



# Self-regulation in the financial sector – status quo and future outlook

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*Self-regulation in the financial sector – status quo and future outlook*

April 2009

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## **Abstract**

*The purpose of this paper is to explore the intervention of private parties in the regulation of financial products and services. Among the most prominent examples of this phenomenon are the self-regulatory organizations that benefit from an official recognition under the rules applicable in a number of jurisdictions harboring major financial centers. In the first part of this contribution, the author shall review the successive steps of the rule making process (establishment of the content of the rule, enactment, monitoring and enforcement of the rule) in order to examine the timing and the extent of intervention of private parties. This first – descriptive – part will be illustrated by examples drawn from the U.S. and the Swiss regulatory frameworks.*

*The second part of this text is an attempt to demonstrate that self-regulation – to the extent it is embedded in appropriate public legislation – constitutes a highly useful tool in the context of the ongoing reorganization of the regulatory and supervisory structures for financial markets, both on a national and an international basis. In this second part of the contribution, it is argued that self-regulatory frameworks should play a role in the new regulatory framework that will emerge from the ongoing financial crisis. In this context, this contribution sets out a number of key issues that ought to be taken into consideration in order to maximize the benefits of self-regulation, whilst minimizing its shortcomings.*

## Acronyms and abbreviations

<b>1934 Act</b>	Securities and Exchange Act of June 6, 1934
<b>AMLA</b>	Swiss Anti-Money Laundering Act of October 10, 1997
<b>BA</b>	Swiss Federal Banking Act of November 8, 1934
<b>CRA</b>	Credit rating agency
<b>FINMA</b>	Swiss Financial Market Supervisory Authority
<b>FINRA</b>	Financial Industry Regulatory Authority
<b>NASD</b>	National Securities Dealers Association
<b>NAV</b>	Net asset value
<b>NRSRO</b>	Nationally Recognized Statistical Rating Organization
<b>NYSE</b>	New York Stock Exchange
<b>SAAM</b>	Swiss Association of Asset Managers
<b>SBA</b>	Swiss Bankers' Association
<b>SEC</b>	U.S. Securities and Exchange Commission
<b>SFBC</b>	Swiss Federal Banking Commission (replaced as of January 1 <sup>st</sup> , 2009 by the FINMA)
<b>SIA</b>	Securities Industry Association
<b>SRO</b>	Self-regulatory organization
<b>Treasury Blueprint</b>	Blueprint for a Modernized Financial Regulatory Structure released by the U.S. Treasury Department on March 31, 2007

*“[The 1934 Act lets] the exchanges take the leadership with government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well-oiled, cleaned, and ready for use, but with a hope it would never have to be used.”*

William O. Douglas, *Democracy and Finance* 82 (Allen ed., 1940)

## **1. Introduction**

The purpose of this paper is to explore different models of self-regulation pursuant to which private parties are associated to the regulation of financial markets and to examine the future of self-regulation in the regulatory frameworks that will emerge from the financial crisis. This paper is divided into two parts.

In the first – descriptive – part of this paper, we shall review the successive stages of the regulatory process – starting from the creation of the rule and continuing until its enforcement – and examine how and to what extent private parties are allowed to intervene in this process. Practical examples, drawn from the U.S. and the Swiss regulatory frameworks<sup>1</sup>, will illustrate the regulatory impact of private entities in these two jurisdictions.

The second part of this paper shall have a forward-looking approach and shall constitute an attempt to identify a series of key structural requirements whose fulfillment should lead to a maximization of the rewards of self-regulatory frameworks whilst mitigating their shortcomings. The identification of these requirements could bear some relevance in the context of the ongoing overhaul of the regulatory frameworks governing financial markets, on a national, continental and international basis. As will be explained in more detail hereinafter, it is the author’s view that the financial crisis was not primarily caused by self-regulation, nor has the financial crisis rendered self-regulation obsolete or outdated. To the contrary, self-regulation represents a

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<sup>1</sup> The special emphasis placed on these two jurisdictions derives from the fact that self-regulation of the financial industry enjoys a long-standing tradition both in the U.S. and in Switzerland.

regulatory tool that, if adequately implemented, should be in line with the current *momentum* towards a more stringent regulation of the financial industry.

## 2. Status quo

As a starting point, it is worthwhile summarizing the factors that ought to be taken into consideration when designing a regulatory structure for the financial industry<sup>2</sup>:

- Protection of the general public (including the investors and the consumers);
- Elimination of negative externalities deriving from failures of financial institutions;
- Preservation and enhancement of fair competition;
- Promotion of an efficient regulation on a cost/benefit basis;
- Advancement of redistributive goals<sup>3</sup>.

Both public regulation and self-regulation can advance these fundamental goals. In most cases, there is however more than a purely binary choice between a public and a private regulatory response. To the contrary, a private ordering system such as self-regulation, on the one hand, and public regulation, on the other hand, should rather be seen as two sides of a broad *spectrum*

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<sup>2</sup> See *inter alia* HOWELL E. JACKSON, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 *Yale Journal on Regulation* 253, 258 (2007) and SIA (SECURITIES INDUSTRY ASSOCIATION), *White Paper: Reinventing self-regulation* (October 14, 2003).

<sup>3</sup> HOWELL E. JACKSON refers for instance to regulations obliging banks to lend to particular borrowers in order to promote economic development or to cross-subsidization obligations between several insurance pools (JACKSON, 259).

within which several regulatory approaches can be classified in accordance with the level of public intervention<sup>4</sup>.

In light of the above, it is difficult to give a uniform definition of the term “*self-regulation*”. In its purest form, self-regulation could be described as a form of behavioral control that a private group imposes upon its members, the latter accepting to subject themselves thereto voluntarily, *i.e.* without any intervention of a public authority<sup>5</sup>. The self-regulatory rules emanate from a web of verbal or written arrangements that set out the behaviors that are deemed admissible within the group. Even though these contractual arrangements can be regrouped into a code of conduct that seems to be of a general and abstract nature, they still find their roots in a private transaction, and not in a decision made by a public authority.

The main advantage of this approach is to leverage the industry’s expertise by shifting at least part of the regulatory burden from the public authority to the industry<sup>6</sup>. The self-regulatory approach also generates rules that are better tailored to the characteristics of the relevant activity and that enjoy a higher degree of acceptance by the rules’ addressees (which in turn should lead to a greater level of compliance<sup>7</sup>). This type of private ordering also has special appeal in the

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<sup>4</sup> STEVEN L. SCHWARCZ, *Private Ordering*, 97 *Northwestern University Law Review* 319, 324 (2002).

<sup>5</sup> ZAYÈNNE D. VAN HEESSEN-LACLÉ & ANNE C. MEUWESE, *The Legal Framework for Self-Regulation in the Netherlands*, 3 *Utrecht Law Review*, 117 (2007).

<sup>6</sup> KATHERINE A. VALASEK, *Winning the jackpot: a framework for successful international regulation of online gambling and the value of the self-regulating entities*, 2007 *Michigan State Law Review*, 777 (2007).

<sup>7</sup> Self-regulation has the advantage of ensuring that the persons and entities that are subject to regulation become active participants in the regulatory process. By providing an opportunity to participate in the regulatory process, self-regulation may render the members of the industry more aware of the goals of regulation and their own stake in them while at the same time making the imposition of regulatory controls more palatable because those regulations are more workable (SIA, 7).



international context<sup>8</sup> because, by allocating regulatory power to private entities, it might overcome the sovereignty issues that stymie the cooperation among States<sup>9</sup>.

