



March 15, 2005

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

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

Dear Mr. Katz:

The NASD staff appreciates the opportunity to express its views on the Securities and Exchange Commission's ("SEC" or "Commission") Concept Release concerning self-regulation (the "Concept Release").¹ NASD commends the Commission's efforts in undertaking this comprehensive review of the self-regulatory system governing the securities industry. Moreover, as a leading advocate of investor protection and market integrity, NASD welcomes the Commission's focus on possible enhancements to the current regulatory system that could strengthen its operation and efficacy.

As further detailed below, NASD firmly believes in preserving a securities industry regulatory model that encompasses self-regulation supervised by the Commission. Self-regulation is a key component in the effective regulation, growth, and vitality of the U.S. securities markets, offering a range of benefits that non-industry or government regulation standing alone cannot replicate.

¹ Securities Exchange Act Release No. 50700 (Nov. 18, 2004); 69 Fed. Reg. 71256 (Dec. 8, 2004) (File No. S7-40-04). The comments provided in this letter are solely those of the NASD staff; the NASD Board of Governors has not considered or endorsed them. For ease of reference, this letter may use "we," "NASD," and "NASD staff" interchangeably, but with the exception of references to NASD systems, these terms refer only to the NASD staff.

As a companion to the Concept Release, the Commission published proposed rules (the "Proposed SRO Rules") relating to the fair administration and governance of self-regulatory organizations ("SROs"). Securities Exchange Act Release No. 50699 (Nov. 18, 2004); 69 Fed. Reg. 71126 (Dec. 8, 2004) (File No. S7-39-04) ("Proposing Release"). The NASD staff has submitted a separate comment letter to the Commission expressing its views on the issues raised in the Proposing Release ("Proposing Release comment letter").

At the same time, there are inherent conflicts and inefficiencies present in the current regulatory environment. NASD believes that these shortcomings would be best addressed by adopting a form of the pure Hybrid model. The pure Hybrid model would enhance efficiency by eliminating inconsistent member rules, staff, and infrastructure, strengthen intermarket surveillance, and minimize some of the current conflicts in the self-regulatory system. If, however, the Commission declines to pursue a pure Hybrid model, NASD believes that the current model should be preserved with the types of enhancements proposed by the Commission in its Proposing Release, as well as additional modifications to address regulatory concerns resulting from market fragmentation. In particular, NASD continues to believe there is a vital need to address the regulatory gaps that exist as a result of the disparities among markets, such as inconsistent rules and regulatory data collection requirements, and resulting surveillance activities, and the inability of any one SRO to analyze all activity across such markets.²

I. Preserving the Statutory Scheme of Self-Regulation

A. Historical Perspective

Self-regulation in the securities industry has a long and effective history. Congress designed the statutory scheme of self-regulation for the securities markets during the 1930s, envisioning that most of the day-to-day responsibilities for market and broker-dealer oversight would be performed by the SROs under the Commission's direct oversight. The Commission was charged with supervising the SROs and compelling them to act where they failed to provide adequate protection. Congress's preference for self-regulation over other forms of regulation was deliberate; Congress recognized that it was impractical for the government to provide the necessary resources to effectively regulate the securities industry. To that end, Congress opted to rely primarily on the resources and expertise of the industry itself, notwithstanding its awareness of the conflicting roles of SROs in the regulatory scheme.³

² NASD previously raised with the Commission its concerns regarding these intermarket surveillance limitations. See Letter from Barbara Z. Sweeney, Senior Vice President and Corporate Secretary, NASD, to Jonathan G. Katz, Secretary, Commission (June 20, 2003) (NASD's comment letter in response to the SEC's Concept Release: Request for Comment on Nasdaq Petition Relating to the Regulation of Nasdaq-Listed Securities, Securities Exchange Act Release No. 47849 (May 14, 2003); 68 Fed. Reg. 27722 (May 20, 2003) (File No. S7-11-03)) ("Intermarket Trading comment letter").

³ As one observer put it:

[S]elf-regulation in the first instance, with the government holding its power in reserve to see that self-regulation is exercised, is after all a necessary recourse in view of the mere physical limitations in time and in personnel, which operate on the direct exercise of the powers of government as the task of regulation becomes more and more extensive over a wider and wider field.

Hearings on H.R. 7852 and 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 514 (1934) (testimony of John Dickinson, Assistant Secretary of Commerce).

This model of securities regulation has proven effective through nearly seventy years of regulatory experience. As discussed in the Concept Release, both Congress and the Commission periodically have examined the role of self-regulation in the securities industry, and while each has taken steps in certain instances to remedy shortcomings, the concept of self-regulation repeatedly has been reaffirmed.⁴

B. Benefits of Self-Regulation

There are many significant benefits to the self-regulatory model, which are evident in the success and adaptability of the U.S. securities markets. Perhaps most importantly, self-regulation can and does extend beyond enforcing legal standards to adopting and enforcing ethical standards (i.e., just and equitable principles of trade). Such ethical standards are broader and more flexible than government regulation, and address ethical lapses, as opposed to civil or criminal offenses.⁵ This authority protects investors, and the industry itself, from dishonest practices that, while not necessarily illegal, are unfair or hinder the functioning of a free and open market.

