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

RE: Securities and Exchange Commission Release 34-50700
File No. S7-40-04, Concept Release Concerning Self-Regulation

Dear Mr. Katz:

The New York Stock Exchange (the "NYSE") welcomes the opportunity to comment on the Concept Release Concerning Self-Regulation (the "Concept Release") and to reiterate our strong support for a regulatory environment of multiple self-regulatory organizations ("SROs"), each appropriate to its market center, operating within the federal regulatory scheme and subject to oversight by the Securities and Exchange Commission (the "Commission").

I.
Executive Summary

Self-regulation has been part of the fabric of the federal regulatory scheme in the United States for 70 years. We believe that it is the most effective way to police the securities markets. As such, all other things being equal, the Commission should preserve as much of the current system of self-regulation as possible, rather than adopt untested and disruptive alternatives.

There are a number of reasons why the current SRO structure has thrived. In particular:

- self-regulation ultimately results in having more precise rules for each individual market, which is more effective than having generalized rules for all markets;
- self-regulation creates a strong economic incentive for markets to enhance their reputations by enforcing the highest standards of ethical conduct; and
- self-regulation is based on the principle that the most effective regulation occurs when the regulator is as close as possible to the regulated activity, thereby developing specialized knowledge in overseeing market operations specific to that market center.

The Commission has raised legitimate concerns about three issues facing self regulation: the structure of existing SROs results in inherent conflicts of interest between their regulatory and business functions; the regulatory programs of multiple SROs and the Commission results in regulatory duplication; and the fragmentation of the securities markets among multiple SROs and trading platforms results in regulatory gaps.

While we acknowledge the Commission's concerns, we are not convinced that resolving them requires a radical rearchitecture of the current SRO system. Our conclusion is based on two premises:

First, we believe that targeted improvements to the current system, some of which are already in progress, and some of which could be quickly begun with a proper mandate from the Commission, could eliminate or manage the inherent conflicts of interest, reduce or eliminate unnecessary regulatory duplication, and better coordinate and harmonize the activities of the various SROs.

Second, we are concerned that none of the alternative structures posited by the Commission for discussion would be any better suited to the task of regulation than the current system.

In short, we do not think there is a compelling case for dismantling the existing SRO system. As the Commission's Rule Proposal Concerning Fair Administration and Governance of Self-Regulatory Organizations (the "Rule Proposal")[1] suggests, it is possible to adequately regulate and monitor SRO conflicts of interest without radical changes; at the very least, the Commission should give the proposed rules an opportunity to work before going forward with a fundamental restructuring. Similarly, regulatory gaps can be addressed by enhancing existing intermarket structures that are already functioning. Improved regulatory coordination can eliminate duplicative processes; harmonization of existing SRO rules can ensure that conflicts among rules are minimized or eliminated, as appropriate.

We believe that an approach that uses and improves on existing structures can accomplish the Commission's goal of improving self-regulation without the significant and costly disruptions that the shift to a single regulator or a super-regulatory agency would entail. At the same time, this approach preserves one of the key advantages of a competitive regulatory structure, namely multiple watchdogs reviewing trading activity.

We are concerned that most of the proposals in the Concept Release would create as many problems as they attempt to solve, but would not effectively address the issues that the Commission has identified. But we are particularly troubled by the suggestion implicit in most of the proposed alternatives that regulation would be improved by consolidation under one or a small number of member SROs or under some form of universal regulator. Member firms may prefer consolidation, but the investing public will be better served – and will perceive that it is being better served – by multiple SROs, each of which shares the mission of protecting investors and promoting a fair and superior national market system. The proposed Member SRO models are

[1] Exch. Act. Rel. No. 34-50699 (November 18, 2004). Contemporaneously with the filing of this comment letter, the NYSE is filing a comment letter with respect to the Rules Proposal.

based on a similarly flawed assumption, namely that market expertise is important only for surveillance of trading in the market. We believe, to the contrary, that there are numerous advantages to retaining the examination and other member-firm regulatory functions in the regulatory structure of the primary market where trading occurs. These advantages include improved examinations and better regulation. Moreover, because member firm regulation and market surveillance functions frequently intertwine, it would substantially degrade the quality of both functions to split them into two or more SROs.

Beyond these fundamental flaws, we believe that the proposed alternatives raise significant questions about, among other things, how such far-reaching changes would be implemented; how the alternate structures would preserve or foster regulatory expertise; and also how the alternative structures would fund their regulatory activities.

