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March 8, 2005

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549
Attention: Jonathan Katz, Secretary

Re: Release No. 34-50700 (November 19, 2004); File No. S7-40-04

Ladies and Gentlemen:

We appreciate the opportunity to comment on the above-captioned release (the "Concept Release"), in which the Commission has invited response to its proposals on a wide range of issues with respect to the self-regulatory system. While we recognize the broad importance of many of the issues the Commission raises in the Concept Release, we focus principally in this letter on the general issue of funding self-regulation, the methods by which market data fees are determined, which is of prime importance to us as a data vendor and to the markets given the pivotal role market data play, and the basis on which the Commission should determine whether affiliates of self-regulatory organizations ("SROs") will or will not be subject to the regulatory requirements imposed on the SROs themselves.

The ultimate objective of our system of regulation of the securities industry should be a balance between federal and industry regulation based upon the shared conviction between government and the private sector that fair and orderly markets and the protection of investors are the best guarantors of confidence in the securities markets. We support the role of self-regulation in achieving that goal. We agree with the Commission that there are conflicts of interest inherent in self-regulatory organizations ("SROs") that require vigilance, periodic review and adjustment. On the whole, however, we think the SROs have demonstrated their capacity to make necessary changes. The system can be improved; we do not believe it should be replaced.

As the Commission itself notes in the Concept Release, greater transparency is essential to the integrity and further evolution of the system. We agree. Greater transparency concerning the revenues and expenses of SROs is essential. In this respect, we fully support the Commission's proposal in the SRO Governance and Transparency Proposal[1] to require each

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[1] Securities Exchange Act Release No. 50699 (November 18, 2004).

SRO to provide the Commission with annual and quarterly regulatory reports regarding key aspects of the SRO's regulatory program, including greater disclosure regarding revenues and expenses and staffing of its regulatory program. The very absence of information from the SROs concerning expenses and the allocation of revenues makes it difficult to reach detailed conclusions about many of the issues the Commission has raised in the Concept Release and how best to address them. Until we know more about how the SROs generate revenues and how they spend it, it is difficult to reach any definitive judgments about how much money they should receive and how they should spend it. Nonetheless, some judgment can be reached on the basis of what is known.

Market data revenues. In the Concept Release, the Commission states that market data revenue has traditionally been a very important component of SRO funding. Between them, the New York Stock Exchange (the "NYSE") and Nasdaq reported combined market data revenues in 2003 of $319 million. For one SRO, the National Stock Exchange, market data fees accounted for more than 80% of its total 2003 revenue. Yet, a detailed accounting of these revenues, including the underlying costs to the SROs of producing the data, and an account of the use of these revenues has been unavailable. As the Commission is aware, critics of the current system have pointed to the use of market data rebates as an indication that fees are excessive. Citing to the recent example of the NYSE's Liquidity Quote, the Commission itself also notes that SROs have attempted to distribute market data in ways that could potentially harm competitors.

We agree with the Commission that market data fees should at least generate sufficient revenue to reimburse exchanges and Nasdaq for the costs they incur in collecting, collating and disseminating market data. The key question is how much of a return on market data fees beyond cost is "fair and reasonable" and, in setting rate structures, what would be "not unreasonably discriminatory". In our comment on the 1999 Market Data Concept Release,[2] we stated that market data fees should be based upon the actual costs of collecting, collating and disseminating market data, with a reasonable return on capital actually and necessarily devoted to those functions. With current and accurate accounts submitted by the SROs, the Commission and market participants would for the first time have a sound basis for assessing the feasibility of that approach. We respectfully submit to the Commission that consideration of market data fees must also fully take into account the monopoly status of the SROs in relation to market data. The rate of return for market data should be determined in light of the fact that broker-dealers are required to turn over their data free of charge to the SROs. The SROs collectively enjoy a government-sponsored monopoly that protects them from competition — and from risk. Market data fees are not currently the result of an open and competitive process. Neither the role of the Networks in negotiating fees nor the notice and comment period the Commission provides on fee filings are an effective substitute for the price-formation mechanism of competitive markets or

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[2] Letter of Bloomberg L.P., dated April 11, 2000, re: SEC File No. S7-28-99.

for more vigorous governmental oversight. We note that the Commission remains concerned about what it has characterized as a "cost-of-service ratemaking approach" to market data fees, but the current system does not adequately protect investors from overcharges. The existence of rampant rebating of market data fees to attract and keep order flow is evidence the fees are much too high.

