



U. S. Securities and Exchange Commission
Washington, D. C. 20549 (202) 272-2650

**News
Release**

Address to the
Legal Advisory Committee
to the
New York Stock Exchange Board of Directors

(transcribed and edited)

New York City
July 29, 1988

**THE "UNIQUE PARTNERSHIP" BETWEEN THE SEC
AND THE
SELF-REGULATORY ORGANIZATIONS**

Edward H. Fleischman
Commissioner
Securities and Exchange Commission
Washington, D.C. 20549

The views expressed herein are those of Commissioner Fleischman and do not represent those of the Commission, other Commissioners, or the staff.

A central conception in the governance of our American securities markets is what has been called the "unique partnership" between the SEC and the several self-regulatory organizations: the New York Stock Exchange, the other exchanges, and the NASD. That partnership is governed in largest part by section 19 of the Securities Exchange Act, so let me start by quoting some excerpts from sections 19(b) and 19(c) of the Act.

Each self-regulatory organization shall file with the Commission . . . copies of any proposed change in, addition to, or deletion from the rules of such self-regulatory organization The Commission shall . . . publish notice . . . [and] give interested persons an opportunity to submit . . . arguments [T]he Commission shall . . . by order approve such proposed rule change, or . . . institute proceedings to determine whether the proposed rule change should be disapproved The Commission shall approve a proposed rule change . . . if it finds that such . . . change is consistent with the requirements of [the Exchange Act] and the rules and regulations thereunder applicable to such [self-regulatory] organization. The Commission shall disapprove a proposed rule change . . . if it does not make such finding [A] proposed rule change may take effect upon filing with the Commission if designated by the self-regulatory organization as . . . constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule The Commission, by rule, may abrogate, add to, and delete from . . . the rules of a self-regulatory organization . . . as the Commission deems necessary or appropriate . . . to conform [the self-regulatory organization's] rules to requirements of [the Exchange Act] and the rules and regulations thereunder applicable to such [self-regulatory] organization, or otherwise in furtherance of the purposes of [the Act] 1/

The operation of that partnership, and one of its fundamental elements, are well illustrated by four or five recent high-profile examples of SEC/SRO interaction.

1/ 15 U.S.C. § 78s(b)-(c) (1982).

When the Commission considered the proposal by the New York Stock Exchange for a 25-point DJI "collar" in February of this year, 2/ there were at least five alternatives available to each Commissioner. First, one could say, "No. I disapprove." Second, one could say, "Very well, I'll approve, even though you, the Exchange, have not really made any effort to demonstrate the reasons for what you are doing or the criteria by which to judge whether you're right or wrong." Third, one could say, "Very well, I'll approve -- not because you are persuasive, but because if anyone knows your market it's supposed to be you; and the SEC shouldn't substitute its judgment for yours on how best to run your market. Presumably, you'll admit you're wrong if the market response shows you that you're wrong." Fourth, one could say, simply, "I approve." Fifth, one could say, "I approve, even though you, the Exchange, didn't go far enough in imposing a priori requirements on your members." It is no coincidence that, with five Commissioners, I can find five alternatives that were available to us. But what is most important is the understanding, implicit in four of those five alternatives, that a degree of deference is due to the self-regulatory organization making decisions on the regulation of the market for which that self-regulatory organization is responsible, and for which it is to be held responsible once that deference is extended.

2/ See Exchange Act Release No. 25,400, 53 Fed. Reg. 7273 (1988):

My own views were set forth at some length in what was, at one point in the process, to have been a separate concurring statement. In that statement, after briefly setting forth my disagreement with the Exchange's proposal and my reasons for disagreeing, I intended to say that I was concurring because, specifically, I was firm in the view that the officers and governors of the Exchange, and of the other exchanges, the NASD, and the boards of trade as well, know their markets more intimately and understand their markets more thoroughly than does any governmental regulatory agency (not to speak of any single individual participating in a regulatory role). To my way of thinking, the officers and governors of each marketplace have the most direct stake in the successful functioning of their own market, and should have, and should be encouraged to take, the initiative in diagnosing their own market's weaknesses and in prescribing their own market's responses. Only a coordinated intermarket initiative could be more constructive.

