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DELEGATION OF POWERS BETWEEN  
THE COMMISSION AND THE SELF-  
REGULATORY ORGANIZATIONS AND  
PROFESSIONAL ASSOCIATIONS

paper submitted by

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DELEGATION OF POWERS BETWEEN THE COMMISSION AND THE  
SELF-REGULATORY ORGANIZATIONS AND PROFESSIONAL ASSOCIATIONS

The primary purpose of this paper is to outline the roles which the Securities and Exchange Commission ("Commission"), industry-organized self-regulatory organizations, and professional associations play in implementing the regulatory scheme established by the federal securities laws of the United States of America.

The Commission has had a long and productive experience in working with self-regulatory organizations and in employing private-sector expertise to carry out its mandate to administer and enforce these laws. The concept of Commission supervised self-regulation of broker-dealers and securities exchanges has been an integral part of the Securities Exchange Act since its enactment in 1934. This form of statutory self-regulation is therefore the focus of much of this paper. In addition, the Commission has traditionally looked to the expertise of the accounting profession in setting accounting standards. That profession is presently working to establish effective voluntary self-regulation with the Commission's encouragement and active oversight. In the investment company and investment adviser areas, the Commission is considering whether to recommend that Congress enact legislation to establish self-regulation on the part of both these industries. The Commission has also taken a number of steps to reduce the extensive government regulation of the investment company industry to the extent consistent with the protection of investors and the public interest.

In this paper, I have undertaken to delineate briefly these different forms of present or possible self-regulatory organizations and to describe the role of such organizations in implementing and assuring compliance with

the federal securities laws. Some of the documents described in this paper have been included in our Supplemental Submissions and that fact is herein noted. In a number of cases, recent actions taken by the Commission concerning self-regulatory organizations also have direct relevance to the two other topics to be discussed in the Conference's plenary session -- competition as a substitute for regulation and adequate disclosure of information in the event of deregulation. These instances have been noted either in the text of this paper or as footnotes and some of the documents relating to these topics have also been included in our Supplemental Submissions. A complete list of these Supplemental Submissions is attached to this paper for those Conference participants who wish to pursue these subjects in greater depth.

#### I. Cooperative Regulation of the Securities Markets

The Securities Exchange Act of 1934 (the "Act"), as amended by Congress in 1975, 1/ provides for a pervasive scheme of "cooperative" regulation of the securities markets in the United States. 2/ Cooperative regulation involves three complementary components -- self-regulation by the industry, oversight of self-regulatory activities by the Commission, and direct Commission regulation.

##### A. Self-Regulatory Organizations under the Securities Exchange Act

The Securities Exchange Act vests primary responsibility for regulating the activities of the broker-dealer community in industry-organized

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1/ Securities Acts Amendments of 1975, Pub. L. No. 94-29 (June 4, 1975).

2/ Report of the Committee on Banking Housing and Urban Affairs, U.S. Senate, S. Rep. 75, 94th Cong., 1st Sess. 23 (1975).

self-regulatory organizations, such as the national securities exchanges, securities associations such as the National Association of Securities Dealers, and the Municipal Securities Rulemaking Board.

Securities exchanges provide physical facilities through which member broker-dealers buy and sell securities listed or otherwise trade on the exchange for their own accounts or on behalf of customers. Currently there are ten national securities exchanges: the New York Stock Exchange, the American Stock Exchange, the Boston Stock Exchange, the Philadelphia Stock Exchange, the Midwest Stock Exchange, the Pacific Stock Exchange, the Cincinnati Stock Exchange, the Chicago Board Options Exchange, the Spokane Stock Exchange and the Intermountain Stock Exchange.

The National Association of Securities Dealers ("NASD") is a securities association comprised of broker-dealers who buy and sell securities in the "over-the-counter" ("OTC") market. The NASD is the only securities association registered with the Commission. The OTC market, unlike an exchange, which is a physical facility, is a network of large and small broker-dealers who trade primarily by telephone and sometimes use an electronic quotation system called "NASDAQ." Broker-dealers who trade in the OTC market must either become members of the NASD or become "SECO" firms subject to rules similar to those of the NASD but which are promulgated by the Commission.

