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March 8, 2005

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

Re: SRO Governance and Transparency Proposal - File No. S7-39-04
SRO Concept Release - File No. S7-40-04

Dear Mr. Katz:

The Bond Market Association ("Association")[1] appreciates the opportunity to comment on the Securities and Exchange Commission's ("SEC" or "Commission") Self-Regulatory Organization ("SRO") Governance and Transparency Proposal ("SRO Rulemaking Proposal")[2] and its Concept Release concerning Self-Regulation ("SRO Concept Release").[3] The Association commends the Commission and its Staff for advancing the public debate regarding the improvement of the regulatory oversight of the securities industry. Reaching the correct answers in this debate will be critical for all investors and the U.S. capital markets.

I. Executive Summary

A. Debt Markets

We urge the Commission, as it considers all aspects of its proposals – SRO governance, transparency, and alternative regulatory models – to expand its focus beyond the equities markets to include careful consideration of the needs of the debt markets. We believe that the debt markets raise distinct questions, and may require specialized solutions, in the

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[1] The Association represents securities firms and banks that underwrite, trade, and sell debt securities, both domestically and internationally. The Association's member firms collectively represent in excess of 95% of the initial distribution and secondary market trading of municipal bonds, corporate bonds, mortgage and other asset-backed securities and other fixed income securities. More information about the Association is available on its website at <www.bondmarkets.com>.

[2] Exchange Act Release No. 50699 (Nov. 18, 2004), 69 Fed. Reg. 71126 (Dec. 8, 2004) ("SRO Rulemaking Proposal").

[3] Exchange Act Release No. 50700 (Nov. 18, 2004), 69 Fed. Reg. 71256 (Dec. 8, 2004) ("SRO Concept Release").

market structure debate. We are concerned, however, that such issues have not received adequate exploration to date. Therefore, we urge the SEC not to miss the opportunity to improve the U.S. securities markets as a whole, including the markets for both debt and equity securities.

B. SRO Governance Proposals

1. General Comments

We believe that self-regulation continues to be the best alternative for the regulation of the securities markets and, therefore, we object to the SEC's proposed model, which contradicts the foundation of self-regulation. In particular, we emphasize the following:

By significantly limiting broker-dealer involvement in all aspects of the self-regulatory process, the SEC's proposal is an unwarranted retreat from self-regulation as established by Congress and contrary to the fair representation requirements of the Securities Exchange Act of 1934 ("Exchange Act").

The SEC's elimination of the cornerstone of self-regulation – the expert participation of the broker-dealer community – impoverishes the knowledge base of the SROs to the detriment of regulatory oversight.

The SEC's proposal changes self-regulation to such an extent that it becomes the equivalent of direct regulation by the government. Therefore, any such proposal must be paired with the elimination of just and equitable principles of trade ("J&E") as an independent standard of conduct, and the imposition of administrative protections, like those set forth in the Administrative Procedures Act ("APA").

The SEC's proposal fails to recognize the inherent differences between the NASD as the regulator of the bond markets and the other SROs. In particular, the SEC attempts to shoehorn the NASD into standards developed for demutualizing exchanges and for listed companies.

2. Specific Comments

We also provide the following specific comments on the SEC's governance proposals:

Members should participate actively in the SROs' boards and key committees as well as the rulemaking, disciplinary and funding-related processes of the SROs. The SEC's proposals go too far in limiting such participation.

The SEC's proposed definition of independence is overly broad and imprecise. It designates a director as interested without establishing that the director is subject to an actual, relevant conflict of interest that may impair his or her decision-making in a material way.

We agree that the governance proposals should not apply to clearing agencies.

C. SRO Transparency Proposal

We believe that today's regulatory system would benefit greatly from increased transparency, which, in turn, promotes accountability and increases investor confidence. As a result, we applaud the SEC's proposals to increase disclosure for SROs.

D. SRO Concept Release

Although we continue our strong support for self-regulation, we recognize that certain modifications to the structure of the current model would increase its efficiency to the benefit of investors and the securities markets as a whole. We believe that a move to the Hybrid Model would address the significant duplication of regulatory effort by the multiple SROs. In particular, the consolidation of membership oversight into one Single Member SRO will eliminate the redundancies and inefficiencies that presently exist, while the retention of individual Market SROs – or, in the case of the debt markets, the creation of a specialized Debt Market SRO – will ensure the continued innovation and creativity that characterize the U.S. capital markets today.

II. SRO Rulemaking Proposal

A. The SEC's Rulemaking Proposal Contradicts the Theoretical Framework of Self-Regulation

We are strong advocates of a self-regulatory system characterized by significant member firm involvement and transparent, efficient processes. Because we believe that member participation is an important strength of U.S. securities regulation, we cannot support governance proposals predicated on the assumption that such participation is detrimental to the self-regulatory process. The SEC's proposal clearly makes, and acts upon, this assumption. The net effect of the Commission's proposal is to create an "independent" set of boards, with taxing, rulemaking and enforcement authority over the industry, answerable only to the SEC. Such an authority will be, as a practical matter, unrestrained by the traditional checks on governmental authority, while at the same time exercising power which in material aspects is broader than even the government's power. Indeed, we believe the SEC's governance proposal seeks to accomplish indirectly what Congress rejected when the SEC sought to do so directly in 1993. Specifically, as the SEC is aware, Congress forcefully rejected the SEC's effort to achieve so-called self-funding.[4] Recognizing the far-reaching adverse effects of the SEC's proposals, we urge the Commission to reconsider its approach.

1. The SEC Seems to Have Deemed Self-Regulation a Failure

[4] In 1993, the SEC supported a legislative change from its current funding structure to self-funding. A bill, H.R. 2239, provided for a form of Commission self-funding called "full cost recovery." Although the House passed H.R. 2239 on July 20, 1993, no further action was taken on the bill because certain members of the Senate Banking Committee were philosophically opposed to a self-funding structure for the SEC.

Recent events have caused the SEC to confront once again the perennial debate of whether self-regulation is a creative solution to securities regulation, or a proven failure. We continue to believe that self-regulation is the former. In contrast, without saying it in so many words, the SEC appears to have determined that self-regulation is a failure.