We do not agree that the Commission is justified in assuming the setting of market data fees is an open process or that the Commission can rely on others to assure that the fees are fair and reasonable and not unreasonably discriminatory. That duty, which the Congress assigned to the Commission in the Securities Acts Amendments of 1975, requires the Commission to assume more than a caretaker's role in policing this important area. While this role is not that of a rate maker, it is a role of vigorously overseeing the SROs to see that the fees they set are fair, reasonable and non-discriminatory. In fact, greater transparency would allow the market to assist the Commission in reaching a rate that is fair without the need for excessive government intervention.

Market data are the lifeblood of the market system. They nourish "smart" order-routing systems. They give all investors, large and small, important real-time information about the prices they may expect to pay and receive when buying and selling securities. Market centers achieve vitality and their economic raison d'être by being places to which orders are routed; market data drive the order-routing decisions. While other sources of revenue are subject to competition, market data fees are not. Market participants, particularly those who need market data to monitor and meet their best-execution obligations, cannot bargain for the price of market data; they must pay. Even if market regulation were included in the cost base of producing market data, we doubt the current fees would meet the statutory standard.

Funding market regulation. The Commission expresses the concern that market data fees are necessary for funding adequate regulation and asks whether market data revenue should be used to cross subsidize SRO regulatory operations. We respectfully submit that it is neither necessary nor desirable that regulation be paid for with market data fees. The argument that data fees should pay for market regulation because market regulation is necessary to safeguard the integrity of the trading and thus the data is unpersuasive. That proposition is illogical in fact. It is no more true than it is true that other aspects of SRO operations are essential to the creation of data, such as executive compensation, operating costs of floor facilities and general overhead of various kinds without which an SRO would have to shut its doors. Indeed, the costs of market surveillance and regulation, however worthy and necessary to the operation of an SRO, have no necessary connection to the data themselves. A corrupt, manipulated market could have very clear and accurate market data as to the quotations entered and trades effected there. The market needs transparency about the revenues and expenses of SROs, including the costs of regulation. The best way to ensure transparent accounting for the costs of regulation is through a separate and distinct allocation of funds to pay for regulation.

Effective regulation. The issue of adequate funding for SRO regulation goes to the question of providing adequate regulation. The discussion of alternatives to the current structure of SROs considers whether any of the Commission's proposed structural changes

would increase SRO regulatory independence. Forming separate and independent corporate subsidiaries on the model of the NASD corporate structure may merit further consideration. We do not believe it would be feasible or desirable for the SEC itself to be solely responsible for market and member regulation. The other four proposals advanced by the Commission are variations on two proposals: a hybrid model that would separate member regulation from market regulation and a single regulator, whether an industry self-regulator or a non-industry regulator modeled on the PCAOB. Throughout the Concept Release, the Commission points to the potential conflicts of interest within the SROs without the additional showing of actual bad effects. Potential conflicts of interest are inherent in any self-regulatory system. Simply identifying the potential conflicts does not provide a basis of abandoning the system nor would reshuffling the structure of self-regulation eliminate those conflicts. We would suggest that the financial services sector is necessarily rife with potential conflicts of interest and that transparency and disclosure, rather than outright bans or structural fixes, has often worked to police the conflicts by providing participants with essential information. For it to be successful, self-regulation requires more self-regulation not less by providing market participants with the transparency and disclosure that enables them to watch the watchers.