National securities exchanges and securities associations such as the NASD are required to register with the Commission. Before permitting such registration, the Commission must determine that the exchange or association has the capacity to carry out the purposes of the Act and to comply (and

enforce compliance by its members and associated persons) with the provisions of the Act, the rules and regulations thereunder, and its own rules. The rules of such self-regulatory organizations regulating the conduct of their members and the markets in which they participate must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principle of trade, to remove impediments to free and open markets, and to protect investors and the public interest. The self-regulatory organization's rules also must provide fair procedures for disciplining its members and their associated persons as well as appropriate sanctions for violations of such rules or of the federal securities laws and the Commission's rules thereunder. 3/ The exchanges and the NASD have developed extensive market surveillance and broker-dealer examination programs in order to fulfill these statutory responsibilities.

The Municipal Securities Rulemaking Board was established by the Securities Acts Amendments of 1975 to propose and adopt a comprehensive body of rules establishing standards for the trading of municipal securities, which are traded over-the-counter. Unlike the exchanges and the NASD, the Board has no authority to enforce its own rules. Its rules are enforced by the Commission, the NASD and the appropriate bank regulatory agencies. 4/

B. Commission Oversight and Regulation of Self-Regulatory Organizations

The self-regulatory organizations exercise their authority subject to Commission oversight and have no authority to regulate independently of the Commission's oversight. To facilitate its oversight function, the Commission

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3/ See Sections 6 (national securities exchanges) and 15A (registered securities associations) of the Securities Exchange Act.

4/ See Section 15B of the Securities Act.

is in constant and close communication with the self-regulatory organizations and has placed stringent recordkeeping and filing requirements on them to enable the Commission to evaluate their activities. 5/ In this regard, the Commission has developed a comprehensive inspection program to ensure that the self-regulatory organizations are fulfilling their statutory responsibilities to regulate the trading and selling practices of their members. To enhance further its oversight capability, the Commission has recently proposed a computerized Market Oversight Surveillance System (MOSS) which would, for the first time, give the Commission a direct surveillance capability over trading activities on the securities exchanges.

Before the rules or amendments to rules of a self-regulatory organization can become effective, the Commission must generally approve them as consistent with the requirements of the Act and the rules and regulations thereunder. 6/ In addition, the Commission has direct authority to abrogate, add to and delete from the rules of self-regulatory organizations as it deems necessary or appropriate in view of the requirements and purposes of the Act. 7/

The Commission also has authority to review self-regulatory organization disciplinary actions against members and their associated persons, denials of membership or association with a member, and denials or limitations of access to services offered by the organizations. The Commission may

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5/ See e.g., Commission Rules 17a-1 (recordkeeping rules of exchanges and associations); 19b-4 (filing of proposed rule changes by self-regulatory organizations); and 19d-1 (notices by self-regulatory organizations of any final disciplinary action, denials or bars respecting membership or summary suspensions).

6/ See Section 19(b) of the Act. See also Supplemental Submission B.

7/ Section 19(c) of the Act. See Supplemental Submission B.

affirm, set aside or reduce a disciplinary sanction and may remand a matter for further consideration by the self-regulatory organization. 8/ With respect to denials of membership or association with a member, or denials and limitations of access to services, the Commission may affirm or set aside the self-regulatory action, and may require the admission of an applicant to membership or association, or access to services denied by the self-regulatory organization. 9/

As noted above, the Commission may adopt rules applicable to self-regulatory organizations as part of its oversight responsibilities. For example, the Commission has recently adopted Rule 19c-3 which permits exchange members to make markets in certain exchange-listed securities in the over-the-counter market. 10/ Several years ago, the Commission adopted Rule 19b-3 prohibiting any national exchange from requiring its members to charge fixed commission rates. 11/ Both of these actions were taken in order to promote competition in the securities markets. The Commission may also exercise its direct rulemaking authority when there is a need for uniform regulation in an area. In this regard, the Commission has imposed uniform broker-dealer recordkeeping requirements and minimum financial responsibility rules. 12/

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8/ See Section 19(e) of the Act.

9/ See Section 19(f) of the Act.

10/ Securities Exchange Act Release No. 16888 (June 11, 1980), a copy of which is included in Supplemental Submission B.

11/ Securities Exchange Act Release No. 11203 (January 23, 1975), a copy of which is included in Supplemental Submission B.

12/ See Sections 15 and 17 of the Act and the rules thereunder. The requirement for the financial and operational combined uniform single report ("FOCUS" report) were initially adopted in Securities Exchange Act Release No. 11935 (December 17, 1975).