The SRO Rulemaking Proposal, when read as a whole, leaves self-regulation an empty husk. The SEC proposal eliminates or marginalizes broker-dealer input in all aspects of self-regulation. For example, the SEC proposes to reduce member "representation" on the board to the ability to nominate 20% of the directors.[5] This process does not reserve any board seats for members, thus making it possible for members to be excluded completely from board representation. The minimal board representation is exacerbated further by the requirement that each key standing committee – the Nominating Committee, Governance Committee, Compensation Committee, Audit Committee, and Regulatory Oversight Committee ("ROC") – be composed solely of independent directors; no member broker-dealers may participate on these essential committees.[6] Member representation on committees and panels related to disciplinary issues is required to be only at the 20% level[7] and, even then, the committee or panel is subject to the jurisdiction of the member-free ROC.[8] With regard to rulemaking, the SEC again promises members only that 20% of the committees that provide advice with regard to trading and disciplinary rulemaking will consist of members.[9] The SEC specifically does not preserve any ability for members to participate in rulemaking on other topics, such as business conduct.

Even funding issues, which directly impact the members' purses, are insulated from member input. For example, the independent ROC would determine the regulatory budget for the SRO.[10] Furthermore, the SEC requires that the SROs provide sufficient funding for each key committee to fulfill its responsibilities. The funding level for each committee would be determined by the committee, which consists entirely of independent persons, and, therefore, would be determined with no member input.[11]

With these proposals, the SEC has turned the requirement that an SRO "assure a fair representation of its members in the selection of its directors and administration of its affairs"[12] on its head. This provision was intended to protect broker-dealers' ability to participate in the self-regulatory process. Congress specifically sought to assure that members have "reasonable representation in all phases of [the SRO's] operations."[13] Its intent was

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5 See Proposed Rules 6a-5(f)(3) and 15Aa-3(f)(3).

6 See Proposed Rules 6a-5(f)(1), (g)(1), (h)(1), (i)(1) and (j)(1); and 15Aa-3(f)(1), (g)(1), (h)(1), (i)(1) and (j)(1).

7 See Proposed Rules 6a-5(j)(3) and 15Aa-3(j)(3).

8 See Proposed Rules 6a-5(j)(4) and 15Aa-3(j)(4).

9 See Proposed Rules 6a-5(k)(2) and 15Aa-3(k)(2).

10 See Proposed Rules 6a-5(j)(2) and 15Aa-3(j)(2).

11 See Proposed Rules 6a-5(e)(3) and 15Aa-3(e)(3). We are concerned that the funding requirements of the ROC, paired with its independent status, transforms the ROC into a mere extension of the SEC staff – and this staff would have the advantage, unlike the SEC, of being self-funded. See, e.g., Section 35 of the Exchange Act ("Authorization of Appropriations").

12 Section 6(b)(3) and 15A(b)(4) of the Exchange Act.

13 S. Rep. No. 75-1455, at 7 (1938) (accompanying S. 3255, 75th Cong. (1938)); H.R. Rep. No. 75-2307, at 7 (1938) (accompanying S. 3255, 75th Cong.. (1938)) at 7.

certainly not the opposite – to abdicate control of the self-regulatory process to independent members of the public. In this regard, Congress specifically rejected a provision that would have required greater participation of the public in the self-regulatory process.[14] Therefore, we cannot agree with the SEC that its interpretation of the fair representation requirement appropriately comports with the intended definition of the phrase. Indeed, we believe the SEC's proposal exceeds its statutory authority and would not survive a challenge in court.[15]

Taken as a whole, the SEC's proposal has limited member involvement in all arenas where such involvement ensures more informed regulation. The SEC has eliminated the very thing that made self-regulation something other than an extension of the government itself. In essence, the SEC has removed the "self" from self-regulation.

2. True Self-Regulation, with Active Broker-Dealer Involvement, Remains the Best Regulatory Alternative

In the Exchange Act, Congress adopted a unique form of regulation for the securities industry, a system that is predicated upon the philosophy of supervised self-regulation. After considering the various possibilities for regulation, Congress concluded that self-regulation offered a number of advantages. It assured that the regulation of a very complex business was informed by the experience and expertise of its participants. It allowed for the use of broad professional business standards, such as "just and equitable principles," that exceed purely legal principles. It addressed the prohibitive cost of regulating the industry on the federal level. Finally, Congress believed that SEC oversight of self-regulatory activities would limit any negative consequences of the conflicts of interest inherent in the system.[16] The unsurpassed preeminence of the U.S. securities markets over the years confirms Congress's decision to rely on this model. For these reasons, we agree that Congress made a wise choice for the industry.

We note further that this model has withstood repeated tests over time. Time and again, usually in reaction to industry developments,[17] Congress and the SEC have revisited the decision to rely upon self-regulation.[18] Yet, each time, the fundamental conclusion remained the same: although self-regulation, with its inherent conflicts of interest, is not a perfect system of regulation, it is the best of the various alternatives. Now, recent governance lapses and concerns about conflicts of interest have again raised questions regarding the efficacy of

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[14] H.R. Rep. No. 94-123, at 61 (1975) (accompanying H.R. 4111, 94th Cong. (1975)). See also 1961-1963 Special Study of Securities Markets, SEC, Report of Special Study of Securities Markets, H.R. Doc. No. 88-95 (1963) ("Special Study") (noting that the SEC and the NASD have interpreted the fair representation provision to require adequate geographic representation (i.e., that "factors of geography, size of firm, and kinds of business be considered")).

[15] See, e.g., American Bankers Ass'n v. SEC, 804 F.2d 739, 755 (D.C. Cir. 1986) (rejecting the SEC's effort to overrule the congressional decision to leave banking regulation to the banking regulators and to assume such authority for itself); Business Roundtable v. SEC, 905 F.2d 406, 416-17 (D.C. Cir. 1990) (finding that the SEC exceeded its statutory authority when it sought to regulate areas of corporate governance that traditionally were left to the states).

[16] See generally S. Rep. No. 73-1455 (1934); H.R. Doc. No. 73-1383 (1934).

