

# MERCATUS CENTER

GEORGE MASON UNIVERSITY

## REGULATORY STUDIES PROGRAM

### **Public Interest Comment on** *The Securities and Exchange Commission's* *Proposed Rule Changes of Self-Regulatory Organizations*<sup>1</sup>

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The Regulatory Studies Program (RSP) of the Mercatus Center at George Mason University is dedicated to advancing knowledge of the impact of regulation on society. As part of its mission, RSP conducts careful and independent analyses employing contemporary economic scholarship to assess rulemaking proposals from the perspective of the public interest. Thus, this comment on the Securities and Exchange Commission's *Proposed Rule Changes of Self-Regulatory Organizations* does not represent the views of any particular affected party or special interest group, but is designed to evaluate the effect of the Commission's proposals on overall consumer welfare.

#### **I. Introduction**

The Securities and Exchange Commission (SEC) has proposed to modify its Rule 19(b) implemented under the Securities Exchange Act of 1934, which requires self-regulatory organizations (or, SROs, such as the New York Stock Exchange) to file proposed rule changes with the Commission before implementing them. Under the revisions the SEC proposes, its Rule 19(b)(4) would be replaced with a new Rule Section 19(b)(6) to govern rule change procedures for the SROs in the future. The new Section 19(b)(6) would:<sup>2</sup>

- (1) Require that the Commission issue a release relating to the proposed rule change within 10 business days of filing with the Commission or within such longer time period as to which the SRO consents in writing.
- (2) Eliminate the pre-filing requirement and the 30-day delayed operational period before a non-controversial rule change can be filed or become operative.

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<sup>1</sup> Prepared by Jay Cochran, Research Fellow in Regulatory Studies, Mercatus Center at George Mason University. This comment is one in a series of Public Interest Comments from Mercatus Center's Regulatory Studies Program and does not represent an official position of George Mason University.

<sup>2</sup> See Proposed Rule Release 34-43860, available at <http://www.sec.gov/rules/proposed/34-43860.htm>. The information on proposed rule changes is taken from Section III, "Description of Rule 19b-6." References to the proposed rule are made by section heading rather than page number since the electronic version of proposed rule can produce different page numbers depending on how the document is accessed, formatted, and printed.

- (3) Expand the categories of proposed rule changes that qualify for immediate effectiveness to include trading rules (other than a trading rule that would make fundamental structural changes to the market, and that would significantly affect the protection of investors or the public interest or impose a significant burden on competition).
- (4) Clarify that where a proposed rule change has become effective pursuant to Section 19(b)(3)(A) of the Exchange Act, no inference may be made regarding whether the proposed rule change is in the public interest, including any impact on competition.
- (5) Permit SROs to file proposed rule changes electronically.

This comment suggests that the SEC has correctly recognized a pressing need for deregulation of SRO filings; however, if the need is as pressing as the SEC and market forces suggest, then the Commission's action does not go nearly far enough. Moreover, given the limited scope of the rule changes, the expected costs and benefits are likely to be small. This should not however be construed as suggesting that the SEC's deregulatory action is incorrect or fatally flawed; merely that it is overly cautious and proceeds from a basic foundation of mistrust of the SROs' willingness and ability to adhere to relevant securities laws.

We recommend instead that the SEC look to benefit from the deregulatory experience already gained by the US Commodity Futures Trading Commission (CFTC). The CFTC processes nearly four-fifths of all SRO rule change requests within 10 days of receipt.<sup>3</sup> Similar treatment by the SEC will help to ensure that the SROs remain viable competitors in world capital markets by being able to respond promptly and innovatively to competition. Moreover, as innovation and increased competition lead to lower transactions costs, investors and the American public will directly benefit as capital flows more efficiently to its highest valued uses.

## **II. Rationale for the Regulatory Change**

The structure of securities markets has been changing rapidly. Physical venues for the exchange of securities must now compete with electronic communications networks (ECNs) and other forms of alternative trading systems (ATSs). Electronic trading venues offer speed and agility that more traditional trading venues may lack (or that are at least more costly on a traditional exchange). Consequently, increased trading volume is finding its way to the ATS networks.<sup>4</sup>

Moreover, the features that traders require in terms of liquidity, speed of execution, execution price, and so on vary widely. Buyers and sellers of stocks have a variety of

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<sup>3</sup> See note 9 below for data sources.

