



# Federal Register

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**Part III**

## **Securities and Exchange Commission**

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**17 CFR Part 240  
Concept Release Concerning Self-  
Regulation; Proposed Rule**

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 240

[Release No. 34-50700; File No. S7-40-04]

RIN 3235-AJ36

### Concept Release Concerning Self-Regulation

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Concept release; request for comment.

**SUMMARY:** The Securities and Exchange Commission ("Commission" or "SEC") is publishing this concept release and seeking public comment on a range of issues related to the self-regulatory system of the securities industry. This release discusses the foundations of the self-regulatory system and new considerations that the Commission and the industry are facing. In addition, this release describes certain enhancements that could be made to the current system that could improve its operation and also discusses a variety of other potential approaches to securities industry regulation.

**DATES:** Comments should be submitted on or before March 8, 2005.

**ADDRESSES:** Comments may be submitted by any of the following methods:

#### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/concept.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-40-04 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

#### Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609.

All submissions should refer to File Number S7-40-04. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/concept.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW.,

Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Christopher B. Stone, Senior Special Counsel to the Director, at (202) 942-7938 who is in the Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street NW., Washington DC 20549-1001.

#### SUPPLEMENTARY INFORMATION:

##### Table of Contents

- I. Introduction
- II. Foundations of Self-Regulation
- III. New Considerations
- IV. Current SRO System Attributes
  - A. Inherent Conflicts With Members, Market Operations, Issuers, and Shareholders
    1. Inherent Conflicts with Members
    2. Inherent Conflicts with Market Operations
    3. Inherent Conflicts with Issuers
    4. Inherent Conflicts with Shareholders
  - B. Inefficiencies of Multiple SROs
  - C. Intermarket Surveillance
    1. Funding
      - a. Regulatory Fees
      - b. Transaction Fees
      - c. Listing Fees
      - d. Market Data Fees
      - e. Miscellaneous Fees
- V. Alternative Regulatory Approaches
  - A. Proposed Enhancements to the Current SRO System
    1. SRO Governance and Transparency Rulemaking
    2. Intermarket Surveillance Enhancements
  - B. Independent Regulatory and Market Corporate Subsidiaries
  - C. Hybrid Model
  - D. Competing Hybrid Model
  - E. Universal Industry Self-Regulator
  - F. Universal Non-Industry Regulator
  - G. SEC Regulation
  - H. Other Models
- VI. Solicitation of Additional Comments

#### I. Introduction

Self-regulation is a key component of U.S. securities industry regulation. All broker-dealers are required to be members of a self-regulatory organization ("SRO"), which sets standards, conducts examinations, and enforces rules regarding its members.<sup>1</sup> Most, but not all, SROs also operate and regulate markets or clearing services.<sup>2</sup>

<sup>1</sup> 15 U.S.C. 78o15(b)(8).

<sup>2</sup> Analysis in this release focuses primarily on one registered national securities association SRO, the National Association of Securities Dealers ("NASD") (including its subsidiary, the Nasdaq Stock Market ("Nasdaq")), and those registered national securities exchange SROs that operate equity or options markets, the American Stock Exchange ("Amex"), the Boston Stock Exchange

Inherent in self-regulation is the conflict of interest that exists when an organization both serves the commercial interests of and regulates its members or users.

The Securities Exchange Act of 1934 ("Exchange Act"),<sup>3</sup> the Maloney Act of 1938 ("Maloney Act"),<sup>4</sup> and the Exchange Act Amendments of 1975 ("1975 Amendments"),<sup>5</sup> reflect Congress' determination to rely on self-regulation as a fundamental component of U.S. market and broker-dealer regulation, despite this inherent conflict of interest. Congress favored self-regulation for a variety of reasons. A key reason was that the cost of effectively regulating the inner-workings of the securities industry at the federal level was viewed as cost prohibitive and inefficient.<sup>6</sup> In addition, the complexity of securities trading practices made it desirable for SRO regulatory staff to be intimately involved with SRO rulemaking and enforcement.<sup>7</sup> Moreover, the SROs could set standards that exceeded those imposed by the Commission, such as just and equitable principles of trade and detailed proscriptive business conduct standards.<sup>8</sup> In short, Congress determined that the securities industry self-regulatory system would provide a workable balance between federal and industry regulation.<sup>9</sup>

Since the self-regulatory system was incorporated into the federal securities laws, the Commission has reexamined it periodically.<sup>10</sup> While steps have been

("BSE"), the Chicago Board Options Exchange ("CBOE"), the Chicago Stock Exchange ("CHX"), the International Securities Exchange ("ISE"), the National Stock Exchange ("NSX") the New York Stock Exchange ("NYSE"), the Pacific Exchange ("PCX"), and the Philadelphia Stock Exchange ("Phlx"). Unless otherwise specifically noted, discussion in this release does not necessarily relate to other registered SROs, including the National Futures Association ("NFA"), the Municipal Securities Rulemaking Board ("MSRB"), the registered clearing agencies, and notice registered national securities exchanges.

<sup>3</sup> 15 U.S.C. 78a et seq.

<sup>4</sup> Pub. L. 75-719, 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C. 78o, authorizing the U.S. Securities and Exchange Commission to register national securities associations).

<sup>5</sup> Pub. L. 29, 89 Stat. 97 (1975).

<sup>6</sup> See generally S. Rep. No. 1455, 73d Cong., 2d Sess. (1934); H.R. Doc. No. 1383, 73d Cong., 2d Sess. (1934); S. Rep. No. 1455, 73d Cong., 2d Sess. (1934).

<sup>7</sup> Id.

<sup>8</sup> Id.

<sup>9</sup> Id.

<sup>10</sup> See e.g., 1961-1963 Special Study of Securities Markets. Securities and Exchange Commission, Report of Special Study of Securities Markets, ("Special Study"), H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963) and *Market 2000: An Examination of Current Equity Market Developments*, Division of Market Regulation, U.S. Securities and Exchange Commission (January 1994) ("Market 2000 Report").

taken over time to redress perceived shortcomings, the SRO structure has been repeatedly reaffirmed both by Congress and the Commission.<sup>11</sup> In recent years, changes in the markets and in the ownership structure of SROs have generated questions about the fairness and efficiency of the current SRO structure.<sup>12</sup> The increased dispersion of order flow across multiple markets has produced questions of comparable regulation by SROs and the effectiveness of cross-market supervision.<sup>13</sup> The increased competition among markets for listings and trading volume has applied pressure on SRO regulatory efforts and sources of funding.<sup>14</sup> Moreover, the advent of for-profit, shareholder-owned SROs has introduced potential new conflicts of interest and issues of regulatory incentives.<sup>15</sup> In addition, recent failings or perceived failings with respect to SROs fulfilling their self-regulatory obligations have sparked public debate as to the efficacy of the SRO system in general.<sup>16</sup>

For these reasons, the Commission is publishing this release to discuss and solicit comments on the role and operation of SROs in today's markets. This release examines a number of issues concerning securities industry self-regulation, including: (1) The inherent conflicts of interest between an SRO's regulatory obligations and the interests of its members, its market operations, its listed issuers, and, in the case of a demutualized SRO, its shareholders; (2) the costs and inefficiencies of the multiple SRO model; (3) the challenges of surveillance across markets by multiple SROs; and (4) the manner in which SROs generate revenue and how SROs fund regulatory operations. Finally, this release examines and seeks comment on certain enhancements to the current system and a number of regulatory approaches or legislative initiatives that could be considered by the Commission to address concerns with the current SRO model.

## II. Foundations of Self-Regulation

Securities industry self-regulation has a long tradition in the U.S. securities markets. In its earliest years, the nascent U.S. securities industry was subject loosely to state laws and, in 1792, the New York broker community negotiated the historic Buttonwood Agreement to

form the first organized stock market in New York.<sup>17</sup> As the NYSE and other stock exchanges developed, trading conventions became formalized as exchange rules. In 1817, the NYSE's Constitution was adopted and the NYSE subsequently adopted a range of rules governing its members and listed companies, including member financial responsibility rules and listed company registration and financial reporting rules.<sup>18</sup> In 1820, a detailed set of NYSE By-Laws was adopted.<sup>19</sup>

Federal regulation of exchanges, and their formal recognition as self-regulatory organizations, followed a number of significant events, including the stock market crash of 1929 and the evidence of NYSE investigatory failures related to market manipulation highlighted at the 1934 Pecora Hearings.<sup>20</sup> In Section 6 of the Exchange Act, Congress recognized the regulatory role of exchanges, and required all existing securities exchanges, including the NYSE, to register with the Commission and to function as self-regulatory organizations.<sup>21</sup>

The stock market crash of 1929 also severely damaged the public reputation of over-the-counter ("OTC") securities dealers. In 1933, in an effort to improve their collective image, OTC dealers formed the Investment Bankers Code Committee ("IBCC"), which promulgated industry best practices.<sup>22</sup> In 1936, the IBCC was succeeded, by the Investment Bankers Conference ("IBC"), a prominent group of investment banks formed to act as a national, voluntary industry organization.<sup>23</sup>

After experience with the IBCC and the IBC, the Commission and leaders of the investment banking community generally agreed that an industry

association needed official legal status in order to effectively carry out the task of self-regulating the OTC market.<sup>24</sup> Ultimately, in 1938, the Maloney Act amended the Exchange Act by adding a new Section 15A and establishing the concept of registered national securities association SROs.<sup>25</sup> To date, the NASD and the NFA<sup>26</sup> are the only registered national securities associations.

In enacting these provisions, Congress concluded that self-regulation of both the exchange markets and the OTC market was a mutually beneficial balance between government and securities industry interests.<sup>27</sup> Through establishment of self-regulation, the securities industry was supervised by an organization familiar with the nuances of securities industry operations. In addition, industry participants preferred the less invasive regulation by their peers to direct government regulation and the government benefited by being able to leverage its resources through its oversight of self-regulatory organizations.<sup>28</sup> Moreover, the SROs had the ability to set prescriptive standards relating to just and equitable principles of trade and detailed business conduct standards.<sup>29</sup> In enacting the Maloney Act in 1938, Congress stated that an approach to securities regulation relying solely on government regulation "would involve a pronounced expansion of the organization of the Securities and Exchange Commission; the multiplication of branch offices; a large increase in the expenditure of public funds; an increase in the problem of avoiding the evils of bureaucracy; and a minute, detailed, and rigid regulation of business conduct by law."<sup>30</sup>

The legislative history of the 1975 Amendments noted that, rather than adopt this purely governmental approach, Congress determined that it was "distinctly preferable" to rely on "cooperative regulation, in which the task will be largely performed by representative organizations of investment bankers, dealers, and brokers, with the Government exercising appropriate supervision in the public interest, and exercising supplementary

<sup>17</sup> Robert Sobel, *The Big Board, A History of the New York Stock Market* 14-27 (The Free Press 1965). The agreement generally bound its signors to give preference to each other when buying and selling. *Id.*

<sup>18</sup> *Id.* at 30-31.

<sup>19</sup> *Id.* at 38-40.

<sup>20</sup> Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* at 1-38 (Aspen Pub. N.Y. 3rd ed. 2003).

<sup>21</sup> Exchange Act Section 6, 15 U.S.C. 78f.

<sup>22</sup> Seligman at 183-85.

<sup>23</sup> The IBC, however, proved to be imperfect, because only seventeen hundred of the nation's six thousand securities dealers ultimately joined. While the Commission realized that this voluntary organization was not effectively regulating the OTC market, it also determined that direct Commission regulation of the OTC market was not practicable. See Seligman at 183-85. While not speaking for the whole Commission, one early Commissioner compared the prospect of regulating the OTC market to building a structure out of sand because "there is no cohesive force to hold it together, no organization with which [the Commission] could build, as authoritatively representing a substantial element in the over-the-counter business." *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> Exchange Act Section 15A, 15 U.S.C. 78o-3.

<sup>26</sup> NFA is a national securities association registered for the limited purpose of regulating the activities of members who are registered as brokers or dealers in security futures products under Section 15(b)(11) of the Exchange Act, 15 U.S.C. 78o(b)(11).

<sup>27</sup> See supra notes 6-9.

<sup>28</sup> *Id.*

<sup>29</sup> Market 2000 Report at VI-6.

<sup>30</sup> S. Rep. No. 1455, 75th Cong., 3d Sess. I.B.4. (1938); H.R. Rep. No. 2307, 75th Cong., 3d Sess. I.B.4. (1938) (duplicate text quoted in both reports).

<sup>11</sup> See e.g., *Id.*; infra notes 30-31.

<sup>12</sup> See generally infra Section IV.

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

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

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

powers of direct regulation.”<sup>31</sup> Similarly, in 1975, Congress stated that a principal reason for retaining a self-regulatory regime was the “sheer ineffectiveness of attempting to assure [regulation] directly through the government on a wide scale,” and that, although the SROs had not always performed their role up to expectations, self-regulation generally was considered to have worked well and “should be preserved and strengthened.”<sup>32</sup>

The Commission has periodically examined the self-regulatory system and the extent to which SROs have successfully fulfilled their statutory obligations.<sup>33</sup> Such analysis has sometimes resulted in SROs making changes to their structures or regulatory programs. For example, after problems regarding the floor operations of Amex specialists, the Commission sponsored the sweeping 1961–1963 Special Study.<sup>34</sup> The Special Study concluded that SROs have a natural tendency to protect member firms and that SRO regulatory operations appear to falter without the “pointed stimuli” of vigilant Commission oversight.<sup>35</sup> Among other conclusions, the Special Study found a need for a reduction in the amount of control that exchange floor members exercised over exchange regulatory operations and governance.<sup>36</sup> Moreover, the study called for a general strengthening of SRO governance.<sup>37</sup>

Another example of past analysis was the Commission’s Division of Market Regulation review of the structure and costs of the SRO system in the Market 2000 Report, which was published by the Commission in 1994. The Market 2000 Report noted the impact that increasing intermarket competition and duplicative SRO rules were having on

the self-regulatory system.<sup>38</sup> In addition, the report discussed the extent to which costs to support the SRO system were being fairly allocated across the markets.<sup>39</sup> The report also examined the desirability of reallocating the regulatory and market functions of SROs and the possibility of the Commission assuming a greater role with respect to the functions carried out by the SROs.<sup>40</sup> While the opinion advanced in the Market 2000 Report was that such changes were unlikely to improve the existing SRO system, it did not foreclose the possibility of reconsidering this position in the future in light of changed circumstances.<sup>41</sup>

Another example of past Commission analysis on this issue was in 1996 when the Commission instituted administrative proceedings against the NASD with respect to OTC market maker pricing collusion.<sup>42</sup> At the same time, the Commission issued the 21(a) Report regarding the NASD and Nasdaq. In the 21(a) Report, issued pursuant to Section 21(a) of the Exchange Act, the Commission discussed at length a range of issues concerning the efficacy of the self-regulatory system and the potential problems associated with inherent SRO conflicts.<sup>43</sup> Of particular concern, in this case, was the lack of independence of the NASD regulatory staff from Nasdaq’s market operations.<sup>44</sup>

In sum, while Congress and the Commission have criticized and modified the SRO system in the past, it has not been radically revised or dismantled since its establishment. Rather, it is generally considered that the SRO system has functioned effectively and has served government, industry, and investors well.<sup>45</sup> Notwithstanding this positive record, because of new considerations in our markets, the Commission believes it is an appropriate time to reexamine and solicit public comment on the efficacy of the system overall.

### III. New Considerations

In recent years, the U.S. markets have experienced increasingly vigorous competition. The effect of this development is that markets operated by SROs have faced increased competition from foreign trading markets and from electronic communications networks (“ECNs”) that have shifted significant amounts of market share away from the primary markets, especially with respect to Nasdaq securities. For example, the NYSE and Amex historically dominated trading in their listed securities, and market makers dominated trading in Nasdaq stocks. Today, however, in the Nasdaq market, automated market centers (such as Nasdaq’s order collector, aggregator, and execution system, SuperMontage, the Archipelago exchange (“ArcaEx”), and the INET ECN) have captured more than 50% of share volume.<sup>46</sup> For Amex-listed stocks (for which approximately 39% of share volume now is represented by two extremely active exchange-traded funds (“ETFs”)—the QQQ and SPDR), Amex now handles approximately 21% of the volume, with the remaining balance split among Arca-Ex, INET, and others.<sup>47</sup> The NYSE has managed to retain approximately 80% of the volume in its listed stocks, but other market centers are raising the level of competition and reducing the NYSE’s share of trading.<sup>48</sup> Moreover, the NYSE and Amex have sought to add automated facilities that are integrated with and complement their traditional exchange floors.<sup>49</sup> In the listed options markets, the proliferation of multiple trading of options and the entry of two new electronic exchanges has raised the tempo of competition among these markets and redistributed their market share.<sup>50</sup>

<sup>31</sup> S. Rep. No. 94–75, 94th Cong., 1st Sess. 7, II (1975).

<sup>32</sup> *Id.*

<sup>33</sup> See e.g., supra note 10. In addition, the Commission speaks implicitly and explicitly to self-regulatory concepts in virtually every SRO rule that is noticed for public comment and approved through the Commission Rule 19b–4 rule filing process. SEC Rule 19b–4, 17 CFR 240.19b–4.

<sup>34</sup> Specialist domination of the Amex resulted in a series of scandals in the late 1950s involving market manipulations. In 1961, the Commission launched an investigation into the trading practices of two Amex specialists in particular. This investigation was ultimately broadened into the Special Study. See Seligman at 281–86.

<sup>35</sup> See generally Seligman at 299–348.

<sup>36</sup> *Id.*

<sup>37</sup> *Id.* Congress recognized that self-regulators may not always be as diligent as desired, and, indeed, may use self-regulation as a device to avoid regulation altogether. Nonetheless, Congress also was of the view that members of the securities industry could bring down to bear on the problems of regulation a degree of expertise and, in many circumstances, expedition not expected of a necessarily more remote governmental agency. Special Study at 693–697.

<sup>38</sup> See Market 2000 Report at III–1.

<sup>39</sup> *Id.* at III–3.

<sup>40</sup> *Id.* at III–5–7.

<sup>41</sup> *Id.* at III–10. See also infra Section IV.

<sup>42</sup> See In the Matter of National Association of Securities Dealers, Inc.; SEC Release No. 34–37538, August 8, 1996; Administrative Proceeding File No. 3–9056 (“21(a) Administrative Order”). See also Report and Appendix to Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and The Nasdaq Stock Market (August 8, 1996) and Securities Exchange Act Release No. 37538 (August 8, 1996) (“21(a) Report”). The undertakings were included in the SEC Order (“21(a) Report Undertakings”).

<sup>43</sup> See 21(a) Administrative Order Section III; 21(a) Report at 40–47.

<sup>44</sup> See 21(a) Administrative Order Section III; 21(a) Report at 52–54.

<sup>45</sup> See e.g., supra note 10.

<sup>46</sup> The figure is based on Nasdaq/UTP Plan market data (as of September 2004).

<sup>47</sup> The figure is based on Network B, CTS Activity market data (as of September 2004).

<sup>48</sup> The figure is based on Network A, CTS Activity market data (as of September 2004). See also e.g., Ivy Schmerken, *Will the NYSE’s Specialist Probe Open the Listed Market to ECNs?*, Wall Street + Technology, July 1, 2003, at 18; Robert Sales, *The Big Picture—ECN Evolution*, Wall Street + Technology, February 1, 2003, at 6.

<sup>49</sup> See Securities Exchange Act Release Nos. 50173 (August 10, 2004), 69 FR 50407 (August 16, 2004) (notice of proposed rule change proposing improvements to NYSE’s existing automatic execution facility, NYSE Direct+®); and 49921 (June 25, 2004), 69 FR 40690 (July 6, 2004) (approval of proposed rule change by Amex to enhance its Auto-Ex technology for exchange-traded funds and Nasdaq stocks traded on the exchange).

<sup>50</sup> In August 1999, 32% of equity options were traded on more than one exchange. By September 2000, that number had risen to 45%. Over the same period, the percentage of aggregate option volume traded on only one exchange fell from 60% to 15%. See Exchange Act Release No. 43085 (July 28,

This heightened competition has benefited trading markets by spurring innovation in trading systems and responsiveness to customers.<sup>51</sup> It has also driven down costs, including fees charged by the trading markets.<sup>52</sup> At the same time, this competition places greater strains on the self-regulatory system.<sup>53</sup> Some industry observers have posited that trading previously covered by one market's rules may move to another market in search of lower regulatory standards.<sup>54</sup> Others have argued that trading across markets may be subject to inconsistent rules across several markets.<sup>55</sup> Some have voiced concerns about falling market share inducing SROs to reduce the rigor of their member and market supervision programs.<sup>56</sup> Also, concerns have been raised about SROs favoring key participants in their markets to encourage those key participants to remain active in their markets or to attract other users.<sup>57</sup> Shifts in market share can undermine revenues supporting an SRO's regulatory functions, without reducing the SRO's responsibility for supervision of its members trading across markets.<sup>58</sup> Shifts in trading to multiple markets also increase concerns about potential gaps in the surveillance of intermarket trading.<sup>59</sup>

Other considerations also may alter the delicate balance of the SRO system. The conversion of some SROs to publicly traded, for profit status may increase the actual or perceived conflicts inherent in the SRO model.<sup>60</sup> Likewise, numerous recent SRO failings related to governance, member oversight and trading supervision raise significant concerns about the efficacy of the self-

regulatory model.<sup>61</sup> Finally, in response to the recently proposed Regulation NMS ("Reg NMS"),<sup>62</sup> commenters raised serious questions about the level of market data fees, which are an important component of SRO revenues and the funding of self-regulation.<sup>63</sup> The Commission believes that it is an appropriate time to issue a concept release to examine and solicit public comment on the extent to which recent developments in our markets warrant changes to the current system.

#### IV. Current SRO System Attributes

This discussion focuses on the following distinctive attributes of the existing SRO system and explores how recent market changes have impacted them: (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.

##### *A. Inherent Conflicts With Members, Market Operations, Issuers, and Shareholders*

Among the most controversial features of the existing SRO system is the inherent conflict that exists within every SRO between its regulatory functions and its members, market operations, listed issuers, and shareholders. The following discussion considers these conflicts.

