

STATEMENT OF JOHN DAMGARD

PANEL 2

Any SRO that operates a for-profit business and performs self-regulation faces an inherent conflict of interest. As a for-profit entity, the exchange must be interested in maximizing trading revenues. As an SRO, the exchange must be interested in rule enforcement and punishing market abuses. Any large traders that contribute heavily to exchange revenues by abusing exchange rules present this conflict in one of its most visible forms. On the other hand, for-profit exchanges may use their disciplinary powers as a source of revenue by extracting massive, disproportionate fines for those out of favor

Recognizing these potential tensions, exchanges have developed Regulatory Oversight Committees to serve as the focal point for administration of the exchange's self-regulatory efforts. While some have called for completely isolating an exchange's business arm from its self-regulatory apparatus, FIA believes that such a drastic measure at this time is unwarranted. Instead we suggest a number of ways to make the ROCs more effective and independent.

We have recommended that the Commission establish as a best practice that DCMs create formal, not advisory, ROCs comprised of non-industry directors in a manner analogous to the independent audit committees public companies must maintain under Sarbanes-Oxley. The ROC should be responsible for the full panoply of an exchange's self-regulatory activities, from market surveillance to financial integrity. The ROC should be empowered to select compliance personnel, supervise their activities and determine their compensation. It is vitally important that the ROC's self-regulatory staff be independent of management for the SROs business operations. The ROC also would be charged with selecting the members of exchange disciplinary panels.

Periodically, the ROC should report to the Board of Directors on the ROC's activities and resource needs. The Board would be responsible for making sure the ROCs have adequate resources and could offer advice to the ROC on self-regulatory issues as they arise. But the self-regulatory buck would stop with the ROC, subject to Commission oversight. FIA would also encourage the Commission to set performance standards for the ROCs and to meet periodically with each ROC to discuss its performance and any issues of mutual interest.

Based on these reviews, the Commission should revisit the performance of the ROCs after an appropriate period of time, we suggest two years, to determine whether a total separation of self-regulation is warranted. But for now we recommend giving the ROC structure a chance to work in the public interest.