THE CONCEPTUAL BASIS AND LIMIT OF SELF-REGULATION BY SECURITIES MARKETS IN NIGERIA AND THE UNITED STATES

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ABSTRACT

This article examines the background to the concept, as well as the practice of self-regulation by securities markets in Nigeria and the United States, as examples of an emerging and a major securities market respectively, against the background of government oversight that limits self-regulation. The paper discusses the advantages and disadvantages of self-regulation of the securities markets. It observes that though the nature of securities market makes self-regulation inevitable, market manipulation by corporate managers and securities professionals as well as deliberate policy choice pave the way for progressively intense government regulatory oversight of the securities markets in focus. It concludes that if government oversight has become unavoidable, Self-Regulatory Organisations (SROs) should be given the statutory authority to determine the contents of their own rules and to enforce them by civil sanctions while government decides criminal sanctions, where necessary, and monitors the SROs to ensure that they enforce their own rules impartially.

1. INTRODUCTION

Government and industry groups otherwise known as Self-Regulatory Organisations (SROs), often regulate commercial activities including trade in securities. SROs participate in regulating the securities markets because trade in securities is a free market economy phenomenon, and many securities markets began as private self-regulatory institutions. However, governments have progressively assumed regulatory oversight over these markets in response to market crisis and as a deliberate policy choice because the orderliness, fairness, integrity, transparency and efficiency of the markets impact on the health of the economy and the efficacy of government policies.

In the United States, one significant government intervention which

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is borne out of corporate crises is the Sarbanes-Oxley Act of 2002 that requires extensive real-time disclosure of securities information by issuers, and which, among other things, prescribes ethical regulations for market professionals. In Nigeria, the federal government exercises oversight of the securities market and SROs under the Investments and Securities Act,[1] a statute which is borne, not out of securities market crisis but, out of a deliberate pre-emptive policy choice. These developments give more prominence to government oversight of SROs to ensure that self-regulation achieves integrity, efficiency and transparency that adequately protect investors in securities. It also makes topical an evaluation of the conceptual basis of self-regulation and the seemingly elastic nature of the limits thereto.

This article examines the background to, the concept, as well as the practice of self-regulation of the securities markets in Nigeria and the United States, as examples of an emerging and a major securities market respectively, against the background of government oversight which delimits the scope of self-regulation. It discusses the advantages and disadvantages of self-regulation of the securities markets. It concludes that though the nature of securities market makes self-regulation inevitable, market manipulation by corporate managers and securities professionals as well deliberate pre-emptive policy choices pave the way for progressive government regulatory intervention in the securities markets. In essence, though the realities of the market require a self-regulatory model, this model must be strengthened by government oversight and intervention. However, the latter must not deprive SROs of the authority to determine the contents of their own rules and respond to the needs of the market.

2. SECURITIES MARKET AS A SELF-REGULATORY ORGANISATION

A securities market is a forum for investors, issuers and financial intermediaries who interact for trade in securities. The market is for capital formation as well as liquidity and risk management. The primary market is for issuers' transactions so as to raise capital by public offering or private placement of securities, while the secondary market is for transactions or trade in outstanding or already issued securities. In all these, investors need information so as to determine the value of securities, the issuers' prospect, economic trend and other factors that are material to their protection. The resulting challenges have necessitated an overlap of regulation and regulatory agencies of the government and market participants.

[1] Cap. 124 Laws of the Federation of Nigeria, 2004

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In Nigeria and the United States, trade in securities is subject to regulatory oversight of the Securities and Exchange Commission (SEC), mandatory disclosure of information that is material to investor protection and anti-fraud rules that non-security transactions are not subject to. However, the securities industry have adopted the self-regulatory model for the development and application of industry rules made to ensure fair, efficient and ethical practices suited to investor protection. In the securities industry, SROs include Securities and Commodities Exchanges and National Association of Securities Dealers (NASD) or similar bodies or firms that operate in the Over-the-Counter (OTC) market. They are major means "... for the enforcement of fair, ethical, and efficient practices in the securities and commodities futures industries" through the making and enforcement of industry rules.[2]

The degree to which securities markets rely on self-regulation vary. While the United States, with a long history of securities dealings, has over time heavily relied on it, Nigeria, whose securities market is barely over forty years old, relies partially but progressively on self-regulation. Even the United States is compelled by recent developments in her securities market toward more government intervention in the regulation of her securities market and market professionals.

SROs offer market participants an alternative and expeditious professional regulatory platform as well as a dispute resolution forum in contradistinction to the government and the courts respectively. Considering their expertise in securities market matters, they are well positioned to make and enforce market regulations.[3] Importantly however, statutes in major and emerging securities markets often place the SROs under government oversight.

The securities markets of the United States and Nigeria respectively began as self-regulatory. It is interesting to note that though one is a major market and the other is an emerging market, there is in them a progressive convergence of regulatory content and oversight as the Nigerian regulatory framework show path-dependence on the United States'. In both markets, the SEC superintends every aspect of self-regulation. The convergence that we see in the regulations of the two markets blazes the trend globally in securities' markets, and it is to the extent recommended by the standards of the International Organisation of Securities Commissions (IOSCO).

[2] John Downes and J.E. Goodman (eds.) *Dictionary of finance and investment terms*, 5th ed., Hauppage, NY, Barron's Educational Series Inc. (1999), at p. 553.

[3] S. Nash *et al*, "Building an effective regulatory structure for an emerging securities market" 7 *Securities Market Journal* (1987), at p. 54.