The shortcomings of self-regulation are the flip sides of its advantages. When rules are designed by the entities whose business activities are supposed to be regulated, conflicts of interests emerge. In addition, if self-regulatory rules only apply to entities that have actually subscribed to these rules in the course of a private transaction, these same entities might actually escape from complying with their duties<sup>10</sup> by terminating the contract or relinquishing their membership in the relevant SRO<sup>11</sup>.

After this short introduction, we shall now delve deeper into our analysis by examining the nature of the intervention of private parties at various stages of the regulatory process, starting with the definition of the content of the rule.

## **2.1 Content of the rule**

### *2.1.1 Concept*

Firstly, private entities may play a role in shaping the content of a rule when lawmakers or regulators initiate a consultation process by releasing a draft version of a rule and inviting the economic actors possibly falling within the ambit of this rule (or otherwise concerned thereby) to

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<sup>8</sup> JEAN-BAPTISTE ZUFFEREY, (*Dé-, re-, sur-, auto-, co-, inter,-*) *réglementation en matière bancaire et financière : thèses pour un état des lieux en droit suisse*, 123 *Revue de droit suisse* 479, 590 (2004).

<sup>9</sup> As regards the fight against money-laundering, a good example of an international self-regulatory initiative is the Wolfsberg Group an association of eleven global banks, which aims to develop financial services industry standards, and related products, for know-your-customer, anti-money laundering and counter-terrorist financing policies. See WOLFSBERG GROUP, *The Wolfsberg Trade Finance Principles* (2008).

<sup>10</sup> ARNOLD MARTI, *Selbstregulierung anstelle staatlicher Gesetzgebung*, *Schweizerisches Zentralblatt für Staats- und Verwaltungsrecht (ZBl)* 561, 564 (2000).

<sup>11</sup> Given its evident shortcomings, this purest form of self-regulation is only rarely implemented in practice: mechanisms are generally put in place with a view to extending the scope of application of the rules beyond the sole SRO members and to avoiding that rule infringement remains unsanctioned.

comment thereon. Most financial markets regulators – such as the SEC<sup>12</sup> or the FINMA<sup>13</sup> – routinely engage in such a dialogue with market participants. The comments and criticisms gathered during this consultation process frequently have a significant impact on the rule that is finally adopted<sup>14</sup> by the regulator. That being said, such a process cannot be characterized as “self-regulation” inasmuch as the creation, the enactment, the monitoring and the enforcement of the rule all remain entirely in the hands of the public authority<sup>15</sup>.

There are however situations in which private parties play a more direct role in shaping the content of the rule. This is primarily the case when a rule mandates market participants to comply with a behavioral standard that the public regulator elects to define by reference to privately-set standards. The public authority thus refrains from defining itself the applicable standard, but prefers to rely on the standards that are supplied by private entities and that are commonly used throughout the industry.

The advantages of such an approach are plentiful. The privately-set standards already bear the seal of approval of the industry and thus benefit from a high level of acceptance among market participants. These standards are also characterized by their flexibility; they can be tailored to varying market or economic conditions in an unbureaucratic or unpoliticized manner. The implementation of such a rule should also be significantly less costly on both sides of the

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<sup>12</sup> All the rules proposed by the SEC are listed on the authority’s website: <http://www.sec.gov/rules/proposed.shtml> (last visited on March 9, 2009).

<sup>13</sup> The draft rules released by the FINMA can be downloaded from the following website: <http://www.finma.ch/e/regulierung/anhoeerungen/pages/default.aspx> (last visited on March 9, 2009).

<sup>14</sup> An example drawn from the regulation of CRAs in the U.S. can help illustrate this point: the SEC chose to shelve its plans for requiring CRAs to differentiate the ratings they issue on structured products from the ratings issued on other securities through the use of different symbols in light of the public outcry triggered by the release of the SEC’s proposed rule on this topic. See SECURITIES AND EXCHANGE COMMISSION, Proposed Rules for Nationally Recognized Statistical Rating Organizations, Release n. 34-57967 118 (2008).

<sup>15</sup> ZUFFEREY, 593.

regulatory equation. Firstly, the regulated entity is not obliged to incur the costs deriving from the need to comply with an unfamiliar – or maybe inappropriate – standard. Secondly, the regulator does not have to engage in the costly process of crafting a standard since this process is outsourced to the (private) standard-setter<sup>16</sup>. From the viewpoint of the regulator, this type of private ordering brings together experts on a *pro bono* basis, effectively saving the public regulator from the costs that would have to be incurred to assemble such expertise.

Finally, unlike other types of self-regulation that will be further discussed below, the democratic legitimacy of rules generated in such a way can hardly be questioned because the enactment of a privately-originated rule into law implies that this rule has been scrutinized and approved in the course of the lawmaking process<sup>17</sup>.

This regulatory approach however also carries important pitfalls. Because the standard-setting and standard-adjustment process rests in private hands, the (commercial) interests of the standard setter may prevail over the interest of the public. This conflict of interests can be mitigated by holding the private standard-setters accountable for their actions and their omissions under a public supervisory framework<sup>18</sup>. Another technique for mitigating this risk is to refer, in the statute or the regulation, to standards set out by two or more private entities (*e.g.* “all market participants must comply with the highest standard established by Private Standard-Setter X and Private Standard-Setter Y”).

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<sup>16</sup> One should not overlook, however, that the public authority will still need to incur costs for the purpose of evaluating the adequacy of the private standard to be enshrined into public law. In all likelihood, these costs are less than those that would need to be incurred for creating a new standard from scratch.

<sup>17</sup> SCHWARCZ, 325.

<sup>18</sup> The costs of the supervision of the standard-setter needs to be taken into account in the costs/benefit analysis that led in the first place to the choice of the self-regulatory path.

Another – albeit *prima facie* less visible – handicap of this regulatory approach is that it may lead to excessive reliance on the privately-set standards that were selected by the regulator only to serve a specific purpose. Following their embedding into the statutory framework, the standards could be relied upon excessively by market participants as a result of a mistaken assumption that the statutory reference is to be construed as an official stamp of approval for the relevant standard.

### 2.1.2 Example

An example of the regulatory technique described under Section 2.1.1 above can be found in the SEC Rule 2a-7<sup>19</sup> by which the SEC regulates money market funds. Whilst exempting money markets from certain regulatory requirements otherwise applicable under the Investment Company Act, the SEC Rule 2a-7 contains maturity, quality and diversification requirements whose purpose is to minimize the deviation between a money market fund’s stabilized share price and the market value of its portfolio. As regards the investments that are admissible for money market funds, the SEC Rule 2a-7 (a) (10) (i) limits a money market fund’s portfolio investments to securities that have “received a rating from the Requisite NRSROs [*i.e.* CRAs] in one of the two highest short-term rating categories”<sup>20</sup>.

The statutory definition of eligible investment for money market funds in the U.S. triggers two comments:

- Firstly, the SEC did not refer to standards issued by unregulated private entities, but by entities, the CRAs, that were subject to the SEC’s supervision<sup>21</sup>. One could have

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<sup>19</sup> 17 CFR 270.2a-7

<sup>20</sup> 17 CFR 270.2a-7 (a) (10) (definition of Eligible Security)

<sup>21</sup> In the U.S., CRAs are regulated by the SEC under the Credit Rating Agency Reform Act of 2006 (109 P.L. 291; 120 Stat. 1327).

expected that this supervision would have led the SEC to oversee the standards set by the CRAs, but the outbreak of the financial crisis uncovered the serious deficiencies that riddled the credit rating industry<sup>22</sup>.

