and 1983. The branch consequently had to postpone further inspection of the NYSE until the core of knowledge could be built. Thus, the Commission did not inspect NYSE enforcement's handling of cases arising from NYSE's examination program, a vital element in NYSE's regulation of its membership, until 1985. However, according to a Commission official, the branch has inspected the major components of the other SROs.

A Commission official explained to us that the branch targets its scarce resources to inspect the SRO functions most needing inspection. In some instances, the Commission will start comprehensively and then narrow its scope of inspection to focus on problems it has noticed in order to keep them from growing. In other instances, we were told the Commission will delay an inspection so that staff can be used elsewhere. For example, the branch chief told us that although one SRO was "due" to be inspected, staff were then occupied with another. A decision was made to postpone the "due" inspection because daily monitoring indicated good regulation at that SRO and because regulation by the other SRO had a much greater impact on the securities industry. Thus, rather than routinely assigning staff to any SRO that had not been inspected for a year or two, the branch chief monitors SRO activities and focuses staff on trouble spots.

Between 1980 and 1984, a personnel disruption also affected the reporting of inspection results. The disruption involved management and staff turnover, differing opinions on the quality of inspection work, and delays in report review. During that time the Self-Regulatory Inspection Branch completed inspections and draft reports but the results of some of these inspections were never formally communicated to the SROs involved. One SRO specifically inquired in January 1983 about the results of inspections done in 1981 and 1982; no response was made until the request was reiterated in late 1984. Nevertheless, during this time the Self-Regulatory Inspection Branch continued to conduct inspections and maintained regular telephone contact with senior SRO staff. Formal periodic meetings were commenced with the SROs in 1984.

During the 1980s, the Self-Regulatory Inspection Branch and the Commission in general have tried to best use available staff by striving for greater SRO and Commission regional office involvement. Of course, heavier reliance on SROs makes Commission oversight and continued staff involvement even more crucial. According to Commission officials, the branch has placed greater reliance on SRO-provided statistics and informal communication rather than on direct physical observation of SRO activities because staffing levels precluded physical observation. However, Commission staff have said this has not posed a problem for them. In early 1983 the Commission told the Congress that in order to handle its expanded workload, the Commission had increasingly relied on SROs to ensure their members' compliance with Commission and SRO rules and regulations. In a mid-1983 letter regarding a self-regulatory inspection, the Commission told an SRO that given the Commission's

declining resources, it was an especially appropriate time for the SRO "to shoulder more responsibility for protecting the public interest."

Beginning in fiscal year 1986, Commission regional offices assumed greater responsibilities for planning, conducting, and reporting results of routine oversight inspections of NASD district offices. According to Commission officials, although regional offices had on their own initiative performed inspection work previously, whether inspections were done and whether reports were sent to SROs varied from office to office. According to one headquarters official, the change in regional office responsibility represented not only a shift in inspection authority but also an increase in oversight because inspections could be done more often. Furthermore, it was an indication that the Commission was moving towards a more integrated approach to oversight, trying to use the resources of the whole Commission, not just those at headquarters. Another headquarters official, on the other hand, believed the formal shift in responsibility would not result in extensive shifts in regional office priorities or resource allocations because these offices had already, to a great extent, participated in SRO inspections. However, he also noted that minor economies to allow greater inspection participation might be achieved through the increased referral of cause matters to the SROs.

Even given the Commission's efforts to generate more oversight from its resources, the question can always be asked as to whether the resource and oversight levels are appropriate. In an internal Commission memorandum regarding its fiscal year 1986 budget submission, the Division of Market Regulation made the point that with increased staff it could "enhance the coverage of its oversight and inspection programs . . . thereby easing the Commission's and the SRO's task of keeping pace with the expected rate of market growth in trading volume and new securities products." In light of the growing market activity, one Commission official told us that if an unforeseen emergency such as a sudden, widespread financial crisis arose, the Commission's oversight work of SRO compliance programs would be severely affected.

Conclusions

Most of the deficiencies the Commission identified in inspections that were formally communicated to SROs are currently considered resolved. However, because the Commission's approach of dealing cooperatively with SROs allows for some give-and-take, if an SRO does not agree with Commission findings or recommendations, additional time may be

required to persuade the SRO that improvements are needed and that the Commission's concerns should be addressed.

Given the Commission's staffing situation in the 1980s, the Commission has not been able to cover all of the items in its self-regulatory inspection program that it intended. However, it has directed its program toward priority areas and has emphasized greater involvement of SROs and Commission regional offices.

The Commission's Oversight Through Surveillance Inspections Results in SRO Improvements

Surveillance is the monitoring of trading activity in order to detect anomalies that indicate improper behavior. Just as the Commission performs self-regulatory inspections to oversee SRO compliance with statutes, rules, and regulations, it also inspects SRO surveillance programs to oversee the SROs' monitoring of trading activity. In order to measure the effectiveness of the Commission's surveillance oversight, we again used the criterion of whether deficiencies identified in inspection reports were resolved. Based on our analysis and discussions with Commission officials, in nearly every case the Commission was successful in persuading the SROs to comply with its recommendations. However, this process of persuasion took varying amounts of time, from weeks to many years.

Description of the Commission's Surveillance Inspection Program

According to the Commission official in charge of surveillance inspections, an SRO must conduct four essential activities if its surveillance operation is to be effective in dealing with violative activity. It must

- collect information,
- routinely analyze the data collected to detect possible violations,
- investigate possible violations, and
- take appropriate disciplinary action.

To oversee SROs' progress in achieving and maintaining these activities, the Commission conducts periodic surveillance inspections as authorized by the Securities Exchange Act.

The Role of the SROs

To conduct effective surveillance for possible violations, an SRO must monitor trading activity. This monitoring is done by comprehensively collecting data in such a way that an "audit trail," or history of each securities transaction, is created. An audit trail consists of such basic information as the name of the security traded, the price and time of the trade, the number of shares traded, and the brokers involved. When an audit trail exists, SROs can use it to recreate trading activity over time.

Using an audit trail, an SRO can analyze trading activity to detect patterns which may indicate possible violations of law or regulation. When an audit trail is automated, this analysis is facilitated by the use of computer programs which manipulate audit trail data and produce exception reports of potential violations. Examples of violations that could be detected include:

- Insider trading—trading by a person who, because of his or her relationship to a listed company, has access to private information that may affect the market performance of that company's stock. This violation can be detected by monitoring shareholders' reports, which "insiders" (such as employees, directors, accountants, attorneys, and major shareholders) must file periodically with the Commission or the SROs, or by linking computerized information on business news events with trading activity occurring at about the same time as the news events reported.
- Pegging—temporarily raising or preventing the drop in price of an underlying security in order to protect or enhance the value of an expiring options position on the same security. Pegging the price of an underlying stock can be detected by monitoring any purchases of significant amounts of the underlying stock by the holders of options to sell the stock, or by monitoring those holders placing large buy orders in the underlying stock at a limit price slightly below the current market price.
- Marking the close—executing a trade or entering a quotation in a security at or near the close of a trading session for the purpose of affecting the closing price in that security. Marking the close can be detected by monitoring price movement patterns in the last 5 minutes of trading.

Having collected trading data and analyzed it for possible violations, the SROs must then investigate possible violative trading activity. If an investigation confirms a violation, SROs have panels of peer SRO members that can take disciplinary action to punish misbehavior and discourage its recurrence.

The Role of the Commission

The Commission conducts its surveillance inspections in much the same way as it performs its self-regulatory inspections. After a pre-inspection phase, Commission staff spend from 2 to 9 days at the various SROs observing trading activity and operations. While there, they collect data related to trading, investigations conducted by the SROs, disciplinary actions taken, various SRO meetings, and other matters. An exit meeting is held with SRO staff, and preliminary inspection findings are discussed. The Commission staff may then spend months at Commission headquarters analyzing the data collected and preparing a memorandum to the Commission and a letter to the SRO communicating their inspection findings. If the Commission sees the need to take enforcement action to require an SRO to remedy deficiencies it has found, it has the powers described in chapter 3.

During the period we studied, from calendar years 1980 through 1984, the Commission reported on different numbers of inspections for different SROs. In general, SROs with higher volumes of trading were reported on more frequently than the smaller, lower volume, regional SROs. Based on reports communicated in 1980-1984, all 11 SROs that traded stock or options were inspected at least once, three SROs were inspected twice, three more were inspected three times, another three were inspected five times, and the remaining one was inspected nine times.

The Surveillance Oversight Program Brought Many SRO Improvements

Just as we did with self-regulatory inspections, we focused on whether changes resulted from Commission surveillance inspection recommendations. To do this, we analyzed all 40 inspection reports issued to NASD and the exchanges from calendar years 1980 through 1984.

The Commission's surveillance inspection program has resulted in many positive changes to SRO operations. SROs have made numerous enhancements to their surveillance systems, and deficiencies cited in Commission inspection reports generally have been resolved.

Surveillance Oversight Has Improved Many SRO Operations

The surveillance inspection program has resulted in improvements in each of the four areas comprising an effective SRO surveillance operation—data collection, analysis, investigation, and discipline.

For example, in the data collection area, the Commission encouraged the SROs to develop not only audit trails, but automated audit trails. In the past, data collection at SROs was done manually and market reconstruction was a tedious, time-consuming, and labor-intensive process. Manual systems were manageable and acceptable to the Commission when trading volumes were low. However, at higher levels of trading volume, manual systems were no longer acceptable to the Commission because of their inefficiency.

Because the Commission was not entirely satisfied with the completeness and thoroughness of SRO automated data collection systems, it encouraged SROs to make the investments necessary to update, refine, or modernize these systems. In this way, the Commission has been instrumental in the development and refinement of automated audit trails at 8 of the 11 SROs. Two of the other SROs are so small and trading volume is so low (less than 1 percent of total U.S. trading activity) that automation is not needed, according to a Commission official. The remaining SRO

was actively encouraged by the Commission to make improvements in its data collection system, and implementation is expected in 1986.

The Commission has encouraged SRO data collection improvements through its pursuit of a Market Oversight and Surveillance System to enhance its own surveillance of the securities markets. Authorized by the Congress, the system was to be developed to provide the Commission with an on-line, automated capability to continuously monitor the performance of systems and professional participants in the marketplace. Concerned that continuous monitoring would entail more direct Commission regulation of trading activity, in August 1981 the SROs responded to the system by developing a plan for an intermarket surveillance program to provide a self-regulatory alternative to the full development of the Commission's system. An Intermarket Surveillance Group recognized that acceptable audit trails at the SROs would be a prerequisite to development of intramarket surveillance as well as intermarket surveillance. Consequently, the SROs had another reason to develop effective audit trails. Thus, "a major accomplishment" of the project was "that it served as a catalyst . . . for the furtherance of the self-regulatory scheme embodied in the Securities Exchange Act of 1934."[1]

Just as the Commission achieved improvements in SRO surveillance data collection, it also oversaw improvements in SRO data analysis. While not every SRO had needed to improve its analysis, the Commission was not satisfied that all the SROs had been doing all they should in analyzing data. For instance, the Commission made recommendations for changing SRO computer programs to assure that known types of violations were detected. The Commission also used computer programs developed by one SRO to encourage other SROs to use similar programs. By the time we talked to Commission officials, they were satisfied that 9 of 11 SROs (accounting for more than 99 percent of all trading activity) were performing adequate data analysis.