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2. 1 Self-regulation of securities market in the United States

Historically, the United States securities market relies, to a substantial extent, on a regulatory system by the market participants. By the time Congress intervened statutorily in the market by enacting the Securities Exchange Act of 1934 that established the SEC, the New York Stock Exchange (NYSE) had already existed for over one hundred years. In fact, about thirty stock exchanges were in existence, but the NYSE accounted for about 80% of the trade in securities. Stock exchanges are privately owned. For example, the NYSE is a not-for-profit corporation with a regular membership of 1,336 as well as other physical and electronic access members. These members and their associated firms have exclusive rights to the trading facilities of the NYSE, and they may lease or transfer their memberships subject to the regulations of the exchange.[4]

Because the United States Congress perceived that Stock Exchanges are prone to manipulation and dangerous speculation of the type that caused the market crash of 1929, it enacted the Securities Exchange Act in 1934 to place all national securities exchanges under federal supervisory oversight.[5] The history and philosophy of the placing of SROs under the regulatory oversight of government in the United States differs from that in Nigeria.

The United States Congress enacted the Securities Exchange Act in response to the market crash and the Great Depression that eliminated investors' confidence in the stock market and halted trade in many securities. Apart from the loss that purchasers of new stock suffered, the value of outstanding stocks fell tragically. While the value of all the securities listed on the NYSE was $89 billion in 1929 before the crash, by 1932 it had declined to an abysmal $15 billion.[6]

The causes of the crash were partly related to abusive practices and manipulative devices of the market participants as well as speculation in stocks. The pre-crash market was driven not by fundamentals, but by speculative frenzy. Speculating in stocks was something of a national pastime. For example, 55 percent of all personal savings were used to purchase securities.[7] The speculation got an impetus from the fact that there was no limit on the amount of credit that a stockbroker could give to an investor for margin trading. Stockbroking firms themselves borrowed the fund from banks. As stock prices began to fall, the creditors began to call

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4 James D. Cox *et al, Securities Regulation: Cases and Materials*, 4th ed., New York, Aspen Law and Business (2004), at p. 1072.

5 *Ibid.* at p. 1073.

6 *Ibid.* at p. 5.

7 *Ibid.*

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on investors to pay up the consequential loss. The systemic impact was a panic sale of securities that further drove the prices down.[8]

More importantly, United States Congress hearings that led to the enactment of the Securities Exchange Act revealed much market manipulation by unscrupulous brokers and dealers. Through crooked and deceitful stock pools, they created a false appearance of active trading in securities by simultaneously buying the same securities that they sold. This lured innocent and unsophisticated investors into putting more and more money on the stock. As these investors caused the prices of the stock to artificially increase, the unscrupulous investors dumped their holding on the market and caused the prices to fall to the extent that the securities were worth no more than mere papers.[9] The market manipulators used false and misleading information and took advantage of non-existence of laws that compel securities issuers to make true and timely disclosure of information that are material to their offerings. Corporate insiders also profited immensely from their use of confidential price sensitive information.[10]

The Securities Exchange Act of the United States adopted a philosophy of facilitating timely disclosure of relevant securities information by issuers and market professionals instead of a direct government regulation of the market.[11] The Act created the SEC and, among other things, gave it regulatory oversight over SROs. It also recognises the capacity of the SROs to make rules that regulate their members and have an impact on the securities market.[12] According to William O. Douglas, the second Chairman of the SEC, the system was one of "letting the exchanges take the leadership, with the Government playing a residual role.... Government would keep the shotgun, so to speak, behind the door, loaded, well-oiled, cleaned, ready for use but with the hope that it would never have to be used."[13] The political choice that the United States made when it enacted the Securities Exchange Act went against independent self-regulation by its securities

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[8] *Ibid.*

[9] Section 2 of the Securities Exchange Act reflected the finding of Congress that the stock prices of those days reflected the scheme of the manipulators, speculators and insider traders as well as the action of the gullible investors.

[10] See S. Thel, "The original conception of Section 10(b) of the Securities Exchange Act " 42 Stan. L. Rev. (1990), at p. 409.

[11] The original proposal for the Securities Exchange Act urged an involving government control of the trading markets and the participants as well as a restructuring of the securities industry. Many of the advisers of the then United States President Roosevelt, including Professor William O. Douglas, who later became the second chairman of the SEC before he was appointed to the United States Supreme Court, were proponents of this view. The latter urged that the disclosure-based approach was unsuitably weak, and that government should be more proactive in determining as well as regulating the corporations that should raise capital from investors. See Douglas, "Protecting the Investor," 23 *Yale L.J.* (1934), at p.521.

[12] See Sections 4 and 19 of the Securities Exchange Act.

[13] W.O. Douglas, *Democracy and finance*, New York, J. Allen (1940), pp. 64-65.

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market and paved the way for regulation by the market under the command and oversight of the SEC.[14]

With the sharing of regulatory power with SROs in the United States, concern heightened over whether or not the SEC could rely on the "enlightened self-interest" of the SROs to protect public interest, and whether or not the industry participants would stifle competition. A general counsel of one of America's biggest securities firms expressed his scepticism in the following words:

> "Should regulation in the financial markets always be direct? The tendency of SRO's to insulate a regulated industry would be avoided; a layer of arguably redundant regulation would be removed and costs might be reduced; full due process standards would avoid competitive and other abuses; and the impact on competition could be monitored more closely, and hopefully, ameliorated. Supporters of self-regulation will counter that SRO's can better provide detailed regulation, deal with ethics and morals, be more responsive, eliminate regulatory tensions and foster participation by the regulated, as well as that the SRO's are somehow inherently preferable as a means of social control. Empirical support for these contentions however is noticeably absent. Even with day-to-day regulation of floor activities on the stock exchanges, probably the most difficult area for SEC to assume, experience with the self-regulatory alternative makes one sceptical."[15]

It is submitted that the anxiety and scepticism in Miller's statement is well taken care of by the dual system of regulation which enables the government not only to share regulatory scope with the SROs, but also to respond to their perceived failings and inadequacies.