#### 1. Inherent Conflicts With Members

The SROs are responsible for promulgating and enforcing rules that govern all aspects of their members' securities business, including their financial condition, operational capabilities, sales practices, and the qualifications of their personnel.<sup>64</sup> In fulfilling these functions, the SROs conduct examinations on the premises of their members, monitor financial and other operational reports, investigate potential violations of rules, and bring disciplinary proceedings when appropriate. In addition, SROs must surveil trading on any markets they operate to detect rule violations and other improper practices, such as insider trading and market manipulation. Unchecked conflicts in the dual role of regulating and serving can result in poorly targeted SRO rulemaking, less extensive SRO rulemaking, and under zealous enforcement of SRO rules against members. It is also important to note that, even where an SRO structure may appear sound, successful self-regulation relies on sufficiently vigorous rule enforcement against members on the part of the SRO. If regulatory staff is disinclined to regulate members, self-regulation will fail. Thus, to be effective, an SRO must be structured in such a way that regulatory staff is unencumbered by inappropriate business pressure.

Pressures that inhibit effective regulation and discourage vigorous enforcement against members can arise for a variety of reasons, including member domination of SRO funding, member control of SRO governance, and member influence over regulatory and enforcement staff. In addition, the economic importance of certain SRO members may create particularly acute conflicts, especially in light of the consolidation of some of the largest securities firms. For example, the number of NYSE specialist firms, which are central to the NYSE's auction trading model, has dropped from 27 in 1999 to 7 in 2002.<sup>65</sup> One NYSE specialist firm in 2003 accounted for over 28% of total NYSE trading volume.<sup>66</sup> The number of specialist firms at the CHX has dropped from 15 in 2002 to 8 in 2004.<sup>67</sup> Approximately 47% and 29% of the NSX's total

2000), 65 FR 47918 (August 4, 2000) (proposing to extend Exchange Act Rule 11Ac1-1 to options). According to the Options Clearing Corporation, by September 2003, 98.3% of equity options classes traded on more than one exchange. As of December 2003, the market shares held by options exchanges were 31.3% by the CBOE, 27.0% by the ISE, 19.8% by the Amex, 12.4% by the Phlx, and 9.5% by the PCX. Options Clearing Corporation, 2003 Annual Report 1 (2004). By June of 2004, the ISE's market share was 33.6%, the CBOE's was 26.0%, the Amex's was 18.6%, the Phlx's was 11.6%, the PCX's was 8.4%, and the BSE Boston Options Exchange ("BOX") facility's was 1.8%. Will Acworth, *Electronic Trading Sweeps Options Industry*, Futures Industry Magazine, September/October 2004 (citing Futures Industry Association statistics).

<sup>51</sup> See generally *infra* Section IV.

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

<sup>61</sup> See *In the Matter of Chicago Stock Exchange*, Securities Exchange Act Release No. 48566 (September 30, 2003). See also *In the Matter of Bear Wagner Specialists LLC*, Securities Exchange Act Release No. 49498 (March 30, 2004); *In the Matter of Fleet Specialist, Inc.*, Securities Exchange Act Release No. 49499 (March 30, 2004); *In the Matter of LaBranche & Co. LLC*, Securities Exchange Act Release No. 49500 (March 30, 2004); *In the Matter of Spear, Leeds & Kellogg Specialists LLC*, Securities Exchange Act Release No. 49501 (March 30, 2004); *In the Matter of Van der Moolen Specialists USA, LLC*, Securities Exchange Act Release No. 49502 (March 30, 2004). See *In the Matter of SIG Specialists, Inc.*, Securities Exchange Act Release No. 50076 (July 26, 2004) and *In the Matter of Performance Specialist Group LLC*, Securities Exchange Act Release No. 50075 (July 26, 2004). See also Securities Exchange Act Release No. 48946 (December 17, 2003), 68 FR 74678 (December 24, 2003) (approving NYSE proposal to restructure NYSE corporate governance structure).

<sup>62</sup> See Exchange Act Release No. 49325 (February 26, 2004), 69 FR 11126 (March 9, 2004) (noticing proposed rulemaking for comment); Exchange Act Release No. 49749 (May 20, 2003), 69 FR 30142 (May 26, 2004) (extending comment period and seeking additional comments).

<sup>63</sup> See *infra* Section IV.

<sup>64</sup> See *e.g.*, Exchange Act Sections 6(b) and 15A(b), 15 U.S.C. 78f(b) and 78o-3(b).

<sup>65</sup> LaBranche & Co. Inc., 2002 Annual Report 6 (2002).

<sup>66</sup> LaBranche & Co. Inc., 2002 Annual Report 14 (2003).

<sup>67</sup> Peter Chapman, *Windy City Loses Another Specialist*, Traders Magazine, July 1, 2004.

transaction charges were derived from one member for the years 2003 and 2002, respectively.<sup>68</sup> In addition, this single NSX member was responsible for generating 93% and 10% of Tape B market data revenues for the years 2003 and 2002, respectively.<sup>69</sup> This single NSX member was also responsible for generating 100% of NSX's Tape C market data revenues in both 2003 and 2002.<sup>70</sup> In the options market, there are just over 40 specialists and market makers on the nation's options exchanges, whereas just three years ago there were over 70.<sup>71</sup>

Thus, the current situation appears to be one in which a declining number of member firms are increasingly important to the business interests of their regulator SROs. The anecdotal evidence cited above could indicate that SROs have become more dependent on large members for their funding, potentially enabling those members to wield significant influence with respect to their regulator SROs. This creates the potential for failures by SROs to enforce rules against these members, especially when compared to enforcement against other smaller or less economically influential members, and SRO failures to develop rules that would disrupt the business practices of important members.

The PCX's proposal in 2001 to enter into an arrangement in which ArcaEx would become the PCX's equity trading facility presented a particularly complicated situation in which an SRO would be affiliated with a member.<sup>72</sup> In the ArcaEx Approval Order, the Commission examined a variety of issues related to self-regulation, including the regulatory responsibilities of the PCX under the new structure and the potential for inherent conflicts to be exacerbated when an SRO is affiliated with a member. In addition, the Commission imposed certain requirements with respect to PCX and ArcaEx that were designed to ensure that the various functions of the affiliated broker-dealer were properly regulated.<sup>73</sup>

In the ArcaEx Approval Order, the Commission discussed the PCX's proposal that Wave Securities LLC ("Wave"), a wholly owned subsidiary of ArcaEx, would be a registered broker-dealer and a member of both the PCX and the NASD. Wave would have two primary functions with respect to ArcaEx. Specifically, Wave would act as an introducing broker for customers that were not PCX members and would provide sponsored access to ArcaEx. Wave would also provide an optional routing service for ArcaEx, and, as necessary, would route orders to other market centers from ArcaEx.<sup>74</sup>

Under Section 6(b)(5) of the Exchange Act, the rules of a national securities exchange must not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.<sup>75</sup> The Commission noted in the ArcaEx Approval Order that the potential for unfair discrimination may be heightened if a national securities exchange or its affiliate owns or operates a broker-dealer. This is because, the Commission stated, the financial interests of the exchange may conflict with its responsibilities as an SRO regarding the affiliated broker-dealer. Moreover, the Commission described the conflict of interest that may arise if a national securities exchange (or an affiliate) provides advantages to its broker-dealer that are not available to other members, or provides a feature to all members that was designed to give its broker-dealer a special advantage. These advantages, such as greater access to information, improved speed of execution, or enhanced operational capabilities in dealing with the exchange, might constitute unfair discrimination under the Exchange Act, the Commission concluded. Thus, the Commission required that the PCX not serve as the self-regulatory organization primarily responsible for examining the Wave broker dealer.<sup>76</sup>

The Commission ultimately determined that, although Wave's routing services would be optional, Wave's order-routing function occupied a special position with respect to ArcaEx. In the Commission's view, Wave was uniquely linked to and endorsed by ArcaEx to provide its outbound routing functionality. Therefore, the Commission concluded that the PCX application of the Wave order-routing function fell within the definition of a facility under Section

3(a)(2) of the Exchange Act<sup>77</sup> and, as such, would be subject to the Commission's continuing oversight. In particular, under the Exchange Act, the PCX would be required to file rule changes and fees relating to the Wave order-routing function, and Wave would be subject to exchange non-discrimination requirements. Thus, the Commission imposed these requirements to address the potential misuse of advantages that might arise from an SRO member carrying out an order-routing function on behalf of an SRO.<sup>78</sup>

In the past, members also have historically controlled the boards and the key committees of SROs. For example, in the 21(a) Report concerning the NASD, the Commission discussed the extent to which large members had made up a majority or substantial proportion of the NASD's Board of Governors.<sup>79</sup> Moreover, the Commission discussed the extensive influence wielded by market maker members over the SRO's disciplinary process due to their strong representation on the NASD's District Business Conduct Committees ("DBCCs"), which served a "grand jury" function with respect to the initiation of disciplinary proceedings.<sup>80</sup> Ultimately, the Commission's settlement with the NASD resulted in significant corporate structure changes designed to prevent these conflicts from occurring in the future.<sup>81</sup>

Recently, the NYSE changed its governance structure to reduce conflicts of interest with respect to members.<sup>82</sup> Specifically, the NYSE created a wholly independent board and regulatory staff that report to an independent board committee.<sup>83</sup> In addition, amendments to the NYSE's charter mandated increased transparency of the NYSE's operations and corporate governance.<sup>84</sup> The governance changes included the

<sup>77</sup> The term "facility" when used with respect to an exchange includes its premises, tangible or intangible property whether on the premises or not, any right to use of such premises or property or any service thereof for the purpose of effecting or reporting a transaction on the exchange (including, among other things, any system of communication to or from the exchange, by ticket or otherwise maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service. (Emphasis added.) Exchange Act Section 3(a)(2), 15 U.S.C. 78c(a)(2).

<sup>78</sup> See ArcaEx Approval Order at 55233–55234.

<sup>79</sup> See 21(a) Report at 41.

<sup>80</sup> See 21(a) Report at 40–44.

<sup>81</sup> See *supra* note 42. See also *infra* Section V.B.

<sup>82</sup> See generally Exchange Act Release Nos. 48764 (November 7, 2003), 68 FR 64380 (November 13, 2003), and 48946 (December 17, 2003), 68 FR 74678 (December 24, 2003) ("NYSE Governance Changes Approval").

<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

<sup>68</sup> NSX, 2003 Annual Report Exhibit I–12 (2004).

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> Eric Noll, *Shifting Models of Option Market Participants*, Futures Industry Magazine, September/October 2004.

<sup>72</sup> See Exchange Act Release No. 44983 (October 25, 2001), 66 FR 55225, 55229–30 (November 1, 2001) (approving SR–PCX–00–25) ("ArcaEx Approval Order"). ArcaEx is operated by Archipelago Exchange LLC. At the time of this approval, PCX's ownership interest in Arca LLC consisted solely of a 10% interest in Archipelago Holdings LLC, the parent company of Arca LLC. See 66 FR at 55225.

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> See Section 6(b)(5) of the Act, 15 U.S.C. 78f(b)(5).

<sup>76</sup> See ArcaEx Approval Order at 55233.

establishment of a fully independent board of directors composed of 6 to 12 fully independent directors, the NYSE Chief Executive Officer (“CEO”), and the NYSE Chairman.<sup>85</sup> The concept of “independence” under the NYSE rules was redefined with respect to directors to exclude essentially all persons with any relationship or association to the exchange, an exchange member, or an exchange listed issuer.<sup>86</sup> A fully independent board committee, the Regulatory Oversight & Regulatory Budget Committee, was established and tasked with overseeing the NYSE’s regulatory plans, programs, budget and staffing proposals on an annual basis.<sup>87</sup>

In an effort to ensure that the NYSE’s regulatory function was sufficiently independent, a new Chief Regulatory Officer position was created that reports directly to the Regulatory Oversight & Regulatory Budget Committee.<sup>88</sup> An additional fully independent committee, the Human Resources & Compensation Committee, was created to set staff compensation.<sup>89</sup> Other fully independent committees included the Audit Committee and the Nominating & Governance Committee, which was designed to ensure that governance procedures are appropriate and to administer the board’s annual self-review process.<sup>90</sup>

Because the new definition of independent director excluded most users of the NYSE’s services, an advisory Board of Executives was also created to ensure that NYSE constituents continued to have a meaningful voice in the affairs of the exchange.<sup>91</sup> This advisory group was to be composed of 22 individuals representing key NYSE constituencies and tasked primarily with advising the board on operational issues.<sup>92</sup> The Board of Directors is required to meet on at least a quarterly basis both with and without the Board of Executives present.<sup>93</sup> In approving these amendments, the Commission noted the importance of independence of regulatory staff from business pressures.<sup>94</sup>

As discussed further below,<sup>95</sup> another recent concern is the extent to which the profit motive of a demutualized SRO could detract from proper self-

regulation. In that regard, the Commission recently approved SRO rule changes that permitted several SROs to convert to for-profit entities.<sup>96</sup> To avoid the potential for member shareholders to wield an in appropriate amount of influence over the regulatory function of the SROs, limits were imposed on the percentage that could be controlled by any one member.<sup>97</sup> SROs have put forth various reasons for demutualizing, but a common theme is an increased ability to more quickly respond to competitive pressures.<sup>98</sup>

In a companion release, the Commission is proposing SRO governance and transparency measures (the “SRO Governance and Transparency Proposal”) to address a range of concerns, including member ownership controls for demutualized exchanges.<sup>99</sup> If adopted, the SRO Governance and Transparency Proposal, which will be discussed in greater detail below,<sup>100</sup> would impose a variety of restrictions on shareholder owned SROs, including effectively restricting revenue from regulatory operations being used to pay dividends to shareholders.

The Commission seeks public comment on the following specific questions related to conflicts in member regulation:

<sup>96</sup> See e.g., Securities Exchange Act Release Nos. 45803 (April 23, 2003), 67 FR 21306 (April 30, 2003) (order approving the restructuring of the ISE from a limited liability company to a corporation); 49718 (May 17, 2004), 69 FR 29611 (May 24, 2004) (order approving the demutualization of the PCX); and 49098 (January 16, 2004), 69 FR 3974 (January 27, 2004) (order approving the demutualization of the Phlx).

<sup>97</sup> *Id.*

<sup>98</sup> See Securities Exchange Act Release Nos. 49451 (March 19, 2004), 69 FR 16305 (March 29, 2004) (PCX stating that by “restructuring its business as a stock corporation with business control and management vested in a Board of Directors, the entity will have greater flexibility to develop and execute strategies designed to improve its competitive position than it has under the current membership-cooperative structure” and that it anticipates that “by restructuring as a stock corporation, PCX management will be better able to respond quickly to competitive pressures and to make changes to its operations as market conditions warrant, without diminishing the integrity of its regulatory programs.”) and 49098, *supra* note (Phlx stating that it proposed to effect a demutualization for a number of reasons, including to “expand its sources of capital and revenue; to facilitate its ability to enter into relationships with strategic for financial partners who may be crucial for the Exchange’s future development, capital formation and viability; to facilitate the introduction for new products and thus potentially increase transaction volume and Exchange revenues; and to better position itself to react to new opportunities and challenges”).

<sup>99</sup> See Exchange Act Release No. 34–50699, (November 18, 2004).

<sup>100</sup> For a more detailed description of the SRO Governance and Transparency Proposal see infra Section V.A.1.

*Question 1:* To what extent are the conflicts caused by member funding of SRO operations a concern? Has consolidation within the securities industry, and the dependence of SROs on a relatively small number of firms for the bulk of their funding, or other developments exacerbated this conflict? If other developments have done so, identify them. Is it possible to minimize these conflicts through SRO governance initiatives that are designed to ensure greater independence of the board and key committees from the regulated members?

*Question 2:* To what extent are member governance conflicts a concern? Have the governance changes recently made by the NYSE and other SROs to enhance their independence been effective in reducing these conflicts? Are there other governance changes that could be made by the SROs that would further reduce these conflicts?

*Question 3:* Can potential conflicts between the regulatory function and SRO members be effectively managed through the recent enhancements made to SRO governance and the changes proposed by the SRO Governance and Transparency Proposal? Are there other measures the Commission should consider?

## 2. Inherent Conflicts with Market Operations

In addition to conflicts with members, an SRO’s regulatory obligations may conflict with the interests of its own or its affiliate’s market operations. The SROs that operate markets (currently, all except the MSRB, the NFA, and the clearing agencies) are responsible for promulgating rules that govern trading in their markets; establishing the necessary systems and procedures to monitor such trading; identifying instances of suspicious trading, such as potential insider trading and market manipulation; and enforcing the Exchange Act, the rules thereunder, and their own rules.<sup>101</sup> If an SRO identifies potential misconduct involving persons or entities within its jurisdiction, the SRO is responsible for conducting a further investigation and bringing a disciplinary action when appropriate. For potential misconduct outside its jurisdiction, an SRO is responsible for making referrals to the Commission or other appropriate agencies and assisting these agencies in their investigations.

As competition among markets grows, the markets that SROs operate will continue to come under increased pressure to attract order flow. This

<sup>101</sup> See e.g., Exchange Act Sections 6(b) and 15A(b), 15 U.S.C. 78f(b) and 78o–3(b).

<sup>85</sup> *Id.* at 74679.

<sup>86</sup> *Id.*

<sup>87</sup> *Id.* at 74681.

<sup>88</sup> *Id.* at 74682.

<sup>89</sup> *Id.* at 74681.

<sup>90</sup> *Id.* at 74680–74681.

<sup>91</sup> *Id.* at 74679–74680.

<sup>92</sup> *Id.*

<sup>93</sup> *Id.* at 74679.

<sup>94</sup> *Id.* at 74687.

<sup>95</sup> See *infra* Section IV.A.4.

business pressure can create a strong conflict between the SRO regulatory and market operations functions. Because increasing inter-market competition has provided members (and those that represent their orders through members) with increasing flexibility as to where to direct order flow, SRO staff may be less inclined to enforce vigorously SRO rules that would cause large liquidity providers to redirect order flow.

For example, one hedge fund typically may account for between 1% and 2% of total daily dollar volume traded on the NYSE.<sup>102</sup> One mutual fund complex may account for as much as 5% of the NYSE's daily trading volume.<sup>103</sup> Approximately half of the 80 million exchange-listed shares executed per day on the CHX is directed to eight specialist firms.<sup>104</sup> Moreover, as of July 2004, the NSX's market share grew to 26.2 percent of the Nasdaq market with the majority of that trading activity being generated by one member, the INET ECN.<sup>105</sup> As of May 2004, the Brut ECN's matched shares reported to the BSE represented 8.7% of overall Nasdaq trading volume.<sup>106</sup>

While regulatory staff is responsible for carrying out self-regulatory obligations, they are also a component of a competitive business organization. As intermarket competition increases, regulatory staff may come under pressure to permit market activity that attracts order flow to their market. Market operations staff may also be less likely to cooperate and communicate with regulatory staff if they think such cooperation or communication will hinder their effort to attract order flow.

In addition, SROs face conflicts in regulating members that are influential in their markets. For example, in the 21(a) Report concerning the NASD, the Commission found that Nasdaq market makers had exerted substantial influence over the affairs of the NASD through their dominant role in its governance, the administration of the NASD's disciplinary process, and the operation of Nasdaq.<sup>107</sup> Other less

favoured constituencies, such as retail and institutional investors and other broker-dealers, particularly those day trading firms that heavily used Nasdaq's Small Order Execution System ("SOES Firms"), did not have comparable representation on the key NASD boards and committees.<sup>108</sup>

The Commission found that market maker influence led to a concerted effort by the NASD staff to bring disciplinary actions against SOES firms.<sup>109</sup> Indeed, the 21(a) Report concluded that the NASD made a high priority of enforcement related to violations of its SOES rules by subjecting firms to special "sweep" examinations, and devoting substantial resources to monitoring, examining, and bringing disciplinary actions for potential violations of the day trading rules.<sup>110</sup> In contrast, the Commission found that the NASD was far less aggressive with respect to its enforcement of rule violations by market makers.<sup>111</sup>

Another concern is the potential for SRO regulatory staff, in the course of developing rules and examining members, to become overly dependent on members for their understanding of market practices and to lose their independent perspective concerning these practices. A potential loss of objectivity could accompany the greater knowledge and expertise that result from having SRO regulatory staff interwoven with SRO market operations.

Also, SROs may have a tendency to abuse their SRO status by over-regulating members that operate markets that compete with the SRO's own market for order flow.<sup>112</sup> Indeed, among other reasons, these concerns led the Commission to require the NASD to establish the Alternative Display Facility ("ADF").<sup>113</sup> Exchange Act rule

<sup>108</sup> *Id.*

<sup>109</sup> *Id.*

<sup>110</sup> *Id.*

<sup>111</sup> For example, complaints related to market makers failing to abide by the firm quote rule were effectively discouraged both by an ineffective procedure for enforcing the rule and by the absence of adequate sanctions for demonstrated misconduct. The Commission found that the small number of NASD formal disciplinary actions for market related rule violations brought against joint NYSE/NASD member firms, which would encompass the larger firms in the securities industry, was cause for serious concern over the NASD's enforcement priorities. See 21(a) Report at 40-44.

<sup>112</sup> Securities and Exchange Commission Concept Release, Regulation of Exchanges, S7-16-97, Exchange Act Release No. 38672 (May 23, 1997), 62 FR 30485 (June 4, 1997) ("ATS Concept Release"). The Commission acknowledged that conflicts could become particularly acute when an ATS member is regulated by an SRO that operates a competing market. *Id.* at 30486-30487.

<sup>113</sup> See Exchange Act Release No. 43863 (January 19, 2001), 66 FR 8020 (January 26, 2001); Exchange

Act Release No. 42166 (November 22, 1999), 64 FR 68125 (December 6, 1999); Exchange Act Release No. 42573 (March 23, 2000), 65 FR 16981 (March 30, 2000); Exchange Act Release No. 43133 (August 10, 2000), 65 FR 49842 (August 15, 2000); and Exchange Act Release No. 43514 (November 3, 2000), 65 FR 69084 (November 15, 2000). The Commission received 104 comments regarding Nasdaq's order collector, aggregator, and execution facility ("SuperMontage") proposal.