- Secondly, the SEC Rule 2a-7 (a) (10) (i) mandates that the eligible investment be rated in a top category by at least two CRAs<sup>23</sup>. The purpose of this set-up was to broaden the foundation on which the standard is based and thus mitigate the risks deriving from a standard set by a single private actor.

It is worth indicating that, whilst the regulatory technique chosen by the SEC obviously had some appeal at the time it was enacted, the CRAs' failures led the SEC to question whether or not credit ratings still constitute an appropriate benchmark for the regulation of the investments made by money market funds. On July 1<sup>st</sup>, 2008, the SEC eventually suggested to remove all references to CRAs from Rule 2a-7<sup>24</sup>. Following the numerous criticisms voiced during the consultation process<sup>25</sup>, the SEC did not pursue this regulatory avenue any further for the time being.

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<sup>22</sup> As an illustration, see the CRAs' failures set out in *Credit Rating Agencies and the Financial Crisis*, House of Representatives, Committee on Oversight and Government Reform (October 22, 2008), available online at: <http://oversight.house.gov/documents/20081023162631.pdf>.

<sup>23</sup> 17 CFR 270.2a-7 para. 21 (i)

<sup>24</sup> SEC, Proposed Rules for Nationally Recognized Statistical Rating Organizations, July 1<sup>st</sup>, 2008. In a nutshell, under the proposed amendments, a security would be an Eligible Security if the board of directors of the money market fund determines that it presents minimal credit risks, which determination must be based on factors pertaining to credit quality and the issuer's ability to meet its short-term financial obligations.

<sup>25</sup> The SEC's proposal drew harsh criticism from the industry, most participants in the consultation process arguing that the removal of the references to CRAs in the SEC rules would destabilize markets and may ultimately lead to less protection for investors (the comments on the proposal are available on the SEC's website: <http://www.sec.gov/comments/s7-19-08/s71908.shtml>, last visited on April 22, 2009). Some also challenged the SEC's assumption that the references to credit ratings in the regulatory framework were construed by the investors as a "seal of approval" by the SEC with respect to the quality or the accuracy of those credit ratings. The SEC's proposal was not addressed during the agency's December 3, 2008 hearing dedicated to CRAs and it is for the time being unclear how the SEC intends to deal with this issue.

The failures that were uncovered within CRAs should however not cast a shadow over the general concept of having a public authority rely on privately-set standards, provided the activities of the entities whose standards are used in the public regulation are properly supervised. Credit ratings failed because their incentives were misaligned and their supervision inadequate<sup>26</sup>. This notwithstanding, the idea of relying on privately-set standards should remain attractive, primarily on the basis of the argument that rules can best be implemented if they benefit from a high degree of acceptance within the market<sup>27</sup>.

## **2.2 Enactment of the rule**

We shall now examine three different regulatory paths that allow private entities to take part in the formal process that leads to the enactment of a rule. The situation in which the initiative rests exclusively with private entities and the State remains neutral as to the outcome of the self-regulatory process will be referred to as stand-alone self-regulation<sup>23</sup> (see Section **2.2.1**). The enactment process can also be characterized by a cooperation between the public regulator and private entities, with the public regulator either officially recognizing self-regulatory solutions (see Section **2.2.2**) or delegating a regulatory authority to SROs (see Section **2.2.3**)<sup>28</sup>.

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<sup>26</sup> On April 15, 2009, the SEC convened a roundtable on credit ratings during which the supervision and the compensation structure for CRAs was discussed. See MARY L. SCHAPIRO, Statement at SEC Roundtable on Credit Rating Agencies (April 15, 2009).

<sup>27</sup> Another example in which public authorities have incorporated the work of CRAs into regulatory standards is the bank capital adequacy requirements set out by the Basel Committee on Banking Supervision (Basel II). In a nutshell, under the Basel II rules, the amount of capital required for loans hinges upon the credit rating of the borrower (HOWELL E. JACKSON, The Role of Credit Rating Agencies in the Establishment of Capital Standards for Financial Institutions in a Global Economy 5 (SSRN).).

<sup>28</sup> VAN HEESSEN-LACLÉ & MEUWESE, 119

## 2.2.1 *Stand-alone self-regulation*

### 2.2.1.1 **Concept**

Stand-alone self-regulation refers to a situation in which private entities elect to create a regulatory structure on their own, without any intervention or mandate given by a public authority. One may wonder why private actors would *sue sponte* decide to impose upon themselves rules that could possibly stymie their business activities.

The most important work conducted on stand-alone self-regulation was conducted by ROBERT ELLICKSON in his study of the relationships among cattlemen in Shasta County, California. This author shows that the community of cattlemen in Shasta County established a set of private norms (regulating *inter alia* the liability in case of cattle trespassing over third party's property) aimed at maximizing the general welfare of the cattlemen's group in the absence of any governmental intervention<sup>29</sup>. As regards more specifically the financial industry, the most important reason for the emergence of stand-alone self-regulation could be the willingness of a trade association to set quality standards for its members in order to improve their competitive position on the market and to mitigate reputational risks. That being said, one should also not forget that trade associations frequently resort to stand-alone self-regulation as a shield in order to ward off an imminent threat of public regulation<sup>30</sup>.

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<sup>29</sup> ROBERT C. ELLICKSON, *Order without law : how neighbors settle disputes* (Harvard University Press 1991).

<sup>30</sup> ZUFFEREY, 591. An illustration of this phenomenon could be the following excerpt of a Wall Street Journal article: "In an effort to head off legal restrictions on privately traded derivatives, six of Wall Street's biggest securities firms have agreed to voluntarily tighten their controls on the most hotly contested aspects of their derivatives sales and tradition." JEFFREY TAYLOR, *Securities Firms Agree to Set Controls on Derivatives*, Wall Street Journal March 9, 1995, at C1. cited in JOHN W. MAXWELL, et al., *Self-Regulation and Social Welfare: The Political Economy of Corporate Environmentalism 2* (SSRN 1998).

### 2.2.1.2 Example

During the late 1980s and the early 1990s, the Swiss asset management industry saw a number of its members involved in money laundering and embezzlement scandals which tarnished the reputation of this sector of the Swiss financial industry as a whole.

In reaction to these affairs, the industry's trade association, the SAAM, implemented in 1999 a "Code of Ethics and Professional Conduct"<sup>31</sup> that details the duties that each member has to comply with in terms of identification of its clients and of the beneficial owners of the managed assets. This Code of Conduct also sets out a number of professional and ethical duties that each SSAM member must comply with when managing the clients' assets. In a number of instances, the provisions of this Code of Conduct go beyond the requirements set forth in the Swiss legal framework regarding the fight against money-laundering or in Swiss statutory contract law, typically with respect to the duties that arise under the contractual relationship between the asset manager and his client<sup>32</sup>. This constitutes therefore a good example of a stand-alone self-regulatory framework whose purpose is to restore the tarnished reputation of a trade association's members by implementing quality standards that go beyond the minimum statutory requirements.

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<sup>31</sup> SWISS ASSOCIATION OF ASSET MANAGERS, Code of Ethics and Professional Conduct of Independent Asset Managers (26 March 1999).

<sup>32</sup> Article 10 of the SAAM Code of Conduct for instance requires the entering into of a written asset management contract defining the client's objectives, the investment policy, the asset manager's compensation and the level of information to be furnished by the asset manager to the client. None of these requirements are anchored in Swiss statutory contract law.



## 2.2.2 *Minimum standards approach*

### 2.2.2.1 **Concept**

Another type of enactment of self-regulatory norms – which increases slightly the level of public intervention – is for the public authority to characterize<sup>33</sup> a set of rules created by a trade association as *minimum standards* that are thus indirectly incorporated in the legal framework. Public regulators would typically be inclined to resort to this regulatory tool when required to implement statutory texts containing vague terms or referring to broad concept without providing any precise definitions. Following this integration in the statutory framework, the self-regulatory rules no longer apply exclusively to the members of the relevant trade association, but to all market participants. The recognition by the public authority thus increases the normative power of the self-regulatory framework.