<sup>4</sup> The SEC estimates, for example, that ECNs "now account for approximately 30 percent of the total share volume and 40 percent of the dollar volume in NASDAQ securities, and approximately 3 percent of the total share and dollar volume in listed securities." See § II-B of the Proposed Rule.

incentives and face a variety of constraints just as, for instance, buyers and sellers of houses or cars or businesses do. Seeking out alternative trading venues is but one way for individual traders to optimize their incentives relative to their constraints. Successful new trading venues thus serve as an indication that new approaches to trading may be more efficient than traditional approaches.

Lastly, product offerings are becoming more sophisticated as individual investors seek levels of risk and return most suitable for their particular investment purposes. Given the technological changes and the ability to indulge a wider variety of preferences through different trading venues, it is unlikely that a 25-year old set of rules governing the SROs will prove adequate to today's needs. We therefore commend the SEC for recognizing these facts and for trying to respond to them.

### III. Costs and Benefits of the Regulation

In response to the inadequacy of older approaches to regulation, the SEC has proposed to expedite the SROs' ability to change some of their internal rules without extensive SEC oversight—provided the rule changes meet the requirements described above. Since the proposed rule only affects a limited number of possible SRO rule changes, however, the costs and benefits are likely to be small.

The SEC in fact estimates that its proposal will affect less than 20 percent of all SRO rule changes requested in a typical year. While such deregulation is marginally beneficial, it is unlikely to trigger sweeping SRO innovations. This obtains because one major obstacle to innovation continues to be a lethargic regulatory oversight process that can take, at times, longer than a year to act on a single request. Table 1 describes the speed with which the SEC has acted on a sample of regulatory changes.<sup>5</sup>

**Table 1**  
SEC REGULATORY VELOCITY

	SEC Rules	SRO Rules
Rules in SEC sample going from proposed to final	76	36
Mean (in days) to go from proposed to final status	343	121
Range (in days) of time to go final <sup>6</sup>	14 – 1,446	0 – 880
Standard deviation from proposed to final	291	166

<sup>5</sup> The data for Table 1 come from the SEC's website, <http://www.sec.gov/rules>, and reflect rules that went from proposed to final within the sample period provided by the SEC. The SEC's regulatory web pages list selected rules that have appeared since 1995. The SEC's sample may be subject to selection bias.

<sup>6</sup> In §V-A of the proposed rule, the SEC estimates that in 1999, 95 rules, which took, on average 101 days for approval, would have been eligible for expedited treatment under 19(b)(6). Of the 36 SRO rules listed Table 1, 10 took fewer than 30 days to approve. Of those sample rules taking less than a month to finalize, three were SRO responses to Y2K preparations in 1999. The remaining seven were rule changes already eligible for expedited review and thus would be unaffected by the proposed rule change.

The first column of numbers applies to SEC rules in general, while the second column applies to rule change affecting the SROs only. The data suggest that changes in general SEC rules can take, on average, just under a year to go from proposed to final status. For the SROs, this procedure is decidedly faster—at about four months—but still glacial when compared to speed at which the securities industry itself moves. Indeed, the wider dispersion (as captured by the standard deviation) relative to the mean indicates that the SROs face a relatively more variable (i.e., more risky) regulatory process.<sup>7</sup> In an industry where the difference between profit and loss can often be measured in seconds, a drawn out and more variable process to finalize self-regulatory regulations does not lend confidence to the idea that innovations will be rapidly forthcoming from the SROs—even under the current proposal to relax SEC oversight somewhat.<sup>8</sup>

Finally, the SEC supplied no information in its proposal to suggest that its incrementalist approach is warranted based on the past conduct of the SROs with respect to securities laws. That is, the SEC failed to show that past SRO rule changes (of any kind) represented deliberate violations of the spirit or letter of securities laws that would justify its go-slow approach. Yet, the proposed rule appears to suffer from an implicit presumption that, but for strict SEC oversight, the SROs would violate securities laws. We would suggest in the alternative that either the SROs can be expected to follow the law—in which case oversight beyond pro-forma review is redundant—or they do not follow the law, in which case the modifier “self-regulatory” is nonsensical. In other words, the default regulatory setting would be in favor of automatic certification unless credible evidence is presented to suggest a securities law violation; rather than the current default setting that tends toward an implied presumption of guilt.