[17] See, e.g., Special Study; Report Pursuant to 21(a) of the Securities Exchange Act Regarding NASD and NASDAQ Market (Aug. 1996).

[18] See S. Rep. No. 94-75 (1975) (Congress reaffirmed its commitment to the self-regulatory system and sought to strengthen it).

self-regulation. The SEC should not allow the recent events to cloud its view of the many proven benefits of the current system. No system will prevent all problems in the industry. Therefore, we object to the SEC's efforts to change the basic nature of self-regulation.

a. The SEC Should Not Discard the Cornerstone of Self-Regulation: Broker-Dealer Expertise

The SEC should not limit broker-dealer participation in the regulatory process. The exclusion of active broker-dealer participation eliminates the most knowledgeable parties from the regulatory process. As has been repeatedly recognized, one of the significant advantages of, and reasons for, self-regulation is the "expertise and intimate familiarity with complex securities operations which members of the industry can bring to bear on regulatory problems."[19] For example, member involvement permits an SRO's board and committees to assess the feasibility of proposed policies and rules early in the decision-making process, thereby minimizing the time and resources spent pursuing actions that are prohibitively costly or otherwise impractical or inappropriate. The elimination of such informed perspectives will lead only to a lack of understanding of the operation of the securities industry, leading to flawed and inefficient regulatory oversight. Indeed, we cannot believe that an expert regulatory staff is an adequate replacement for those in the trenches of the business every day.

The need for such industry expertise is at its peak with regard to the debt markets. For example, in creating the Municipal Securities Rulemaking Board ("MSRB"), Congress recognized the unique nature of the municipal securities markets and acknowledged the value of having rules developed by MSRB members with expertise in the municipal securities industry.[20] As a result, Congress required two-thirds of the MSRB to be broker-dealer or bank representatives involved in the municipal securities business.[21] We believe that trading in other debt securities, such as mortgage- and asset-backed securities and high yield and distressed debt, is as specialized as trading in municipal securities, and, therefore, relevant knowledge and experience is no less important for these other debt markets. Indeed, the need for industry representation in such a complex and specialized industry cannot be overstated.[22]

Furthermore, the SEC's proposal to limit member participation across the board ignores the lack of homogeneity in the member population. For example, the NASD has members of all sizes as well as members engaged in all types and kinds of businesses. Those few members privileged to participate in the self-regulatory process cannot represent the

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[19] Report of the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, Securities Industry Study, S. Doc. No. 93-13,at 149 (1973).

[20] In establishing the MSRB, Congress stated:

> it is important that the regulation of the municipal securities industry by the [MSRB] and the [SEC] take into account the uniqueness of the industry and its distinctions from the corporate securities industry. Thus, rules which may be suitable and appropriate for the latter may not be so for the former.

S. Rep. No. 94-75, at 47-48 (1975).

[21] See Section 15B(b)(1) of the Exchange Act. See also S. Rep. No. 94-75, at 47 (1975) (noting the "ingenuity of the financial community" with regard to rulemaking).

[22] Similarly, Congress recognized the need for expert member input in the complex world of clearance and settlement. See Section 17A(b)(3)(c) of the Exchange Act.

breadth of the membership's perspectives.[23] Certain perspectives will be favored over others (e.g., larger broker-dealers favored over smaller broker dealers, or equity trading interests favored over debt trading interests). We do not believe that greater representation on advisory committees for such diverse interests is sufficient replacement for active involvement in the actual decision-making of the SRO.

b. Self-Regulation Without Broker-Dealer Involvement Is the Equivalent of Direct Governmental Regulation

The series of proposed changes in the SRO Rulemaking Proposal, when taken together as a cohesive whole, strike at the very heart of self-regulation as envisioned by Congress. Without broker-dealer involvement, regulation becomes the equivalent of direct governmental regulation. Indeed, we believe that such a radical change in regulatory structure requires congressional action – not just SEC rulemaking – to implement. If the SEC is not prepared to provide members with greater and more substantive representation, the SEC must acknowledge explicitly that it has moved away from a true self-regulatory structure.

First, the SEC must eliminate the J&E powers of the SROs. By curtailing broker-dealer involvement in the regulatory process, the SEC has eliminated the legitimate basis for its reliance on J&E as a regulatory tool. The Exchange Act requires the rules of SROs to be "designed to . . . promote just and equitable principles of trade."[24] The concept of J&E involves the application to the industry of business standards that go beyond the legal requirements that the SEC imposes. Congress required SROs to utilize J&E "to cope with those methods of doing business which, while technically outside the area of definite illegality, are nevertheless unfair both to customers and to decent competitors, and seriously damaging to the mechanism of the free and open market."[25] Such higher ethical standards are only appropriate, however, if they are imposed by businesspeople, reviewing each other's conduct.[26] It is not appropriate for a governmental actor to rely on the relatively vague principles of J&E; government rules must provide adequate notice of the prohibited conduct.[27]

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[23] See, e.g., Special Study at 610.

[24] Sections 6(b)(5) and 15A(b)(6) of the Exchange Act.

[25] S. Rep. No. 75-1455, at 3 (1938). Congress repeated the need for such "businessman's judgment" in the securities industry when it established the MSRB:

> The need to raise the level of conduct in the municipal securities business to a highly professionalized plane can . . . best be met through ethical standards adopted by individuals actually engaged in the business rather than through rigid proscriptions imposed by "outsiders."

See S. Rep. No. 94-75, at 47 (1975).

[26] S. Rep. No. 75-1455, at 4 (1938) (noting reliance on "cooperative regulation"). When the industry agreed to be subject to the ethical standards of just and equitable principles of trade, the governance of securities associations was controlled completely by member firms. Even with the advent of professional staffs and boards with significant independent representation, the industry was willing to forego the protections available to all other Americans. The Commission's proposals, however, change the basic understanding on which such forbearance was based. See, e.g., First Montauk Securities Corp. v. Four Mile Ranch Development, 65 F. Supp. 1371, 1377-78 (S.D. Fla. 1999) (noting that a member is contractually bound to abide by an SRO's rules when it becomes a member of the SRO).

