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REGARDING SELF-REGULATORY ORGANIZATIONS:
EXPLORING THE NEED FOR REFORM

BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES
U.S. HOUSE OF REPRESENTATIVES

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I am William J. Brodsky, Chairman and Chief Executive Officer of the Chicago Board Options Exchange, Incorporated ("CBOE"). CBOE was the first listed options exchange in the U.S., and we continue to be the largest options exchange in the United States. Our exchange trades options on individual stocks, stock indexes, exchange-traded funds, and debt securities. We also are one of the larger self-regulatory organizations (SRO") in the U.S., with oversight of the activities of over 1,400 members. I welcome the opportunity to present CBOE's views on the future of SROs.

A year ago the Securities and Exchange Commission ("SEC" or "Commission") issued two companion releases regarding SROs. The first was a release proposing a series of sweeping changes to SRO governance, transparency, and regulatory oversight in a new Regulation SRO.[1] The second was a Concept Release Concerning Self-Regulation ("Concept Release") that explored the changing role of SROs and a wide variety of possible "big picture" approaches to overhauling the SRO structure, ranging from incremental changes to complete assumption of SRO responsibilities by the SEC.[2] The two releases were prompted by the many major changes in the structure, ownership and operation of U.S. securities markets that have taken place over the past few years. Some of the recent structural changes that have the potential to impact self-regulation are the result of the Commission's decisions to permit SROs to organize as for-profit corporations and to demutualize so as to be owned by stockholders who are not necessarily members of the SROs. Other changes to securities markets arise from the fact that in recent years the securities markets have become increasingly electronic and in some cases are now structured as electronic communications networks that are not SROs and that rely on other SROs

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[1] Securities Exchange Act Release No.51019.

[2] Securities Exchange Act Release No. 50700.

for their regulation. These changes have raised questions for the SEC as to whether the conflicts that have always been inherent in self-regulation continue to be manageable.

CBOE takes great pride in its regulatory program and its leadership in options market regulation. We have taken a variety of actions over the past few years to address concerns about potential conflicts of interests in self-regulation. CBOE created a Regulatory Oversight Committee ("ROC") comprised completely of independent directors and chaired by Susan Phillips, former Chair of the Commodity Futures Trading Commission and Governor of the Federal Reserve Board. The ROC is responsible for overseeing the performance of CBOE's regulatory division and functions in much the same manner as an internal audit committee at a public company. During the course of the year, the ROC meets regularly with the head of the CBOE regulatory division, with other regulatory division staff, with CBOE systems staff, and with internal auditors of the regulatory division to manage and assess the workings of the regulatory division. The ROC in turn reports directly to the CBOE Board concerning its role in overseeing the division. The ROC also meets at least annually with senior staff of the SEC to address issues of mutual concern. This structure has facilitated the independence of CBOE's regulatory division without separating it completely from the exchange.

As described below, CBOE does not think a proper response to recent changes in the structure of SROs or to recent regulatory issues should be for the Commission to propose and adopt rules that would have the effect of eliminating self-regulation of securities markets entirely, or making radical changes to the way in which self-regulation operates. Rather, we strongly believe that the Commission should continue to evaluate Regulation SRO and the Concept Release in light of comments received and the changes many SROs, including CBOE as noted above, have already made to their governance structure and practices in recent years to

help assure that the SRO acts consistent with its self-regulatory obligations. Now is not the time for the Commission to discard or radically change the way in which self-regulation operates in U.S. securities markets.

Historically, self-regulation has been a cornerstone of securities markets regulation, and its removal or drastic alteration would affect the entire fabric of federal securities regulation. Recent structural changes to securities markets that may impact the conflicts of interests inherent in self-regulation do not alter this reality. Indeed, at the time the Securities Exchange Act of 1934 (“Exchange Act”) was adopted, Congress recognized that self-regulation inherently involved conflicts between the public interest in having honest and regulated securities markets and exchange members' self-interest in avoiding what some of them may characterize as excessive regulation. At the same time, by choosing self-regulation as the model for the regulation of securities markets, Congress demonstrated its belief that, with appropriate safeguards, self-regulation could lead to better regulation of securities markets by permitting the specialized knowledge and experience of those closest to the markets to be brought to bear on the complex problems of how best to regulate them.