It seemed to me that, whether in the particular matter the judgment of the Exchange was right or wrong, its own market would undoubtedly show it so -- and I was willing to trust that proposed Rule 80A would be strengthened, adapted or deleted, promptly, at the instance of the Exchange itself, in light of that market showing, in order that the Commission could continue to find the Exchange's actions "consistent with the requirements of the Act".

The Commission's final release in the matter of the DJI collar reflected key points of several individual preceding draft

statements, including recognition of the intimacy of Exchange officials' understanding of their own market and of the desirability of Exchange rulemaking initiatives, and also including confidence in the Exchange's willingness to assess whether its initiative in this particular case was right or wrong on the basis of market results as they subsequently appeared. 3/

* * * * *

Sometimes the deference that I see as fundamental to this partnership frustrates me greatly. For example, I thought that the New York Stock Exchange's compliance rule proposals approved by the Commission last May 4/ were inappropriately structured, so I urged strongly in the public meeting the principal criticisms presented by the member firms' lawyers: first, concern over the invasion of the attorney-client privilege, to the extent it exists between compliance and trading staff personnel; second, concern over the impact, within the member firms, of the Exchange's organizational misconception of the relationship between managerial supervision and the compliance function; and third, concern that the new system, under the new rules, would divert necessary effort to a reporting procedure without meaningful, practical improvement in actual surveillance or compliance. Yet, in light of the statutory standard that "the Commission shall approve . . . if it finds that such . . . change is consistent with the requirements of [the Act] and the rules

3/ See Exchange Act Release No. 25,599, 53 Fed. Reg. 13,371 (1988) .

4/ See Exchange Act Release No. 25,763, 53 Fed. Reg. 20,925 (1988) .

and regulations thereunder applicable to [the Exchange]," I could urge, I could fulminate, I could sound off as a Commissioner (and I did), but, since the arguments as to inconsistency with certain subdivisions of section 6(b) of the Act didn't seem to me to hold water, in the last analysis I had to vote "yes". I can only hope that Dave Marcus and his staff will monitor the operation of amended rules 342 and 351 to determine whether they actually do contribute more than they detract, and will report upstairs whatever they find.

* * * * *

Sometimes the deference in this partnership is truly constructive, as when, at the end of nearly three years' consideration, the Commission adopted rule 19c-4 5/ and passed back to the exchanges and the NASD the responsibility for adapting, responding, and molding the general approach and the specific provisions of the new rule to the myriad patterns of capital structure created by the host of exchange-listed and NASDAQ-authorized companies. On the listed company side, I sincerely believe that, for most of this century, exchange (and, more recently, NASD) listing standards have interacted with the mandatory and permissive provisions of the corporate laws of the several states, subject to Commission rules of specific application, to provide an accepted framework for the safeguarding of public shareholder rights and the inhibition of corporate managers' overreaching; and that, as a result of that

5/ See Exchange Act Release No. 25,891, 53 Fed. Reg. 26,576 (1988).

interaction, there has been achieved a merger of substantive protections and procedural requirements, illuminated by Commission-mandated disclosure, that has in fact raised the level of generally accepted corporate practice among American public business enterprises.

With the new rule 19c-4, the Commission has deliberately challenged the exchanges and the NASD, and their respective "stock list" staffs, to demonstrate the resiliency and insight of which that interactive process is capable. For, in my view, fundamental to the implementation of rule 19c-4 will be the capability of the respective stock list staffs of the New York Stock Exchange, the other exchanges, and the NASD to rise to the analytical and interpretive issues left to them to determine, in light of the Commission's statements in the release, when applying the rule, and to abandon the vestiges of past practice in interpreting and applying listed company rules without notice of the substance of their actions to the Commission or to the listed companies and their counsel generally. Stated policies, practices, and interpretations of the exchanges and of the NASD are "rules" of those organizations by virtue of rule 19b-4 under the Act, and must be treated as such under section 19(b). 6/ Of course, not every stock list staff application of any rule qualifies as a "policy", but multiple application does begin to

6/ "A stated policy, practice, or interpretation of [a] self-regulatory organization shall be deemed to be a proposed rule change unless (1) it is reasonably and fairly implied by an existing rule of the self-regulatory organization or (2) it is concerned solely with the administration of the self-regulatory organization" 17 C.F.R. § 240.19b-4(c) (1987).

resemble a "practice" (at least so it seems to me), and general application certainly rises to the level of an "interpretation".

