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**By Electronic Mail and U.S. Mail**

Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, D.C. 20549-0609

Re: **File No. S7-40-04**  
**Concept Release Concerning Self-Regulation**

Dear Mr. Katz:

The American Stock Exchange LLC (“Amex” or “Exchange”) appreciates the opportunity to submit the following comments with respect to the Commission’s concept release that pertains to issues related to the self-regulatory system of the securities industry (File No. S7-40-04).<sup>1</sup> We are also transmitting to the Commission today a separate letter with our comments on the Commission’s closely related release that proposes new rules for the fair administration and governance of self-regulatory organizations (“SROs”).<sup>2</sup>

There are two primary topics that we would like to specifically comment on herein. First, our comments will focus on the discussion of alternative regulatory approaches. Second, we have reviewed and wish to comment on the discussion on market data fees, which should be read in close conjunction with the discussion on regulatory fees in our other letter referenced above.

**I. Alternative Regulatory Approaches**

Given the level of uncertainty, the Amex believes it is much too early to settle on a single alternative. We would like to take this opportunity to urge that the Commission

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<sup>1</sup> Securities Exchange Act Release No. 50700 (November 18, 2004), 69 Fed. Reg. 71256 (December 8, 2004) (the “Release”).

<sup>2</sup> Securities Exchange Act Release No. 50699 (November 18, 2004), 69 Fed. Reg. 71126 (December 8, 2004) (the “Governance Proposal”).

move cautiously and deliberately in making its decision in order to allow the SROs adequate time to accumulate experience under the new rules for SRO governance, administration and reporting that will be required under the Governance Proposal, as finally implemented. The experience gained from those very significant changes will be critical to informing the decision on a long-term regulatory approach, and time will be required to accumulate that experience.

More specifically and based upon our experience over the past eight months as the only floor-based market with an outsourced regulatory program, we think that the universal regulator models and the direct Commission regulatory model both have the potential to significantly increase the cost of regulation. While the time-frame of our experience is too narrow to make grand pronouncements, it is fair to say that, even after taking into account the incremental cost of enhancements, Amex's costs to perform largely the same program as before with mostly the same people have climbed dramatically. In part, this increase results from the time requirement and degree of difficulty inherent in coordinating the operations of our marketplace, which exists in a highly competitive environment characterized by rapid changes in both rules and systems, with a third-party regulatory provider. More fundamentally, each of these models as well as the hybrid approach could result in substantially higher costs for the simple reason that each approach amounts to a monopoly and is therefore likely to be attended by the absence of cost consciousness typically associated with monopoly pricing.

Should this increase in cost be passed along to the exchanges (the Release is silent on this point), this increase could become a significant issue in an exchange's ability to remain competitive with non-SRO markets that are able to offer trading opportunities without incurring the same regulatory costs. More fundamentally, we believe that regulatory decisions should appropriately take impact on competition into account, and should not discourage innovation, the success of competitive organizations or the creation of new exchanges.

In addition to cost factors, we are concerned that certain of the alternatives suggested in the Release (the two universal regulator models and direct Commission regulation) would outsource all market regulation and result in the complete elimination of all of the markets' self-regulatory authority. Different market models and structures necessarily require different SRO rules, but market rulemaking, market surveillance and market rule enforcement would be carried out under these alternatives by persons who would likely lack market specific expertise. The Amex believes that such a structure would stifle competition by seriously impairing the ability of an SRO to be nimble and react quickly to competitive challenges. The market regulation function for a given SRO must involve individuals who understand and are intimately familiar with the complicated systems and rules of that particular market so that needed market structure changes can be quickly approved and implemented. It is unrealistic to expect persons in a distant bureaucracy, who lack both detailed knowledge of how that market works and the incentive to cooperate with the market to respond quickly to competitive events, to carry out this regulatory function in a satisfactory manner.

In making the foregoing observations, we do distinguish, however, between market regulation and member firm regulation. The current system that requires each SRO to perform its own member firm regulation has resulted in widely differing standards that compromise investor protection. These differences in member firm regulation are highly inefficient and impose significant costs on broker-dealers because of differing investor protection rules, examination programs and enforcement across markets. A solution that relieves individual SROs of this responsibility and results in uniform regulation across all markets would be highly desirable, and it should logically be funded directly by the broker-dealers who will benefit from the resultant cost savings, not by the SROs.