Private funding also is a critical advantage to the self-regulatory model. Millions of dollars can be spent on examination, enforcement, surveillance, and technology without the need to compete with the demand for funds from all other agencies of the federal government. In a

⁴ See, e.g., the Securities Exchange Act of 1934 (“Exchange Act”), Pub. L. 73-291, 48 Stat. 881 (1934); the Maloney Act of 1938, Pub. L. 75-719, 52 Stat. 1070 (1938); SEC, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 4 (1963) (“Special Study”); the Exchange Act Amendments of 1975, Pub. L. 94-29, 89 Stat. 97 (1975); the National Market Advisory Board, Report to the Congress: The Possible Need for Modification of the Scheme of Self-Regulation in the Securities Industry so as to Adapt it to a National Market System (Dec. 31, 1976); Market 2000: An Examination of Current Equity Market Developments, Division of Market Regulation, SEC, Study VI, at 3 (Jan. 1994) (“Market 2000 Report”).

As the Special Study concluded: “[r]egulation in the area of securities should, in short, be a cooperative effort, with the Government fostering maximum self-regulatory responsibility, overseeing its exercise, and standing ready to regulate directly where and as circumstances may require.” Special Study at 726.

⁵ As William O. Douglas, former SEC Chairman, stated:

Self-regulation . . . can be pervasive and subtle in its conditioning influence over business practices and business morality. By and large, government can operate satisfactorily only by proscription. That leaves untouched large areas of conduct and activity; some of it susceptible of government regulation but in fact too minute for satisfactory control; some of it lying beyond the periphery of the law in the realm of ethics and morality. Into these larger areas self-government, and self-government alone, can effectively reach.

Speech to the Bond Club of Hartford, Connecticut (Jan. 7, 1938), quoted in Sam Scott Miller, Self-Regulation in the Securities Market: A Critical Examination, 42 Wash. & Lee L. Rev. 853, 858 (1985).

self-regulatory system, the industry – not the taxpayers – pays for most regulation. Regulators operating in the private sector also are better positioned to move more quickly to address regulatory issues because, among other things, they are not subject to many of the spending restrictions of the federal government, and are better able to develop large-scale systems (such as market surveillance systems, the Central Registration Depository (CRD®) system, or the Trade Reporting and Compliance Engine (“TRACE”), the corporate bond transaction reporting service).

Moreover, private sector regulators are able to tap industry expertise in ways not readily available to the government and use this expertise to better protect investors and ensure market integrity. Among other things, this expertise helps to ensure that rules are practical, workable, and effective.⁶ Also, industry participants often are in the best position to identify potential problems, thus enabling regulators to stay ahead of the curve. In this regard, we believe that the response of NASD and the industry to the problems surrounding mutual fund breakpoints exemplifies the benefits of self-regulation, including the use of collective judgment and industry expertise to address complex problems in an expeditious manner. It also demonstrates the confidence with which the Commission can turn to NASD and the industry to evaluate and resolve difficult regulatory issues.⁷

⁶ As the Special Study noted, “[t]he expertness and immediacy of self-regulation often provide the most expedient and practical means for regulation.” Special Study at 722.

⁷ The mutual fund breakpoint initiative began in late 2002, when as a result of several routine examinations, NASD discovered that some firms had failed to deliver breakpoint discounts to investors purchasing Class A shares of front-end load mutual funds. In light of its examination findings with respect to a number of securities firms, NASD issued in December 2002 Special Notice to Members (“NtM”) 02-85, which reminded broker-dealers of their obligation to apply correctly breakpoint discounts to front-end sales load mutual fund transactions. Contemporaneously, the SEC staff issued a letter emphasizing the importance of the NtM and imploring the industry to heed its message. At the same time, the staffs of NASD, the SEC, and the New York Stock Exchange, Inc. (“NYSE”) conducted further examinations of broker-dealers to assess whether they properly delivered breakpoint discounts. The examination findings were memorialized in the Joint SEC/NASD/NYSE Report of Examinations of Broker/Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds, published on March 11, 2003, and available at <http://www.sec.gov/news/studies/breakpointrep.htm>.

After the completion of those examinations, NASD oversaw an industry-wide self-assessment of breakpoint discount delivery, followed by mandated refunds to customers. NASD and the SEC brought enforcement actions against 15 securities firms with higher-than-average breakpoint failure rates, with fines totaling \$21.5 million. See Fifteen Firms to Pay Over \$21.5 Million in Penalties to Settle SEC and NASD Breakpoints Charges (Feb. 12, 2004), available at <http://www.sec.gov/news/press/2004-17.htm>.

In addition, in January 2003, at the request of the Commission, NASD convened and led a Joint NASD/Industry Breakpoint Task Force (the “Task Force”) that included representation from a cross-section of industry members involved in mutual fund sales – the Investment Company Institute, the Securities Industry Association, the National Securities Clearing Corporation, broker-dealers, mutual funds, and transfer agents – to examine and rectify the industry failure to deliver appropriate breakpoint discounts. In July 2003, the Task Force published its recommendations in the Report of the Joint

Moreover, as the Special Study noted, the participation by those regulated raises the level of consciousness of regulation in the industry and increases the likelihood of compliance and peer scrutiny.⁸ Extensive industry participation in self-regulatory processes encourages awareness of regulatory issues as well as enhances acceptance of self-regulatory initiatives and has the benefit of contributing to a strong compliance culture within the firms that participate in the development of the rules.

Accordingly, NASD agrees that a re-examination of the existing self-regulatory system is warranted, but we also strongly believe that the statutory scheme of self-regulation supervised by the Commission should be preserved. NASD believes that the substantial benefits of self-regulation, as illustrated recently by the response to the mutual fund breakpoint issues,⁹ continue to greatly outweigh any shortcomings.