As another example of what the Commission has accomplished, the Commission noted that the parameters of one SRO for detecting certain violations were too high. (For example, a parameter could be set to produce an exception report on trading activity in a particular stock when the number of shares traded exceeded 300 shares per day.) Because the

[1]Securities and Exchange Commission, Final Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Energy and Commerce Regarding the Market Oversight and Surveillance System (January 15, 1985), p. 3.

parameters were too high, trading violations below those parameters that should have been detected might have gone undetected. The Commission recommended that the parameters be lowered, suggesting what levels the Commission believed would be more appropriate parameters. The SRO concurred and lowered the parameters for detecting the violative trading.

Commission-Cited Deficiencies Have Generally Been Resolved

As was the case with self-regulatory inspections, through written and verbal contact with the SROs the Commission is generally satisfied that the deficiencies noted in its surveillance inspections have been resolved. Based on our analysis and on conversations with the Commission staff, we believe that about 94 percent, or 259 of the 275 deficiencies we counted in the 40 inspection reports we reviewed, have been resolved. Less than 2 percent of the deficiencies were resisted outright by the SRO without the Commission being convinced of the SRO's position.

The Commission staff attribute the high resolution rate to their cooperative working relationships with the SROs. As already described in chapter 3, this cooperative relationship can entail the Commission's persuading the SROs that changes or improvements are needed for effective self-regulation and offering advice on how specific problems can be overcome. A former director of the Division of Market Regulation told us he believes it is the responsibility of the Commission staff to persuade the SROs of the need to change in order to assure that the SROs actually comply with the Commission's recommendations.

Despite the desire for cooperative relationships, the Commission has threatened to take, and actually has taken, strong and direct action against an SRO when it was deemed necessary. For example, in a 1980 inspection letter to an SRO, the Commission advised the SRO that it was possibly violating two sections of the 1934 act. The Commission made this point in a largely successful effort to induce the SRO to take action on developing and implementing an automated audit trail and making other improvements the Commission felt were necessary. Likewise, in 1985 the Commission threatened an SRO with regulatory action if surveillance improvements were not made in 90 days.

The Commission has twice used the enforcement powers against SROs granted it in Section 19(h) of the Securities Exchange Act of 1934, as amended. (We have described these provisions in ch. 3.) Both of these instances involved 1980 administrative actions taken by the Commission to address surveillance problems. In each case, the SROs settled the

action by agreeing to implement certain changes. Both cases involved the Commission censuring an SRO.

As mentioned in chapter 3, the cooperative give-and-take between the Commission and the SROs to achieve changes results in minor modifications occurring relatively quickly, and complex or sensitive ones requiring more time. Although we found no criteria to say how long any changes should take, a former commissioner told us that implicit in the concept of SRO self-regulation versus the Commission's direct regulation is that the former takes more time and therefore may be less efficient. If SROs resist Commission findings or recommendations, the discussion that ensues adds to the time needed to resolve any shortcomings seen by the Commission.

Our analysis of Commission inspections indicates that some changes, such as alteration of surveillance parameters, may be agreed upon by an SRO during a Commission inspection team's exit conference, and these changes are implemented by the SRO within weeks or months.

At the other extreme was the time taken by the NYSE to achieve changes in its audit trail. In 1963, a Commission study team special report recommended that NYSE obtain and preserve more market data.[2] However, according to the Commission's 1977 annual report, after 14 years the NYSE had not yet implemented an audit trail acceptable to the Commission. In 1979 when the Division of Market Regulation was reorganized into its current structure, such an audit trail still did not exist according to the Commission, which "significantly undermined" NYSE's ability to enforce the act and Commission and NYSE rules. In 1983 the Commission noted substantial progress toward audit trail implementation and looked forward to full implementation. It also stated to the Congress that progress in this complex area had at times been slow. In 1985 it reported to the Congress substantial progress made in 1984, although accuracy problems still needed to be remedied.

SRO changes made to disciplinary programs further illustrate the varying amount of time involved in changes and the inherent difficulty of making those changes. For instance, in early 1982 the Commission criticized an SRO for a continuing reluctance to issue charges against members for apparent, serious rule violations. An internal Commission document noted that reluctance to discipline a member was not unique

[2]Report of the Special Study of Securities Markets of the Securities and Exchange Commission, Part 2 (88th Cong. House Doc. 95), U.S. Government Printing Office, Washington, D.C., 1963, p. 358.

to that SRO but rather was probably the most pervasive weakness still existing in SRO surveillance and disciplinary programs. However, by early 1984 the Commission reported on substantial improvements to that SRO's disciplinary program, although significant delays in disciplinary processing still occurred.

Improvements to all phases of all disciplinary programs did not occur as rapidly as the one just discussed. Based on a surveillance inspection performed in 1979 and reported on in 1980, the Commission found that discipline at one SRO was weak. More specifically, formal disciplinary action was rarely taken, even when violations were substantial or continued. The SRO disagreed but, according to the Commission, undertook substantial efforts to address the deficiencies noted in the inspection. Because efforts were being made, the Commission did not write a deficiency letter to the SRO in 1982 even though it noticed that the SRO continued to rely on an informal disciplinary process to address substantial and clear-cut violations by specialists.[3] In a 1985 letter, however, the Commission noted the same disciplinary problems with the specialist area that it noted in the 1979 inspection—(1) an overreliance on informal discipline, (2) light sanctions, and (3) recidivism. The SRO responded by noting recent actions it had taken. The Commission's Assistant Director, Market Operations and Surveillance, told us he was pleased with these recent actions and other expected ones, and he was confident that the current SRO management would ensure improvements.

This same official advised us that effective disciplinary programs cannot be once established and then left alone; rather, continued attention is necessary to assure that the effectiveness of these programs is maintained. This concern with disciplinary programs was also reflected in the perceptions expressed in a November 1984 memorandum to the commissioners that we discuss in chapter 6. Although not dealing with surveillance discipline, the memorandum discussed Commission staff perceptions that certain SRO units were reluctant to take aggressive disciplinary action, such as expulsion. It added that the prosecution of sales practice abuses highlighted a limitation of the self-regulatory

[3]A specialist is a key member of an SRO, responsible for maintaining an orderly market in selected securities. ". . . specialists in stocks that are popular with the public earn a substantial portion of their income acting in this riskless agency capacity." When acting as an agent, the specialist receives orders to buy or sell a security allocated to him by the SRO. Such orders are usually not at the current price levels of the security, but rather are above or below the current price. The specialist's function as [an agent] is riskless because the execution of these orders is a function of fluctuating prices in the marketplace. Also, "[a]s a legally recognized market-maker, a specialist enjoys certain financing and tax advantages not available to most investors." See Allan H. Pessin, Fundamentals of the Securities Industry (New York: New York Institute of Finance, 1978), pp. 253-55.

system. According to the memorandum, even where SRO staff had aggressively investigated violations, disciplinary panels composed of members often appeared reluctant to sanction their peers.

Conclusions

The Commission's surveillance inspection program is generally effective in achieving SRO changes. The follow-up to deficiencies noted in surveillance inspections was nearly always successful in correcting them.

Just as in self-regulatory inspections, the Commission's means of assuring resolution of deficiencies involved cooperatively working with SROs to persuade them of the need for change. Rather than invoking a rule or censuring an SRO or in some other way taking direct regulatory action, the Commission tended more to encourage and foster the efficient and equitable operation of SROs. We did note instances, however, where the Commission either threatened to take stronger action or actually did.

The resolution of some Commission findings under the self-regulatory process took longer than others. Findings varied in their complexity and SRO amenability to take quick corrective action under the self-regulatory concept.

Commission Review of SRO-Proposed Rule Changes Is Working Well

The Commission has statutory authority to review and approve (or deny) SRO-proposed rule changes. It reviews proposed rule changes to ensure that they are consistent with the objectives specified in the Securities Exchange Act. During its review, the Commission must comply with procedural requirements designed to provide for adequate public comment on, and timely review of, proposed rule changes.

Based on discussions with Commission and SRO officials as well as on our analysis of files, we have concluded that the Commission's review of SRO-proposed rule changes is working well, because the Commission gives reasonable guidance to SROs, conducts a high-quality review of rules, and acts in a reasonable amount of time.

Description of the Program

The Congress passed Section 19(b) of the Securities Exchange Act to give the Commission broad statutory authority to review and approve (or deny) any SRO-proposed rule changes. The act required the Commission to approve an SRO-proposed rule change only if it finds it consistent with the requirements of the act and relevant rules and regulations. If the Commission cannot make such a finding, it must disapprove the proposed rule change. The act also requires the Commission to comply with certain procedural requirements during the review process that provide for adequate public comment on, and timely Commission review of, SRO-proposed rule changes.

SRO-proposed rule changes range from the routine to the complex and controversial. They may cover activities such as organization and administration, membership requirements, listing requirements for traded companies, financial products traded, business conduct, and discipline. SRO-proposed rule changes may range from a relatively minor one that establishes telephone rates for SRO members to a highly controversial one to permit the trading of options on over-the-counter listed securities on both the exchanges and NASD.

Three Major Statutory Categories of Rule Change Approval

To provide the Commission the flexibility to respond appropriately to these different types of rule changes, the Congress established three major categories of rule change approval. The SROs submit proposed rule changes to the Commission under one of these three categories, and in calendar year 1984 the Commission approved 306 of them.

Each category was established for a different type of SRO-proposed rule change, and each imposes different time limits for Commission action.[1] The first category covers those proposed rule changes, including all controversial ones, submitted for "normal" review under Section 19(b)(2) of the act. The Commission is required by law to provide for public comment and act upon the proposed rule changes within specified time periods. The Commission must either (1) approve the proposal within 35 days following its publication for comment, absent extenuating circumstances[2] or (2) institute and conclude a proceeding to determine whether the proposed rule change should be disapproved within 180 days following publication for comment, again absent extenuating circumstances.[3] In calendar year 1984, about 44 percent (134 of 306) of the approved rule changes were approved under this process.

The second category of SRO-proposed rule changes covers those which are submitted under Section 19(b)(2) for "accelerated" review. These proposed rule changes may be approved by Commission order more quickly than those submitted for "normal" review—within 30 days following publication for comment. In calendar year 1984, about 25 percent (75 of 306) of the approved rule changes were given accelerated approval.

Accelerated approval is granted for several different reasons, according to Commission officials. For example, the officials said that Commission approval of an SRO-proposed rule change will sometimes prompt other SROs to submit essentially identical proposed rule changes for accelerated approval. In other instances, the Commission may grant temporary accelerated approval to enable an SRO to continue an ongoing pilot program. Finally, in unusual circumstances the Commission may also grant temporary accelerated approval of a proposed rule change in case of an emergency.

The third category was essentially designed for minor, noncontroversial proposed rule changes of an SRO. The act allows an SRO-proposed rule

[1]Section 19(b)(3)(B) established a fourth category of rule change for summary approval on an emergency basis. The Commission has restricted this provision's use and has not invoked it for several years, according to Commission officials.

[2]The Commission may designate up to 90 days to take action on a proposed rule change if it finds it necessary and publishes its reasons; or the SRO may consent to a time extension for Commission action.

