



March 8, 2005

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

Re: Concept Release No. 34-50700, File No. S7-40-04

Via: e-mail rule-comments@sec.gov

Dear Mr. Katz,

The Boston Stock Exchange (“BSE” or “Exchange”) appreciates the opportunity to submit its comments in response to the Securities and Exchange Commission’s (“SEC” or “Commission”) Concept Release No. 35-50700 (November 18, 2004), File No. S7-40-04, entitled “Concept Release Concerning Self-Regulation (“SRO Concept Release” or “Release”).”

SRO Concept Release Overview

A. System Has Worked

The SRO Concept Release provides a significant historical summary of the industry's self-regulatory system. It states that self-regulation has been in effect in the industry for seven decades, has functioned effectively for government, industry and investors, and is key to the regulation of the securities industry. It adds that Congress has consistently favored self-regulation due to the costs of regulating, the complex nature of the industry, the ability of self-regulatory organizations ("SRO") to set higher standards, it provides supervision by an entity familiar with the industry, and provides leverage to the government and its resources, among others. In addition, the Release notes that Congress preferred supervision of the industry by its peers and that regulation limited to government alone would be ineffective.

B. Periodic Reviews Have Been Performed

The Release states that the review of the SRO structure is not new, as there have been periodic reviews of this area performed over the last few decades. It states there is a current need for review due to inherent conflicts of interest, costs of multiple regulators, surveillance challenges, the ways revenue are generated and how regulatory operations are funded. In addition, the Release states that recent changes in the market, including SRO ownership, additional order flow to competing markets, increased competition for trades and listings, and certain perceived SRO governance failings have added to the need for a comprehensive review.

C. Potential Regulatory Approaches

The Release outlines a number of potential regulatory approaches to the SRO system including: enhancement of the current system; independent regulatory and market corporate subsidiaries; single member SRO; competing hybrid model; universal industry self-regulator; universal non-industry regulator; and pure SEC regulation.

A Measured Approach

We believe that it is healthy for all organizations and structures to assess themselves periodically to determine if they are operating at the highest levels. And, there are changes to the SRO system that could be made to improve operations and efficiencies. However, we are urging the Commission to take a measured approach to such changes and move to enhance the current system. We believe that, as history has shown, the SRO system has worked over the last seven decades and has provided valuable regulatory oversight to the industry. We believe that the SRO Governance Rule Proposal, issued in conjunction with this Release, can provide the necessary enhancements to the current system and that the changes that will develop out of these new rules must be given a chance to work. As the Release indicates, there are substantial concerns with any of the alternate approaches, and real risks of unintended consequences if the current system is jettisoned for an alternate, untested approach.

Conflicts Are Addressed

The Release indicates that one of the most controversial features of the existing system is the inherent conflict that exists with SROs between their business and regulatory operations.

A. Member Conflicts

It states that SROs are responsible for regulating all aspects of their members' securities business while they are reliant on such members to send business to the market center to remain profitable. The Release adds that member domination of SRO funding, governance and control over regulation and enforcement could discourage SROs from adequately performing their regulatory duties. It adds that the recent trend of declining membership has made such members more important to the future of such SROs.

The Exchange agrees with the Commission that to be an effective SRO there must be a structure in place that allows regulatory staff to operate without pressures from business operations. We believe that the separation of business and regulatory operations and the creation of a Chief Regulatory Officer (CRO) who reports directly to the Board of Governors through the Regulatory Oversight Committee (ROC), would effectively address these member conflict concerns. We believe that certain recent governance changes, including the establishment of a majority independent Board of Governors, increased independence of policy-setting committees and the additional changes that will be forthcoming in the SRO Governance Rule Proposal adequately address the governance

control issues. Finally, we should not forget that there is a comprehensive and continual oversight of the SRO system by the Commission through its Market Regulation and OCIE divisions.

B. Conflicts With Market Operations

The Release outlines concerns about the general conflicts an SRO faces between its regulatory obligations and market operations. It states that SROs are responsible for monitoring their market operations, enforcing their rules, and, that as competition for business grows, the SROs will face increased pressure to keep the order flow it currently receives. The Release adds that SROs may be less inclined to enforce rules in this competitive atmosphere if it could mean the potential loss of business. The Release requests a response to the extent of such conflicts, whether lax regulation is being used as a marketing tool, whether the establishment of CROs and ROCs have addressed these concerns and whether the SRO Governance Rule Proposal will provide the necessary answers to such issues.