If the Commission finds that a self-regulatory organization has violated the Act or its own rules or is unable to enforce compliance with its rules by members or associated persons, the Commission has the power to suspend the organization's registration for up to 12 months, revoke its registration, censure it or impose limitations on its activities. 13/ The Commission has authority to bring civil actions in the federal courts to enjoin violations of the rules of a self-regulatory organization. The Commission, of course, also has authority to bring such actions to enjoin violations of the Act or of the Commission's own rules promulgated under the Act. The Commission may suspend for up to twelve months or expel from a self-regulatory organization any member or associated person who, among other things, has wilfully violated the federal securities laws or the rules of the Municipal Securities Rulemaking Board. 14/ Similarly, the Commission may remove from office or censure any officer or director of a self-regulatory organization. 15/

C. The National Market System

A major example of the operation of the self-regulatory process involves the Congressional mandate that the Commission facilitate the development of a national market system. 16/ While the Congress did not delineate precisely the roles which the Commission, the self-regulatory organizations and members

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13/ See Section 19(h) of the Act.

14/ Id.

15/ Id.

16/ See Section 11A of the Act. See also Supplemental Submission C.

of the securities industry should perform in this process, it expected that the securities industry would assume primary responsibility for the design and development of the technical components of the system in response to competitive forces. The Commission's role is to act as a catalyst by removing unnecessary barriers to competition and, when necessary, taking regulatory action to achieve a particular goal.

The evolution of the national market system has required the Commission to weigh the benefits of rapid change against the risks to investors, the securities industry, and the securities markets themselves. Significant progress has been made over the last few years. A consolidated transaction reporting system is now operational and makes last sale information with respect to listed securities available to brokers, dealers and investors. As part of this system, the industry also developed a high-speed data transmission line which, for the first time, enables vendors of market information to supply current trading information even when the traditional ticker network falls behind due to heavy volume. Equally important a functioning consolidated quotation system has been made operational. Although this system still needs improvement, quotation information for reported securities is now an integral part of the nation's securities markets.

While our regulatory scheme is far more complex than its tiered structure may first appear, on balance, it has worked exceedingly well. As the markets evolve toward a national market system the strength of our system will be challenged continually. Its effectiveness will lie in the continuing dedication of the Commission and the self-regulatory organizations to obtain specified goals and their ability to communicate freely and cooperate fully.

## II. The Accounting Profession and Self-Regulation

In contrast to the treatment of securities markets and broker-dealers, self-regulation of the accounting profession has not to date been mandated by statute. Nonetheless the accounting profession plays a major role in promoting public confidence in the integrity and credibility of financial reporting by publicly-owned companies. Recently, the accounting profession has, with active oversight by the Commission, undertaken a major initiative to establish effective voluntary self-regulation.

### A. The Role of the Accounting Profession

Various Acts of Congress administered by the Commission clearly authorize the Commission to prescribe the methods to be followed in the preparation of accounts of publicly-owned companies and the form and content of the financial statements to be filed with the Commission by such companies. The Commission also has the responsibility to assure that investors are furnished with the information necessary to make informed investment decisions.

While fully aware of these responsibilities, the Commission has historically looked to the standard-setting body designated by the accounting profession to provide leadership in establishing and improving accounting principles. <sup>17/</sup> The Financial Accounting Standards Board ("FASB") is presently designated by the Council of the American Institute of Certified Public Accountants ("AICPA"), a private-sector professional association, to establish such accounting principles. The Commission's longstanding policy has been to

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<sup>17/</sup> See Accounting Series Release No. 150 (December 20, 1973), a copy of which is included in Supplemental Submission E.

support the application of private-sector expertise — as presently represented by the FASB — to the complex issues of financial reporting. For example, the Commission has endorsed FASB Statement No. 33 which recently initiated an innovative approach to reporting the effects of inflation and changing prices. Another example is the Commission's endorsement of FASB Statement No. 34 which describes the circumstances under which companies may capitalize interest payments in their financial statements.

If, however, the Commission determines that a private sector accounting standard does not fall within a range of acceptable solutions, the Commission will exercise its statutory authority and develop more appropriate standards. An example of one of the relatively few instances where the Commission reached an independent judgment that differed from that of the private sector standard-setting body occurred in 1978. Then the Commission rejected the FASB's decision that the oil and gas industry must use a "successful efforts" accounting standard and instead announced that it proposed to develop a new approach called "reserve recognition accounting." The Commission's direct involvement in the area of oil and gas accounting resulted from the unique requirements of the Energy Policy and Conservation Act of 1975, which directed the Commission to ensure the development and observance of uniform accounting practices for the oil and gas industry. Even though rejecting the FASB decision in this particular area the Commission continues to view the FASB as the primary source of accounting standards for the private sector.

