

discipline members for violating its rules and the federal securities laws.

SROs play an increasingly important role in the regulation of financial services in the United States. SROs participate with us in overseeing the public securities markets, including broker-dealers.⁶³ They also oversee the municipal bond market,⁶⁴ and the system of clearance and settlement of securities trades.⁶⁵ An SRO also plays an important part in the oversight of the futures markets, including futures commissions merchants, commodity pool operators, and commodity trading advisers.⁶⁶ In the Sarbanes-Oxley Act, Congress affirmed the role of private sector regulatory organizations by establishing the Public Company Accounting Oversight Board, which is charged with overseeing the audit of public companies.⁶⁷

United States Supreme Court Justice Stewart stated that the purpose of the provisions of the Exchange Act creating SROs was "to delegate governmental power to working institutions which would undertake, at their own initiative, to enforce compliance with ethical as well as legal standards in a complex and changing industry."⁶⁸ Our experience with SROs suggests that this delegation of authority can have many advantages:

⁶³ National Securities Exchanges register with us as SROs pursuant to Section 6 of the Exchange Act [15 U.S.C. 78f]. Currently, there are nine active securities exchanges. Section 15A of the Exchange Act [15 U.S.C. 78o-3] authorizes us to register one or more national securities associations to regulate the activities of member broker-dealers. NASD is the only national securities association currently registered under this section. Section 15A was added in 1938 to regulate the activities of brokers who traded securities of issuers that were not listed on the exchanges. Maloney Act, Pub. L. No. 75-719, 52 Stat. 1070 (1938).

⁶⁴ The Securities Amendments Act of 1975 [Pub. L. No. 94-29, 87 Stat. 97 (1975)] added section 15B to the Exchange Act [15 U.S.C. 78o-4], which directed the Commission to establish the Municipal Securities Rulemaking Board ("MSRB"). Unlike the other SROs, the MSRB was created by Congress solely to write rules governing the municipal securities market; it is not a membership organization and does not have authority to discipline its members.

⁶⁵ Clearing agencies register with us pursuant to Section 17A(b) of the Exchange Act [15 U.S.C. 78q-1(b)]. Currently, there are 13 clearing agencies registered with us.

⁶⁶ See Commodity Futures Trading Commission ("CFTC") Rule 170.15 [17 CFR 170.15] (membership in a registered futures association mandatory) and National Futures Association ("NFA") Bylaw 1101 (membership in the NFA mandatory for any registered party that transacts futures business with the public). The NFA performs various functions for the CFTC, including processing of applications for registration and conducting proceedings to deny, condition, suspend, restrict or revoke the registration of persons registered with the CFTC.

⁶⁷ Section 101 of the Sarbanes-Oxley Act, *supra* note 22.

⁶⁸ *Silver v. New York Stock Exchange*, 373 U.S. 341, 371 (1963) (Stewart, J., dissenting).

SROs can marshal resources not available to the Commission and can have greater access to industry expertise. They can act more nimbly than a government agency, which is subject to significant personnel, contracting, and procedural requirements. An SRO can require its members to adhere to higher standards of ethical behavior than we can require under the securities laws. Moreover, industry leaders who participate in the regulatory process acquire a greater sense of their stake in the process.⁶⁹

Proposals to create SROs for funds or investment advisers have been considered by Congress, the Commission, and members of the investment management industry in past years. In 1983, we requested comment on the concept of designating an "inspection-only" SRO for funds.⁷⁰ And in 1989, we submitted legislation to Congress requesting authority to designate one or more SROs for investment advisers.⁷¹ Both initiatives

⁶⁹ See Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 88-95, pt. 4, at 722 (1963) ("Special Study").

⁷⁰ Investment Company Act Release No. 13044, *supra* note 59.