[27] See, e.g., In re Timothy L. Burkes, 51 S.E.C. 356, 360 n.21 (1993), aff'd mem., Burkes v. SEC, 29 F.3d 630 (9th Cir. 1994) (J&E is "not limited to rules of legal conduct but rather [] it states a broad ethical principle"); Gustafson v. Strangis, 572 F. Supp. 1154, 1158 (D. Minn. 1983) (the "special focus of the NASD Rules has been held to be professionalization of the securities industry," and the rules are "affirmatively and vaguely phrased in

Second, if the SEC proceeds with its proposed approach, SRO actions must be subject to the same protections that apply to government action generally. Specifically, the SEC should impose on the SRO processes protective measures similar to those found in the APA,[28] among others, and implemented by government agencies, like the SEC.[29] Such measures would provide members with recourse should they take issue with the SROs' actions.

c. The SEC's Rationale for the SRO Rulemaking Proposal Fails to Recognize the Distinct Characteristics of the NASD

It is not clear why the SEC believes the proposed rules should apply to national securities associations as well as to exchanges. The SRO Rulemaking Proposal and the Concept Release are based on the premise that there is an inherent conflict between an SRO's market operations and its regulatory responsibilities.[30] The Commission therefore proposes that an SRO separate its market and regulatory operations, designate a chief regulatory officer who reports to the Board, and have a majority independent Board. We question whether the conflicts of interest at the NASD require any changes to its existing structure. The NASD no longer has any market interests (or would have no such interests if the SEC would approve the NASD's spin-off of its interest in NASDAQ). It certainly does not run a "market" with respect to fixed income securities. Unlike some of the equity exchanges, no small group of members represents a large proportion of its operations. The NASD's voting system gives one vote to each member firm, regardless of its market share or capital size. The NASD has already separated its market and regulatory operations into two separate corporate entities. The President of NASDR for Regulatory Policy and Oversight is the equivalent of an independent Chief Regulatory Officer. The NASD and NASDR already have majority independent Boards, albeit Boards in which independence is defined differently than under the Commission's proposal. Yet, the SEC attempts to apply the same proposals to the NASD as to the other SROs. In contrast, we believe that the SEC should allow each of the SROs the flexibility to adopt governance structures that address each entity's distinct needs.

For example, the SEC looks to its recent approvals of rules related to the smaller exchanges and the NYSE to buttress its current proposal. Many of the SEC's proposed governance provisions are based on incremental changes the SEC approved for smaller exchanges, such as the Pacific Exchange or the Philadelphia Stock Exchange, as they were in the process of demutualizing.[31] Even the NYSE changes reflect the specific – and difficult –

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terms of what shall be instead of in terms of concrete proscriptions"); In re Benjamin Werner, 44 S.E.C. 622, 623 (1971) (the NASD has authority to impose sanctions for violations of "moral standards" even if there was no "unlawful" conduct); In re Daniel Joseph Alderman, 52 S.E.C. 366, 369 (1995), aff'd, 104 F.3d 285 (9th Cir. 1997) (the rule "sets forth a standard intended to encompass a wide variety of conduct that may operate as an injustice to investors or other participants in the marketplace"); Eichler v. SEC, 757 F.2d 1066, 1070 (9th Cir. 1985) (a finding of scienter is irrelevant to J&E).

[28] See 5 U.S.C. §§ 551-559.

[29] For example, other protective requirements are found in the Paperwork Reduction Act, Government in the Sunshine Act and the Freedom of Information Act. See 44 U.S.C. §§ 3501-3502, 5 U.S.C. § 552b and 5 U.S.C. § 552, respectively.

[30] SRO Concept Release at 71259-71264.

[31] See SRO Rulemaking Proposal at 71132 & n.61 (noting rule changes related to Pacific Exchange, Philadelphia Stock Exchange and International Securities Exchange).

circumstances faced by that exchange.[32] Yet, the SEC attempts to transform these individualized approaches into order of magnitude changes appropriate for all SROs. We do not believe that these individualized determinations should be used *carte blanche* as precedent for changing the basic requirements of the Exchange Act. We cannot forget that an SRO's decision to impose certain requirements voluntarily – and as a part of a member process ensuring active member firm involvement – is different from an SEC rule requiring such provisions for all SROs. We urge the SEC to allow each SRO to make its own determination as to the governance that is best-suited to it.

Similarly, we are not persuaded by the SEC's arguments that SROs should be subject to the exact same requirements as their listed companies.[33] A wholesale importation of all the listing requirements without analyzing the need for modifications to address the self-regulatory role played by each SRO cannot be supported. After all, listed companies exist for a variety of reasons and engage in a variety of business activities, none of which have the specific purpose of overseeing the persons who make up the company. The very mandate of an SRO is to oversee its members, and to do so in a manner that involves those members in the oversight process. In particular, the focus on independent governance for listed companies clashes with the need for member involvement in SROs. Therefore, we believe that SROs should be held to a governance standard that is tailored to reflect the SROs' unique role, not a standard that is the cookie-cutter application of the listing standards to a new and different context.

B. Specific Comments on the SRO Rulemaking Proposal

In additional to the general concerns regarding the anti-self-regulation policies underlying the SRO Rulemaking Proposal discussed above, we provide more specific comments below on the particulars of the proposal.

1. Greater Broker-Dealer Participation Is Necessary for All Aspects of the Regulatory Process, Including Governance, Discipline, Rulemaking and Funding

We strongly believe in the value of direct member involvement in all aspects of the self-regulatory process. The SROs greatly benefit from member experience and knowledge in their decision-making across the board. We object, therefore, to the SEC's proposal to limit member representation in, among other things, SRO governance, rulemaking, disciplinary processes and funding. We believe that permitting individual SROs to fashion the most appropriate processes for their own organizations is the best approach.[34] For example, with

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[32] See SRO Rulemaking Proposal at 71129-30 & n.36 (noting concern regarding substantial executive compensation package). See also SEC Press Release 2004-42 (Mar. 30, 2004) (announcing SEC settlement with NYSE specialist firms).

[33] See SRO Rulemaking Proposal at 71129 (noting SEC's desire to hold SROs to the corporate standard applied to their listed companies).