We believe that the recent organizational separation of regulation from business operations, creation of a CRO, regulatory operations reporting directly to the SRO board through the ROC and certain changes in the proposed governance rules will adequately address these conflicts of interest. The Exchange does not agree with the general proposition that lax regulation is being used as a marketing tool. In fact we have determined just the opposite. Certain recent enhancements to our trading system to

further enforce our rules and pro-actively restrict the ability to violate our trading rules has actually increased our execution quality numbers, which has become an effective marketing tool. In addition, the Exchange's focus on enhanced surveillance tools and a new fine schedule reflect the BSE's efforts to reinforce its regulatory and enforcement program, contrary to the Release's implications of the potential of lax regulation to retain business. We are asking the Commission to allow the recent series of SRO Governance Rule Proposal changes to take shape and be monitored for their effectiveness on the industry.

C. Conflicts With Listed Issuers

The Release outlines conflicts between regulatory responsibilities of SROs and the business interests of their listed companies. It states that SROs must enforce their listings rules, both initial and maintenance, and with increasing competition from market centers to secure listings it may put pressure on SROs to relax enforcement of listings rules in order to keep the listed company as a client.

This matter presents an opportunity to raise an issue, similarly raised in our SRO Governance Rule Proposal response, that not all SROs are the same and should not be treated the same. First, competitive pressures of a large market center to secure and maintain a prominent listing are generally not present in regional listings programs that tend to attract small-capitalized, lesser-known companies. Second, listing fees at regional exchanges tend to be de minimus compared to larger market centers and not a

material incentive to gain or maintain a listing. Third, all listings programs are subject to oversight by the Commission. Finally, recent changes to corporate governance of publicly listed companies through Sarbanes Oxley, as well as adoption by SROs of enhanced corporate governance changes have created new controls that should be given time to work.

Multiple SROs Strengthen The Industry

The Release raises concerns that the current SRO system could cause the potential for conflicting and duplicative regulation. It states that such issues could potentially be further aggravated by greater market fragmentation of order flow. The Commission asks whether the lack of inter-market rules across markets trading the same type of securities causes regulatory arbitrage. It raises the question of whether there are inefficiencies resulting from multiple SROs overseeing the activities of the same members.

The Exchange refers the Commission to efforts that have already been made to address these issues, including Rules 17d-1 and 2 of the Exchange Act, which allows a member of multiple SROs to be assigned to a single SRO to act as its DEA and allows SROs to establish joint plans for allocating regulatory responsibilities. It is also important to note that the Commission, in its rule approval process, will review and approve an SRO rule filing only after a comprehensive review of similar rules effective or filed by other SROs. While there may be certain instances where uniform rules would be prudent, each SRO is different, with certain unique business features (such as the Exchange's Competing

Specialist Initiative) that require separate and distinct rules and enforcement of such rules.

We believe that separate SROs provide a unique, competitive atmosphere that can only strengthen the industry as it allows for both regulatory and business innovations that would not be present otherwise. For example, the creative market model of the Boston Options Exchange, LLC (“BOX”), with its innovative Price Improvement Period (“PIP”), has provided significant cost savings benefits for investors. BOX has also become an industry leader with its high execution quality standards. These positive innovations, which only improve the industry, are a direct result of competition that would not exist without separate and distinct SROs.

SROs Are Self-Funded And Leverage Resources

The Release indicates that a key benefit of the SRO system has been its self-funding structure, which leverages Commission resources. It further states that the Commission currently does not have the resources to take on the current responsibilities of the SROs. It reiterates what has been discussed above – that Congress believes that SROs perform a key regulatory function as long as they are properly funded. The Release points out the absence of specific rules pertaining to the funding of a system with diverse business models and markets.

The Exchange believes that the current SRO system is providing a valuable, self-funded, regulatory service. As discussed, it would be impractical for the Commission to take on full responsibility of SROs. Due to the unique market features of each SRO, particularly those who compete through increased levels of automation, it would be difficult for any single entity to adequately surveil each market. We believe that the current system, requiring SROs to meet their statutory obligations, which is subject to SEC oversight, remains valid. In fact, with certain enhanced regulatory disclosure requirements proposed in the SRO Governance Rule Proposal, the Commission will have greater information to gauge whether obligations are being met.

Alternate Regulatory Approaches

The Release discusses a number of potential regulatory approaches to the SRO system. The alternatives are discussed below.