[3]The Commission may extend the time for conclusion of such proceedings up to 60 days if it finds good cause and publishes its reasons; or the SRO may consent to a time extension for Commission action.

change to become effective upon filing with the Commission if (1) it constitutes a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule; (2) it establishes or changes a due, fee, or other charge; or (3) it applies solely to the administration of the SRO. In addition, the Congress also authorized the Commission to specify any additional categories of proposed rule changes eligible for effective-upon-filing status. In calendar year 1984, about 32 percent (97 of 306) of the approved rule changes were given this approval.

A detailed discussion of Commission filing requirements and review procedures for SRO-proposed rule changes appears in appendix V.

Commission Guidance Is Adequate

The Commission provides the SROs with regulatory guidance to help ensure that they understand the requirements of the rule review program. They have provided this guidance through several different methods including formal rulemaking, written correspondence, and continuous informal dialogue with SROs.

The Commission establishes some policies for guidance to SROs by passing its own formal rules. For example, the Commission passed a rule to clarify which SRO actions constitute a rule change that must be approved under the act. While the act provides a basic definition of the term "rule," it also gives the Commission authority to decide which "stated policies, practices, and interpretations" of SROs also constitute rules. In 1975 and later in 1980 the Commission issued its own formal rules clarifying which SRO-stated policies, practices, or interpretations would be considered SRO rule changes for purposes of the act.

The Commission has also provided other kinds of written guidance to the SROs when minor policy questions have arisen. For example, in 1983 the Commission wrote to the exchanges and NASD that changes in small order execution systems were considered rule changes for purposes of the act and must be filed for review under Section 19(b)(2) of the act. More recently, the Commission wrote to the SROs explaining revised publication procedures for SRO-proposed rule changes.

Commission officials stressed that they continuously provide guidance to SROs by frequent contact throughout the entire rule review process. They said that SROs will not hesitate to contact them whenever questions or issues arise. For example, they stated that SROs will request guidance

if they are uncertain whether an anticipated action constitutes a proposed rule change subject to Commission review. Or, sometimes the SRO may be planning to submit a potentially controversial proposed rule change and will contact the Commission to identify and address major Commission concerns before submitting the formal proposed rule change.

SRO officials we interviewed believed that the Commission had provided good regulatory guidance to them. They told us in effect that they had a good idea of what constituted a rule change, of the different categories of rule change approval, and of the filing requirements for proposed rule changes. They cited the regulations, written correspondence, and their frequent contact with Commission staff as the means through which this regulatory guidance has been provided.

Quality of Staff Review Is Considered Good by Industry Members

SRO officials uniformly agreed that Commission staff perform a high quality, thorough review of SRO-proposed rule changes. They stated that Commission staff did a good job of identifying and analyzing complex issues. They attributed this assessment to Commission management's ability to retain mid-level staff and the recruitment of high quality staff attorneys.

The act specifies the criteria to be used by the Commission in its review of the hundreds of different proposed rule changes submitted each year. These criteria are essentially the same for each different type of SRO, but they vary to take into account the functional and organizational differences that exist between the exchanges, NASD, clearing agencies, and the Municipal Securities Rulemaking Board.

Staff review is not limited to the criteria specified in the act. When appropriate, Commission staff also consider whether the proposed rule change is consistent with other statutes and with existing professional standards. For example, one Commission official stated that he often checks for compliance with the constitutional provisions concerning due process, particularly when reviewing proposed rule changes pertaining to discipline. Another Commission official added that any proposed rule change pertaining to accounting will be checked for consistency with generally accepted accounting principles.

Commission Acts on Proposed Rule Changes Within Reasonable Periods of Time

In order to develop an opinion on the timeliness of Commission action on SRO-proposed rule changes, we discussed the subject with both Commission and SRO officials and also performed a separate analysis of all 306 proposed rule changes approved in 1984. We analyzed the issue by distinguishing between two key time intervals. The first interval was the date the proposed rule change was filed with the Commission to the date it was published for comment. There is no statutory requirement that the Commission publish proposed rule changes for comment within any time frame, but we found that half of all SRO-proposed rule changes were published for comment within 22 days of filing with the Commission. See appendix VI for more details.

Most SRO officials were generally satisfied that the Commission published proposed rule changes for comment in a timely manner, but some felt that there was room for improvement. In the past, according to some officials, the Commission staff had sometimes refused to publish proposed rule changes for comment as a tactic to negotiate desired amendments to the proposed rule change. While the tactic did give the Commission bargaining leverage, it also adversely affected Commission/SRO working relations since it was perceived by SROs as an abuse of regulatory authority.

Although they did not believe that Commission staff continue to refuse to publish proposed rule changes as a tactic to negotiate desired concessions, several SRO officials made comments that periodic delays occurred in getting proposed rule changes published for comment. They had different explanations for the delays. Some suggested that Commission staff resources were limited, one felt that Commission staffing levels were adequate but that they were not efficiently utilized, and another believed the Commission may have a tendency to overanalyze proposed rule changes before they are published for comment in the Federal Register.

Commission officials maintain that they do a good job of publishing these filings for comment but agreed that there were periodic minor delays. Some were caused, they said, by imperfections in SROs' submissions. Some officials complained of insufficient administrative support. However, they pointed out that they have recently taken steps to expedite the publication of proposed rule changes for comment. For example, they now publish the Federal Register insert in both the Federal Register and the SEC Docket rather than delay publication by preparing a separate notice for inclusion in the SEC Docket.

The second key time interval we examined was the date the filing was published for comment to the date it was approved (or disapproved). The act requires the Commission to approve or disapprove SRO-proposed rule changes within prescribed time frames unless the SRO grants a time extension for Commission action. We found that the average "normal" SRO-proposed rule change was approved within 54 days following publication for comment. A more detailed discussion of the approval period appears in appendix VII. SRO officials were generally satisfied that the Commission acted upon proposed rule changes in accordance with the requirements of the statute. Both Commission and SRO officials agreed that they had a good working relationship with one another and that the SRO would grant a Commission request for additional time when necessary.

SROs Were Primarily Responsible for the Status of Aged Filings

We performed an additional examination of 45 of 65 proposed rule changes that had been published for comment in 1983 or earlier but had been neither approved nor disapproved in 1984 (aged filings) and discussed their status with Commission and SRO officials. The proposals had been open for periods ranging from 1 to 8 years.

SROs were primarily responsible for the status of the 45 aged proposals. We found that in most cases (32 of 45) the Commission was awaiting the SRO's next move. In the majority of these filings (25 of 32), the SRO had lost interest in obtaining Commission approval for one reason or another. For example, in 1983 the CBOE submitted several proposed rule changes to trade options on 16 narrow-based industry indices. According to both Commission and CBOE officials, the exchange later discovered that no market existed for these indices and consequently lost interest in them. In another instance, an SRO filing had been superseded by a later filing. In 1980 the NYSE submitted a proposed rule change pertaining to "percentage orders." Commission staff raised several issues with the NYSE, and the NYSE did not pursue the matter for several years. However, recently the proposal was superseded by a new NYSE filing which, according to a Commission official, is intended to address the Commission's concerns.

In other instances the Commission staff had raised issues with the SRO concerning the proposed rule change and were waiting for a response.

In some instances (13 of 45), the SRO was awaiting Commission action. Five of these were controversial proposed rule changes raising substantive policy issues, such as the NASD proposal to trade options on over-

the-counter securities, which were subsequently approved in 1985. The others (8 of 45) remained unapproved at the conclusion of our review. Three of these were 9-year-old filings from three clearing agencies proposing not to charge for certain services among depositories. The Commission views the subject as a conflict of regulatory objectives, according to a Commission official. The Commission must balance the positive effects that not charging will have on competition among the depositories against its policy of charging fees to those who use identifiable services. Furthermore, the Commission also has to weigh these proposed rule changes in view of its mandate to facilitate the development of a national system for the clearance and settlement of securities transactions, according to this official. The official stated that the Commission had been wrestling with the issue for a long time and had tried to develop a factual analysis as a basis for a regulatory decision. However, the official said certain data were simply not available, and the Commission had finally decided to resolve these filings based, in large part, on policy considerations. In February 1986 the commissioners decided to defer action on these filings until they collected additional information on a related issue.

We discussed the status of these filings with SRO officials. An SRO official who supported the proposed rule changes expressed dissatisfaction with the length of time the Commission has taken to analyze these filings. An SRO official who opposed the proposed rule change voiced satisfaction with the status of the open filings.

The Commission Provides for Adequate Public Comment

The act requires the Commission to follow certain procedures designed to assure an opportunity for adequate public comment. The Congress established these statutory requirements in part because it found that some major policy decisions had been made without the benefit of adequate public input. Section 19(b) of the act requires the Commission to publish notice of an SRO-proposed rule change with an explanation of the terms of substance or a description of the subjects and issues involved. We confirmed that the Commission publishes notices of proposed rule changes in the Federal Register and that these notices include a statement that describes the basis or purpose of the proposed rule change.[4] While we found that these descriptions of the proposed rule changes

[4]The act does not specifically require that the notice be published in the Federal Register. However, the legislative history indicates that the Congress intended that the Commission follow the procedures in Section 553 of the Administrative Procedures Act which requires publication of proposed rule changes in the Federal Register.

appeared reasonably complete, we did not attempt to evaluate their adequacy.

In addition, Section 19(b) of the act also requires the Commission to provide for the submission of written data, views, and arguments concerning the proposed rule change. We verified that the notices of SRO-proposed rule changes did solicit written public comment.[5]

Finally, Section 23(a) requires the Commission to maintain public files of SRO-proposed rule changes. We verified that the Commission does maintain these files in the public reference room at Commission headquarters.

Commission officials believed that adequate opportunity was provided for comment on proposed rule changes. However, they emphasized that comments were not received very frequently and identified four groups potentially involved in commenting on proposed rule changes. First, SROs compete with one another for market share and will comment on each others' proposals when they believe their interests are threatened. Commission officials believe that the intense competition among the SROs helps ensure that controversial issues are fully aired and that the Commission fully considers all perspectives. Second, SRO membership is composed of different interest groups ranging from specialists to those firms handling retail orders. They have different priorities and will comment on proposed rule changes when they believe their interests are threatened. The third group comprises institutional investors who occasionally submit comments on proposed rule changes. Finally, small investors rarely comment on proposed rule changes. Commission officials indicated that this was a potential weakness of the rule review process but believed that they themselves adequately represented the interests of the small investor in the rule review process.

SRO officials we interviewed believed that the Commission gave fair consideration to their comment letters in reviewing proposed rule changes.

Conclusions

We believe the rule review process is working well. The Commission has been reviewing SRO-proposed rule changes within reasonable amounts of time. It has complied with statutorily established procedural requirements designed to provide for adequate public comment on, and timely

[5]The Commission maintains that it is not legally required to conduct hearings on SRO-proposed rule changes.

review of, proposed rule changes. Furthermore, SRO officials told us that the Commission has both provided good regulatory guidance to SROs and conducted thorough reviews of SRO-proposed rule changes to identify and analyze regulatory issues.