II. Benefits of NASD Structure and the Pure Hybrid Model

In discussing ways in which to enhance the self-regulatory system, the Concept Release focuses on four perceived weaknesses of the existing model: (1) the inherent conflicts of interest between SRO regulatory operations and members, market operations, issuers, and shareholders; (2) the costs and inefficiencies of multiple SROs, arising from multiple SRO rulebooks, inspection regimes, and staff; (3) the challenges of surveillance of cross-market trading by multiple SROs; and (4) the funding SROs have available for regulatory operations and the manner in which SROs allocate revenue to regulatory operations. As described below, we believe that the current NASD structure of insulation from competitive trading markets, enhanced by the reforms represented by the Proposed SRO Rules, and the evolution toward some form of pure Hybrid model, will promote the benefits of the self-regulatory model while minimizing the weaknesses identified in the Concept Release.

The Commission set forth several alternative versions of the pure Hybrid model. Under the first option, the Market SROs would maintain all the functions that SROs currently carry out with respect to their market operations, including promulgating market rules, conducting market surveillance, and taking enforcement action against rule violators. Alternatively, the Market

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NASD/Industry Task Force on Breakpoints, available at http://www.nasdr.com/breakpoints_report.asp. Following publication, working groups of industry members and regulator staffs implemented many of the Task Force's recommendations and substantial progress has been made toward implementing the remaining ones.

⁸ Special Study at 722.

⁹ In addition to its work on breakpoint-related issues, industry's intimate knowledge of operational capabilities has been key in many other major industry-wide initiatives, including addressing the Y2K problem and moving to decimals.

SROs could retain responsibility for promulgating rules and conducting surveillance, but enforcement actions would be referred to the Single Member SRO. Under a third option, the Market SROs' responsibilities would be limited to market rule promulgation, and the Single Member SRO would be responsible for all market surveillance and enforcement functions. Although NASD would support any of the pure Hybrid alternatives, we believe the first model to be the most preferable. To maximize the benefits of that model, however, we believe that intermarket regulation should be performed by the Single Member SRO, the definition of a market rule (as opposed to a member conduct rule) should be construed narrowly, and outsourcing of market regulatory responsibilities to other SROs should continue to be permitted.

A. Inherent Conflicts with Members, Market Operations, Issuers, and Shareholders

The Commission notes that there is an inherent conflict in an SRO's dual role of regulating and serving members that, if gone unchecked, "can result in poorly targeted SRO rulemaking, less extensive SRO rulemaking, and under zealous enforcement of SRO rules against members."¹⁰ The Commission adds that, to be effective, an SRO must be free of undue influences, such as "member domination of SRO funding, member control of SRO governance, and member influence over regulatory and enforcement staff."¹¹

NASD agrees, and, as detailed in the Proposing Release comment letter, has taken effective action to address the full range of member conflict issues, implementing rigorous corporate structure changes to prevent undue influence of regulated firms over boards, key committees, and staff.¹² Among other things, as part of its 1996 settlement with the Commission, NASD entered into a series of undertakings that are binding on NASD and cannot be changed without Commission approval.¹³ These undertakings reflect both structural and procedural changes to many of the core aspects of NASD operations and address the very conflicts of concern to the Commission. For instance, as a result of these undertakings, the NASD Board of Governors and all key committees are balanced (i.e., include a number of Public

¹⁰ See Concept Release, 69 Fed. Reg. at 71259.

¹¹ Id.

¹² For a comprehensive discussion of NASD's governance structure and its implementation of numerous safeguards to address potential conflicts concerns, see Proposing Release comment letter at 5-9 (Section I, NASD's Unique Status).

¹³ In the Matter of National Association of Securities Dealers, Inc., Administrative Proceeding File No. 3-9056, Securities Exchange Act Release No. 37538 (Aug. 8, 1996). See also Report pursuant to Section 21(a) of the Exchange Act regarding NASD and The Nasdaq Stock Market, Inc., Securities Exchange Act Release No. 37542 (Aug. 8, 1996) ("21(a) Report").

and Non-Industry Governors that equals or exceeds the number of Industry Governors).¹⁴ The NASD disciplinary process and member application process are almost entirely staff driven. Further, although the rulemaking process involves member committees, those committees are advisory only, and the staff has the ability to bring proposals to the Board irrespective of committee views.

With respect to potential conflicts with market operations, the Commission indicates that the increased pressure to attract order flow may cause SRO staff to be more lenient in enforcing rules that would cause large liquidity providers to redirect order flow.¹⁵ The Commission notes that, while regulatory staff is responsible for carrying out the self-regulatory obligations, they are also a “component of a competitive business organization” and may come under pressure to permit market activity that attracts order flow to their market.¹⁶ In addition, the Commission notes that SROs face conflicts in regulating members that are influential in their markets, and that, depending on the extent to which regulatory staff relies on industry expertise in developing rules and examining members, regulatory staff may become overly dependent on members for their understanding of market practices and may have a tendency to over-regulate members that operate competing markets.¹⁷

As discussed in greater detail in the Proposing Release comment letter, NASD is in a unique position among U.S. securities SROs. In 1996, NASD began to separate its regulatory operations from any interest in a trading market and further is in the process of divesting its ownership interest in any such market. NASD has fully divested itself of the American Stock Exchange, Inc. (“Amex”)¹⁸ and is in the process of spinning off The Nasdaq Stock Market, Inc.