### 2.2.2.2 **Example**

The regulation of the business of banking in Switzerland offers an interesting illustration of this minimum standards approach. One of the statutory requirements for the issuance and the retention of a license for the conduct of banking operations in and from Switzerland is that “the persons charged with the administration and the management of the bank enjoy a good reputation and thereby assure the proper conduct of business operations”<sup>34</sup>. The practice of the Swiss regulator, the FINMA, shows that the crucial terms are “proper conduct of business operations”<sup>35</sup>. That being said, neither the statutory text, nor the analysis of the legislative history that led to the adoption of this norm shed any light as to the meaning of these five words.

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<sup>33</sup> Such official recognition of SRO rules can take place either spontaneously or at the request of the trade association that has created the rules.

<sup>34</sup> Article 3 al. 2 lit. c BA.

<sup>35</sup> As an example, the FINMA recently published the result of investigations conducted by the SFBC (*i.e.* the authority preceding the FINMA) in connection with the cross-border provision of financial services in the U.S. by UBS, a major Swiss bank. This report indicates that, in the regulator’s view, the UBS failed to “assure the proper conduct of business operations” in relation

A number of rules of conduct applicable to banking operations were however released under the auspices of the SBA, the trade association of the Swiss banking industry<sup>36</sup>. At the outset, these rules constituted an example of stand-alone self-regulation<sup>37</sup> that applied exclusively to the SBA's 363 members. These rules however drew the attention of the Swiss Federal Banking Commission (the authority preceding the FINMA), which was under a statutory duty to verify that banks active in Switzerland complied with their obligation to ensure the "proper conduct of business operations". The public authority reviewed the SBA's rules and issued an administrative guideline whereby these rules were formally recognized as minimum standards applicable to banking operations in or from Switzerland<sup>38</sup>.

Consequently, the FINMA now considers that the statutory requirement of "proper conduct of business operations" is met for all banks that comply with the SBA guidelines that the FINMA has recognized as minimum standards. From a legal perspective, the integration of the SBA guidelines into the Swiss statutory framework entails the following two consequences:

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to the cross-border business with private clients in the U.S. and is sanctioned accordingly by the regulator (see SWISS FINANCIAL MARKET SUPERVISORY AUTHORITY FINMA, EBK investigation of the cross-border business of UBS AG with its private clients in the USA, p. 17 (2009), available online at: <http://www.finma.ch/d/aktuell/Documents/kurzbericht-ubs-x-border-20090218-e.pdf>).

<sup>36</sup> The SBA regroups 363 Swiss banks or Swiss subsidiaries of non-Swiss banking groups. Membership with the SBA is not mandatory for banks active in Switzerland and thus a number of entities active in the Swiss banking sector are not members of the SBA.

<sup>37</sup> See Section 2.2.1 above.

<sup>38</sup> According to the FINMA Circular n. 2008/10, the following self-regulatory norms issued by the SBA were recognized as minimum standards by the FINMA: the Guidelines for Fiduciary Transactions (1993), the Guidelines for Management of Country Risk (1997), the Guidelines on the Handling of Dormant Accounts, Custody Accounts and Safe-Deposit Boxes held in Swiss Banks (2000), the Guidelines with respect to Foreign Debtors (2001), the Guidelines with respect to the Examination, the Valuation and the Performance of Real-Estate Backed Credits (2004), the Allocation Directives for the New Issues Market (2004), the Portfolio Management Guidelines (2005), the Guidelines with respect to the Treatment of Forged Money, Coins and Bars (2007), the Guidelines on Informing Investors about Structured Products (2007), the Recommendations for Business Continuity Management (2007), the Directives on the Independence of Financial Research (2008).

- (i) *A de facto* extension of the scope of the SBA guidelines, inasmuch as they no longer apply only to SBA members, but to any entity conducting the business of banking in or from Switzerland<sup>39</sup>.
- (ii) A breach of the SBA guidelines – that were created by a private group – may trigger an administrative sanction being imposed by the FINMA upon the entity in breach<sup>40</sup>, in addition to any sanction that could be taken at the level of the SRO.

### 2.2.3 *Statutory delegation of regulatory authority to SROs*

#### 2.2.3.1 **Concept**

Another form of public-private collaboration in the enactment of rules occurs when the statutory law delegates to a private entity or to a trade association the power to regulate a certain activity. The level of public intervention then depends upon the level of discretionary power allocated to the private entity when designing the self-regulatory structure: the SRO could benefit from broad latitude or its discretion could be strictly limited by the law. Furthermore, the self-regulatory framework could be subject to the authority's prior approval or such consent could take place impliedly if the authority decides not to regulate the relevant activity itself.

In the absence of an express statutory delegation in favor of an SRO, it is debatable whether or not a regulator has the power to decide independently whether or not rulemaking authority should be delegated to an SRO. An important point here is that the delegation of rule-making

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<sup>39</sup> The SBA guidelines apply *de facto* to any bank active on the Swiss market because a failure to comply with the SBA guidelines triggers, from the FINMA's perspective, the almost non-rebuttable presumption that the relevant bank no longer is in a position to guarantee the "proper conduct of its business operations" and is thus in breach of its obligations under the BA.

<sup>40</sup> The FINMA can order the banking institution to correct the failures within a specified framework or prevent the bank from conducting certain business activities. As an *ultima ratio*, the FINMA may withdraw the banking license, which in turn triggers the immediate liquidation of the relevant entity.

authority to an SRO decreases the level of democratic control and accountability over the final rule, regardless of any corrective measure that is taken to bridge this democratic deficit<sup>41</sup>. Consequently, the decision as to the principle of the delegation of rule-making authority to a private entity should not fall out of parliamentary reach and should be taken by a public body that is directly accountable to the voters, namely the legislative body (and not by an agency of the executive branch). If a statute does not provide expressly for the delegation of rulemaking authority to an SRO, the regulator should not be allowed to decide *sua sponte* to delegate such authority<sup>42</sup>.

### 2.2.3.2 Example

An illustration of a statutory delegation of regulating power to an SRO is the deposit protection scheme applicable to deposits made with Swiss banks. The principle of a deposit protection scheme is anchored in Article 37h BA<sup>43</sup>, but, except for certain minimum rules, the implementation and operation thereof is left entirely up to the banks taking deposits in Switzerland.

Swiss banks and securities dealers<sup>44</sup> fulfilled the mandate received from the Swiss legislator by establishing the Swiss Banks' and Securities Dealers' Depositor Protection Association in

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<sup>41</sup> See Section 3.2 below.

<sup>42</sup> This problem arises for instance in the Swiss legal framework governing the fight against money-laundering. Rather than establishing the rules of conduct that should apply to Swiss banks, the FINMA elected to define these rules of conduct by referring to the provisions of the Code of Conduct established by the SBA (see Article 14 of the FINMA Ordinance on the fight against money-laundering in the banking sector).

<sup>43</sup> The statutory provision, Article 37h BA, reads as follows:

<sup>1</sup> Banks shall ensure that privileged deposits within the meaning of Art. 37b [i.e. deposits until CHF 100'000<sup>43</sup>] with Swiss branches are secured. Banks holding such deposits must become affiliates of a self-regulatory scheme.

<sup>2</sup> The self-regulatory scheme is subject to the authorization of the FINMA. [...]