Within the past few years, the CFTC has gradually moved toward a more flexible regulatory approach that culminated in self-certification by SROs that their any proposed rule changes are in accord with the principles of the Commodity Exchange Act. According to data supplied by the CFTC, between October 1, 2000 and March 31, 2001, 79 percent of 124 rule change submissions by the SROs were processed in 10 days or fewer, and 98 percent were processed within 45 days.<sup>9</sup> Although the proposed SEC rule contains aspects of self-certification, extending the self-certification process to cover a wider variety of potential rule changes, as the CFTC did, would likely increase the

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<sup>7</sup> Stated differently, the distribution of possible time lengths faced by the SROs is skewed right.

<sup>8</sup> In addition, during the process of a regulatory filing, the SROs would likely have to divulge any innovations they are making that would necessitate a change in rules in the first place, thus giving less heavily regulated competitors advance notice of those innovations.

<sup>9</sup> CFTC data compiled by the Divisions of Trading and Markets, and Economic Analysis, CFTC. The cumulative distribution of the 124 SRO rule changes submitted to the CFTC is as follows:

No. SRO Rules	CFTC Process Time	Share of Total (124)
68 Rules	0–2 Days	55%
30 Rules	3–10 Days	79%
24 Rules	11–45 Days	98%
2 Rules	45–180 Days	100%

benefits that the SEC claims to be seeking with its proposed changes. We respectfully urge the SEC, therefore, to evaluate whether the more flexible and less prescriptive approach of the CFTC may not also be appropriate for the securities SROs, especially since both regulatory agencies have some overlapping authority over these entities.

### **A. Minimal Costs**

Essentially, the rule changes the SEC is proposing will maintain the SRO regulatory status quo, with only minor modifications. If adopted, the SEC 19(b)(6) rule changes will allow a number of trading rules to be effective upon filing.<sup>10</sup> In addition, the Commission is also considering whether to allow the SROs to file such rule changes electronically. Electronic filing is likely to represent a measurable cost reduction compared to the current requirement to file 9 paper copies with the Commission on any proposed rule change.<sup>11</sup>

Nevertheless, since the SROs still must file documentation justifying any proposed changes under the new rule, and must certify that the proposed changes meet the requirements of Section 19(b)(6), the SRO preparation phase of a proposed rule change will be largely unchanged.<sup>12</sup> However, there will be some learning curve related costs, as the SROs adjust to the new forms and requirements of the modified rule. Learning curve costs though should taper off quickly. Indeed, the SEC estimates that the newly modified 19(b)(6) forms should be less burdensome than the forms that are being replaced—leading it to estimate a reduction in compliance time of 2 hours—from an old total of 35 hours to new total of 33 hours.

### **B. Marginal Benefits**

As stated above and in the SEC release letter, the new rule is expected to cover less than 20 percent of all SRO rule changes. While this is better than nothing it remains an insignificant change in the regulatory structure surrounding the SROs. Indeed, the SEC claims that faster rule changes available under the proposed rule will lead to increased innovation by the SROs in terms of product offerings and technological innovation. The SEC suggests in turn that these innovations will generate trading efficiencies, lower transactions costs, and therefore, lead to more efficient US securities markets.

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<sup>10</sup> The Commission is also considering whether to allow the operative dates of any 19(b)(6) rule changes to be suspended for 60 days to allow the SEC to withdraw any it finds contrary to the public interest. This adjustment to the proposed rule, however, would have the effect of nullifying any advantages obtained from faster approvals and would not represent a material change from the prevailing status quo.

<sup>11</sup> We would suggest offering electronic filing as an option rather than a requirement of the new rule. There are short-run costs associated with changing from a paper-based filing system to an electronic one, and while the benefits of electronic filing in the long run will likely outweigh the costs, an approach that allows the SROs to determine for themselves the most cost-effective conversion path seems the one most likely to generate preferred combinations of cost savings and filing efficiency.

<sup>12</sup> Indeed, the proposed requirement to have either the CEO or chief counsel of an SRO certify any filing may represent an increased burden stemming from the rule change.