¹⁴ The NASD By-Laws impose balancing requirements on the following committees: National Nominating Committee (Article VII, Section 9(b)); Executive Committee (Article IX, Section 4(b)); Audit Committee (Article IX, Section 5(a)); and Finance Committee (Article IX, Section 6(a)). In addition, the Plan of Allocation and Delegation of Functions by NASD to Subsidiaries imposes balancing requirements on the Management Compensation Committee (Section I.C.2); Market Regulation Committee (Section II.C(b)); and the National Arbitration and Mediation Committee (Section V.C(b)). Finally, the NASD Regulation By-Laws require that the National Adjudicatory Council be balanced (Article V, Section 5.2(a)). For definitions of the terms “Public Governor,” “Non-Industry Governor,” and “Industry Governor,” see Articles I(ff), I(cc), and I(o) of the NASD By-Laws, respectively.

¹⁵ See Concept Release, 69 Fed. Reg. at 71262.

¹⁶ Id.

¹⁷ Id.

¹⁸ NASD completed its divestiture of Amex to members of Amex as of December 31, 2004. See also Securities Exchange Act Release No. 50926 (Dec. 23, 2004); 70 Fed. Reg. 131 (Jan. 3, 2005) (Order granting approval to amendments to NASD By-Laws and rules relating to the divestiture of NASD’s interest in Amex).

(“Nasdaq”) as an independent company.¹⁹ Following divestiture of its trading market, NASD, as mandated by the Commission, will continue to operate the Alternative Display Facility (“ADF”), as well as TRACE; however, each of these is a transparency and regulatory facility, not a competitive trading market.²⁰ In addition, NASD will continue to operate a system for all residual equity securities, including the OTC Bulletin Board (“OTCBB”).²¹ None of these transparency facilities, however, is a competitive market that gives rise to the types of conflicts of concern to the Commission. Importantly, these facilities are not designed to attract or compete for order flow, nor do they have any dependency on order flow providers.

With respect to concerns regarding possible “member domination of funding,” NASD is in a unique position insofar as virtually all broker-dealers are required to be NASD members. As a result, while NASD is dependent on its members for funding of its regulatory programs and operations, we do not face the same types of competitive pressures as other SROs to retain our members and are not reliant on the trading volume of any particular market or market participant for funding.

¹⁹ This comment letter, like the Proposing Release comment letter, reflects NASD’s expectation that it will be divested of any meaningful ownership interest in Nasdaq prior to the effective date of any rules the Commission may adopt in the areas addressed by the Concept Release and the Proposing Release. While it is likely that NASD will have a temporary, residual ownership interest in Nasdaq immediately following Nasdaq’s registration as an exchange, NASD will diligently pursue full and prompt divestiture of such residual interest. Moreover, as further discussed in the Proposing Release comment letter, NASD believes that any such residual interest would not give rise to the types of conflicts of concern to the Commission, particularly given that NASD would not control or operate Nasdaq, as well as the existence of many other safeguards.

²⁰ NASD created ADF solely to meet the requirements established by the SEC in connection with its approval of SuperMontage. See Securities Exchange Act Release No. 46429 (Aug. 29, 2002); 67 Fed. Reg. 56862 (Sept. 5, 2002) (Order with respect to the implementation of Nasdaq’s Supermontage Facility). It is a “display only facility” that simply handles quotation and trade collection, trade comparison, and information dissemination; it does not provide listing or order execution services. Similarly, TRACE is a “display only facility” for corporate bonds that was created for regulatory and transparency purposes; it does not provide listing or order execution services. For further discussion of ADF and TRACE, see Proposing Release comment letter at 6-7.

²¹ NASD has not yet assumed direct responsibility for OTCBB unlisted equity securities, although it has agreed to the transfer from Nasdaq. In addition, Nasdaq’s exchange registration is prompting NASD to consider its potential role in regulating a residual facility that would process all trades in exchange-listed securities executed otherwise than on an exchange. Similar to ADF and the OTCBB, this residual facility would be created to satisfy regulatory transparency concerns. See Securities Exchange Act Release No. 44396, Nasdaq Stock Market, Inc. Files Application For Notice as a National Securities Exchange, at 2 (June 7, 2001); 66 Fed. Reg. 31952, 31953 (June 13, 2001) (Commission states that before Nasdaq can register as a national securities exchange, Nasdaq must satisfy its obligations under Section 11A of the Exchange Act.)

As a result, NASD does not face the same order flow, market competition, and revenue dependency conflicts faced by SROs affiliated with competitive markets.²² Moreover, the adoption of any version of the pure Hybrid model would further minimize the conflicts in the marketplace generally, by reducing the regulatory scope of the individual market SROs and ensuring that intermarket regulation, which often carries with it greater opportunities for competitive conflict, is taken out of the hands of individual Market SROs.

B. Costs and Inefficiencies of Multiple SRO Model

The Concept Release articulates the Commission's concern that the multiple SRO model may result in duplicative and conflicting SRO rules, rule interpretations, and inspection regimes, as well as redundant regulatory staff and infrastructure. Although we have endeavored to reduce regulatory inefficiencies whenever possible,²³ it is clear that inefficiencies are inevitable in a structure with multiple SROs with substantially overlapping jurisdiction.

NASD believes that the pure Hybrid model of self-regulation is a superior alternative structure that would address the concerns with the existing multiple SRO framework described in the Concept Release. A Single Member SRO, unaffiliated with any one market, would be

²² NASD notes that it is not subject to shareholder conflicts insofar as it does not have, or expect to have, any shareholders. With respect to issuer conflicts, NASD will not own or administer any listing venue or own any publicly traded entity.