We submit that the substantial resources and effort necessary to create and implement a wholly-new structure to perform essentially the same functions as the current system, just under new management, would be better spent renovating and improving the existing system.

II.
The Current SRO Structure Fulfills the Exchange Act's Statutory Mandate

Self-regulation, examined critically against the proposed alternatives, remains the most successful and effective model for regulating the securities industry. Investor protection has long been a concern of securities market participants. Indeed, it has been a core element of the NYSE's rules since before the enactment of the Securities Exchange Act of 1934 (the "Exchange Act").[2] These rules have, in the main, fostered fair trading practices that contributed to the NYSE's reputation as a high-quality marketplace. That reputation for fair dealing, in turn, has long attracted order flow to the NYSE. In short, the lesson of our experience is that self-interested actors will support strong investor protection because it is good for business.

We therefore do not agree that self-regulation is in dire straits or that recent events lead inexorably to the conclusion that nothing will save it except a radical restructuring of the securities industry. Indeed, even after similar market abuses were uncovered in 1961, the Commission itself pointed out one of the principal benefits of self-regulation:

> [M]embers of the affected business can bring to bear on the problems of regulation a degree of expertness, and in many circumstances expedition, not to be expected of a necessarily more remote governmental agency. . . [P]ersons on the scene and familiar with the intricacies of securities and markets from daily and full-time pursuit of the business can more readily perceive and comprehend some types of problems and more promptly devise solutions than a governmental agency which, however great its collective knowledge and skill, may be able to concern itself only intermittently with specific problems, may become aware of them only after the

[2] 15 U.S.C. § 78a *et seq.*

> event, and often must defer decision and action until thorough investigation or study has been completed.[3]

We believe very much in the wisdom of keeping regulation close to the market that is being regulated. But we also recognize that the events of the past five years raise legitimate concerns – conflicts of interest, regulatory duplication and regulatory gaps – and that those concerns need to be addressed. For the reasons discussed below, however, we believe that the problems that the Commission has identified can be more effectively resolved not through wholesale reform but through targeted improvements that reduce or eliminate conflicts-of-interest, adapt or enhance current structures to address regulatory gaps, and promote increased coordination among the SROs in the area of rulemaking, examinations and enforcement.

A. Conflicts of Interest Can Be Successfully Managed <u>Within the Current SRO Structure</u>

Much has been written and said about the supposed inability of SROs and associations to manage the inherent conflicts of interest between business and regulation, and there have been suppositions that those conflicts of interest inevitably harm the investing public. We disagree.

In 2003, the NYSE faced a crisis like few it has ever known. The NYSE's governance structure was perceived to have broken down, its specialist firms were accused of self-dealing at the expense of customers, and public confidence in the NYSE reached historic lows. The NYSE, critics argued, could not effectively manage the conflicts of interest inherent in its structure. In swift reaction, however, the NYSE implemented – with Commission approval – sweeping changes to its governance structure. Among other things, the NYSE ensured that members of the Board of Directors were independent of the interests of the NYSE members whom they regulated, functionally separated market operations from regulation, assured the independence of regulatory decision-making, and installed a Chief Regulatory Officer ("CRO") who reports directly to the Board of Directors through the Board's Regulatory Oversight Committee ("ROC"). The NYSE also separated the functions of Chief Executive Officer ("CEO") and Chairman of the Board, installed new board members, including a new chairman, and hired a new CEO. And, significantly, the NYSE, joined by the SEC, took strong disciplinary action against its specialist firms, including full disgorgement of improper profits and unprecedented fines.[4]

Eighteen months later, it is evident that the new structure is effective. The ROC actively oversees the activities of NYSE Regulation and has approved both staff and technology resource increases. Indeed, we take it as a mark of the soundness of the NYSE's approach that the Commission's Rule Proposal propounds a structure for all SROs that is fundamentally consistent with the structure that the NYSE put in place 18 months ago.

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[3] Securities and Exchange Comm'n, *Report of Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, 88th Congress, 1st Sess. (1963), at Chapter XII, p. 3.

[4] The specialist firms were fined a total of $247,028,778. *See* NYSE Hearing Panel Decisions 04-49, 04-50, 04-51, 04-52, 04-53, 04-116 and 04-117.

