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United States Senate

COMMITTEE ON FINANCE

WASHINGTON, DC 20510-6200

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September 19, 2006

Via Electronic Transmission

The Honorable David M. Walker
Comptroller General
United States Government Accountability Office
441 G Street, NW
Washington, D.C. 20548

Dear Comptroller Walker:

As Chairman of the Committee on Finance (Committee) and a senior member of the United States Senate, I have a constitutional duty to conduct oversight into the activities of government agencies. Recently, I have received a number of allegations surrounding the activities of the Securities and Exchange Commission (SEC) and the Enforcement Division thereof. Upon initiating an investigation into these allegations, a number of further questions have arisen surrounding the role that the various market participants play in referring cases for review to the SEC through self-regulation.

Self-regulatory organizations (SROs) are exchanges and associations that operate markets—such as the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD)—that govern the securities markets subject to oversight by the SEC. Section 16(g) of the Securities Exchange Act of 1934 provides authority for various market participants to self regulate with oversight conducted by the SEC. At the time this system was created, Congress, regulators, and market participants recognized that this structure possessed inherent conflicts of interest due to the conflicting role of SROs as both market operators and regulators. This system of industry self-regulation with federal oversight, as opposed to federal regulation, was adopted to prevent excessive government involvement in market operations, potentially hindering competition and innovation. Also, Congress concluded that self-regulation with federal oversight would be more efficient and less costly to taxpayers.

This system of self-regulation via the SROs can function effectively, however, for it to do so, SEC must vigilantly ensure that SROs are fulfilling their regulatory responsibilities related to, among other things, member conduct, market activity, and trading practices, as proscribed in section 16(g). SEC must also have effective programs to deter and detect potential abuses of SRO authority arising from inherent conflicts of interest.

Accordingly, I request GAO to review the actions taken by SEC to ensure that SROs are enforcing member compliance with federal securities laws and preventing potential abuses of SRO authority as a result of conflicts of interest. Specifically, I ask that GAO examine:

- (1) The structure of SEC's SRO inspection program. For example, frequency and duration of inspections, process for determining coverage of inspections, and level of resources dedicated to this function.
- (2) Compare the SRO inspection program with the approach used by banking regulators as part of their large bank examination program, particularly in areas such as examination planning, allocation of examination resources, ongoing monitoring, and communication of examination results.
- (3) A review of SEC's oversight of the SRO that addresses the following:
 - a. How does the SEC ensure that SROs vigorously oversee their own members as opposed to the outside public in transactions (e.g. Are referrals disproportionately of non-members of each SRO? Is there an inherent conflict with SROs referring members?).
 - b. How does the SEC ensure that the SROs maintain a wide net of referrals? For instance, do they cast a wider net on sell side transactions or buy side transactions?
 - c. How does the SEC ensure that SRO's are rigorous in catching aberrational trading that far predates a material announcement? Do the SROs focus only on the preceding few weeks of a material announcement, or do they scope a wider period of time?
 - d. How does the SEC ensure that SROs review potential repeat offenders?
 - e. Does the SEC ever inquire into the integrity and security of data maintained by the SROs? Is there adequate protection to ensure that influential individuals do not have access to SRO data that is non-public?
- (4) A review of how effectively the Office of Compliance Inspections and Examinations (CIE) coordinates with other SEC divisions, such as Market Regulation and Enforcement, in overseeing SRO activities.
- (5) Determine how well SEC measures the effectiveness of its oversight of SROs including an analysis of any enforcement actions taken by the SEC against any SROs pursuant to the SEC's authority in § 16(g)(2) of the Securities Exchange Act of 1934 (codified at 15 U.S.C. § 78s (2006)). In conducting this review please highlight what action, if any, SEC has taken against any SRO under the authority available under the Act.

In closing, I thank you for your cooperation in addressing my concerns regarding SROs. The American public relies upon these organizations to ensure that the trading of securities is efficient, equitable, and fair. Any failure by either the SROs or the SEC in failing to prevent violations or in failing to report them cannot be tolerated. Should you

have any questions regarding this matter please contact Emilia DiSanto or Nick Podsiadly of my staff at 202-224-4515. Additionally, I ask that GAO keep my staff apprised of this matter as it is ongoing and request regular meetings and communications with my staff while conducting this review with the issuance of the final report no later than June 2007.

Sincerely,

A handwritten signature in blue ink that reads "Chuck Grassley". The signature is written in a cursive, flowing style.

Charles E. Grassley
Chairman