<sup>5</sup> In the event the self-regulatory scheme does not meet the requirements [set out in this Article], the [Swiss government] may regulate the deposit insurance by way of ordinance. [...]

<sup>44</sup> Given the wording of Article 37h al. 1 BA, membership in this private association is *de facto* mandatory for all banks and securities dealers that accept deposits in Switzerland.

1980<sup>45</sup>. In a nutshell, the system works as follows: in the event a Swiss bank or a Swiss securities dealer becomes insolvent, the members of this association will supply funds to the association in such a way as to ensure that the deposits which are deemed preferential under the BA (in substance deposits up to CHF 100'000 for each depositor) be paid out to depositors as quickly as possible. The contribution due by each bank is computed on the basis of the *ratio* between the preferential deposits this bank holds and the aggregate amount of preferential deposits held by Swiss banks overall, being understood that the maximum amount that banks are required to contribute collectively for each insolvency event is capped at CHF 6 billion<sup>46</sup>. The financial crisis so far claimed two casualties in the Swiss financial sector: the Geneva branch of the Icelandic *Kaupthing Bank*, which was shut down by the FINMA on October 9, 2008, and *ACH Securities SA*, a securities dealer that failed on February 24, 2009. In those two cases, the self-regulated deposit protection scheme played its role well and allowed an orderly and timely payment of the privileged deposits. This harmonious outcome reinforced the view prevailing in Switzerland according to which a deposit protection system that is operated privately – albeit under the supervision of the FINMA – ought to be preferred to the public structure set up in the jurisdictions harboring the other major financial centers<sup>47</sup>.

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<sup>45</sup> EINLAGENSICHERUNG DER SCHWEIZER BANKEN UND EFFEKTEHÄNDLER, Vereinbarung der Schweizer Banken und Effektenhändler über die Einlagensicherung (September 5, 2005).

<sup>46</sup> This CHF 6 billion amount would by far be insufficient to cover the privileged deposits in the event of a collapse of one of the two major Swiss banks – UBS or Credit Suisse – or the collapse of several medium-sized banks. It is worth noting that, following the outbreak of the financial crisis, the Swiss deposit protection system was revised by increasing the privileged amount from CHF 30'000 to CHF 100'000 and the aggregate coverage from CHF 4 billion to CHF 6 billion.

<sup>47</sup> For instance in the U.S., Canada, the EU Member States and Hong Kong.

## 2.3 Monitoring and enforcement

### 2.3.1 Concept

The task of *monitoring* the application of rules can be allocated to private entities, typically to the trade association that enacted – or participated in the enactment of – the relevant rules in the first place. On the one hand, the main advantage is that the monitoring authority is in close contact with the activities that are to be supervised and thus generally in a better position to detect any irregularities. A supervisory structure based upon the principle of “peer review” also enjoys an increased degree of acceptance by market participants. One could also expect the detection rate to be rather high because the SRO is composed of – respectively controlled by – industry members who have a strong incentive to avoid that their competitors gain any competitive advantages through unfair or illegal means. On the other hand, there is an obvious risk that the interests of the supervisor (*i.e.* the SRO) or of its members are not aligned with the interests of the investors’ community. The mere existence of this possible conflict of interest – even before it materializes – can suffice to cast a cloud over the credibility of the monitoring system in the eyes of the consumers of financial products and services. Such conflict of interests may also lower the deterrence value of the monitoring structure, since wrongdoers could expect – rightfully or wrongfully – a certain degree of leniency from their industry peers. It flows from the above that the conduct of monitoring proceedings must be overseen by a public authority, either through the filings of regular reports by the SROs or through direct controls (*e.g.* by conducting sample checks within the industry)<sup>48</sup>.

As regards the delegation of *enforcement authority* to private entities, the primary concern that arises is the jurisdictional scope of such power. The SRO, as a private entity, only benefits from

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<sup>48</sup> Depending upon the industry, it may well be that the costs incurred by the regulator to supervise the SRO are equivalent or higher to the costs the regulator would have to incur in order to monitor directly the private entities. As the case may be, the insertion of an additional supervisory layer (here the SRO) could thus have an adverse impact on the efficiency of the self-regulatory regime.

sanctioning power over its own members. As a result, an entity that engages into unlawful behavior could seek to evade from sanctions by relinquishing its SRO membership. This problem needs to be dealt with at the level of the statutory framework in which the self-regulatory rules are embedded, for example by providing for a mandatory membership in an SRO and a prohibition for a SRO to accept a new member against which a sanction imposed by another SRO is still pending.

Another risk arising when enforcement power is delegated to private entities is that an SRO becomes dominated by one or several members that use their predominant position within the SRO to engage into anti-competitive behaviors that could harm the interests of the other SRO members<sup>49</sup>. One crucial requirement in order to prevent such a situation from occurring is for the SRO to ensure that its enforcement activities comply with procedural rules similar to due process guarantees. This point will be further addressed under Section 3.3 below.

### 2.3.2 *Example*

A situation in which monitoring and enforcement powers have been delegated to a SRO can be found in the regulations of securities exchanges in the U.S. The enforcement of the 1934 Act is subject to a so-called dual-enforcement mechanism whereby the enforcement of the act is made both by the SEC and by the SROs. The 1934 Act was the result of a political compromise, whereby the SEC would not be authorized to directly regulate all aspects of trading on exchanges, but rather to supervise the self-regulatory activities of the – at the time – 21 exchanges which, in turn, had the responsibility of enforcing the 1934 Act<sup>50</sup>. This political compromise was rooted in the fact that, in the 1930s, exchanges had already been in operation

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<sup>49</sup> ZUFFEREY, 591.

<sup>50</sup> RICHARD L. STONE & MICHAEL A. PERINO, *Not just a private club: self regulatory organizations as state actors when enforcing federal law*, 1995 Columbia Business Law Review, 455-456 (1995).

for a substantial number of years and had a long history of self-governance. The SRO system was thus deemed preferable to governmental regulation because the SRO system defrays much of the costs onto the market users and makes efficient use of the exchanges' expertise<sup>51</sup>. Nowadays, nearly all U.S. broker-dealers are members of the FINRA, the SRO formed in 2007 by the merger of the NASD and the regulatory and enforcement units of the NYSE<sup>52</sup>.

Despite the delegation of enforcement authority to the SROs, the SEC retains some supervisory power over the SROs' enforcement proceedings, as well as the authority to enforce directly violations of the 1934 Act. Section 6(b)(6) of the 1934 Act, which specifies the requisites for an exchange to be registered, requires *inter alia* that the rules of an exchange must provide that member firms and their associated persons will be appropriately disciplined for violations of the 1934 Act (or the rules of the exchanges), the possible sanctions including expulsion or suspension from the exchange, limitation of activities, functions, and operations, fine or censure. As regards the enforcement proceedings, Section 6(d) of the 1934 Act establishes a series of procedural minimum standards that the SROs need to comply with in the course of any disciplinary proceeding: specific charges must be brought; the member must be notified of the charges and provided with an opportunity to defend against these charges. Each disciplinary sanction must be supported by a statement specifying the act or practice in which the member or associated person engaged and the specific provision of the 1934 Act the member is deemed to have violated. The importance for SRO proceedings to be subject to procedural minimum standards that go beyond the standards set out in the 1934 Act will be further discussed under Section 3.3 below.

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<sup>51</sup> JAKE KEAVENY, *In defense of market self-regulation: an analysis of the history of futures regulation and the trend toward demutualization*, 70 Brooklyn Law Review, 1451 (2005).