11Ac1-1<sup>114</sup> requires that SRO members communicate their best bids and offers to an SRO and in the late 1990s broker-dealer choice as to where to post quotes in Nasdaq securities was effectively limited to Nasdaq.<sup>115</sup> Thus, certain users of Nasdaq were concerned that they would be put at a distinct competitive disadvantage if they were compelled to provide their best bids and offers to the exclusive securities information processor ("SIP") for Nasdaq securities through the new SuperMontage system.<sup>116</sup> These users argued that, not only would their quotes be subject to a competing market's trading rules, but that the situation would be rife for abuse because of Nasdaq functioning both as a regulator and competitor of the ECNs.<sup>117</sup> Thus, before permitting the launch of Nasdaq's SuperMontage, the Commission required that the NASD provide an alternative, the ADF, to Nasdaq's SuperMontage on which to quote Nasdaq securities.<sup>118</sup>

The Commission specifically seeks public comment on the following questions related to conflicts with market operations:

*Question 4:* To what extent do conflicts exist between SRO regulatory and market operations functions? Has increased intermarket competition exacerbated this potential conflict? Are markets today attempting to use "lax regulation" as a means to attract business? Are they attempting to use "aggressive regulation" as a weapon against competitors? Is it unrealistic to expect a "cost center," such as regulation, to resist pressure from a function that generates business revenue in a modern business enterprise?

*Question 5:* To what extent has internal SRO separation of these functions addressed these concerns? Has the restructuring of the NASD, and the recent governance changes of the NYSE and other SROs to enhance their independence, been effective in better insulating the regulatory function from the market function?

*Question 6:* Can potential conflicts between the regulatory function and

Act Release No. 42166 (November 22, 1999), 64 FR 68125 (December 6, 1999); Exchange Act Release No. 42573 (March 23, 2000), 65 FR 16981 (March 30, 2000); Exchange Act Release No. 43133 (August 10, 2000), 65 FR 49842 (August 15, 2000); and Exchange Act Release No. 43514 (November 3, 2000), 65 FR 69084 (November 15, 2000). The Commission received 104 comments regarding Nasdaq's order collector, aggregator, and execution facility ("SuperMontage") proposal.

<sup>114</sup> 17 CFR 240.11Ac1-1.

<sup>115</sup> 66 FR 8020, 8052-8055.

<sup>116</sup> *Id.*

<sup>117</sup> *Id.*

<sup>118</sup> *Id.*

<sup>102</sup> See Citadel Investment Group LLC Web site (<https://www.citadelgroup.com/>).

<sup>103</sup> Charles Forelle, *Fidelity Opposes NYSE Proposal Over Limits on "Sweeps" of Trades*, The Wall Street Journal, August 17, 2004, at C3.

<sup>104</sup> Traders Magazine, *The Windy City's Auto-Ex Democracy* (March 1, 2004).

<sup>105</sup> Isabelle Clary, Markets Editor, Securities Industry News, *Brut Buy May Boost Nasdaq*, (September 6, 2004).

<sup>106</sup> Isabelle Clary, Markets Editor, Securities Industry News, *Nasdaq Strikes Back with Brut Deal* (May 31, 2004). The Brut ECN has subsequently shifted the reporting of all of its Tape C trading activity to Nasdaq. See Nasdaq Head Trader Alert #2004-115, Nasdaq Completes Acquisition of Brut LLC (September 7, 2004).

<sup>107</sup> See 21(a) Report at 40-44.

SRO market operations be effectively managed through the recent enhancements made to SRO governance and the changes proposed by the SRO Governance and Transparency Proposal? Are there other measures the Commission should consider?

### 3. Inherent Conflicts With Issuers

Another potential SRO conflict is with listed issuers. The SROs promulgate and administer listing standards that govern the securities that may be traded in their markets. For corporate securities, these rules include minimum financial qualifications and reporting requirements for their issuers. Obtaining a listing on a prominent SRO market provides corporate issuers with enhanced visibility and prestige in the eyes of investors, as well as the appearance of a well-operated and well-regulated trading market for their securities. An active market for secondary trading in a corporation's securities benefits not only its shareholders, but also the corporation itself through enhanced capital-raising capacities.

SRO listing standards also have a major role in corporate governance, particularly since the passage of the Sarbanes-Oxley Act.<sup>119</sup> Specifically, under recently adopted rules, SROs are prohibited from listing any security of an issuer that is not in compliance with certain standards.<sup>120</sup> Each member of the audit committee of the issuer must be independent according to specified criteria.<sup>121</sup> In addition, the audit committee of each issuer must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the issuer, and each such registered public accounting firm must report directly to the audit committee.<sup>122</sup> Moreover, each audit committee must establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.<sup>123</sup> Each audit committee must also have the authority

to engage independent counsel and other advisors, as it determines necessary, to carry out its duties and each issuer must provide appropriate funding for the audit committee.<sup>124</sup>

The SROs are responsible for monitoring issuers and delisting the securities of those that fail to meet SRO minimum requirements, but also compete vigorously to attract and retain listings, as illustrated recently by the high profile competition to list the Google Initial Public Offering.<sup>125</sup> This competition has been heightened by new listing venues. For instance, the equity trading facility of the PCX, ArcaEx, has been actively courting issuers to list<sup>126</sup> and in the Spring of 2004, Nasdaq launched a high profile dual listing program for NYSE stocks.<sup>127</sup> Moreover, there are indications that international stock exchanges are becoming more competitive with respect to attracting foreign companies to list on their markets (rather than on U.S. markets).<sup>128</sup>

As issuers are offered new alternatives as to markets on which to list their securities, SROs face increasing competitive pressure to gain and retain listings. As with SRO competition for members and order flow, competition for issuers may cause an SRO to fail to discharge its self-regulatory responsibilities properly. This can take the form of admitting to trading issuers that fail to satisfy initial listing standards; delaying the delisting of issuers that no longer satisfy maintenance standards; failing to enforce listing standards (including the new issuer corporate governance standards); and reducing (or even eliminating) listing fees. This competition also can reveal itself in an unwillingness to restrict issuer activities or impose requirements that may be more stringent than similar rules of competitor SROs.

Another issue with respect to listings relates to conflicts associated with listings of members' proprietary products such as Exchange Traded Funds ("ETFs"). In some instances, the creator of a proprietary product may be an SRO member that becomes the specialist or primary market maker of the product. In the equity markets, the

issuer typically has authority with respect to where the stock is to be listed. With respect to such proprietary products, the product creator (and potentially the product's sole specialist or primary market maker) may have significant authority as to where the product is listed. When an SRO member is a combined member/issuer of a popular product and that member wields authority with respect to transferring the listing of the product to another SRO, the SRO may be disinclined to regulate that member vigorously.

The Commission specifically seeks public comment on the following questions related to conflicts with issuers:

*Question 7:* To what extent have conflicts arisen between SRO regulatory and issuer listing functions? Has the recent increase in competition among SRO markets for listings created incentives to admit issuers that fail to satisfy initial listing standards or delay the delisting of issuers that no longer satisfy maintenance standards? To the extent increased competition for listings has caused SROs to waive or lower listing fees, has this negatively impacted regulatory funding and further inhibited enforcement of listing standards?

*Question 8:* Has the sponsorship of popular proprietary products by member firms compounded the inherent conflicts discussed above with both members and issuers? Specifically, are SROs disinclined to regulate vigorously either the trading activity of popular proprietary products or the activity of members firms that are the sponsors of such products?

### 4. Inherent Conflicts With Shareholders

Another significant conflict of interest for SRO responsibilities is with SRO shareholders. SRO demutualization raises the concern that the profit motive of a shareholder-owned SRO could detract from proper self-regulation. For instance, shareholder owned SROs may commit insufficient funds to regulatory operations or use their disciplinary function as a revenue generator with respect to member firms that operate competing trading systems or whose trading activity is otherwise perceived as undesirable. Moreover, as with the inherent conflicts discussed above, this conflict can be exacerbated by increased intermarket competition.<sup>129</sup>

<sup>129</sup> It is also possible for demutualization of SROs to cause complicated transactional issues to arise. For instance, complications could surface if a demutualized SRO bid to purchase a listed company. Another problematic situation could be one in which a demutualized SRO competes with

<sup>124</sup> *Id.*

<sup>125</sup> Andrei Postelnicu, *Listing Chief Sets Sights Abroad*, Financial Times, August 23, 2004, at 25.

<sup>126</sup> Andrei Postelnicu, *ArcaEx launches listings drive*, Financial Times, September 16, 2004, at 22.

<sup>127</sup> *Nasdaq CEO: Competitive Practices Could Have Helped NYSE*, Dow Jones News Service, August 25, 2004.

<sup>128</sup> Yuka Hayashi, *Foreign Firms Consider Listing Shares in Tokyo*, Wall Street Journal, October 18, 2004, at C16.

<sup>119</sup> Pub. L. 107-204, 116 Stat. 745 (2002).

<sup>120</sup> See generally Exchange Act Release No. 47654 (April 9, 2003), 68 FR 18788 (April 16, 2003).

<sup>121</sup> *Id.* at 18790.

<sup>122</sup> *Id.*

<sup>123</sup> *Id.*

A variety of ownership controls for demutualized SROs can potentially prevent some of these conflicts.<sup>130</sup> Indeed, as previously noted, this concept release is being published in conjunction with the SRO Governance and Transparency Proposal, which would, if adopted, impose a variety of restrictions, including an effective restriction on revenue from regulatory operations being used to pay dividends to shareholders.

The Commission specifically seeks public comment on the following questions related to conflicts with shareholders:

*Question 9:* What are the conflicts between a demutualized SRO's regulatory responsibilities and the profit-making orientation of its shareholders? To what extent do they heighten the inherent SRO conflicts with members, market operations, and listed issuers discussed above?

*Question 10:* Can potential conflicts between the regulatory function and SRO shareholders be effectively managed through the recent enhancements to SRO governance and the changes proposed by the SRO Governance and Transparency Proposal? Or are there other measures the Commission should take to help ensure that the effectiveness of the regulatory function is not diminished?

#### B. Inefficiencies of Multiple SROs

Securities industry self-regulation carries with it an inherent inefficiency in that it can cause duplicative and potentially conflicting regulation. Specifically, the existence of multiple SROs can result in duplicative and conflicting SRO rules, rule interpretations, and inspection regimes. The system can also result in redundant SRO regulatory staff and infrastructure across SROs.

Congress and the Commission have put in place methods for reducing a certain amount of regulatory duplication. Pursuant to Exchange Act Section 17(d) and Rule 17d-1,<sup>131</sup> when

a listed company for the purchase of a third entity. Conflicts would clearly present themselves in these situations.

<sup>130</sup> For instance, several exchanges that have converted to shareholder-owned structures have limited the ability of any person, including their members, to directly or indirectly own and vote more than a certain percentage of the interest in the exchange. See e.g., Securities Exchange Act Release Nos. 49718 and 49098. Exchanges also have similar limits on concentration of ownership of facilities that are separate corporate entities from the exchange. See e.g., Securities Exchange Act Release Nos. 50170 and 49067. The Commission approved these limitations on a case-by-case basis pursuant to the rule filing process of Section 19(b) of the Exchange Act and Rule 19b-4 thereunder. 15 U.S.C. 78s(b) and 17 CFR 240.19b-4.

<sup>131</sup> 15 U.S.C. 78q and 17 CFR 240.17d-1.

a member belongs to more than one SRO, the SEC shall designate the responsibility to one SRO for examining the member for compliance with applicable financial responsibility rules.<sup>132</sup> The undesignated SRO is relieved of responsibility for examining the member for compliance with financial responsibility rules.<sup>133</sup> In addition, Rule 17d-2 under the Exchange Act permits SROs to establish Commission approved joint plans for allocating regulatory responsibilities with respect to common members.<sup>134</sup> An SRO participating in such a regulatory plan approved by the Commission is relieved of regulatory responsibilities with respect to a broker-dealer member, if those regulatory responsibilities have been allocated to another SRO under the regulatory plan.<sup>135</sup>

The options SROs, for example, have utilized a 17d-2 agreement to reduce regulatory redundancies.<sup>136</sup> The options markets' 17d-2 Plan reduces regulatory duplication for a large number of firms currently members of two or more of the SRO participants by equitably allocating regulatory responsibility for a set of options sales practice rules that are substantially identical for each of the SRO participants.<sup>137</sup>

While the potential for the SRO system to cause regulatory redundancies is not a novel issue for the Commission,<sup>138</sup> it appears that the inefficiencies caused by the SRO system are being aggravated by greater market

<sup>132</sup> 17 CFR 240.17d-1.

<sup>133</sup> *Id.*

<sup>134</sup> 17 CFR 240.17d-2.

<sup>135</sup> *Id.*

<sup>136</sup> See generally Exchange Act Release No. 49197 (February 5, 2004), 69 FR 7046 (February 12, 2004).

<sup>137</sup> Under the plan, the SRO participant responsible for conducting options-related sales practice examinations of a firm, and investigating options-related customer complaints and terminations for cause of associated persons of that firm, is known as the firm's Designated Options Examining Authority ("DOEA"). Pursuant to the plan, any other SRO of which the firm is a member is relieved of these responsibilities during the period the firm is assigned to a DOEA. The options 17d-2 Plan is administered by a committee, the Options Self-Regulatory Council, which is composed of one representative from each SRO signatory to the plan. Under the Options 17d-2 plan, common options rules across the different options SROs have been designated and are enforced by the DOEA. The DOEAs for common members are assigned based on a variety of factors, including the most equitable allocation of the regulatory burden of carrying out the duties of the DOEA. In addition, all DOEA assignments are made by a majority vote of all SRO participants of the plan. Common rules covered by the plan include those related to the opening of options accounts, the supervision of options trading, and customer suitability for trading options. See e.g., Exchange Act Release No. 49197 (February 5, 2004), 69 FR 7046 (February 12, 2004).

<sup>138</sup> See supra Section II.

fragmentation of order flow among SROs. Thus, a recent U.S. General Accounting Office ("GAO") analysis is worth discussing. In May of 2002, the GAO issued a report, which specifically focused on the implications of market fragmentation with respect to securities industry regulatory redundancies.<sup>139</sup> It ultimately discussed a broad range of issues related to the relationship between self-regulation and intermarket competition for order flow. The GAO Report recommended that the Commission work with the SROs and broker-dealers to implement a formal process for systematically identifying and addressing material regulatory inefficiencies caused by differences in rules and rule interpretations among SROs and by multiple examinations of broker-dealers.<sup>140</sup> In the wake of the GAO Report, the Commission supported the formation of a joint NASD and NYSE task force with the mission of examining their conflicting rules and determining how those conflicts could be resolved. The Commission has been working with the SROs in this respect and facilitating SRO rule amendments when appropriate.<sup>141</sup>

More recently, in light of issues raised in a petition for rulemaking filed by Nasdaq, the Commission published a concept release covering the regulation of intermarket trading of Nasdaq securities.<sup>142</sup> The Intermarket Trading Concept Release discussed Nasdaq's concern about the potential development of "regulatory arbitrage" when SRO rules are inconsistent across markets.<sup>143</sup> Specifically, according to Nasdaq, this type of arbitrage could result in the attraction of order flow and members to certain SROs over others because of the prospect of lax regulation.<sup>144</sup> The Intermarket Trading Concept Release sought public comment on the importance of uniformity with respect to a variety of rules related to intermarket trading of Nasdaq-listed securities, including rules related to market manipulation, illegal short

<sup>139</sup> U.S. General Accounting Office Report to Congressional Committees, "Securities Markets Competition and Multiple Regulators Heighten Concern about Self-Regulation" (May 2004) ("GAO Report").

<sup>140</sup> GAO Report at 30.

<sup>141</sup> See e.g., notice and comment process for the adoption of a uniform NASD and NYSE "branch office" definition. Exchange Act Release Nos. 48897 (December 9, 2003), 68 FR 70059 (December 16, 2003); 46888 (November 22, 2002), 67 FR 72257 (December 4, 2002).

<sup>142</sup> Concept Release: Request for Comment on Nasdaq Petition Relating to the Regulation of Nasdaq-Listed Securities, Exchange Act Release No. 47849 (May 14, 2003), 68 FR 27722 (May 20, 2003) ("Intermarket Trading Concept Release").

<sup>143</sup> Intermarket Trading Concept Release at 27724.

<sup>144</sup> *Id.*

selling, insider trading, fraud, front running, marking the open or close, non-compliance with the limit order display rule, and non-compliance with the firm quote rule.<sup>145</sup> The Intermarket Trading Concept Release solicited comment on whether uniform rules are necessary to prevent regulatory arbitrage.<sup>146</sup> It also noted Nasdaq's contention that the disparities in rules between SROs pose a serious threat to investor protection and discussed Nasdaq's request that the Commission exercise its authority under Sections 12(f)(2) and (3) of the Act<sup>147</sup> to prohibit the launch or continuation of Nasdaq trading by any market that failed to adopt adequate regulatory protections, including rules related to inter-market trading issues.<sup>148</sup>

The Commission received a variety of comments in response to the Intermarket Trading Concept Release. Commenters, including certain SROs and ECNs that compete with Nasdaq for order flow, argued that there is, in fact, no unequal regulation across markets and that trading that falls within each SRO's purview is effectively regulated.<sup>149</sup> Some commenters voiced a qualified endorsement of uniform rules in certain areas, but were careful to note that uniform rules should in no way restrict each SRO's ability to craft rules that reinforce its own unique intra-market structures or competitive business models.<sup>150</sup> At least one

commenter even supported the creation of a single independent regulator that would be responsible for regulating all broker-dealers in all markets.<sup>151</sup>

Thus, while the Intermarket Trading Concept Release drew out thoughtful public commentary on discrete issues related to the SRO system's regulatory inefficiencies and redundancies, this concept release seeks public commentary on these issues in the broader context of the efficacy of the SRO system overall. Specifically, the Commission specifically seeks public comment on the following questions:

*Question 11:* Is the lack of intermarket rules across markets trading the same type of securities causing regulatory arbitrage and, if so, what is the impact of this on the SRO system? Should this issue be addressed through changes at the SRO system level, rather than at the individual SRO level?

*Question 12:* How significant are the inefficiencies resulting from multiple SROs overseeing the activities of the same members? In what areas do these issues primarily arise?

### C. Intermarket Surveillance

Another area in which the SRO system has recently come under increasing strain because of market fragmentation is with respect to SRO and Commission supervision of intermarket trading. When order flow was largely concentrated in the primary markets, traders had limited ability to cloak illicit activity by spreading trades across markets. When trading takes place in multiple active markets, however, it is possible for traders to veil illegal trading activity by dispersing trades across markets.

The Intermarket Trading Concept Release specifically sought public

letter"); letter from Edward J. Joyce, President and Chief Operating Officer, Chicago Board Options Exchange, Incorporated, to Jonathan G. Katz, Secretary, Commission, p. 2 (June 30, 2003) ("CBOE letter"); letter from Eric Schwartz, Managing Director, Goldman Sachs & Co., and Duncan Niederauer, Co-Chief Executive Officer, Spear, Leeds & Kellogg, L.P., to Jonathan G. Katz, Secretary, Commission, p. 2 (July 25, 2003) ("GS/SLK letter"); letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Commission, p. 1 (June 19, 2003) ("ICI letter"); letter from Barbara Z. Sweeney, Senior Vice President and Corporate Secretary, NASD, to Jonathan G. Katz, Secretary, Commission, p. 12 (June 20, 2003) ("NASD letter"); letter from Donald D. Kittell, Executive Vice President, Securities Industry Association, to Jonathan G. Katz, Secretary, Commission, pp. 3-5 (June 27, 2003) ("SIA letter"); and Mary McDermott Holland, Mark Madoff, and John C. Giesea, Securities Traders Association, to Jonathan G. Katz, Secretary, Commission, p. 3 (June 19, 2003) ("STA letter").

<sup>151</sup> See letter from W. Hardy Callcott, SVP & General Counsel, Charles Schwab & Co., Inc., to Jonathan G. Katz, Secretary, Commission (July 7, 2003) ("Schwab letter").

comment on this topic.<sup>152</sup> The release focused public attention on Nasdaq's contention that its extensive audit trail data was of limited use for cross-market surveillance, because it cannot capture relevant data for executions that take place on other markets trading Nasdaq securities, and other markets do not have comparable systems that can interact with NASD's Order Audit Trail System ("OATS"), which captures regulatory data concerning the important stages in the life of a trade.<sup>153</sup>

The Intermarket Trading Concept Release also focused comment on the role of the Intermarket Surveillance Group ("ISG"), which is an industry organization created in 1983 to coordinate intermarket surveillance among the self-regulatory organizations by cooperatively sharing regulatory information pursuant to a written agreement between the parties.<sup>154</sup> The goal of the ISG's information sharing is to coordinate regulatory efforts to address potential intermarket trading abuses and manipulations.<sup>155</sup> Although the ISG Agreement was not established under Section 11A or 17(d) of the Securities Exchange Act of 1934,<sup>156</sup> ISG asserts that the Commission has required new markets to become ISG members as a condition of registration, thus recognizing its importance.<sup>157</sup> ISG's full members are the Amex, BSE, CBOE, CHX, NSX, ISE, NASD, NYSE, PCX, and the Phlx (collectively "Full Members").<sup>158</sup> Each of the Full Members is an SRO for which the Commission has direct oversight.<sup>159</sup> As

<sup>152</sup> Intermarket Trading Concept Release at 27724.

<sup>153</sup> Intermarket Trading Concept Release at 27724. OATS is part of an integrated audit trail system, developed by NASD. It provides a source of timed, sequenced order events, which, when combined with existing quotation and trading information, assists in the surveillance of the Nasdaq market. See OATS Subscriber Manual 2004.3, 1-1 (October 4, 2004). The general objective of OATS is to recreate daily market activity by capturing and maintaining order data reported by member firms. OATS Subscriber Manual at 2-1.

<sup>154</sup> Intermarket Trading Concept Release at 27723.

<sup>155</sup> *Id.*

<sup>156</sup> 15 U.S.C. 78k-1 or 78q(d).

<sup>157</sup> See ISG letter at 1.