The SEC's expected benefit sequence may not follow for 2 reasons. First, even if lower transactions costs materialize, it does not necessarily follow that lower costs will efficiently translate into lower costs for non-SRO members. How frictionless the process is will depend in part on the degree of competition faced by the SROs from alternative trading venues.<sup>13</sup> Second, the rule prohibits "fundamental structural changes to the market, and that would significantly affect the protection of investors or the public interest or impose a significant burden on competition."<sup>14</sup> In other words, the "innovations" permitted under the rule are likely to be marginal not fundamental, since fundamental changes must still go through the lengthy notice and comment period. It is unlikely therefore, that major innovations will result from this proposed rule change.<sup>15</sup>

#### **IV. Conclusion**

One way to "level a playing field" is to saddle all players with the same regulatory burden. The other way is to lighten the load of those who are regulated most heavily, relatively speaking. To the SEC's credit, it has opted for the less restrictive course, albeit in very small steps. The proposed changes should not add appreciable costs to the current regulatory process, but neither should they confer significant social benefits. Any innovation that does occur in response to the proposed changes is therefore likely to be similarly small.

The proposed rule, unfortunately, still betrays a fundamental mistrust of the proposition that SROs will operate in the public interest even when the public's interest may be at variance with the SROs' member interests. Such a view is largely misplaced given today's increasingly sophisticated investors, the competition the SROs face from alternative trading venues, as well as the technological advances that facilitate detection of actual securities law violations. In part, the SEC has implicitly recognized these mitigating factors in the expedited procedures it has offered in Rule 19(b)(6). The SEC's proposed solution, however, is just one small step on a long road toward more efficient US capital markets and the SROs who contribute to that efficiency.

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<sup>13</sup> The recent rescission of Rule 390 at the New York Stock Exchange is a large step toward doing away any vestigial monopoly trading privileges in certain NYSE-listed stocks, for example.

<sup>14</sup> See the introductory material in § III of the Proposed Rule.

<sup>15</sup> This is not meant to suggest the proposed changes are worthless; rather, it simply suggests that to expect, as the SEC does, significant innovation because of this rule change is not reasonable.

**APPENDIX I**  
**RSP CHECKLIST**  
*Proposed Rule Changes of Self-Regulatory Organizations*

<b>Element</b>	<b>Agency Approach</b>	<b>RSP Comments</b>
1. Has the agency identified a significant market failure?	The SEC has implicitly recognized that no market failure exists requiring the currently lengthy review procedures for SRO rule changes.  <b>Grade: A</b>	The proposed rule changes suggest that a regulatory failure, as against a market failure, may be present, inasmuch as past SEC slowness to act on SRO rule changes may be thwarting innovation at SRO trading venues.
2. Has the agency identified an appropriate federal role?	The proposed rules reflect adjustments under the 1934 Securities and Exchange Act.  <b>Grade: A</b>	
3. Has the agency examined alternative approaches?	Only alternatives within a command and control framework were considered such as whether to <i>require</i> electronic filings.  <b>Grade: D</b>	The proposed rule does not explicitly consider that the SEC itself may be part of the problem. Delays notifying the SROs about approvals of rule changes, for example, exacerbate regulatory delay and thwart potential innovations.

<b>Element</b>	<b>Agency Approach</b>	<b>RSP Comments</b>
4. Does the agency attempt to maximize net benefits?	The SEC does consider costs and benefits, but shows no indication of a desire to maximize net societal benefits.  <b>Grade: C</b>	The rule confers only marginal benefits.
5. Does the proposal have a strong scientific or technical basis?	SEC offers no scientific or technical support for the rule beyond simple observations that the US securities markets are changing rapidly.  <b>Grade: D</b>	No evidence supports a contention that the SROs regularly violate the law with their proposed rule change filings. With respect to electronic filings, the SEC ignores that it already permits such actions with respect to EDGAR filings today. It chose not to leverage this existing expertise regarding SRO rule filings.
6. Are distributional effects clearly understood?	No discussion appears in the proposed rule, except at the most general level, indicating that the SEC considered wealth distribution effects of its present or proposed rules.  <b>Grade: D</b>	No supporting analysis studied the possible wealth redistribution that a slowed process may effect between, for example, SROs and ATSS, between the industry as a whole and the investing public, or between domestic and foreign trading venues. No connection is drawn between slow SEC regulatory responses to the SROs' and the SROs' abilities to adapt to a dynamic marketplace, and that this may result in undesired wealth transfers.
7. Are individual choices and property impacts understood?	No discussion of property effects appears in the proposed rule.  <b>Grade: F</b>	An explicit consideration of reputational capital or other property constraints operating on the SROs may have enabled the SEC to see that its approach is not the only available approach to ensuring a level playing field for competition.