Commission Oversight in an Era of Growing Markets and Constrained Budgets

As the Commission states in its fiscal year 1986 and 1987 budget estimates, the securities markets have been growing rapidly over the past several years and are expected to continue to do so. Yet, the Commission's staff resources devoted to overseeing SROs have declined. The Commission stated in its fiscal year 1986 budget estimate that it has worked to maintain sufficient oversight by

- simplifying and clarifying regulations,
- shifting more responsibilities to SROs, and
- improving the productivity of Commission inspectors through automation.

Similar themes have been stated in Commission budgets for the past several fiscal years.

Although we did not specifically evaluate each of these initiatives, we did address the second and third topics in the course of our work. Moreover, since Chairman Dingell's concern in his request was about the Commission's ability to administer federal securities laws effectively with limited resources, and since Chairman Wirth expressed similar concerns in hearings held in March 1986, we have also included our observations about the Commission's budget and its efforts to maintain sufficient market oversight.

The strategy to shift more responsibility to the SROs needs careful follow-up. Although the SROs say they can handle a greater workload, the Commission's staff has expressed reservations about the SROs' ability to do so.

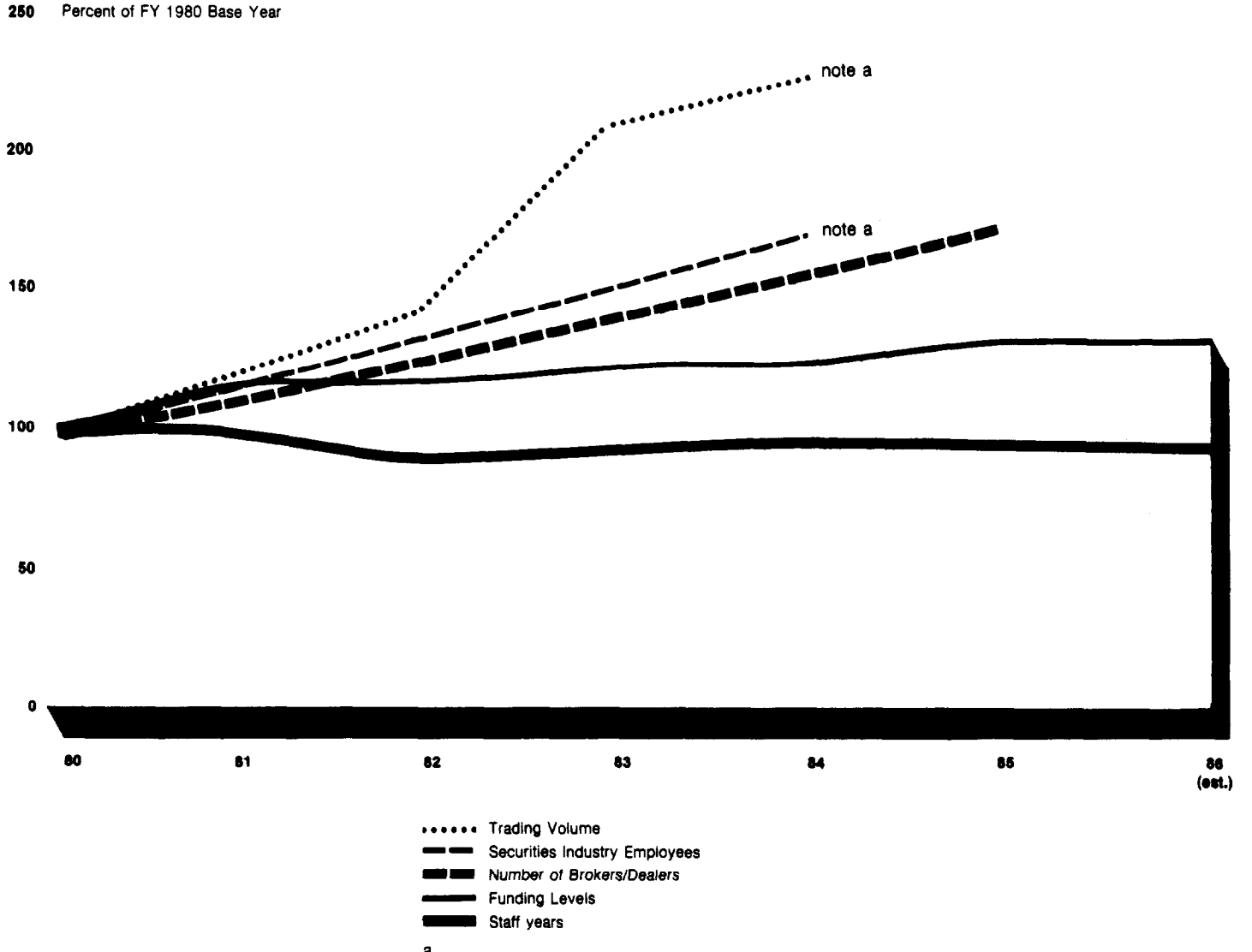
A 1985 experiment with increasing the Commission's examiner efficiency by using microcomputers showed promise. However, because budget constraints prevented the early purchase of the required computer equipment, the Commission has not yet realized the benefits of this strategy.

Securities Markets Have Grown in Size and Complexity

By various measures used to indicate the scope of market size and activity, the United States' securities markets have grown significantly over the past several years. As figure 6.1 shows, the volume of trading on the exchanges and in the over-the-counter market increased about 125 percent between fiscal years 1980 and 1984. The number of actual transactions increased about 38 percent since 1981, reflecting more large blocks of shares traded by large institutions, such as mutual funds.

Very recently individual investors have increased their trading, encouraged by a continued upward movement of the market. Growth in the number of transactions is important because a transaction, as the interaction of an investor with market professionals, is one of the basic activities that must be watched for potential problems.

Figure 6.1: Selected Indicators of Market Activity Compared to Commission's Market Regulation and Supervision Staff and Funding Levels



[a]For purposes of comparing these statistics to the others, we converted information available only on a calendar year basis to a fiscal years basis. We did this by assuming a constant rate of growth over a 12 month period. When we prepared this graph, 1985 figures were not available.

Also of importance for oversight is the number of practitioners in the industry. Between 1980 and 1984, 54 percent more broker-dealers were registered and 69 percent more people were employed full-time in the securities industry.[1]

Another point of concern has been the growth of new products and trading strategies that could challenge oversight programs. Much media and congressional attention has been drawn to such new products as futures and options based on composite indices of groups of securities, and repurchase agreements (essentially loans by one party secured by the other party's holdings of government securities), products which some customers and industry professionals may not fully understand. Concern also has been raised about trading strategies based on the relationships between futures, options, and related securities. These strategies are complex, could cause wider than normal market fluctuations, and could exacerbate the potential for cross-market trading abuses.

While the effects of these developments have been difficult to quantify, many experts who practice in the market or oversee it, as well as members of Congress, have indicated that these changes represent increased challenges to the Commission's oversight program. The Commission itself has acknowledged these challenges in its own budget documents, stating that market activity and complexity have increased, and the dimensions of the regulatory task have expanded.

Commission Oversight Staff Resources Have Declined

During the same period that securities markets have been growing in size and complexity, the Commission's staff devoted to overseeing SROs has declined. As figure 6.1 also shows, the 1985 staff level was about 91 percent of that for 1980. The greatest decline in staffing levels occurred between 1981 and 1982. Though the level increased by almost 5 percent during 1983, this was followed by another small decline. Given current restrictions on the entire federal budget, the Commission expects the staff resources devoted to market supervision and regulation to decline in 1986 and to rise slightly in 1987 to 238.5 staff-years.

[1]See note a on figure 6.1.

The Commission Is Referring More Broker-Dealer Cases to SROs Despite Some Staff Misgivings

As one strategy to use in dealing with the increase in the number of registered broker-dealers, the Commission decided to refer more cause matters to SROs. These matters are those that the Commission believes are serious enough to warrant a broker-dealer examination or an enforcement investigation.

Increasing referrals to SROs provides the Commission with opportunities for increasing other activities of its own, but some Commission staff members are uncertain about the job the SROs will do. The Commission intends to carefully monitor its expanded number of referrals because of staff concerns that SROs may not be diligent in these matters or commit adequate resources themselves.

Commission Cause Examinations Decline but Other Commission Examination Efforts Increase

Because of the Commission's policy of referring more cause matters to the SROs, the number of Commission cause examinations decreased by 45 percent between fiscal years 1982 and 1983, from 385 to 211, although it leveled off in 1984. The Commission's fiscal year 1987 budget estimate reported 145 cause examinations for fiscal year 1985 and projected lower numbers for 1986 and 1987.

The decrease in the number of Commission cause examinations allowed the Commission to increase the frequency of, and time spent on, oversight examinations, its more direct way of measuring SRO performance. The number of oversight examinations rose 56 percent from 249 in fiscal year 1982 to 389 in 1984. The number of staff-days spent on oversight examinations grew from 2,858 in fiscal year 1982 to 6,201 in 1984, a rise of 117 percent.

The Commission was also able to increase the number of its oversight examinations because it successfully requested legislation to terminate the Securities and Exchange Commission Only (SECO) program. When the termination became effective, the Commission no longer directly regulated certain broker-dealers or had to conduct the 250 or so examinations of these broker-dealers each year. The SROs became responsible for the examinations, and Commission resources were freed for other matters.

In addition to raising the number of its direct SRO oversight examinations, the Commission is testing the feasibility of conducting an additional type of review. This review entails nationwide examinations of large broker-dealer firms. Such examinations would allow the Commission to select specific branch offices for scrutiny and increase its

emphasis on the sales practices of each. According to Commission officials, the Commission has rarely approached examinations in a nationwide and sales practice-oriented way in the past.

The Commission Staff Perceive the SROs as Having Difficulty Investigating and Prosecuting Complicated Sales Practice Violations

Although the Commission's policy is to refer more matters to the SROs, the Commission staff has expressed reservations about the desirability of increased referrals. Staff members are not reluctant to refer certain financial and operational matters to the SROs, but certain regional offices have stated concerns about the SROs' willingness and capability to investigate and prosecute complicated alleged sales practice violations.

Staff memoranda dating from 1978, 1981, 1983, and 1984 express the need for more SRO emphasis on the sales practice side of examinations. According to a November 1984 memorandum to the commissioners initialed by the Director of the Division of Market Regulation and describing the policy on, and practice of, making referrals, Commission regional offices considered the SROs to be less able than the Commission to identify and take effective action on sales practice cases. For example, regional offices and the Division believed that SRO examinations were often not thorough. The review of customer accounts was based on a random sample rather than on a more time-consuming review of the most active accounts or the accounts that could be traded without the customer's knowledge. SRO examiners were thus not necessarily looking at the accounts most likely to be subject to abuse. The regions also believed the SROs lacked sufficient personnel to handle sales practice matters. As a result of these perceptions, the regional offices appeared less likely to refer complicated sales practice violations to the SROs. Out of 117 closed referrals (referrals on which final SRO action had been taken) made to the SROs between January 1983 and June 1984, 46 had sales practice violations as the principal type of violation. Only 2 of the 46 cases concerned churning, considered a complicated sales practice violation;[2] the remaining 44 sales practice matters that were referred and closed primarily involved the suitability of a security recommended for investment, considered a more straightforward violation to pursue.