In a recent meeting with the FASB, the Commission emphasized the importance of the FASB exercising positive leadership and continuing to make progress on its long-awaited development of a conceptual framework. The Commission

stated its belief that the FASB must take appropriate action in controversial areas and urged members of the accounting profession and the corporate community to continue to support the FASB's decisions and join more actively in the standard-setting process.

B. Voluntary Self-Regulation by the Accounting Profession

The Commission's preference that the private-sector retain the initiative for reform and improvement is evident in the Commission's oversight of the accounting profession's initiatives to establish effective self-regulation. In recent years, the role and responsibility of the accounting profession for promoting public confidence in the integrity of financial reporting has come under greatly increased scrutiny from the public and from Congress. This increased scrutiny resulted in large part from the disclosure in the 1970's of widespread questionable payments by publicly-owned companies and a number of unexpected failures by major corporations. These events raised doubts about the credibility and integrity of the financial controls and reporting of publicly owned companies.

Following a broad examination by Congress of the nature and structure of the accounting profession, legislation was introduced in 1978 to create a self-regulatory organization for accountants patterned after the National Association of Securities Dealers. While sharing the concerns about public confidence in the integrity and credibility of financial reporting, the Commission continues to believe that the accounting profession should remain under essentially private direction but with active Commission

oversight. Accordingly, the Commission has undertaken to report to Congress periodically on the progress made by the accounting profession in responding to the challenges which Congress and others had placed before it and on the Commission's own oversight initiatives in this area.

The Commission's Reports indicate that the accounting profession has undertaken substantial initiatives designed to assure the independence of auditors, the establishment of meaningful self-regulation and self-discipline and improvement of the accounting and auditing standard-setting processes. The centerpiece of the voluntary self-regulatory program initiated by the AICPA is the concept of "peer review" in which each member accounting firm must be reviewed at least once during each three-year period. 18/

The Commission is encouraged by the progress that is being made but some uncertainties relating to the accounting profession's self-regulatory program remain, such as the effectiveness of the peer review program, the fact that the disciplinary mechanism remains untested, and the need for increased leadership from the private sector. The Commission will continue to be active in overseeing the accounting profession's efforts to attain effective self-regulation and to assure that the accounting profession makes substantial progress toward its primary goal of promoting public confidence in the integrity and credibility of financial reporting by public companies.

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18/ The second "Report of the Securities and Exchange Commission on the Accounting Profession and the Commission's Oversight Role" is included as part of Supplemental Submission E.

III. Possible Self-Regulation by Investment Companies and Investment Advisers

The Commission is giving preliminary consideration to recommending legislation that would establish self-regulation on the part of both the investment company and investment adviser industries. The staff is presently in the very early stages of evaluating these concepts and it is not yet possible to say what, if any, recommendations the Commission may make in these areas. There are, however, significant differences in the current regulatory schemes applicable to these two industries and the effect which self-regulation would have on each of them.

A. The Concept of Self-Regulation and the Investment Company Industry

The investment company industry at present is subject to extensive and detailed regulation by the Commission. In 1978 the Commission embarked upon a study intended to enhance the industry's decision-making authority and responsibility. As a result, the Commission has adopted or proposed more than 25 rules which reduce federal government agency involvement in investment companies activities and permit greater freedom of action by investment company directors. Some of these rules remove the requirement of prior Commission approval for certain types of business transactions between an investment company and its affiliates and instead prescribe standards of conduct to be followed by the investment company's directors in exercising their business judgment. These rules also place much of the responsibility for exercising this business judgment on the independent directors. <sup>19/</sup> The

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<sup>19/</sup> See Address by Commissioner John R. Evans, 1980 Mutual Funds and Investment Management Conference, March 27, 1980, included in Supplemental Submission F.

Commission's withdrawal of its Statement of Policy on investment company advertising coupled with the adoption of a new rule permits investment companies much more flexibility in mass media advertising. Other rules are intended to eliminate undue delays and costs which have resulted over the years under the regulatory system.

Effective self-regulation by the investment company industry could go even further toward reducing the Commission's direct regulatory role. A self-regulatory program which maintains high standards of integrity for the industry and which includes an effective system to determine and enforce compliance with such standards would allow the Commission to limit its operations primarily to an oversight role. 20/ Effective self-regulation would also have the practical effect of reducing the amount of Commission resources expended in administering the Commission's inspection program for investment companies. The Commission is therefore considering whether to recommend that such self regulation be established by legislation.