With those caveats, the Amex would like to offer some positive comments, along with a few cautions, on one of the alternative regulatory approaches presented. We are favorably impressed at this point with the potential of the “hybrid model” under which the Commission would designate a “market neutral single self-regulatory organization (‘Single Member SRO’) to regulate all SRO members with respect to membership rules . . .”<sup>3</sup> The particular rules covered are those relating to the financial condition of members, margin practice, handling of customer accounts, broker registration, branch office supervision and sales practices. Under this approach, the Amex and each other SRO “would be solely responsible for its own market operations and market regulation.”<sup>4</sup>

We agree that one of the advantages of this approach is the elimination of duplicative regulation with respect to membership rules brought about by the centralization of broker-dealer regulation. Another strength of the approach, as discussed above, is the fact that the market regulation function would remain with the Amex and the other SROs, thus avoiding the problem of regulators lacking specific market expertise in the markets they regulate (which would be the case if an independent party were used for market regulation). As suggested above, we believe that the designated Single Member SRO should be funded directly by broker-dealers.

Despite our generally positive view of the hybrid approach, we would like to point out that some of the regulatory areas are not as neatly separable as the model seems to contemplate. Therefore, the regulatory structure would probably have to be adjusted to account for the fact that membership in a marketplace creates additional non-market regulatory issues that are probably best left to the marketplace SRO rather than the Single Member SRO. For example, while qualification exams generally could be centralized in the Single Member SRO, specialist exams should probably be left to each marketplace. Similarly, while the Single Member SRO could perform financial and operational reviews, the Amex has an interest in ensuring that its specialists meet the higher capital standards that we impose upon them. Even the review of so-called “upstairs” activity can be directly related to the Amex’s regulation of its market as, for example, with the review of order tickets from upstairs firms in connection with our examination or investigation of floor broker order handling activity. This means in practice that our member firms

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<sup>3</sup> 69 Fed. Reg. 71277.

<sup>4</sup> 69 Fed. Reg. 71278.

would be subject to the dual jurisdiction of the Single Member SRO and the Exchange, although our jurisdiction would be limited to activities that directly impact or relate to activity in our marketplace.

Before reaching a final decision on the hybrid model or any of the other proposed alternatives, the Commission should consider a less radical approach – one that is based on cooperative action among SROs and sharing of information as under 17d-2 plans. This model has been used for many years by the participants of the Options Self-Regulatory Council to regulate options sales practice activity. Similarly, in the commodity industry, the CFTC oversees the Joint Audit Committee (“JAC”), which consists of representatives of the various SROs, and is responsible for dividing the audit duties among the SRO participants, and devising the audit program that must be followed by each SRO. Under the JAC’s umbrella, SROs regulate member firms that belong only to their respective organization, but share the audit duties for common members by performing a single audit on behalf of all SROs for whom the member firm is a member. It has been a successful program allowing cost savings and efficiencies to the SROs and, importantly, to the member firms who are subject to the audits. We recommend that the Commission examine the JAC as a possible model for such regulatory sharing of responsibilities.

This type of cooperative action could also take the form of the creation by the exchanges of a national market plan under Section 11A(a)(3)(B) of the Securities Exchange Act of 1934 for the purpose of conducting certain regulatory functions on behalf of the participants. Such an approach would have the cost efficiencies of the hybrid without the monopolistic attributes of the hybrid. Additionally, this cooperative approach seems particularly promising in terms of the ability of the SROs to gain access to the information that they need for regulatory purposes from the broker-dealers while eliminating overlapping and conflicting regulation by the individual SROs, whereas a Single Member SRO under the hybrid model, operating as a separate, detached bureaucracy, might present more difficulty in accessing such information in a timely fashion from the SRO members.

## **II. Issues Regarding Market Data Fees**

The Amex wishes to respond to a number of the questions posed by the Commission in Section IV.D.2.d of the Release regarding market data fees. To begin with, Question #24 asks: “*Are current market data fees significantly limiting access of market participants, investors, or other users to data?*”<sup>5</sup> The Amex believes that it is absolutely clear that market data fees are reasonably priced and in no way limit access to market data. The Release itself notes that market data revenue “represents a relatively small portion of the securities industry’s total expenses”<sup>6</sup> and that this is “[i]n contrast to the importance of market data revenue to overall SRO funding.”<sup>7</sup> More specifically, the

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<sup>5</sup> 69 Fed. Reg. 71275.