Clearly, among the safeguards embedded in SRO regulation has always been the role of the Commission as overseer of SROs (the proverbial "well-oiled shotgun behind the door"). This includes the Commission's rule-making authority to adjust and fine-tune the process of self-regulation as needed in response to changes in markets and newly identified problems. Regulation SRO was proposed in response to some of the very same structural changes and issues that are cited in the Concept Release as reasons for considering more fundamental changes to self-regulation.

While we have concerns with some aspects of Proposed Regulation SRO, overall, CBOE supports the underlying concepts and believes they will serve to enhance exchange governance structures and practices. Regulation SRO will increase the likelihood that SROs will serve to protect investors and the public interest, act consistent with their regulatory obligations, and be effective regulators. Such changes, however, are many steps removed from a paradigm shift in the way in which self-regulation applies to the securities markets. We question the wisdom of making the kinds of major changes that are discussed in the various approaches of the Concept Release until after the provisions of Regulation SRO as well as the enhancements exchanges have made independently have been in effect for a sufficiently long time to enable their impact on perceived regulatory problems to be evaluated. In addition to the governance changes that exchanges have made recently, there has also has been a paradigm shift away from manual handling of trades to more electronic trading which has the effect of dramatically changing the nature of securities regulation. We believe the impact of all these significant developments -- the adoption of Reg SRO, exchange governance changes, and the movement toward electronic trading – must be assessed before more drastic and potentially disruptive measures are adopted. After these developments have been evaluated, if further changes are deemed necessary, the SEC would be able to propose and adopt additional rule changes within its authority or, if more radical changes are believed to be called for, it could suggest legislation for this purpose.

Beyond its important oversight role, we believe there are other steps the Commission could take in order to improve the quality of self-regulation. One such step would be for the Commission to make available to all SROs clear written statements of the standards and best practices that it believes should apply to specific regulatory matters across all markets whenever it concludes that such clarification is warranted. In our view, too often there have been

disparities in the way in which certain regulations are interpreted and applied from one exchange to another because of the absence of clear guidance from the Commission. We believe that if the SEC were to make its views known on such matters to all SROs in a clear and consistent way, and do so promptly upon a determination that a need for such guidance is needed, SROs would have a better understanding of what is required of them and would be in a better position to regulate their markets and their members accordingly.

We recognize that the SEC has brought several actions against SROs over the past few years for failure to regulate their members adequately. We do not view the lapses in SRO performance as reason to gut a system of self-regulation that has been in operation for over seventy years. In fact, we believe the current system routinely detects and finds violations and other potential problems because of the familiarity of the regulators with the marketplace. It would be very difficult to duplicate this attention to the details of a particular market in a large single regulator whose management was removed from the marketplaces it regulates. On a day-to-day basis the SROs act as the SEC's frontline monitors of the markets. It would be hard to imagine how the SEC could operate if the system of self-regulation were eliminated. For much of my tenure as head of CBOE, the SROs and SEC have acted as partners in trying to ensure fair and honest markets. Recent events have caused the SEC to take a more adversarial approach toward SROs. I think it would benefit the markets if the SEC looked for ways to renew and strengthen this partnership.

We believe that the existing model of multiple SROs, each responsible for regulating its own market, has for the most part, well served the objective of sound regulation. This model has permitted the specialized knowledge that each SRO has concerning its own unique rules and procedures to be brought to bear to the regulation of its market. It also fosters competition in the

development of new, more efficient, regulatory systems, which also benefits the overall quality of regulation. On the other hand, we agree that the existence of multiple SROs can result in unequal regulation across markets. CBOE also recognizes that requiring each SRO to build and maintain its own regulatory systems and programs may result in unnecessary duplicative costs and other inefficiencies.