As noted previously, the NYSE is separately filing a comment letter with respect to the Rule Proposal. That comment letter addresses many of the conflict issues that led to the current re-examination of the self-regulatory system. In particular, the letter argues that any conflicts of interest between an exchange's or association's regulatory and business functions can and should be addressed; splitting the regulatory and business functions into two different entities will not resolve the concerns raised by the Commission.

At the end of the day, the physical or organizational location of the regulators is not controlling; the quality and integrity of the regulators is. Of course, there is a benefit to keeping regulation and markets together. Remaining an integrated, yet independent, part of the NYSE allows NYSE Regulation to participate in identifying regulatory concerns in the development of new trading systems such as the NYSE's Hybrid Market[sm]. Similarly, closeness to the market allows NYSE Regulation to identify trends that raise regulatory concerns and require particular focus from our member firm regulation or market surveillance divisions. We do not suggest that the NYSE approach is the only approach to self-regulation, only that in our case it provides tangible benefits that should be applauded and not discarded.

We strongly believe that the issue of conflicts should not be used to justify further radical restructuring of the NYSE specifically or the self-regulatory structure generally. At the very least, wholesale restructuring of the current system is premature, as it is too soon to tell whether the structural reforms implemented by the NYSE and proposed by the Commission to be extended to all SROs will effectively manage conflicts of interest. Therefore, the Commission should, at a minimum, give those reforms a reasonable period of time to season before attempting to evaluate them or making any radical changes.

B. Regulatory Gaps Can Be Addressed By Enhancing Intermarket Structures <u>that Already Exist and Are Functioning</u>

The existing SRO structure is fundamentally sound. While there have been areas where regulators were reactive when proactive measures would have been more effective, on the whole, the system is well adapted to its purpose, and detects or prevents far more violations than it misses. Investor complaints are timely investigated and violators are rooted out and prosecuted; last year, for example, the NYSE's enforcement division initiated approximately 3,560 preliminary investigations and more than 400 formal investigations, and concluded almost 200 formal disciplinary actions. Examinations of member firms take place regularly, and violations and non-compliance are routinely detected and corrected before any harm is done. In 2004, for example, the NYSE's division of member firm regulation conducted 76 sales practice examinations, 363 financial and operations (FINOP) examinations and 30 special examinations. Millions of transactions each day are automatically screened by the division of market surveillance for evidence of manipulation or other improper activity, and reams of data are examined for illegal or unethical conduct. Most of this work goes unnoticed precisely because the system works as intended.

Given this background, the fact that SROs sometimes fail to catch wrongdoing does not automatically mean that the structure is at fault. The hard truth is that no system of regulation – federal or self-regulatory – is foolproof. And even if there are benefits to a radically restructured regulatory environment, it would be unreasonable to assume that any of the alternative structures

proposed by the Commission would themselves be immune from similar and occasional failures. In fact, as discussed below, the alternatives that involve consolidation of the regulatory structure into a single entity likely would be more prone to error.

Still, we recognize that SROs can do better. Indeed, we are mindful of the criticism that the Commission has leveled in connection with the NYSE's failures regarding specialist firms trading ahead of customer orders. Like any quality regulatory program, we have learned from these experiences, and we have undertaken affirmative steps to improve our efforts. Among other things, we have conducted a comprehensive evaluation of key aspects of regulation, instituted a process for more regularized self-critical review, and formed a risk assessment group to identify and investigate possible issues within the marketplace.

These actions are consistent with the oft-repeated mandate from Congress and the Commission that every registered exchange and association must maintain and fund an effective examination, surveillance and enforcement regulatory program. Significantly, however, this directive has *never* been interpreted to mandate one market center, structure, model or self-regulatory organization. Rather, the federal regulatory scheme recognizes differences among marketplaces, and provides universal principles that each market center then translates into rules appropriate to that market; the scheme also delegates to the various exchanges and associations enforcement of the federal securities laws across all market centers.

This approach only makes sense. Competitive differences in market structures require different ways of implementing the universal principles contained in the federal securities laws. For example, rules that regulate floor-trading in the NYSE's auction market are not applicable to markets with no market-making function. Different SROs possess different special expertise in their own exam programs – the NYSE in major firm financial operations (FINOP), the NASD in mark-ups and underwriting rules, the CBOE in options trading rules. The "single regulator" – the Commission – strives to ensure, via its inspection, SRO oversight and rule making processes, that all markets have appropriate regulatory programs to effectively protect investors.

