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# SELF-REGULATORY ORGANIZATIONS

By DAVID L. RATNER\*

To an American observer, the most striking feature of the provisions in the proposed *Securities Market Law for Canada (Draft Act)* relating to self-regulatory organizations (SROs) is their similarity to the comparable provisions of American law. This is not really surprising, since the problems that have arisen in the operation of self-regulation in the Canadian securities markets, as described in the excellent background paper by Peter Dey and Stanley Makuch,<sup>1</sup> have closely paralleled the problems that developed in the United States and provided the impetus for reforms in that country. Provincial securities commissions, cognizant of these problems, had adopted a number of American ideas prior to the promulgation of the *Draft Act*; to this extent, the *Draft Act* constitutes a codification of current provincial practices as well as a response to the American experience.

There are, of course, significant differences, most notably in the fact that governmental supervision of self-regulation in Canada has thus far been at the provincial, rather than the federal level. But the problems that have arisen in the relationship between the Toronto Stock Exchange (TSE), the most important stock exchange in Canada, and the Ontario Securities Commission (OSC) have been quite similar to those that have characterized the relationship between the New York Stock Exchange (NYSE) and the Securities and Exchange Commission (SEC) in the United States. This is not surprising, since the securities industries in the United States and Canada are organized along very similar lines, and since self-regulation has certain distinctive attributes and tensions that are likely to exhibit themselves wherever the system is in place.

“Self-regulation” is a system under which all or a major portion of the responsibility for policing the conduct of the firms in an industry is undertaken by an industry organization, rather than directly by a government agency. As Dey and Makuch note, the legislation in Ontario and other provinces recognizing and modifying the self-regulatory system has never been based on any clear rationale as to why self-regulation is preferable to direct government supervision.<sup>2</sup> Why has self-regulation, which is found in few other industries, been so pervasive, and been accepted by government, in the securities field?

The answer, I believe, lies in the nature of secondary trading in securities. Unlike other goods that are produced and marketed by competing enter-

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<sup>1</sup> Dey & Makuch, “Government Supervision of Self-Regulatory Organizations in the Canadian Securities Industry” in Anisman *et al.*, *3 Proposals for a Securities Market Law for Canada* (Ottawa: Minister of Supply and Services, 1979) [hereinafter *3 Proposals*] at 1399-1484.

<sup>2</sup> *Id.* at 1433-35.

prises and consumed by their purchasers, securities, once marketed, continue to trade from hand to hand in a secondary market. To make this market efficient, there must be a central facility in which the securities can be quoted and traded, and that facility must have rules to govern the conduct of the individuals or firms entitled to use it. Stock exchanges began providing those facilities, and imposing those rules, almost two hundred years ago in the United States, and almost a hundred and fifty years ago in Canada, long before government regulatory commissions came into existence.

When the speculative excesses of the 1920's revealed weakness in the regulation by stock exchanges of their members, the response in both Canada and the United States was not to supplant self-regulation with government regulation, but to recognize and regularize self-regulation by the exchanges, adding a level of government supervision to assure that the exchanges fulfilled their obligations to the public. This scheme of "supervised self-regulation," established in Ontario by the *Security Frauds Prevention Act, 1930*,<sup>3</sup> and in the United States by the *Securities Exchange Act of 1934*,<sup>4</sup> marked a departure from the pattern in England, where stock exchanges continue to regulate their members with very little formal government supervision.<sup>5</sup> The self-regulatory scheme adopted in Ontario, however, was far less elaborate than the one established in the United States, with the Canadian SROs being given very limited powers.

When the decision was made in the United States in 1938, and in Ontario in 1947, to establish more systematic regulation of the "over-the-counter" (OTC) markets (that is, securities traded outside the organized exchanges), both jurisdictions opted for a new self-regulatory organization, subject to government supervision, rather than direct government regulation. Again, however, the functions delegated to the Ontario SRO were far more limited than those in the United States. At that time, the OTC markets did not offer any central facility that would have provided the natural impetus for self-regulation. The subsequent introduction in the United States in 1971 of the NASDAQ system, a computerized quotation system operated by the National Association of Securities Dealers (NASD), has made the OTC market much more similar to a stock exchange in this respect.