[34] See, e.g., H.R. Rep. No. 94-123, at 61 (1975) (accompanying H.R. 4111, 94th Cong. (1975)) (recognizing that "the proportion of public representatives to nonpublic representatives may vary from exchange to exchange because of differing circumstances"); S. Rep. No. 94-75, at 29 (1975) (accompanying S. 249, 94th Cong. (1975)) (noting that "[i]t would be difficult to prescribe a single 'proper' decision-making procedure appropriate to the circumstances of every [SRO], and it is doubtful that any such formal procedure would better

regard to the NASD, the principal regulator of the bond markets, we support the current composition of the NASD Board, with its independent and member directors, as well as the member participation on key NASD committees, and do not believe the current composition should be changed to conform to the SEC's proposal.[35]

More specifically, we are concerned about the SEC's interpretation of the fair representation requirement in the context of the composition of the board of directors. We do not believe that limiting member board representation to the nomination of 20% of the directors,[36] with no specific provision for members to sit on the board, fairly captures the concept of fair representation. Member representation on the SRO boards must be maintained and supported by the SEC.

Similarly, we object to the breadth of topics reserved for the sole consideration of the all-independent Standing Committees.[37] The combined jurisdiction of the Standing Committees can be interpreted so broadly as to place almost all of the SRO considerations within the ambit of one or another of the Standing Committees, thus denying members fair representation in the administration of the affairs of the SRO. The SEC even requires that any matter recommended by or otherwise within any Standing Committee's jurisdiction be voted on by a majority of the independent directors on the board.[38] Adding insult to injury, the proposed rule requires that, if a majority of independent directors is not present at a Board meeting, the penalty is not that the measure cannot be voted on, and not that the independent directors are penalized for neglecting their duty to attend Board meetings, but that one or more of the member directors who attend the meeting must be prevented arbitrarily from voting on the matter. We believe this forced sterilization of the "non-independent" vote is inconsistent with basic notions of fairness.
Because of the significant limitations on member participation in the SEC's proposal, we recommend that the SEC revisit the independence requirements for the proposed Standing Committees.

Most importantly, we find the SEC's exclusion of broker-dealers from the Regulatory Oversight Committee to be particularly puzzling. Under the SEC's proposal, the fully-independent ROC would have broad oversight concerning the SRO's regulatory programs, including its performance and planning, budgeting and staffing, and monitoring, review and enforcement.[39] It is imperative that the oversight of such a wide array of regulatory functions

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serve the goal of effective securities regulation than the present practice of encouraging each organization to develop procedures which best serve its needs and those of public investors").

[35] See, e.g., By-Laws of the NASD, Inc., Art. VII, Sec. 4 (requiring the "number of Non-Industry Governors [to] exceed the number of Industry Governors" on the Board); id., Art. VII, Sec. 9 (requiring the "number of Non-Industry committee members [to] equal or exceed the number of Industry committee members" on the National Nominating Committee); id., Art. IX, Sec. 5 (requiring a majority of the Audit Committee members to be Non-Industry Governors); id., Art. IX, Sec. 6 (requiring the "number of Non-Industry committee members [to] equal or exceed the number of Industry committee members plus the Chief Executive Officer of the NASD" on the Finance Committee).

[36] See Proposed Rule 6a-5(f)(3) and Proposed Rule 15Aa-3(f)(3).

[37] See Proposed Rules 6a-5(f)(1), (g)(1), (h)(1), (i)(1), and (j)(1) and Proposed Rules 15Aa-3(f)(1), (g)(1), (h)(1), (i)(1), and (j)(1).

[38] See Proposed Rule 6a-5(c)(6) and Proposed Rule 15Aa-3(c)(6).

[39] See Proposed Rule 6a-5(j)(2) and Proposed Rule 15Aa-3(j)(2).

be informed by the intimate knowledge of, and experience with, the industry. An ROC must have a thorough and detailed understanding of how the markets and broker-dealers operate, and how any regulatory actions will affect such operation. As discussed above, we believe this is particularly true of the often esoteric bond markets. Only the market participants have such detailed knowledge. Therefore, we recommend that the ROC consist of 50% members and 50% independent persons. Without such a change in the SEC's proposal, the ROC will operate less efficiently and less effectively in providing meaningful regulatory oversight.

We similarly believe that there should be active member representation on the Audit and Compensation Committees. We agree with the SEC's assertion that it is important to have independent perspectives on the Audit and Compensation Committees. We differ from the SEC, however, as to how an independent director should be defined for these purposes. We believe that the members of these Committees should be independent from management, not independent as broadly defined by the SEC. For example, the Audit Committee is charged with oversight of the SRO's financial and legal controls. Members as a group would not be incented to shade the finances of the SRO; in fact, the incentive is likely to be the opposite. Such an approach parallels the requirements of the Sarbanes-Oxley legislation, which focuses on independence from management.[40] Similarly, the recent issues related to executive compensation packages at the SROs developed because of a lack of independence from management, not from conflicts related to members as a group.[41] Therefore, the Compensation Committee need not preclude the participation of members. In both cases, it is in the member's best interest to ensure adequate controls. We recommend that 50% of the committee members of these two committees be composed of members, where such members are deemed independent from management.

We are also concerned that the Commission's proposal will work to minimize member input into disciplinary matters. The Commission has proposed that at least 20% of any committee, subcommittee or panel responsible for conducting hearings, rendering decisions, and imposing sanctions with respect to member disciplinary matters be members of the exchange or association. We are concerned that this 20% floor will gravitate toward a 20% ceiling because of the excessive emphasis the SEC has placed on the role of independence in SRO governance. Furthermore, we question the SEC's application of a 20% threshold, which originally was conceived and applied in the context of demutualizing exchanges, to the NASD.[42] The SEC used the 20% threshold to preserve a role for members in what were soon to be publicly-owned organizations. Such a threshold, however, does not serve a similar purpose for the NASD, which, by its very structure, poses no threat of demutualization. Therefore, we urge the Commission specifically to permit 50% of each disciplinary committee to be members.