Experience has shown that the sharing of regulatory scope by SROs and government offers a symbiotic regulatory framework that enables the government to control risks to investors that SROs are ill positioned to reach. For instance, the quest of an exchange for voluminous securities listing and trading offers an incentive to a self-regulatory system that effectively and efficiently protects investors. But there are risks that require

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[14] Adam C. Pritchard, "Self-regulation and securities markets" http://www.cato.org/pubs/regulation/regv26n1/v26n 1-6 visited on 16/11/05.

[15] Sam S. Miller, "Self-regulation of the securities markets: A critical examination," 42 *Wash. & Lee L. Rev.* (1985), at p. 868.

[16] *Op. cit.*

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the regulatory intervention of an independent authority. Pritchard[16] cites market "cornering" as one form of volume-increasing manipulation that exchanges employ to show that they lack the incentive to regulate because the ensuing regulation would not promote trading volume. This therefore justifies government intervention in aspects that self-regulation does not reach. As he puts it:

> "Exchanges may play an important role in setting disclosure standards for listing corporations and enforcing those standards because of the relation between the availability of information and liquidity. We cannot expect them, however, to play an important role in other corporate governance questions such as the enforcement of fiduciary duties.... Government regulation may be necessary to curb abuses of this type, particularly if longstanding practices must be overcome to bring companies into line with current best practices."[17]

In 2002, the United States Congress enacted the Sarbanes-Oxley Act[18] in response to the Enron and WorldCom crisis that arose from fraudulent destruction of audit records and concealment of corporate information. The Sarbanes-Oxley Act signifies the alertness and preparedness of government to take certain issues in securities regulation beyond self-regulation and to criminalise certain non-disclosure of material violation of securities law.[19] It underscores the fact that self-regulation is to the limit that statutes may permit, and the limit may shrink. It points the way in the direction of prompt and more intense government oversight over SROs to the extent that would not have been necessary had the latter been fully effective to prevent market abuses. The oversight limits the rule-making latitude permitted SROs by dictating the timing and content of the rules of SROs as well as subjecting the rules to a SEC-determined test of reasonability.[20] Government regulation has reached so deep a level that it is hard to imagine what an independent self-regulation was in the United States.[21]

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[17] *Ibid.*

[18] 15 USC 7201, Public Law 107 – 204, 30 July, 2002.

[19] See e.g. Section 307 *Ibid.*

[20] For example, section 501(a)(1) of the Sarbanes-Oxley Act provides that "...upon the authorization of the [SEC], a registered securities association or national securities exchange, shall have adopted, not later than 1 year after the date of enactment of this section, rules reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances, in order to improve the objectivity of research and provide investors with more useful and reliable information, including rules designed ...to foster greater public confidence in securities research, and to protect the objectivity and independence of securities analysts..."

[21] Adam C. Pritchard, *op. cit.*

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2.2 Self-regulation of securities market in Nigeria

The Nigerian securities market began as a self-regulatory organisation in 1959, although the House of Parliament initiated its establishment through a committee set up in 1958 to find the ways and means of establishing a shares' market. In 1960, based on the report of the committee, the Central Bank of Nigeria collaborated with the Investment Company of Nigeria Limited (later called the Nigerian Industrial Development Bank) and the business community to set up the defunct Lagos Stock Exchange (LSE). The latter metamorphosed into the Nigerian Stock Exchange (NSE) on 2 December 1977[22] with branches in some major Nigerian cities. The LSE was a private company limited by guarantee but with a share capital, and it was established under the repealed Companies Ordinance.[23] The self-regulation of the LSE was on the basis of its memorandum and articles of association.

In 1961, the Federal Government of Nigeria decided to protect and control the LSE by statutory means. It enacted the Lagos Stock Exchange Act[24] (repealed in 1999 by the Investment and Securities Act) that gave the LSE the monopoly over securities trading in Nigeria, including the admission of market participants to its membership.[25] Government oversight of the Nigerian securities market was born, not of a response to market crash as in the United States but of the Federal Government's own deliberate regulatory initiative. The Government regarded the stock market as an important institution that impacts on the health of the economy and decided to regulate and protect it. It enacted the Lagos Stock Exchange Act on 6 June 1961 to provide *inter alia* that "[t]he business of Stock broking in Nigeria in relation to stocks, shares and other securities for the time being granted a quotation by the [Lagos Stock] Exchange shall be undertaken only by members of the Exchange."[26] The Exchange was to operate and admit members on its own in accordance with public policy while rendering a quarterly report to the Minister of Finance. The Act required the intervention of the Minister only if it was necessary to restore public confidence in the Exchange; otherwise, it never attempted to regulate the Exchange.[27] Thus, the Act gave to the Federal Government of Nigeria a

[22] The change followed the report of the Pius Okigbo's *Financial System Review Panel* (1976) that the Federal Government of Nigeria set up to study the structure and operations of the Nigerian financial system and to make recommendations for improvement.

[23] Cap. 37 Laws of the Federation of Nigeria, 1958. The Ordinance made no special provisions for the membership of the LSE to exceed the maximum membership of a private company, but its foundation members were less than the maximum of fifty members.

[24] 1961, No. 14

[25] Sections 3-6 *Ibid.*

[26] Section 3 of the Lagos Stock Exchange Act (now repealed).

[27] Sections 5 and 6 *Ibid.*

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contingent but loose oversight of the Exchange.[28] However, with the passage of time, the Government has progressively dictated the pace and content of market regulation.

The NSE has three categories of members, namely council members, ordinary members and dealing members. The National Council of the exchange is responsible for its governance and policy-making. It functions through committees that are responsible for listing and delisting of securities, membership and discipline.[29]

To facilitate its operations, the NSE has General Listing Requirements, that is, a compendium of rules and regulations on how a company may be listed on or delisted from the exchange. The document also contains a schedule of listing fees, the rights attached to listed shares and the obligations of quoted companies.