As noted above, no explicit rationale has been enunciated for preferring a system of supervised self-regulation to direct government regulation. It is generally assumed, however, that self-regulation is less expensive and more flexible than government regulation, and that it can be more effective in controlling undesirable practices. The rationale of the assumption is that people administering the system have both a better understanding of how the business works and a pecuniary interest in eliminating unfair methods of competition. At the same time, there is a recognized danger that self-regulators may be under- or over-zealous, depending on their view of a particular practice, and

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<sup>3</sup> S.O. 1930, c. 39.

<sup>4</sup> 15 U.S.C.A. §§ 78a-77jj (1976).

<sup>5</sup> *Supra* note 1, at 1408, 1424.

that their rules and enforcement activities may be tainted by a self-interest in eliminating competition and protecting their own way of doing business.<sup>6</sup>

The question, then, is whether the changes proposed in the *Draft Act* can be expected to strengthen the desirable features of self-regulation, while reducing the likelihood of its being perverted to improper purposes. While many of the provisions of the *Draft Act* are similar to provisions of the American Law Institute's *Federal Securities Code* (ALI Code) currently being proposed in the U.S., the ALI Code provisions in this area are basically a reorganized restatement of the present self-regulation provisions of the *Securities Exchange Act of 1934*, as amended in 1975. The *Draft Act* seems designed to deal with roughly the same problems with which the U.S. Congress attempted to deal in the 1975 amendments, and can therefore be best analyzed by comparison with that legislation.

An evaluation of the *Draft Act* must focus on several distinct but inter-related questions: jurisdiction and allocation of functions; procedures for registration of an SRO; SRO governance; procedures for changing an SRO's rules; reconciling self-regulation with maintenance of competition in the industry; review of SRO enforcement proceedings and sanctions; and possible civil liabilities and other sanctions for an SRO's dereliction of duty or for violations of SRO rules.

#### *Jurisdiction and Allocation of Functions*

The most important effect of the *Draft Act*, of course, would be to transfer supervisory responsibility over SROs from the provincial governments to the federal government, a step that the United States took in 1934. While each stock exchange is physically located within a single province, securities firms in Canada, as in the United States, do business on a nationwide basis, and an effective SRO must be able to exercise jurisdiction over all of its member firms' activities. The Investment Dealers Association (IDA), which regulates the capital and trading practices of firms engaged in underwriting and OTC trading in non-speculative securities, is already organized on a national basis, so that the present system results in "fragmented" supervision of its regulatory activities by the securities commissions in the various provinces. The increasing use of computers and electronic communications systems in the securities business will of course hasten this "nationalization" of securities trading, so that supervision of the SROs at the national level should produce a more efficient and more effective system of regulation.<sup>7</sup>

Since large securities firms may be members of several exchanges as well as one or more associations, some agency must have authority to decide which SRO will have principal responsibility for each firm in the event of overlap or

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<sup>6</sup> *Id.* at 1439-40.

<sup>7</sup> The Canadian federal legislative jurisdiction under the "trade and commerce" clause of the *British North America Act*, 30 & 31 Vict., c. 3, s. 91(2), has been read far more restrictively than the American provisions giving Congress legislative jurisdiction over interstate commerce. For a discussion of the jurisdictional basis of the *Draft Act*, see Anisman & Hogg, "Constitutional Aspects of Federal Securities Legislation" in 3 *Proposals*, *supra* note 1, at 156-76.

regulatory gaps. This authority, given to the SEC by the 1975 Amendments,<sup>8</sup> would be lodged in the new Canadian Securities Commission (CSC) by the *Draft Act*.<sup>9</sup> Again, this is an authority that can best be exercised at the national level.

#### *Registration of SROs with the CSC*

One of the most important features of the *Draft Act* is that it would formalize the procedures and standards for registration of an SRO with the Commission. This contrasts sharply with the present situation in Ontario, where the law provides simply that a stock exchange must be "recognized in writing" by the OSC, and expressly "recognizes" the IDA and BDA only for purposes of auditing their members' financial affairs.<sup>10</sup>

The substance of the *Draft Act* follows very closely the pattern found in the present American law and carried forward in the ALI Code, including the criteria to be applied in determining whether an SRO meets the requirements for registration.<sup>11</sup> One minor difference is that the *Draft Act* would require an interprovincial association of securities firms to register with the CSC, while American law merely *permits such registration*.<sup>12</sup> However, since the *Draft Act* defines "association" to include only groups that actually supervise their members or regulate conduct or entry into the business,<sup>13</sup> dealers would still be free to form non-regulatory trade associations which would not be required to register. The *Draft Act* attempts to minimize possible dislocative effects of the registration requirement (and thus to remove one possible basis for industry opposition) by a "grandfathering" provision which requires the CSC to grant any application for registration made within 90 days of the effective date of the Act by any organization that is registered or recognized under the securities act of a province in the capacity for which the application is made. The CSC may, however, require a change in the by-laws of such an organization to ensure its fair administration or to bring them into conformity with the Act.<sup>14</sup>

Registration of an SRO is of course only the jurisdictional handle to enable the CSC to regulate its activities; the most important questions are those relating to the scope and operation of that supervisory power.