Regardless of any changes to the structure of the self-regulatory system, we believe there should be a consolidated informational base that all regulators should be able to draw on. Having separate and uncoordinated regulatory data is inefficient and detracts from the quality of regulation. It may be, for example, that OATS and the NYSE's Order Tracking System would provide a basis for creating a unified industry utility. The Commission itself is in the best position to make that determination. Whether added to the present infrastructure or used for an entirely new infrastructure, however, we believe up-to-date technology should be deployed to make regulation and surveillance both effective and cost-efficient. The argument for consolidated regulatory data is made stronger by the growing competition among markets. We fully agree with the Securities Industry Association proposal for the creation of a neutral industry utility such as The Depository Trust and Clearing Corporation to maintain a consolidated order audit trail with the costs of development and maintenance shared across the industry.

As the Commission continues to deliberate on what, if any, structural changes to introduce to the self-regulatory system, we respectfully suggest that it can and should address issues that fall within its regulatory ambit. Existing opportunities for regulatory arbitrage between and among regulatory systems should be removed. Perhaps the most notorious of these is the exemption from short-sale regulation for trading Nasdaq securities on the regional exchanges.

Affiliated entities. Finally, in the SRO Governance and Transparency Proposal, the Commission asks whether entities affiliated with an SRO should be subject to the same degree of regulation as the SROs themselves with respect to their charters, by-laws and rules. We think the Commission took the correct approach to this issue in its order granting Nasdaq Tools a conditional exemption from various filing and rule-making procedures.

On March 7, 2000, as the Commission knows, Nasdaq purchased Financial Systemware, Inc., a manufacturer of software products, and formed a wholly owned subsidiary

that has been named Nasdaq Tools, Inc. ("Nasdaq Tools"). Through a series of steps, the Commission granted Nasdaq an exemption (the "FSI exemption") that allows Nasdaq to avoid treating FSI's business as subject to the regulatory requirements, including the rule-filing requirements, applicable to the NASD and Nasdaq themselves.[3]

In granting the FSI exemption, the Commission recognized the danger of Nasdaq's leveraging its trading monopoly into a competitive adjacent market and imposed conditions to prevent that leveraging. In particular, the Commission conditioned the exemption on the presence of effective competition in the provision of order-management system services and software to market makers, and required that NASD encourage the development of software by NASD members and competing software vendors. To maintain the opportunity for what it called fair competition, the Commission required NASD and Nasdaq to continue to provide open-architecture systems that enable full public access to NASD's facilities.

The Commission also required that it not be necessary, currently or in the future, to use the software marketed by FSI to access Nasdaq or any other NASD market-related facility and that full and fair public access to Nasdaq be available. Thus, brokers and dealers that wish to access Nasdaq are not to be forced to purchase or use FSI products or services. NASD and Nasdaq also agreed to treat FSI in the same way as any other third-party vendor — and not to give it any special advantages regarding planned or actual changes to Nasdaq. Specifically, FSI would not be given any advance or private knowledge of such changes. In addition, to enforce and emphasize the separation of Nasdaq and FSI, the Commission required that the two companies have separate and distinct office space and prohibited them from sharing employees. The Commission also specifically noted that NASD and Nasdaq proposed that Nasdaq would operate FSI as a stand-alone business, capitalized separately and not subsidized by NASD members or other revenues of NASD or Nasdaq.

We believe the FSI exemption provides both a useful model and precedent for the structural separation of an SRO and an affiliate. In exchange for freeing SRO affiliates from SRO-like regulation, the FSI exemption requires that affiliated entities are effectively separate from their SRO parents and ensures that SROs do not leverage their government-conferred monopolies into competitive markets.

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[3] Securities Exchange Act Release No. 44201 (April 18, 2001).

We appreciate the opportunity to present our views on these important issues and we hope our comments prove useful to the Commission in its deliberations. If members of the Commission or the staff wish to discuss these matters with us, please let me know.

Respectfully submitted,

Kim Bang by R.D.B.

cc: The Hon. William H. Donaldson, Chairman
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