In order to permit the Commission to refer more complicated cases to SROs, the Commission has discussed with them ways to improve sales practice examinations and increase disciplinary resources. Two SROs have acknowledged that only a limited amount of their examination

[2]Churning refers to excessive trading in a customer's account against the interests of the investor for the purpose of generating commissions for the broker and the brokerage firm.

time is devoted to sales practice reviews. One of them is enhancing its sales practice program to expand the scope of the sales practice checklist used in examinations and increase the time spent on sales practice reviews. Also, it is enhancing sales practice training.

SROs Have Not Always Met Their Examination Cycles

In addition to concerns about the SROs' abilities in the sales practice area, Commission staff have also expressed concern about the SROs' ability to do more examinations than they have been doing. The staff believed that SROs may have insufficient manpower and inexperienced staff, based on the fact that the SROs were not always able to handle the workload they already had.

Although the SROs have established cycles for conducting routine examinations, in calendar years 1983 and 1984 they did not always start and complete as many examinations as they had projected. For example, one SRO instituted an examination cycle requirement that 100 percent of a certain type of examination be started in a particular calendar year, and that 85 percent of all started examinations be completed in that year. Six of this SRO's 13 units did not start all their required core examinations (examinations for which this SRO is the sole designated examining authority) in 1983, and 7 did not start all their examinations in 1984. Two units in each year started fewer than 90 percent of their required examinations. The same SRO had six units in 1983 and seven units in 1984 that did not complete 85 percent of all core examinations started, although all but three units finished both years above 80 percent. The SRO contended to the Commission that the examinations were behind only at low-priority broker-dealer firms that did not hold customer funds or securities.

This same SRO also reported growing backlogs, for example, in its handling of customer complaints and terminations for cause (dismissals of registered representatives). Between 1982 and 1984, the number of complaints received increased by 97 percent, the number resolved increased by 93 percent, and the number pending increased by 152 percent (to 1,565 actual cases). Moreover, the number of complaints that were pending for over 3 months grew by 218 percent (to 940 actual cases).

Another SRO had to postpone over 100 routine examinations from 1983 into 1984 because of examination changes and ran about a month and a half behind its 1984 schedule for certain types of members. Because the Commission did not have backlog statistics on this other SRO's customer

complaints or terminations for cause, it could not tell us the extent to which backlogs might or might not be growing.

Regarding another workload indicator—the number of cause examinations—a statement in the Commission's fiscal year 1986 budget estimate may be questioned. According to the budget estimate, the number of SRO cause examinations increased while the number of Commission cause examinations declined. However, a Commission official could not substantiate that the number of SRO cause examinations had increased and told us that the budget reflected the belief that an increase was expected to occur.

Commission officials have expressed their concern, however, that the SRO cause examinations may not meet Commission standards. While the Commission prefers that certain referrals be pursued through on-site cause examinations at broker-dealer locations, Commission officials were concerned that the SROs prefer telephone inquiries. According to the statistical profile developed by the Commission of 117 closed referrals made to SROs between January 1, 1983, and June 30, 1984, SROs made on-site visits in 56 of them. Forty-six others were closed by an investigation without an on-site visit, and the remaining 15 were closed in various other ways. In the future, according to a Commission official, the Commission will compile additional statistics to determine if the number of SRO cause examinations is appropriate given the decrease in Commission cause examinations.

The Commission communicates its displeasure to the SROs when they do not meet examination projections, and two SROs have taken steps to streamline their examination programs to handle their workloads. One SRO waived 474 firms in 1983 and 210 firms in 1984 from the routine examination cycle based on the firms' past "clean" examination records. The other SRO began tailoring its examinations in 1982, emphasizing certain areas in order to focus on perceived regulatory risks. Commission officials questioned whether this practice might decrease the depth of coverage of particular broker-dealers. The same SRO also plans to lengthen the amount of time between examinations of broker-dealers whose customers are less exposed to risk; when the examinations are performed, however, they will be conducted in greater depth.

The SROs are confident that in ways like these they will be able to handle any increased workload. One SRO planned to add an estimated 65 staff members and projected a 35 percent rise in the time spent on cause examinations to meet the projected increase in referrals. Another SRO

planned to reassess its already increased staffing levels after it obtained a better idea of the number of referrals made. Upon reassessment, according to a Commission official, it believed the situation was under control. According to figures supplied to the Commission, the two major SRO examining authorities had increased their examination staffs 28 percent and 41 percent, respectively, over 3-year periods ending in 1985.

Over the years the Commission has urged the SROs to enhance their sales practice reviews and meet their examination cycles. The Commission is now instituting, for the first time, a computerized referral tracking system to replace manual logs maintained by the various regions. Officials told us of plans to contact the SROs periodically to assess the adequacy of SRO actions taken on the referrals. A Commission official also planned to compile statistics in fiscal year 1986 on all referrals to evaluate the referral program. In these ways the Commission will monitor how the SROs assure compliance with the Securities Exchange Act through their examination programs. Given the Commission staff's concerns about the SROs' willingness and ability to handle referrals, and given the shift in examination responsibility towards the SROs, we believe that such Commission attention is warranted.

Recent Change Made to Commission Inspection Program

The 1986 budget estimate said that with the Commission entrusting greater responsibility to SROs to implement and upgrade their various systems, it is crucial for the Commission to monitor the effectiveness of SRO internal operations. It is crucial because, as the Commission told one SRO in a 1983 self-regulatory inspection letter, given the Commission's declining resources the SRO needed "to shoulder more responsibility for protecting the public interest." Commission officials told us that because of its limited staffing levels, the Commission was placing greater reliance on SRO-provided statistics and informal communication rather than on direct physical observation of SRO activities.

As described in chapter 3, the Commission is now delegating more responsibilities for planning, conducting, and reporting on inspections of one particular SRO to its regional offices. According to a headquarters Commission official, this will free headquarters self-regulatory inspections staff, never numbering more than five in the 1980s, to concentrate on other SROs. Since this shift toward more regional responsibility was only to be operational by fiscal year 1986, it was too early for us to evaluate what impact it was having.

Enhancing Examination and Inspection Productivity

In addition to dealing with its growing workload by increasing SRO responsibilities, the Commission highlighted in its 1986 budget estimate an effort to enhance productivity through automation. However, in the examination and inspection areas, it is too early to ascertain the ultimate impact of this effort.

According to Commission officials, several measures have been taken or planned to increase the productivity of examiners. These include initiating the computerized referral tracking system mentioned above and allowing examiners to access a central registration depository. This depository contains disciplinary and other information on registered personnel at all broker-dealers registered with the NASD.

The officials noted, though, that the major productivity gains will come from an effort to automate portions of broker-dealer examinations. This effort was tested in early 1985. In the test, one Commission regional office used a portable computer on two broker-dealer examinations, employing such techniques as computerized examination checklists and schedule preparation. It concluded in an April 1985 letter that for the two examinations, time savings were significant. It also concluded that a microcomputer significantly enhanced its review of an NASD district office. However, it cautioned that the training required to obtain the maximum benefit from the computer would be extensive.

Although the results of the test were positive, the Commission as of the time of our field work had not been able to expand the use of these computers to allow various regional offices to use them on-site at broker-dealers. According to Commission officials, the reason for this was the unavailability of funding for more computers. Consequently, the Commission's use of portable computers on examinations was delayed, and Commission officials did not know by how much they can expect to increase examiner productivity. In its written response to our draft report, however, the Commission noted that funds for portable computers can be allocated, and bids were to be solicited shortly.

Conclusions

The Commission's budget has provided for declining oversight staff resources in the face of securities markets that are increasing in both size and complexity. Acknowledging this, the Commission's budget estimates contained initiatives for ameliorating this situation, whose outcome has been uncertain.

If SROs can successfully handle more of the examination workload previously handled by Commission staff, then the extent and quality of broker-dealer examinations could be unaffected. However, in light of Commission staff concerns, the Commission plans to monitor the shift in responsibility closely. Also, whether delegating more responsibilities to Commission regional offices will enhance the Commission's ability to conduct inspections of SROs remains to be seen.

Plans for improving examiner and inspector productivity through automation have been uncertain. Early test results on one strategy were encouraging, but funding limitations have precluded the early implementation of that potential productivity enhancement.

Commission Review of SRO Disciplinary Actions

As agreed with Chairman Wirth's office, we did not do a detailed analysis of the Commission's review of appealed SRO disciplinary actions. We did, however, compile statistics on the results of Commission reviews from fiscal years 1980 through 1984.

According to the Securities Exchange Act of 1934, as amended in 1975, the SROs must file with the Commission all notices of disciplinary actions taken against SRO members. These actions are subject to the Commission's review on its own motion or after receiving an appeal from an aggrieved party. The review is intended to assure that fair procedures are followed by the SRO and that sanctions are coherently and uniformly imposed. After reviewing a sanction, the Commission can affirm it, set it aside, reduce it, or remand it to the SRO for further proceedings. The Commission is not authorized by law to increase a sanction, although in September 1984 it criticized an SRO for taking one action it considered as too lenient given the broker-dealer's prior history of misconduct.

As table I.1 indicates, the percentage of reviewed cases affirmed by the Commission generally rose between fiscal years 1980 and 1984.

Table I.1: Resolution of Commission Reviews of SRO Disciplinary Actions

	Number and percentage of cases in fiscal year					
	1980	**1981**	**1982**	**1983**	**1984**	**1980-84**
Affirmed	4	5	7	9	9	34
Not affirmed	7	12	3	1	2	25
Total	**11**	**17**	**10**	**10**	**11**	**59**
Affirmed	36%	29%	70%	90%	82%	58%
Not affirmed	64%	71%	30%	10%	18%	42%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

Officials at both the Commission and the NASD, which was involved in about 80 percent of the reviewed cases from 1980 to 1984, attribute the increased affirmation rates at least in part to an increased use of attorneys by the local NASD office.

Detailed Description of the Broker-Dealer Examination Program

The Commission carries out a variety of tasks to accomplish its broker-dealer oversight program objectives. To explain this work, we have separated the program into three parts: what the Commission does to select broker-dealer firms for examination, what the Commission does during the actual examinations, and what the Commission does with examination results.

The Commission Targets Firms for Oversight Examinations

Before the Commission's regional offices can conduct oversight examinations, they must select appropriate firms to examine. They do this by considering various factors developed by the Division of Market Regulation in the broker-dealer examination guidance sent to the regions. These factors include determining whether the firm

- engages in a general securities business,
- holds funds and securities entrusted to the firm by the customer,
- is large and has a high activity level, and
- has been examined by an SRO during the last 6 months.

An official in the Division of Market Regulation told us that regions are doing a better job now in selecting firms for oversight examinations. According to the regional office evaluations performed by the Division, two of nine regions were not selecting the proper firms for oversight in fiscal year 1985.

The Division recently announced a new goal of how many oversight examinations its regional offices should conduct. In 1983 oversight hearings, the Commission told the Congress that regional offices tried each year to conduct oversight examinations of at least 5 percent of all SRO examinations of broker-dealers' main offices and 1 percent of their branch offices. In April 1985, however, the Division stated that the regional offices should conduct oversight examinations of at least 6 percent of all members' main offices in their regions. It did not mention a goal for branch office examinations. According to draft figures provided us in January 1986, six of the Commission's nine regional offices met the 6 percent criterion for fiscal year 1985 for firms doing a public business. We were told that three regions had not met the guidelines either because of a diversion of resources to work on instances of fraudulent activities of government securities dealers or because of an influx of new, inexperienced examiners. Nationally, the figures revealed that over 7 percent of the firms conducting a public business received Commission oversight examinations.