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<sup>8</sup> See *The Securities Exchange Act of 1934*, § 17(d)(1), 15 U.S.C.A. § 78q (1971).

<sup>9</sup> Anisman *et al.*, 1 *Proposals for a Securities Market Law for Canada* (Ottawa: Minister of Supply and Services, 1979), s. 9.05.

<sup>10</sup> *The Securities Act, 1978*, S.O. 1978, c. 47, s. 22.

<sup>11</sup> *Supra* note 9, s. 9.01; *The Securities Exchange Act of 1934*, §§ 5, 6, 15A U.S.C.A. §§ 78e, 78f (1971), 78o-3 (1979); American Law Institute, *Federal Securities Code, Proposed Official Draft* (Philadelphia: American Law Institute, 1978) [hereinafter *ALI Code, POD*] § 802.

<sup>12</sup> *Supra* note 9, s. 9.01; *The Securities Exchange Act of 1934*, § 15A(a), 15 U.S.C.A. § 78o-3 (1979 supp.).

<sup>13</sup> *Supra* note 9, s. 2.05.

<sup>14</sup> *Id.*, s. 9.04; *The Securities Exchange Act of 1934*, as originally enacted, did not contain any comparable exemption, reflecting the fact that there was no significant state regulation of stock exchanges at the time.

### *SRO Governance*

The *Draft Act* follows American law in requiring that an SRO's by-laws "ensure fair representation of its members in the administration of its affairs."<sup>16</sup> However, it does not require any representation of the interests of issuers and the investing public on the governing board of an SRO. American law, as amended in 1975, requires that one or more members of the board of directors of a securities exchange or association be "representative of issuers and investors and not be associated with a member."<sup>16</sup> The Ontario Act incorporating the TSE goes further, providing for two "public directors" to be elected by the board with the approval of the Ontario government.<sup>17</sup> The NYSE, following a recommendation by William McChesney Martin, changed its governance system in 1972 to provide for a twenty-one member board of directors with a full-time paid chairman, ten broker representatives, and ten "representatives of the public, none of whom are, or are affiliated with, brokers or dealers in securities."<sup>18</sup> While smaller SROs may not warrant the degree of outside involvement that is appropriate for the NYSE, it is surprising that the *Draft Act* does not attempt to push Canadian SROs somewhat further toward representations of the interests of non-members in their governing bodies.

### *Changes in SRO By-Laws*

One of the most sensitive issues relating to self-regulation in the United States has been whether an SRO could change its by-laws or rules without first obtaining the approval of the SEC. Prior to 1975, a stock exchange in the United States was free to do so (although, owing to an anomaly in the law, a securities association was not), and unadvertised changes in the rules of the NYSE in the areas of market access and financial responsibility led to acrimonious arguments between the NYSE and the SEC when the changes were announced.<sup>19</sup> Furthermore, both congressional committees that studied the securities industry after the 1970 crisis were critical of the SEC for engaging in informal private negotiations with the SROs over proposed rule changes rather than putting them out for public comment.<sup>20</sup> The 1975 amendments

<sup>15</sup> *Supra* note 9, s. 9.03(1)(c); cf. *The Securities Exchange Act of 1934*, §§ 6(a)(3), 15A(b)(4), 15 U.S.C.A. §§ 78f (1971), 78o-3 (1979).

<sup>16</sup> *The Securities Exchange Act of 1934*, §§ 6(a)(3), 15A(b)(4), 15 U.S.C.A. §§ 78f (1971), 78o-3 (1979).

<sup>17</sup> *The Toronto Stock Exchange Act*, R.S.O. 1970, c. 465, ss. 6, 7.

<sup>18</sup> *NYSE Constitution*, Art. II.

<sup>19</sup> U.S., *Securities Industry Study, Report of the Subcommittee on Securities of the U.S. Senate Banking Committee*, Senate Document No. 93-13, 93d Congress, 1st Session, [hereinafter *Senate Study*] at 172-75 (1973).