²³ For example, pursuant to SEC Rule 17d-2, NASD, the NYSE, Amex, the International Securities Exchange ("ISE"), the Chicago Board Options Exchange, the Boston Stock Exchange, the Pacific Exchange, and the Philadelphia Stock Exchange are participants in a plan administered by the Options Self-Regulatory Council that reduces regulatory duplication for a large number of firms by allocating regulatory responsibility for certain options-related sales practice matters to one of the participants. The Commission also has recognized that contractual regulatory agreements between SROs outside of the Rule 17d-2 context may be permissible in instances where it is consistent with the public interest, provided that the ultimate responsibility and primary liability for self-regulatory facilities rests with the original SRO rather than the SRO retained to perform the regulatory services.

Also, following the 2002 issuance of a report by the U.S. Government Accountability Office regarding market fragmentation and regulatory redundancies, a joint NASD and NYSE task force was formed to examine conflicting NASD and NYSE rules and determine how those conflicts could be resolved. The NYSE regulatory staff and we have committed to meeting regularly to coordinate our regulatory efforts in all program areas with a view towards reducing regulatory inefficiencies and burdens. For instance, among other areas, NASD and the NYSE recently issued a memorandum providing joint guidance regarding the NASD supervisory control and NYSE internal control amendments. See NtM 05-08 (Jan. 2005). We also coordinated with the NYSE on the development of Rules 3510 (Business Continuity Plans) and 3520 (Emergency Contact Information). See Securities Exchange Act Release No. 49537 (Apr. 7, 2004); 69 Fed. Reg. 19586 (Apr. 13, 2004) (Order Approving Proposed Rule Changes Relating to Business Continuity Planning of Members). In addition, NASD and the NYSE have issued joint memoranda providing interpretive guidance relating to NASD and NYSE rules governing research reports and analysts. See, e.g., NtMs 02-39 (July 2002) and 04-18 (Mar. 2004).

solely responsible for regulating all SRO members with respect to member conduct rules. The Single Member SRO therefore would promulgate member conduct rules, inspect members for compliance with the rules, and take enforcement action against those members that fail to comply. Meanwhile, each SRO that operates a market would retain narrower responsibility for its market operation and regulation.

The pure Hybrid model would reduce the inherent conflicts that exist between the regulatory function and market operation of an SRO because the Single Member SRO would not be affiliated with any single market.²⁴ It would eliminate inconsistent member rules, and reduce redundant staff, technology, and infrastructure. It would centralize member regulation, but would maintain the value of having market regulatory staff proximate to the markets. And as a single, market-neutral voice, the Single Member SRO would serve as a more effective liaison with both internal and external constituencies, including the SEC, Congress, regulated firms, and other domestic and international financial regulators. Moreover, the pure Hybrid model would eliminate the possibility of unequal funding of member regulation and inconsistent member regulation.

C. Challenges of Cross-Market Trading By Multiple SROs

The Concept Release indicates that market fragmentation has led to concerns in the area of intermarket surveillance by self-regulatory bodies. In this regard, the Concept Release discusses Nasdaq's petition relating to the regulation of Nasdaq-listed securities,²⁵ which addressed Nasdaq's concern about the potential development of regulatory arbitrage when certain SRO rules are inconsistent across markets. In addition, with trading in most liquid securities now occurring on multiple markets, no single SRO is able to capture a complete picture of all the trading in each product, all trading by one broker-dealer, and under certain circumstances, even all the trading related to a single order.

²⁴ The Single Member SRO could nonetheless provide market regulatory services to some or many markets pursuant to regulatory services agreements ("RSAs"). In this regard, NASD will continue to provide regulatory services to Nasdaq pursuant to an RSA executed by the parties in June 2000; we will not, however, control or operate Nasdaq, nor will NASD participate in Nasdaq's business-related decisions. Accordingly, NASD will not be subject to the commercial competitive pressures attendant to owning or operating a trading market. NASD also provides regulatory services to other entities through RSAs, including Amex, Chicago Climate Exchange, ISE, and the Public Company Accounting Oversight Board. We also conduct, pursuant to a Rule 17d-2 agreement, options sales practice exams on behalf of other SROs. See supra note 23. NASD also has responsibility for regulating the over-the-counter markets but is not subject to commercial competitive pressures because, by definition, these residual markets do not compete with existing marketplaces and NASD's activities are designed solely to provide a regulatory framework that protects investors and ensures market integrity.

²⁵ See supra note 2 and accompanying text.

For example, NASD believes that there is no order and transaction audit trail at another SRO that is equivalent to NASD's audit trail for trading in Nasdaq-listed securities. The lack of uniformity of order and transaction data contributes to the potential for regulatory gaps between markets and may provide incentives for market participants to conduct activities where less regulatory data is collected on an automated basis. Moreover, when a market does not impose certain trading rules that are beneficial to the integrity of the market, unequal regulation can exist and can create market advantages.

NASD believes that minimum data-collection standards are required to ensure adequate regulation across all markets.²⁶ Consolidating that data would permit effective intermarket regulation while ensuring that no single market created a competitive price advantage by failing to meet its most important self-regulatory responsibility.