Requiring publicity and evenhandedness in this matter is not, however, a demand for cross-market homogeneity. I still think, as I thought a year ago, 1/ that the responsiveness of each exchange and of the NASD may be expected to differ in detail, and that, given some parameters of consistency in view of the text and purpose of the rule itself, their several resolutions will be consonant but needn't be uniform. To me, that is as it should be.

It is responsibility and care that the implementation of rule 19c-4 should elicit from the stock list staffs -- precisely the sort of responsibility and care that they have traditionally brought to the performance of their professional function. The Commission, I am sure, will demand that much, and Bill Bohrs and his staff, I am equally sure, will respond with no less.

* * * * *

Sometimes the deference in this partnership is positively exciting. I find it so, for example, in the arena of margin. Whatever may in 1934 have been, or whatever may since last October be, the hopes and expectations for manipulation of margin levels to affect market activity (and that certainly was the prevalent notion when the Act was written in 1934), for at least ten years the Federal Reserve Board has had silent doubts about

1/ See Exchange Act Release No. 24,623, 52 Fed. Reg. 23,665, at 23,678 (1987) (Concurring Statement of Commissioner Fleischman).

the effectiveness of using margin as a tool to combat the "evils" of speculation. 8/

The cry for higher margins in the futures markets since last October has, from the beginning, confused me greatly. Is it higher margin on the short side, the sell side, that is being sought? No. But why would we want to dissuade that category of buyers whom the Brady Commission Report identified as "trading-oriented investors" and who were net long on both October 19 and October 20? 9/ To use the pejorative word, they were "speculators" -- and I only wish there had been more of them.

In fact, I am part of the SEC majority that recently voted to submit a legislative package to the Congress on the subject of margin. 10/ The draft legislation includes three separate but related proposals.

First, it would vest margin authority in the Board of Governors of the Federal Reserve System, but would require the Fed to delegate that authority in the first instance to the exchanges and the NASD, and to the futures contract markets as well. 11/ This would not be a delegation of the powers to make the definitions, prescriptions, and proscriptions of activities that are contained in sections 1 to 17 of present regulation T, 12/ but rather would be a

8/ But see Hardouvelis, Margin Requirements and Stock Market Volatility, FRBNY Quarterly Rev., Summer 1988, at 80.

9/ See Report of the Presidential Task Force on Market Mechanisms 43-44 (1988).

10/ The legislative package ("Margin Legislation") was transmitted to George Bush (as President of the Senate) under cover of a letter dated July 6, 1988, and is available from the SEC's Office of Legislative Affairs.

11/ See Margin Legislation, supra note 10 (proposed amendment to § 7(a)(1) of the Securities Exchange Act); id. (proposed new § 24(a) of the Commodity Exchange Act).

12/ 12 C.F.R. § 220.1-.17 (1987).

delegation of authority with respect to the part of regulation T that effectively sets margin levels, part 18, where the percentage amounts are inserted. 13/

Second, when margin levels are to be fixed or altered by a securities or futures market, the legislative proposal would require that the standard be "prudential margin"; 14/ that is, margin calculated not to encourage or dissuade trading, but rather to protect the marketplace -- the clearing process, the clearing members -- against possible payment defaults by any customer or group of customers, or by any market participant or group of market participants. 15/ The proposal also would require the SEC and the CFTC to review only the methodology for determining what margin is prudential and whether that methodology had been correctly applied, and not to review what the amount or other usage of margin should be; so that, once the general methodology has been approved, margin changes approved by the securities and futures markets can be effective upon filing with the respective regulatory agencies. 16/

And third, the legislative proposal would vest residual authority in the Federal Reserve Board to intervene whenever the Fed determines that there are larger concerns at stake affecting commerce, industry, the nation's economy, or the financial markets generally. 17/

The SEC's margin legislation proposal has received precious little publicity, perhaps because it is politically infeasible.