3. THE CIRCUMSPECT SELF-REGULATORY SYSTEM

3.1 The Stock Exchange

From the foregoing, it is beyond doubt that in the Nigerian and American securities markets, statutes set the standards that SROs must meet.[30] In the United States, the Securities Exchange Act requires a securities exchange to be registered under the terms and conditions of the Act by filing an application in the form prescribed by the SEC. The application must contain "the rules of the exchange and such other information and documents as the [SEC], by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors."[31] The SEC is not obliged to register any exchange unless it is satisfied that it could carry out the purposes of the Securities Exchange Act and enforce compliance

[28] See H. I. Alile and R. A. Anao, *The Nigerian Stock Market in Operation*, Lagos, The Nigerian Stock Exchange, (1986), pp. 22-23.

[29] The functions of the Council include
- Enforcement of the articles as well as the rules and regulations of the exchange;
- Investigation of complaints from investors and the members, as well as settling disputes between investors and brokers or members *inter se*;
- Policing the securities market, and initiating disciplinary measures against erring members;
- Granting quotation to companies, and deciding to delist, suspend or withdraw quotation from a quoted company when it deems it necessary;
- Making, amending or revoking regulations and prescribing fees for the effective operation of the Exchange.

[30] See Section 6 for stock exchanges and Section 15A for securities associations of the Securities Exchange Act of 1934.

[31] Section 6(a). *Ibid.*

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by its members as well as persons associated with its members, with the provisions of the Act, the rules and regulations made pursuant to it, and the rules of the exchange.[32]

In addition to ensuring the discipline of its members, an exchange in the United States must ensure that its rules provide for a fair representation of its members on its governing bodies, reflect public and private interests, and prevent unnecessary burdens on competition. The exchange must design the rules:

> "...to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediment to and perfect the mechanism of a free and open market and a national market system, and in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or to regulate by virtue of any authority conferred by this title matters not related to the purposes of this [Act] or the administration of the exchange."[33]

After registration, the Securities Exchange Act of the United States confers on an exchange the power and responsibility to make its own regulations on its governance and the discipline of its members, thereby making it a self-regulatory organisation under government oversight. Since 1975 United States Congress has strengthened the regulatory oversight of the SEC so that it must approve any rule change that a SRO proposes, and it may, of its own motion abrogate, add to, and delete from the SRO rules in the interest of the public and the protection of investors.[34]

As the SROs regulate and monitor their members, the SEC in turn monitors the SROs as well as securities broker-dealers so as to ensure that

[32] Section 6(b)(1) *Ibid.*.

[33] Section 6(5) *Ibid.* Section 3(a)(1) of the Securities Exchange Act defines a securities exchange as including any facility intended "for bringing together purchasers and sellers of securities" or for otherwise performing for securities "the functions commonly performed by a stock exchange as that term is generally understood." However, the rise of proprietary trading systems (PTSs) and communication linkages that provide facilities for the interaction of purchasers and sellers of securities away from the traditional trading floors raised the need for the SEC to define which facilities are exchanges that must be registered. In response the SEC observed that to apply the Section 6(b) registration requirement to them would be absurd, and to characterise such electronic trading system as exchanges would stifle innovation and competitiveness in securities trading. Consequently, the SEC introduced the regulation of PTSs through the requirements of record-keeping and reporting obligations that it imposed on broker-dealers. See Securities Exchange Act Release 35, 124, 58 S.E.C. Dock. 1211 (20 December, 1994).

[34] See Section 19(b) and (c) of the Securities Exchange Act.

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they meet their responsibilities.[35] It may embark on "a review of the activities of registered securities associations and national securities exchanges in the development of the system."[36] If an SRO disciplines any of its members by denying the member "membership or participation...or prohibits or limits any person in respect of services offered by such organisation...or bars any person from becoming associated with any member..." it must promptly notify the SEC. The latter may review the entire proceedings and reduce the sanction, but it has no power to increase it.[37] The SEC may, of its own motion, enforce the rules of an SRO if it is of the opinion that the SRO is "unable or unwilling to take appropriate action" against any person who has violated the rules of an SRO.[38] In addition, the SEC may bring enforcement proceedings against the SRO itself, though it hardly does so, as a threat of such an action is leverage enough for it.

In tandem with the practice in the United States, the Investments and Securities Act (ISA)[39] gives the Nigerian SEC the regulatory oversight over securities business and SROs. The SEC must register Securities Exchanges, Capital Trade Points, Futures, Options and Derivatives Exchanges, Commodity Exchanges and other recognised Investment Exchanges.[40] The SEC "[acts] as a regulatory apex organisation for the Nigerian capital market [and for] the promotion and registration of self-regulatory organisations and capital market trade associations to which it may delegate its powers."[41] The SROs must not exceed the scope of the powers that the SEC delegates to them, and the latter has special departments that regulate the former.[42] The SEC must register them before they commence business, and are recognised as SROs. The SEC prescribes the form and content of the registration application[43] and, it may register a body corporate as a Securities Exchange or Capital Trade Point once it is satisfied that the rules of the body satisfactorily provide for:

(a) the exclusion from its membership of persons who are not of good character and who do not possess a high degree of business integrity;
(b) the expulsion, suspension or discipline of members for conduct

[35] It is usual that all SROs must comply with the SEC rules on "orderly, fair and equitable dealings in securities." They also must have a SEC-approved code of conduct for securities a market operator that maintains proper standards of conduct and professionalism in securities business.
[36] Section 17B Securities Exchange Act.
[37] Section 19(d) and (e) *Ibid.*
[38] Section 21(f) *Ibid.*
[39] No 45 of 1999.
[40] Sections 8(a)(b) *Ibid.*
[41] Section 8(n) *Ibid.*
[42] Section 9 *Ibid.*
[43] Section 20 *Ibid.*