We take as a given that all exchanges and associations must adequately fund their regulatory programs. The NYSE is committed to adequately funding its own program and believes that in any conflict between regulatory needs and limited resources, the proper answer is not to compromise on regulation, but rather to find the requisite resources. Of course, we recognize that this is only part of the answer; even with adequate funding for regulation, it is also important to ensure that the current SRO structure does not result in regulatory gaps that can and should be filled, and duplicative processes that can and should be eliminated.

In the markets for NYSE-listed securities, for example, a number of mechanisms have been employed to avoid both regulatory gaps and regulatory duplication. For example, some SROs have filed Rule 17d-2 agreements (*e.g.*, in the options sales practice area); these cooperative arrangements could be supplemented by additional bilateral arrangements or replaced with broader multilateral arrangements, either independent of the Commission or under its auspices and guidance. Other intermarket structures, such as the Intermarket Surveillance Group ("ISG"), which currently facilitates coordination of joint investigations and intermarket surveillances, could also be given an expanded and enhanced role.

The ISG is a signature example of how the current regulatory structure evolves, and it provides both a tool for enhancing the current SRO structure to serve new regulatory challenges and a blueprint for the creation or enhancement of other intermarket structures. Since its creation by the United States SROs in 1983, the ISG has been a forum to share surveillance information and to coordinate investigations that effect intermarket surveillance. It has grown to include every domestic exchange and association, as well as many foreign affiliates, and has had particular success in coordinating intermarket surveillances and investigations of insider trading and manipulation across markets.[5]

The ISG has been an effective model for surveilling NYSE-listed securities traded across diverse markets. ISG participants have concurrent jurisdiction over intermarket surveillance investigations, and responsibility is assigned among ISG members in order to ensure that they adequately share surveillance information and coordinate inquiries and investigations. In addition, an ISG participant can obtain from any other participant information needed in the course of its own investigation, including pertinent market data or the identity of the beneficial owner of an account. Furthermore, the ISG coordinates the exchange of market data among the SROs, such as daily audit trail information, short interest data, and other surveillance information.

We acknowledge the Commission's concerns that, in audit trail review (as well as other intermarket surveillance areas), market fragmentation and different audit trail collection points may impede effective surveillance and investigation. These are legitimate concerns. In response, however, we note that the Commission has, not that long ago, approved the NASD Order Audit Trail System ("OATS") and the NYSE Order Tracking System ("OTS") in order to provide accurate, time-sequenced records of orders, quotations and transactions, beginning with the receipt of an order by member firms, and documenting the life of the order through the execution or cancellation of that order.[6] We also note that support has been developing for a consolidated audit trail of securities transactions. For example, the NASD and NYSE have, without Commission directive, participated with the Securities Industry Association and firms to reconcile wherever possible the data requirements of OATS and OTS.

We can all learn from these examples. Since the Commission believes that OATS and OTS are effective and necessary regulatory tools, we would support an expansion and strengthening of existing intermarket structures by, for example, requiring all market centers to systematize the tracking of orders. The existing Consolidated Equity Audit Trail ("Equity Audit Trail") platform

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[5] In addition to the NYSE, full ISG members are the American Stock Exchange, LLC, the Boston Stock Exchange, Inc., the Chicago Board Options Exchange, Inc., the Chicago Stock Exchange, Inc., the International Securities Exchange, Inc., the NASD, the National Stock Exchange, Inc., the Pacific Exchange, Inc. and the Philadelphia Stock Exchange, Inc.. Affiliate members include the Australian Stock Exchange, Boerse Dusseldorf, Cayman Islands Stock Exchange, Chicago Board of Trade, Chicago Mercantile Exchange, Euronext LIFFE, Frankfurter Wertpapierboersen, Hong Kong Exchanges and Clearing Corporation, Investment Dealers Assoc. of Canada, London Stock Exchange, Market Regulation Services, Inc. (Canada), Montreal Exchange, New York Board of Trade, OneChicago, LLC, Osaka Securities Exchange, Oslo Borse, SFE Corp., Stockholmborsen, Tokyo Stock Exchange, Virt-X Exchange Ltd.