The same member participation concerns are raised with regard to SRO rulemaking. The Commission is proposing that at least 20% of the persons serving on any committee that

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[40] See, e.g., Section 10A(m)(3) of the Exchange Act, as added by Pub. L. No. 107-204.

[41] See, e.g., New York v. Grasso, et al., No. 401620/2004 (complaint filed N.Y. Sup. Ct. May 24, 2004) (alleging management's influence over certain board members).

[42] See, e.g., Exchange Act Release No. 49718 (May 17, 2004), 69 Fed. Reg. 29611 (May 24, 2004) (order approving the demutualization of the Pacific Exchange); Exchange Act Release No. 49098 (Jan. 16, 2004), 69 Fed. Reg. 3974 (Jan. 27, 2004) (order approving the demutualization of the Philadelphia Stock Exchange).

is not a Standing Committee and any committee, subcommittee, or panel that is subject to the jurisdiction of a Standing Committee, and that is responsible for providing advice with respect to trading rules or disciplinary rules, be members of the exchange or association.[43] We believe that the 20% threshold and the limited rulemaking topics subject to member involvement must change to recognize the value of member input.

Finally, as we discussed above, we question the SEC's insulation of funding issues from members. Under the proposal, the regulatory budget as well as the budgets for each of the key committees would be determined solely by independent persons, with no input from members. Again, we believe the lack of member involvement is not supportable for an SRO. Not only is member involvement crucial to informed regulation, but exclusion of members from the budgeting process amounts to taxation without representation.

2. Definition of Independence is Too Broad and Imprecise

We believe there is a role for independent perspectives in the self-regulatory process. Such independence, however, must be defined to exclude those who are truly conflicted. In this regard, we believe that the SEC cast its net too widely by proposing an overly broad and complex definition of "independence."[44] The SEC would require a director of an SRO to have no material relationship with the SRO or its affiliate, an SRO member or its affiliate, or an issuer traded or listed on the SRO or its facility.[45] This definition also identifies a number of circumstances under which a director would not be considered independent, such as whether the director or an immediate family member has had a material relationship with the SRO or its affiliate within the past three years.[46]

This definition of independence is so far-reaching that it eliminates anyone with significant and recent industry experience from being an independent director of an SRO. As a result, the only realistic candidates for independent directorships are academics or persons who fall outside of the SEC's proposed three-year look-back period. Although three years may seem like a reasonably short time frame for a look-back period and may be appropriate for listed companies, the rapid pace of change in U.S. capital markets renders such a person's industry knowledge and experience stale for the purposes of an SRO engaged in oversight and rulemaking. In order to effectively guide and implement an SRO's operations and decision-making, a director must have relevant and current industry knowledge and experience. Sacrificing this experience will result in inferior SRO oversight. Therefore, we question the SEC's underlying assumption that a board composed of independent directors with little or no relevant experience or knowledge will provide a more effective oversight mechanism than one with greater member representation. For example, we do not agree that an independent board, lacking in relevant experience, will identify regulatory violations more swiftly than an interested, yet knowledgeable, board.

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[43] See Proposed Rule 6a-5(k)(2) and Proposed Rule 15Aa-3(k)(2).

[44] See Proposed Rule 6a-5(c)(1) and Proposed Rule 15Aa-3(c)(1). We also believe that the definition is overly complex. Such a complicated definition will be very difficult to apply as a practical matter, thus adding significant unnecessary costs to regulation.

[45] See Proposed Rule 6a-5(b)(12), (c)(2) and Proposed Rule 15Aa-3(b)(13), (c)(2).

[46] See Proposed Rule 6a-5(b)(12)(i) and Proposed Rule 15Aa-3(b)(13)(i).

As a point of reference, we note that apparently at least 18 of the last 34 SEC Commissioners (excluding the current Commissioners) would have failed the SEC's proposed independence test. The 18 Commissioners would have been disqualified as independent because they would have been considered to have had a "material relationship" in an employment context within the three years prior to becoming Commissioners.[47] The Commissioners play essentially the same role as the directors of an SRO board, but with enhanced oversight responsibilities for the securities industry. Yet, no complaint is made about their lack of independence. Indeed, this experience has been viewed historically as a significant strength of the Commission.

The proposed definition of independence also declares as ineligible persons whose "conflicts of interest" are far too remote to be of any real concern. For example, the proposed definition applies the three-year look-back periods of many of the independence provisions to relatives of the director and persons residing in the director's home.[48] This has the effect of designating directors "interested" for trivial reasons or reasons unrelated to the SEC's concerns about the regulatory requirements of an SRO. Suppose that a director's daughter is, or worse still, two years ago was, an executive officer of a garbage collection company that is or was providing garbage-related services to the SRO that were valued in excess of $200,000. For that reason, the director would be disqualified from being an independent director.[49] Although we agree the director should recuse himself from votes related to garbage service, such a relationship has no bearing on the director's ability to make other "independent decisions that affect the SRO without competing pressures or conflicts of interest."[50]

Furthermore, the proposed definition fails to identify candidates who may be no less biased than broker-dealers and other excluded parties. For example, a person associated with a hedge fund or other institutional investor may be considered an independent director if he or she has no material relationship with the SRO, a member or an issuer listed or traded on the exchange. Yet, an institutional investor's significant securities-related interests may influence the decision-making of that director in ways similar to a person associated with an issuer or a member.

Given the many limitations of the SEC's proposed independence definition, we cannot recommend this approach over the NASD's current definitions of Industry, Non-Industry and Public directors.[51] The NASD's approach, paired with general state corporate law that

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[47] See Proposed Rules 6a-5(b)(13), (b)(12)(v) and Proposed Rules 15Aa-3(b)(14), (13)(vi).

[48] See Proposed Rules 6a-5(b)(11) and 15Aa-3(b)(12) (defining an "immediate family member" as "a person's spouse, parents, children, and siblings, whether by blood, marriage or adoption, or anyone residing in such person's home") and Proposed Rules 6a-5(b)(12)(i)-(vii) and 15Aa-3(b)(13)(i)-(vii) (extending three-year look-back periods to immediate family members)

[49] Proposed Rules 6a-5(b)(12)(iv) and 15Aa-3(b)(13)(iv) state that a director is not independent if an immediate family member is an executive officer of any organization to which the SRO made payments for services in the past three years that exceeded two percent of the recipient's consolidated gross revenues for that year, or $200,000, whichever is more.

