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The Fourth Annual Albert A. DeStefano Lecture on Corporate, Securities & Financial Law

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Authors

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LECTURES

THE FOURTH ANNUAL ALBERT A. DESTEFANO LECTURE ON CORPORATE, SECURITIES & FINANCIAL LAW

PANEL DISCUSSION: CRISIS IN CONFIDENCE— SELF-REGULATION IN THE SECURITIES INDUSTRY[†]

MODERATOR:

John F.X. Peloso^{*}

Senior Counsel, Morgan, Lewis & Bockius LLP

PANELISTS:

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Partner, Wilmer Cutler Pickering Hale and Dorr LLP

Robert Colby^{**}

Deputy Director, Division of Market Regulation,
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[†] The panel discussion herein was held at Fordham University on April 26, 2004. It has been edited to remove the minor cadences of speech that appear awkward in writing and to identify significant sources when referred to by the speakers.

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^{**} The U.S. Securities and Exchange Commission ("SEC" or "Commission"), as a matter of policy, disclaims responsibility for the private statements of its employees.

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Vice Chairman,
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WELCOME & INTRODUCTION

DEAN TREANOR:¹ Good evening, everyone. I am Bill Treanor, the Dean of Fordham Law School, and it is my pleasure to welcome you to the Fourth Annual Albert A. DeStefano Lecture, which is entitled "Crisis in Confidence—Self-Regulation in the Securities Industry."

I thank our distinguished panelists for graciously being with us tonight and for sharing their expertise and insight.

I especially thank Becker Ross Stone DeStefano & Klein for establishing this lecture series honoring Albert A. DeStefano, a prominent alumnus of the Law School who is currently Of Counsel to the firm, and for the support which they have given to our Center for Corporate, Securities and Financial Law (the "Center"). Our faculty and students, as well as members of the community at large, all benefit from the firm's generosity.

In these times in which continual controversies and new developments have pushed the issues of corporate law and corporate governance to the forefront of debates throughout the country, the Law

Accordingly, the views expressed herein by Mr. Colby and Ms. Nazareth are their own and do not necessarily reflect the views of the Commission or their colleagues on the staff of the Commission.

1. William Michael Treanor is the Dean of the Fordham University School of Law.

School is particularly proud to have established the Center. The Center allows the Law School to capitalize on its strengths in the business law area. Our business law faculty is comprised both of well-known scholars and prominent practitioners. Our students are enthusiastic about business law and many of them will form the next generation of business law leaders. Our current law alumni include many leaders in the business community. And of course we are located in New York City, the financial capital of the world.

Tonight's DeStefano Lecture is an important component of the work of the Center, which is designed to provide a forum for dialogue on policy issues and business law. In addition to the DeStefano program, the Center offers a second annual public lecture, the A.A. Sommer Lecture, which is typically given in the fall. This year's lecture was delivered by The Honorable William McDonough, Chairman of the Public Company Accounting Oversight Board.²

In addition to our public lectures, the Center hosts private roundtable discussions. Last fall, the Center sponsored a roundtable discussion on "The Role of the Corporate Attorney After Enron and the Sarbanes-Oxley Act,"³ a discussion that was held just after the SEC released its proposed rules regarding attorney conduct.⁴

In the spring the Corporate Center sponsored a roundtable that considered "The Continued Role of Self-Regulation in the Securities Industry,"⁵ a roundtable that inspired tonight's program. Just last week, the Center sponsored a roundtable on "Directors' Evolving Duty of Public Faith and the Role of Ethics in the Board Room."⁶

The Center also hosts the bi-annual Eugene P. and Delia S. Murphy Conference on Corporate Law. Our most recent conference, which was held this past November, was entitled "Recent Developments in Corporate Law,"⁷ and featured leading scholars from across the country

2. William J. McDonough, *The Fourth Annual A. A. Sommer, Jr., Lecture on Corporate, Securities & Financial Law*, 9 FORDHAM J. CORP. & FIN. L. 587 (2004).

3. For more information on this roundtable discussion and other Center events, please visit <http://www.fordham.edu/law/faculty/fisch/source.html>.

4. Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7245 (2002); Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. 205 (2004).

5. See *supra* note 3.

6. See *id.*

7. See *id.*

presenting current work on cutting-edge issues in business law.

Within the Law School, the Center works closely with the *Fordham Journal of Corporate & Financial Law*, which is one of the few student-run journals specializing in business law. The Journal publishes transcripts of many of the Center's public programs. The most recent issue, which is available this evening, contains the proceedings from last year's DeStefano Lecture.

Fordham's students also enjoy the Center's Business Law Practitioners Series, which introduces students both to prominent practitioners from the public and private sectors and to developing issues in business law. These programs enjoy the generous support of a variety of donors. Becker Ross Stone DeStefano & Klein, of course, provided support for this lecture. The Center also receives substantial support from the law firm of Morgan, Lewis & Bockius as well as the General Electric Company and Eugene F. Murphy.

Guidance for the Center's many initiatives is drawn from the leadership of a distinguished Board of Advisors as well as the active participation of our many distinguished alumni in the business law area.

Indeed, for playing an important role in organizing tonight's program and for serving as Moderator of the program, I am grateful to John Peloso, the Chair of the Center's Board of Advisors and one of our many prominent alumni. I am also grateful to Pamela Chepiga, a member of the Board of Advisors and another one of our prominent alumni, who created our Securities Arbitration Program and who assisted in planning the program. And finally, I am grateful to Professor Caroline Gentile of our faculty for the critical role she has played in the work of the Center.

Instrumental in all the projects of the Center is Professor Jill Fisch, who was just recently honored by her appointment as the Alpin J. Cameron Professor of Law. Professor Fisch teaches and writes in the areas of corporate and securities law and is one of the nation's leading business law scholars. She is also a teacher of extraordinary excellence, which I can say as somebody who has co-taught with her.

To introduce you to tonight's program, I now present to you Professor Fisch.

PROF. FISCH:⁸ Thank you. On behalf of the Fordham Center for

8. Jill E. Fisch is the Alpin J. Cameron Professor of Law at the Fordham University School of Law and is the Director of the Fordham Center for Corporate,

Corporate, Securities and Financial Law, I too, want to welcome you to tonight's Albert A. DeStefano Lecture.

As you know, the issue of self-regulation in the securities industry has generated a fair amount of recent controversy. Self-regulation is a concept that dates back to the adoption of the Securities Exchange Act of 1934 ("34 Act").⁹ The self-regulatory organizations ("SROs"), including the National Association of Securities Dealers, Inc. ("NASD") and the New York Stock Exchange, Inc. ("NYSE") in particular, have long claimed an expertise in regulating the activities of market participants.

Yet, we have seen many recent changes. We have seen changes in the business structure of the NASD and NASDAQ and changes in the governance structure of the NYSE. We have seen developments in new technology, including new trading entities, electronic exchanges, and electronic trading systems.

We have seen Wall Street develop new ways of investing and new ways of defrauding investors. This, in turn, generates a greater need for oversight of market participants and regulatory enforcement against wrongdoers. And we have seen a shifting and expansion of the SEC's regulatory mandate and its role in supervising the SROs.

Let me highlight just a few of the issues that I think are on the table for our panelists tonight.

The Commission is considering new rules governing the way stocks are traded, rules that could facilitate automation but possibly sacrifice getting investors the best possible price.

The NYSE, as you know, is still embroiled in controversy over the pay package of its former Chairman and CEO Richard Grasso. The NYSE and the SEC also recently released findings of improper stock-trading activity among the Big Board's five largest specialist firms, findings that have resulted in a settlement in which the firms will pay a combined \$241.8 million in fines and restitution.¹⁰

And, despite its recent implementation of new corporate governance listing standards designed to promote greater responsibility

Securities and Financial Law.

9. Sec. Exch. Act of 1934, 15 U.S.C. §§ 78a-78mm (2005).

10. Press release, Sec. and Exch. Comm'n, Settlement Reached With Five Specialist Firms for Violating Federal Sec. Laws and NYSE Regulations (Mar. 30, 2004), at <http://www.sec.gov/news/press/2004-42.htm> (last visited Mar. 18, 2005).

and independence by issuers' boards of directors, NASDAQ has come under scrutiny for the unusually poor attendance records of its own directors.