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inconsistent with just and equitable principles in the transaction of securities business or for a contravention of or failure to comply with the rules of the Securities Exchange or Capital Trade Point or of this Act;

(c) the conditions under which securities may be listed for trading on that particular Securities Exchange or Capital Trade Point;

(d) the conditions governing dealings in securities by members;

(e) the class or classes of securities which may be dealt in by members;

(f) a fair representation of persons in the selection of members of the Board of the Securities Exchange or Capital Trade Point and the administration of its affairs and provide that one or more members of the Board shall be representative of listed companies and investors; and

(g) carrying on of the business of the Securities Exchange or Capital Trade Point in the interest of the public.[44]

It is important to note that the SRO must, prior to registration, undertake by an oath to promptly furnish the SEC with any amendments to its rules and the listing requirements; keep such records and render such returns as the SEC may demand from time to time; and comply with as well as get its members to comply with the provisions of the ISA and SEC rules and regulations.[45]

The Nigerian SEC may, after consultation with the Board of an SRO, amend its rules or listing requirements provided that it informs the SRO of the content of the amendment and the commencement day thereof. However, it may dispense with the consultation if the purpose of the amendment is the protection of investors.[46] If an SRO takes disciplinary action against a member through fines, reprimands, suspension, expulsion or any other sanction, it must inform the SEC within seven days.[47] The latter may affirm or set aside the disciplinary measure, and it may of its own motion, discipline the erring member if it is dissatisfied with the way the relevant SRO has handled the matter. In all cases, the member and SRO have the right to be heard. Any person who is dissatisfied with the decision of a SRO or the SEC may appeal to the Investments and Securities Tribunal (IST) within one month after he has been informed of it.[48] If any person is not satisfied with

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44 Section 21 *Ibid.*

45 Rules 22(vi), (xii) and xiii) Securities and Exchange Commission, Rules and Regulations Pursuant to Investment and Securities Act (ISA) of 1999 (SEC Rules and Regulations).

46 Section 23(3) *Ibid.*

47 Section 24 *Ibid.*

48 Section 25 *Ibid.*

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a decision of the IST, he may appeal on points of law to the Court of Appeal after notifying the IST Secretary, within thirty days of the decision.[49]

Every broker or dealer must be a member of one or more SROs depending on the number of Securities Exchanges he effects transactions on. In addition, a broker/dealer must be a member of an Association of Securities Dealers to be able to transact business in an OTC market.[50]

3.2 The National Association of Securities Dealers

Another category that is an SRO is the National Association of Securities Dealers (NASD) established under the statutes of major and emerging securities markets. In 1938, the United States Congress widened the scope of self-regulation by conceptualising this association to regulate brokers and dealers in the OTC market,[51] that is, the market for securities that are not traded on any exchange. The NASD is the only association of that category in the United States. Its regulatory role is most prominent in the discipline of brokers and dealers, and it extends to violations of statutes, SEC rules and the rules of the SRO.[52] The NASD owns and runs the National Association of Securities Dealers Automated Quotations (NASDAQ) market that is the biggest OTC market in the world.

As in the United States, Nigerian law also provides that the SEC shall register the NASDs that comply with Rule 23 of the SEC Rules and Regulations.[53] The association owes towards the SEC responsibilities that are identical to those of the other SROs. The OTC market aggregates competent professionals who assist issuers and investors to make good decisions. It also facilitates an open competition for investors' orders so as to produce an efficient pricing system. The efficient entry and exit mechanism that the market offers provides a great opportunity for portfolio diversification.[54] The efficiency, fairness, and transparency that the market must offer are best achieved through the SRO under government oversight.

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[49] Section 243(1) *Ibid.*

[50] Rule 42 of the SEC Rules and Regulations. By virtue of this rule, if a broker/dealer effects transactions only on a securities exchange of which he is a member, that exchange is the appropriate SRO. But where the broker/dealer also transacts business on another exchange and OTC, the exchange and the Association of Securities Dealers shall be the appropriate SROs.

[51] An OTC market is for securities that are not listed on any Stock Exchange. The participants transact business through telephone and computer network that connect dealers in stock and investors.

[52] Sections 6 & 15A of the Securities Exchange Act.

[53] The Nigerian NASD has applied to the SEC to be registered as a SRO so as to operate the OTC. The SEC has not registered it because it has not fully complied with its requirements. The proposed OTC is to be fashioned after the United States National Association of Securities Dealers Automated Quotations (NASDAQ) market system.

[54] SEC, *Securities and Exchange Commission Annual Report and Accounts*, The Nigerian Securities and Exchange Commission, Abujâ, (2000), p.24.

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To recapitulate, the SEC may review the disciplinary proceedings of SROs, including the NASD.[55] In *Re Robert Jautz*[56] the United Ststes SEC overturned a sanction that NASD imposed on a registered representative of one of its member firms. The NASD found that the appellant, Jautz abused his position to obtain a loan from a customer, and failed to promptly repay the loan. It sanctioned Jautz and fined him $500 for violating Article III, Section I of the NASD Rules of Fair Practice that commands members to "observe high standards of commercial honor and just and equitable principles of trade."

3.3 The Central Securities Clearing System

Another important SRO is the Central Securities Clearing System Limited that facilitates clearing and settlement of trade in securities. The Bank for International Settlements and the International Organisation of Securities Commissioners of securities regulation stipulates the development of an efficient securities trade clearing and settlement system within each member jurisdiction. Participants in the securities market should set up the system with clearing and depository facilities, and it must aim at a settlement period of the transaction day plus a maximum of three days (T+3).[57] The securities regulators of the Group of Thirty (G30),[58] in its report on securities settlement systems, had recommended a clearing and settlement period of (T+3) for the major markets, and (T+5) for emerging markets.[59]

In response to the recommendations above, the leading SRO in Nigeria, the NSE established the Central Securities Clearing System Limited (CSCS) in 1992. The CSCS facilitates the exchange of stock and bond holdings as well as offers custodian services. As a clearinghouse, it facilitates the validation, delivery and settlement of securities transactions. The NSE holds 51 per cent of its shares while stockbrokers, stock registrars, investment bankers and other market participants hold the remaining 49 per cent.