<sup>52</sup> DEPARTMENT OF THE TREASURY, *Blueprint for a modernized financial regulatory structure*, p. 59 (2008), available online [at: http://www.treas.gov/press/releases/reports/Blueprint.pdf](http://www.treas.gov/press/releases/reports/Blueprint.pdf).



### 3. Future outlook

The aim of this second part is to identify general principles that could have some relevance for shaping the future self-regulatory structures that could and should emerge from the ongoing overhaul of the regulation both in the U.S. and in Europe.

The escalation of the financial meltdown during the last months invigorated the calls for regulatory reforms. As a general rule, most policy- and lawmakers seem to advocate a tighter and more comprehensive supervision of financial markets. In this context, self-regulation is generally not seen in a favorable light, given the impression of laxness associated with this approach<sup>53</sup>. It is likely that the new regulatory initiatives that are currently discussed, taken or implemented will considerably limit the scope of self-regulation and other forms of regulation based on the participation of private entities. The purpose of this second part of the contribution is to provide some solutions to the shortcomings of self-regulatory frameworks with an aim to ensuring that this regulatory approach will not disappear from the new regulatory environment that will in all likelihood emerge soon.

#### 3.1 Self-regulation should be coordinated with the statutory framework.

Self-regulation cannot live on its own. In most cases, a self-regulatory framework needs to be embedded in and coordinated with the statutory framework in order to ensure that the self-regulatory rules are legitimate, authoritative and efficient:

- The *legitimacy* of a self-regulatory framework is a crucial topic. A commentator has compared this legitimacy issue to the *Wizard of Oz*: when human beings are seen to be behind the process (something which happens when the rulemaking process becomes

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<sup>53</sup> DAVID GOW, *Financial: Hedge funds and private equity try to head off tighter EU controls: Self-regulation has failed, declares ECB chief Trichet: McCreevy removed from overseeing tighter rules*, The Guardian February 24, 2009, at 28.

gradually more open for participation by the public) the “authority of the source imposing” the law weakens<sup>54</sup>. That being said, it could also be argued that the fact that the shapers of the rules are closely related to the relevant market and knowledgeable of its characteristics should enhance the legitimacy of the rules. To a significant degree, the legitimacy of a self-regulatory framework can derive from the expertise and the knowledge of the private entities enacting this framework<sup>55</sup>.

- The *authority* of a self-regulatory norm should not solely rest on the private means of enforcement available at the level of a private entity, such as the SRO. The sanctions available at the level of the SRO (as well as the reputational damage) are generally not a sufficient deterrent. Furthermore, a rule cannot be authoritative if an addressee of such rule can evade a sanction for breach by resigning from the group that enacted this rule. Consequently, the self-regulatory norm should be made subject to an official recognition by a public authority. This form of public recognition ensures that the rule is formally binding throughout the financial sector, *i.e.* beyond the circle of the SRO members (see Section 2.2.2 above). This reinforces once again the need for a strong coordination between the public and the self-regulatory frameworks.
  
- The *efficiency* of the rule can be analyzed on two separate levels: the enactment process of a self-regulatory framework is, generally speaking, more efficient than the enactment process of a statutory rule, given the high level of expertise that exists within the SRO, the streamlined enactment procedure and the internalization of costs within the industry<sup>56</sup>. On the other hand, delegating the monitoring and the enforcement of a rule to

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<sup>54</sup> STEVEN L. SCHWARCZ, *A Fundamental Inquiry Into the Statutory Rulemaking Process of Private Legislatures*, 29 Georgia Law Review 909, 977 (1995).

<sup>55</sup> SCHWARCZ, *Private Ordering*, 334.

<sup>56</sup> PETER GRAJZL & PETER MURRELL, *Allocating Law-Making Powers: Self-Regulation vs. Government Regulation 2* (SSRN 2005).

SROs might not lead to an increase in efficiency, given the conflict of interest issues raised in this context and the need for a close supervision by the public regulator in order to mitigate this risk.

The discussion of these three factors– legitimacy, authority and efficiency – shows that a self-regulatory framework cannot produce optimal results on its own. Self-regulation can however constitute an appealing regulatory technique if it is appropriately embedded in a statutory framework that ensures its credibility in the eyes of the consumers of financial products and services.

### **3.2 The enactment process for self-regulatory rules should be modeled after the legislative process.**

For the concerned market participants, the consequences deriving from the need to comply with a self-regulatory regime do not differ very much from those flowing from publicly-enacted rules, despite the fact that the process that leads to the creation of the rules is significantly different. In this context, some critics argue that self-regulatory schemes lack democratic legitimacy. The fact that the authors of self-regulatory rules are not directly accountable to the voters is of course somewhat inherent to any form of regulation that is enacted by private parties. This notwithstanding, the veil of opacity that covers the enactment process within the SRO should be lifted.

This result could be achieved by ensuring that the enactment process for self-regulatory rules closely models the legislative process. Consequently, SROs should be encouraged, respectively forced, to take into account the following points when enacting their rules:

- the need for a rule to address a shortcoming identified in the market and the compliance of the rule with the principle of proportionality ;

- the establishment of a cost/benefit analysis that covers separately the costs of enactment, of compliance and of enforcement of the contemplated rule ;
- the interaction of the self-regulatory framework with existing rules ;
- the impact of the proposed rule on competition and barriers of entry on the market ;
- the coordination with international standards and rules addressing similar issues ; and
- the set-up of a consultation process allowing SRO members, industry stakeholders and public authorities to comment on the proposed rule.

In this context, experience has shown that self-regulatory frameworks are best developed in the context of a symbiotic relationship between the public authority and the SRO<sup>57</sup>, as opposed to a situation in which a SRO develops a rule entirely on its own. The public authority should therefore be associated to the self-regulatory process in order to ensure an optimal coordination between the statutory and the self-regulatory frameworks.

### **3.3 The enforcement process should comply with due process minimum standards.**

As shown under Section 2.3.2 above, enforcement powers can be delegated to SROs. The delegation of enforcement powers to private entities raises the question as to whether or not the parties to the enforcement procedure may invoke constitutional rights, such as, in the U.S., the *due process* right or the privilege against self-incrimination embodied in the Fifth Amendment of the U.S. Constitution. Similar constitutional questions arise in other jurisdictions as well.

As a general rule, the constitutional rights enshrined in the U.S. Constitution apply to public entities. Some argue, first, that fundamental rights apply only to the relationship between public

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<sup>57</sup> SWISS FEDERAL BANKING COMMISSION, L'autorégulation dans le secteur financier suisse 23 (2007). SECURITIES AND EXCHANGE COMMISSION, Concept Release Concerning Self-Regulation (17 CFR Part 240) 71257 (2004).

authorities and citizens and, second, that market participants deciding to join a SRO are impliedly “waiving” their fundamental rights in the event the SRO decides to initiate enforcement procedures against the member<sup>58</sup>. That being said, there are circumstances in U.S. constitutional law in which private entities are subject to an obligation to adhere to constitutional rights if these private entities are deemed to be “state actors”. The case law of the U.S. Supreme Court evidences three theories in order to determine whether a private entity can be characterized as a “state actor”: (i) the nexus theory, (ii) the public function theory and (iii) the joint participation theory.

- (i) Under the *nexus theory*, the plaintiff must show that “there is sufficiently close nexus between the State and the challenged action of the regulated entity, so that the action of the latter may be fairly treated as that of the State itself.”<sup>59</sup>
- (ii) The relevant test under the *public function approach* hinges around the “determination of whether the activity performed by the private party may be characterized as a function traditionally and exclusively reserved to the state.”<sup>60</sup>
- (iii) Finally, under the *joint participation theory*, the U.S. Supreme Court examines whether a “[c]onduct that [was] formerly 'private' may become so entwined with governmental policies or so impregnated with a governmental character that it can be regarded as governmental action.”<sup>61</sup>

The requirements of these three tests however appear difficult to apply to practical cases, especially in the context of enforcement proceedings conducted by SROs. The currently

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<sup>58</sup> This thesis is exposed, but not defended in VAN HEESSEN-LACLÉ & MEUWESE, 123.