I cannot imagine a finer panel to identify the new challenges for the SROs and to help us understand how those challenges can best be met.

It is our goal here at the Center to identify important and timely issues in corporate and securities law and to provide a forum in which those issues can be debated. I want to add my thanks to Becker Ross Stone DeStefano & Klein for establishing this lecture series as a means of doing that.

As you know, the lecture series is named for our distinguished alumnus Albert A. DeStefano, and we are most grateful to have the honor of hosting this wonderful program. As Dean Treanor has mentioned, support for the Center's programs is drawn from the leadership of the distinguished Board of Advisors, and I want to echo Dean Treanor's special thanks to John Peloso and Pam Chepiga for organizing tonight's program. We also enjoy the active participation and support of many other distinguished alumni in the business and financial law areas.

The Center could not function, however, without the commitment of the Fordham faculty, and I want to acknowledge in particular Professor Caroline Gentile, one of our newest hires. Professor Gentile teaches corporations and corporate finance. In her short tenure, she has already written several major law review articles and she has been instrumental in shaping the Center and its programs.

I also want to acknowledge the hard work of the Corporate Center Fellow, Florencia Marotta, and the fabulous students on the *Fordham Journal of Corporate & Financial Law*. Many of you met them on your way in, and they have helped tremendously with the logistics of this program.

Finally, where would the Center be without the guidance of a senior mentor? For the Center this guidance has come in the person of Constantine "Gus" Katsoris. Professor Katsoris, the Wilkinson Professor of Law, has just received his second Bene Merente Medal acknowledging forty years of service on the Fordham faculty. Professor Katsoris's connection to Fordham goes back even further, however, as he received both his law and undergraduate degrees from Fordham.

Professor Katsoris teaches in the areas of income tax and accounting. His scholarship includes work on a range of business law

topics, but he enjoys particular expertise and influence on issues relating to securities arbitration. His accomplishments are too numerous to describe here, but as a result of his range of professional activities he knows virtually everyone in the securities industry, which as you can imagine makes him invaluable to the Center.

I am honored to present to you now Professor Katsoris to speak to you about Mr. DeStefano's accomplishments and then to introduce the participants in tonight's program.

Thank you.

PROF. KATSORIS:¹¹ Thank you, Jill.

Al DeStefano was and is a close friend of mine, and it is an honor to speak on his behalf. I called Al a few weeks ago in the hope of arranging his presence here tonight, but, regretfully, he informed me that unexpectedly his beloved son, Albert A. DeStefano, Jr., had passed away on Holy Thursday of Easter Week.

After we exchanged some understandably emotional and sentimental conversation, two things became very clear to me. Number one, Al was nurtured by his religious roots and his firm belief in an afterlife. Secondly, he felt consoled that his son's name would somehow be perpetuated by the lecture series that also bears his name.

For those of you who never met Al, let me briefly describe him to you. He started at Fordham Law School as an evening student, worked during the day, and yet he still managed to make Law Review and graduate at the top of his class. He accomplished all this with the demeanor of kindness, of honesty, and great integrity.

After graduation, armed with these same characteristics of kindness, humility, and integrity, he rose to become a Senior Partner in the firm of Becker Ross Stone DeStefano & Klein. Yet, despite his professional successes, his family always came first, and in the process he never forgot his Fordham family. For over ten years, he found the time to come back and lecture to our students on the intricacies of corporate mergers and acquisitions.

His compassion for others, however, did not stop there. For many years, he was a member of the Board of Directors of Gallaudet University in Washington, which is the only liberal arts university for the deaf in the world. For thirty-five years he served as Secretary and

11. Constantine N. Katsoris is the Wilkinson Professor of Law at the Fordham University School of Law.

Trustee of the Helen Keller Services for the Blind. For twenty years he served as Trustee for the Cleary School for the Deaf.

By honoring Albert A. DeStefano, Sr. with this lecture series, Fordham honors itself. And, as of tonight, it also honors his beloved son, Albert A. DeStefano, Jr.

It is now my pleasure to briefly introduce and thank our distinguished panelists for this evening. It is a line-up of all-stars in the securities industry, several of whom honored us last year as part of the panel of the DeStefano Lecture.

Starting on my far right and moving to the left: Brandon Becker, who is a Partner at the Wilmer Cutler Pickering Hale & Dorr LLP firm and former Director of the SEC's Division of Market Regulation; next to him is Robert Colby, the Deputy Director of the SEC's Division of Market Regulation; next to him is Annette Nazareth, the present Director of the SEC's Division of Market Regulation; skipping over John Peloso for the moment, we have Marc Lackritz, who has been the President of the Securities Industry Association for over ten years; next to him is Richard Ketchum, the Chief Regulatory Officer of the NYSE and a former Director of the SEC's Division of Market Regulation, and also a distinguished member of our Adjunct Faculty.

To my left is Mary Schapiro, the Vice Chairman of the National Association of Securities Dealers. Mary was the featured speaker at the inauguration of the A. A. Sommer Lecture several years ago, delivering an extraordinary lecture on "The Regulation of the Securities Industry in the Wake of the 9/11 Tragedy."¹² I will never forget that, Mary. It was a brilliant lecture.

Finally, I would like to introduce our moderator of the panel, the maestro for this evening, John Peloso. John's lists of accomplishments speak for themselves and it would take much too long to mention them all.

In many ways, John Peloso and I have a lot in common. We are both of Mediterranean ancestry, we both teach at Fordham, we both received our undergraduate and our law degrees at Fordham, and we both attended New York City Jesuit high schools. But that is where the similarity ends, because John attended a preppy Jesuit high school on the East Side, called Regis, and I attended a more traditional Jesuit high

12. Mary L. Schapiro, *The Regulation of the Securities Industry in the Wake of the 9/11 Tragedy*, 7 FORDHAM J. CORP. & FIN. L. 5 (2001).

school on the West Side, called Xavier. Anyone familiar with Jesuit education knows that the rivalry between these two schools is comparable to the feud between the Hatfield's and the McCoy's. But, John, besides teaching Latin and Greek, the Jesuits at Xavier taught me to forgive and forget. So tonight, John, I want you to know I forgive you for going to Regis High School.

Ladies and gentlemen, it is my great pleasure to introduce one of Fordham Law School's distinguished graduates, my high school friend John Peloso.

MR. PELOSO: Gus, I did not think there was much of a competition because I do not really think there is any comparison between the two schools, although Xavier put somebody on the Supreme Court first, because that is where Justice Scalia went. No comment.

PANEL DISCUSSION

MR. PELOSO: Now to business.

Rick Ketchum has asked me to mention to you that something awfully urgent has come up which may require him to leave a little bit early, so if you see him leave it is not because of something else.

Our format tonight is basic and simple. My role will be to throw out what would probably be fairly obvious questions to the panel relating to the subject of self-regulation, and the panelists will express their views.

As Jill said, I could not think of a more appropriate panel to discuss the whole issue of self-regulation than the people here at the table tonight.

The first question I throw out is the broad one, which is: Is the system of self-regulation in the securities industry being carried out today as it was envisioned by the drafters of the legislation in 1934?

In answering that, and I thought I would throw this out for the panel, I thought it might be interesting to see what the *Report of the Special Study of the Securities Markets*,¹³ (the "Report") which was reported out in August of 1963, thirty years after the passage of the securities laws, and which is a wonderful source of history in this industry. I thought it would be interesting to see what the Report

13. SECURITIES AND EXCHANGE COMM'N, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, pt. 1-4 (1st Sess. 1963) [hereinafter REPORT].

concluded on self-regulation thirty years after passage as a prelude to our discussion tonight as this will be the seventieth year after the passage of the 1934 securities legislation. There are a few quotes that I think are instructive.