In the context of unlisted trading privileges, NASD believes that all SROs trading Nasdaq securities should have rules requiring detailed audit trail information. As noted above, an SRO that does not require the submission of detailed audit trail information not only degrades the quality of regulation in the overall market, it provides a competitive advantage to that particular SRO through lower regulatory costs and fewer regulatory burdens on market participants. Moreover, we believe that certain rules that further investor protection and market integrity should be uniform, or at least consistent, across markets, particularly if by allowing a market not to impose such rules provides that market a competitive advantage.²⁷

The Commission asks whether the Intermarket Surveillance Group ("ISG") is in a position to address concerns with intermarket surveillance. As discussed in NASD's Intermarket Trading comment letter, the ISG was created to facilitate information sharing and to assist in coordinating inquiries and investigations across SROs. Although the ISG certainly has been beneficial in coordinating the exchange of information between SROs relating to intermarket activities, it is not, and was never intended to be, the equivalent of having an SRO or other SEC-regulated entity directly responsible for oversight of all intermarket activities. In addition, the

²⁶ NASD already has taken steps to improve the effectiveness of NASD's automated surveillance for potential violations of NASD rules and the federal securities laws. As described in NtM 04-80 (Nov. 2004), NASD published for comment three proposed changes to the Order Audit Trail System ("OATS") Rules (NASD Rules 6950-6957) that would require members to record and report to OATS: order information relating to exchange-listed and OTC equity securities (OTCBB and Pink Sheets); enhanced information, including execution data, relating to orders routed to non-members or exchanges; and order information relating to proprietary orders generated during the course of market-making activities. NASD believes this additional information would enable NASD to create a more comprehensive and accurate order and transaction audit trail and significantly improve the effectiveness of NASD's automated surveillance for potential violations of NASD rules and the federal securities laws. The comment period for NtM 04-80 expired on January 20, 2005, and we are reviewing the comment letters.

²⁷ These rules would include pre-trade and post-trade transparency rules such as firm quote rule, locked and crossed markets rules, order and transaction reporting requirements, and certain front-running restrictions.

ISG audit trail, which was created by the ISG as a surveillance tool for intermarket investigations, is not comparable to the audit trail information collected by NASD and the market SROs for their own surveillance purposes. However, the ISG would be a logical forum to discuss standards and integration of multiple SRO audit trails.

D. SRO Funding Sources

The Concept Release identifies five primary sources of SRO funding: (1) regulatory fees charged by SROs to members that typically take the form of per member or per transaction fees and that generally are allocated to funding self-regulatory operations; (2) transaction fees that are associated with members' or others' use of the SRO's systems, such as order routing systems, trade execution systems, and electronic connectivity services; (3) listing fees that are paid by issuers that list their securities on an SRO's market; (4) market data fees that are paid by all users of market information; and (5) miscellaneous fees, including fees for administering joint industry plans and market systems and fees derived from product licensing, investment gains, and fines.

In the Concept Release, the Commission acknowledges the importance of the SRO self-funding structure, the need for SRO regulatory operations to be sufficiently funded, and the constraints on government funding.²⁸ The Commission also notes that Congress did not provide specific guidance as to the proper levels or methods of funding for SRO operations, and that a reasonable reading of the Exchange Act indicates that it intended that regulatory funding be sufficient to permit SROs to fulfill their statutory responsibilities.²⁹ Central to the Commission's concerns are the inherent tensions between the allocation of assets for regulation and for business, resulting in the specific questions of whether it should prescribe specific regulatory funding and allocation levels for SROs and, if so, how.³⁰

The funding of an SRO's regulatory operations is critical to the SRO's ability to perform its regulatory responsibilities effectively. Given NASD's exclusive focus on regulation, rules specifying allocation levels between regulation and commercial activity would not apply to our regulatory program and operations.³¹ Further, we believe that each SRO is in the best position to

²⁸ Concept Release, 69 Fed. Reg. at 71267. As stated in the Market 2000 Report: "the resources necessary for the Commission to assume SRO regulatory functions directly and effectively are not realistically attainable." Market 2000 Report, Study VI, at 6.

²⁹ See Concept Release, 69 Fed. Reg. at 71267.

³⁰ *Id.* at 71268 (Questions 17 and 18).

³¹ The driver for prescribing specific funding and allocation levels, similar to proposed Rules 15Aa-3(n)(4) and 6a-5(n)(4), appears, in large part, to be concerns regarding each SRO's devoting an appropriate level of resources to its regulatory operations. (Such proposed rules would require any funds received by an SRO from regulatory fees, fines, or penalties to be applied only to fund programs and operations directly

determine appropriate funding and allocation levels, provided that it meets its statutory obligations (subject to Commission examination). As stated earlier, a significant benefit of the SRO model is that it is subject to fewer funding constraints, and thus is able to be flexible in its approach to regulation and to rapidly respond to emerging regulatory issues. Accordingly, as a general matter, we believe that any constraints on an SRO's funding would only serve to impede the SRO's ability to regulate effectively. In this regard, NASD notes that it reassesses its funding structure on an annual basis to ensure proper funding of regulatory expenses.³²

III. Potential Limitations on the Pure Hybrid Model

The Concept Release identifies certain potential limitations with the pure Hybrid model. For example, the Commission notes that this approach could reduce self-regulatory knowledge of business practices by removing the Single Member SRO from market operations. In addition, this model would raise a "boundary issue" between member and market rules, in that every SRO rule would have to be characterized as either a member or market rule. The Commission further notes that while the Single Member SRO approach could reduce certain conflicts, it would not resolve conflicts arising from member funding and control, and from reliance on industry members for business expertise. Also, the Commission believes that conflicts would persist in the Market SROs, along with the related concerns about unequal funding and unequal regulation with respect to the Market SROs. Moreover, although inconsistent *member* rules, staff, and infrastructure would be eliminated, inconsistent *market* rules, staff, and infrastructure would remain.