The Commission Evaluates the Quality of SRO Examinations

Once the region has selected a broker-dealer firm to examine, it analyzes the quality of the SRO work at that firm. It employs standard examination procedures, and these procedures include specific ways to find broker-dealer violations that SROs have missed and violations found by the SROs but not remedied.

According to Commission guidelines, in preparing for an examination, Commission examiners obtain the SRO examination report and its supporting workpapers. Examiners use the workpapers to familiarize themselves with the SRO findings.

Next, examiners visit the broker-dealer firm generally unannounced and conduct an examination using a Commission checklist. The checklist includes various steps to follow in determining whether the brokerage firm is conducting its business in compliance with various securities laws, rules, and regulations.

The checklist is divided into several parts. One part deals with the financial and operational aspect of a firm. A second concerns the sales practices of a firm's employees (how the firm deals directly with customers). Historically, according to Commission officials, the Commission has emphasized the financial and operational aspect of a broker-dealer which deals with a firm's financial viability. If a firm is not financially viable, customers are exposed to a greater risk of losing money.

While completing the checklist, Commission examiners are supposed to assess the adequacy of the SRO examination previously conducted. According to the broker-dealer examination guidelines issued by the Division in November 1982, the essence of this assessment is determining whether and why violations existed at a firm but were not detected by the SRO. Examiners also make such determinations as whether an SRO's examination scope was adequate and whether SRO action taken to remedy deficiencies was appropriate and effective.

After completing this part of the process, the Commission examiner writes a report, and the regional office reviews and approves it. This report may include not only a section regarding the firm's compliance with law and rules at the time of the Commission examination but also a separate section detailing the results of the assessment of the SRO examination's adequacy. If the Commission finds deficiencies at a broker-dealer, it is supposed to notify the broker-dealer in writing and send a copy of the letter to the SRO.

The Commission Meets With SROs to Discuss Examination Results and Improve Programs

In addition to communicating examination results to the SROs in writing, the Commission discusses the results in periodic meetings. Recently it reemphasized the importance of meeting with the SROs and of always documenting those meetings.

According to Commission officials, when a regional office completes a sufficient number of examination reports, it meets with the SROs to discuss the results. The 1982 broker-dealer examination guidance recommended that the regional offices meet with the SROs regulating significant numbers of firms in their regions to discuss general oversight comments at least twice a year. These meetings are important for the exchange of information necessary to improve SRO examination programs. The regions also use these meetings to discuss other Commission regulatory efforts.

According to a Commission official, the meetings held by the regional offices help the Division of Market Regulation improve the SROs' programs from a national perspective. The improvement occurs through the input provided by the regional offices when they talk to Division officials and when they document the results of their individual meetings and send copies to the Division. The Division can then discuss with the SROs patterns in examination results. For example, at a recent Division meeting with one SRO, the Commission said that a number of oversight examinations revealed that SRO examiners were not properly selecting samples of customer accounts. The SRO agreed to hold internal discussions on the problem.

Because the Division recognizes the importance of regional offices holding and documenting meetings with the SROs, it criticizes the regions if they are lax. According to Division evaluation reports, three of the Commission's nine regional offices did not meet regularly or properly communicate with the SROs in their jurisdictions some time in either fiscal year 1982, 1983, or 1984. Additionally, six regional offices in that time period were criticized for not documenting meetings or sending documentation of oversight comments to the Division.

In the April 1985 broker-dealer examination guidance issued during our review, the Division reemphasized the importance of frequently contacting the SROs and documenting the results of all discussions or meetings with them regarding oversight examination findings. It said that the resulting information is used for Division discussions with SROs.

During our review the Division initiated a practice of holding quarterly meetings with NYSE and NASD, the major examining authorities. The purpose of these meetings was to improve communication with the SROs and discuss policy matters, unique and novel issues, and national problems identified by the regional offices. Although the Division had previously held meetings like this, they were not on a regularly scheduled basis and were not necessarily documented.

Causes of Broker-Dealer Firm Failures

As noted in chapter 2, fraud is just one of the causes for broker-dealer firms failing. According to Commission officials, firms also fail for other reasons, such as poor investment decisions, heavy concentration problems, excessive use of leverage (debt), and/or books and records problems. Concentration problems can occur when a firm lends heavily to just one or a few customers,[1] or when the firm invests heavily in just a few securities or a few types of securities, such as over-the-counter, low-priced, speculative issues. According to a Commission official, heavy concentration may lead to failure if the market goes against the concentrated issues or if a customer who has borrowed heavily from the firm defaults on that obligation. Also, heavy use of leverage can lead to failure because it inhibits a firm's ability to sustain losses and still meet all of its debt obligations. Books and records problems, according to Commission officials, can contribute to a firm's failure if, for example, the firm does not have good enough information to collect on its assets or to keep from making duplicate payments.

According to our analysis of 16 failed firms as confirmed by a Commission official, fraud, heavy concentration, and heavy use of debt appeared among the major factors contributing to the failure of one or more firms. While these were identified as major contributing factors in the failure of these firms, neither we nor the Commission were able to assert a single ultimate cause for each of the 16 failures. Rather, several factors contributed to some of the firms' failures.

A 1974 NASD staff report on 72 firm failures also found a multitude of causes for firm failures. The report identified over 20 "problem areas" or "characteristics" as proximate or possible reasons for failures and, in many cases, noted that several of these characteristics were exhibited in a single firm. The report also commented that no two failures were exactly alike, and even though similar problem areas (such as books and records and trading losses) surfaced repeatedly in this study, "varying degrees of material differences were noted."

Similarly, we noted that fraud was a factor contributing to 6 of the 16 failures we studied, but to varying degrees. In one case—the $40 million case mentioned in the Commission's fiscal year 1983 annual report—fraud was clearly the cause of the failure. This was in contrast to

[1] As a common business practice, broker-dealers lend money, subject to regulation, to customers who then buy securities on margin. In this way, customers use part of their own money together with the borrowed money to invest. In October 1985, the Commission adopted a rule change intended, in part, to reduce the risk of broker-dealer collapses by limiting the amount a firm may lend to any one customer.

another case in which heavy concentration and poor books and records in addition to fraud contributed to the failure.

Another example of the 16 failures we analyzed also shows the variety of factors that can contribute to a firm's failure. In this case the failure largely resulted from concentration and books and records problems, although high overhead expenses relating to branch office expansion were also present. The firm's business was concentrated in new issue underwritings of low-priced, speculative stocks. When the market began to decline, the firm experienced several months of operating losses. During the same period that the firm saw a decline in new issue underwriting, according to a Commission official, it also began to suffer books and records problems due to a change in its business operations. At the time the firm ceased doing business, its books and records were in such a chaotic condition that neither the firm, the Commission, nor the SRO was able to determine its financial condition. The firm had not performed a cash reconciliation of accounts for the past few months, and its records indicating the location of securities bought and sold by the firm were in very poor condition.

Details About Commission Self-Regulatory Inspections

The following paragraphs add a few details to chapter 3 on how often self-regulatory inspections are conducted and on how they are performed.

The Commission varies the scope and frequency of its inspections to accommodate (1) differences in SRO composition; (2) special circumstances and recent developments in each SRO; and (3) according to a Commission official, each SRO's regulatory history. The Commission has set tentative time frames for how often each SRO should be fully and routinely inspected. These time frames, however, are flexible and are subject to change based on the circumstances of a particular SRO or of the securities industry in general.

When it actually performs its inspections, the Self-Regulatory Inspection Branch organizes its work into three phases: pre-inspection, information gathering, and report writing. During the pre-inspection phase, the branch reviews SRO documents and logs to obtain a picture of the SRO's regulatory efforts since the last inspection. The pre-inspection phase allows the Commission to identify specific areas of concern and to prepare a list of documents to be requested during the second phase, information gathering. The Commission staff accomplishes the information gathering phase by spending time on-site at the SRO. At this time, the Commission reviews the SRO's practices and procedures by gathering files and interviewing SRO staff. The Commission staff then evaluates the information obtained on-site to prepare itself for the third phase, report writing. During this phase, the staff drafts a memorandum to the Commission summarizing the results of the inspection. Upon Commission approval, the Division of Market Regulation may send a letter to the SROs formally communicating Commission findings.

Commission Filing Requirements and Review Procedures for SRO-Proposed Rule Changes

The commissioners have delegated authority to the Director of the Division of Market Regulation to review and approve SRO-proposed rule changes. However, they have retained authority to disapprove proposed rule changes.

The Commission reviews a proposed rule change by analyzing a completed form prepared and submitted by an SRO. This form must contain enough information to support a Commission finding that the proposed rule change is consistent with the act. Specifically, it contains (1) the text of the proposed rule change; (2) the purpose of and statutory basis for the proposed rule change; (3) an SRO statement of its effect on competition; (4) an SRO summary of any written comments it has received concerning the proposed rule change; (5) the basis for accelerated or effective-upon-filing status, if applicable; and (6) an indication of whether the SRO consents to an extension of time for Commission action. To solicit public comment, the Commission also requires the SRO to prepare a document containing much the same information as the form reviewed by the Commission for publication in the Federal Register.

Once the proposed rule change has been filed with the Commission, the staff conducts a preliminary review. Before the proposal is published for comment, an administrative review is conducted to determine whether the submitted form and the accompanying document are sufficiently complete to enable staff to review and solicit informed public comment. The Commission will contact the SRO for clarification or additional information if the staff's administrative review reveals a problem. For example, the SRO may prepare a document to be published in the Federal Register which inadequately summarizes the proposed rule change. Or, the SRO may have inadequately summarized comments received from its membership on the proposed rule change. In such cases, Commission staff will then contact the SRO and request a more accurate summary or a more complete analysis of the comments.

The staff also performs a preliminary legal and regulatory issues review to identify any proposed rule change which is clearly inconsistent with the requirements of the act or other applicable statutes. In such cases, the staff works with the SRO to resolve the major problems before the proposed rule change is published for comment.

Following these preliminary reviews, the Commission publishes the proposed rule change in the Federal Register and SEC Docket (a weekly Commission publication) to solicit public comment. Concurrently, Commission staff continues its review of the proposed rule change; it may

resolve lingering issues with the SRO, analyze public comments, and review any additional supporting information submitted by the SRO.

The rule review process often requires continuous dialogue between the Commission and the SRO as each tries to further differing organizational objectives. An important objective of the Commission is to ensure that the regulatory purpose of the act—such as protecting the public interest—is realized. In contrast, one SRO objective is to improve the welfare of the SRO's membership. An SRO-proposed rule change may improve the welfare of the SRO membership, yet be inconsistent with the purpose of the act. When this occurs, the Commission and the SRO discuss the proposed rule change and negotiate necessary modifications to assure that the proposal satisfies the regulatory purpose of the act.

