

Regulation of the Securities Markets

Overview

“Today the Commission is at a crossroads in its oversight of the U.S. markets, and is faced with a range of decisions that will fundamentally impact the structure of our markets for years to come. Significant issues include: what it means to be an exchange; the self-regulatory model of market supervision; access to markets; and the proper regulatory framework for market data.”

Annette Nazareth, Director
Division of Market Regulation

146 staff in the Division of Market Regulation and 11 staff in the Office of Filings and Information Services:

- Supervised roughly 7,900 registered broker-dealers with approximately 94,900 branch offices and 664,100 registered representatives.
- Reviewed and approved the proposed rule changes of 13 registered exchanges, 2 securities associations, and 11 registered clearing agencies.
- Prepared for the Commission’s consideration rules and rule amendments under the Securities Exchange Act of 1934 (Exchange Act).
- Responded to 393 requests from securities professionals, issuers, and other market participants for exemptive relief or interpretive or no-action advice.
- Advised on significant enforcement actions and task forces.

Key Results

Issue	Result
Analyst Conflicts of Interest	<p>The Commission adopted Regulation Analyst Certification (Regulation AC), which requires analysts to certify the truthfulness of their views and to disclose whether they have received compensation related to their views and recommendations expressed in research reports and public appearances.²⁸ We also approved, pursuant to the Sarbanes-Oxley Act of 2002, comprehensive self-regulatory organization (SRO) rules governing analysts' conflicts.²⁹</p>
Listed Company Corporate Governance	<p>The Commission approved the New York Stock Exchange (NYSE) and Nasdaq proposals requiring shareholders to approve all equity compensation plans, including those involving officers and directors, subject to limited exceptions.³⁰</p>
Bank "Dealer" Rules	<p>The Commission adopted rules implementing the statutory exceptions for banks from the definition of "dealer," under the Gramm-Leach-Bliley Act (GLBA).³¹</p>
Mutual Fund Breakpoints	<p>The Division of Market Regulation partnered with the Office of Compliance, Inspections & Examinations (OCIE) and the National Association of Securities Dealers (NASD) to formulate a comprehensive plan to address breakpoint overcharges by broker-dealers that sold front-end load mutual funds, which should result in a significant number of refunds to customers.³²</p>

Issue	Result
Rating Agencies	The Commission issued a report on the “Role and Function of Credit Rating Agencies in the Operation of the Securities Markets” and issued a concept release regarding “Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws.” ³³

Main Activities	Fiscal 2003	Fiscal 2002	% Change
SRO Proposed Rule Changes (# Closed)	813	717	+13%
SEC Rulemaking and Interpretive Proposals	13	19	-32%
Interpretive, Exemptive, and No-Action Request Letters (# Closed)	393	481	-18%
Telephone/Internet Inquiries for Guidance	18,000	16,000	+13%
Analysis of Proposed Enforcement Actions	565	536	+5%

Securities Markets, Trading, and Significant Regulatory Issues

Analyst Conflicts of Interest

On February 6, 2003, the Commission adopted Regulation AC, which requires that broker-dealers and associated persons obtain research analyst certifications regarding the truthfulness of their views and whether they have received any compensation related to their specific recommendations or views.³⁴ By requiring certifications of core standards of good conduct, Regulation AC should help promote the integrity of both research reports and public appearances by research analysts and also strengthen investor confidence in analyst recommendations.

On July 29, 2003, the Commission approved proposed rule changes filed by the NYSE and NASD designed to fulfill the mandates of Section 501 of the Sarbanes-Oxley Act.³⁵ The new rules address analyst conflicts by, among other things: (1) separating research analyst compensation from investment banking influence; (2) prohibiting analysts from participating in pitches or other communications for the purpose of soliciting investment banking business; and (3) prohibiting firms from retaliating against analysts for expressing views adverse to the firm’s investment banking business.

Strengthening Financial Sector Resilience

The Commission continued to work with the trading markets and market participants to improve their resilience in the post-September 11 environment. In particular, the Commission issued a policy statement that sets forth general business continuity sound practices (including a next-day resumption goal) that should be implemented by the trading markets.³⁶ Additionally,

the Commission, along with the Federal Reserve Board and the Office of the Comptroller of the Currency, issued an “Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System,” which identified specific business continuity objectives for all financial firms and sound practices to ensure the resilience of the U.S. financial system.³⁷

Options Intermarket Linkage Plan

In 2003, the Commission approved several initiatives designed to more fully integrate the options market into the national market system. Among these initiatives, the Commission approved proposals to allow the Options Pricing Reporting Authority to calculate and disseminate a consolidated best bid or offer for the options market³⁸ and to permit the full implementation of the

Options Intermarket Linkage Plan.³⁹ The Commission also approved proposals by the Chicago Board Options Exchange, Inc.⁴⁰ and the Pacific Exchange, Inc.⁴¹ designed to enhance intramarket competition at these exchanges by providing all market makers in a particular trading crowd the opportunity to automatically update their individual quotes in all series in a given options class.