[6] See Exch. Act Rel. No. 47689 (April 17, 2003)

could easily be adapted to further enhance intermarket coordination immediately. And, rather than waiting for a radical new SRO structure to be conceived, legislated and implemented, the ISG – with its existing administrative structure and an enhanced mandate from the Commission – immediately could begin developing a consolidated database to house and provide access to all order information (OATS and OTS) and transactional information (Equity Audit Trail) necessary to enable either the SRO where abusive practices are occurring or the SRO where the security involved is listed to conduct effective intermarket surveillance in real time.[7]

This approach could accomplish the Commission's objective of improving self-regulation without the significant disruptions that would inevitably result from the shift to a single regulator or a super-regulatory agency. At the same time, this approach would retain one of the key advantages of a competitive environment, namely multiple watchdogs reviewing trading activity.

C. Improved Regulatory Coordination and Harmonization of SRO Rules Can be Achieved Within the Current SRO System

1. Regulatory coordination can be improved within the current SRO system

We agree with the Commission that duplication of regulatory efforts is counterproductive and a waste of scarce resources. To the extent possible, it should be eliminated. As with the problem of regulatory gaps, however, we believe that the solution lies in intermarket coordination, not wholesale restructuring.

The Commission and the securities industry have been concerned about regulatory duplication and overlap since the enactment of the Exchange Act. Certainly, any regulatory scheme should promote the efficient use of limited regulatory resources, by among other things, limiting unnecessary overlap and duplication among self-regulatory organizations. The key, however, is eliminating only that which is duplicative – we should not use the laudable goal of reducing duplication as a pretext for reducing regulatory coverage. To the contrary, the experiences of the past few years demonstrate the need to strengthen the regulatory process.

We recognize that regulators have not always coordinated their efforts effectively. During the past few years, the Commission and other SROs have moved to conducting jointly a larger number of targeted examinations focused on specific areas of concern, such as research, mutual fund sales, hedge funds and underwriting practices. Whereas, in the past, such focuses sometimes resulted in duplicative examinations at each of the firms engaged in these activities, the Commission, NYSE and NASD have developed a coordinated plan of examination that divides responsibility for review

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[7] For example, effective surveillances relating to insider trading, market manipulation and stock or options frontrunning in multiple markets can be hindered because away-market data such as order information, position limit reports and large option position reports (for options) are not available electronically on a real time or near real time basis to the SRO that has generated an alert or flag in the course of its routine surveillance. Consolidating this data in real time or near real time would permit SROs to immediately detect and review all aberrational activity in the multiple market centers, which could significantly deter or prevent the violative conduct. This is just one example of how the Commission's goals in the Concept Release, and the goal of the SROs – improved intermarket surveillance – could be achieved without a radical restructuring of the industry.

of each firm among the regulators, uses the same examination scope and shares findings. This coordinated approach has been well received by the broker-dealers. The harmonization of rules and rule interpretations has assisted in this process.

We have further leveraged this approach in 2005 by identifying a number of areas where we are seeking to share oversight responsibility, including research, anti-money laundering, business continuity, branch office visits, and agreeing with the NASD to divide responsibility for the examinations in these areas. And we are sharing examination scopes and will conduct joint training in appropriate areas. As an example, we recently hosted two days of training on anti-money laundering with approximately 150 participants from the NASD, SEC, AMEX, CBOE, Chicago Stock Exchange, Pacific Stock Exchange, Philadelphia Stock Exchange, and the Department of the Treasury.

To further reduce duplication in the examination process, we are piloting a single documentation request with the NASD for joint examinations. As a result, member firms will not have to respond to duplicative requests or provide the same documents to both regulators. We will also enhance communication between the examiners on-site.

This is only a small sample of the many instances in which SROs have worked to enhance inter-SRO cooperation. These and many other examples of cooperation suggest that coordinated regulation using existing regulatory resources and intermarket structures should be strongly encouraged as a way to eliminate unnecessary duplication and maximize regulatory effectiveness.

Two other existing intermarket structures – the Intermarket Financial Surveillance Group ("IFSG") and the Joint Audit Committee – warrant highlighting here as additional examples of ways in which inter-regulatory coordination has been effective in the past. As with the ISG, we believe they can continue to be effective vehicles for improved intermarket coordination in the future.

The IFSG, which was established in 1989 in response to the 1987 market correction, is an expansion of the individual financial surveillance programs established by SROs in the securities and futures industries. Both industries recognized the need to coordinate their financial monitoring of mutual member broker-dealers across markets and industries. Today, virtually all Commission-registered exchanges and CFTC-registered contract markets meet on a regular basis to coordinate their financial surveillance programs, share information and harmonize their financial rules. The Commission and the CFTC participate in these meetings as observers.