Nonetheless, in balancing the pluses and minuses of multiple SROs, we believe that the best answer is not to delegate market regulation to a sole or "single member" self-regulator that would be independent of, and would not be involved in, the operation of any market. While the delegation of regulatory responsibilities to such a sole self-regulator might well avoid some of the problems cited in the Concept Release that result from the operation of multiple SROs, the consequence of following this approach would be to destroy the major advantage of self-regulation. That is, to assure that persons involved in the regulation of securities markets are close to the markets they regulate, and therefore have an in-depth understanding of their rules and the ways in which they and their members operate. A single SRO also would be tantamount to a new mini-SEC. It is inevitable that a sole SRO would quickly evolve into a bureaucratic entity that functions as an adjunct arm of the SEC. Self-regulation would lose the “self” aspect. There are better means to reduce duplicative costs and inefficiencies from multiple SROs.

We are intrigued by an approach suggested by the Securities Industry Association (“SIA”) that would consolidate regulation of members into a single SRO but leave regulation of trading to each individual market. Under that approach, a single SRO would be responsible for sales practice, financial responsibility, and business conduct examinations, but each market would retain the responsibility to regulate trading and other conduct on its marketplace. The SIA proposal is designed to eliminate duplication of regulation by multiple SROs at the level

where such regulation overlaps but maintain specialized regulation at the trading level where it is needed. While the SIA approach is one way to achieve greater efficiency, there are other alternatives which SROs can and do utilize to reduce costs and promote efficiency. One approach is the use of SEC Rule 17d-2 agreements which are used by SROs to allocate regulatory responsibility with respect to common members. Another new alternative that has great potential benefits in eliminating duplication, increasing efficiency, and enhancing the overall quality of regulation is the use of a National Market System Plan to conduct regulatory functions that are common among SROs. For example, five U.S. options exchanges recently filed with the Commission a proposed Options Regulatory Surveillance Authority ("ORSA") Plan. The purpose of the Plan is to enable the five exchanges to act jointly with respect to insider trading investigations involving options traded on one or more of the five exchanges. The regulatory functions governed by ORSA could be expanded in the future. The core part of the plan, as currently proposed, is the delegation to the CBOE to operate a joint surveillance and enforcement facility for detecting and investigating possible instances of insider trading. CBOE has already established a state-of-the-art automated facility for the surveillance of insider trading, and it has a fully staffed Office of Insider Trading that uses the facility for ongoing surveillance. Although CBOE would conduct the surveillance and analysis work, each exchange will remain responsible for regulating its market and for bringing enforcement proceedings whenever it appears from the ORSA information that persons subject to its jurisdiction may have engaged in insider trading. By sharing the costs of these investigations and by sharing the regulatory information generated by ORSA, the five exchanges will be able to support a regulatory program that is comprehensive and eliminates duplicative efforts and costs. Under the Plan, the five exchanges will establish a Policy Committee to oversee operation of the Plan. Thus, governance

of ORSA will remain with the five exchanges and enforcement actions would be conducted by each exchange. The conduct of regulatory functions through ORSA also would eliminate concerns of uneven regulation among markets. ORSA shows that SROs working together can preserve the benefits of multiple SROs while reducing the costs and eliminating duplication.

CBOE has taken other steps to reduce duplicative regulation among multiple SROs. Last year pursuant to our Rule 17d-2 agreement we reallocated to the NASD the responsibility for conducting sales practice examinations of the CBOE members that had been allocated to us under this agreement. As the NASD conducts sales practice examinations of the majority of broker-dealers, and has conducted specific options sales practice examinations, we determined that it would reduce costs if these sales practice examinations were consolidated into the NASD. We will continue to look for ways to work with other SROs to reduce overlapping regulation of our members.

Thank you for the opportunity to testify at this important hearing. CBOE strongly believes in the benefit of self-regulation and is pleased that the Committee is exploring this issue. We intend to continue to work with the other SROs and the SEC to provide the level of market oversight that all investors deserve.

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