Liquidity Quote Service

The Commission approved the NYSE’s Liquidity Quote Service, which permits the Exchange to disseminate quotes that are at a specific price interval below the best bid or at a specific price interval above the best offer and reflect aggregated trading interest on

the Exchange.⁴² Specifically, liquidity quotes could include orders on the specialist’s book, trading interest of brokers in the trading crowd, or the specialist’s interest, and are intended to show additional depth in the market for particular stocks.

National Do-Not-Call Registry

In light of amendments to the Federal Trade Commission’s Telemarketing Sales Rule and its national Do-Not-Call Registry, the Division

worked with the NASD to conform its telemarketing rules to these more stringent federal standards.⁴³

Commodities Futures Modernization Act

The Commission continued to implement the Commodities Futures Modernization Act in 2003. In November 2002, the Commission approved rules proposed by those national securities exchanges that are registered to trade security futures (Chicago Mercantile Exchange, NQLX, and OneChicago) that established margin requirements for security futures, which facilitated the

launch of security futures trading.⁴⁴ Specifically, the exchanges' rules set minimum initial and maintenance margin levels for security futures, adopted modified margin levels on strategy-based offsetting positions involving security futures, and established standards under which the exchanges' market makers can receive good faith margin treatment for their security futures positions.

Confirmation Letters

In September 2003, the Division granted a limited exemption to Nasdaq from the contra-party disclosure requirement of the Exchange Act's customer confirmation rule (Rule 10b-10) for NASD members using SuperMontage's post-trade anonymity feature to execute trades on behalf of customers.⁴⁵

In August 2003, the Division issued a limited exemption from Rule 10b-10 to Goldman, Sachs & Co., permitting it and its affiliated broker-dealers, upon the request of clients who have granted Goldman Sachs investment discretion over their accounts, to send these clients monthly statements in lieu of trade-by-trade confirmations of securities transactions.⁴⁶

Anti-Money Laundering/Patriot Act

As part of the U.S. delegation to the Financial Action Task Force on Money Laundering (FATF), an inter-governmental anti-money laundering organization, the staff helped revise the "Forty Recommendations on Money Laundering" to strengthen international efforts to combat money laundering and terrorist financing.⁴⁷

Together with the SROs and other federal regulators, the staff worked to ensure that

regulated entities implement vigorous compliance programs. In 2003, we contributed to broad-based interagency work to implement the USA PATRIOT Act, including rules affecting broker-dealers, mutual funds, and investment advisers.⁴⁸ On May 9, 2003, the Commission and the U.S. Department of the Treasury jointly issued final rules that require broker-dealers to implement reasonable procedures to verify

the identity of any person seeking to open an account, to the extent reasonable and practicable; to maintain records of the information used to verify the person's identity;

and to determine whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided to broker-dealers by any government agency.⁴⁹

Arbitration and Mediation

Division of Market Regulation staff collaborated with the Office of General Counsel (OGC) and the U.S. Office of the Solicitor General on the Commission's brief in *Howsam v. Dean Witter Reynolds*,⁵⁰ which addressed whether arbitrators or courts should resolve questions under an SRO time-limitation rule. The U.S. Supreme Court agreed with the Commission's position that arbitrators should resolve disputes under the applicable eligibility rule. The staff also formulated the

Commission's response to recently enacted California laws that affected arbitrations conducted within that state. The Division assisted OGC in preparing *amicus* briefs arguing that the California laws are preempted by federal law,⁵¹ and also worked closely with the SROs on implementing rule changes to mitigate the effect of new California laws on their arbitration programs.⁵²

Credit Rating Agencies

The Commission engaged in a number of initiatives relating to credit rating agencies. On January 24, 2003, the Commission submitted to the President and Congress a report on the role and function of credit rating agencies in the operation of the securities markets⁵³ in response to the congressional directive contained in Section 702 of the Sarbanes-Oxley Act of 2002.⁵⁴ To assist in the preparation of the report, the Commission held full-day public hearings on November 15 and 21,

