

"The Future of Self Regulation"
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It's a pleasure to be here with so many friends and colleagues. Shortly after I return home from the West Coast, my service to the securities industry through the NASD will draw to a close. To tell the truth, I look forward to a vigorous and active retirement...but not before speaking with candor about a subject I've given thought and energy to for most of my professional career. That subject is self regulation.

Over the decades, it has helped make U.S. markets the envy of the world, and it has helped keep the U.S. securities industry at the forefront of innovation.

Self regulation has a proud past, which I do not intend to dwell on.

Today, I want to talk about its future.

Landmark changes have been made to the NASD's corporate and governance structure. We embarked on a new era of stock trading. We operate in the midst of an environment that is constantly changed and challenged by technology. It's fair to ask: what is the future of self-regulation? It's a pressing question, because I believe the fate of self regulation will materially impact the future of this country's securities industry and the organized securities markets such as Nasdaq and the traditional exchanges.

My thoughts on this matter are my own personal views. They do not represent an official position of the NASD. They will almost certainly be met with disagreement by many in this room and by some of my colleagues at the NASD.

The disagreement will probably begin with my fundamental assessment. It is that self regulation is being steadily eroded by excessive process--and an overabundance of rule-making and regulation.

I believe very strongly that a significant erosion in self regulation will over time result in an erosion of investor protection and with it investor confidence in our markets.

When self regulation is in fact SHARED regulation--when industry practitioners work in concert with regulators and self regulators--it promotes a culture of integrity that pervades the entire securities industry. In such an environment, investor confidence flourishes.

Equally important, self regulation allows innovation and competitiveness to thrive--not in spite of the rules, but with the help of well-crafted rules and regulations.

While there have been positive strides made in the evolution of self regulation, I see some disturbing trends that could threaten further progress toward even more nimble and effective regulation.

First, I fear that self regulation could become dominated by professional regulators. If the role of industry practitioners is significantly reduced, one of the hallmarks of self regulation--namely its ability to create rules that truly work in the real world--will be at risk.

Look at the mandate of the NASD and you will see that it is "to promote just and equitable principles of trade." Our rule-making turf, if you will, lies in the area of determining what constitutes "fair dealing" among our peers.

Government regulation deals in bright line differences. So does self-regulation, but it's really at its best when discerning among fine shades of gray. Only those who've been in the market are equipped to make such judgment calls, to parse fine distinctions between best practices and inferior ones.

Former SEC Commissioner and NASD Board member Al Sommer says: "People who confront the realities of the market day after day, if they are

sensitive and sensible, don't need a comprehensive set of legal rules to know when someone in the industry is doing something they shouldn't."

Second, cost-effective regulation is being threatened by regulation at any cost. Currently, the SIA estimates that the industry spends well over a billion dollars fulfilling its self regulatory obligations through a combination of personnel, technology investment, accounting costs, and administration expenses, among others. The industry also contributes significantly to the cost of running the SROs, which themselves must be mindful of the expenses they pass along to the industry.

These costs in turn are ultimately passed on--in one form or another--to the investor. For this reason, both government and self regulators need to approach each new regulation and rule with the same skepticism to which the private-sector subjects every new initiative. In his crusade to re-invent government, Al Gore talks about "results rather than rules." He is right on the mark.

Third, self regulation is being weighted down by process. This is not unique to securities regulation, but to regulation generally in this country. As Philip Howard notes in his book "The Death of Common Sense," regulation today resembles central planning. The result of what Howard calls "governing by excruciating detail" is to suffocate innovation and competitiveness.

Much of the blame can be placed on an old foe of ingenuity and responsiveness--micromanagement.

SROs are being subjected not just to SEC oversight--which is vital and important--but to a level of micromanagement which can result in a loss of competitiveness and inefficiency.

Reacting to change quickly--and being flexible in the face of change--is the key to staying competitive...indeed it is the key to the success of our industry and our markets. But the current regulatory process--full of comment periods, regulatory reassessments, and constant re-writing of rules--is neither flexible

enough nor responsive enough to react quickly enough to the changes happening all around us.