<sup>158</sup> In its comment letter, ISG states that it has also established an affiliate category of membership to all futures exchanges and non-U.S. organizations to join. Moreover, ISG notes that certain ISG affiliate members (One Chicago LLC, Nasdaq LIFFE Markets LLC, CME Inc. and Island Futures Exchange LLC) by virtue of their status as "notice registered National Securities Exchanges" and as signatories to the Addendum for Securities Futures products, have already submitted themselves to elements of the ISG Agreement, as amended in 1994. As such, ISG maintains they have accepted ISG as the appropriate forum for resolving inter-market issues. See ISG Letter p. 1-2.

<sup>159</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> *Id.*

<sup>147</sup> Exchange Act Sections 12(f)(2) and (3), 15 U.S.C. 78l(f)(2) and (3). Intermarket Trading Concept Release at 27725.

<sup>148</sup> See Intermarket Trading Concept Release at 27724-27725.

<sup>149</sup> See letter from John S. Markle, Associate General Counsel, Ameritrade Holding Company, to Jonathan G. Katz, Secretary, Commission, pp. 2-3 (July 10, 2003) ("Ameritrade Letter"); letter from William O'Brien, Chief Operating Officer, Brut, LLC, to Jonathan G. Katz, Secretary, the Commission, p. 2 (June 19, 2003) ("Brut Letter"); letter from Jeffrey T. Brown, Cincinnati Stock Exchange, to Jonathan G. Katz, Secretary, Commission, pp. 5-6 (June 19, 2003) ("CSE Letter"); letter from Michael J. Simon, Senior Vice President and Secretary, ISE, to Jonathan G. Katz, Secretary, Commission, p. 2 (June 19, 2003) ("ISE Letter"); letter from Brian F. Colby, Chairman, Intermarket Surveillance Group, to Jonathan G. Katz, Secretary, Commission, pp. 1-2 (June 18, 2003) ("ISG Letter"); letter from Darla C. Stuckey, Corporate Secretary, NYSE, to Jonathan G. Katz, Secretary, Commission, pp. 4-5 (June 19, 2003) ("NYSE letter"); letter from Meyer S. Frucher, Phlx, to Jonathan G. Katz, Secretary, Commission, pp. 2-6 (June 17, 2003) ("Phlx Letter").

<sup>150</sup> See Ameritrade Letter pp. 2-3; letter from Kim Bang, Bloomberg Tradebook LLC, to Jonathan G. Katz, Secretary, Commission, p. 2 (June 20, 2003) (Bloomberg letter); Brut letter pp. 3-4, letter from Richard Ketchum, General Counsel, Global Corporate & Investment Bank, Citigroup Global Capital Markets, to Jonathan G. Katz, Secretary, Commission, pp. 7-9 (July 8, 2003) ("Citigroup

a result, the regulatory procedures that these SROs have developed, individually and jointly, including those developed for insider trading and certain types of market manipulation, are subject to Commission jurisdiction and are regularly examined for sufficiency.<sup>160</sup>

In its petition, Nasdaq asserted that, for a variety of reasons, the data, received through ISG regarding other markets, is insufficient to enable Nasdaq to properly surveil intermarket trading activity.<sup>161</sup> Nasdaq also posited that consolidated regulation of Nasdaq trading across all markets for intermarket surveillance purposes would be fundamentally more effective because of the flaws of ISG data and because the ISG is composed of some members that do not necessarily trade Nasdaq securities (including certain non-Full Members that are not regulated as SROs by the Commission).<sup>162</sup>

In response to the Intermarket Trading Concept Release, the Commission received a variety of comments on intermarket surveillance and order audit trail issues.<sup>163</sup> Some commenters argued that existing audit trail systems were well designed, even though they did not interact with Nasdaq's.<sup>164</sup> In addition, many commenters were concerned that complying with multiple SROs' different order audit trail systems would be burdensome and expensive to implement and administer.<sup>165</sup> Other commenters argued that Nasdaq had understated the effectiveness of ISG and that the organization should be allowed to continue in its role as the facilitator of regulatory data sharing among markets.<sup>166</sup>

In its comment letter, the ISG described its consolidated audit trail system, which supplements individual

markets' surveillance systems by facilitating the analysis and review of information concerning potential trading violations.<sup>167</sup> By allowing the SROs to share their regulatory information, ISG asserts, the SROs are able to view trading activity in the context of all markets' clearing level quote and trade data.<sup>168</sup> The ISG argued that its Equity Audit Trail system provides a consolidated view across all markets of quotes and trades, including clearing information.<sup>169</sup> Moreover, ISG stated that its systems serve their purpose well and that no other market had raised the issues that Nasdaq raised in its petition.<sup>170</sup> Specifically, the ISG claimed that neither the time delays in receiving information through ISG nor the lack of a uniform synchronization protocol had proven to be problematic.<sup>171</sup>

In the NYSE's comment letter, it generally supported the traditional role of the ISG.<sup>172</sup> Moreover, the NYSE described its own order audit trail, the Order Tracking System ("OTS"), and how its rules are comparable to those of the NASD's OATS.<sup>173</sup> The NYSE raised the possibility of the Commission requiring that each individual market establish an order audit trail system similar to the NYSE's and the NASD's and mandating that the data from these separate order audit trails be integrated into the ISG's consolidated order audit trail.<sup>174</sup>

In its comment letter in response to the Intermarket Trading Concept Release, the NASD echoed many of the concerns raised by Nasdaq in its petition. Specifically, the NASD argued that the current model of coordinated regulation results in regulatory gaps and that potential misconduct can occur across markets undetected by regulators.<sup>175</sup> It also argued that the less detailed regulatory information collected by the ISG lacks certain critical pieces of information to effectively assist SROs in regulating intermarket trading activity.<sup>176</sup>

With respect to the options markets, in September of 2000, the Commission accepted settlement agreements from the Amex, CBOE, Phlx, and PCX in connection with administrative proceedings, alleging, among other things, that these options exchanges had

inadequately discharged their obligations as SROs by failing to enforce compliance with certain rules, including order handling rules, reporting rules, and rules prohibiting anticompetitive conduct.<sup>177</sup> As a result, in settling the Commission's enforcement action, the options exchanges undertook a variety of steps to prevent future self-regulatory lapses, including the design and implementation of a consolidated options audit trail system ("COATS").<sup>178</sup> COATS would enable the options exchanges to reconstruct markets promptly, effectively surveil them and enforce order handling, firm quote, trade reporting and other rules.<sup>179</sup> The full extent to which COATS effectively enhances intermarket options surveillance is not known as of yet because the system is in the final stage of its implementation. COATS, however, suggests the potential for a consolidated audit trail for the equity markets.

While the full implementation of robust intermarket order audit trails would be a significant step forward, an order audit trail is simply a tool that can be used by regulators to better surveil for illicit trading activity. In the 2000 Options Settlement, the options exchanges undertook to design and implement, concurrent with the design and implementation of COATS, effective surveillance systems to use the newly available COATS data to enforce the federal securities laws and SRO rules.<sup>180</sup> Thus, even when COATS is fully implemented and even if a similar intermarket audit trail were developed for the equity markets, the SRO regulatory function would still play a critical role in the regulation of intermarket trading.

The Commission specifically seeks public comment on the following questions related to intermarket surveillance and regulation:

*Question 13:* To what extent does our market model of multiple competing SROs create gaps in intermarket trading surveillance? What types of illicit trading activity in particular can be hidden from regulators by dispersing trading across multiple markets?

*Question 14:* How effectively does the ISG serve as a facilitator of regulatory data sharing and surveillance coordination among SROs? Is the ISG's order audit trail effective as a regulatory

<sup>160</sup> *Id.*

<sup>161</sup> For instance, ISG audit trail information is clearing level data, rather than executing firm level data. According to Nasdaq, the ISG data time fields are not generated by clocks subject to uniform synchronization protocols, as is the case with OATS data. Moreover, Nasdaq states that ISG data is transmitted two days after the trade takes place and in a format that cannot be readily integrated into the NASD's automated surveillance systems. Nasdaq argued that the two day delay significantly hinders NASD's ability to investigate unlawful trading activity on a real-time basis and can prevent NASD from obtaining non-stale regulatory information in an ongoing investigation. Inter-Market Trading Concept Release at 27723.

<sup>162</sup> *Id.*

<sup>163</sup> See *infra* notes 164–176.

<sup>164</sup> CSE letter at 3–7 and ISG letter at 2.

<sup>165</sup> Ameritrade letter at 3; CSE letter at 17–18; ISE letter at 3–4; GS/SLK letter at 3–4; Phlx letter at 6–7; SIA letter at 4; STA letter at 3.

<sup>166</sup> Ameritrade letter at 2; Brut letter at 6; CBOE letter at 2; CSE letter at 10–13; ISE letter at 3–4; ISG letter at 2; NYSE letter at 3–5; Phlx letter at 6–7; and SIA letter at 7.

<sup>167</sup> ISG letter at 2.

<sup>168</sup> *Id.*

<sup>169</sup> *Id.*

<sup>170</sup> ISG letter at 2–3.

<sup>171</sup> ISG letter at 2–3.

<sup>172</sup> See generally NYSE letter.

<sup>173</sup> NYSE letter at 4–5.

<sup>174</sup> NYSE letter at 4–5.

<sup>175</sup> NASD letter at 9.

<sup>176</sup> NASD letter at 8.

<sup>177</sup> See Exchange Act Release No. 43268 (September 11, 2000), File No. 3–10282, ("Options Settlement").

<sup>178</sup> See *Id.* at Section IV.B.e.

<sup>179</sup> *Id.*

<sup>180</sup> *Id.*

tool? How feasible would it be to require all markets to adopt order audit trails similar to those of the NYSE and the NASD and ultimately to integrate all markets' order audit trails into the ISG's consolidated order audit trail?

*Question 15:* How similar are the order audit trail systems of the NYSE and the NASD? Could they be merged into one consolidated system and what would be the benefits of such a consolidated system? Should NASD's OATS or NYSE's OTS requirements be extended to all equity markets to enhance the ability of SROs to surveil intermarket activity? If so, could all markets' individual order audit trails be successfully integrated into the ISG's consolidated order audit trail or another consolidated system? How useful a regulatory tool would the ISG's consolidated order audit trail system be if all markets were required to adopt their own order audit trail systems and their data was required to be integrated into the ISG's?

*Question 16:* To what extent is there a need for an order audit trail to provide crossover surveillance between the equities and options markets? To what extent would such crossover surveillance detect specific types of illicit trading activity?

#### D. Funding

Another feature of the SRO system to be discussed relates to the funding of SRO regulatory operations. One of the key historical benefits of the SRO system is its self-funding structure, which leverages the limited resources of the Commission. Experience appears to indicate that the Commission, in its current form, does not have the resources to effectively carry out on its own the full panoply of duties for which the SROs are currently responsible. In 1983, after 18 years of experience with directly regulating over-the-counter broker-dealer activity through the SEC Only ("SECO") program,<sup>181</sup> the regime

<sup>181</sup> The SECO program was implemented because neither the Exchange Act nor the Maloney Act compelled broker-dealers to become SRO members. In 1964, the Commission was in favor of compulsory membership in the NASD. Congress, however, opted for Commission regulation of broker-dealers who were not members of an association. Congress intended the SECO regulations to mirror the substantive and most of the procedural requirements of the NASD so that SECO firms would not enjoy a competitive advantage over NASD members or escape the regulation of ethical standards. Consequently, the Commission was tasked with designing rules to promote just and equitable principles of trade; to regulate the training and competency of securities industry professionals; to adopt regulations regarding broker-dealers and associated persons qualifications and training; and to adopt standards to cooperate with associations on qualification

was repealed.<sup>182</sup> Congress amended the Exchange Act provisions covering direct regulation of broker dealers by the SEC and imposed compulsory SRO membership.<sup>183</sup>

At the time of the repeal of the SECO program, the House Committee on Energy and Commerce reported to the Committee of the Whole House that the SECO program was unnecessarily costly and diverted the SEC's limited resources away from areas of major concern, merely to duplicate the functions of the NASD.<sup>184</sup> The House Committee stated "that any attempt to put SECO regulation on a par with that provided by the NASD would require significant expenditures by the Commission for additional staff and administrative costs."<sup>185</sup> The committee also noted that SROs were better able to maintain ethical standards for the industry and to perform certain detailed oversight functions.<sup>186</sup> The House also cited the limitations of enforcement and compliance remedies available to the Commission in comparison to the remedies available to the NASD.<sup>187</sup>

In the Market 2000 Report, the Commission's staff provided its retrospective impression of the SECO program's performance. The staff noted its belief that the SECO experience illustrated "that the resources necessary for the Commission to assume SRO regulatory functions directly and effectively are not realistically attainable."<sup>188</sup> The SECO experience demonstrated the important role that SROs play in maximizing the Commission's limited resources. It also illustrated that regulation must be properly funded and have sufficient resources to be effective. In that regard, the most finely-balanced SRO structure will not ensure that SRO statutory obligations are met, if regulatory operations are insufficiently funded. Thus, SRO funding arrangements are critical to the SRO system.<sup>189</sup>

exams and exam fees. See Market 2000 Report VI-6.

<sup>182</sup> See Pub L. 98-38; Exchange Act Release No. 20409 (November 22, 1983), 48 FR 53688 (November 29, 1983).

<sup>183</sup> *Id.* See also Exchange Act Section 15, 15 U.S.C. 78o.

<sup>184</sup> H.R. Rep. No. 98-106 (1983).

<sup>185</sup> H.R. Rep. No. 98-106, at 7 (1983).

<sup>186</sup> *Id.*

<sup>187</sup> *Id.* at 6.

<sup>188</sup> See Market 2000 Report at VI-6.

<sup>189</sup> As noted above, two ongoing Commission rulemakings have a bearing on SRO funding. First, proposed Reg NMS contains a provision that would reallocate market data revenues to encourage price formation. The Commission is also proposing the SRO Governance and Transparency Proposal, a rulemaking that would greatly increase SRO transparency with respect to funding (including regulatory funding) and funding allocations.

#### 1. Overview

While Congress was fairly prescriptive in its initial enactment of the Exchange Act and in subsequent amendments as to the standing responsibilities of SROs, it has not provided explicit guidance as to the proper levels or methods of funding for self-regulatory operations.<sup>190</sup> Section 6 of the Exchange Act, which addresses the registration of national securities exchanges, requires that "the rules of the exchange provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities."<sup>191</sup> Section 15A contains a similar provision in connection with the registration of national securities associations.<sup>192</sup> These provisions also require that an SRO be "so organized and [have] the capacity to be able to carry out the purposes" of the Exchange Act and "to comply, and \* \* \* to enforce compliance by its members, and persons associated with its members, with the provisions" of the Exchange Act.<sup>193</sup> Accordingly, while Congress provided only general guidance with respect to SRO funding, a reasonable reading of the Exchange Act indicates that it intended that regulatory funding be sufficient to permit SROs to fulfill their statutory responsibilities under the Exchange Act, and contemplated that such funding would be achieved through equitable assessments on the members, issuers, and other users of an SRO's facilities.

The Commission to date has not issued detailed rules specifying proper funding levels of SRO regulatory programs, or how costs should be allocated among the various SRO constituencies. Rather, the Commission has examined the SROs to determine whether they are complying with their statutory responsibilities. This approach was developed in response to the diverse characteristics and roles of the various SROs and the markets they operate. The mechanics of SRO funding, including the amount of revenue that is spent on regulation and how that amount is allocated among various regulatory operations, is related to the type of market that an SRO is operating. Prior to the SRO Governance and Transparency Proposal, the Commission had not proposed requiring a single

<sup>190</sup> See generally Exchange Act Sections 6 and 15A, 15 U.S.C. 78f and 78o-3.

<sup>191</sup> Exchange Act Section 6(b)(4), 15 U.S.C. 78f(b)(4).

<sup>192</sup> See Exchange Act Section 15A(b)(5), 15 U.S.C. 78o-3(b)(5).

<sup>193</sup> See Exchange Act Section 15A(b)(2) and 6(b)(1) 15 U.S.C. 78o-3(b)(2) and 78f(b)(1).

regulatory structure for all SROs, and the financial structure of each individual SRO is a result of a variety of factors, including the SRO's particular history and competitive position. Thus, each SRO and its financial structure is, to a certain extent, unique. While this uniqueness can result in different levels of SRO funding across markets, it also is a reflection of one of the primary underpinnings of the National Market System. Specifically, by fostering an environment in which diverse markets with diverse business models compete within a unified National Market System, investors and market participants benefit.<sup>194</sup>

The "appropriate" amount of funding to be spent by SROs on regulatory operations is governed by a variety of factors, including the SRO's business model, trading systems, regulatory responsibilities, and types of members. For instance, electronic marketplaces may be able to supervise trading occurring in their markets at lower cost than floor-based markets because their trading systems may capture comparatively more information associated with any given trade. Likewise, the characteristics of an SRO's membership base may affect the appropriate level of regulatory funding and how the funding is allocated.

Potential varying levels of regulatory funding notwithstanding, all SROs must meet their statutory obligations. The Exchange Act itself, as well as the Commission's rules and automation review policies thereunder, impose on the SROs important regulatory and operational responsibilities, including most of the day-to-day responsibilities for market and broker-dealer oversight.<sup>195</sup> Satisfying these self-regulatory responsibilities requires a substantial expenditure of expertise and funds. The SROs' combined total operating expenses in 1998 were \$1.68 billion<sup>196</sup> and total combined SRO operating expenses in 2003 were \$2.4 billion.<sup>197</sup> As stated above, a significant benefit of self-regulation in the

securities industry is that this significant cost is largely self-funded.

The Commission's supervision of the adequacy of SRO regulatory funding presents considerable challenges. Given the inherent tension between an SRO's role as a business and as a regulator, there undoubtedly is a temptation for an SRO to fund the business side of its operations at the expense of regulation. For example, if the "appropriate" amount of regulatory spending would seriously impair the financial stability of an SRO, that SRO would likely reduce regulatory spending rather than jeopardize its financial viability. When the Commission examines the underlying reasons for regulatory failings, it is often clear that an SRO has not allocated sufficient resources to its regulatory function. Without such failings, however, it can be difficult for the Commission to determine whether an SRO is insufficiently funding its regulatory function or simply administering an efficient regulatory program.<sup>198</sup>

If the Commission's SRO Governance and Transparency Proposal is adopted, however, it could illuminate more clearly SRO practices with respect to regulatory spending levels and allocations. Specifically, the detailed accounting of SRO revenues and expenses proposed could enable the Commission to more accurately and efficiently compare these items. Under the current reporting regime, SROs update their Form 1 annually, including an updated financial statement, but their financial information is not necessarily submitted in a comparable format.<sup>199</sup> Thus, the Commission could use this new information to assist in its effort to detect when an SRO is becoming an industry outlier in terms of relative regulatory spending levels. If the Commission made such a determination, it has the ability to pursue a range of regulatory responses,

<sup>198</sup> Even if the Commission were to determine that an SRO was insufficiently funding regulation, it would then have the difficult task of deciding whether to take extreme action (such as deregistration of an SRO) or more measured action (such as the NASD's 21(a) Undertaking requiring that it commit \$100 million on self-regulatory enhancements). See *e.g.*, 21(a) Report requiring that the NASD expend \$100 million over a five year period, to enhance its systems for market surveillance, including the development and implementation of an enhanced audit trail, and to increase its staffing in the areas of examination, surveillance, enforcement, and internal audit; see also NYSE settlement in connection with Exchange Act section 11(a), 15 U.S.C. 78k(a), violations requiring establishment of OTS, Exchange Act Release No. 41574 (June 29, 1999), Administrative Proceeding File No. 3-9925; see also Options Settlement requiring establishment of COATS.

<sup>199</sup> See Exchange Act Rule 6a-2, 17 CFR 240.6a-2, and 15Aj-1, 17 CFR 240.15Aj-1.

including designating that SRO for heightened Commission oversight or stronger action, such as SRO deregistration.

Although not proposed in the SRO Governance and Transparency Proposal, the Commission could also consider developing formal or informal regulatory spending guidelines for SROs. Establishing uniform guidelines for SROs generally would be a very complex task, however, given the diversity of their marketplaces and memberships and the evolving nature of regulatory oversight. While the SRO Governance and Transparency Proposal would likely result in a heightened Commission ability to detect low regulatory spending levels, it is important to note that gauging the effectiveness of an SRO's self-regulation cannot necessarily be accurately judged by considering capital expenditures in isolation.

The Commission specifically seeks public comment on the following questions related to SRO funding generally:

*Question 17:* Should the Commission prescribe specific regulatory funding and allocation levels for SROs and, if so, how? Also, how would these levels be determined?

*Question 18:* Could enhanced transparency of SRO funding be used effectively to promote adequate SRO regulatory funding levels or would other steps be more effective in that regard? What measures could be used to promote adequate SRO regulatory funding levels?

## 2. SRO Funding Sources

To provide commenters a basis for considering SRO funding, this section discusses the five primary sources of SRO funding: (a) Regulatory fees; (b) transaction fees; (c) listing fees; (d) market data fees; and (e) other miscellaneous fees. While each source of SRO revenue is important, this discussion will provide an extensive discussion of market data and specifically the level of fees charged for market data.

### a. Regulatory Fees

SROs charge members fees for joining and maintaining membership. In addition, SROs charge regulatory fees to members that typically take the form of per member or per transaction fees and are generally allocated to funding self-regulatory operations. SROs also contract with other SROs to provide regulatory services. In 1998, regulatory fees accounted for approximately 19%

<sup>194</sup> See generally Exchange Act Section 11A, 15 U.S.C. 78k-1.

<sup>195</sup> See generally Policy Statement: Automated Systems of Self-Regulatory Organizations, Exchange Act Release No. 27445 (November 16, 1989), 54 FR 48703 (November 24, 1989); Policy Statement: Automated Systems of Self-Regulatory Organizations (II), Exchange Act Release No. 29185 (May 9, 1991), 56 FR 22490 (May 15, 1991).

<sup>196</sup> See Concept Release, Regulation of Market Information Fees and Revenues ("Market Data Concept Release"), Exchange Act Release No. 42208 (File No. S7-28-99) (December 9, 1999), 64 FR 70613, 70615 (December 17, 1999).