As discussed throughout, NASD believes that the benefits of the pure Hybrid model outweigh its limitations, and that such limitations can be effectively reduced and managed. In this regard, we believe that a Single Member SRO could reduce concerns about conflicts arising from member funding and control by establishing a corporate governance structure and other safeguards to ensure that member funding and control do not unduly influence the Single

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related to the SRO's regulatory responsibilities.) In this regard, as stated in the Proposing Release comment letter, NASD believes that all of its fees would be deemed "regulatory fees" for purposes of proposed Rule 15Aa-3(n)(4), and all of its business and operational expenses would be eligible for funding from such fees. See Proposing Release comment letter at 11-13.

³² The Commission seeks specific comment on whether it should require that SRO funding for regulatory operations be derived only from regulatory fees, rather than allowing the cost of regulatory operations to be subsidized by other revenue sources. See Concept Release, 69 Fed. Reg. at 71269 (Question 19). NASD firmly believes that the Commission should continue to permit the cost of regulatory operations to be subsidized by other revenue sources, provided that those revenue sources do not raise the conflict of interest concerns identified by the Commission. In this regard, NASD notes that certain of its regulatory operations, such as ADF, are funded in part from NASD's balance sheet.

Member SRO's impartiality. In this regard, the current NASD structure, as well as many of the provisions set forth in the Proposing Release, accomplishes such objectives.

As for the Commission's related concerns regarding over-reliance on the industry, there is nothing unique to the pure Hybrid model that makes more difficult the balancing of the need for industry expertise with the requirement of staff independence. As noted above, we believe that such concerns can be effectively addressed via corporate governance controls and undertakings regarding the role of members in the SRO's operations.³³ Also, as the Commission has acknowledged, the importance of industry expertise in the regulatory process remains even in the face of potential conflicts.³⁴

As to any concerns about the loss of expertise between regulators and the markets, such concerns would be reduced significantly if the Commission adopts a form of pure Hybrid where the individual market SROs retain jurisdiction over that conduct truly core to their respective marketplaces. Such an approach would achieve the desired cost savings and reduction of regulatory overlap, while ensuring that specialized market expertise continues to inform the regulation of trading on that market. Moreover, the Member SRO staff would coordinate with the Market SRO staff in the development of member regulation rules and examination protocol in those instances where, for example, specialized technology or products may affect the development of the rule or examination program.

We agree that concerns about unequal funding of Market SROs remain. However, such concerns would be minimized to the extent the Single Member SRO assumed a greater role in the areas of intermarket surveillance and trading related to member regulation. Further, the Single Member SRO should be funded through sources other than listing, market data, and market operation revenues. For instance, NASD's funding for its member regulation activities comes primarily from a transaction-based Trading Activity Fee ("TAF"), a Personnel Assessment, and a three-tiered flat rate Gross Income Assessment. The TAF assesses a transaction-based fee that is not linked to trading activity on or reported through any particular market. As the Concept Release states, "[a] principal factor in the Commission's approval of the TAF was its explicit recognition of NASD's broad responsibilities with respect to its members' activities, irrespective of where securities transactions take place."³⁵

³³ See Proposing Release comment letter at 5-9 (Section I, NASD's Unique Status).

³⁴ See 21(a) Report at 17 ("Industry participants bring to bear expertise and intimate knowledge of the complexities of the securities industry and thereby should be able to respond quickly to regulatory problems.").

³⁵ Concept Release, 69 Fed. Reg. at 71269.

NASD believes that the boundary issues between member and market rules that would exist under the pure Hybrid model are analogous to those that currently exist between NASD's Conduct Rules and Nasdaq's Marketplace Rules, which have not presented any significant concerns. In light of its experience, NASD generally suggests that listing standards, market membership criteria (e.g., specialist or market maker requirements), short sale rules, as well as pre-trade and post-trade transparency rules (such as firm quote rule, locked and crossed markets rules, and order and transaction reporting requirements) be categorized as market rules, and all other rules (including limit order protection, best execution, and certain front-running restrictions) be categorized as member rules promulgated by the Single Member SRO.³⁶

Notably, we do not recommend that the Commission pursue a Competing Hybrid model, because, even with the adoption of uniform member rules, it would eradicate many of the benefits offered by the pure Hybrid model – thereby retaining inefficiencies present in today's model, including overlapping examination and enforcement programs and additional costs. Moreover, as the Commission notes, it could impair the ability of an SRO to discipline members if the members were free to choose another, possibly more lenient, regulator.

IV. Regulation By a Universal Non-Industry Regulator or SEC Direct Regulation Should Not be Pursued as Workable Alternatives

NASD does not believe that regulation by a Universal Non-Industry Regulator or SEC direct regulation should be pursued as alternatives to private sector regulation. Neither model can provide the unique benefits of private sector regulation: the ability to promote adherence to ethical standards beyond the legal standards that could be established by a universal non-industry body or the Commission, readily available access to industry expertise, and the flexibility to act expeditiously, either when faced with market problems or in an effort to stay ahead of the curve.

A. Universal Non-Industry Regulator

As the Commission recognizes, establishing a Universal Non-Industry Regulator would require significant industry reshaping, and there would be serious drawbacks. Under this approach, one non-industry entity would be designated to be responsible for all member and market regulation for all members and all markets. The Universal Non-Industry Regulator would be solely responsible for promulgating member and market rules, inspecting for compliance with member and market rules, and taking enforcement action with respect to member and market rules.

The Commission states that, while not exactly analogous, this model could resemble the regulatory regime recently adopted for audits of public companies, through establishment of the

³⁶ As noted, we believe that certain market rules, such as short sale rules and pre-trade and post-trade transparency rules, should be uniform.