It is certainly not nimble enough to handle the fast pace of technological change.

Each new twist in technology--which can happen in the blink of an eye--requires a response from the market operators and regulators. The time period from initial response to implemented rule or regulation often takes two to three years. Technology, on the other hand, turns over every twelve to eighteen months. By the time a new rule is implemented, two generations of technology have passed us by.

To remain competitive, markets like Nasdaq are going to have to be able to turn on a dime. We've been trained to think of the competition and challenges *between* the markets. But the greatest challenge to both auction and dealer markets comes from technology itself. The competition organized markets are facing from information vendors, private trading systems, and increasingly from innovative uses of the Internet are manifestations of the power technology holds to grab market share--indeed to CREATE new markets--and do so in record time.

As cross-border trading increases...as competition for capital investment heats up...as new markets emerge and mature with the advantages of the latest technology--the traditional markets could find themselves severely disadvantaged. While the world races forward, we'll be plodding along under the weight of an elaborate and outmoded regulatory process.

Now let me be very clear. This is a systemic problem. It is not a problem of SEC leadership. In fact, the turnaround time on rule filings by the Commission staff during Arthur Levitt's tenure has improved substantially.

I might also add that Chairman Levitt deserves credit for reaching out to individual investors as no SEC Chairman has in recent history. From the SEC's Plain English initiatives and Town Hall Meetings...to the enormous task of making the information on EDGAR available on-line, and FREE to

investors...and, of course, the push for better access by all investors to best prices...All those initiatives have been healthy.

What is NOT healthy--and what CAN be improved--is the pace at which the SROs and the SEC, under their current rules and structures, now operate. It's very sluggishness often creates new problems on top of existing ones.

Let me give you an example.

The NASD, back in 1993, proposed a system that would allow limit orders to be publicly disseminated and protected. This was a decidedly pro-investor initiative, in line with recommendations made in the SEC's own Market 2000 report [issued in 1993]. Our proposal was rejected in late 1994. An alternative and expanded solution that would have allowed limit orders to be reflected in the public quote was advanced by the NASD in early 1995. No action was taken until August 1996 when the SEC proposed its own package of order handling rules. Investors have had to wait until this month--almost four years after the NASD's initial proposal--to obtain the benefits of market-wide reflection of limit orders.

While SEC oversight of the market is important, I suggest that the time-honored way of developing policy is outdated. Both the NASD and SEC need to do a better job of working together. After all, the NASD and the SEC ultimately exist to serve the same customer base -- the investor.

Clearly, we need a system that is more responsive to a rapidly changing world--and specifically, more responsive to changes in technology.

These are some of the key challenges self regulation currently faces, and they're serious. Now, how should we respond to them?

One...partnership needs to take the place of partisanship when it comes to developing policies and rules governing the operation of the markets. Cooperation needs to replace suspicion...and plain speaking needs to replace opaque guidance.

Two...even though a conscious effort has been made to speed up the process of regulatory review, there are two areas in particular where we routinely hit speed bumps.

Contrary to its statutory obligation to publish a proposed rule change upon filing--which sets in motion a 35-day window within which the SEC must act--the SEC at times delays publication if it has qualms with a given SRO proposal. The Commission may even request that an SRO withdraw its proposal. The remedy for this first problem is clear: the SEC should publish all proposals it receives from the SROs promptly upon filing.

Delays can also occur after a filing has been published for comment in the form of a request by the SEC to the SROs to grant an extension beyond the 35-day limit to further consider the proposal. One extension often grows into many, and a rule filing can languish for months, even years.

There are several ways to remedy this problem. The first is to hold the SEC strictly accountable to a set time period, perhaps through a default process like the one the CFTC abides by, whereby filings that are not timely acted upon are deemed to be automatically approved. The second option of course is for the SROs to Just Say No when the SEC asks for an extension. This is not, as you might suspect, easy to do.