<sup>197</sup> Data compiled from SRO 2003 Annual Reports.

of SRO revenue,<sup>200</sup> while, in 2003, approximately 23% of SRO revenue was derived from such fees.<sup>201</sup>

A recent development with respect to SRO regulatory fees was the NASD's establishment of a Trading Activity Fee ("TAF"), to supplement the regulatory fees it historically charged its members.<sup>202</sup> The TAF assessed a transaction-based fee that was not linked to trading activity reported through Nasdaq systems.<sup>203</sup> In

<sup>200</sup> Market Data Concept Release at 70625.

<sup>201</sup> Data compiled from SRO 2003 Annual Reports. Note that the NYSE 1998 Consolidated Statement of Revenue did not account for "Data Processing Fee" revenue. Due to an intervening change in accounting procedures, the NYSE 2003 Consolidated Statement of Revenue includes this item. To provide a more accurate comparison between the 1998 and 2003 percentages, "Data Fee Processing" revenue was not included in total SRO revenue for the purpose of calculating the percentage of total SRO revenue represented by regulatory fee revenue. Based on SRO 2003 Annual Report Consolidated Statements of Income certain items were allocated to regulatory fees with respect to the NYSE ("Regulatory Fees" and "Annual Membership Fees"), the BSE ("Members' Dues and Fees"), the Phlx ("Regulatory Fees"), the NASD (including Amex and Nasdaq consolidated statements of income) ("Regulatory Fees," "Registration Fees," "Qualification Fees," "Corporate Financing Fees," and "Fines"), the PCX ("Regulatory and Registration Fees," "Archipelago Revenue: Regulatory Oversight," and "Member and Participant Dues"), the CHX ("Member Services and Fees" and "Member Dues"), the CBOE ("Regulatory Fees" and "Other Member Fees"), and the NSX ("Regulatory Fees").

<sup>202</sup> See Exchange Act Release Nos. 46817 (November 12, 2002), 67 FR 69784 (November 19, 2002) ("TAF Proposing Release"); 47946 (May 30, 2003), 68 FR 34021 (June 6, 2003) ("TAF Approval Order"). See also Exchange Act Release Nos. 49114 (January 22, 2004), 69 FR 4194 (January 28, 2004) (proposing to amend the TAF and extend it to Trade Reporting and Compliance Engine ("TRACE")-eligible and municipal securities); 50485 (October 1, 2004), 69 FR 60445 (October 8, 2004) (approving proposal to amend the TAF and extend it to TRACE-eligible and municipal securities).

<sup>203</sup> In its filing, the NASD noted its belief that assessing the regulatory fees only for Nasdaq transactions was no longer appropriate for three reasons. First, on a corporate entity level, Nasdaq was separating itself from the NASD and attempting to register as a national securities exchange. Second, the NASD believed that the historic regulatory fee structure was out of step with recent changes in the markets, such as the drastic growth in trading volumes, reductions in average trade size, decimalization, and trading no longer remaining exclusive to the listing market. Finally, the regulatory fee was only assessed against Nasdaq-listed and other transactions that are reported through Nasdaq's trade reporting system, although these fees were used to support member regulatory activities across all markets. See TAF Proposing Release at 69785.

The Commission received a total of 23 comment letters on the proposal, all of which objected to the proposal, either for substantive or procedural reasons. Commenters of the TAF proposal argued that the NASD should not charge members for services related to transactions on other markets, where the NASD does not provide the relevant service. In addition, commenters argued that the TAF proposal was anti-competitive in that it indirectly subsidized Nasdaq by effectively reducing the cost of regulatory services the NASD

approving the TAF, the Commission found that it was reasonably designed to recover the NASD's costs related to regulation and oversight of its members.<sup>204</sup> A principal factor in the Commission's approval was its explicit recognition of the NASD's broad responsibilities with respect to its members' activities, irrespective of where securities transactions take place.<sup>205</sup> Specifically, the Commission noted that, as a national securities association, the NASD has the responsibility to oversee its members' finances and conduct toward their customers, except in limited circumstances where this responsibility is allocated to another SRO.<sup>206</sup> The Commission further stated that the NASD's responsibility exists even if the conduct involves a transaction executed on a market not directly regulated by the NASD because it has direct responsibility to oversee the firm's dealing with the public in effecting the transactions and may also have responsibility to oversee the impact of the trading on the firm's financial condition.<sup>207</sup>

The Commission specifically seeks public comment on the following question related to SRO regulatory fees:

**Question 19:** Under current SRO cost structures, SRO funding for regulatory operations is not derived strictly from revenue associated with regulatory fees

provides to Nasdaq. They also posited that the TAF could establish a dangerous precedent under which fees could be charged by SROs for trading activity that had little or no nexus to that SRO's market. See TAF Approval Order at 34022-34023.

In response, the NASD clarified that the TAF was to be used only to fund its member regulatory activities in a variety of areas such as sales practices, examinations, financial and operational reviews, new member applications, and enforcement wherever such member activity occurs. In addition, the NASD argued that it regulates the activities of its members in all securities, not simply Nasdaq securities. The specific revenues from the TAF, the NASD stated, would not fund regulatory activities of the Nasdaq stock Market and, thus, not create an inappropriate regulatory subsidy. Finally, with regard to comments that no clear nexus existed between the TAF and the corresponding NASD regulatory responsibilities, the NASD maintained that its mandate is broad, and that its regulatory obligations "exist separate and apart from any market-specific rules and obligations." See TAF Approval Order at 34023.

<sup>204</sup> TAF Approval Order at 34023-34024.

<sup>205</sup> *Id.*

<sup>206</sup> *Id.*

<sup>207</sup> The Commission also stated its belief that the TAF approval was not a harbinger for the imposition of fees on transactions executed on markets for which an SRO either has little or no nexus to regulatory tasks performed by the SRO or for which the SRO has no business interest. Most SROs, the Commission concluded, do not have the broad aegis of the NASD regarding members' customer business, and so will not have a regulatory nexus to support a transaction fee applicable to other markets. See TAF Approval Order at 34023-34024.

and operations. Instead, SROs cross subsidize the cost of regulatory operations with revenue that is not strictly derived from regulatory fees and operations. Should the Commission 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? If regulatory funding should be limited strictly to revenue generated by regulatory fees, how should the Commission address a situation in which an SRO does not generate sufficient regulatory revenue to fully fund regulatory operations?

#### b. Transaction Fees

Another important source of revenue for SROs that operate markets is derived from 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. These fees are paid by any user of an SRO's market facilities for services, including executing, reporting, and clearing transactions. In 1998, transaction fees accounted for approximately 30% of SRO revenue,<sup>208</sup> while, in 2003, approximately 27% of SRO revenue was associated with transaction fees.<sup>209</sup>

The intense intermarket competition for order flow has put substantial pressure on these fees. For example, greater competition among options markets has caused transaction fees to all but disappear in the options markets.<sup>210</sup> The equity markets have also come under intense competitive pressure to lower transaction fees. As discussed in the Reg NMS proposal, transaction fees have decreased steadily

<sup>208</sup> Market Data Concept Release at 70625.

<sup>209</sup> Data compiled from SRO 2003 Annual Reports. Note that the NYSE 1998 Consolidated Statement of Revenue did not account for "Data Processing Fee" revenue. Due to an intervening change in accounting procedures, the NYSE 2003 Consolidated Statement of Revenue includes this item. To provide a more accurate comparison between the 1998 and 2003 percentages, "Data Fee Processing" revenue was not included in total SRO revenue for the purpose of calculating the percentage of total SRO revenue represented by transaction fee revenue. Based on SRO 2003 Annual Report Consolidated Statements of Income certain items were allocated to transaction fees with respect to the NYSE ("Transaction Fees"), the BSE ("Transaction Fees"), the Phlx ("Transaction Fees"), the NASD (including Amex and Nasdaq consolidated statements of income) ("Transaction Fees"), the PCX ("Transaction Fees and Data Service Charges"), the CHX ("Transaction Fees"), the CBOE ("Transaction Fees"), and the NSX ("Transaction Fees").

<sup>210</sup> See generally Concept Release: Competitive Developments in the Options Markets, Exchange Act Release No. 49175 (February 3, 2004), 69 FR 6124, 6125 (February 9, 2004) ("Options Concept Release").

in recent years.<sup>211</sup> In addition, most ECNs and Nasdaq are paying a per-share rebate for limit orders that become executed against incoming orders, thereby further reducing net transaction fees.<sup>212</sup> Thus, not only are SRO transaction fees being driven lower, but competition is compelling certain SROs to rebate a significant percentage of transaction fees collected to market participants.

The Commission specifically seeks public comment on the following questions related to SRO transaction fees:

*Question 20:* SRO transaction fees have been driven sharply lower in recent years by competition. In light of that, why has the overall percentage of SRO revenue associated with transaction fees not dropped as dramatically since 1998 (approximately 27% in 2003 compared to approximately 30% in 1998)?

*Question 21:* How has the trend of decreasing transaction fees impacted the SROs' ability to fulfill their statutory obligations?

#### c. Listing Fees

Another important source of revenue for some SROs is listing fees, which are paid by issuers that list their securities on an SRO's market. Initial listing fees are paid at the time of listing and are typically related to the amount of shares being offered. Listing maintenance fees are paid annually and are generally related to the issuers' total shares outstanding in the listed security. In 1998, listing fees accounted for approximately 23% of SRO revenue,<sup>213</sup> while, in 2003, these fees represented approximately 20% of SRO revenue.<sup>214</sup>

<sup>211</sup> See supra note 62.

<sup>212</sup> Most ECNs and Nasdaq pay a per-share rebate for limit orders that become executed against incoming orders. This rebate rewards market participants for submitting "resting" limit orders that give depth to the trading book. The ECNs and Nasdaq also impose a per-share access fee on the incoming marketable orders that execute against the resting limit orders and thereby "remove liquidity" from the book. In this way, the ECNs and Nasdaq use access fee rebates as payment to attract liquidity to their limit order books. Because non-subscribers cannot place limit orders on an ECN's book and therefore cannot receive the rebates, the fees that they pay act as a subsidy to the subscribers that place standing limit orders on the ECN's book. See Reg NMS at 11157.

<sup>213</sup> Market Data Concept Release at 70625.

<sup>214</sup> Data compiled from SRO 2003 Annual Reports. Note that the NYSE 1998 Consolidated Statement of Revenue did not account for "Data Processing Fee" revenue. Due to an intervening change in accounting procedures, the NYSE 2003 Consolidated Statement of Revenue includes this item. To provide a more accurate comparison between the 1998 and 2003 percentages, "Data Fee Processing" revenue was not included in total SRO revenue for the purpose of calculating the percentage of total SRO revenue represented by

These revenues have been highly concentrated in the primary listing markets, with secondary markets charging little or no listing fee.<sup>215</sup> This concentration is exemplified by the fact that of the \$9,182 billion worth of stocks listed on exchanges in 2002, \$9,119 billion was listed on the New York Stock Exchange.<sup>216</sup>

The Commission specifically seeks public comment on the following question related to SRO listing fees:

*Question 22:* To what extent has increased inter-market competition impacted SRO listing fee revenue? To what extent has this impacted the SROs' ability to fulfill their regulatory obligations?

#### d. Market Data Fees

Market data revenue has traditionally been a very important component of SRO funding.<sup>217</sup> In 1998, market data

listing fee revenue. Based on SRO 2003 Annual Report Consolidated Statements of Income certain items were allocated to listing fees with respect to the NYSE ("Listing Fees"), the BSE ("Listing Fees"), the NASD (including Amex and Nasdaq consolidated statements of income) ("Issuer Services"), and the CHX ("Listing Fees").

<sup>215</sup> The recent increase in intermarket competition for equity listings has raised issues related to listing fees and SRO funding. In early 2004, for example, the Nasdaq Stock Market launched a dual listing program to attract NYSE-listed issuers and offered a one year waiver of all entry fees and annual fees for NYSE-listed companies that became dually listed. Craig Karmin, *Nasdaq Recruits Six NYSE Firms to Dual Listings*, Wall Street Journal, January 13, 2004, at C1.

<sup>216</sup> See Commission, 2003 Annual Report, 140 (2004).

<sup>217</sup> As noted above, while the level of fees charged by the SROs for market data was not directly addressed in Reg NMS, broad industry interest in the issue was apparent from the comments received by the Commission in response to Reg NMS. Thus, while each source of SRO revenue is important, this discussion examines market data extensively and specifically examines the level of fees charged for market data. Various commenters in response to Reg NMS stated that market data revenues are an important source of funding for SROs and should therefore not be capped or reduced. See letter from William J. Brodsky, Chairman and Chief Executive Officer, The Chicago Board Options Exchange, Inc., to Jonathan G. Katz, Secretary, Commission, p. 9 (July 1, 2004) ("Reg NMS CBOE letter"); letter from David A. Herron, Chief Executive Officer, Chicago Stock Exchange, to Jonathan G. Katz, Secretary, Commission, pp.18–19 (June 30, 2004); and letter from David Humphreville, President, The Specialist Association, to Jonathan G. Katz, Secretary, Commission, p. 17 (June 30, 2004). One Reg NMS commenter believed that, in absence of market discipline, the Commission and SROs must ensure that the collection and allocation of revenues to different regulatory functions maximize investor protections at a reasonable cost. See letter from Huw Jenkins on behalf of UBS Securities LLC, Managing Director, Head of Equities for the Americas, to Jonathan G. Katz, Secretary, Commission, p. 10 (June 30, 2004) ("Reg NMS UBS letter"). An SRO commenter stated that it is consistent with the purpose and intent of Section 11A of the Exchange Act for a significant portion of the market data revenue to be used by SROs for operations and regulation because such costs are

revenue represented approximately 21% of SROs' total revenues,<sup>218</sup> while, in 2003, approximately 18% of SRO revenue flowed from market data.<sup>219</sup> Market data revenues represented 16% of NYSE revenues and 24% of Nasdaq revenues in 2003.<sup>220</sup> For one SRO, market data fees accounted for more than 80% of its total 2003 revenue.<sup>221</sup>

In contrast to the importance of market data revenue to overall SRO funding, it is worth noting that it represents a relatively small portion of the securities industry's total expenses. For example, in 1998, the total SRO market data revenue of \$410.6 million represented a very small portion of the securities industry's total expenses for the year—less than 1/4th of one percent.<sup>222</sup> In spite of revenue derived from market data playing an important role in SRO funding, some SROs rebate substantial market data revenues to the market participants that contribute to creating the market data.<sup>223</sup>

The U.S. equity markets are not alone in their reliance on market data revenues as a source of funding. All of the other major world equity markets currently derive large amounts of revenues from selling market information, despite having significantly less trading volume and less market capitalization than the NYSE and Nasdaq. To illustrate, the following table sets forth the respective market information revenues, dollar value of trading, and market

directly related to the quality of the market data disseminated. See Reg NMS CBOE letter, p. 9.

<sup>218</sup> Market Data Concept Release at 70625.

<sup>219</sup> Data compiled from SRO 2003 Annual Reports. Note that the NYSE 1998 Consolidated Statement of Revenue did not account for "Data Processing Fee" revenue. Due to an intervening change in accounting procedures, the NYSE 2003 Consolidated Statement of Revenue includes this item. To provide a more accurate comparison between the 1998 and 2003 percentages, "Data Fee Processing" revenue was not included in total SRO revenue for the purpose of calculating the percentage of total SRO revenue represented by market data fee revenue. Based on SRO 2003 Annual Report Consolidated Statements of Income certain items were allocated to market data fees with respect to the NYSE ("Market Data Fees"), the BSE ("Communications, Net Note B"), the Phlx ("Security Price Data and Floor Charges"), the NASD (including Amex and Nasdaq consolidated statements of income) ("Market Data Fees"), the PCX ("Peripheral Equipment and Market Data Fees"), the CHX ("Market Data Fees"), the CBOE ("OPRA Income"), and the NSX ("Market Data Fees").

<sup>220</sup> Data compiled from NYSE and NASD 2003 Annual Reports.

<sup>221</sup> See NSX, 2003 Annual Report Exhibit I-12 (2004).

<sup>222</sup> See Market Data Concept Release Appendix.

<sup>223</sup> See Reg NMS at 11179.

capitalization for the largest world equity markets in 2003:<sup>224</sup>

	Data revenues (millions)	Trading volume (trillions)	Market capitalization (trillions)
London .....	\$180	\$3.6	\$2.5
NYSE .....	172	9.7	11.3
Nasdaq .....	147	7.1	2.8
Deutsche Bourse .....	146	1.3	1.1
Euronext .....	109	1.9	2.1
Tokyo .....	60	2.1	3.0

Understanding market data pricing and the role that market data plays with respect to SRO funding is an important part of this discussion. Congress recognized that SROs would charge for market data when it gave the Commission authority in the 1975 Amendments to determine the extent to which SRO fees charged for market data are “fair and reasonable,” are “not unreasonably discriminatory,” and achieve “equitable allocation” of reasonable fees among persons who use an SRO’s facilities.<sup>225</sup> Market information revenues serve an important and unique role in that they provide a broad source of SRO funding. The fees are paid by all users of market information, including, for example options and futures markets participants that otherwise would not contribute (through transactions services fees or listing fees) to the funding of the particular markets on whose information they rely.<sup>226</sup>

In addition to being important to SROs, market data is also critical to

market participants and investors. Market data is essential to investors and other market participants not physically present in a trading market, enabling them to make informed decisions when to buy and sell. It provides the basis for investment and portfolio decisions. And it creates confidence in the fairness and reliability of the markets. The current market data systems for equities and options collect quotes and trades from many different market centers and disseminate them to the public in a single stream of information for each security. This market information has been an essential element in the success of the U.S. securities markets. In addition to providing transparency of buying and selling interest, consolidated data is the principal tool for addressing fragmentation of trading among many different market centers, and for facilitating the best execution of investor orders by their brokers.<sup>227</sup> Market data fees can have a major impact on the effectiveness of the market data system. The level of these fees and their structure determines the extent that market data is available to different types of market participants and investors. And market data can

have anticompetitive effects if it is sold on discriminatory terms or in an unfair fashion.<sup>228</sup>

Market data fees also support the timeliness, accuracy, and reliability of the market data being disseminated. Market data, whether consolidated or not, that is untimely or untrustworthy could harm investors and reduce confidence in the fairness of the U.S. securities markets. One of the Commission’s most important market structure responsibilities is to assure the integrity of market data.<sup>229</sup> Today, market data from all equity and options markets is highly reliable and widely used. In order to promote the wide public availability of this information, market data fees must be fair and reasonable.<sup>230</sup> Consistent with this is the notion that such fees should at least generate sufficient revenue to provide adequate funding for the dissemination of market data.

Currently, the Commission typically reviews market data fees in the context of proposed fee changes filed by the three networks that disseminate market data in NMS stocks. These fee filings are published for notice and comment before Commission action.<sup>231</sup> After

<sup>224</sup> Table data is derived from the 2003 annual reports of the various markets and from statistics compiled by the World Federation of Exchanges.

<sup>225</sup> See Exchange Act Sections 6(b), 11A(c), and 15A(b), 15 U.S.C. 78f(b), 78k–1(c), and 78o–3. Two provisions of the Exchange Act directly address market data fees. Section 11A(c)(1)(C) grants rulemaking authority to the Commission to assure that all securities information processors may obtain market information from an exclusive processor of that information (*i.e.*, the processors for the three Networks) on terms that are fair and reasonable. Section 11A(c)(1)(D) also grants rulemaking authority to the Commission to assure that all persons may obtain market information on terms that are not unreasonably discriminatory. The Commission applies these standards in reviewing fee filings submitted by exclusive processors for the three consolidated networks that disseminate market data in NMS stocks. The three Networks are (1) Network A, which disseminates data in stocks listed on the NYSE; (2) Network B, which disseminates data in stocks listed on Amex and the regional exchanges; and (3) Network C, which disseminates data in stocks listed on Nasdaq. The Commission also applies these standards in

reviewing market data filings submitted by individual SROs.

<sup>226</sup> See Market Data Concept Release at 70628.

<sup>227</sup> Reg NMS at p.11176.

<sup>228</sup> In the past, SROs have attempted to distribute market data in ways that could potentially harm competitors. For example, in proposing a new “depth of book” market data product, Liquidity Quote, the NYSE asserted that it would incorporate a downstream data consolidation restriction clause into its agreements with market data vendors for the product that would prohibit its being integrated with any other market data product. A variety of anti-competition arguments were raised in connection with this proposal and, ultimately, the Commission approved the proposal, but made the approval expressly contingent upon the NYSE not applying the downstream restrictions that were in its vendor agreements at the time of the approval. See generally Exchange Act Release Nos. 47091 (December 23, 2002), 68 FR 133 (January 1, 2003); 47614 (April 2, 2003), 68 FR 17140 (April 8, 2003).

<sup>229</sup> When Congress mandated the creation of a national market system, it stated that “communication systems, particularly those designed to provide automated dissemination of last sale and quotation information with respect to

securities, will form the heart of the national market system.” H.R. Rep. No. 94–229, 94th Cong., 1st Sess. 93 (1975). While Congress did not specifically mandate the creation of a consolidated market data processor system, the Commission has recently emphasized the benefits of consolidated market data, particularly for retail investors. See Reg NMS at 11177.

<sup>230</sup> See Exchange Act Section 11A(c)(1)(C). 15 U.S.C. 78k–1(c)(1)(C).

<sup>231</sup> Several Reg NMS commenters believed that the existing notice and comment process for effecting market data fee changes does not facilitate informed and meaningful public and industry participation and comment. See letter from Gary Cohn, Managing Director, Goldman, Sachs & Co., to Jonathan G. Katz, Secretary, Commission, p. 12 (July 19, 2004) (“Reg NMS Goldman letter”); letter from Carrie E. Dwyer, Charles Schwab & Co., Inc., to Jonathan G. Katz, Secretary, Commission, p. 9 (June 30, 2004) (“Reg NMS Schwab letter”); letter from Marc Lackritz, President, Securities Industry Association, to Jonathan G. Katz, Secretary, Commission, pp. 24 and 26 (June 30, 2004) (“Reg NMS SIA letter”); and letter from Mary McDermott-Holland, Chairman, John C. Giesea, President/CEO,

these filings are published, the Commission determines whether the fees are fair and reasonable, not unreasonably discriminatory, and otherwise consistent with the requirements of the Exchange Act.<sup>232</sup> Although most market data fee filings currently involve Network fees, the same standard applies and the same questions arise with regard to the market data fees of an individual SRO.