<sup>20</sup> *Id.* at 201-204; U.S. *Securities Industry Study, Report of the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce*, 92d Congress, 2d Session, [hereinafter *House Study*] at 110 (1972). In 1967 the OSC rejected a suggestion by the TSE that proposed changes in the commission rate be resolved by private consultation, and ordered a public hearing on the question, *supra* note 1, at 1451-52. A short time later the SEC took the same position with the NYSE and ordered its first public hearing on commission rates, Sec. Ex. Act Rel. No. 8324 (May 28, 1968). It is understood that informal private negotiation is still the dominant practice in Canada with respect to matters other than commission rates, although the Ontario

changed American law to require prior notice to the SEC, with the opportunity for public comment, before any rule change can be put into effect.<sup>21</sup> The Canadian *Draft Act* follows a similar approach, and also contains a provision, found in present American and Ontario law, authorizing the CSC to require a change in the by-laws of an SRO when such change is found to be necessary to further the purposes of the Act.<sup>22</sup> This provision will be important when the CSC seeks to require a by-law change that is likely to be opposed by a majority of the members, as was the case in the United States when the SEC ordered an end to the fixing of stock exchange commission rates in 1975.<sup>23</sup>

With respect to fixed commission rates, the *Draft Act* would specifically authorize their continuance, subject to the CSC's power to require changes.<sup>24</sup> This provision may raise a question similar to that which arose under American law prior to 1975—whether the CSC's power to require a change in fixed commission rates includes the power to eliminate rate-fixing on some or all transactions.<sup>25</sup> The commentary on this section does not give a definitive answer, although the provisions requiring that SRO by-laws impose "a restraint on competition only to the extent necessary to achieve the objectives specified in" the Act<sup>26</sup> would presumably imply such a power if the CSC determined that fixed rates were not necessary to achieve such purposes.

The ability of an SRO to fix rates bears on another important question, namely, what incentives there are for firms to join an SRO and subject themselves to its rules. In the case of a stock exchange, the ability to obtain access to the trading floor and to take advantage of the more favourable commission rate for members are obvious incentives. In the case of an association of dealers in OTC securities, the incentive is less clear-cut. As a practical matter, a securities firm must be a member of the IDA to participate in a national underwriting in Canada, since the managing underwriter (generally an IDA member) will choose only IDA members for the underwriting and selling groups.<sup>27</sup> Similarly, in the United States a securities firm must be a member of the NASD to participate in a national underwriting, since the rules of that organization permit members to offer underwriting or selling group discounts only to other NASD members.<sup>28</sup> The *Draft Act* would specifically permit the IDA to establish minimum rates for OTC transactions (if it could persuade the CSC that they were necessary to achieve the purposes of the Act).<sup>29</sup> The

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and Quebec commissions are now more frequently holding public hearings on important by-law changes.

<sup>21</sup> *The Securities Exchange Act of 1934*, § 19(b), 15 U.S.C.A. § 78s (1979).

<sup>22</sup> *Supra* note 9, s. 9.07; *The Securities Exchange Act of 1934*, § 19(c), 15 U.S.C.A. § 78s (1979); *The Securities Act, 1978*, S.O. 1978, c. 47, s. 22(2)(b).

<sup>23</sup> See SEC Rule 19b-3, adopted in Sec. Ex. Act Rel. No. 11203 (Jan. 23, 1975).

<sup>24</sup> *Supra* note 9, s. 9.08.

<sup>25</sup> See Sec. Ex. Act Rel. No. 11203 (Jan. 23, 1975).

<sup>26</sup> *Supra* note 9, s. 9.08(b).

<sup>27</sup> *Supra* note 1, at 1409.

<sup>28</sup> NASD Rules of Fair Practice, Art. III, s. 25, authorized by *The Securities Exchange Act of 1934*, § 15A(c), 15 U.S.C.A. § 78o-3 (1979).

<sup>29</sup> *Supra* note 9, s. 9.08.