If anybody is really interested in this, it is Part IV, Chapter 12, called "The Regulatory Pattern."¹⁴ The subject here is "The Purposes and Use of Self-Regulation." The Report quoted the *Silver v. NYSE* case with which many of you may be familiar.¹⁵ It said that the purpose was "to delegate governmental power to working institutions which would undertake at their own initiative"—these words are really interesting—"to enforce compliance with ethical as well as legal standards in a complex and changing industry."¹⁶ There are a lot of components to that definition. The Report further analyzed the concept this way: historically, they concluded that it was based upon issues of "practicality and expediency."¹⁷ Presumably, the Commission could not do everything. But it recognized several other advantages, which I think are very relevant to what we are talking about tonight.

First the Report mentioned the expertise of the people in the industry, of the members of the industry, and referred to securities as "intricate merchandise," which comes from a federal court opinion in New York.¹⁸ The Report then concluded that the persons on the scene in the industry can be more effective sometimes than a government agency in regulation.¹⁹ This is very interesting again when you think of what we are dealing with today.

The Report quoted Justice Douglas, who was formerly Chairman of the SEC,²⁰ who put it this way: "Self-discipline in conformity to law, voluntary law obedience so complete that there is nothing left for the government representatives to do"—think about that today—"obedience to ethical standards beyond those any law can establish."²¹

14. *Id.* at part IV, 493.

15. *Silver v. N.Y. Stock Exch.*, 373 U.S. 341 (1963).

16. *Id.* at 371.

17. REPORT, *supra* note 14 part IV, at 693.

18. *Sec. and Exch. Comm'n v. Capital Gains Research Bureau, Inc.*, 306 F.2d 606, 614 (1962).

19. REPORT, *supra* note 14 part IV, at 694.

20. William O. Douglas, Chairman of the SEC from 1937 to 1939.

21. REPORT, *supra* note 14 part IV, at 694 (quoting a 1938 speech by Chairman Douglas).

The Report also suggested that one of the benefits of the industry participating in the process was that it would make it more palatable and they would be more aware of their own stake in the process.²² This is a very relevant concept.

And finally, the creators of the Report recognized, on the other hand, that there were some limitations. The ones they identified were: the weakness in human nature, to perhaps not be as diligent as they otherwise might; the members might be more complacent about the public interest factor and not be as motivated to deal with that; they may be more inclined to interpret rules more narrowly.

Anyway, that is the end of what I had to say. But it seems to me that it is an interesting backdrop to throw out the question to the panel: Is the system of self-regulation being carried out today with those kinds of principles being practiced?

I would like to start with Annette.

MS. NAZARETH: Those are very interesting words. I have to say that even when Chairman Douglas articulated that, I suspect that that was somewhat aspirational. I think that there has always been a recognition that self-regulation, while it has worked generally well over time, has flaws, as can be expected when any self-interested group oversees its own activities.

On the other hand, I think it has, as you stated, been helpful to tap the industry expertise and make the industry responsible for funding much of its oversight. But there have been some very notable failures in self-regulation, and you indicated in your remarks that you think this is one of those times when we should yet again question whether this model can work.

There also have been some changes in the structure of the industry that have made it more complex to continue with the model that we have. We certainly have more competition among markets than we have had before. A consequence of that is order flow that shifts from one marketplace to another, which can make it difficult for SROs to rely on a steady stream of income to fund regulation, a significant portion of which comes from the market data revenues.

The proliferation of ATSS²³ and ECNs²⁴ which are competitors of

22. *Id.*

23. Alternative trading systems (ATSS) are electronic trading platforms that reduce the need for personal contact on the trading floor. Securities and Exchange

the SROs and are also regulated by them, have further complicated our self-regulatory regime. This clearly was not something which was originally contemplated by the 34 Act. And today with the trend toward demutualization and for-profit exchanges, we have yet another additional layer of complexity and potential concern that, likely could not have been envisioned by Congress when it implemented the system of self-regulation in the federal securities laws. The 34 Act instead contemplated traditional mutual organizations.

Therefore, we find ourselves addressing new concerns not directly envisioned by the 34 Act relating, for example, to the possible undue influence of persons controlling shareholder owned exchanges over the regulatory function.

MR. PELOSO: Can I just ask you, Annette, why would the increasing complexity in the industry work against self-regulation? I would think, to pick up the Report's idea, that the increasing complexities in the industry might make the use of that expertise in the regulatory process more important.

MS. NAZARETH: Well, I think industry expertise is valued and necessary, and is something that the staff would be reluctant to compromise. But on the other hand, with more marketplaces aggressively competing for the same order flow, there is a risk that the quality of regulation could be compromised. In essence, order flow providers can choose the venue in which they will bring their order flow and among other things, can shop for the best regulatory deal. The Staff has actually seen examples of this in the options markets. That is of great concern as well.

I do not think that situations such as this were contemplated by the 34 Act. The markets were much less competitive and fragmented when that statute was adopted. Certainly, at that time the over-the-counter market largely resided under one umbrella, but now the market is much more diverse and competitive and I think it is much harder to assure ourselves that we have the same level of regulation across all markets.

MR. LACKRITZ: Could I address that question about complexity? I completely agree with what Annette is saying and I think the challenge

Commission at <http://www.sec.gov/divisions/marketreg/mrecn.shtml>.

24. Electronic Communications Networks (ECNs) are electronic trading systems that automatically match buy and sell orders at specified prices. Securities and Exchange Commission at <http://www.sec.gov/divisions/marketreg/mrecn.shtml>.

is that the increasing complexity and the increasing competition has also created increased conflicts of interest among and between the SROs, for example, and the industry.

The SROs are in the process of building up their businesses. They have far more of their revenues coming from market data fees than they do from member fees and they are creating new products and services that compete directly with the industry. At some level, that is part of the reason, I suspect, why the NASDAQ separated from the NASD. But in fact it creates a fundamental conflict of interest.

You also have a lot of the firms in the industry sponsoring trading platforms that are competing directly with the trading platforms of the SROs. So, all of a sudden, instead of having a simple world where you have many SROs and oversight of SROs, the walls are disappearing, and the result is that there is more competition, more complexity, and more conflicts of interest. This creates a totally different situation and a totally different context, I think, from what we have had in the past.

MR. PELOSO: What does that do for the concept of self-regulation, accepting that thesis, Mary?

MS. SCHAPIRO: I was actually going to take a little different approach because I think the NASD is rather uniquely situated, since we, depending on the day of the week, do not operate markets or do not want to operate markets, and really exist as an SRO in a different form than Marc or Annette were really describing.

Given that, I think some of the words you used, John, actually are pretty close to accurate, even right now, for self-regulation, despite some of the issues that we have seen evolve over the last couple of years including SROs acting on their own initiative, as well as evolving legal and ethical aspects.

When we write rules at the NASD, they are well informed by the industry perspective through a series of committees, but they are decided ultimately by a Board of Governors that is composed of a majority of non-industry people who very much have the public interest at heart. The industry pays for the nearly \$600 million of additional regulation. We think we get better, more effective, operational rules as the result of the industry participation.

And we have this very elastic standard of ethical conduct, which is "commercial honor and just and equitable principles of trade."²⁵ Some

25. NASD Conduct Rule, Exch. Act Release No. 34-45156 (December 14, 2001).

ethical violations do not necessarily fit under specific rules.

So I think in a lot of ways, because we do not face some of the conflicts, and because we have been solely a regulator for a long time, we meet a lot of the standards that were set out, which were perhaps aspirational at the time they were spoken.

Some of the weaknesses you raised I think have also been addressed by all of the SROs over the intervening thirty years through the change in exchange governance and SRO governance. The governance has moved more towards public representation, as a result of a much more vigorous oversight of the SROs in the last ten years by the SEC.

So the frailties of human nature and not acting in the public interest I think have been addressed in a lot of ways. That is not to say that it is perfect, but I think it suffers from no more flaws than really any governing construct would.

MR. BECKER: Well, I would like to just pick up a couple of points there, more from the defense side.

Historically there was the view that self-regulation would articulate ethical norms above and beyond those set forth in a positive law. Nevertheless, the combination of recent developments and the pressure of press scrutiny has meant that for some technical purposes, civil private rights of action and the like, the idea that there is this penumbra of ethical business obligations above and beyond those stated in positive law has pretty much collapsed. The idea that the SEC is going to defer to some violation of NASD advertising rules as being an ethical norm but not implicating § 10(b)²⁶ or Rule 10b-5²⁷ is just not credible in the current competitive environment.