In reviewing a market data fee filing, the Commission has relied to a great extent on the ability of the Networks to negotiate fees that are acceptable to SRO members, information vendors, investors, and other interested parties. The negotiation process is buttressed by

the public notice and comment procedures that accompany the Commission's consideration of proposed rule changes.

As equities and options markets have evolved in recent years, strains began to develop in the arrangements for market data, particularly with respect to setting fees. In evaluating the issues raised, an extensive public record has been developed on the subject of market data fees in the last five years. In 1999, the Commission initiated a full-scale review of market data fees and revenues in the Market Data Concept Release. The review was prompted, in part, by the Commission's concern that retail investors might be paying too much for

market data.<sup>233</sup> The Market Data Concept Release included the role of revenues derived from such fees in funding the operation and regulation of markets.<sup>234</sup> The Market Data Concept Release presented for public review a great deal of factual information on market data fees and revenues.<sup>235</sup> In the course of that effort, the Commission emphasized that market data must be affordable for retail investors.<sup>236</sup> At about the same time, the Networks filed proposed rule changes that reduced retail investor fees generally by 75% to 80%. The following table sets forth retail investor fees for NYSE and Nasdaq stocks in 2003 and in 1998:

	NYSE		Nasdaq	
	2003	1998	2003	1998
Per Query .....	¼¢ to ¾¢ .....	1¢	½¢	1¢
Monthly .....	\$0.50 to \$1.00 .....	\$5.25	\$1.00	\$4.00

The per-query fees are charged each time that a retail investor requests quote and trade information in a particular stock. The monthly fees represent limits on the total amount that a retail investor

can be charged for market data in any month. Thus, for example, all retail investors currently have access to an unlimited quantity of the millions of best quotes and trades in Network A

stocks during each trading day for no more than \$1 per month, compared to the \$5.25 that was charged before the Commission's review of market data fees.<sup>237</sup>

The Security Traders Association, to Jonathan G. Katz, Secretary, Commission, p. 15 (June 30, 2004) ("Reg NMS STANY letter"). A few of these commenters also believed that these procedures, which provide that market data fee changes are effective upon filing, gives excessive power to self-interested parties. See Reg NMS Schwab letter, p. 9; Reg NMS SIA letter, p. 26; and Reg NMS STANY letter, p. 15. The SIA also stated that "[t]he fact that the Commission may abrogate the proposal and require refiling does not equate to a substantive review or challenge to the fees charged, and has not proved such in the past." See Reg NMS SIA letter, p. 26. The SIA and STANY also suggested that this is responsible, in part, for excessive market data fees. See Reg NMS SIA letter, pp. 3 and 26-27; STANY letter, p. 15. Schwab recommended amending Commission rules and the joint-SRO plans to eliminate the "effective upon filing" process for market data fee changes, including changes that would impact the treatment of market data users and market data distribution policies. See Reg NMS Schwab letter, p. 9. Schwab also recommended that the Commission require the joint-SRO plans to file material policy changes as rule changes that require public notice and comment prior to adoption. See Reg NMS Schwab letter, p. 9. Although fees charged by SROs to members generally are effective on filing, market data fees charged to the public are published for notice and comment before approval. See Exchange Act Rule 19b-4, 17 CFR 240.19b-4.

<sup>232</sup> See Exchange Act Section 11A, 15 U.S.C. 78k-1; Exchange Act Rule 11Aa3-2, 17 CFR 240.11Aa3-2.

<sup>233</sup> The Internet had greatly expanded the opportunity for retail investors to obtain access to real-time market data through on-line accounts with their broker-dealers, and investor demand for this data had grown exponentially. For example, the Market Data Concept Release noted that the revenues derived from fees applicable to retail investors had grown from \$3.7 million in 1994 to \$38.9 million in 1998, and represented

approximately 9% of total market data revenues. Market Data Concept Release at 70614 and 70631.

<sup>234</sup> See generally *Id.* at Section IV.  
<sup>235</sup> The Appendix, for example, included 16 tables setting forth all of the different subscriber fees of the Networks, the revenues, expenses, and distributions of the Networks, and the revenues and expenses of each of the individual SROs that are participants in the Networks. In addition, the Market Data Concept Release included information to help the public assess whether the level of market data fees remained fair and reasonable. For example, the release noted that even prior to creation of the national market system and the Networks, market data revenues were an important source of SRO funding—market data revenues represented 14.7% of the NYSE's total revenues in 1975, compared to 15.3% in 1998. Market Data Concept Release at 70621. As noted above, market data revenues represented 16.0% of NYSE revenues in 2003. In addition, although the total amount of market data revenues had grown substantially in recent years, the increase was proportional to the increase in other SRO revenues. In 1994, market information revenues amounted to \$246.1 million and represented 20% of SRO funding. In 1998, such revenues amounted to \$410.6 million and represented 21% of SRO funding. The Commission noted that "the growth in market information revenues has simply kept pace with the growth of other SRO revenues during the prolonged expansion in trading volume of the last five years. The SROs are no more, but also no less, dependent on market information revenues today than they were in 1994." Market Data Concept Release at 70615. Moreover, the percentage growth in market data revenues from 1994 to 1998 was 67%, but had not kept pace with the percentage growth in the securities industry's total revenues during this major expansion of trading, which was 139%. *Id.* at 70626.

<sup>236</sup> The Commission noted that one of the most important functions of the Commission is to assist retail investors in accessing the information they

need to protect and further their own interests. Moreover, the Commission stated that communications technology had progressed so that broad access to real-time market information should be an affordable option for most retail investors. This information, the Commission believed, could greatly expand the ability of retail investors to trade securities. The Commission stated its intention that to assure that market information fees applicable to retail investors do not restrict their access to market information and that such fees must be non-discriminatory when compared with the fees charged to professional users of market information. Market Data Concept Release at 70614.

<sup>237</sup> See Network C / NASD-2003-132, Securities Exchange Act Release No. 48386 (August 21, 2003), 68 FR 51618 (August 27, 2003) (extending pilot program for reduced non-professional NQDS user fee); Network C / NASD-2002-117, Securities Exchange Act Release No. 46446 (August 30, 2002), 67 FR 57260 (September 9, 2002) (extending pilot program for reduced non-professional NQDS user fee); Network C / NASD-2001-56, Securities Exchange Act Release No. 44788 (September 13, 2001), 66 FR 48303 (September 19, 2001) (extending pilot program allowing for reduced non-professional NQDS user fee); Network C / NASD-2001-32, Securities Exchange Act Release No. 44363 (May 29, 2001), 66 FR 30254 (June 5, 2001) (permanently approving reduced Level 1 Service fees for non-professional users on a monthly and per query basis); Network B / CTA-01-01, Securities Exchange Act Release No. 44047 (March 7, 2001), 66 FR 15151 (March 15, 2001) (reducing the initial ticker charge at each customer location from \$21.50 to \$13.50 and thereby creating a uniform charge for each location); Network C / NASD-00-47, Securities Exchange Act Release No. 43190 (August 22, 2000), 65 FR 52460 (August 29, 2000) (establishing pilot program for reduced non-professional NQDS user fee); Network C / NASD-00-19, Securities Exchange Act Release No. 42715 (April 24, 2000), 65 FR 25411 (May 1, 2000)

In reviewing the basis for evaluating market data fees, the Market Data Concept Release laid out in detail a "flexible cost-based approach" to market data fees.<sup>238</sup> The Commission noted that terms such as "fair" and "reasonable" generally need standards to guide their application in practice, and that one such standard often used to evaluate fees is the amount of costs incurred to provide a service.<sup>239</sup> The Commission stated that an inflexible cost-based standard, although unavoidable in some contexts, can entail severe practical difficulties.<sup>240</sup> Instead, Congress, consistent with its approach to the National Market System in general, granted the Commission some flexibility in evaluating the fairness and reasonableness of market information fees.<sup>241</sup> Specifically, Congress articulated general findings and objectives for the National Market System in section 11A and directed the Commission to act accordingly in overseeing its development.<sup>242</sup> Congress thereby allowed the Commission to adopt a more flexible approach than ratemaking.<sup>243</sup>

To illustrate the practical difficulties of a strict, cost-of-service ratemaking approach, the Market Data Concept Release described one prior instance in

(extending pilot program for reduced Level 1 Service fees for non-professional users on a monthly and per query basis and further reducing the Level 1 Service monthly fee for non-professionals); Network B / CTA/CQ-99-02, Securities Exchange Act Release No. 42138 (November 15, 1999), 64 FR 63350 (November 19, 1999) (reducing the Network B non-professional subscriber flat service rate, permanently approving and reducing tiered pay-for-use rates for non-professional subscribers, and allowing non-professional subscribers to pay the lower of the pay-for-use or flat rates); Network A / CTA/CQ-99-01, Securities Exchange Act Release No. 41977 (October 5, 1999), 64 FR 55503 (October 13, 1999) (reducing, *inter alia*, the Network A non-professional subscriber flat service rate, permanently approving and reducing tiered pay-for-use rates for non-professional subscribers, and allowing non-professional subscribers to pay the lower of the pay-for-use or flat rates); Network C / NASD-99-25, Securities Exchange Act Release No. 41499 (June 9, 1999), 64 FR 32910 (June 18, 1999) (establishing pilot program for reduced Level 1 fees for non-professional users on a monthly and per query basis); Network C / NASD-99-17, Securities Exchange Act Release No. 38608 (May 12, 1997), 62 FR 27095 (May 16, 1997) (increasing monthly subscriber fee for Level 1 Service); Network B / Securities Exchange Act Release No. 29879 (October 29, 1991), 56 FR 56430 (November 4, 1991) (increasing Network B professional and non-professional subscriber fees); and Network A / Securities Exchange Act Release No. 29863 (October 25, 1991), 56 FR 56429 (November 4, 1991) (increasing Network A professional and non-professional subscriber fees).

<sup>238</sup> Market Data Concept Release at 70629-70632.

<sup>239</sup> *Id.* at 70619.

<sup>240</sup> *Id.*

<sup>241</sup> *Id.*

<sup>242</sup> *Id.*

<sup>243</sup> *Id.*

which the Commission had sought to implement such an approach in 1984.<sup>244</sup> In that instance, Instinet had brought a proceeding before the Commission asserting that the NASD's fee for full quotation information from all Nasdaq market participants was an unwarranted denial of access to the information.<sup>245</sup> The Commission found in favor of Instinet, primarily because the NASD had failed to submit an adequate cost-based justification for the fee.<sup>246</sup> The Instinet Order emphasized, however, that the scope of its decision was limited to the particular competitive context presented in the proceedings and did not apply to all market data fees.<sup>247</sup>

<sup>244</sup> See generally Securities Exchange Act Release No. 20874 (April 17, 1984), 49 FR 17640 (April 24, 1984) ("Instinet Order").

<sup>245</sup> *Id.*

<sup>246</sup> *Id.*

<sup>247</sup> *Id.* The Market Data Concept Release then related the long process that ensued to arrive at a cost-based fee:

The practical difficulties of implementing this strict, cost-of-service approach are demonstrated by the subsequent history of the fee involved in the Instinet Order (later named the "NQDS" fee). In August 1985, the NASD proposed a revised fee of \$79 per month. The Commission did not approve this proposal, but instead instituted proceedings to determine whether it should be disapproved, based primarily on the question whether the fee included some costs that were inconsistent with the Instinet Order. In September 1986, the NASD proposed another NQDS fee of \$50.75 per month. This proposal was supported by an extensive and complex ratemaking analysis. It included a comprehensive allocation of costs to pools consisting of six resources and eleven services. The major categories of costs were summarized as (1) operational costs, which were allocated to the six resource pools based on identifiable personnel, equipment, and physical facilities dedicated to those operations, (2) systems and product/service development costs, which were allocated to the six resource cost pools based on the historical or anticipated level of effort to be devoted to the respective resources, (3) overhead and general and administrative costs, which were allocated directly to resource and service cost pools to the extent that a causal relationship existed between those resources or services and the incurrence of the affected costs, and (4) residual overhead and general and administrative costs, which were allocated to resource and service cost pools based on the total cost input base.

The Commission had not acted on this proposal when the NASD, in July 1990, proposed yet another NQDS fee of \$50 per month. This fee, however, included last sale information in addition to quotation information. The Commission approved the fee in October 1990. Notably, the Commission did not undertake any cost-based explanation of the \$50 fee, nor did it express any opinion on the extensive cost-of-service analysis that had been included in the NASD's September 1986 proposal. Instead, it noted that, "in reviewing the fairness and reasonableness of the proposal, the Commission finds it significant that the proposed fee of \$50 is the result of negotiations among the concerned parties after protracted proceedings." The \$50 fee approved for NQDS information in 1990 has remained unchanged up to the present.

Market Data Concept Release at 70623 (footnotes omitted).

While recognizing the practical difficulties of a detailed cost-of-service approach, the Commission nevertheless concluded in the Market Data Concept Release that "the total amount of market information revenues should remain reasonably related to the cost of market information."<sup>248</sup> In this regard, one of the issues on which comment particularly was requested was whether the Commission should adopt "a conceptual approach to evaluating the fairness and reasonableness of fees that, among other things, could establish a link between the cost of market information and the total amount of market information revenues."<sup>249</sup> Critical to this concept was the determination of what SRO costs should be included in the cost of market data.

The Market Data Concept Release's flexible, cost-based approach was intended to arrive at an approach to market data fees that could be implemented in a reasonably efficient manner, as opposed to a full-fledged ratemaking approach. The first step in fashioning the approach was to identify the categories of SRO costs incurred to generate and disseminate market data. All direct market data costs, such as market data recordation, communication, consolidation, and dissemination, would be included. The flexible cost-based approach would also have included in market data costs some portion of "common costs"—those costs that support multiple SRO functions, in addition to market data, and therefore must be allocated among these services.<sup>250</sup> These common costs comprised the costs of operating the market that produced the market data and the costs of regulating that market so that the data was not inaccurate and not derived from fraudulent or abusive conduct.<sup>251</sup> The Market Data Concept

<sup>248</sup> *Id.* at 70627.

<sup>249</sup> *Id.* 70615.

<sup>250</sup> As the Commission described in the Market Data Concept Release, under the flexible, cost-based approach, the information that the SROs provide to the Networks would not be considered cost-free. Before quotations and transaction reports can be consolidated and made available to the public, an organized market must provide a mechanism for facilitating the buying and selling of securities in a fair and orderly manner. In addition, the SROs must establish, monitor, and enforce trading rules, as well as otherwise regulate their markets to prevent fraudulent and manipulative acts or practices. The SROs incur substantial costs in performing these functions, and they contribute substantially to the value of the information. *Id.* at 70627.

<sup>251</sup> In contrast to costs incurred to operate and regulate markets, the flexible, cost-based approach set forth in the Market Data Concept Release excluded those SRO costs that did not directly contribute to the quality of market data. These included the costs of member regulation (*e.g.*, sales practice and net capital requirements) and those

Release noted that there is little value to market information that is tainted by fraud, deception, or manipulation.<sup>252</sup> Moreover, the goal of producing high quality market data cannot be achieved by a poorly operated market that is prone to systems outages and delays.<sup>253</sup>

The Market Data Concept Release recognized that not all common costs should be funded by market data, and that any resulting allocation decision would be conceptually difficult.<sup>254</sup> While the Market Data Concept Release's approach to evaluating the fees of the Networks would require aggregating the allocated costs of the contributing SROs, the Market Data Concept Release specifically stated that a distribution of the revenues need not follow the costs of each SRO, but could be based on the quality of the data contributed by the SRO and its contribution to the market data stream.<sup>255</sup> The Market Data Concept Release also questioned whether the rebate of market data revenues demonstrated that the existing fees were too high.<sup>256</sup>

In reflecting on the Market Data Concept Release and the industry's reaction to it, the Commission gained an understanding of the serious divisions in the securities industry over how best to regulate market data. Specifically, there was a sharp division on the fairness and reasonableness of the existing fee levels of market data. In addition, there was a split of opinion as to whether market information fees should provide funding for other SRO functions such as market regulation or should be more closely related to the direct cost of producing the data. Also significant in the comments to the Market Data Concept Release were proposals that more competition be introduced to the compilation and dissemination of market data.<sup>257</sup>

To help resolve these divisions, the Commission established its Advisory

costs directly associated with other SRO services. Advertising and marketing expenditures were specifically excluded from market data costs.

<sup>252</sup> Market Data Concept Release at 70627.

<sup>253</sup> For example, in times of significant price volatility and spikes in trading volume, it is critically important that the markets remain fair and orderly and that investors continue to have access to a timely stream of market information.

<sup>254</sup> Market Data Concept Release at 70628–70629.

<sup>255</sup> Market Data Concept Release at 70628.

<sup>256</sup> Market Data Concept Release at 70630–70632.

<sup>257</sup> See generally Report of the Advisory Committee on Market Information: A Blueprint for Responsible Change (September 14, 2001), Section V (available at <http://www.sec.gov>) ("Advisory Committee Report"). The Advisory Committee Report includes a comprehensive description of the arrangements for disseminating market data to the public, including the terms, fees, and revenues of the Plans.

Committee on Market Information in the summer of 2000. In its 2001 report, however, the Advisory Committee specifically rejected the flexible cost-based approach.<sup>258</sup> The Advisory Committee report noted the consensus view that it was essentially a "ratemaking" approach that was unwise and, ultimately, unworkable.<sup>259</sup> The Advisory Committee recommended retaining price transparency and consolidated market information as core elements of the U.S. securities markets, while adopting a "competing consolidators" model of data dissemination.<sup>260</sup> Under this model, vendors and market data users would themselves consolidate the data from the various markets, with each SRO separately providing and setting fees for its own data, rather than consolidating this data through the Networks.

In commenting on proposed Regulation NMS, a number of SROs said the current market data Networks and their fees were reasonable, while several larger markets and their adherents advocated the competing consolidator model. Many other commenters said that the fees they pay to obtain basic market data—NBBO and trades—are excessive, and are not reasonably related to the cost of producing such data.<sup>261</sup> As in earlier debates, some

<sup>258</sup> See Advisory Committee Report.

<sup>259</sup> In the view of a majority of the Advisory Committee, "the 'public utility' cost-based ratemaking approach is generally disfavored today. It is resource-intensive, involves arbitrary judgments on appropriate costs, and creates distortive economic incentives. Accordingly, the Advisory Committee recommends that the Commission not adopt a cost-based approach for determining whether market information fees are consistent with the Exchange Act \* \* \* Furthermore, the Advisory Committee does not recommend any specific changes to the standard under which the Commission reviews market data fees and revenues, or to the manner in which it conducts this review." Advisory Committee Report at Section VII.D.3.

<sup>260</sup> Advisory Committee Report at Section V.

<sup>261</sup> Many commenters, mostly securities firms and associations, believed that the Commission failed to address the main underlying problem, which they believe to be the root of the economic and regulatory distortions that the Commission is trying to address—whether the current fees for market data are excessive in relation to the actual cost of collecting and disseminating market data. See letter from Daniel M. Clifton, Executive Director, American Shareholders Association, to Jonathan G. Katz, Secretary, Commission, ASA Letter, p. 2 (June 10, 2004) ("Reg NMS ASA letter"); letter from Kim Bang, President and Chief Executive Officer, Bloomberg Tradebook, LLC, to Jonathan G. Katz, Secretary, Commission, pp. 2 and 8–9 (June 30, 2004) ("Reg NMS Bloomberg letter"); letter from C. Thomas Richardson, Citigroup Global Markets, Inc., to Jonathan G. Katz, Secretary, Commission, pp. 4 and 15 (July 20, 2004) ("Reg NMS Citigroup letter"); Reg NMS Goldman Sachs Letter, pp. 2 and 10; letter from Samuel F. Lek, Chief Executive Officer, Lek Securities Corporation, to Jonathan G. Katz, Secretary, Commission, (no page numbers) (May 24,

commenters said that market data fees should be limited to covering solely the costs incurred to disseminate consolidated market data, not the costs incurred by the individual SROs to produce the data and provide it to the Networks.<sup>262</sup> Other commenters said that a prerequisite for evaluating the appropriateness of funding SRO operations and regulatory costs from market data revenues was a transparent accounting of the revenues received for market data and the expenses incurred in operating and regulating the SRO's market.<sup>263</sup>

As noted above, to provide greater transparency of SRO revenues and

2004) ("Reg NMS Lek letter"); letter from Thomas N. McManus, Managing Director and Counsel, Morgan Stanley, to Jonathan G. Katz, Secretary, Commission, pp. 3 and 21 (August 19, 2004) ("Reg NMS Morgan Stanley letter"); letter from David Colker, Chief Executive Officer and President, NSX, to Jonathan G. Katz, Secretary, Commission, pp. 6–7 (June 29, 2004) ("Reg NMS NSX letter"); Reg NMS Schwab letter, p. 2; Reg NMS SIA letter, pp. 3 and 22; and Reg NMS STANY letter, p. 14.

A range of commenters believed that the current level of market data fees warranted review. See letter from Ellen L. S. Koplow, Executive Vice President and General Counsel, Ameritrade, Inc., to Jonathan G. Katz, Secretary, Commission, Letter, pp. 3 and 10 (June 30, 2004) ("Reg NMS Ameritrade letter"); letter from James J. Angel, Ph.D., CFA, Associate Professor of Finance, McDonough School of Business, to Jonathan G. Katz, Secretary, Commission, Letter I, p. 5 (June 30, 2004) ("Reg NMS Angel letter"); Reg NMS ASA Letter, p. 2; Reg NMS Bloomberg Letter, pp. 2 and 8–9; letter from William O'Brien, Chief Operating Officer, Brut, LLC, to Jonathan G. Katz, Secretary, Commission, pp. 21–23 (July 29, 2004) ("Reg NMS Brut letter"); Reg NMS Citigroup Letter, p. 15; letter from W. Leo McBlain, Chairman, Financial Information Forum, and Thomas J. Jordan, Executive Director, Financial Information Forum, to Jonathan G. Katz, Secretary, Commission, p. 3 (July 9, 2004) ("Reg NMS FIF letter"); letter from Richard M. Whiting, Executive Director and General Counsel, Financial Services Roundtable, to Jonathan G. Katz, Secretary, Commission, pp. 6–7 (June 30, 2004) ("Reg NMS FSR letter"); Reg NMS Goldman Sachs letter, pp. 2 and 10; letter from Ari Burstein, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Commission, pp. 21–22 (June 30, 2004) ("Reg NMS ICI letter"); Reg NMS Lek letter (no page numbers); Reg NMS Morgan Stanley letter, pp. 3 and 21–22; Reg NMS Nasdaq letter, pp. 4 and 24–26; Reg NMS NSX letter, pp. 6–7; Reg NMS Schwab letter, p. 2; Reg NMS SIA letter, pp. 3 and 22; Reg NMS STANY letter, p. 14; and Reg NMS UBS letter, p. 10.