13/ Id. § 220.18.

14/ See Margin Legislation, supra note 10 (proposed new §§ 6(b)(9) and 15A(b)(12) of the Securities Exchange Act); id. (proposed new para. 12A to § 5a of the Commodity Exchange Act).

15/ Cf. Interim Report of the Working Group on Financial Markets at 5 (May 1988) (defining "prudential" margins for stocks, stock index futures, and options as "the maintenance margin levels needed to protect broker-dealers, futures commission merchants, and clearing corporations from investor and trader defaults on their margin obligations").

16/ Margin Legislation, supra note 10 (proposed amendment to § 19(b)(2)(B) of the Securities Exchange Act); id. (proposed amendment to § 8a(7)(C) of the Commodity Exchange Act).

17/ Id. (proposed amendment to § 7(b) of the Securities Exchange Act); id. (proposed new § 24(b) of the Commodity Exchange Act).

After all, it would amend not only the Securities Exchange Act but also the Commodity Exchange Act (to achieve parallel results). But I put it to you that the proposal would take away from margin-fixing a responsibility that margin is incapable of discharging; it would take away from the Fed a task the Fed doesn't want to do but is afraid to surrender; and it would refocus margin on market participant protection, where I think it belongs, administered by the knowledgeable self-regulatory organizations with limited SEC or CFTC review and with ultimate Fed oversight.

* * * * *

Sometimes the deference in this partnership is particularly delightful because I so strongly agree with the proposals being made. The joint New York Stock Exchange/Chicago Mercantile Exchange announcement of coordinated circuit breakers, 18/ common development of policy on intermarket frontrunning, 19/ and New York Stock Exchange individual investor order priority, 20/ falls into that category. So would, if and when it comes, a response

18/ See Exchange Act Release No. 26,062, 53 Fed. Reg. 35,399 (1988); Letter from Todd E. Petzel, Vice President, CME, to Jean A. Webb, Secretary, CFTC (Sept. 1, 1988).

19/ See Exchange Act Release No. 25,233, 53 Fed. Reg. 296 (1987). See generally Raisler, Identifying and Controlling "Frontrunning", FIA Rev., July - Aug. 1988, at 5.

20/ Details of the NYSE's Individual Investor Express Delivery System, submitted for SEC consideration on September 23, 1988, are available in SEC File No. SR-NYSE-88-24.

to the Katzenbach proposal for Exchange floor-traded market baskets. 21/

"Shock absorbers", dissemination of imbalance amounts and other market information, "express lanes", "market baskets" -- they all make so very much sense to me. Not only in themselves, but as way stations on the road to the New York Stock Exchange of the future:

- o Trading U.S. and world-class securities on the floor, and undoubtedly in some derivative fashion off the floor as well -- all the time, in real time.
- o Not seeking to avoid volatility, but rather responding to spikes and dives arising out of unusual short-term activity by recognizing volatility for what the professionals have always known it to be: an inherent element of the market, an element of risk, ameliorated by the very access to the marketplace and the capacity and liquidity that the marketplace can deploy.
- o Not dodging regulatory responsibility for fear of competition whether at home or abroad, but rather imposing requisite regulation in furtherance of generally accepted, congressionally mandated, public market purposes -- speedy and efficient clearing and settlement, and forceful prohibition of market manipulation, just to name the basics. And imposing that regulation as a fundamental part of the investor protections -- or perhaps better to say the "investor attractions" -- afforded by the New York Stock Exchange.
- o Providing in this manner what the New York Stock Exchange has, for all the post-war years, prided itself in providing: the world's premier marketplace for trading in corporate equity securities.

And thereby best serving, as Mr. Katzenbach reminded us, 22/ the ultimate function that secondary trading markets do serve: to

21/ See Katzenbach, An Overview of Program Trading and Its Impact on Current Market Practices: A Study Commissioned by the New York Stock Exchange 29-30 (1987).

22/ See id. at 24.

justify, by the liquidity that they evidence, the expenditure of funds by investors in primary markets -- the investment of new funds into productive business enterprise.