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[55] See H. I. Alile and R. A. Anao, *The Nigerian stock market in operation*, Lagos, The Nigerian Stock Exchange (1986), pp. 22-23.

[56] Securities and Exchange Commission (15 April 1987).

[57] Bank for International Settlements, *Report of the Committee on Payment and Settlement Systems (CPPSS)-IOSCO Joint Task Force on Securities Settlement Systems, Consultative Report*, Basel, (January 2001).

[58] The Group of Thirty (G.30) is a 'think-tank' of 30 high-level individuals drawn from central banks, commercial banks, economists and finance ministries of countries which include Australia, Austria, Belgium, Canada, France, Germany, Italy, Japan, Singapore, Spain, Switzerland, United Kingdom and United States. The group made nine core proposals on securities trade clearing and settlement systems which the member-countries of IOSCO, including Nigeria, have been complying with since the 1990s. See Hal S. Scott and Phillip A. Wellons, *International securities regulation*, New York, Foundation Press (2002), pp. 416-418.

[59] SEC, *Secondary Market in Securities Transactions*, Abuja, Research and Marketing Department (2000), pp. 11 and 42.

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The Nigerian SEC must register all securities clearing settlement depository and custodial agencies before they could operate. Importantly, each of the agencies must have a paid up capital of N500 million (five hundred million naira),[60] and post a fidelity bond of at least 25 per cent of the paid up capital for the protection of investors. Its sworn undertakings are identical to those of the other SROs, and it must inform the SEC of the internal control measures in respect of access to demobilised securities.[61]

The United States has long had an efficient securities clearing system that seems to set the pace globally. Two clearinghouses serve the nation's seven stock exchanges. The National Securities Clearing Corporation (NSCC), which is jointly owned by the New York Stock Exchange, the American Stock Exchange and the National Association of Securities Dealers processes 99 per cent of all stock trade. The clearing houses are financially structured to maintain adequate resources to assure settlement of trades. The members must maintain any minimum capital specified by the clearinghouse as guarantee fund, and the clearinghouse may make claims on items in process as well as on a defaulting member's remaining assets on deposit with the clearinghouse. The structure of clearinghouses aims to solve problems quickly to avoid systemic impact by promptly isolating a failing member.[62]

4. GREATER CAUSE FOR STATUTORY INTERVENTION?

A scholar in securities regulation describes the concept of self-regulation of securities dealings as, "[a] curious political choice, for it entrusts an important regulatory responsibility to an organization whose members are the regulated industry and whose self-interest will naturally diverge from that of the public. Its justification invokes the natural expertise of the industry participants, their interest in a good reputation, and the desire to remove some of the costs of regulation from the government and tax-payers."[63]

Sidney Shapiro has employed a transaction cost analysis to explain why governments increasingly use private institutions and resources to achieve public goals, including the making and enforcement of regulations.[64] He points out that ". . . the government's decision to rely on private

[60] About US $4 million.
[61] Rule 25, SEC Rules and Regulations.
[62] See Hal S. Scott and Phillip A. Wellons, *op cit.*
[63] James D. Cox *et al*, Securities regulation: Cases and materials, *op. cit.* at p.1074.
[64] Sidney A. Shapiro, "Outsourcing Government Regulation", http://www.law.duke.edu.journals/dlj/articles/dlj53p.389 visited on 16/11/05

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means in regulatory context is a type of make-or-buy decision. When it makes this decision, an agency must determine whether to produce and implement regulatory policy inside the agency or involve private actors in these functions." Transaction cost then becomes a tool for fashioning "a normative framework that suggests when the government should outsource regulation."[65] In opting for self-regulation by securities markets, government achieves its regulatory oversight at the lowest transaction cost.[66]

It seems however that it is not in all situations that transactional cost determines whether or not government would outsource regulation. Experience has shown that financial crises with potential adverse effect on investor confidence in the securities market, economic growth and the political fortune of the government often dictate the regulatory option that governments adopt. Just as the market crash of 1929 prompted the United States Congress to intervene in securities regulation, the accounting scandals and insiders' dealings in Enron, Arthur Anderson, WorldCom and Adelphia have prompted the federal government to respond with more interventionist statutes to curb corporate abuses.

The most significant of these interventionist statutes in the United States is the Sarbanes-Oxley Act of 2002.[67] The Act attempts to give more efficacies to investor protection by improving the quality, accuracy and reliability of corporate disclosures and financial reporting. Beyond the existing rule initiatives of self-regulatory organisations and the SEC, the Act requires enhanced financial disclosures from securities issuers. For example, Section 401(a) (j) requires the SEC to adopt rules requiring each annual and quarterly financial report filed with the Commission to disclose:

> "all material off-balance sheet transactions, arrangements, obligations(including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses."

By virtue of Section 401(b) (1), the SEC must demand that pro forma financial information included in any report presented to it by securities issuers and their agents, or put in any public disclosure of securities information must not contain any untrue statement of a material fact. The

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[65] Sidney A. Shapiro, *op. cit.*
[66] *Ibid.*
[67] 15 USC 7201, Public Law 107 – 204 – 30 July, 2002

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report must also not omit to state a material fact necessary in order to make the pro forma financial information not misleading.