<sup>59</sup> Jackson v. Metro. Edison Co, 419 U.S. 345, 351.

<sup>60</sup> Brentwood Acad. v. Tennessee Secondary School Athletic Ass'n, 531 U.S. 288, 295.

<sup>61</sup> Evans v. Newton, 382 U.S. 296, 298.

prevailing view vis-à-vis the legal characterization of SROs as private or public actors can be exemplified by the following statement of the Supreme Court of New York: “[W]hile Congress certainly provided for comprehensive federal regulation of the securities industry [...] and charged the SROs with the duty of self-regulation, the fact that the [SROs are] subject to extensive oversight by the SEC, and ultimately federal court review [...] does not metamorphose the [SROs] into a [state actor]”<sup>62</sup>.

Whilst steadily refusing to characterize SROs as “state actors” in the constitutional meaning, courts also compelled SROs, under certain circumstances, to adhere to a fundamental notion of fairness. For instance, the District Judge MacMahon, of the Southern District of New York, held in *Crimmins v. American Stock Exchange*<sup>63</sup>, that “[w]hen an exchange conducts such [enforcement] proceedings under the self-regulatory power conferred upon it by the 1934 Act, it is engaged in governmental action, federal in character, and the Act imposed upon it the requirement that it comply with *fundamental standards of fair play*” (emphasis added)<sup>64</sup>.

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<sup>62</sup> The People of the State of New York v. Cohen et al., 718 N.Y.S.2d 147, 151.

<sup>63</sup> *Crimmins v. American Stock Exchange*, 346 F. Supp. 1256, 1259.

<sup>64</sup> The question of whether or not the defendant in SRO enforcement proceedings may invoke constitutional rights arises in similar terms in Switzerland. The constitutional basis for such a claim would be Article 35 para. 2 of the Swiss Constitution, which reads as follows: “whoever acts on behalf of the State is bound by fundamental [constitutional] rights and is under a duty to contribute to their implementation”. Rather surprisingly, the issue of whether or not the enforcement proceedings initiated by Swiss SROs fall within the ambit of Article 35 para. 2 of the Swiss Constitution has not yet called the attention of Swiss legal scholars. In addition, there is no case law that deals specifically with this issue. That being said, the Swiss Supreme Court has held that a private entity to whom the power to organize a fair on the public domain has been delegated must comply with the constitutional principle of equality of treatment when allocating the booths to the fair’s participants (*Société romande des marchands forains (SRMF) und A.-P. v. Verwaltungsgericht des Kantons Neuenburg*, 2.P.96/2000, E. 5c (Swiss Federal Court)). On the basis of this case law – and more importantly Article 35 para. 2 of the Swiss Constitution – it is fair to say that enforcement proceedings conducted by Swiss financial SROs should be subject to the constitutional limitations.

The outcome of these judicial decisions has been criticized by some U.S. legal scholars<sup>65</sup>. The first criticism is that the U.S. courts have denied the application of constitutional rights whilst still imposing a – rather vague – “standard of fair play” upon SROs. Secondly, these authors argue that since U.S. securities law provides for a double enforcement mechanism of the 1934 Act by the SEC and the SROs, it is surprising that the SEC should be required to honor constitutional privileges in the proceedings it initiates, whilst the SROs are free to impose sanctions without having to comply with these constitutional privileges.

The line of argumentation defended here starts by rebutting the assertion that fundamental rights would only apply to a public-private relationship and that private entities adhering to an SRO would impliedly “waive” any constitutional right they might have enjoyed otherwise. The first prong of this assertion omits to take into account the fact that the relationships between market participants and the SRO, as well as the relationships among market participants themselves, can be characterized by power relations (and power abuses) not dissimilar to those existing between the State and the citizens. The second assertion – according to which market participants would be free to join or to quit an SRO – is equally unconvincing because it fails to take into account the impact of peer pressure and the fact that SRO membership might be mandatory. Consequently, a strong case can be made that fundamental rights ought to have a so-called “horizontal effect” and thus also apply to private relationships, typically the one between an SRO and its members.

Secondly, the delegation of enforcement authority to an SRO triggers a fundamental concern from a constitutional perspective, namely that this regulatory technique is chosen in order to circumvent procedural privileges that would otherwise be owed to the citizens if the enforcement

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<sup>65</sup> See STONE & PERINO, 453 and WILLIAM I. FRIEDMAN, *The Fourteenth Amendment's Public/Private Distinction Among Securities Regulators in the U.S. Marketplace--Revisited*, 23 Annual Review of Banking & Financial Law (Boston University) 727, 728 (2004).

was made directly by the public authority. This concern is rendered particularly vivid by the dual-enforcement mechanism which applies in the context of U.S. securities law and which mandates the implementation of a level-playing field for defendants, regardless of the counterparty the latter are facing. Since the provisions of the 1934 Act can be enforced both by the SEC and by the SROs, it is difficult to see why a defendant would benefit from constitutional protection when facing a SEC investigation, whilst being deprived of such constitutional rights when the inquirer is an SRO. In addition, given the high level of cooperation between the SEC and the SROs, a real risk exists that information gathered by the SRO (in the context of proceedings not subject to any constitutional requirement) be somehow transmitted to and used by the SEC in the context of its own proceedings.

This issue however emerges beyond the scope of a regulatory structure providing for a dual-enforcement mechanism. Indeed, in any case in which enforcement authority is delegated to an SRO, the SRO should be obliged to operate within the constitutional limits that would apply if the enforcement activity was carried out by the State. For purpose of clarity, this obligation to comply with the constitutional *minimum standard* ought to be expressly enshrined in the statutory basis for the delegation of enforcement authority to the SROs.

#### **3.4 The regulatory framework should allow the coexistence of several SROs.**

An important aspect of the design of a statutory framework in which a self-regulatory structure is to be embedded is the number of SROs (one or several) that ought to regulate the relevant activity. I shall make the case in the following paragraphs that, in most circumstances, a regulatory set-up in which several SROs coexist in a given industry should be preferred.

The reasoning is based upon the argument that one of the principal objections against self-regulatory structures is that a single SRO overseeing an industry is in a position to exploit its



monopolistic position and engage into anti-competitive behavior<sup>66</sup>. Creating a self-regulatory framework in which several SROs compete would thus allow market participants to choose the combination of price and self-regulatory standards that matches best their preferences<sup>67</sup>. A number of *caveats* must however be mentioned at this stage:

- The first *caveat* is an externality problem. Having an unconstrained competition among SROs may lead to an externality problem, if for instance the lower standards implemented by an SRO have adverse effects on third parties. This externality problem must be addressed by imposing minimum standards upon SROs. In a nutshell, this means ensuring through public regulation that all SROs implement rules that satisfy minimum quality standards. In practical terms, all SROs competing within a certain industry would need to submit their internal regulations to the approval of the public authority<sup>68</sup>.
  
- The second *caveat* derives from an informational deficit: in a model that sees several SROs competing with each other, it might be difficult for the public to recognize the distinctions of regulatory quality among SROs (and, thus, the differences in the services and products offered by the entities that are members of these SROs). In a situation in which costs can easily be compared but the intrinsic quality remains hidden, SROs (and, thus, their members) will have a natural tendency to lower their quality standards. In order for the model to function, there is a need to ensure that the public is in a position to

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<sup>66</sup> ANTHONY I. OGUS, *Rethinking self-regulation*, 15 Oxford Journal of Legal Studies 97, 103 (1995).