2002.⁵⁵ The Commission also published a concept release on June 4, 2003,⁵⁶ seeking comment on a number of issues relating to credit rating agencies, including whether credit ratings should continue to be used for regulatory purposes under the federal securities laws. Further, on February 24, 2003, the Division of Market Regulation recognized Dominion Bond Rating Service Limited as a nationally recognized statistical rating organization.⁵⁷

Net Capital Developments

On August 1, 2003, the Commission adopted amendments to the broker-dealer reporting requirements to allow a broker-dealer to send each of its customers certain net capital information only twice a year (instead of sending its full balance sheet and certain other financial information) if it makes its balance sheet available to its customers on the Internet and provides its customers with a toll-free number they can call to obtain a paper copy of the balance sheet (in case the customer does not have access to the Internet).⁵⁸

On July 11, 2003, the Division issued a letter concerning the application of the financial responsibility rules when a third party agrees to assume responsibility for payment of a broker-dealer's expenses.⁵⁹ Such expense-sharing agreements could be improperly used as a basis for not recording expenses and liabilities on the broker-dealer's books and records. For purposes of broker-dealer recordkeeping requirements and the net capital rule, the letter set out the Division's view regarding the proper recording of broker-dealer expenses and liabilities, the proper treatment of capital contributions and withdrawals, and requirements for access to records, including those of unregistered entities.

On March 11, 2003, the Commission adopted amendments to the broker-

dealer customer protection rule to allow the Commission to expand the categories of assets a broker-dealer could use as collateral when borrowing securities from customers.⁶⁰ In addition, the Commission issued an order, pursuant to those rules, to allow broker-dealers to use many categories of securities they were not previously allowed to use as collateral when borrowing securities from customers.⁶¹ The Commission also delegated authority to the Director, Division of Market Regulation, to expand the categories of assets a broker-dealer could use as collateral when borrowing securities from customers in the future.⁶²

On May 22, 2003, the Commission published guidance to clarify certain issues relating to the broker-dealer books and records rules,⁶³ some of which were raised as a result of the amendments to those rules that were adopted by the Commission on October 26, 2001.⁶⁴

On May 7, 2003, the Commission publicly clarified its views on the operation of its rule permitting broker-dealers to store required records in electronic form. Specifically, the Commission stated that broker-dealers may employ a storage system that prevents alteration or erasure of records for their required retention period.⁶⁵

Risk Assessment Program

The Commission staff monitored the risk management capacities of the largest independent broker-dealers. The

staff also conducted a comprehensive review of the firms' internal management and aggregate market risk and credit risk profiles.

Automation Review Policy Program

Since the events of September 11th, our staff has worked to improve the ability of the markets, clearing organizations, and broker-dealers to respond to the threats they face in today's environment. These initiatives include updates in contingency plans, expanded audits of critical systems and communications lines, and

improvements in back-up facilities for core functions. In 2003, the staff performed 8 on-site inspections and issued 45 recommendations for improvements in information technology resources. In addition, staff attended 12 annual technology briefings presented by the exchanges and tracked systems problems.

Outlook for 2004

Our main objectives are to:

- Focus on the structure of the U.S. equities and options markets. Among the issues that we expect to consider are: (1) access to markets; (2) market data; (3) the self-regulatory model; and (4) the function of an exchange in the modern era.
- Focus on final implementation of the options exchanges' initiatives to create a consolidated order audit trail for surveillance purposes and to reform the Options Price Reporting Authority.
- Prepare for the Commission's consideration final rules, which were proposed on October 24, 2003, to establish two separate voluntary regulatory frameworks for supervising broker-dealers and their affiliates on a consolidated basis. If adopted, one proposal would establish an alternative method for broker-dealers that are part of a holding company that manages risks on a group-wide basis and whose holding company consents to group-wide Commission supervision to compute certain net capital charges. The second proposal would implement new Exchange

- Act provisions that create a statutory structure for the consolidated supervision of holding companies of broker-dealers and their affiliates.
- Continue work on initiatives designed to enhance market integrity and investor confidence, including:
 - o amendment of the rules governing short selling;
 - o adoption of final amendments to the rules governing issuer repurchases;
 - o implementation of the requirements of the Sarbanes-Oxley Act, including its statutory disqualifications provisions;
 - o development of the appropriate regulatory approach to credit rating agencies;
 - o continuation of our effort to strengthen and improve the operations of the U.S. clearance and settlement system; and
 - o development of an effective consolidated supervision program for broker-dealers and affiliates.
 - Prepare for the Commission's consideration proposed new or revised bank broker rules, mutual fund confirmation rules, penny stock rules, amendments to Form BD, and a registration rule for banks effecting transactions in security futures.