<sup>6</sup> 69 Fed. Reg. 71270.

<sup>7</sup> *Id.*

Release points out that, in 1998, the total SRO market data revenue represented “less than ¼ of one percent”<sup>8</sup> of the securities industry’s total expenses for the year. In addition, the growth over time in market data revenues has not kept pace with the growth in other SRO revenues. The Release cites data from the Commission’s 1999 Market Data Concept Release showing that the 67% growth in market data revenues from 1994 to 1998 did not keep pace with the 139% growth in the securities industry’s total revenues during this period.<sup>9</sup> This translates into more than a 30% decline in market data fees as a percentage of total industry revenues during this period.

The Amex believes that many of the complaints concerning market data fees are from securities industry participants that are far more profitable than the SROs and are seeking to further lower costs that are minor to them but are crucial to SRO revenues and, consequently, to SRO regulatory programs. It is, in fact, quite surprising that this issue continues to be raised given the clarity of the evidence that market data is reasonably priced.

Question #25 in the Release inquires: “*Should the Commission reconsider the flexible cost-based approach?*”<sup>10</sup> The Amex believes that the answer to this question is a resounding “No.” Our view is that this approach would lead the industry into the swamp of true old-style rate-making. The definitive answer to this question was, in fact, provided some time ago by the 2001 report of the Commission’s own Advisory Committee on Market Information. Their report “noted the consensus view that it was essentially a ‘ratemaking’ approach that was unwise and, ultimately, unworkable.”<sup>11</sup> Variations on the theme, such as the “narrow cost-based approach that takes into account only limited costs, such as consolidation costs”<sup>12</sup> suggested in Question #26 in the Release are no less problematic. We also cannot help but observe that brokerage firms and money managers use funds from one area to cross-subsidize other important and necessary business areas. We believe that, similarly, SROs should not be prevented from using their market data revenues for other purposes as well.

Finally, the Commission has posed questions regarding the importance of market data fees as a component of SRO funding. Question #30 in the Release asks: “*If the Commission were to implement a revised approach to market data fees that substantially reduced this element of SRO funding, would SROs be able to raise the level of other revenue sources to remain adequately funded to comply with their statutory obligations?*”<sup>13</sup> The Amex believes that this question must also be answered in the negative. The idea that the Commission would seriously contemplate such an approach flies in the face of (a) the previously cited slower growth of market data revenues relative

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<sup>8</sup> *Id.*

<sup>9</sup> 69 Fed. Reg. 71272 n. 235.

<sup>10</sup> 69 Fed. Reg. 71275.

<sup>11</sup> 69 Fed. Reg. 71274.

<sup>12</sup> 69 Fed. Reg. 71275.

<sup>13</sup> *Id.*

to security industry revenues, (b) the fact that all exchanges have these fees as an important source of revenue and (c) the price stability of equity market data fees, which have not risen in many years. Related Question #32 in the Release asks: “*If market data fees were substantially reduced and SROs were unable to replace these revenues from other sources, would SROs be able to adequately fund their regulatory operations?*”<sup>14</sup> The Amex believes it is clear that the SROs would not be able to do so without some other replacement income source. In partial response to Question #31, SROs that are true SROs (providing listings and rigorous market regulation) are currently underfunded even with the current level of market data revenues. Such fees are a critical component of SRO funding.

Thank you for giving us the opportunity to express our views on these important issues. If the Commission or members of its staff have questions concerning any matters raised in this letter, please contact me at (212) 306-2200.

Sincerely,

/s/ Neal Wolkoff

cc: The Hon. William Donaldson, Chairman  
The Hon. Paul Atkins, Commissioner  
The Hon. Roel Campos, Commissioner  
The Hon. Cynthia Glassman, Commissioner  
The Hon. Harvey Goldschmid, Commissioner  
Annette Nazareth, Director, Division of Market Regulation  
Robert L.D. Colby, Deputy Director, Division of Market Regulation  
Lori A. Richards, Director, Office of Compliance Inspections and Examinations  
Giovanni P. Prezioso, General Counsel

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<sup>14</sup> *Id.*