Second, the regulatory structure changed. Now every broker-dealer has to be a member of an SRO, there is no other alternative, as was done in the past.²⁸

Third, the governance of the SROs is changing. To the extent that the SROs were in fact created as membership organizations to reflect the membership's views, to reflect the ethical norms, as opposed to law-generative bodies to reflect public law considerations and policies, they have now been transmogrified into public law-making bodies, and

26. Sec. Exch. Act of 1934, 15 U.S.C. § 78j(b) (2005).

27. 29 C.F.R. § 240.10b-5 (2005).

28. Sec. Exch. Act of 1934, 15 U.S.C. § 78(o) (2005).

accordingly there have been new standards in the name of conflicts of interest. Basically they have become public boards making public rules for an industry. This in part undermines the credibility and expertise of those bodies as a reflection of the industry itself.

And finally, the ever-more-vigorous SEC oversight has highlighted the possibility that the SROs, rather than being a reflection of evolving industry norms, are more of an extension of the government. Therefore the SROs are more of an enforcement arm of the government without the protections of the government when you are dealing with them, rather than a reflection of industry norms.²⁹

MR. PELOSO: Before you leave that point, I think I saw a very interesting phrase in the Report, which I was not going to mention unless it became relevant. Part IV, Chapter 12, of the Report recognizes that when an SRO conducts delegated activity it is “acting as an official arm or a delegate of governmental power.”³⁰ This is an interesting subject when you think of what you just said, Brandon, which is that you do not have the same constitutional rights before the exchanges.

MR. BECKER: There is a long body of cases protecting the ability of SROs to act as if they were membership organizations, which you are familiar with, John, and that is an important body of law.³¹ But what that body of law does not reflect is the interaction between the press and the plaintiffs’ bar, and then the competition among regulators, and then actions based on failure to provide e-mails. This suggests that a broker-dealer does not have a great deal of flexibility in responding to the demands of its “membership” organization, which it is compelled by statute to be a member of in the first place.

MR. PELOSO: Rick, can the NYSE effectively compete in the marketplace and at the same time conduct its self-regulatory activities?

29. See e.g., *Turf War on Street Hurts All Parties*, FIN. TIMES, May 1, 2004 at 11.

30. REPORT, *supra* note 14 part IV, at 697.

31. *Desiderio v. NASD*, 191 F.3d 198, 207 (1999); see also *United States v. Shvarts*, 90 F.Supp.2d 219 (E.D.N.Y. 2000) (“It is beyond cavil that the NASD is not a government agency; it is a not-for-profit corporation. It was not created by statute, none of its directors ... are government officials or appointees. It receives no government funding ..., [and] its actions cannot be imputed to the government.”), *abrogated on other grounds by*, *United States v. Coppa*, 267 F.3d 132 (2d Cir. 2001); *Marchiano v. National Ass’n of Securities Dealers, Inc.*, 134 F.Supp.2d 90, 95 (D.D.C. 2001); *United States v. Bloom*, 450 F.Supp. 323 (E.D. Pa. 1978); *United States v. Solomon*, 509 F.2d 863 (2d Cir. 1975).

MR. KETCHUM: Sure, but it cannot do it the way the Report discussed forty years ago, which is why the words are, not surprisingly, not quite the same and why Brandon has to deal with a different reality and—guess what?—so do Mary and I, and I guess I even did when I previously worked at Citigroup.

Yes, the NYSE, as NASDAQ, as any of the options exchanges, and as any marketplace, faces, as Annette points out, a much more competitive environment than before. They are competing and member firms, as Marc pointed out, are sponsoring various alternatives to classic primary markets, and this creates risks and concerns of retribution and balance in deciding what areas to pursue or not. That is a fact. It requires a different type of governance environment for self-regulation than existed before.

Mary described what happened at the NASD. I would say the great thing about Mary is that she created that culture even before NASDAQ spun off through a separate reporting relationship with the board.

I think that is the answer why the NYSE will operate effectively as a self-regulatory organization and as a marketplace. The NYSE today in its new governance environment, indeed, has managed to segregate its members so that they operate under a separate advisory board, albeit it we are fortunate enough to have a regulatory committee, which is what I report directly to, that has two out of three members with a great deal of financial experience.

It may or may not be the greatest solution, but that is it, guys. I think if self-regulation is going to operate in an environment where there are greater concerns of conflict in how it operates, then it is going to have to be an entity that has a more public-driven board than before.

As Mary indicated, the SRO remains an entity that is substantially committee-driven and has in its fiber concern and a strong ethic of understanding the industry and understanding the market that it regulates. I think, in judgment, when one looks at the alternatives and recognizes that we are not in a world of banking regulation where you can provide a primarily oversight environment with relatively little enforcement function, I am not sure you want to lose that, from a knowledge standpoint, from leverage with respect to industry resources, or from the flexibility—albeit, Brandon is right, sometimes that is concluded as fraud in fairly amazing situations over the last couple of years. It does not change the continuing ability for those SROs as well to try to work out regulatory structures that are outside of the fraud

context and deliver differential penalties from what is outside the fraud context.

So is it the same self-regulatory model that existed before? No. Does it depend on, for better or worse, a concept of gentlemen's understanding and commitment to an ethical environment that may have existed in a less-competitive securities market thirty years ago? No. Does it still provide something unique and different and has it evolved to address some of those conflict issues that people were concerned with? Yes.

And then I think the question comes at the end: Does it continue to provide value-added to investors, to the industry, and to the SEC? Yes, of course I am prejudiced, but I think yes. That seems to me the fair set of questions.

MR. BECKER: Could I make a small comment from a different context? I have always thought that in the government securities markets, if you looked at it in the early 1960s, you could run that market basically through a club membership, and the New York Federal Reserve could decide who was in the club and who was not, when it was a relatively smaller market.

It never seemed like a surprise to me that with the explosion of the U.S. debt markets, all the people who came into that market, the development of new technologies and trading systems, that you eventually got the Government Securities Act of 1986,³² which is a more bureaucratized oversight process.

I think that is part of what Rick and Mary were just describing. I mean we do have a bigger, more complicated system that cannot rely on basically the same level of informality that it did before. And if you are on the defense side, you want to have procedural protections and safeguards because it is no longer the same sort of club that you joined a long time ago.

MR. PELOSO: What has really emerged here in terms of the relative roles of the Commission, on the one hand, and the SROs, on the other? One would think when you read the literature that the whole idea was that the SROs would regulate themselves and only when they really did not regulate themselves would the SEC step in. Maybe that is wrong, but that is the sense you get.

32. Government Securities Act of 1986, Pub. L. No. 99-571, § 1, 110 Stat. 3208 (1986) (codified as amended at 15 U.S.C. § 78o-5 (1986)).

Today one gets the impression that we have regulation essentially by the SEC, and the SROs are basically being asked to toe a mark. Now, there may be nothing wrong with that, but it seems to me the model has changed.

What do you think, Marc?

MR. LACKRITZ: I completely agree that the model has changed. I think the basic question is: Is there any "self" in self-regulation? I mean, do we have any "self" left at all?

I think we get imprisoned at some level by language; language that consists of terms that we have always used in the past. But when you see that of the twenty members of the Board of the NASD only eight come from the securities industry, is that really self-regulation? When you have a Board of the NYSE that includes nobody, not a single individual, from the securities industry, is that self-regulation? When you have the SEC providing direction to the SROs on what they should be enforcing and by vigorously overseeing them—which I might add may well be in the public interest because that is an important function to be served—is that really self-regulation?

I would suggest to you that none of this is self-regulation anymore. It is a different form of regulation. Does it work well, does it serve the public? I think those are the relevant questions.

But it seems to me that the terms we are using are no longer relevant because I think self-regulation has really changed that dramatically, just to be somewhat controversial.

MS. SCHAPIRO: I have to respond to that. Whether you call it "self-regulation" or you call it "private sector regulation," my view is there is still an enormous amount of industry participation in the regulatory process at the SROs. I will let Rick speak to the NYSE.