Public Company Accounting Oversight Board (“PCAOB”). Like the PCAOB, the board of the Universal Non-Industry Regulatory would consist of full-time members appointed by the Commission, and the SEC would have ongoing oversight responsibility for supervising the universal regulator, including appointing and removing members, approving its budget, and approving its rules. The sources of funding for this model would have to be established, with the Commission determining whether shifting a significant cost of regulation of the securities industry to issuers would be appropriate or if some other funding structure would be more appropriate (such as a fee on trades or on market and broker-dealer revenues).

NASD believes that, in the context of a diverse securities industry with widely differing business models, the drawbacks to the Universal Non-Industry Regulator model far outweigh any benefits. Of greatest concern is that this model would significantly curtail industry’s involvement in shaping regulatory policy and lower the degree of market expertise in the regulator, thus eliminating nearly all of the unique benefits, as recognized by Congress, of private sector regulation for the securities markets. NASD also finds compelling the Commission’s concern that the model would become inefficient, inflexible, and unresponsive to evolutionary practices. NASD further notes that any Universal Non-Industry Regulator could face greater difficulty in establishing and enforcing ethical standards of conduct, such as just and equitable principles of trade.

Accordingly, NASD urges the Commission not to reverse the many, and long-standing, benefits accorded by the private sector regulatory model in the securities industry by pursuing a Universal Non-Industry Regulator. As experience has shown, the structure of regulation that has developed under the federal securities laws is well suited to addressing the complexities of these markets, with the attendant need for industry input and expertise.

B. SEC Direct Regulation

Another alternative proffered by the Commission would be the termination of the SRO system in favor of direct Commission regulation of the industry. Under this approach, the Commission would be solely responsible for the member and market regulation of all members and all markets. The Commission would be responsible for the promulgation of detailed member and market rules, the surveillance of members and markets, and the enforcement of member and market rules. With respect to funding, the public would be directly responsible for substantially all of the costs of regulating the industry, albeit perhaps through a range of fees imposed on the industry for the Commission’s increased services.

Again, NASD does not believe that SEC direct regulation would be a viable alternative to the current private sector regulatory regime. As noted in the Concept Release, the Commission would be responsible for detailed regulation and interpretation of complex areas previously conducted by the SROs, without the benefit of direct industry involvement and expertise. Furthermore, regulatory responsibilities would be carried out within the limits and intricacies of the federal rulemaking process and would be subject to a political environment. The

Commission also would be responsible for the development and operation of the various large-scale regulatory facilities developed and operated by NASD, such as CRD and TRACE.³⁷ And, as the Commission notes, the public would have to bear substantial costs for the regulation of the securities markets, including the operation of all regulatory facilities.

Indeed, as discussed in the Concept Release, in 1983, the Commission requested that Congress terminate the Commission's direct regulation of OTC broker-dealer activity through the SEC Only (SECO) program due, in part, to inadequate resources, including funding limitations.³⁸ Such resource problems would be greatly exacerbated if the Commission undertook to regulate directly all forms of broker-dealer activity in today's challenging and ever-changing marketplace.

V. Conclusion

NASD appreciates the opportunity to express its views on private sector regulation in the U.S. securities markets. For the foregoing reasons, NASD recommends that the Commission considering pursuing the pure Hybrid SRO model, which is the optimal approach to ensuring effective, efficient, and uniform regulation in the increasingly fragmented securities markets. Alternatively, the Commission should continue its work to strengthen the current SRO model, as evidenced by the Proposing Release, and to address the conflicts that can arise when an SRO also operates a trading market.

³⁷ In this regard, we note that in July 2000, the Commission formally designated NASD as the entity to establish and maintain the Investment Adviser Registration Depository (IARDsm) system, thus enabling investment advisers to register electronically and for the Commission and states to more readily track such information. Under the federal securities laws, NASD does not regulate firms or individuals registered solely as investment advisers.

³⁸ The SECO program, which was a program of direct SEC regulation of a limited number of broker-dealers, was intended to provide comparable regulation for broker-dealers that chose not to be regulated by NASD. The SECO program lasted from 1964 to 1983, after which time it was abandoned in favor of compulsory NASD membership. As noted in the Concept Release, at the time of repeal of the SECO program, the House Committee on Energy and Commerce reported that the program was unnecessarily costly and unnecessarily diverted the Commission's limited resources, merely to duplicate the functions of NASD. See Concept Release, 69 Fed. Reg. at 71267. The committee also noted that SROs were better able to maintain ethical standards for the industry and to perform certain detailed oversight functions. Id. In the Market 2000 Report, the Commission staff noted its belief that the SECO program illustrated "that the resources necessary for the Commission to assume SRO regulatory functions directly and effectively are not realistically attainable" and that the SROs play an important role in maximizing the Commission's limited resources. See Market 2000 Report, Study VI.

Mr. Jonathan G. Katz
March 15, 2005
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If you have any questions regarding the foregoing or require additional information, please call T. Grant Callery, Executive Vice President and General Counsel, at 202-728-8285, Elisse Walter, Executive Vice President, Regulatory Policy and Programs, at 202-728-8230, or Patrice Gliniecki, Senior Vice President and Deputy General Counsel, at 202-728-8014.

Very truly yours,

A handwritten signature in black ink that reads "Robert R. Glauber". The signature is written in a cursive style with a large, prominent initial "R".

Robert R. Glauber
Chairman and CEO

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Annette L. Nazareth, Director, Division of Market Regulation
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