<sup>262</sup> Many commenters believed that market data revenues should not be used to fund regulatory costs of the SROs. See Reg NMS Citigroup letter, pp. 15–16; Reg NMS FIF letter, p. 3; Reg NMS Goldman Sachs letter, p. 11; Reg NMS Schwab letter, p. 3; and Reg NMS SIA letter, pp. 3 and 23.

<sup>263</sup> Some Reg NMS commenters believed that market data fees are not transparent enough to allow a proper assessment of the appropriateness of fees charged because SROs' operating costs and use of revenues are not revealed. See Reg NMS Ameritrade Letter, pp. 10–11; letter from W. Hardy Callcott, to Jonathan G. Katz, Secretary, Commission, pp. 2–3 (May 6, 2004) ("Callcott letter"); Reg NMS Goldman Sachs letter, p. 11; Reg NMS Schwab letter, p. 7; Reg NMS SIA letter, pp. 22–23 and 25; and Reg NMS STANY letter, pp. 14–15.

expenses, the Commission is proposing in the SRO Governance and Transparency Proposal to require SROs to file with the Commission public reports detailing their sources of revenues and their uses of these revenues, specifically including their costs of regulation.<sup>264</sup> These reports could provide observers greater ability to evaluate the role of market data revenues in financing an SRO, and to compare these revenues to the expenses of operating and regulating their market. This information also could empower users to respond to market data fee changes on a more informed basis.

Thus, given the concerns raised in response to proposed Reg NMS regarding market data fees and because these issues are related to considerations of overall SRO funding and regulatory operations, the Commission is seeking comment on a number of issues.

*Question 23:* Should market data revenue be used to cross subsidize SRO regulatory operations?

*Question 24:* Are current market data fees significantly limiting access of market participants, investors, or other users to data? Why are certain market data fees more problematic than others, such as those associated with SRO data products that are not part of the consolidated quote stream? If so, which fees and why?

*Question 25:* Should the Commission reconsider the flexible, cost-based approach?

*Question 26:* Should the Commission consider a narrow cost-based approach that takes into account only limited costs, such as consolidation costs?

*Question 27:* On a conceptual basis, what should be included in the cost of generating market data?

*Question 28:* Are there other, better cost-based approaches? What are their potential benefits and drawbacks?

*Question 29:* Should the Commission require a more detailed explanation of how SROs spend the revenue generated from market data fees? Would the requirements proposed in the SRO Governance and Transparency Proposal that SROs detail their sources and uses of revenues add sufficient transparency in this area, or should more detailed reporting be mandated?

*Question 30:* 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?

*Question 31:* What SRO fees or other charges presently are under priced? What SRO fees or charges are over priced? On balance, are SROs over funded or under funded? What would be the impact on smaller SRO members of funding regulatory costs exclusively through regulatory fees?

*Question 32:* 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? If an SRO's funding were to become insufficient because of such a decline in revenue, should that SRO lose its status as a registered SRO?

*Question 33:* If market data fees were substantially reduced, would this exacerbate the conflicts inherent in the SRO system—in particular, the incentive to fund business functions at the expense of regulation?

*Question 34:* To what extent would the enhancements proposed in the SRO Governance and Transparency Proposal mitigate these concerns about inherent conflicts? Are there other measures that could mitigate these conflicts?

*Question 35:* Should the Commission require that all SRO fees and charges be closely related to the cost of the SRO providing the service in question? What would be the benefits and risks of doing so?

#### e. Miscellaneous Fees

In addition to regulatory fees, transaction fees, listing fees, and market data fees, SROs receive revenue from a variety of miscellaneous sources as well. For instance, SROs charge fees for administering joint industry plans and market systems.<sup>265</sup> SROs also derive funding from product licensing,<sup>266</sup> investment gains, and fines. In 1998, these types of miscellaneous SRO fees accounted for 8% of SRO revenue,<sup>267</sup> while, in 2003, 12% of SRO revenue was associated with these miscellaneous fees.<sup>268</sup> This relatively significant

<sup>265</sup> For example, the NASD operates both the Central Registration Depository ("CRD") System for registered representative registration and the Investment Advisor Registration Depository ("IARD") system. In addition, certain SROs earn fees from the administration of the consolidated data networks.

<sup>266</sup> For example, Nasdaq receives licensing fees from regional exchanges that report trades in Nasdaq-100 Index Tracking Stock. Nasdaq, 2003 Annual Report 43 (2004).

<sup>267</sup> Market Data Concept Release at 70625.

<sup>268</sup> Data compiled from SRO 2003 Annual Reports. Note that the NYSE 1998 Consolidated Statement of Revenue did not account for "Data Processing Fee" revenue. Due to an intervening change in accounting procedures, the NYSE 2003 Consolidated Statement of Revenue includes this item. To provide a more accurate comparison between the 1998 and 2003 percentages, "Data Fee

increase (a 50% increase compared with the 1998 percentage for miscellaneous fees) may have been caused by an increase in certain SRO sources of revenue, such as derivative product licensing fees, and by the intervening establishment of SRO relationships with other markets.<sup>269</sup>

The Commission specifically seeks public comment on the following question related to SRO miscellaneous fees:

*Question 36:* In light of the recent growth in SRO revenue that is derived from miscellaneous fees, how important are these fees to SRO funding generally and will this growth trend continue? If so, how does this revenue pose conflicts with respect to the SRO regulatory function? How should these conflicts be addressed? How does it relate, if at all, to the SROs' fulfilling their statutory obligations?

#### V. Alternative Regulatory Approaches

In order to focus consideration of the strengths and weaknesses of the SRO system, the following section discusses a variety of enhancements and alternative approaches, which would require either Commission or Congressional action to achieve.

Specifically, this section will examine: (1) Proposed enhancements to the current SRO system; (2) implementing an independent regulatory and market corporate subsidiary model; (3) implementing a hybrid model; (4) implementing a competing hybrid model; (5) implementing a universal industry self-regulator model; (6) implementing a universal non-industry regulator model; and (7) establishing direct Commission regulation of the securities industry. The discussion of each alternative examines how effectively it would manage the current SRO system's inherent limitations.

It is important to note that this discussion does not attempt to provide an exhaustive list of every potential option and alternative approach that

Processing" revenue was not included in total SRO revenue for the purpose of calculating the percentage of total SRO revenue represented by miscellaneous fee revenue. Based on SRO 2003 Annual Report Consolidated Statements of Income certain items were allocated to miscellaneous fees with respect to the NYSE ("Facility and Equipment" and "Investment Income"), the BSE ("Interest" and "Other"), the Phlx ("Clearing and settlement," "Dividend and Interest," and "Other"), the NASD (including Amex and Nasdaq consolidated statements of income) ("Dispute Resolution Fees" and "Other Revenue"), the PCX ("Archipelago Revenue: Original Consideration Amortization," "Communications," and "Other"), the CHX ("Interest" and "Other"), and the CBOE ("Interest" and "Other").

<sup>269</sup> E.g., the Amex's affiliation with the NASD and Arca's affiliation with the PCX.

<sup>264</sup> See *supra* note 99.

could be considered. The purpose of this section is to provide a discussion of what appear to be some of the more promising alternatives. Public comment sought, however, is not limited to the options and alternative approaches described herein. In addition, while this section attempts to detail the strengths and weaknesses of the various options and alternative approaches, it should be noted that such a discussion is inherently speculative. The full range of strengths and weaknesses of any given option or alternative approach would likely not be known until that approach were fully implemented.

#### A. Proposed Enhancements to the Current SRO System

The current SRO system has provided essential regulation of markets and members for over seven decades. Nonetheless, this system has inherent limitations that should be considered. This section discusses possible enhancements to the status quo that could be implemented to address these SRO limitations.

##### 1. SRO Governance and Transparency Rulemaking

The Commission today is proposing an SRO Governance and Transparency Proposal.<sup>270</sup> If adopted, the proposed rulemaking would strengthen SRO governance, enhance SRO disclosure and reporting requirements, and address various issues that have arisen with respect to shareholder-owned SROs.<sup>271</sup> The proposed governance standards would require SROs that are national securities exchanges and registered securities associations to have a majority independent board and fully independent Nominations, Governance, Audit, Compensation, and Regulatory Oversight Committees (or their equivalent).<sup>272</sup> SROs also would be required to effectively separate their regulatory function from their market operations and other commercial interests.<sup>273</sup>

With respect to the regulatory function, each SRO would be required to establish standards to assure the independence of its regulatory program. At a minimum, the regulatory function of an SRO would be required to be overseen by a Chief Regulatory Officer who reports to, and is evaluated by, an independent Regulatory Oversight Committee. Moreover, SROs would be required to provide the Commission with specified information concerning

their regulatory programs on a regular basis. As part of this proposal, each SRO would be required to prepare for the Commission annual and quarterly regulatory reports that would give details regarding key aspects of the SRO's regulatory program. As part of the annual report, each SRO also would be required to disclose employment arrangements with its Chief Regulatory Officer and other key regulatory personnel. The filing of this regulatory program information is intended to bolster the Commission's SRO inspections program and thus would be kept confidential to the extent permitted by law.

In addition to filing quarterly and annual reports about their regulatory programs, each SRO would be required to disclose publicly information about its regulatory program and provide greater disclosure regarding revenues and expenses and staffing of its regulatory program. Finally, the SRO Governance and Transparency Proposal proposes ownership and voting concentration limits on members that are broker-dealers to mitigate the conflict of interest that would arise if a broker-dealer were to control a significant interest in its regulator or if a member could exercise too much control over the operations of the SRO.

If the proposed SRO Governance and Transparency Proposal is adopted, a number of benefits could be gained. Regulatory conflicts with members, market operations, issuers, and shareholders could be reduced. The strict reporting lines of the Chief Regulatory Officer reporting to an independent board committee could reduce the SRO regulation conflicts. In addition, the wholly independent Regulatory Oversight Committee's sole responsibility for budgeting decisions with respect to regulatory operations could help insulate the budgeting process from business pressures.

While the Governance and Transparency Proposal could help manage a variety of the traditional SRO limitations, it would not eliminate them. For instance, conflicts could persist in spite of the majority independent board because of the influence of representatives of large members serving on the board, particularly if intermarket competition pressures continue to increase. In addition, the fact that the independent directors would necessarily rely on the expertise of the industry directors to some degree could undermine some of the structural protections put in place. Moreover, the independent directors' own imperceptible institutional biases

could compromise some of the structural protections.

Concerns regarding unequal regulation and unequal regulatory funding across markets would persist under the SRO Governance and Transparency Proposal. This would be true even if each SRO's Regulatory Oversight Committee were to make regulatory budgeting decisions irrespective of business or other pressures. These committees would not all necessarily allocate regulatory funding in the same fashion in the different SROs; thus, regulatory inequalities could still exist. The concerns regarding conflicting SRO rules, conflicting SRO rule interpretations, conflicting SRO inspection regimes, and redundant regulatory staff and infrastructure across markets would remain under this proposal. Finally, the proposal also does not address potential intermarket trading surveillance issues.

The Commission specifically seeks public comment on the following questions related to the SRO Governance and Transparency Proposal:

*Question 37:* To what extent would the changes proposed in the SRO Governance and Transparency Proposal effectively manage inherent SRO limitations related to conflicts, funding, redundancies, and intermarket surveillance?

*Question 38:* To what extent would the changes proposed in the SRO Governance and Transparency Proposal continue to provide the benefits of the current SRO system (e.g., largely self-funded system with market specific expertise of SRO regulatory staff enhancing rule promulgation and enforcement)?

*Question 39:* If adopted, would the SRO Governance and Transparency Proposal enable the Commission, investors, and market participants to perceive when a particular SRO was insufficiently funding its regulatory function? If so, could this lead the SROs to develop and follow voluntary guidelines or standards with respect to regulatory spending levels?

*Question 40:* Would the changes proposed in the SRO Governance and Transparency Proposal more effectively manage inherent SRO limitations compared to the NYSE's recent corporate and regulatory function restructuring?<sup>274</sup>

<sup>274</sup> See Exchange Act Release Nos. 48946 (December 17, 2003), 68 FR 74678; 48764 (November 7, 2003), 68 FR 64380 (November 13, 2003) (regarding NYSE governance and regulatory function amendments).

<sup>270</sup> See supra note 99.

<sup>271</sup> *Id.*

<sup>272</sup> *Id.*

<sup>273</sup> *Id.*

## 2. Intermarket Surveillance Enhancements

Another incremental improvement to the current system could be the enhancement of the Commission's and the SROs' ability to regulate intermarket trading activity. As discussed at length above, several equity markets have developed individual order audit trails, the options markets have developed COATS to assist in the surveillance of order flow in the options markets, and the ISG has developed a clearing level order audit trail. Full implementation of a more robust intermarket order audit trail for both the options and equity markets could enhance the surveillance of intermarket order flow. It would not by itself, however, manage any of the other inherent SRO limitations, including conflicts, regulatory redundancies, and funding problems. In addition, even with a consolidated order audit trail, the Commission would have to be vigilant in determining whether the SROs used it to enhance surveillance and regulation of intermarket trading.

The Commission specifically seeks public comment on the following questions related to intermarket surveillance enhancements:

*Question 41:* To what extent would the establishment of a more robust intermarket surveillance regime more effectively manage inherent SRO limitations related to conflicts, funding, redundancies, and intermarket surveillance?

*Question 42:* To what extent would enhancing intermarket surveillance continue to provide the benefits of the current SRO system (e.g., largely self-funded system with market specific expertise of SRO regulatory staff enhancing rule promulgation and enforcement)?

*Question 43:* To what extent is COATS serving as an effective tool for enhancing intermarket surveillance?

*Question 44:* To what extent should COATS be used as a template for the establishment of a consolidated order audit trail for the equity markets?

*Question 45:* To what extent are SROs effectively using intermarket order audit trail data to enhance surveillance?

*Question 46:* What are examples of illicit intermarket trading activity that can be engaged in undetected by regulators?

### B. Independent Regulatory and Market Corporate Subsidiaries

Another approach would be to increase SRO regulatory independence through mandated SRO internal restructuring. One option would be to

require that all SROs create independent subsidiaries for regulatory and market operations. This model could resemble the NASD corporate structure that was devised in the wake of the joint Department of Justice and SEC investigation into OTC market maker pricing collusion that resulted in a Commission enforcement action.<sup>275</sup> Among the most important NASD Undertaking resulting from the settlement was a corporate restructuring of the NASD and the establishment of an independent regulatory corporate subsidiary, NASD Regulation, Inc. ("NASDR").<sup>276</sup>

Under this model, regulatory staff of each SRO would be placed within an independent regulatory subsidiary, which would report directly to the corporate parent's board. Substantially all regulatory operations would be housed in the regulatory subsidiary, including examination, rulemaking, and enforcement responsibilities. All market operations responsibilities would be placed within an independent market subsidiary.

This model would provide a more clear organizational separation than most SROs currently exhibit. It would help strengthen an independent attitude in the regulatory subsidiary, which could address conflicts with members, market operations, issuers, and shareholders. This approach might establish even more clearly defined divisions between the regulator and the market functions than the proposed SRO Governance and Transparency Proposal. While the SRO Governance and Transparency Proposal relies on corporate reporting lines to insulate the regulator function, this model would house the regulator and market in distinct corporate subsidiaries that would be governed by separate boards.

As with making incremental changes to the current system, however, this model would not alleviate all SRO limitations. A primary purpose of the regulatory subsidiary would be supervising the competitive market subsidiary. Thus, the independent regulatory subsidiary would still be a component of a larger competitive enterprise and subject to business pressure on some level. With respect to regulatory funding, the influence of major members, issuers, and shareholders, and increased intermarket competitive pressure could still have a detrimental impact on the regulatory budgeting process. Even though an independent board committee would be

responsible for budgeting decisions, there would still be reliance on major members and the market operation for funding. As with the approaches already described, the self-funding of regulatory operations by each SRO would cause a continued degree of unequal funding and unequal regulation across markets. Moreover, conflicting SRO rules, conflicting SRO rule interpretations, conflicting SRO inspection regimes, redundant SRO regulatory staff and redundant regulatory infrastructures across markets would remain. This approach also could reduce market specific knowledge on the part of regulatory staff by removing it on a corporate level from market operations. In addition, the intermarket trading surveillance issues in the system would persist.

The Commission specifically seeks public comment on the following questions related to the separate market and regulatory subsidiary SRO structure model:

*Question 47:* To what extent would the implementation of the separate market and regulatory subsidiary SRO structure model effectively manage inherent SRO limitations related to conflicts, funding, redundancies, and intermarket surveillance?

*Question 48:* To what extent would the separate market and regulatory subsidiary SRO structure model continue to provide the benefits of the current SRO system (e.g., largely self-funded system with market specific expertise of SRO regulatory staff enhancing rule promulgation and enforcement)?

*Question 49:* To what extent is the separate market and regulatory subsidiary SRO structure model effective in managing inherent SRO limitations specifically with respect to the NASD?

### C. Hybrid Model

Another option, which would require significant system restructuring, would be the Commission's designation of a market neutral single self-regulatory organization ("Single Member SRO") to regulate all SRO members with respect to membership rules, including rules governing members' financial condition, margin practice, handling of customer accounts, registered representative registration, branch office supervision, and sale practices. The Single Member SRO would be solely responsible for promulgating membership rules, inspecting members for compliance with "member" rules, and taking enforcement action against those members that fail to comply. Each SRO that operates a market ("Market SRO")

<sup>275</sup> See 21(a) Administrative Order and 21(a) Report.

<sup>276</sup> See 21(a) Report at 50-55.

would be solely responsible for its own market operations and market regulation.

This approach would have a variety of sub-options with respect to the Market SROs' role in surveillance of the market and enforcement of "market" rules. For instance, the Market SROs could maintain all of the functions that SROs currently carry out with respect to their market operations, including promulgating market rules, conducting market surveillance, and taking enforcement action with respect to violations of market rules. Alternatively, the Market SROs could be responsible for promulgating rules and conducting surveillance, but enforcement actions could be referred to the Single Member SRO. Another option would limit the Market SROs' responsibility to market rule promulgation and the Single Member SRO would be responsible for all other market surveillance and enforcement functions.

As with the approaches already discussed, this Hybrid model could improve upon the current system in a variety of respects. For instance, because the Single Member SRO would not be affiliated with a particular market, inherent conflicts that exist between the regulatory function and market operation of an SRO would be reduced. It would also eliminate duplicative regulation with respect to membership rules. This approach could result in beneficial synergies by the centralization of membership regulation, while maintaining the value of having market regulatory staff embedded within the Market SROs. The Single Member SRO would also potentially serve as a more effective liaison with the SEC, Congress, and international entities on behalf of the industry because it would be a single, market neutral voice. Depending on the extent to which the Single Member SRO was delegated responsibility under this approach for intermarket surveillance, cross-market surveillance could be simplified and enhanced.

As with other models, this approach has limitations. For example, 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. Some rules, such as those related to member capital requirements, would likely be categorized as member rules, because they are unrelated to direct trading activity and deal with requirements

imposed on members in support of trading operations. In contrast, certain rules, such as those related to the priority of orders on a market's trading floor or system, would clearly be characterized as trading rules. A variety of other rules, however, such as those related to front running or margin requirements, could be categorized as either "market" or "member" rules because they embody elements of both types of rules.

While this Single Member SRO approach could reduce certain conflicts, it would not resolve the conflicts arising from member funding, and control, and from reliance on industry members for business experience. Also, conflicts would persist unabated in the Market SROs. As noted above, sub-issues with respect to the duties of the Market SROs would have to be determined and the extent of this conflict would depend on the extent of the Market SRO's regulatory responsibility. For instance, the Market SRO's role in market rule promulgation, market surveillance, and market rule enforcement would have to be determined.

The concerns about unequal funding and unequal regulation of members would be substantially reduced. Specifically, unequal funding and unequal regulation with respect to member regulation would be eliminated because only one Single Member SRO would exist. However, other funding issues could arise. Either the Single Member SRO would be required to depend solely on regulatory fees for funding or the Market SROs would have to contribute to the Single Member SRO from listing, market data, and market operation revenues. Determining the absolute and relative amounts of these contributions would raise difficult issues. Specifically, an allocation formula would have to be devised for determining the relative amount that each Market SRO owed annually for funding the Single Member SRO. The formula could be weighted based on a host of complex and potentially subjective factors, including trading volume, average member size, number of members, type of security traded on the market, and type of business (e.g., agency or proprietary) engaged in by the SROs' members. The concern about unequal funding and unequal regulation would also persist with respect to the Market SROs. Although, inconsistent member rules, staff, and infrastructure would be eliminated, inconsistent market rules, staff, and infrastructure would remain.

The Commission specifically seeks public comment on the following

questions related to the Hybrid SRO structure model:

*Question 50:* To what extent would the implementation of the Hybrid model more effectively manage inherent SRO limitations related to conflicts, funding, redundancies, and intermarket surveillance?

*Question 51:* To what extent would the Hybrid model continue to provide the benefits of the current SRO system (e.g., largely self-funded system with market specific expertise of SRO regulatory staff enhancing rule promulgation and enforcement)?

*Question 52:* How would the Single Member SRO be funded under the Hybrid approach?