B. The Concept of Self-Regulation and the Investment Adviser Industry

In contrast to investment companies, the investment adviser industry is presently subject to only limited regulation. For some time, the Commission has been aware of a need to reevaluate its investment adviser regulatory program in light of the extensive growth of that industry and the increasing variety and complexity of the services provided by investment advisers. Self-regulation for the industry is being considered in connection with

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20/ See Address by Chairman Harold M. Williams, Investment Company Institute, General Membership Meeting, May 14, 1980, included in Supplemental Submission F.

the broader issue of whether more extensive regulation of advisers is appropriate. The Commission staff is presently conducting a comprehensive study of the regulatory scheme applicable to investment advisers. In this connection, the Commission has also recently solicited comments on whether the authority to prescribe and administer requirements for investment advisers should be vested in one or more self-regulatory organizations, whether minimum professional qualification standards of testing or training should be established and whether specific financial responsibility requirements should be established. 21/

CONCLUSION

The foregoing is of necessity a brief outline of present and possible self-regulatory organizations and the Commission's actual or contemplated relationships to these organizations. Substantially more detailed information is provided on various aspects of self-regulation in the Supplemental Submissions listed on the attachment to this paper. We would also be pleased to provide additional information on particular areas to Conference participants.

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21/ Investment Advisers Act Release No. 717 (April 4, 1980), a copy of which is included in Supplemental Submission F.

VI INTERAMERICAN CONFERENCE OF SECURITIES  
COMMISSIONS AND SIMILAR AGENCIES  
MONTREAL, 8-12 SEPTEMBER 1980

SUPPLEMENTAL SUBMISSIONS  
BY  
SECURITIES AND EXCHANGE COMMISSION  
UNITED STATES OF AMERICA

Supplemental  
Submission

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- Section I.    General Regulatory Framework
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- B.      Authority of the Securities and Exchange Commission over  
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- Memorandum
- Securities Exchange Act Release No. 16215  
(September 21, 1979) Order Approving Rule Change.
- Securities Exchange Act Release No. 16968  
(July 8, 1980). Order Instituting Proceedings  
to Determine Whether to Disapprove Proposed Rule  
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- Securities Exchange Act Release No. 17083  
(August 1, 1980) Order and Statement of Reasons  
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Securities Exchange Act Release No. 11203 (January 23, 1975). Adoption of Securities Exchange Act Rule 19b-3 (Unfixing of Commission Rates).

Securities Exchange Act Release 16888 (June 11, 1980), Adoption of Securities Exchange Act Rule 19c-3. (Off-Board Trading Restrictions).

C Development of a National Market System

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Securities Exchange Act Release No. 15671 (March 22, 1979) Development of a National Market System - Status Report

Securities Exchange Act Release No. 16214 (September 21, 1979). Temporary Order Extending ITS System Authority

Securities Exchange Act Release No. 16410 (December 7, 1979). Procedures and Requirements for National Market Systems.

D The Role of the Securities and Exchange Commission and the Self-Regulatory Organizations in the Standardized Options Markets

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Securities Exchange Act Release No. 15575 (February 22, 1979). Program for Implementing Certain Recommendations Made by Options Study

Securities Exchange Act Release No. 16701 (March 26, 1980). Termination of the Options Moratorium

E Securities and Exchange Commission Reports to Congress on the Accounting Profession and the Commission's Oversight Role

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Accounting Series Release No. 150 (December 20, 1973). Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards

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F

Possibility of Self-Regulation with Respect to Investment Companies and Investment Advisers

Deregulation of the Investment Company Industry

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Investment Advisers Act Release No. 717 (April 4, 1980).

Address by Chairman Harold M. Williams, "Some Further Challenges to Mutual Funds" (May 14, 1980).

Address by Commissioner John R. Evans, "Deregulation Has Its Price" (March 27, 1980).

G

Adequate Disclosure in an Arena of Deregulation

Memorandum

Submission of the Securities and Exchange Commission to U.S. Regulatory Council

Securities Act Release No. 6180 (January 17, 1980).  
Exemption of Limited Offers and Sales by Qualified Issuers

Securities Exchange Act Release No. 16866 (June 2, 1980).  
Consideration of a System of Classifying Small Issuers for Purposes of Modifying Certain Reporting and Other Requirements