American law specifically prohibits an association of OTC dealers from setting minimum rates and fees.<sup>30</sup> However, in the limited area of underwritings, the SEC recently approved NASD rule changes that specifically preserve the right of a managing underwriter to set the price at which all securities must be sold in a so-called fixed price offering.<sup>31</sup> The proposed Canadian provision would expressly permit this kind of exception to the normal rule of competition in the OTC market.<sup>32</sup>

### *Effect of Self-Regulation on Competition*

One problem raised by any system of "self-regulation" is that it authorizes the firms in an industry, acting collectively, to impose restrictions on the manner in which they will compete with one another. This automatically brings the self-regulatory scheme into conflict with the laws prohibiting agreements in restraint of trade, represented in the United States by the antitrust laws and in Canada by the *Combines Investigation Act*.<sup>33</sup>

Two questions arise. First, to what extent, and in what manner, should an SRO be exempted from the laws prohibiting restraints of trade in order to permit it to exercise its intended functions? Second, what safeguards should be built into the regulatory scheme to assure that the protected activities of the SRO do not unduly burden competition?

The United States Supreme Court has addressed the first of these questions on two occasions. In *Silver v. NYSE*,<sup>34</sup> in 1963, it laid down the basic rule that repeal of the antitrust laws "is to be regarded as implied only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary." Twelve years later, in *Gordon v. NYSE*,<sup>35</sup> the Supreme Court was required to apply that rule in a suit alleging that certain aspects of the NYSE's fixed commission rate structure violated the antitrust laws. The Court held that "these requirements for implied repeal are clearly satisfied here," and that the NYSE could not be held liable under the antitrust laws for fixing rates.

In the course of Congressional studies that preceded the 1975 amendments, spokesmen for the SROs requested an explicit legislative exemption from the antitrust laws for their regulatory activities. Committees in both houses of Congress rejected this proposal, finding that the test laid down by the Supreme Court in *Silver* (*Gordon* had not yet been decided) was an adequate and appropriate resolution of the conflict.<sup>36</sup> It should be noted, however, that this rejection of a legislative solution of the conflict did not represent a judgment that the question was better suited to judicial than to legisla-

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<sup>30</sup> *The Securities Exchange Act of 1934*, § 15A(b)(6), 15 U.S.C.A. § 78o-3 (1979).

<sup>31</sup> Sec. Ex. Act Rel. No. 16960 (July 7, 1980).

<sup>32</sup> Sec. Ex. Act Rel. No. 15807 (May 9, 1979).

<sup>33</sup> R.S.C. 1970, c. C-23, as am.

<sup>34</sup> 373 U.S. 341, 83 S. Ct. 1246 (1963).

<sup>35</sup> 422 U.S. 659, 95 S. Ct. 2598 (1975).

<sup>36</sup> See Senate Study, *supra* note 19, at 233-40; House Study, *supra* note 20, at 160-61.



tive resolution, but rather a concern that removal of the threat of antitrust liability would encourage the exchanges to fight harder to preserve unjustified anti-competitive rules. The approach taken in the 1977 bill to amend the Canadian *Combines Investigation Act*,<sup>37</sup> which would specifically exempt a defined category of "regulated conduct" from the prohibitions of that Act,<sup>38</sup> is very similar to the approach taken by the Supreme Court in the *Gordon* case and would avoid the problem of having to await the outcome of litigation to determine whether an action gave rise to liability. This seems to be a sensible approach, assuming that the exempted conduct is subject to effective government control to assure that it is not used for primarily anti-competitive purposes.

That concern leads directly to the second question: what role should the CSC play in assuring that SRO by-laws or rules do not unnecessarily burden competition? In the United States, the 1975 amendments specifically provided that the rules of an SRO must not "impose any burden on competition not necessary or appropriate in furtherance of the purposes of" the *Securities Exchange Act*.<sup>39</sup> The SEC may approve an SRO rule change only if it finds the change consistent with this provision, as well as the other requirements of the Act.<sup>40</sup> The Canadian *Draft Act* follows a similar approach, providing that the by-laws of an SRO may not "restrain competition to an extent not necessary to achieve the objectives" of the Act.<sup>41</sup> The CSC would be required to take this standard into account not only in passing on proposed by-law changes, but also in determining whether to set aside or modify a sanction imposed in an SRO disciplinary proceeding.<sup>42</sup> While provisions of this sort do not guarantee that the CSC would give adequate weight to competitive factors, they represent probably the best balance the legislature can strike in this difficult area.

### *Qualifications for Membership*

There are two distinct legislative objectives in connection with admission of members to an SRO. The first is to assure fairness in the decisions on applications for membership by particular individuals or firms. The second is to assure that the criteria for membership do not unfairly discriminate against certain types of firms on the basis of their other activities or the identity of their owners.