[50] SRO Rulemaking Proposal at 71136.

[51] See By-Laws of the NASD, Inc., Art. I, para. (n), (o), (bb), (cc), (ee) and (ff).

analyzes conflicts on a case-by-case basis,[52] has produced appropriate candidates in the past. Indeed, this standard permits the NASD to benefit from the expertise of knowledgeable candidates while maintaining a prohibition on the participation of individuals currently in situations that would create true conflicts of interest. Therefore, we believe that the NASD should be allowed to continue to use this approach.

3. SRO Rulemaking Proposal Should Not Apply to Clearing Agencies

The Commission has requested comment on whether its governance proposals should be applied to clearing agencies. We believe that clearing agencies should continue to be governed and owned by the persons who engage in clearing transactions, as they are today.[53] Such a structure ensures that ownership, governance, and resource allocation procedures prioritize the interests of those who actually use clearing agencies because they are the sole constituent.[54] In addition, the experience such persons have in clearing transactions is integral to the successful administration and operation of clearing agencies. We agree, therefore, with the Commission's decision not to apply the proposed governance rules to clearing agencies.

III. SRO Transparency Proposal

Another limitation of today's regulatory environment is the lack of public information about SRO activities. The Commission aims to correct this deficiency by proposing additional disclosure requirements for SROs.[55] The revised SRO registration forms, Form 1 and Form 2, and proposed Rule 17a-26 would provide greater transparency regarding the governance structure of SROs and their regulatory programs and processes, and would provide the mechanism for more timely disclosure of the specified information. We agree with the Commission that such improved transparency would enable "members, market participants, investors and regulators to more readily monitor the effectiveness and performance of SROs and promote greater accountability by SROs with respect to their Exchange Act obligations."[56] Indeed, such transparency will be even more important if the SEC limits member participation in the self-regulatory process, as proposed. Such transparency may provide members with their only information about the SROs' regulatory programs. Therefore, we welcome the SEC's proposals for increased transparency.

Specifically, we support the increased transparency represented by Exhibit I of Form 1 and Form 2. In particular, we support the increased detail, such as itemization of revenues

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[52] A basic principle of corporate law holds that a director who is interested for one purpose is not interested for all purposes. See, e.g., Del. Code, tit. 8, § 144 (discussing treatment of interested directors). Unlike the SEC's categorical standards, a case-by-case approach corresponds to this principle.

[53] See Section 17A(b)(3)(C) of the Exchange Act (stating that the rules of the clearing agency must "assure a fair representation of its shareholders (or members) and participants in the selection of its directors and administration of its affairs. (The Commission may determine that the representation of participants is fair if they are afforded a reasonable opportunity to acquire voting stock of the clearing agency, directly or indirectly, in reasonable proportion to their use of such clearing agency.)").

[54] See, e.g., LIBA Statement of Principles to Be Applied to the Consolidation of Stock Exchange and Infrastructure Providers in Europe (Feb. 3, 2005) (stating that "Central Clearing and Settlement Providers should be owned by users, broadly in proportion to usage").

[55] See Proposed Rule 6a-2(a)-(c); Proposed Rule 15Aa-2(a)-(c) and Proposed Rule 17a-26.

[56] SRO Rulemaking Proposal at 71154.

and expenses, that is required under the proposed rules. To further the interests of transparency, however, we set forth below several suggestions for enhanced disclosure in Exhibit I to Form 2, which applies only to the NASD:

(1) Items 1(a), (b) and (c) require a national securities association ("Securities Association") to provide information regarding the percentage or dollar amount of its total annual budget, revenues and expenses devoted to regulatory activities, in the aggregate and itemized by program area. The term "program area" is not defined, although examples are given. We assume that the Commission's intention is that the Securities Association report on the areas set forth in the instructions to Exhibit H, which lists, as part of the regulatory program, (1) member firm regulation, (2) market surveillance, (3) enforcement, (4) listing qualifications, (5) arbitration, (6) rulemaking and interpretation, and (7) the process for assessment and development of regulatory policy. We believe the term is important enough that it should be defined. We believe it is important that the NASD also provide a breakdown by business line (equities and debt) and, within the debt category, by product type, or, at a minimum, provide figures for municipal securities and all other securities. This is the only way the industry can know whether the trading activity fee is determined appropriately to cover the cost of regulation.[57] In addition, municipal dealers pay significant regulatory fees to the MSRB. They are entitled to know if they are paying their fair share of the cost of regulation by the NASD, or whether their fees to the NASD are subsidizing the regulation of other product areas.

(2) Item 1(c)(i)(H) requires the Securities Association to itemize "other revenues" as "appropriate." We believe the Securities Association should itemize any category that comprises 5% or more of total revenues.

(3) We believe that revenues and expenses for conducting seminars for the industry should be itemized, as the expenses for training the Securities Association's personnel are currently listed.

(4) Item 1(c)(ii)(E) requires the Securities Association to itemize information technology expenses. We believe the NASD should report separately on the expenses for TRACE.

(5) We commend the Commission for its proposal to require SROs to prepare an updated Form 1 or Form 2 annually, within 60 days of the end of their fiscal years, and to continuously post their most recent forms and any amendments on a publicly accessible internet website. We note that Rule 17a-26 would require national securities exchanges and registered securities associations to file quarterly and annual reports with the Commission, but that much of the information on these reports would be available only to the Commission. Moreover, quarterly financial reports are not required to be filed. We believe that SROs should make public quarterly unaudited financial statements in the same detail as required for their annual financial statements.

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[57] See, e.g., Letter from Lynnette K. Hotchkiss, Senior Vice President and Michele C. David, Vice President, The Bond Market Association (Feb. 17, 2004) (commenting on File No. SR-NASD-2003-201 (Proposed Expansion of the NASD's Trading Activity Fee to Certain Fixed Income Securities)).