The Joint Audit Committee, which was initially formed in 1979, is made up of representatives of the various CFTC-registered contract markets ("DSROs"). It meets periodically to harmonize financial rules across the futures industry. To avoid duplicative reviews by futures and security industry regulators, a CFTC interpretation permits futures industry DSROs to rely, under certain circumstances, on examination reviews conducted by the securities-side designated examining authority for dual member broker-dealers. The NYSE has long been an active participant and facilitator at these meetings in order to share its examination expertise and to help facilitate this process. In addition, through this same process, the NYSE is able to rely on qualified futures industry counterparts to conduct reviews of futures and/or commodities balances at mutual

member firms. This coordination and sharing of expertise could serve as a model for coordination within the securities industry.

In the end, we believe that multiple regulators can be effectively coordinated to enable the regulators – each with a particularized focus and expertise – to examine firms efficiently; this ensures that "multiple eyes" are watching over the industry. It also means that when gaps in the regulatory scheme are identified, regulators can move quickly – again, with the appropriate expertise and focus – to address those gaps and provide effective oversight.

2. Harmonization of SRO rules can be achieved within the current SRO system and Commission rule-approval process

We agree with the Commission that to the greatest extent possible, exchange and association rules should be harmonized so that industry participants are not unreasonably held hostage to conflicting trading and organizational standards, or to conflicting standards of conduct. But we do not agree that achieving this goal of uniformity either requires, or is best achieved through, radical restructuring of the current SRO system.

Effective regulation does not inherently require that all rules be uniform across the industry. In fact, there may be circumstances in which it is appropriate and necessary to the needs of a marketplace that there be differences among the rules. For this reason, the federal regulatory scheme itself does not require strict uniformity, but rather articulates broad principles of sound regulation, and empowers the Commission to ensure that exchange and association rules adhere to them.

It is the role of the Commission, working with the SROs, to ensure that the rules of each exchange or association are adequate to their purpose; this can and should include consideration of whether the various exchange and association rules are consistent across markets, and not just whether they are consistent with the federally-mandated norms. Significantly, the Commission is empowered to tolerate or permit necessary differences, as well – that is, where multiple regulators are adopting divergent rules on the same subject, the Commission can ensure that the differences are limited to areas in which they are necessary to the various market centers' purposes or operations. In view of this delegation of power from Congress, we believe that the present system provides adequate opportunities for harmonization and differentiation where appropriate.

Recently, the NYSE has been working with other SROs to advance the process of harmonizing rules in areas of common concern, including research, IPOs, roadshows, and business continuity planning, where uniformity is necessary and desirable. In addition to the areas mentioned, we have worked with the NASD to develop a uniform definition of "branch office" and to harmonize rules relating to SIPC disclosures. We have also developed a uniform branch office form and a joint analyst qualification examination.

Of course, we recognize that the existence of differing SRO rules may create opportunities for regulatory arbitrage, and believe that the Commission and the SROs should work together to control or eliminate it, either through improved coordination of regulatory programs, or through

the elimination of such opportunities by better harmonizing the applicable rules between the SROs.

Ultimately, we believe that marketplace rules should be tailored to comport with a market's structure. Moreover, in reviewing the various SROs, the Commission should be guided by the need to ensure consistent obligations and the need to avoid duplicative and/or conflicting rule requirements. We are confident that resolving conflicts and ambiguities among similar SRO rules will lead to more efficient markets, and relieve firms of the burdens of duplication. But we are just as confident that achieving this goal does not require a fundamental reinvention of self-regulation, or worse, its elimination.

D. The NYSE Model Can Adequately Fund Regulation

As the largest market center in terms of the capitalization of its listed companies, and the strength of its member firm organizations, the NYSE is a large, stable, and unique institution. NYSE Regulation has multiple sources of revenue, faces no crisis in adequately funding its regulatory operations, and does not anticipate one, even in years where NYSE revenue from regulatory fees declines as the revenues of member firms decline. All regulatory fees, fines and penalties are devoted to regulation under the current structure of the NYSE, but as regulation supports all business lines, revenues from other fees (including market data revenue, which is the subject of separate comments to the Commission) help fund NYSE Regulation.[8]

The market in listed equities is comparatively unfragmented and the NYSE is not dependent upon new market entrants to fund surveillance of listed equities or products traded on the NYSE. Where intermarket surveillance and coordination of investigations is required, the NYSE has worked well, through the ISG, with other U.S. and international exchanges. In addition, the NYSE has participated in joint sweeps and investigations with one or more other regulators, the Commission and, on occasion, one or more of the 50 state securities commissions, and various prosecutors' offices across the country.