⁷¹ The legislation was introduced as S. 1410 and H.R. 3054, 101st Cong. (1989). Consideration by the Commission of an SRO for investment advisers appears to have first begun in 1963 when our Special Study of the Securities Markets recommended that membership in an SRO should be required of all registered investment advisers. Special Study, *supra* note 69, pt. 1, at 158-59. In 1976, the Commission asked Congress for the authority to conduct a formal study of the feasibility of establishing one or more SROs for investment advisers. S. Rep. No. 94-910, at 10 (1976).

In 1986, the NASD conducted a pilot program to determine the feasibility of examining the investment advisory activities of its members who were also registered as investment advisers. See Staff of the Securities and Exchange Commission, *Report on Financial Planners to House Comm. on Energy and Commerce, Subcomm. on Telecommunications and Finance*, at 118-23 (Feb. 1988). In 1993, the House of Representatives passed a bill that, among other things, would have amended the Advisers Act to authorize the creation of an "inspection-only" SRO for investment advisers. H.R. 578, 103rd Cong. (1993).

Industry organizations and their members and commenters have, from time-to-time, also called for the creation of an SRO for investment advisers. See Note, *Financial Planning: Is It Time for a Self-Regulatory Organization?*, 53 Brook. L. Rev. 143 (1987); Charles Lefkowitz, *The World of Financial Planning: Why an SRO Makes Sense*, 87 Best's Review, Dec. 1986, at 32. In 1985, the International Association of Financial Planners proposed the creation of an SRO for financial planners based on the NASD model. See Letter from Hubert L. Harris, Executive Director of the International Association for Financial Planning, to Kathryn B. McGrath, Director of the Commission's Division of Investment Management (June 19, 1985) (transmitting summary of proposal for financial planner SRO adopted by the Association's board of directors) (available in File No. S7-03-03). Not all industry participants have supported the creation of an SRO. See David Tittsworth, Executive Director,

reflected the concern of the Commission that our resources were inadequate to address the growth of investment advisers and funds.⁷² Any SRO would be subject to the pervasive oversight of the Commission. We would examine its activities, require it to keep records, and approve its rules only if we conclude that they further the goals of the federal securities laws. Disciplinary actions could be appealed to the Commission. We would expect to be vigilant in preventing SRO rules that impose a burden on competition not necessary to further a regulatory purpose. Our staff would continue to examine the activities of funds and advisers, both to ensure adequate examination coverage and to provide oversight of the SRO examination program.

We request comment on whether one or more SROs should be established for funds and/or investment advisers. Should the SROs be limited in their authority? For example, should they be limited to conducting examinations? How should the activities of an SRO be financed?⁷³

4. Fidelity Bonding Requirement for Advisers

Another means to privatize some of the compliance function would be to require investment advisers to obtain fidelity bonds from insurance companies. Fidelity bonds provide a source of compensation for advisory clients who are victims of fraud or embezzlement by advisory personnel. They result in additional oversight of advisers by insurance companies, which are unwilling to issue bonds to advisers that place their assets at risk by having poor controls or that hire employees with criminal or poor disciplinary records. The cost of that oversight is reflected in the premiums charged for the bond. High-risk advisers would be denied bonds or would be charged

Investment Counsel Association of America, Statement for our Roundtable on Investment Adviser Regulatory Issues (May 23, 2000) ("We continue to oppose the creation of a self-regulatory organization for the advisory profession * * * [which] is unwarranted and would impose a new layer of cost and bureaucracy on the profession.") (available at: <http://www.sec.gov/rules/other/f4-433/tittsw01.htm>). Others object to being regulated by a particular SRO. See Aaron Luccetti, *NASD's Push to Extend Its Reach Spurs Anger of Investment Advisers*, Wall St. J., Nov. 12, 1998, at C1.

⁷² We issued the 1983 concept release out of a concern, in part, that the growth in money market funds (which were then a novel type of fund) would outstrip our examination resources. In 1983, money market funds had \$179 million of assets under management. Today, they have nearly \$2.3 trillion of assets. Investment Company Institute, *2002 Mutual Fund Fact Book* 86.

⁷³ Other financial SROs, for example, are financed by fees imposed on members and users of their services rather than by public funds.