IV. SRO Concept Release: Advocating Hybrid Model

We disagree that the inherent notion of self-regulation – that is, the members' active participation in their own regulation – needs modification. We do believe, however, that certain changes should be made to address some of the limitations of the current model. Specifically, we believe that investors and the securities industry would benefit greatly if inefficiencies were decreased. Furthermore, we believe that the benefits of such improvements would be maximized if the SEC broadened its reform perspective beyond the equities markets to include the particularized needs of the debt markets as well.

A. Oversight of Membership Rules Should Be Combined in One Single Member SRO

We believe that one of the primary disadvantages of securities regulation today is the level of inefficiency embedded in the system. The existence of multiple SROs results in duplicative and conflicting SRO rules, rule interpretations, inspection regimes and disciplinary actions as well as redundant SRO regulatory staff and infrastructure across SROs. Attempts to limit this duplication to date, through, for example, the use of Designated Examining Authorities and coordinated examinations, have proven relatively ineffective. Each point of needless duplication only adds cost to the securities industry to the detriment of investors. Therefore, we believe that the time is right to contemplate a new regulatory model that definitively addresses the inefficiencies of duplicative regulatory action.

We believe that combining the oversight of all membership rules into one Single Member SRO would address the inefficiencies in the most effective manner. As the SEC suggests, the Single Member SRO would regulate all SRO members with respect to rules governing members' financial condition, margin practice, handling of customer accounts, registered representatives registration, branch office supervision and sales practices ("membership rules"), and would be solely responsible for promulgating membership rules, inspecting members for compliance with membership rules and taking disciplinary actions against those members that fail to comply with such rules.[58]

A switch to a Single Member SRO raises issues as to how regulation will be funded. As a starting point, we believe that regulation must be well-funded because it is essential for protecting investors and maintaining investor confidence in the markets. We believe that the most logical source of funds should be fees paid by the membership. We urge the SEC to analyze any proposed fee structures, however, for any biases in favor of or against any particular class of members. No class of members should subsidize the fees paid by another class of members.

We also believe that the proposed unitary structure would require additional safeguards on budgeting decisions. Because broker-dealers would have no choice but to join the Single Member SRO, broker-dealers must have the ability to appeal fee changes that are inappropriate, whether in size or type. Such a process would help to provide a check on fee increases by a monopolistic entity. Furthermore, we believe that the Single Member SRO

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[58] SRO Concept Release at 71277-78.

should be a non-profit, mutual entity. Because of its unique status, the Single Member SRO should not have the ability to charge members for services and then use those funds to make a profit for the SRO.

B. Specialized Market SROs Should Oversee Each Relevant Market, Including the Debt Markets

We believe that the continued individualized oversight of trading is important for the promotion of innovation and creativity in the U.S. capital markets. Therefore, we would not suggest one uniform Market SRO, but, rather, a specialized Market SRO for each of the relevant markets. Each Market SRO would engage in market-related rulemaking, and have the option to enforce its market rules, or to delegate the enforcement of the market rules to the Single Member SRO. We would enhance the efficacy of the SEC's proposal, however, by including a Market SRO dedicated to the debt markets.

We believe that the SEC's current review of the regulatory structure of the securities markets provides the SEC with an opportunity to optimize the regulatory oversight of the bond markets. Yet, despite the fact that the U.S. bond market (even excluding exempt securities such as U.S. government and agency securities) is larger than all the U.S. equity markets combined, the SEC's discussion of various regulatory models in its Concept Release fails to mention or account for the debt and fixed income markets at all.[59] In particular, under its Hybrid Model, the SEC proposes Market SROs only for markets that already have an SRO, i.e., the exchange markets. The SEC appears to assume, without any discussion, that the debt markets (other than the municipal bond market) would continue to be crammed into a generalized regulatory model that was created for equities.[60] We believe there is no justification for the dedication of a Market SRO for each of the equity exchanges – no matter how small[61] – without providing the same opportunity for specialized and knowledgeable oversight to the much larger bond market. We believe the SEC should look to the MSRB as an example for how the proposed Debt Market SRO would provide specialized market regulation for the debt markets as a whole. In particular, we believe that the MSRB model of providing rulemaking only, with enforcement provided by the NASD, is the better structure for the Debt Market SRO.

As further support for a separate Debt Market SRO, we note that the implementation of the Hybrid Model is predicated on the separation of the Market and Member SROs. Assuming that the NASD becomes the Single Member SRO, this raises issues with regard to the NASD's multiple roles in both member and market regulation. For example, in the Concept Release, the SEC questions how the Competing Hybrid Model, a variation on the Hybrid Model, would address the NASD's role in overseeing the OTC market as well as its

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[59] Indeed, the terms "bond," "debt" and "fixed income" rate not a single mention in the Concept Release. Even the terms "over-the-counter" and "OTC" are referred to only 14 times in the 105 pages of the Concept Release.

[60] Although the creation of another national securities association for these purposes would be permissible, it is very difficult as a practical matter. See Section 15A of the Exchange Act.

[61] For example, an ATS with (i) at least 50% of the average daily dollar trading volume in any security and 5% or more of the average daily dollar trading volume in any class of securities; or (ii) at least 40% of the average daily dollar trading volume in any class of securities over the previous year may be required to register as an exchange. Rule 3a1-1(b) under the Exchange Act.

operation of the Alternative Display Facility ("ADF").[62] We believe that the exact same question about dual roles should be raised with regard to the bond markets. If the NASD were to become the only Member SRO under the Hybrid Model, then we question the NASD's continuing role as the Market SRO for the debt markets. For these reasons, we urge the SEC to expand its focus beyond the equities markets and amend its proposals to recognize the distinct needs of the bond markets.

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The Association appreciates this opportunity to address the issues the Commission has raised in the SRO Rulemaking Proposal and in the SRO Concept Release. We look forward to working with the members of the Commission and the Staff to improve SRO efficacy in the months ahead. If you have any questions concerning these comments, or would like to discuss our comments further, please feel free to contact me at 646.637.9200 or via email at mgross@bondmarkets.com.

Sincerely,

Marjorie Gross

Senior Vice President and
Regulatory Counsel

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Annette Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Brandon Becker, Wilmer Cutler Pickering Hale and Dorr LLP

[62] SRO Concept Release at 71279.