III.
The Proposed Alternatives to the Current SRO Model are Inherently Flawed

Experience teaches us that regulation of the vast and complex securities markets will never be an easy task, but will require that regulation grow commensurately with the industry and markets. As described more fully below, we are concerned that most of the proposals in the Concept Release would create as many problems as they attempt to solve.

Perhaps the most notable flaw in the proposed alternatives to the current SRO system is the implicit suggestion that consolidation of regulation, whether under one or a small number of member SROs or under some form of universal regulator, would somehow improve regulation. As the Commission itself has recognized in the past, there is a substantial benefit to having regulators

[8] As noted in the NYSE's comment letter to the Rule Proposal, the NYSE takes all necessary steps to ensure that business interests will not improperly affect regulatory decision-making. *See* Letter from Mary Yeager, New York Stock Exchange, to Jonathan Katz, dated March 8, 2005, regarding Exch. Act Rel. 34-50699.

located close (organizationally and physically) to the marketplace that they are regulating. The benefits of such an arrangement are many, but include expert familiarity with products traded and strategies employed by market participants in that market, the ability to seamlessly craft regulations that are tailored to the specific marketplace, and the ability to identify problems or abuses earlier than remote, less experienced regulators can.

We have described above some examples of the progress that SROs have made to address conflicts, and to collectively reduce duplication and address regulatory gaps. We have also offered a vision of additional steps that could be taken. If these issues can be addressed while preserving the superior knowledge and expertise of market-based SROs, we believe there is little basis to justify consolidation into a single regulator. In a merger analysis, such a step would only be justified based on synergies or cost savings. From a synergy standpoint, we think it would be counterproductive; any single SRO model inevitably would be unable to sustain each of the particular areas of special expertise that the NYSE, NASD and options exchanges currently possess. From a cost savings standpoint, no one would argue that there should be a reduction of regulatory resources and therefore cost savings, if any, are likely to be insignificant.

In fact, we believe that consolidation of regulatory authority could easily lead to a reduction in the regulatory scope, and that therefore, investors will be better protected by multiple SROs that specialize in their areas of expertise but coordinate efforts in order to reduce regulatory overlap. Some firms may argue that consolidation is an improvement, but public investors expect much more of the securities industry regulators. The public will be better served – and will perceive that it is being better served – by multiple SROs, each of which shares the mission of protecting investors as well as promoting a fair and superior national market system.

Although we believe that none of the proposed alternatives improve on the existing SRO system, the comments below focus on the Member SRO Model and the Independent Regulatory and Market Corporate Subsidiaries Model.

A. <u>The Proposed Member SRO Models</u>

The Commission proposes two models that would split the existing SROs along functional lines into one or more "Member SROs" and "Market SROs". Under either the Single Member Hybrid Model or the Competing Member Hybrid Model (collectively, the "Member SRO" model), the member-firm regulatory functions that are currently carried out by the various SROs would be moved to one or more "Member SROs".

The proposed Member SRO model is based on the flawed assumption that market expertise is important only for surveillance of trading in the market. As discussed below, we believe that the model described by the Commission raises as many problems as it solves, and does not effectively address a number of the issues that the Commission has identified in the Concept Release.

1. The Member SRO model assumes surveillance functions can separated from the rest of regulation

The principal flaw in the Member SRO proposal is the underlying proposition that specialized knowledge about a particular market is necessary only for the surveillance of trading in that market and that market surveillance and member firm examinations are discrete and separable functions. Our experience teaches us that the same specialized knowledge that is an asset to effective market surveillance also informs and enhances both the examination and regulation of member firms, and the vigorous enforcement of member firm rules and market rules. And as our experience with specialist interpositioning drove home, market surveillance without a concomitant compliance effort in the "back office" supported by a coordinated examination program is a recipe for disaster.

One-size-fits-all regulation is not a reasonable or achievable goal in any area of self-regulation. In fact, both the member examination and enforcement programs would be harmed if they were separated from the specialized market expertise of the surveillance departments and from the readily available communication with the technology and market operations departments of the "business" side of the NYSE.