As discussed, Commission staff review all SRO-proposed rule changes to ensure that they are consistent with the requirements of the act. However, since the act has numerous objectives, the Commission must sometimes balance these objectives against one another in their review of proposed rule changes. For example, the NASD submitted a controversial proposed rule change to trade options on over-the-counter securities. The Commission had to decide whether an NASD-registered broker-dealer should be allowed to trade both over-the-counter securities and their options. The proposed rule change could further an objective of the act—to improve the functioning of the market by increasing the depth and liquidity of the market for these products. On the other hand, the proposed rule change could adversely affect achievement of another objective of the act by potentially imposing an unfair burden on competition due to preferential access to market information. The Commission had to weigh these competing considerations in their deliberations. They eventually decided that the benefits of the proposed rule change outweighed the potential costs. They conditionally approved the proposed rule change, provided the NASD first develop and submit for Commission review an adequate surveillance program designed to help protect against potential abuses.

The staff of the Division of Market Regulation approve SRO-proposed rule changes once their concerns have been addressed, according to Commission officials. However, if a proposed rule change raises major policy issues, the staff will prepare an analysis and a recommendation and submit the matter to the commissioners for their consideration.

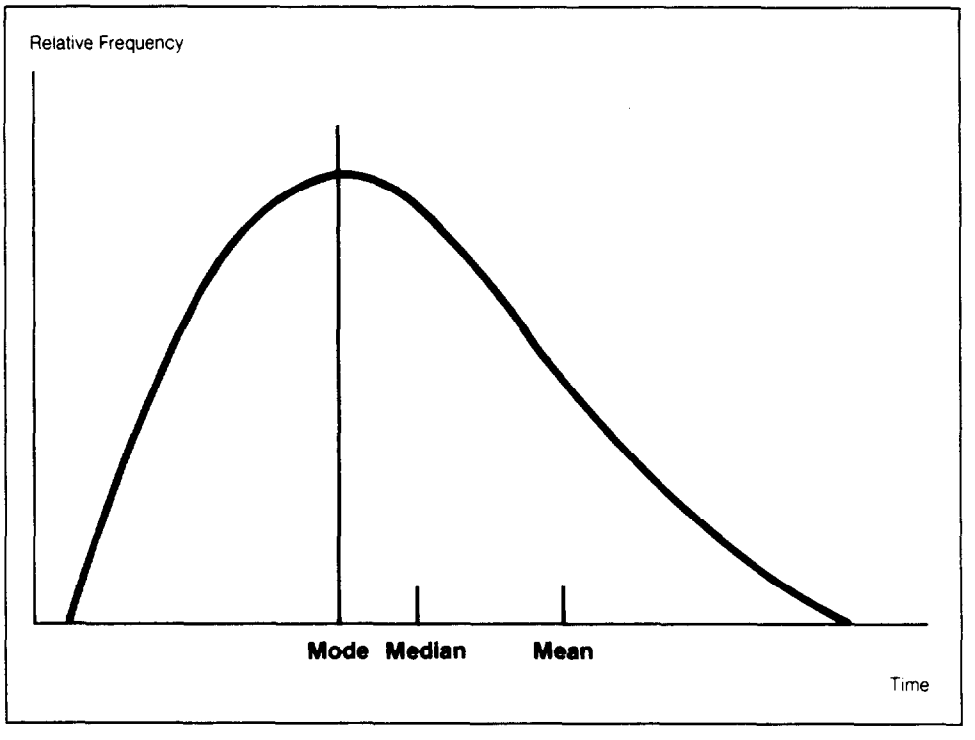
Commission orders are subject to judicial review pursuant to Section 25(a) of the act. A person adversely affected by an order must file a

written petition with the U.S. Circuit Court of Appeals in either (1) the District of Columbia, (2) the place of residence, or (3) the principal place of business within 60 days following entry of the order. Upon filing of the petition, the court has jurisdiction to affirm, modify, or set aside the order, in whole or in part.

Time Required to Publish SRO-Proposed Rule Changes for Comment

We computed the time interval between the date of filing and the subsequent date of publication in the Federal Register for each of the 306 proposed rule changes approved in 1984. We found that the frequency distribution of these time intervals generally corresponded to a textbook example of a positively skewed frequency curve shown in figure VI.1. This type of frequency distribution is characteristic of data which have a lower limit but no theoretical upper limit. A few extreme values skew the frequency distribution. Consequently, the mean (or average) is much larger than other measures of central tendency, such as the median and mode.

Figure VI .1: Time Required to Publish SRO-Proposed Rule Changes for Comment



We computed the cumulative frequency distribution shown in table VI.1. We found that 50 percent of the proposed rule changes were published for comment within 22 days and 75 percent were published for comment within 35 days.

Table VI.1: Cumulative Distribution of the Time Required to Publish an SRO-Proposed Rule Change for Comment

	Number of days
25 percent of filings published for comment within	17
Mode (most frequently occurring time interval)	21
Median (50 percent of filings) published for comment within	22
75 percent of filings published for comment within	35
Mean	40
90 percent of filings published for comment within	52

Commission's 1984 Rule Change Approvals Were Completed Within Reasonable Amounts of Time

There is a statutory requirement that the Commission act upon an SRO-proposed rule change within prescribed time frames once it has been published for public comment. We found that SRO-proposed rule changes were usually approved within the time frames established by the statute. However, a relatively small percentage of controversial filings did take a long time to approve. In these cases, the Commission obtained the SRO's consent for a time extension to consider the proposed rule change.

We analyzed the universe of all rule change approvals in 1984. We found that 75 percent of the proposed rule changes were approved within 36 days following publication for comment and that 90 percent of the filings were approved within 65 days.[1]

In addition, we also analyzed a subset of proposed rule changes composed exclusively of "normal" approvals. Commission and SRO officials told us that these filings were the most important in terms of their policy implications and consequently took longest to review and approve.

In our analysis of "normal" approval orders we again found that the distribution of data generally corresponded to the shape of the positively skewed frequency curve discussed earlier in appendix VI. Again, a few extreme values skewed the frequency distribution. In this instance, 3 percent of the filings were not approved for over 180 days following publication for comment. As a result, the mean (or average) time interval of 54 days was significantly higher than the median and mode values.

We also computed the cumulative frequency of "normal" approval orders shown in table VII.1. We found that 50 percent of the SRO-proposed rule changes were approved within 36 days and 75 percent of such filings were approved within 43 days. (See table VII.1)

[1]We found that 92 percent were approved within the 90-day statutory time frame frequently cited by the Commission in its budget documents. The act states that the Commission has unilateral authority to extend the period of time during which it considers a proposed rule change from 35 days up to a maximum of 90 days following publication for comment provided it finds it appropriate and publishes its reasons for so finding. It rarely finds it necessary to do this since the SROs almost always grant time extensions for Commission action.

Table VII.1: Cumulative Distribution of the Time Required to Approve an SRO-Proposed Rule Change Once Published for Comment[a]

	Number of days
25 percent of filings approved within	33
Mode (most frequently occurring time interval)	35
Median (50 percent of filings) approved within	36
75 percent of filings approved within	43
Mean	54
90 percent of filings approved within	79

[a]Excludes accelerated approvals and effective-upon-filing SRO-proposed rule changes.

SROs are almost always willing to grant time extensions for Commission action, according to Commission officials. They stated that minor delays beyond the 35-day statutory requirement usually occurred because the Commission was awaiting additional information from the SRO before giving final approval to the filing. They stated that SROs grant time extensions for complex or controversial filings because they understand that these filings simply cannot be evaluated within a 35-day period of time.

SRO officials also stated that they were generally satisfied that the Commission acted upon proposed rule changes within reasonable time frames. They emphasized that the Commission acted quickly on high-priority filings which was the key consideration from their perspective. They were not concerned if there were minor delays in approving routine filings and agreed that it simply required more than 35 days to review complex or controversial filings.

In order to illustrate the complexities of lengthy Commission rule approvals, we prepared a chronology of events for the two proposed rule changes approved in 1984 that had been outstanding the longest amounts of time. (See apps. VIII and IX.)

Chronology of Events for an Aged Proposed Rule Change: NASD 78-14

	This chronology describes the major events as the Commission considered an aged NASD-proposed rule change. Among other things, this proposed rule change would have required that block trades be reported to NASD by members who are not registered market makers in the traded security.
September 25, 1978	NASD filed a proposed rule change with the Commission.
October 27, 1978	The Commission sent a letter to the NASD explaining that the filing was incomplete; consequently, it had not been published for public comment. It requested that NASD submit an amendment to the proposed rule change.
May 14, 1979	NASD submitted an amendment to the proposed rule change.
June 15, 1979	Notice of the proposed rule change was published in the Federal Register, soliciting public comment.
July 19, 1979	Merrill Lynch submitted a comment letter questioning the proposed reporting requirements.
April 7, 1980	Commission and NASD officials met to discuss the proposed rule change.
May 20, 1980	Staff memorandum analyzed the issues raised by the proposed rule change.
August 15, 1980	Internal staff memorandum discussed the status of all outstanding NASD-proposed rule changes. With respect to NASD 78-14, the memorandum noted that only one relatively minor issue remained to be resolved.
Fall 1981	Commission and NASD staff agreed to divide the proposal into two parts so that the noncontroversial parts of NASD 78-14 could be quickly approved.

February 24, 1982	NASD submitted a new proposed rule change (NASD 82-2) incorporating many of the noncontroversial features of NASD 78-14 and excluding certain reporting requirements for block trades.
March 15, 1982	Notice of this proposed rule change was published in the Federal Register.
March 26, 1982	The Commission gave accelerated approval to the proposed rule change.
October 1983	Commission staff contacted NASD officials to determine whether they planned to pursue that part of NASD 78-14 pertaining to reporting requirements for certain block trades.
November 16, 1983	NASD officials informed the Commission staff that NASD planned to revive it. They planned to file an amendment to NASD 78-14 restating the filing and correcting any problems the Commission staff had with the original filing.
November 1983 -February 1984	Commission and NASD staff discussed the submission of an amended NASD 78-14 filing.
August 7, 1984	NASD filed an amended NASD 78-14 proposed rule change with the Commission.
September 12, 1984	Notice of the proposed rule change was published in the Federal Register.
October 19, 1984	The Commission approved the proposed rule change.

Chronology of Events for an Aged and Contested Proposed Rule Change: CBOE 80-16

	This chronology describes the major events as the Commission considered a controversial Chicago Board Options Exchange (CBOE) proposed rule change. Among other things, this proposed rule change would have required market makers to personally conduct a substantial portion of their trading on the floor. It was opposed by dual CBOE-Chicago Board of Trade (CBT) members who traded in person on the CBT floor and who used floor brokers to handle their trades on the CBOE floor.
June 9, 1980	CBOE filed a proposed rule change with the Commission.
June 30, 1980	Notice of the proposed rule change was published in the Federal Register, soliciting public comment.
July 16, 1980	CBOE filed an amendment to the proposed rule change.
August 1, 1980	Notice of the amendment was published in the Federal Register.
August 13, 1980	The CBT submitted a comment letter, on behalf of those members who are dual CBT-CBOE members, opposing the proposed rule change.
October 8, 1980	CBOE submitted a letter taking issue with CBT's assertions.
February 12, 1981	The Commission approved the proposed rule change.
April 13, 1981	Mr. Clement (petitioner), a dual CBT-CBOE member, filed a petition for review of the Commission approval order in the U.S. Court of Appeals for the Seventh District.
April 14, 1981	Mr. Clement applied to the Commission for a stay of the rule pending judicial review.
May 22, 1981	The Commission issued an order denying stay.