Yes, our board has a majority of non-industry members, but we have dozens of committees representing hundreds of industry participants with specific subject matter expertise, whether it is fixed income or variable annuities or bank broker-dealer issues. We have hundreds of participants in regional committees that represent brokerage firms in different parts of the country. These participants have their different ways of doing business that are in fact regional and illustrate that this is an enormously diverse industry. There are 5,600 broker-dealers that do business with the public.

We have hearing panels that adjudicate disciplinary actions. Two of the three people on a hearing panel are industry members.

We have a new program, called consultative committees, of people who are rolling off of district committees after their three years of service, who can advise us on what kinds of cases we should be bringing. They can look at specific fact patterns and give us input into the whole disciplinary process. We take to them some of our thorniest issues, whether it is municipal bond pricing or what to do with respect to particular types of products. They give us localized, very specific expertise to help us address those kinds of questions.

And then we can do something the government really can not do, and that is provide tools for firms for compliance. So if we have new anti-money laundering rules under the Patriot Act,³³ we can write a template that firms can use to fulfill their anti-money laundering “know your customer” obligations.

We can hold phone-in workshops where 2,000 or 3,000 firms call in and spend three hours on the phone listening to NASD staff help them walk through the interstices and the intricacies of all of these new rules and how they fit together and how they potentially work together.

Those are things the government is not in a position to do. They have to convene an advisory committee under the Federal Advisory Committee Act.³⁴ They can not have a set of standing committees that are just available to them to provide expertise. They have tremendous talent on the Commission, but they do not get to move people in and out depending upon the types of expertise they need, whether it is insurance-related or investment company-related.

I think there is still a huge amount of “self” in self-regulation and a huge amount of value that is provided to the process that reflects itself not only in our disciplinary actions and in our rule-making, but also in our comment letters to the SEC and in our everyday conversations with SEC staff about the rules the Commission is contemplating.

MR. KETCHUM: I would just add a little bit, but I would take a slightly different tack, although I certainly agree with what Mary said.

In some ways, Marc, you’re right. As I said before, it has changed. The governance environment and the expectations of the SEC change the manner in which we work. But we do not work the way the

33. Uniting And Strengthening America By Providing Appropriate Tools Required To Intercept And Obstruct Terrorism Act of 2001 (USA Patriot Act), Pub. L. No. 107-56, § 311-377, 115 Stat. 272 (2001).

34. Federal Advisory Committee Act, Pub. L. 92-463, § 9, 86 Stat. 770 (1972).

government does, and I think that is the point Mary made.

We do view our mission differently from an education standpoint and from an interface standpoint with the industry. We interact with the industry in a different way and feel comfortable about interacting with the industry in a different way than the SEC either has the opportunity, the luxury, or maybe even the comfort to do.

In the end, I want to stay away from "she [sic] protests too much."³⁵ It is up to other people to decide whether indeed self-regulation, as defined in this environment, continues to provide value. I guess I would not be back in it if I did not think it did, and particularly in seeing how people like Mary made it and make it operate in that way.

But it will be different. I think the question I always ask in asking whether you want to eliminate self-regulation is the question of what you want to operate in its path as a separation. Indeed, I think if you do move to the alternative, either an entirely bank regulatory type of environment from the strict government standpoint, or to an accounting board type of environment where it is entirely separated from not only markets but expected to be separated from the industry, it may work better, it may work worse. But it will be undeniably different as to its ethics and how it relates with the industry that it does regulate.

MR. PELOSO: In the enforcement part of the self-regulatory process, what is the panel's view as to whether the SROs are being delegated a portion of the larger enforcement initiative dictated by the SEC, or are they enforcing their own rules? Is there coordination between the SROs and the Commission?

I will tell you from a practitioner's standpoint, sometimes it is hard to tell how the territory has been divided up. On the one hand, when a practitioner suggests that there are too many parallel proceedings and everybody is investigating everybody, we are always told, "But no, we talk to each other, we do not overlap."

So which is it? If you talk and overlap, how do you divide everything up, or do you?

MS. SCHAPIRO: Well, let me start off and then I will let Rick speak to this too.

First of all, we are required to enforce not only NASD rules but also the federal securities laws and SEC rules. That requires coordination

35. WILLIAM SHAKESPEARE, *HAMLET*, Act III, Scene 2 (stating "The lady doth protest too much.").

between SROs and the Enforcement Division at the SEC.

The one thing I can unequivocally say, is that we are not delegated any areas to be responsible for that the SEC will then not be responsible for. I think it is fair to say that if we have good coverage in a particular area, the SEC is likely to have a comfort level that we are enforcing SEC rules in that area and not wander in. This is because they have precious few resources as it is to do the job they need to do. To the extent we can all leverage our resources by not duplicating each other, it is to our benefit, the NYSE's, and the SEC's.

I would say there is a high level of coordination. We do some cases together. Those are relatively few. Some of them are the big ones, like the global settlement with respect to research and investment banking conflicts of interest, and there are the occasional very, very large cases, where we will actually each take a section of the case and do the investigation and then globally settle it. But it is a pretty rare instance where we actually duplicate each other's efforts.

The cases we bring, we bring because we think we need to bring them, not because the SEC has directed us to.

MR. KETCHUM: I am a new recruit here and I probably cannot help but I have my Citibank hat on a little bit as well.

I think we can do better. I think Mary is absolutely right on the whole. I think people can be focused on a few events with respect to extremely high-profile cases, and I think there are some situations where we can do better with respect to coordination.

I think that on the whole what you usually see is the SEC leveraging either the NASD or NYSE or both resources, which results in more than three different entities striking out on their own. I think there is less of a willingness at the SEC to delegate decision-making while continuing to use the leverage of the self-regulatory organizations with respect to major cases.

But as I say, I am looking at this mostly from the outside in.

MR. PELOSO: Annette, what is your view of that subject from the SEC standpoint?

MS. NAZARETH: I am not in the Enforcement Division, but I do believe that we try to coordinate. Obviously, there are some very high-profile cases where the Commission wants to have a presence as well as have the SROs involved, but my sense is that those are selected because there is a certain message that people want to convey.

Otherwise, I agree with Mary, I think that there is a sense that we

have precious resources that we want to leverage and for the most part the intention is not to duplicate each other's work.

MR. LACKRITZ: You know, John, if I could just interject for a second, if you look at the panel, we have lots of regulators and self-regulators and an industry representative here on this panel. The dogs that did not bark here are the state securities administrators. In fact, that is really the development that has thrown all this into a fairly significant state of transition, confusion and competition. This is because we have a state attorney general, in this case Attorney General Spitzer, discovering something that was not discovered by the SROs or the SEC, bringing an action, and suddenly creating a totally different paradigm for how the laws ought to be enforced. The result is that the regulatory agency, the SEC, and the SROs are under enormous pressure for competitive reasons to in fact do something, get out there, and show their stuff. That, it seems to me, does create the potential for lots of duplication, lots of repetition, and lots of inefficiencies in a system that otherwise should be relatively efficient.

MR. PELOSO: Well, I think about a year ago Attorney General Spitzer was quoted in the papers as saying, in words or substance, that self-regulation did not work.³⁶ Some of you may have seen that. So you know where he stands, I suppose.

MS. SCHAPIRO: I just want to disagree with something Marc said. I should actually start, though, by agreeing with something Rick said, which is something we can always do better, there is no question about it. There are a lot of people out there working towards the same goals, and it is not always perfect.

I do not want to be naïve and say that there is no competition among regulators because there probably is some, but I think that it is nowhere near what the industry believes there is. But when somebody like Attorney General Spitzer identifies a problem, the fact that all the other regulators run towards it does not mean they are competing. It is that a serious investor protection issue has been surfaced and needs to be addressed by everybody to the greatest extent we possibly can.

So again, while not trying to be a Pollyanna, I think we are motivated by a broad investor protection concern about some of the conduct that was going on in the fund area and less by competition

36. David Cay Johnston, *Officials of 14 States Pledge Protection of Pension Assets*, N.Y. TIMES, August 13, 2002, at 7.

among the regulators.