The *Draft Act* pursues the first objective by providing that an SRO may deny an application for membership only for reasons specified in the law, and must file with the CSC a copy of any decision denying admission, together with the reasons therefor.<sup>43</sup> This is designed to eliminate the possibility of an appli-

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<sup>37</sup> R.S.C. 1970, c. C-23, as am.

<sup>38</sup> See *supra* note 1, at 1471-74.

<sup>39</sup> *The Securities Exchange Act of 1934*, §§ 6(b)(8), 15A(b)(a), 15 U.S.C.A. §§ 78f (1971), 78o-3 (1979).

<sup>40</sup> *The Securities Exchange Act of 1934*, § 19(b)(2), 15 U.S.C.A. § 78s (1979).

<sup>41</sup> *Supra* note 9, s. 9.03(4)(b).

<sup>42</sup> *Id.*, ss. 9.06(4)(b), 9.10(2).

<sup>43</sup> *Id.*, ss. 9.09(1)-(3), 9.10(1).

cant being "blackballed" in a secret vote of the members, without being able to find out the reasons for the denial.<sup>44</sup>

The second objective is the one that has raised the more serious policy questions, both in Canada and the United States. In the United States, the NYSE has steadfastly refused to admit to membership banks, insurance companies, mutual fund advisers or other types of financial institutions, or brokerage firms owned by such institutions.<sup>45</sup> The most acrimonious disputes in the long battle over stock exchange commission rates resulted from the decision by certain "regional" exchanges to admit institutions to membership, and thus entitle them to "recapture" most of their commissions in transactions effected on these exchanges.<sup>46</sup> Even though the unfixing of commission rates in 1975 removed most of the incentive for institutions to join exchanges, the securities industry importuned the Congress to ban "institutional membership,"<sup>47</sup> and Congress obliged with a provision that bars any member of an exchange from executing transactions for any institutional account over which it exercises investment discretion.<sup>48</sup>

This prohibition has been difficult both to interpret and to enforce.<sup>49</sup> (Ironically, its major impact has not been on financial institutions, but on certain large NYSE member firms, which were forced to dispose of their investment advisory affiliates.)<sup>50</sup> The Canadian *Draft Act* wisely eschews this approach, providing that an SRO may not condition membership "on the basis of the volume of the required business or any other business that the person carries on."<sup>51</sup> This is designed to assure that any financial institution that the CSC permits to register as a broker or dealer may become a member of any SRO, including a stock exchange.<sup>52</sup>

A related question is whether foreign securities firms should be admitted to membership in SROs. In the United States, this question has been intertwined with the institutional membership question, since European securities firms are generally affiliated with banks. In Canada, the question is more closely related to concern over domination of Canadian commercial activity by large American firms, so that the *Draft Act* quite sensibly delegates responsibility for that decision to the government rather than the SROs themselves.<sup>53</sup>

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<sup>44</sup> Anisman *et al.*, *2 Proposals for a Securities Market Law for Canada* (Ottawa: Minister of Supply and Services, 1979) at 161.

<sup>45</sup> See Senate Study, *supra* note 19, at 68-71.

<sup>46</sup> *Id.*, at 71-73.

<sup>47</sup> *Id.*, at 77-85.

<sup>48</sup> *The Securities Exchange Act of 1934*, § 11(a)(1), (2), 15 U.S.C.A. § 78k (1979).

<sup>49</sup> See, e.g., Sec. Ex. Act Rel. No. 16406 (Dec. 5, 1979).

<sup>50</sup> For example, Merrill, Lynch & Co. was forced to dispose of its investment advisory affiliate, Lionel D. Edie & Co., which it sold to Edie employees for \$8.4 million.

<sup>51</sup> *Supra* note 9, s. 9.09(2).

<sup>52</sup> *Supra* note 44, at 160.

<sup>53</sup> *Id.*, at 160-61.

*Review of SRO Disciplinary Proceedings*

The present law in Canada with respect to the conduct and review of SRO disciplinary proceedings is sketchy and haphazard, comparable to the state of American law prior to the 1975 amendments. In Ontario, disciplinary actions by the TSE can be appealed to the OSC, but there is no provision for such appeal from actions by the IDA.<sup>54</sup> In the United States prior to 1975, a similar discrepancy existed, but in reverse, since disciplinary actions by the NASD were appealable to the SEC, while actions by the exchanges were not.<sup>55</sup> This led persons aggrieved by exchange disciplinary proceedings to seek relief under the antitrust laws, a development abetted by the Supreme Court in the *Silver* case in 1963 when it held that an exchange's failure to disclose the basis for a disciplinary action deprived it of whatever immunity from the antitrust laws it might otherwise enjoy for its actions.<sup>56</sup>