<sup>67</sup> This is typically a strategy pursued by the SAAM, which indicates on its website that “[t]hrough the comprehensive Code of Ethics and Professional Conduct, the SAAM supervises adherence to the requirements of the Anti-Money Laundering Act and the serious and professional practice of independent asset management. This essentially differentiates it from other self-regulatory bodies in terms of the AMLA and also makes SAAM membership a seal of quality.” ([http://www.vsv-asg.ch/htm/e\\_sro\\_standesregeln.htm](http://www.vsv-asg.ch/htm/e_sro_standesregeln.htm), last visited on March 12, 2009).

<sup>68</sup> This is for instance the case in the Swiss regulatory framework dealing with the fight against money-laundering where there are nine SROs that financial intermediaries could become affiliated to.

make an informed choice between several offerors of financial products and services based upon the SRO these offerors are affiliated to. In order to supply such information, the public authority could for instance devise a scoring system in order to classify the various SROs that have been authorized by the public authority to regulate a particular market. In addition, given its importance in the financial sector, reputation – both of the SROs and of the market participants – may constitute a powerful tool for the consumers to distinguish between the quality standards set by different SROs.

While this self-regulatory model might seem complicated *prima facie*, its appeal resides in the fact that it leverages the knowledge of market participants and incentivizes SROs to develop an optimal self-regulatory structure given the competitive pressure they are subject to. One cannot deny of course that a multiple SRO regime could lead to economic inefficiencies (in particular due to the absence of the economies of scale that could be realized in a single SRO regime<sup>69</sup>). That being said, one might also argue that these inefficiencies are more than compensated by the benefit of having several SROs compete for the optimal regulation of an industry, subject to the minimum standards imposed by the public regulator<sup>70</sup>. If choice and competition are important in how financial products and services are offered, there are probably also analogous benefits in terms of how financial intermediaries are regulated.

There are examples in which competitive pressures have had an impact on the quality of self-regulation<sup>71</sup>. In 2003, the SEC issued a report that indicated that the American Stock Exchange had massive shortcomings in its regulation of options trading and that it had attempted to cover

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<sup>69</sup> KEAVENY, 1447, see also COMMISSION, Concept Release Concerning Self-Regulation (17 CFR Part 240) 71264.

<sup>70</sup> To the extent possible, studies would need to be conducted in order to determine whether the benefits flowing from a multi-SRO structure outweigh these economic inefficiencies.

<sup>71</sup> The following example is drawn from KEAVENY, 1450.

up these deficiencies. Shortly after the release of this report, board members of the NASD (the NASD held a majority stake in the American Stock Exchange) and of the American Stock Exchange voted to have the NASD take over the self-regulation of the American Stock Exchange. This decision was taken in light of American Stock Exchange's poor performance in the regulatory arena<sup>72</sup>.

The practical advantages of the multi-SRO model envisioned here are also illustrated by the fact that it has some similarities with the regulatory rationale underlying E.U. law as a whole: in a nutshell, the E.U. has abandoned its original intent to harmonize the regulatory frameworks applicable in each Member State. Instead, the focus has been placed on the identification of the “essential safety requirements” that are needed to control externalities (and referred to as “minimum standards” in the self-regulatory model described here). The E.U. Member States are free to develop their own rules in order to meet these “essential safety requirements” (or even go beyond them). Given the free circulation of goods and services, suppliers of goods and services can select the national regulatory regime they want to comply with, which in turn allows customers to select the quality standards imposed by the national systems (and the prices) in accordance with the customers’ preferences.

#### **4. Concluding remarks**

A realistic assessment of the future prospects of self-regulation must take into account the fact that the current trend in the regulation of financial markets is not favorable – to say the least – to

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<sup>72</sup> JENNY ANDERSON, *NASD may take over regulation of exchange*, New York Post October 21, 2003, at 31.

self-regulation<sup>73</sup>. Even before the outbreak of the financial crisis in the summer of 2007, many States had already started moving away from allocating any regulatory power to private entities:

- Following the entry into force of the *U.K. Financial Services and Markets Act* on December 1<sup>st</sup>, 2001, a number of missions previously carried out by SROs were transferred to the *Financial Services Authority*<sup>74</sup>.
- Similarly, a number of French SROs were integrated into the *Autorité des marchés financiers* when this consolidated agency was created in August 2003<sup>75</sup>.
- In its 2004 Concept Release concerning Self-Regulation, the SEC also developed several regulatory models that would have resulted in a transfer of regulatory power from SROs to public authorities<sup>76</sup>.

The outbreak of the financial crisis triggered calls for a tighter supervision of financial markets. Given the image of laxness that is associated with self-regulatory frameworks, it is highly unlikely that self-regulation will play a prominent role in the regulatory structure that will emerge from the crisis. This is unfortunate, in particular if one considers that the financial crisis heavily impacted on the banking industry, despite the fact that the banking sector was heavily regulated by public regulation (as opposed to self-regulation). The crisis also evidenced that the statutory framework failed to stay up to speed with the sweeping development of financial services and products. This diagnosis would therefore call for an enhancement of self-regulatory frameworks, given their flexibility and their level of acceptance within the market. In addition,

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<sup>73</sup> “[T]he era of self-regulation is over.” said U.N. Secretary-General Ban Ki-moon on October 25, 2008.

<sup>74</sup> STAVROS GADINIS & HOWELL E. JACKSON, *Markets as regulators: a survey*, 80.6 Southern California Law Review 1239, 1256 (2007).

<sup>75</sup> SWISS FEDERAL BANKING COMMISSION, *L’autorégulation dans le secteur financier suisse* 16.

<sup>76</sup> SEC, Concept Release Concerning Self-Regulation (17 CFR Part 240).

self-regulatory frameworks are less costly for the government since most of the set-up and implementation costs are borne by the industry.

As regards more specifically the regulatory reform in the U.S., the Treasury's *Blueprint* recognizes that the effective and efficient functioning of self-regulation is critical to the integrity and competitiveness of financial markets in the U.S. Markets and financial products have evolved and continue to evolve at a pace that the public legislative and regulatory process often fails to accommodate. A self-regulatory system can help to cover gaps in public regulation and can typically respond to market developments more quickly than can government oversight. As private bodies, SROs may adopt rules and aspire to standards that extend beyond statutory or regulatory requirements while at the same time maintaining a flexibility that can help to better protect investors and encourage innovation in the offering of financial services and products<sup>77</sup>.

In the European Union, the *de Larosière Group*, a group of experts appointed by the E.U. Commission to review amendments to the regulation of financial services within the E.U., recognized that the reform of the present regulatory framework "should be done being mindful of the usefulness of self-regulation by the private sector"<sup>78</sup>.

The considerations set out in this contribution plead in favor of embedding self-regulatory frameworks in the set of national and international rules that will emerge in the wake of the crisis. In light of the current political climate, it remains to be seen whether these arguments will be taken into account by policy- and lawmakers anxious to respond to their constituencies' call for a stricter regulation of financial markets and products.

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<sup>77</sup> U.S. TREASURY, p. 122.

<sup>78</sup> THE HIGH-LEVEL GROUP ON FINANCIAL SUPERVISION IN THE EU (CHAIRMAN BY JACQUES DE LAROSIÈRE), Report, p. 15 (25 February 2009), available online at: [http://ec.europa.eu/internal\\_market/finances/docs/de\\_larosiere\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf).

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