Three...all new rules emanating from either the SEC or SROs should be accompanied by a meaningful cost-benefit analysis that is circulated for public consumption.

Four...SROs themselves need to rethink how they draw the lines of responsibility. The current SRO structure is too cumbersome and duplicative.

The NASD, in acting on recommendations of the Rudman Commission, took a major step in the right direction. The Rudman Committee recognized the pitfalls of an SRO trying to be both a regulator of its broker-dealer membership and an operator and regulator of securities markets. It concluded that both missions are thereby diminished. In recommending a new structure and

governance for the NASD, the Committee advised putting daylight between our regulatory endeavors and the operation of markets such as Nasdaq.

The result was an evolution in our corporate structure. We now have a new subsidiary, NASD Regulation, with regulatory responsibility for both the broker dealer community and the markets...and a Nasdaq subsidiary which operates Nasdaq. Much daylight has been placed between market operations and broker-dealer regulation.

Now, that's a good first step. But in order for members to be cost-effectively regulated, and for markets to be able to respond quickly to change, particularly technological change...a further evolution of the SRO structure is needed.

The line between operating and promoting markets and regulation of broker-dealer activities needs to be drawn even more distinctly.

Change would come much faster to markets if the functions pertaining to the operation of those markets resided within a dedicated market entity-- Nasdaq...the NYSE...the CBOE...or the American and regional stock exchanges. The markets, of course, would operate with SEC oversight, but each would have a representative governance and ownership structure that focused specifically on issues of consequence to market participants--access, listing standards, operating rules, systems and pricing, among others.

Now for my final recommendation, which to some may sound extreme, but is neither new nor radical.

It deals with who should regulate broker-dealer activities including qualifications testing, registration, and training of registered personnel; underwriting and distribution practices; sales practices; financial and operational examinations; arbitration services; enforcement and discipline; and establishing rules and regulations generally for the broker-dealer profession.

As I suggested, these functions should be separated from the markets. More than that, I feel that since the industry itself is consolidating, the various entities which currently oversee broker-dealer regulation should do the same.

It is time to seriously consider consolidating the responsibility for regulating broker-dealer activities into a single entity that is totally unaffiliated with any of the markets.

You don't need separate SROs, each conducting their own on-site examinations. You don't need separate SROs, each enforcing their own rules of fair practice, and conducting their own disciplinary and arbitration hearings.

Most important, you don't need multiple SROs overburdening the SEC with often similar rules pertaining to a common membership.

A combined self regulatory entity would allow us to put the best talent from all the SROs under one roof. It would eliminate duplication. It would be more cost-effective and should be able to create more uniformity in everything from rule-making to enforcement and disciplinary sanctions.

It should also be able to move rule-making along at a brisker pace, if only by cutting substantially the number of proposals the SEC must review.

Finally, a single SRO stands at least as good a chance, and perhaps a better chance, of achieving the ultimate goal of self regulation, which is investor protection through the promotion of self discipline among the broker-dealer community.

It seems unlikely that the concept will be tried...but that doesn't mean that it should not be tried. And with an SEC that has supported securities litigation reform, and negotiated partial preemption of state regulation with the states and the Congress...who's to say that ending the Balkanization of SRO regulation is too tall an order?

For the good of the industry--and for the public--I call upon my colleagues at the NASD, the MSRB, the Exchanges, together with the SEC, to actively move toward what I believe is the right long-term solution.

The transformation the NASD has gone through in recent months represents a significant milestone in the history of our organization. The continued evolution of self regulation as I have described would not only be a milestone for the entire securities industry, but for our nation's capital markets and all who participate in them.

Since its inception in the Thirties, self regulation has worked, and worked well. If given the opportunity to evolve...if the energy and resourcefulness of both industry and non-industry participants are allowed to shine through...and if the heavy hand of process is replaced with the deft touch of partnership--then it will work far better for investors, issuers and the securities industry.

Thank you.

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