The *Draft Act* follows the approach taken in the 1975 amendments in the United States, imposing basic due process requirements on SRO proceedings, and providing for CSC review of disciplinary actions.<sup>57</sup> In fact, the due process provisions are considerably more detailed than those found in American law, incorporating many of the safeguards that the CSC must follow in its own disciplinary actions. There is a sensitive balancing question here, since an "over-judicialization" of SRO proceedings, while furnishing additional protection to the respondent, may make those proceedings as cumbersome, expensive, and time-consuming as the governmental proceedings for which they are intended to be a substitute.<sup>58</sup>

*SRO Responsibility for Financial Condition of Members*

An important responsibility of SROs in both Canada and the United States is to assure that their members can meet their financial commitments to customers and others. In the United States prior to 1970, the responsibility for determining how much "net capital" stock exchange member firms were required to maintain was delegated to the exchanges, which maintained contingency funds, financed by assessments on their members, to satisfy claims of creditors of member firms that fail.<sup>59</sup> A Congressional study in the wake of the operational and financial crisis that engulfed the United States securities industry in 1968-70 showed that the NYSE, which had maintained a similar trust fund for the benefit of creditors, repeatedly "reinterpreted" its net capital

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<sup>54</sup> *Supra* note 1, at 1461-62.

<sup>55</sup> See Senate Study, *supra* note 19, at 151-53.

<sup>56</sup> *Silver v. NYSE*, *supra* note 34.

<sup>57</sup> *Supra* note 9, ss. 9.09(4), 9.10; *The Securities Exchange Act of 1934*, §§ 6(d), 15A(b), 19(d), (e), (f), 15 U.S.C.A. §§ 78e (1971), 78o-3 (1979), 78s (1979).

<sup>58</sup> In the U.S., however, there are still complaints about the fairness of SRO proceedings; see Lowenfels, *A Lack of Fair Procedures in the Administrative Process: Disciplinary Proceedings at the Stock Exchange and the NASD*, 64 Cornell L. Rev. 375 (1979); Poser, *Reply to Lowenfels*, *id.* at 402. For a recent decision upholding NASD procedures against a variety of constitutional attacks, see *First Jersey Securities, Inc. v. Bergen*, 605 F. 2d 690 (3d Cir. 1979).

<sup>59</sup> *Supra* note 1, at 1412-14.

rules to avoid putting firms out of business and thus triggering a "domino effect" which could have brought about the collapse of the entire industry.<sup>60</sup> The SEC was simultaneously incapacitated by the fear that the NYSE would suspend firms from membership and thus remove the protection of the trust fund if the SEC intervened.<sup>61</sup>

In December 1970, in response to the pleas of the industry, Congress established a government-backed Securities Investor Protection Corporation to take over the task of indemnifying customers of failed securities firms.<sup>62</sup> As a condition of doing so, however, it instructed the SEC to eliminate the exemption from SEC net capital rules enjoyed by the members of the major SROs, and to write its own rules governing financial responsibility of all broker-dealers.<sup>63</sup> The SEC did so,<sup>64</sup> and has also begun to move away from reliance on a "net capital" test, which it found not to be the most appropriate or flexible way to assure a firm's ability to meet its financial commitments.<sup>65</sup> The Canadian securities industry did not go through as serious a crisis as its American counterpart, and the contingency fund maintained by the Canadian SRO's to compensate customers of insolvent member firms is still in operation. The *Draft Act* specifically recognizes and continues that fund as a separate SRO.<sup>66</sup> However, the situation in Canada differs significantly from the situation in the United States prior to 1970. The capital requirements for Canadian securities firms are set by the provincial securities commissions as conditions of registration, and the SRO's merely perform audits to ensure compliance with those conditions and with any higher requirements that they themselves might impose. The *Draft Act* continues this pattern by authorizing the CSC to establish standards of financial responsibility,<sup>67</sup> continues the present auditing practices,<sup>68</sup> and permits the CSC to delegate further enforcement powers to an SRO.<sup>69</sup>

The American experience does not necessarily suggest that the approach taken in the *Draft Act* is unwise, but rather indicates that, under the proposed arrangements, the CSC should be especially vigilant, and ready and willing to take strong action, in the event of major financial problems affecting the larger firms in the industry.