The Sarbanes-Oxley Act also mandates the American SEC to review disclosures made by issuers reporting to it, whose securities are listed on any national securities exchange or traded on an automated quotation facility of a national securities association.[68] The SEC may do the review for the following –

(1) issuers that have issued material restatements of financial results;
(2) issuers that experience significant volatility in their stock price as compared to other issuers;
(3) issuers with largest market capitalisation;
(4) emerging companies with disparities in their price to earning ratios;
(5) issuers whose operations significantly affect any material sector of the economy; and
(6) any other factors that the Commission may consider relevant.[69]

The foregoing and some other provisions of the Act further take the issue of transparency and fairness of transactions beyond market self-regulation.[70]

The American Act also seeks to increase the responsibility of management for corporate disclosures and financial statements, and to strengthen the independence of accounting firms and the role of audit committees in securities regulation.[71] It contains two certification provisions. Section 302 requires the principal executive officer(s) and the principal financial officer(s) or persons performing similar functions in every reporting company to, *inter alia*, certify each annual or quarterly report to the SEC. The certification must state that, among other things, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made not misleading. It must also state that the certifying officers are responsible for putting in place the reporting companies' internal control.

Section 906 of the Act requires each periodic report containing

[68] Section 408(a) *Ibid.*

[69] Section 408(b) *Ibid.*

[70] See generally all the provisions of Section 401. See also Section 403 on disclosures of transactions involving issuers' management and major shareholders. This section requires any of them who beneficially own more than 10 percent of any listed equity security to file with the Securities and Exchange Commission and the relevant national securities exchange the particulars of all his equity securities holding and dealings in those securities within the stipulated time.

[71] For further reading on the Sarbanes-Oxley Act and the expanded rule-making power of the American Securities and Exchange Commission, See John J. Huber, *et al.* "The new disclosure and corporate governance regime: What every corporate and securities lawyer must know," 1335 *Private Law Institute/Corporation* (2002), p. 517.

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financial statements filed by a domestic or foreign issuer of securities to be accompanied by a written statement or certification by the chief executive officer and the chief financial officer or their equivalent. This section, which amends the United States Federal Criminal Code,[72] provides levels of criminal penalties of a fine of $1 million or imprisonment for not more than 10 years, or bot. , or a fine of not more than $5 million or imprisonment for not more than 20 years, or both, depending on the intent of the certifying officers.

To facilitate real-time disclosure of securities information so as to improve the usefulness of the disclosure to investors, Section 409 of the Sarbanes-Oxley Act requires every issuer to disclose to the public on a rapid and current basis, information concerning material changes in the financial condition or operations of the issuer as the SEC may determine or as may be useful for the protection of investors and in the interest of the public. The Act, amongst other things, also empowers the American SEC to promptly issue rules setting forth minimum standards of professional conduct for certain securities professionals in the public interest and for the protection of investors.[73]

The enhanced duties that the Sarbanes-Oxley Act imposes on securities issuers and their agents, increases the cost of running a public company and will impact on investors' earnings. Auditors' fees and premiums for officers' and directors' insurance will increase, and the shareholders will pick up fresh bills for the litigations that will arise under the new statutes.[74]

The Nigerian National Assembly has not enacted any new securities statute after the Enron experience but it relies on provisions in the Investments and Securities Act that prohibit practices such as making of statements or dissemination of misleading information to falsely induce trade insecurities and the employment of any device, scheme or artifice to defraud other persons in securities transactions.[75] There is no doubt that Nigeria needs to enact a proactive pre-emptive statute to curb the Enron kind of crises.

Government oversight is however important for the effectiveness of market regulation. Self-regulation is contractual in nature. By this contract, an exchange regulates corporate issuers through its listing requirements,

[72] Title 18 of the U.S. Code.

[73] Section 307 Sarbanes-Oxley Act provides that the Securities and Exchange Commission shall issue rules that will compel attorneys representing securities issuers, including in-house counsel who help in preparing periodic securities reports, to report "evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company" for appropriate remedial measures or sanctions. This provision has reversed the Commission's twenty-year policy of not regulating the professional conduct of attorneys.

[74] Adam C. Pritchard, *op. cit.*

[75] See Sections 81-87 of the Investments and Securities Act.

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and it wields authority over broker/dealers through membership rules. But there are individuals who participate in market abuses and are beyond the enforcement reach of the exchange due to the principle of privity of contract. Governmental authority is needed in this area. In addition, SROs enforce their rules through civil penalties. But there are market abuses that criminal sanctions deter. Exchange rules traditionally specify disclosure requirements and prohibit insider trading, but government intervention is needed for criminal sanctions for breach of the rules.[76]

The interest of the market in its own reputation seems to be a credible incentive for a self-regulatory market to engage in efficacious regulatory practices. The volume of trade in securities is affected by investors' confidence in the integrity of the market, while the profits of brokerage firms are related to the volume of trade. Therefore, it is imperative on SROs to have an effective self-regulatory framework.[77]

Phillip D. Parker identifies the advantages of the self-regulatory model as the technical expertise and flexibility of the SROs, cost savings to government as well as the acceptability of the SROs' rules over those of government regulators. He adds pertinently:

> "Market professionals who are actively engaged in the business may have a better understanding of many technical aspects of exchange regulati . . . An SRO may have a greater ability to adapt to new developments in the securities markets . . . Because the members of an SRO elect its directors and have an opportunity to participate in the rule-making process, there may be a greater willingness to comply with the rules governing their conduct."[78]

Against the advantages, Parker identifies as disadvantages conflict of interest, antitrust implications, and due process concern. He further elaborates as follows:

> "Because a securities exchange is both a business venture and a regulatory body, there is always a danger that the rules will not be enforced in circumstances where the enforcement would be detrimental to business . . . Because the members of an SRO are collectively regulating their own behaviour, there is a danger of

[76] *Ibid.*

[77] Sidney A. Shapiro and Randy Rabinowitz, "Voluntary regulatory compliance in theory and practice: The case of OSHA, 52 *Admin. L. Rev.* (2000), at p.138.