MR. BECKER: I think structurally everyone works hard to try to be efficient and not waste their time and energy, but we all have too many war stories about a high-profile press event. This is where the regulators are tripping over one another to get through the door, and they have not coordinated their activities, and they are not leveraging their resources. They are asking you for the same documents on the same day, and they are asking you for the same e-mails, and they want to interview the same witnesses, and they are not willing to defer to one another.³⁷ That is not a pretty picture.

Allocating resources across an industry-wide problem, for example, late trading, and deciding who is going to take firms A-to-D and who is going to take firms E-to-G, makes a lot of sense. If you were a systems analyst professor, you would divide it up and think about how you were doing that in an efficient manner. But sending five different regulators into the same firm on the same day so they can fight over who gets to talk to whom does not make a lot of sense.

MR. PELOSO: Maybe we need to have self-regulation in one super-enforcer.

MR. BECKER: Well that is an interesting thought, because there is a big difference between the enforcement issues and the structural issues. You could make that distinction.

MR. PELOSO: Bob Colby, we have not heard from you. What is your view of what participation the industry has these days in the self-regulatory process?

MR. COLBY: I think the changes in the governance have been all for the good, in the sense that they have given the self-regulators the freedom to express themselves if they will.

But I think Mary is absolutely right; it is incorrect to say there is no industry participation in the self-regulatory organizations. We see it every day. Sometimes we see it positively, sometimes we see it negatively. We see rule filings that clearly have been shaped in a way that they are much more focused, much clearer, much more workable, and still achieve the ends. That is a positive sense.

We see other rule filings where we just cannot understand why the SRO does not go the final step and complete the process and come up with what seems like a solution. Then we realize that there has been

37. See *supra* note 29.

heavy involvement of an industry committee in the process and the committee just does not want that outcome.

From both ways I think the industry is still very, very involved in the process, and I think on the large part that is good.

One aspect that no one has touched on is that there is a huge amount of the regulation of the securities industry and the markets that is very, very detailed and is working very well. If the Commission were to do it, this regulation would not be a pretty picture. Things like the Uniform Practice Code³⁸—I mean how many people ever know what the Uniform Practice Code is, or how yields are calculated in municipal markets? There is a formula in the Municipal Securities Rulemaking Board (“MSRB”) Rule Book listing five different ways to calculate yields, and so everybody calculates it that way. Bond yield calculators are even programmed that way. This creates standardization that only an industry group that is close to industry practice could do.³⁹

MR. LACKRITZ: But, John, I do not think I said that the industry was not involved with self-regulatory organizations. I mean it is like the story about the chicken and the pig: a guy is having scrambled eggs and bacon for breakfast, and he says, “You know, the chicken is sort of involved because they lay the eggs, but the pig is really committed because there is the bacon.”

We have moved from a situation of having the industry really committed to self-regulation to one where yes, it is involved, but it is a very different, reduced role. Yes, there is input, sure, but, with all due respect to Mary and the staff of the NASD and Rick and the staff of the NYSE, it is much more staff-driven now than it has been in the past.

I think that is partly because the industry has changed so dramatically. We have moved from having a relatively small club basically dealing in this industry, overseeing one another, understanding why and how you get in the club, to a more democratized system in the last twenty years, and as a result you have a lot more people and investors and institutions in the marketplace. There are a lot more participants. It is not the homogeneous, common sort of small group.

As a result, yes, you have industry involvement, but it is not

38. NASDAQ, UNIFORM PRACTICE CODE, *at* <http://www.sec.gov/pdf/nasd1/11000ser.pdf> (last visited Mar. 4, 2005).

39. MUNICIPAL SECURITIES RULEMAKING BOARD, MSRB RULE BOOK, *at* <http://www.msrb.org/msrb1/rules/ruleg33.htm> (last visited Mar. 4, 2005).

anything close to self-regulation as it was understood forty or fifty years ago. It is totally different now.

MR. PELOSO: Where do the new electronic markets fit in this picture, the Instinet's, etc.? Are they more like the regulated or the self-regulatory body?

MR. COLBY: Let me assure you they are not self-regulatory.

MR. PELOSO: Well, that is the one joke of the evening.

MR. COLBY: Electronic markets complicate the SRO question a lot because they are running trading markets similar to the NASD, which is a self-regulatory organization that began running a screen in 1971 and then developed into the NASDAQ market.

But the 34 Act was written around trading markets. Congress said, "We're going to have our trading markets register and be self-regulatory organizations."⁴⁰

Now, the electronic markets are trading markets but they are not self-regulatory organizations. That might be a model for the future, but right now we have the model split, where some markets are SROs and some are not. There are some advantages to being an exchange in this world and there are some disadvantages, and I do not think the balance has settled out yet.

We have applications from some of these electronic markets to become exchanges. I do not think we have any de-applications from exchanges.

MR. PELOSO: I would not dream of asking where you think that issue is going to go, but I will ask you if you might comment on some of the points on both sides of those issues as to whether they should be a self-regulatory organization or not. Or you may not want to comment.

MR. COLBY: It gets very complex. First of all, when ATSS are running a trading market they do not pretend to oversee their members. In fact, this is a condition for ATSS not to be self-regulatory organizations: that they do not use trading market power in order to exercise constraints or requirements for their members. So they really just run trading markets.

So the first question is: Is there something about running a trading market that naturally compels it to be a self-regulatory organization?

MR. PELOSO: And if not, do they have an unfair competitive edge over the exchanges?

40. See *supra* note 10 at § 78(f).

MR. BECKER: Well, it is framed that way, and we are of course conflicted some six ways from Sunday on this. What some electronic markets highlight is the unbundling of the trading mechanism. These markets are looking for the cheapest way to run a server and process an algorithmic match. These markets do not want to pay for member firm services, they do not want to pay for oversight, and they do not want to sell a brand name based on listing standards, or vetting issues, or member oversight. These markets want to sell you the cheapest, fastest execution. In effect, while such an approach sometimes is discussed as unfair competition, it also dramatically demonstrates what happens when you unbundle the trading engine from all of the processes that goes along with operating a floor.

MR. COLBY: Can I add to that? The funding area gets very complicated. This is close to Mary's heart. The markets that have become self-regulatory organizations, the ECNs that have become exchanges, still do not take on extensive member regulation. They expect the NASD to cover that largely as a free good.

Some of the smaller exchanges historically have not done member regulation. That said, the market has become more competitive. There was a day when all the SROs said, "Well, it is good for the industry so we are not going to try to work out who should be bearing these different costs. We will just let the NYSE and the NASD do all the customer-related supervision and they will find a way to collect for it somehow. We will just do our floor and our own particular floor members' supervision."

But now we are in a world where these markets are extremely competitive with one another. For the industry's good the larger SROs are still bearing these costs and funding them one way or another, but this is not an equitable allocation of the costs of supervising SRO members and trading floors.

MR. PELOSO: Marc, this is part of your constituency.

MR. LACKRITZ: First of all, I think there is no question about the fact that the advent of technology and the ECMs⁴¹ has been a marvelous development for the public and investors. It has been a terrific boon to

41. Exempt commercial markets (ECMs) are electronic trading facilities providing for the execution of principal-to-principal transactions. Commodity Futures Trading Commission, at <http://www.ctfc.gov/dea/deaxcombackgound.htm> (last visited Mar. 4, 2005).

competition, it has created more innovation, it has reduced trading costs, it has improved executions, and it spurred the SROs to new innovations. It seems to me it is sort of an unalloyed good.

The problem you get into is when you get back into a self-regulatory morass, then you start trying to figure out, "Well, are they more like an SRO, are they more like a broker-dealer, and how do they get regulated?" And then they are sort of in another world, a nether region.

Here are a few examples. The Archipelago Pacific Exchange consists of one ECM that has actually migrated into being, in essence, an exchange. Then there are all the other ones that are sort of outside, floating around, where they are not fish and they are not fowl, but they are adding some value because they are providing competition.

It seems to me they are definitely a force for good. They are regulated now like broker-dealers basically, and I do not think that makes a lot of sense. But on the other hand, I do not think you want to constrain the innovation and you do not want to constrain the ability of these entities to innovate, because that is where they really bring much more value than whatever regulatory interstices they might happen to fall into.