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<sup>60</sup> Senate Study, *supra* note 19, at 29-32.

<sup>61</sup> House Study, *supra* note 20, at 12. Note that the TSE took a similar position at the time of the Windfall investigation, when it "apparently felt that once the Commission had been drawn into the affair the exchange was absolved from further responsibility." *Supra* note 1, at 1426.

<sup>62</sup> 15 U.S.C.A. § 78ccc.

<sup>63</sup> See Senate Study, *supra* note 19, at 39; House Study, *supra* note 20, at 31.

<sup>64</sup> See SEC Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (1975).

<sup>65</sup> See Sec. Ex. Act Rel. No. 11497 (June 26, 1975).

<sup>66</sup> *Supra* note 9, s. 9.13.

<sup>67</sup> *Id.*, s. 8.02(3).

<sup>68</sup> *Id.*, s. 9.11.

<sup>69</sup> *Id.*, s. 9.05.

### Civil Liabilities

One of the most complicated legal aspects of a system of self-regulation is the extent of possible civil damage liability for enforcement or non-enforcement of, or non-compliance with, SRO by-laws or rules.

With respect to liability of an SRO for imposing sanctions that are subsequently set aside by the CSC, the *Draft Act* specifically provides that such action by the CSC would not affect the validity of the SRO action, and therefore would not give rise to civil liability, unless the SRO action violated the Act or its own by-laws.<sup>70</sup>

An unresolved question in the United States is the liability of an SRO to persons injured by its failure to enforce its rules with respect to a member firm. A number of lawsuits were brought against the NYSE by investors in the wake of the 1970 financial crisis, alleging that they had lost money as a result of the Exchange's failure to enforce its net capital rules against some of its members. While the courts recognized that such a right of action might exist, all of the fully litigated cases resulted in judgments for the Exchange, either on the ground that the Exchange's omissions were not related to the plaintiff's loss, or that the plaintiff lacked standing to sue, or for other reasons.<sup>71</sup> The *Draft Act*, like American law, requires SROs to enforce their rules against their members (except when they are specifically excused from doing so by the CSC),<sup>72</sup> but does not deal specifically with the question of civil liability.

A related, but separate, question is the civil liability of a member firm for damages resulting from the firm's violation of an SRO rule. Courts in the United States have reached varying and inconsistent views on this question, depending in part on the nature of the rule, its place in the regulatory scheme, and the seriousness of the violation.<sup>73</sup> In light of recent Supreme Court decisions limiting the implication of private rights of action under the securities laws, there may no longer be any such right of action for violation of SRO rules in the United States.<sup>74</sup>

The ALI Code would resolve the problem by giving the SEC the power to designate those SRO rules which would give rise to civil liability.<sup>75</sup> The *Draft Act* takes the position, novel in the Canadian context,<sup>76</sup> that the courts should be able to imply a private right of action for a violation of SRO rules if (a) it would not be inconsistent with the restrictions on express rights of action and (b) the plaintiff belongs to the class of persons intended to be

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<sup>70</sup> *Id.*, s. 9.10(5); *supra* note 44, at 164.

<sup>71</sup> See Ratner, *Securities Regulation* (2d ed. St. Paul, Minn.: West Publishing Co., 1980) at 922-23.

<sup>72</sup> *Supra* note 9, ss. 9.03(1)(e), 9.14(1); *The Securities Exchange Act of 1934*, § 19(g)(1), 15 U.S.C.A. § 78s (1979).

<sup>73</sup> See *supra* note 71, at 923-39.

<sup>74</sup> See *Jablon v. Dean Witter & Co.*, 614 F. 2d 677 (9th Cir. 1980).

<sup>75</sup> See *ALI Code, POD*, *supra* note 11, § 1721.

<sup>76</sup> *Supra* note 44, at 274.

protected by the rule.<sup>77</sup> This approach seems preferable to that currently being followed in the United States by putting the responsibility for determining whether to imply a private right of action in a particular case where it belongs—in the court passing on that case.

### *Conclusion*

This brief review of the self-regulation provisions of the *Draft Act* indicates that it is a coherent, well reasoned proposal that would eliminate many of the gaps and anomalies found in the present provincial laws. It would also conform Canadian law more closely to the pattern of supervised self-regulation now found in the United States, which has its good and bad features but has overall proved to be a relatively flexible vehicle for dealing with certain practices that do not warrant direct government supervision or intervention.

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<sup>77</sup> *Supra* note 9, s. 13, 16.