*Question 53:* To what extent would the boundary issue with respect to "member" and "market" rules be a concern in implementing the Hybrid approach? Which types of rules would be subject to the "boundary" problem (i.e., which types of rules could be categorized either as "market" or "member" rules)? How should these "boundary" issue rules be categorized and why?

*Question 54:* In establishing itself, should the Single Member SRO draw personnel, facilities, or other assets from the existing SROs? If so, would the Market SROs from which personnel, facilities, or assets were drawn be able to replace those resources? Would there be any conflicts of interest with respect to Single Member SRO personnel allegiance to their former Market SROs?

*Question 55:* To what extent should the Market SROs or the Single Member SRO under the Hybrid approach be responsible for market rule promulgation, market surveillance, and enforcement of market rules?

#### *D. Competing Hybrid Model*

Another approach involving a significant departure from the current system would be a derivative of the Hybrid approach. Under this approach, Market SROs would exist as in the pure Hybrid approach and market regulation would be conducted separately from member regulation. Rather than one Single Member SRO, however, this approach would permit the existence of multiple competing member SROs ("Competing Member SROs"), which would be required to be registered with the Commission and, thereby, authorized to provide member regulatory services. Under this approach, each Market SRO member would also have to be a member of one of the Competing Member SROs. A Competing Member SRO would charge its members a regulatory fee. Because of the potential disparity in bargaining

power between the Competing Member SROs and individual brokerage firms, this regulatory fee would likely need to be subject to appropriate oversight, including Commission approval. The Competing Member SROs would be responsible for promulgating the range of member rules described in the Hybrid discussion, inspecting members for compliance with member rules, and taking enforcement action against those members that fail to comply. Under this approach, as with the pure Hybrid approach, Market SROs would retain their market regulatory responsibilities.

Under this approach, members of Competing Member SROs would have the right to periodically switch Competing Member SROs. A limit on the frequency with which members could switch between Competing Member SROs would likely need to be imposed for a variety of reasons. For instance, members could conceivably avoid being effectively regulated by switching between Competing Member SROs whenever regulatory action loomed. Further, Competing Member SROs may not vigorously regulate important members that are able to switch to another Competing Member SRO, if the members believe they can receive more lenient regulation from a different Competing Member SRO. In addition, longer Competing Member SRO experience with a particular member would likely result in increased institutional knowledge and potentially more effective regulation.

As with the pure Hybrid model, this approach would have a variety of sub-issues to be resolved with respect to the Market SROs' role in promulgating market rules, conducting surveillance of the market, and enforcement of market rules. For instance, the Market SROs could maintain all of the functions that SROs currently carry out with respect to their market operations. Alternatively, the Market SROs could be responsible for promulgating market rules and conducting market surveillance, but enforcement actions could be referred to the Competing Member SRO of the offending Market SRO member. Another option would be the Market SROs being responsible solely for market rule promulgation and the Competing Member SROs being responsible for all other market surveillance and enforcement functions. This approach would also require considering whether Competing Member SROs should be required to have uniform membership rules to ensure uniformity of rules governing the membership of each market and to limit the potential for regulatory arbitrage. In addition, difficult issues would have to be

addressed with respect to the criteria for a Commission determination as to whether a Competing Member SRO was "authorized" to provide member regulation.

This model carries with it a variety of benefits. For example, as with the pure Hybrid model, if uniform membership rules were required, this approach could significantly reduce conflicts and inconsistent application and enforcement with respect to membership rules. In addition, it would concentrate membership regulatory expertise in a small number of entities, while continuing to foster market specific expertise in the regulatory staff embedded in Market SROs. As with the Hybrid model, the Competing Member SROs could be more effective liaisons with the SEC, Congress, and international entities on behalf of the industry.

This approach would be a compromise between the Single Member SRO approach and the current system of numerous redundant SRO member regulators. Moreover, this approach would not require the potential elimination of one of the existing primary member regulators in favor of another. Depending on the extent to which the Competing Member SROs are delegated responsibility for inter-market surveillance (and if ultimately a limited number of these Competing Member SROs are registered), cross-market surveillance could be simplified and enhanced. Finally, this model might succeed in centralizing member regulation to a much greater extent than under the current system, but at the same time foster competitive discipline by allowing Competing Member SROs to compete with each other.

As with the approaches already discussed, this model has significant drawbacks. For instance, and as discussed above, it would require the same difficult "boundary issue" determinations between "market" and "member" rules to be made as would be made under the Hybrid approach. As with the pure Hybrid approach, this model could reduce self-regulatory experience by separating self-regulatory member staff from market operations. Moreover, conflicts with members, market operations, issuers, and shareholders would remain unabated in the Market SROs.

Competition could result in an effort by the Competing Member SROs to reduce their fees to attract and keep members and the Commission would ultimately continue to be responsible for determining whether funding remained adequate. This model could reduce

conflicting member rules, but would only eliminate these conflicting rules if the Competing Member SROs adopted a uniform set of member rules. In addition, conflicting market rules across Market SROs would still exist. Ideally, under this approach, competitive forces would discipline the Competing Member SROs and discourage them from becoming unresponsive.

As noted above, a significant issue with the Competing Member SRO model would be the ability of an SRO to discipline members if the members could then choose another regulator. This could be addressed by limitations on the ability of members to make changes or a charge for switching from one regulator to another, but such barriers might tend to diminish the benefits of competition.

Finally, if the NASD should be one of the Competing Member SROs, its specific role in overseeing the OTC market and its operation of the ADF, in particular, would also require further analysis under this model. While the NASD, as a registered national securities association under Exchange Act Section 15A,<sup>277</sup> is responsible for overseeing OTC broker-dealer activity, many of its rules related to member use of the ADF could be characterized as market rules (e.g., NASD Rule 4300A regarding direct and indirect electronic access to best bids and offers posted in the ADF).

The Commission specifically seeks public comment on the following questions related to the Competing Hybrid SRO structure model:

*Question 56:* To what extent would the implementation of the Competing Hybrid SRO structure model effectively manage inherent SRO limitations related to conflicts, funding, redundancies, and intermarket surveillance?

*Question 57:* To what extent would the Competing Hybrid SRO structure model continue to provide the benefits of the current SRO system (e.g., largely self-funded system with market specific expertise of SRO regulatory staff enhancing rule promulgation and enforcement)?

*Question 58:* What should the criteria be upon which Competing Member SROs would be registered under the Competing Hybrid approach?

*Question 59:* What would be the ideal number of Competing Member SROs under the Competing Hybrid approach?

*Question 60:* What limitations, if any, should be placed on members' ability to change Competing Member SROs?

<sup>277</sup> 15 U.S.C. 78k-1.

*Question 61:* Should the Competing Member SROs be required to adopt a uniform set of member rules?

#### *E. Universal Industry Self-Regulator*

Another model, which would require significant restructuring, would be the establishment of a universal industry self-regulator ("Universal Industry Self-Regulator"). Under this model, one industry self-regulatory organization would be responsible for all market and member rules for all members and all markets. The current SROs' self-regulatory authority would be transferred to the Universal Industry Self-Regulator, including member and market rulemaking, member and market surveillance, and member and market rule enforcement. This approach likely would require legislation or significant restructuring of the current SROs.<sup>278</sup> Under this approach, all member firms would be registered directly with the Universal Industry Self-Regulator and all markets would be non-SROs registered with the Universal Industry Self-Regulator similar to how ATSS are currently registered with SROs. Under this approach, the markets' self-regulatory authority would be eliminated.

This model could resolve weaknesses of prior alternatives in a variety of ways. For instance, and as discussed above, it would erase the "boundary" issues between market and member rules associated with the Hybrid and Competing Hybrid Models because one entity would be responsible for all "market" and "member" rules. This model would establish a level playing field among competing markets in that they would all be subject to the same uniform standards of a single SRO. The Universal Industry Self-Regulator would benefit from a broader knowledge of regulated entities and markets because it would be responsible for all member and market regulation. Because one SRO would exist that would not be subject to inter-market competition, conflicts with market operations, issuers, and shareholders would be almost entirely eliminated as would regulatory redundancies.

Moreover, this approach would address the arguments that unequal funding of regulatory operations and unequal allocation of costs for regulation across the markets cause

<sup>278</sup> See Exchange Act Sections 6 and 15A, 15 U.S.C. 78f and 78k-1. It is conceivable that this approach could be achieved by the SROs engaging in an omnibus market and member regulatory agreement pursuant to Exchange Act Rule 17d-2, 17 CFR 240.17d-2. However, this approach would require significant restructuring of the existing SROs.

market distortions. Specifically, the existence of one SRO would prevent unequal regulation in the sense that only one entity would be responsible for the regulation across all markets. Because one SRO would be in possession of all regulatory data (rather than it being held by disparate SROs), this model would also facilitate the development of a consolidated order audit trail for intermarket trading and better enable the regulation of intermarket trading. Because of the central role the Universal Industry Self-Regulator would play in the U.S. securities markets, demutualization of the entity would likely be prohibited. Thus, the primary concern of the profit motive of a shareholder owned market detracting from proper self-regulation could be eliminated under this approach as well.

As with other models discussed, this approach has limitations. The Universal Industry Self-Regulator would be precluded from being a market specific regulator and as such would likely lack market specific expertise. In addition, member conflicts would still remain under this approach in that the Universal Industry Self-Regulator would still rely on members for funding. As discussed above, this conflict would be further complicated if the Universal Industry Self-Regulator became particularly dependent on certain large members for the disproportionately large amount of funding that they provide the SRO in regulatory fees. This universal approach would still require separate market rules to account for different market structures and types of securities traded. For instance, the market operation of an options exchange has markedly different trading rules than an equity exchange. There would also be the potential under this model for the functions of the Universal Industry Self-Regulator and the SEC to overlap with one another. Moreover, the potential for the Universal Industry Self-Regulator to become unresponsive to industry developments would greatly increase because of its size, scope, and lack of competition. Finally, implementing this model would effectively result in the elimination of the existing SROs' role and, thus, could be met with significant resistance.

The Commission specifically seeks public comment on the following questions related to the universal industry self-regulator SRO structure model:

*Question 62:* To what extent would the implementation of the Universal Industry Self-Regulator model effectively manage inherent SRO limitations related to conflicts, funding,

redundancies, and intermarket surveillance?

*Question 63:* To what extent would the Universal Industry Self-Regulator model continue to provide the benefits of the current SRO system (e.g., largely self-funded system with market specific expertise of SRO regulatory staff enhancing rule promulgation and enforcement)?

*Question 64:* Would the NASD's role as the regulator of the OTC market be completely occupied by the Universal Industry Self-Regulator or would there be a continuing need for the NASD's existence?

*Question 65:* To what extent would the Universal Industry Self-Regulator compete or conflict with the Commission?

#### *F. Universal Non-Industry Regulator*

Another approach, which would also require significant industry reshaping, would be the establishment of a universal non-industry regulator ("Universal Non-Industry Regulator"). Under this approach, one non-industry entity would be designated to be responsible for all markets and member regulation for all members and all markets. As with the Universal Industry Self-Regulator, this model would require all member firms to be registered with the Universal Non-Industry Regulator. All markets would be registered with the Universal Non-Industry Regulator similar to how ATSS are currently registered with SROs and would not have any self-regulatory authority. 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.

While not exactly analogous, this model could resemble the regulatory regime recently adopted for audits of public companies. Specifically, the Public Company Accounting Oversight Board ("PCAOB") was established, pursuant to the Sarbanes-Oxley Act,<sup>279</sup> as an independent, non-profit corporation, to oversee the audits of public companies that are subject to the securities laws, and related matters, in light of significant failings in self-regulatory oversight of the accounting profession.<sup>280</sup> If this approach were to

<sup>279</sup> Pub. L. 107-204, 116 Stat. 745 (2002).

<sup>280</sup> Prior to the establishment of the PCAOB, the American Institute of Certified Public Accountants ("AICPA") established and interpreted Generally Accepted Auditing Standards ("GAAS"). The AICPA is a private, professional organization composed of certified public accountants ("CPAs"). The Public Oversight Board ("POB"), created by the

be adopted in the securities industry, an independent, non-profit, non-governmental body could be established to be the Universal Non-Industry Regulator. The board of the Universal Non-Industry Regulator would consist of full-time members appointed by the Commission, and would be tasked with overseeing all member and market rules for all members and all markets. 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 Universal Non-Industry Regulator approach would reduce substantially, if not eliminate, the industry's self-regulatory role in that the universal regulator's board would be entirely selected by the Commission and its staff would be entirely appointed by the board.

The sources of funding for this model would have to be established. The PCAOB is primarily funded through accounting support fees, as provided in the Sarbanes-Oxley Act, paid by issuers.<sup>281</sup> The goal of this funding structure is to ensure that the PCAOB's funding is independent of both the accounting profession and the federal government.<sup>282</sup> A determination by

AICPA, administered peer reviews of CPAs to assess whether CPAs' auditing practices were in conformity with GAAS. Jerry W. Markham, *Accountants Make Miserable Policemen: Rethinking the Federal Securities Laws*, 28 N.C.J. Int'l L. & Com. Reg. 725, 764-80 (2003). In addition, the Financial Accounting Standards Board ("FASB") promulgated Generally Accepted Accounting Principles ("GAAP").

The PCAOB was given broad authority, including the power: (1) to register public accounting firms; (2) to set rules covering auditing, ethics, quality control and independence standards; (3) to inspect the auditing operations of registered public accounting firms; (4) to investigate and discipline registered public accounting firms and associated persons of such firms; and (5) to enforce compliance with the new legislation, the PCAOB's own rules and certain securities laws. The standards for audits of public companies are now set by the PCAOB, not the accounting profession. While the AICPA still has a role in setting the standards for audits of non-public companies, the POB has been terminated. There has been no change in the setting of accounting standards, where the FASB, as the standards-setting body designated by the Commission, retains primary responsibility for the promulgation of GAAP, subject to the Commission's oversight. Markham at 790-92.

<sup>281</sup> Section 109 of the Sarbanes-Oxley Act.

<sup>282</sup> The Sarbanes-Oxley Act provides that the PCAOB be funded by accounting support fees assessed on issuers as defined therein. Each year the PCAOB develops an operating budget that must be approved by the Commission. The 2003 PCAOB budget, as approved by the Commission, was \$68 million. The accounting support fees are equal to the PCAOB's total budgeted outlays for the fiscal year in which they are set, less the amount of fees received from public accounting firms to cover the cost of processing and reviewing registration applications. The accounting support fees are based

Congress would have to be made as to whether shifting the 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 markets and broker-dealer revenues).<sup>283</sup>

This model would have several advantages over other approaches. For instance, this approach would likely eliminate the member rule and market rule boundary concerns that exist under the Hybrid and Competing Hybrid approaches. Even more than the Hybrid and Competing Hybrid approaches, this model would result in broad interaction between the regulator, members, and markets. Conflicts with members, market operations, issuers, and shareholders would be substantially eliminated under this model because the entity would have no direct affiliation with any of those constituencies. Regulatory redundancies would also be effectively diminished because the Universal Non-Industry Regulator would be responsible for all "member" and "market" rules for all members and markets. This would be particularly true if the NASD's role were completely subsumed by the new Universal Non-Industry Regulator. As with the Hybrid and Competing Hybrid models, this approach would address the concern of unequal funding and unequal allocation of regulatory costs across markets. Moreover, cross market surveillance would likely be facilitated by this approach because the Universal Non-Industry Regulator would be responsible for all regulatory data from all markets. Because of the critical role the Universal Non-Industry Regulator would play in the U.S. securities markets, demutualization of the entity would likely be prohibited. Thus, the primary concern of the profit motive of a shareholder owned market detracting from proper self-regulation could be eliminated under this approach as well.

This model also has serious drawbacks. For example, it could result in a lower degree of market specific expertise in the regulator. In addition, the degree of direct industry involvement with respect to rulemaking and enforcement would be significantly reduced, which could reduce the

on the average monthly U.S. equity market capitalization of publicly traded companies, investment companies, and other equity issuers. Issuers with average market capitalizations below \$25 million and investment companies with net assets of less than \$250 million are exempt from the fees. PCAOB, 2003 Annual Report 15 (2004). The 2004 PCAOB accounting support fee, as approved by the Commission, was \$101 million.

<sup>283</sup> Total combined SRO operating expenses in 2003 were over \$2.4 billion. See supra note 197.

Universal Non-Industry Regulator's ability to refine and target its regulation. Market rules would still differ to account for different market structures and types of securities traded. As with the Universal Industry Self-Regulator, there would be the potential under this model for the regulatory entity and the SEC to overlap or even compete with one another. In addition, there is also the risk that this model would become inefficient, inflexible, and unresponsive to evolutionary market practices. Also similar to the Universal Industry Self-Regulator, this model would likely require legislation and could be met with resistance from the existing SROs, whose SRO role would be largely eliminated.

The Commission specifically seeks public comment on the following questions related to the Universal Non-Industry Regulator model:

*Question 66:* To what extent would the implementation of the Universal Non-Industry Regulator model effectively manage inherent SRO limitations related to conflicts, funding, redundancies, and intermarket surveillance?

*Question 67:* To what extent would the Universal Non-Industry Regulator model continue to provide the benefits of the current SRO system (e.g., largely self-funded system with market specific expertise of SRO regulatory staff enhancing rule promulgation and enforcement)?

*Question 68:* How would the Universal Non-Industry Regulator model be funded?

*Question 69:* What would be the relationship between the Universal Non-Industry Regulator, the Commission, and the NASD under this model?

#### G. SEC Regulation

Another alternative that will be discussed in this section 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 market and member regulation of all members and all markets. All member firms and markets would be required to register directly with the Commission under this model. Markets would be non-SROs registered with the Commission similar to how ATs are currently registered with SROs. The markets' registered status, however, would carry with it no self-regulatory authority. 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, this model would require dramatic change in that 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. The Commission, however, is not self-funded under its enabling statute and, thus, Congress would need to appropriate funds for this approach.<sup>284</sup>

Benefits could be gained from this approach. For instance, because only one centralized regulator would exist, SEC direct regulation would eliminate substantially all of the conflicts that exist between SRO regulation and members, market operations, issuers, and shareholders. As with the Hybrid, Competing Hybrid, Universal Industry Self-Regulator, and Universal Non-Industry Regulator approaches, direct SEC regulation would provide the Commission with a broader understanding of the members and markets. Conflicting member rules, interpretations, and inspection regimes, and regulatory redundancies would be eliminated under this model because the Commission would be able to adopt uniform member rules. The Commission would need to adopt numerous detailed operations and conduct rules for members to replace existing SRO rules related to business practices and just and equitable principles of trade. Cross market surveillance would likely be facilitated by this approach because the relevant regulatory data would be collected and examined by the Commission, rather than by disparate SROs. In addition, this model could potentially align the U.S. regulatory scheme more closely with those of a variety of other countries.<sup>285</sup>

<sup>284</sup> Although the Commission currently deposits the variety of fees that it collects in the U.S. Treasury, where its deposits are treated as offsetting collections and not general funds of the Treasury, it cannot deposit its fees in a depository institution, and its monies are annually appropriated and apportioned. U.S. General Accounting Office Report to Congressional Committees, "SEC Operations—Implications of Alternative Funding Structures," 1 (July 2002).

<sup>285</sup> For instance, the Financial Services Authority ("FSA") was created in the United Kingdom in

An SEC-only approach would also have numerous problems. The SEC would be responsible for detailed regulation and interpretation of complex areas previously the province of SROs, without the aid of direct industry involvement and with a significant lessening of industry input in rulemaking. Market specific rules, under this model, would still conflict because of the markets' different market structures and types of securities traded. Direct Commission regulation would be governed by the limitations and rules addressing federal rulemaking and would be undertaken in a political environment and the cost of carrying out all of the duties of the SROs would be extensive. It is important to note that the Commission has attempted to undertake direct SRO level regulatory duties in the past. As discussed above, the Commission ultimately requested that Congress terminate the SECO program because the Commission could not effectively carry out the detailed responsibilities required.<sup>286</sup>

The Commission specifically seeks public comment on the following questions related to the direct SEC regulation model:

*Question 70:* To what extent would the implementation of the direct SEC regulation model effectively manage inherent SRO limitations related to

1997 and is an "independent non-governmental body which exercises statutory powers." Through the creation of the FSA, the duties of nine regulatory entities were consolidated and the use of the British equivalent of U.S. SROs was abandoned. The FSA was given extensive financial regulation responsibility, assuming the same roles played in the U.S. by the SEC, the Commodity Futures Trading Commission, federal and state banking regulators, state insurance and state securities commissions, as well as the SROs. Among other initiatives, the FSA has assigned one office to develop policy on prudential issues across all financial sectors, so as to develop a common approach to risk and capital requirements. The agency also announced that it was streamlining the existing financial services rules and has been focusing its regulatory attention on high-risk firms. See Jerry W. Markham, *A Comparative Analysis of Consolidated and Functional Regulation: Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, United Kingdom, and Japan*, 28 Brooklyn J. Int'l L. 319, 374–82 (2003).

<sup>286</sup> See supra note 181.

conflicts, funding, redundancies, and intermarket surveillance?

*Question 71:* To what extent would direct SEC regulation continue to provide the benefits of the current SRO system (e.g., largely self-funded system with market specific expertise of SRO regulatory staff enhancing rule promulgation and enforcement)?

*Question 72:* Could current SRO staff be effectively drawn upon by the Commission under the direct SEC regulation model, or would this staff be inappropriately influenced by their prior affiliations with specific SROs?

#### H. Other Models

Alternative models of regulation exist that were not specifically explored in this release. Such approaches may be variations of the above alternatives or completely different models. The Commission specifically seeks public comment on the following question:

*Question 73:* Are there any other approaches to regulation of the securities industry that are worthy of consideration whether discussed herein or not? Should the current model remain unaltered?

## VI. Solicitation of Additional Comments

In addition to the areas for comment identified above, we are interested in any other issues that commenters may wish to address relating to the current structure of the SRO system, potential enhancements that could be made to the current system, or potential models that could be implemented that would restructure the SRO system. Please be as specific as possible in your discussion and analysis of any additional issues. Where possible, please provide empirical data or observations to support or illustrate your comments.

By the Commission.

Dated: November 18, 2004.

**Margaret H. McFarland,**  
Deputy Secretary.

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