MR. BECKER: But you have a very difficult governance issue, because if you go back to Annette's observation about her concerns regarding the role of control persons, I think that is a way of saying, "Well, how do you deal with governance issues?" If you are trying to turn these things into SROs, are you really going to just come and say, "Well, great, you have this great trading engine, and by the way, we would like you to have a 50 percent public board of people who have no idea what your business is?"

MR. LACKRITZ: If I can just follow up on that, one of the things that I think has changed about the governance issues in these SROs is that we now have a majority of members of the boards of the SROs coming from the public. This means that they are not associated with the industry, God forbid, because we do not want to get too much expertise into the board.

But at the same time, you look at how this has evolved and you have to ask yourself: "Wait a minute. If the SEC, which is a public body created by the Congress, overseen by the Congress, is an independent regulatory agency which is responsible to the public, how much public intervention do you need in this situation?"

Now, everybody says, "Well, but the SROs may have missed a couple of things here," or "the industry is lax because they are too buddy-buddy with one another," or whatever that rationale is. At the same time, if you then build in so much layering of public participation, it seems to me you lose something in that process. You lose the expertise; you lose the involvement and the engagement of the industry.

MR. PELOSO: It kind of seems to me that that may be part of what has happened. If you go back to the Report's analysis of the pluses and minuses of what the industry could contribute, it seems to me that there is an emphasis on the limitations; that is, that the industry expertise has been translated into industry self-interest and may be suspect, which leads you to have a lack of expertise.⁴²

That is nowhere more evident than in the dispute resolution process, which I know is under Mary's jurisdiction. It started out, I think, some years ago as being desirable to have people who were familiar with the industry sit on these cases, the theory being that they would be able to sort through these issues quickly, bringing their expertise to the table, and so it would be a quick process.

I think the rules have changed since the Supreme Court allowed arbitration of securities law issues.⁴³ It seems to me the quid pro quo was that new rules came into effect so that now you really have arbitration panels probably being more like civil juries than industry panels.

Is that because you have people who would normally be an outside arbitrator, such as a lawyer such as myself, are now considered to be industry people if you spent X amount of your time working for securities firms, so you are presumed not to be fair? Isn't that an instance of where you have the industry expertise, so to speak, mistrusted, and therefore the "self" from self-regulation seems to be withdrawn?

MS. SCHAPIRO: I would be happy to answer that, but I have to respond to Marc first.

MR. LACKRITZ: I would have been disappointed if you hadn't.

MS. SCHAPIRO: I know you would.

"Public" does not mean people were dragged in off the street, when

42. REPORT, *supra* note 14, part IV, at 695.

43. Rodriguez de Quijas et al. v. Shearson/American Express, Inc., 490 U.S. 477, 482 (1989).

we talk about public directors, or in the case of the NASD, public governors. Our public directors include the Dean of Fordham's Business School, the former Executive Director of CalPERS, the CEO of Vanguard, the retired CEO of Metropolitan Life, the retired CEO of Prudential Assurance from the U.K., and the CEO of Moody's. These are not unsophisticated people who lack an understanding of financial markets or securities markets. I say that just to put to bed any sort of vision of the public being whoever happened to walk by the office that day and looked like they had nothing else to do.

MR. LACKRITZ: I do not think I said that is the way they were picked.

MS. SCHAPIRO: No, but I just want to make sure it was clear that they bring an expertise to the board. I guess what I really want to say is that they bring an expertise to the board that is very, very important. And while it might not be in the intricacies of the operation of trading desks, the industry does bring that and these people do bring a basic understanding of financial markets at a minimum, and sometimes much, much more than that.

I actually do not think the changes in the arbitration process have really been driven by board members. I think it has been driven by, first of all, the enormous influx of retail investors into our markets and the requirement that they arbitrate as a result of signing pre-dispute arbitration agreements, and the plaintiffs' bar. I think the plaintiffs' bar is really largely responsible for many of the additional procedural requirements that have been layered onto the process over the years.

MR. BECKER: Just to more broadly state it, a lot of people lost a lot of money over the last several years, and in part they lost it because of substantial and sustained abuses within the industry. That has called into question its credibility, so that there have been structural reforms that in some respects I think have gone too far but are necessary elements and the logical consequences of a loss of trust in the ability of self-policing that is going to take time to come back. I do not think that is great rocket science, but I think it is part of this.

MR. LACKRITZ: Could I just respond to that? I might add, just in terms of material disclosure, that Brandon actually is our outside counsel on a number of issues, so the fact that I am disagreeing with him, I want to make sure that is clearly disclosed.

People lost a lot of money in the last couple of years because the market took a downturn, the bubble burst, the economy was in recession,

we had terrorist attacks, and there were corporate governance scandals. I would suggest that the amount of industry misbehavior that caused people to lose money is at least at number five or six on the list, it is not anywhere close to the top.

Pendulums go back and forth as they always do. And maybe during the 1990s it went too far in one direction, but it clearly has the potential of going way too far back in the other direction if we are not very careful and we do not proceed thoughtfully, carefully and specifically. I think that is really important.

But I really think, just to follow up on my friend Mary's notion this time with respect to Brandon, pinning all these losses on industry misbehavior is completely ludicrous. We had a speculative bubble, everybody bought into it. Now, is the industry partly responsible? Yes, absolutely. Did we help to enable it? Yes, absolutely. Are we responsible for this? I would say that is really an overreach, a grotesque overreach.

MR. BECKER: I think it is obviously the Clinton Administration's problem.

[Laughter.]

MR. PELOSO: Does anybody think that there should be a single industry arbitration forum, as opposed to having the arbitration process conducted separately by each SRO?

MS. SCHAPIRO: There practically is. I think more than 90 percent of the cases are filed with NASD at this point. Last year we did about 9,000 cases in the NASD arbitration forum. We already do the arbitration for the Philadelphia, for the Amex, for the MSRB. We're moving that way.

We are not suggesting that there is not a value in multiple arbitration forums, because there may well be, but practically —

MR. PELOSO: Do you think we are gravitating towards arbitration being outsourced?

MS. SCHAPIRO: I think there are tremendous economies of scale in running an operation like that. We have thousands of arbitrators on the roster, and mediators, training them, and maintaining the technology for list selection. All of those things really argue, I think, for a common forum.

MR. PELOSO: I wish Rick were still here because he was saying this evening that the arbitration function of the NYSE has just been put under his mantle.

MS. SCHAPIRO: Oh, good. That was a big question for a while.

MR. LACKRITZ: But, John, part of the problem in arbitration is that we have a process that was originally designed to be a simple, efficient, fair alternative to litigation. That made a lot of sense. If you look at some of the research in terms of arbitration awards versus people having to go to court, I think it demonstrates fairly clearly that arbitration has worked extremely well. It is much faster, it is far more efficient, and it is very fair. I mean investors win something like 52 or 53 percent of the cases that are brought in arbitration.⁴⁴ Notwithstanding the facts, it is still given a bad name in lots of different press and reviews.

But what has happened to the process, partly because of the Due Process Clause, partly because of the plaintiffs' bar, and partly just because of the nature of lawyers, is it has gotten to the point where we now have so much due process in arbitration that it is threatening to become just like litigation. It is just as long, the discovery process is just as complicated, difficult and contentious. I think we are risking getting far away from the whole purpose that arbitration was designed for in the first place.

I think the NASD has done a fabulous job in terms of setting up arbitration panels and in developing expertise. It obviously has the best brand name with respect to arbitration. That is why you are attracting the entire market share.

MS. SCHAPIRO: I think it has more to do with the fact that we have fifty-plus locations around the country where people can arbitrate. We have really reached out to try to make it as easy for investors as we can.

MR. LACKRITZ: I guess I am just concerned that it is going to become much too litigation-like and it will lose the value that it had when it was first proposed.

MS. NAZARETH: John, I am interested in your question, just because I am not quite sure what the problem is. I agree with Mary that there are probably some economies of scale and as long as there were a sufficient number of arbitrators so that customers who were bringing their cases to arbitration did not suffer greater delays it would work. As

44. Dagen McDowell, *Frustrated Fund Investors Seek Arbitration*, at <http://www.thestreet.com/funds/mutualfundmondaydm/10029650.html> (last visited Mar. 4, 2005).

a policy matter, if it was consolidated into one SRO, it would not offend me. But, I guess I do not really understand why it is a problem if people have a choice as to which arbitration venue to go to.