[78] In, "The concept of self-regulation under the federal securities laws," an unpublished paper delivered at the SEC International Institute for Securities Market Development, Washington D.C. (12 March, 1999).

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> collusive behaviour that ultimately hurts customers....
> A member's right to conduct business can be taken away by individuals exercising a form of governmental power. A member may have all of the procedural rights, however, that would apply if the government were the disciplinary body."[79]

It is significant that despite Parker's evaluation and critique of the self-regulatory system, this system has been an indispensable part of the United States regulatory system for more than seventy years. It has also been a significant part of the Nigerian regulatory approach as well. The SROs continue to assume more important role and occupy positions of significance in securities regulation too. The National Association of Securities Dealers in the United States controls the American Stock Exchange. However, to ensure that the SROs do not become law unto themselves, government regulatory oversight in major and emerging markets have to adequately respond to the perceived and potential disadvantages of self-regulation. The SEC may, *suo moto*, enforce the regulations of the SROs that they fail to enforce because of their perception that they may thereby suffer adverse economic or financial detriment. The United States securities statutes and antitrust laws continue to respond to new developments in self-regulation. The United States government intervention in the securities market, prompted by the collapse of Enron and WorldCom may mark the beginning of a new kind of intervention in the global securities regulation. The enactment by the Federal Government of Nigeria in 1999 of the ISA and the SEC Rules and Regulations made pursuant to it is also indicative of more government intervention in securities regulation. The Nigerian National Assembly however has not enacted an anti-trust statute to address collusive and cartel-building conduct of SRO members so as to further strengthen investor protection.

The subjection of self-regulation to the supervisory oversight of the SEC and judicial review not only recognises its importance, but it also guides the direct intervention of the legislature. In *First Jersey Sec. Inc.* v *Bergen*,[80] the respondent broker-dealer complained that the NASD violated due process by subjecting it to a disciplinary hearing before a panel whose members were its business competitors. Denying it the relief sought the court said:

> "[S]elf-regulation is the best 'first-line' defense against unethical or illegal securities practices. It allows the industry to set its own standards of proper conduct and permits their members

[79] *Ibid.*
[80] 605 F. 2d 690 (3d Cir. 1979), *cert. denied.* 444 U.S. 1074 (1980).

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> to discipline themselves applying their own expertise and experience.
> "Although Congress preferred self-regulation by a private body over direct involvement of governmental agency, it established safeguards to prevent abuse of the system . . . For example, the NASD Code of Procedure . . . requires the disqualification of any panel member who may have a personal interest in the outcome of a case. Further insurance against abuse is provided by the supervisory role of the SEC . . . We believe that the intrinsic benefits of a system of self-regulation, insulated with extensive procedural and substantive protections and subject to judicial review, render insignificant objections of bias to the system which inherently involves disciplining by potential competitors."[81]

There is no doubt that government oversight enhances the efficacy and the effectiveness of market regulation. However, the oversight must not be so overbearing as to stifle the incentives of the SROs to respond to the needs of the market. Pritchard[82] contends persuasively that government must allow the SROs ample authority to determine the content of their own rules while it "audits" the SROs to ensure that they enforce the rules impartially, and where need be, provide criminal sanctions for breach of the rules. While the exchange determines disclosure requirements and prohibition of market manipulation, it should also impose civil penalties, but government should, where appropriate, impose and enforce criminal sanctions through criminal proceedings.[83]

5. CONCLUSION

Self-regulation has become the securities markets' practice and procedure. Many securities markets began as, and are still self-regulatory. A number of countries including the United States, Nigeria, Australia, Hong Kong and Singapore are primarily self-regulatory. Self-regulation has commended itself to these markets because trade in securities is a free market phenomenon. The practice thrives on the bases that the interest of securities markets in their own reputation and their quest for trade volume make it imperative for them to establish an efficacious self-regulatory framework for investor protection. In addition, self-regulatory organisations have the technical expertise and experience to set their own ethical standards and

[81] *Ibid* at 698-699.
[82] *Op. cit.*
[83] Pritchard, *op. cit.*

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to promptly respond to the needs of the market.

Government regulators in the major and emerging markets under focus realise the inevitability of self-regulation. In recognising self-regulation, government shifts some cost of regulation to investors while at the same time using private means to achieve public ends. Securities markets and their regulators benefit from the social control that SROs exercise over their members as more information is available to government regulators at a lesser expense to tax payers. These vital factors show that self-regulation progressively has justified its importance.

Government intervention and oversight is however important for the effectiveness of market regulation which is contractual in nature. The securities markets need government to reach those who are outside the contracts created by the listing regulations and membership rules of the market. Importantly also, sharp practices in securities dealings that self-regulation has not been able to contain as evidenced by the Enron-type of crisis, call for more inclusive and intense government intervention in securities regulation. The justification receives strength in the other latent disadvantages of the self-regulatory system which include non setting and enforcement of regulations that would reduce the economic gains of the self regulator, collusive behaviour and the fact that the interest of the self-regulatory entities may diverge from the interest of the public.

Experience has shown that the scope of self-regulation is shrinking. The monumentally adverse consequences on investors occasioned by previous market abuses, and the recent accounting fraud as well as the criminal concealment of corporate information by corporate professionals have provoked a proactive and more intrusive approach to government regulation of securities markets. However, the reforms that new statutes introduce result in increased cost to securities issuers and investors. If care is not taken, government intervention could become so overbearing as to stifle the ability and initiative of the SROs to respond to new developments in the market. It is important then that the government allows the SROs ample authority to determine the content of their own rules while it monitors their response to new developments and ensure that they enforce their regulations. While the SROs enforce their rules with civil sanctions, government should continue to provide criminal sanctions where appropriate.

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