January 8, 1982	Case argued before the U.S. Court of Appeals for the Seventh District.
April 5, 1982	Case decided. Commission approval order vacated and remanded to Commission because the Commission did not adequately consider anticompetitive and discriminatory impact with respect to an in-person trading requirement.
May 11, 1982	Commission reviews filing and grants temporary 90-day approval for those uncontested parts of the proposed rule change.
August 16, 1982	Temporary partial approval was extended an additional 90 days in anticipation of a substantive CBOE amendment to CBOE 80-16.
October 19, 1982	CBOE filed an amendment to the proposed rule change.
November 9, 1982	Notice of the amendment was published in the Federal Register. In addition, temporary partial approval extended another 60 days.
December 13, 1982	CBT submitted a comment letter opposing the amended proposed rule change asserting that the proposed rule change would have anticompetitive and discriminatory effects on dual CBOE-CBT members.
December 30, 1982	Commission extended public comment period and temporary partial approval.
March 29, 1983	Commission extended public comment period and temporary partial approval of those portions of the proposed rule change not at issue.
May 10, 1983	CBOE submitted a letter proposing, among other things, that the proposed rule change be approved on a 1-year pilot basis.

June 1983 -April 1984	While considering the CBOE proposal, the Commission extended its temporary and partial approval several times. During this interval, the Commission received two additional letters from the CBT opposing the proposed rule change.
June 1, 1984	The Commission permanently approved the uncontested portions of CBOE's proposed rule change and approved the contested part on a 1-year pilot basis.

Comments From the Securities and Exchange Commission

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

June 20, 1986

William J. Anderson
Director
General Government Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

This is in response to your letter to Chairman Shad dated May 14, 1986 with which you submitted copies of a draft report entitled Securities Regulation: Securities and Exchange Commission Oversight of Self-Regulation. The Division of Market Regulation has reviewed the draft report and is submitting this letter in response to your invitation to comment. 1/

The Division is pleased to note that the Report concludes that: 1) The Commission "accomplishes the objectives of the oversight program," 2) when deficiencies have been noted "the Commission has reached agreement [with the SRO] on corrective action in most of the cases GAO reviewed," 3) that "the Commission has achieved improvements in the way SROs monitor market activity," and 4) the "the Commission effectively reviews and approves changes to SRO rules." The Report also concludes that, given the trend toward placing greater responsibility for monitoring broker dealer activity on SROs, careful monitoring of SRO performance is required. The Division agrees fully and plans to continue to emphasize careful oversight of the SROs.

The Report also notes that, while the Commission has authorized formal administrative action against several SROs for failing to fulfill their self-regulatory responsbilities, the Commission generally has sought to negotiate solutions to SRO weaknesses that have been detected. Again we agree with this conclusion and believe GAO's findings regarding the effectiveness of the Commission's oversight programs demonstrate the validity of this approach.

1/ The Division previously has submitted technical comments verbally to the GAO staff.

See comment 1.

Finally, the Report observes that a Commission initiative to use portable computers to enhance broker dealer examinations might be jeopardized by a lack of funds. The Commission recently has determined, however, that funds can be allocated to this project, and solicitation of bids on a contract to purchase portable computers will be published shortly to initiate this process.

The Division appreciates this opportunity to comment on the GAO Report and would commend the GAO staff for its thorough and useful Report.

Sincerely,

Richard G. Ketchum

Richard G. Ketchum
Director

The following are GAO's comments on the Securities and Exchange Commission's letter dated June 20, 1986.

GAO Comments

1. The report acknowledges this recent development. (See p. 66.)

Comments From the New York Stock Exchange

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

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Robert J. Birnbaum
President &
Chief Operating Officer

NYSE
New York
Stock Exchange, Inc.

July 18, 1986

Mr. William J. Anderson
Director
General Government Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Anderson:

The New York Stock Exchange, Inc. appreciates the opportunity to comment on the draft report entitled "Securities Regulation: Securities and Exchange Commission Oversight of Self-Regulation" which you recently sent to me.

We think the draft report amply demonstrates that the SEC's policy of working with the self-regulatory organizations (SROs) in a cooperative spirit to achieve improvements in regulation when needed is a sound and productive one. The draft report extensively documents the major improvements SROs have made in the area of regulation and surveillance under the SEC's oversight.

In the case of the New York Stock Exchange, these improvements include the intensive application of current technology to regulation and surveillance functions, expansion of staff and staff training, upgrading of examination and regulation procedures, and many other measures. The growth of the Exchange's regulatory costs from 24.9 million dollars in 1981 to over 42 million

dollars in 1986 is largely a reflection of these improvements. We have invested to improve the quality of our regulation willingly, out of a conviction that effective regulation is a cornerstone of our mission and of the nation's capital markets.

While we appreciate the fact that the draft report takes cognizance of many of the major improvements that we and other SROs have made, we are troubled by the repeated statements appearing in it that seem to create some doubt about the oversight process and self-regulation. 1/ These statements are disturbing because they are made despite the numerous documented instances of substantial changes and improvements which, singly and collectively, serve to dispel any reasonable doubt about the effectiveness of self-regulation in the securities industry and the SEC's discharge of its oversight duties. I would hope that these remarks might be removed, so that the tone of the report would more accurately reflect its findings.

In summary, it appears to us that self-regulation has worked very well and continues to do so. Perhaps the best measure of its success lies in the positive history of interaction between the SEC and the SROs and in the recognition by the domestic and foreign investing public of the effectiveness of the ongoing cooperation between the SEC and the SROs. I assure you that the NYSE intends to continue to meet its self-regulatory obligations and to promote the highest standards of professional conduct in the future.

Very truly yours,

Robert J. Birnbaum

See comment 1.
Now on p. 12.
See comment 2.

Now on p. 35.
See comment 3.
Now on pp. 32-34.
See comment 4.
Now on p. 62.

1/ E.g.: Two supposed "dangers" of self-regulation cited with nothing indicating such dangers are borne out by experience (p.15); SRO resistance to SEC recommendations stated to be a "possibility", although there is no indication this "possibility" is reflected in practice to any significant degree (p.42); variations of the word "prod" used where "recommend" would be more accurate (pp. 45,47,49); comments expressing doubt about SRO capability repeated, without data indicating such comments are well-founded (pp. 87,90).

The following are GAO's comments on the New York Stock Exchange's letter dated July 18, 1986.

GAO Comments

1. We added language on p. 12 to indicate the "dangers" are a constant potential.

2. There are examples of such resistance in practice cited on pp. 35-36 and 45-46.

3. We changed the wording of the report in response to this concern.

4. We believe our information based on Commission documents and analysis of examination statistics substantiates the doubts reported. (See pp. 62-65.)

Comments From the American Stock Exchange

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

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Kenneth R. Leibler
President and
Chief Operating Officer

American Stock Exchange

Mr. William J. Anderson
Director
General Government Division
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

July 25, 1986

Dear Mr. Anderson:

The American Stock Exchange appreciates the opportunity to comment on the General Accounting Office draft report evaluating the effectiveness of the SEC's oversight of self-regulatory organizations ("SROs"). The Exchange agrees with the overall conclusion of the report that, despite the problems cited, the SEC is accomplishing its statutory objectives in overseeing the SROs. The Exchange has developed a strong working relationship with the Commission which is crucial to the Congressionally-mandated program of self-regulation in the securities industry.

The comments in the draft report that are critical of the SROs are mainly generic in nature relating to all the SROs, with little express criticism of individual SROs. The Amex itself is not the subject of any specific comments. While we cannot respond on behalf of all SROs, we would like to respond to the generic criticism from the Exchange's own perspective.

See comment 1.

Section 2 of the report notes that the Commission, in conducting follow-up broker-dealer examinations to evaluate the effectiveness of on-site SRO exams, regularly uncovers hundreds of violations missed by SROs. While some are serious violations, most are not. Most in fact are financial and operational violations that are technical in nature, not sales practice violations relating to customer accounts. Among the reasons given for the missed violations (though not one of the major causes), was the use of inexperienced and low-paid SRO examiners and SRO failure to expand the examination scope when warranted. In this regard, the Exchange would like to point out that its Examinations and Options Sales Practice Departments are in fact staffed with well-trained, experienced

AMEX

See comment 2.

examiners. Moreover, it should be noted that these Departments have in the past not been faulted by SEC inspection teams for any significant number of missed violations.*

Sections 3 and 4 of the report focus on the SEC's self-regulatory and surveillance inspections conducted at the SROs. The report criticizes the negotiating process that the Commission uses to effect changes noted in SEC inspection reports (as opposed to utilizing the expanded statutory sanctions against SROs authorized by the 1975 Securities Acts Amendments), arguing that this approach leaves open the possibility that SROs can resist Commission recommendations and lengthen the time needed for problem resolution. You should be aware that the negotiating process is critical to the Exchange's relationship with the SEC. This cannot be overemphasized. As the Commission itself stated to the GAO, more effective regulation can be achieved by maintaining a cooperative rather than adversarial relationship with SROs. Moreover, it has achieved the desired results - effecting the needed changes at SROs. It is entirely appropriate for SROs to treat SEC comments in a critical and analytical manner. The discussion involved in resolving problems does take time, but it is a natural part of the give and take of the negotiating process and it is typically not extensive or of long duration. The Amex, for its part, has over the years been able to routinely resolve problems cited by the Commission. We respond in detail to SEC inspection reports, adopting recommended changes where appropriate and defending our position to the Commission's satisfaction where we disagree. In many cases, changes we suggest are implemented as more effective alternatives to SEC recommendations.

Section 6 of the report discusses the Commission's overall objective of shifting more regulatory responsibility to the SROs to help ease the Commission's budgetary problems. In placing greater reliance on SROs, the Commission has been referring more cause matters to SROs; i.e., broker-dealer examinations that the SEC normally performs itself in response to specific problems at broker-dealers. The Commission staff has reportedly expressed reservations concerning the ability of the SROs to handle an increase in cause matters referred by the

* The Examinations Department is responsible for examining all sole-Amex upstairs member firms, as well as all floor members and member organizations. The Options Sales Practice Department is responsible for examining all assigned dual member firms solely with respect to their options sales practice activities.

AMEX

Commission, particularly sales practice violations. The staff's reluctance to increase referrals is apparently based on the alleged inferior quality of SRO sales practice exam referrals and on the fact that SROs have not always been able to meet their own examination schedules. In this regard, the Exchange would like to stress that its Options Sales Practice Department has always met its assigned examination schedules, consistently performing an exemplary job in investigating sales practice violations. While the Commission has not referred many cause matters to the Exchange, we are prepared to handle an increase in SEC referrals in an effort to assist the Commission in light of its budgetary concerns.

We hope that our comments have been helpful to the GAO and would be pleased to discuss them with GAO staff at their convenience.

Sincerely,

AMEX

The following are GAO's comments on the American Stock Exchange's letter dated July 25, 1986.

GAO Comments

1. GAO did not imply that all SROs had been criticized by the Commission for all the deficiencies discussed in this report. GAO comments were based on inspections conducted at several SROs.

2. GAO did not criticize the negotiating process, and the report generally observes the process is working well.

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