MR. PELOSO: I do not think personally there is a problem. It just seemed to me that we were gravitating towards one forum, and I was just wondering whether anybody has expressed the view that that is the way it ought to end up because of economies of scale. I do not see any problem. In my own experience, I have not experienced any problem.

I cannot let us disband without asking this question, which we have touched on before: when the SROs are enforcing the federal securities laws, as distinguished from their own rules—although those two ideas sometimes come together, but not always—does the panel regard the SRO as essentially acting in a quasi-governmental capacity or functioning with a governmental function in the context of affording constitutional rights? Does anybody have a view about that?

MR. BECKER: Yes.

MS. SCHAPIRO: No.

MR. PELOSO: Yes and no, okay.

Annette, do you have a view about that?

MS. NAZARETH: No.

MR. PELOSO: Brandon?

MR. BECKER: When you send every document request you receive from an SRO to a U.S. Attorney, you do not think of the document request from the SRO as being quasi-governmental.

MS. SCHAPIRO: I am not sure what that means.

MR. BECKER: It means that you are more worried about the criminal liability when you are running parallel proceedings with an SRO. Whether or not the SRO wants to tell you “we are just thinking about your ethical standards,” if the U.S. Attorney is thinking about a new case on mail fraud or wire fraud, you are not thinking about ethical standards. Irrespective of the good faith of the SRO and its individuals and the fact that they are trying to fulfill their responsibilities, when you put that overlay of criminal inquiry on top of parallel SRO inquiries, it is like trying to deal with a request from the Division of Enforcement with a parallel Office of Inspections and Examinations (“OCIE”), which comes in and looks at broker-dealers. If OCIE comes in and asks for a bunch of documents at the same time that there is a parallel inquiry by the Division of Enforcement, that is not just a question about technical compliance and oversight procedures.

MS. SCHAPIRO: I obviously understand that. I think the problem is that the SROs cannot step away every time there is criminal interest in something, or “We will have complete criminalization of the securities laws,” which was the hue and cry a few years ago. We have to obviously fulfill our obligations to enforce the securities laws and NASD rules.

I will say I think it is pretty rare that we bring a case that does not allege violation of NASD rules or our ethical standards and just alleges a violation of the SEC rules. We work very hard not to be a state actor under the law; and not to operate at the direction of the SEC in any way.

MR. PELOSO: Of course there is one exception. That is when the NASD is sued for some reason in federal court, they assert that they have the same immunity protections as the federal government, and you have been successful at that.

MS. SCHAPIRO: We have been successful defending our immunity.

MR. LACKRITZ: But my understanding is there was a case back in 1999 in the Second Circuit—I should confess I am a recovering lawyer. I was trained as a lawyer. I have never practiced securities law, which should be obvious—but I understand there was a case in the Second Circuit that basically said that in fact the NASD and the SROs actually function as contractual enforcement agencies, and specifically said they are not an agency of the federal government, they do not have the same power, they do not have the same authority, and as a result do not have the same rights.⁴⁵

MS. SCHAPIRO: That is right. That is why the constitutional rights do not apply. Our enforcement is by virtue of a contract that when you sign the U-4 to become a member of the NASD through your brokerage firm, you have contractually obligated yourselves to fulfill NASD rules and requirements and also to provide us with testimony and documents whenever we request them. That is why there is no Fifth Amendment privilege against self-incrimination. You can refuse to give us the documents, but then we can act upon your membership.

MR. BECKER: That body of law was developed when we still had more of a club-like approach to the SROs.⁴⁶ That was effectively eliminated with the amendment to § 15(b)(8) of the 34 Act, which

45. *Desiderio v. NASD*, 191 F.3d 198, 207 (1999).

46. *See supra* note 31.

compelled every broker-dealer to become a member of an SRO.⁴⁷ So the only contract is the one that is in the statute that directs you to be a member of an SRO, and you get to pick whether it is the NYSE or the NASD, but you are still stuck with being in an SRO.

But the body of case law Mary refers to is well developed and there has not been a lot of willingness of the courts to reexamine it because, in part, I think they are concerned that to reexamine it would open up the proverbial floodgates.

MR. PELOSO: It remains an interesting issue, and I suspect that sometime in the future the right case might bring a change in the law. But who knows?

We are at the end of where we said we were going to stop, but would everybody here entertain a question or two before we go have a glass of wine?

Does anybody have something they want to raise with the panel? I guess I will use the prerogative of cutting it off if it goes too long.

QUESTION: Actually, it might be a question for Mr. Colby. There is consolidation in the ECM space, and we could see a very large ECM that would hit the 40 percent threshold under Regulation ATS.⁴⁸ At that stage, would you require that ECM to become an exchange?

MR. COLBY: Yes. Regulation ATS gives the Commission discretion to require a dominant market to register as an exchange, and I would not wish to predict what the Commission would do in that situation.

QUESTION: Ms. Nazareth, could you talk a little bit about how the debate over NYSE self-regulation would be affected if the SEC were to sanction the NYSE over the specialist case? And could you also talk a little bit about whether the flaws have been magnified in the last year in terms of NYSE self-regulation, and are there real questions about whether that ought to continue?

MS. NAZARETH: I think the of recent self-governance changes at the NYSE hold out a promise for a better structure. The problems that you alluded to with the specialists obviously preceded all of these changes. I hope that the NYSE governance changes and other related Commission initiatives dealing with enhanced SRO governance, transparency and oversight—if adopted—would continue to improve

47. See *supra* note 10 at § 78(o).

48. 17 C.F.R. § 242.301 (2005).

how the SROs operate. In light of this, I would not expect in the short term for the staff to be recommending further significant governance changes at the NYSE.

QUESTION: There was a proposal last year in front of Congress to limit the ability of the state regulators, their enforcement ability.⁴⁹ It passed, I believe, the House and had a fair amount of support in Congress to limit their authority over the securities laws. I am curious what the panelists' thoughts are on whether the states should stay involved or not.

MR. PELOSO: It sounds like it is right up your alley.

MR. LACKRITZ: You are right. There was a proposal that Congressman Baker put forward as part of SEC enforcement legislation that was going to try to preclude individual states from using enforcement actions to regulate the industry within their states. It would try to preempt states from regulating the industry, as opposed to enforcing anti-fraud statutes or enforcing their law.

There were a lot of mischaracterizations that flew around about what this language actually did. It was not designed in any way, shape, or form to limit their enforcement power or their enforcement ability, and yet that is the way it was pitched by Attorney General Spitzer and some of the opponents of the legislation. It became sufficiently controversial that Congressman Baker dropped it out of his SEC enforcement legislation. The bill went forward and the Committee reported it without the provision about curbing the states' ability to regulate nationally.

From the standpoint of the industry, it is a bit ludicrous to think—you know, you think about Gulliver's Travels and Gulliver being tied down by a bunch of Lilliputians—that if you are competing globally, the notion of fifty different states being able to regulate your business obviously is not a particularly effective or efficient way to regulate.

So from our perspective it makes a great deal of sense to have the SEC as our primary preeminent national regulator setting uniform national standards. At the same time, the states have an important role as enforcers of the regulations and laws.

So the question is: how can you craft something in a way that does not impinge on the states' enforcement ability but also does not allow them to create regulations in the course of either settling an enforcement

49. Sec. Fraud Deterrence and Restitution Act of 2003, H.R. 2179 (2003).

dispute or regulating on their own? That is what we were trying to do. Congressman Baker, I think, was trying to do something similar.

MR. BECKER: That touches on an issue that haunts this other debate, which is rule-making by enforcement. You would not quite have, I think, the same pressures on this preemption side if states were using enforcement actions to address someone who runs away with the money or someone who recommends unsuitable securities. But when, instead, what you are doing is in the name of settling a case, creating what are in effect industry-wide rules, I think it puts more pressure on the preemption analysis.

MR. PELOSO: On behalf of the School and the Center, I would like to thank our distinguished panel for traveling up here to be with us and expressing the views that you have. Thank you very much.