A. Enhancements to the Current SRO System

The Release discusses the essential regulation that SROs have provided to the industry over the last seven decades. It notes that the current SRO Governance Rule Proposal would strengthen SRO governance and address many of the issues and concerns that have been raised about SRO limitations. The Release adds, that the adoption of the SRO Governance Rule Proposal would reduce the number of regulatory conflicts, the separation of the CRO position would reduce regulation conflicts and the establishment of a ROC would help insulate regulatory operations from business pressures. The SRO

filing requirements would further assist the Commission in its oversight role. The Release also discusses concern that independent directors may rely more on industry directors and there may be the potential for unequal regulation and funding.

The BSE has been proactive with enhanced surveillance and regulatory initiatives and would continue to support enhancements to the current SRO system. The SEC Governance Rule Proposal provides several corollary initiatives that would strengthen the SRO mandate. The system that has been so valuable to the industry over the last seven decades may need some updates but it does not need an overhaul. We urge the Commission to allow the SRO Governance Rule Proposal, including the practical limitations that we support, before any additional changes to the SRO structure are considered.

B. Independent Regulatory and Market Corporate Subsidiaries

The Release explores the possibility of mandated internal SRO restructuring – the creation of independent subsidiaries for regulation and business in order to provide separation of regulatory operations from business pressures.

The concern the Exchange has with this alternate model was raised recently in a Section 21(a) Report issued to a market center that currently uses this model. The concern is that the regulatory entity would become too far removed from business operations to adequately regulate the market. One of the key benefits of the current SRO system is the

fact that the regulatory body of the SRO is on the frontline of the market and business operations and is better able to surveil the market from that standpoint.

C/D. Hybrid and Competing Hybrid Models

The Release discusses a “Hybrid Model” – that would create a market neutral single SRO (“Single Member SRO”) to regulate broker dealers. A “Market SRO” would be responsible for market operations and regulation. The Release states that conflicts could be eliminated with a Single Member SRO as well as duplicative regulation.

The Release offers a “Competing Hybrid Model,” similar to the Hybrid Model above, with Market SROs, but offers the possibility of multiple, Competing Member SROs (rather than a Single Member SRO).

The Exchange could not support these hybrid structures due to the limitations raised by these models, including the probable reduction of self-regulatory knowledge of business practices as well as the unwieldy SRO rule process that would require the separation of each rule filing into member or market rules.

E. Universal Industry Self-Regulator

The Release offers the potential alternative of one industry SRO responsible for all market and member rules. Member firms would be registered with the industry SRO and

all markets would be non-SROs registered with the industry SRO. No SRO would be present under this model.

Although this model offers the potential for uniform regulation and funding, it would lack the material advantage that the current SRO system offers – market specific expertise. It also would inhibit innovation that could be unique to a particular market and require more attention from a regulator unfamiliar with the market and/or product. It would also be removed from the frontline, and become more bureaucratic in its mission with less attention to competitive initiatives. It should not be forgotten that, although we all operate under the national market system, each market center has separate and unique characteristics that call for tailored regulation. We are concerned that the benefits of the current SRO system, that have been enumerated by many over the years, would be lost if this model were to be adopted. Finally, there is some question as to whether this model would actually be creating a duplicate or potentially competing interests of the Commission.

F. Universal Non-Industry Regulator

The Release offers the potential alternative of one non-industry entity responsible for all industry regulation. This would be an independent, non-profit, non-governmental body whose board would consist of full-time members appointed by the SEC (e.g. similar to the PCAOB established by Sarbanes Oxley).

This model would not offer the market expertise and frontline experience provided by the current SRO system. It is difficult to conceive of a regulatory entity that could efficiently regulate the industry with little or no industry input. We are also similarly concerned about the potential duplicative nature that this entity would have with the Commission.

G. SEC Regulation

This alternate suggestion would completely eliminate SROs and make the SEC the entity directly responsible for regulating the industry.

This model raises many of the concerns we have indicated in the alternate models above and would not offer the benefits of the current SRO system – benefits for both the industry and the Commission.

Conclusion

Thank you for the opportunity to respond to the SRO Concept Release. The Exchange remains committed to its regulatory charge and has taken steps to pro-actively recognize market-wide changes with increased automation along with its obligations to enhance governance best practices. We urge the Commission to take a measured approach to these matters. The current SRO system has offered substantial benefits to the industry throughout the years and should be allowed to continue to do its part which includes recognition of enhancements needed to keep pace with changes within our markets and

SRO Concept Release, S7-40-04, Rel. No. 34-50700
Boston Stock Exchange, Inc. Response
March 8, 2005
Page 14

continue to maintain the strongest and best-regulated industry in the world. If you have any questions do not hesitate to contact me or John Boese, Chief Regulatory Officer.

Sincerely,

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