For example, although surveillance of NYSE floor brokers is an important function of the NYSE market surveillance division, we have found it effective (with the Commission's approval) to supplement that surveillance with examinations by the NYSE member firm regulation division, which, in coordination with market surveillance, also examines the books and records of floor brokers during examinations for evidence of possible violations of trading rules. Significantly, the interaction between member firm regulation and market surveillance is not sequential; to improve the examinations (and thereby improve surveillance), the divisions actively coordinate examination scopes and surveillance goals, and engage in joint training. Market surveillance staff, in coordination with member firm regulation staff, perform follow-up reviews of examination findings. Member firm regulation staff data-mine alert findings and trends and actively consult with market surveillance staff in planning examination scopes. This type of integration between market surveillance and member firm regulation would be impossible, or substantially impeded, if the two groups were split between two or more SROs.

The Member SRO model is also flawed because it assumes that member-firm regulation plays no role in the development of new trading platforms and trading rules. In connection with the NYSE's proposed hybrid market initiative, for example, all areas of the NYSE – business and regulatory – have contributed to the drafting and refining of the rules. And while the business side has been primarily responsible for the form and content of the proposed rules, both the market surveillance and member firm regulation divisions have had pivotal roles in ensuring that trading under the proposed rules can be appropriately policed through timely and effective surveillance and examinations. Working groups comprising representatives from member firm regulation and market surveillance have been working diligently to develop new surveillances and complementary examination modules that would capture and evaluate the fast-paced trading of the NYSE Hybrid Market^sm^. Without such extensive and seamless coordination, developing and implementing an initiative as complex as the NYSE's Hybrid Market^sm^ would be difficult, if not impossible.

Finally, separating the regulatory function into "market" and "member" functions may degrade valuable synergies that currently exist between market surveillance and member firm regulation functions, particularly in situations that do not clearly involve just member firm rules or just market rules. A recent example, described below, illustrates this point.

In connection with the implementation of Regulation SHO, the NYSE realized that due to the new short sale restrictions, its specialist firms could be prevented from complying with their obligation to make continuous two-sided markets in specialty securities. Ultimately, a taskforce of regulatory employees from the NYSE's member firm regulation and market surveillance divisions, in consultation with the Commission, devised a process for managing potential Regulation SHO-related disruptions. A number of things about this process are instructive in connection with the Commission's consideration of a hybrid regulatory model:

First, because the short sale restrictions involved aspects of both member firm and market regulation, the situation required a degree of fluid and ongoing collaboration between employees of the NYSE's member firm regulation and market surveillance divisions that would have been difficult to achieve if the two groups had been located within separate regulatory entities.

Second, timely input on the appropriate regulatory and business response was required, often in short time frames, from a broad group of constituents both within and outside the NYSE. Coordinating multiple constituents in a timely manner would have been much more difficult if the member firm regulation and market surveillance functions had themselves been fragmented between two or more regulatory organizations.

Third, resolving the issues presented required that the various participants have a strong working knowledge of the NYSE's trading rules and its member firm rules, particularly as they applied to specialist firms and trading. In addition, the working group benefited from having access to data maintained separately by market surveillance and member firm regulation. It is not clear that this knowledge base could easily be matched in separated regulatory organizations.

Significantly, this type of interaction among the various regulatory divisions of the NYSE is not unusual; similar formal and informal interactions between the various constituent parts of NYSE Regulation occur on a daily basis and regularly enhance the NYSE's regulatory effectiveness. It would be significantly less effective and more inefficient if the functions were split into two or more organizations. Thus, in view of our experience, we are concerned that creating separate regulatory structures, along the lines proposed by the Commission, would have a negative impact on the quality of regulation.

2. The Member SRO model creates as many problems as it solves

In addition to the fundamental flaw described above, we believe that the Member SRO model does not effectively address the issues that the Commission is raising in the Concept Release. To the contrary, we believe that the model creates a number of new problems that would weaken the regulatory oversight of the markets.

The Member SRO model may have the unintended consequence of establishing an entrenched and intransigent bureaucracy that is immune from competitive pressure to innovate or engage in self-improvement. Under the current system, there are very real differences between the various exchanges and associations with respect to how they approach regulation. Membership in multiple exchanges and associations is a voluntary contractual relationship that broker-dealers choose for

reputational advantage and to assist them in servicing their customers. And while withdrawal from membership is relatively infrequent, the fact that it is an option for broker-dealers with multiple memberships impels exchanges and associations to continually improve and reassess their approach to regulation.

We also note that although the Commission proposes a bright-line division between member regulation and market regulation, the reality of SRO regulation is that there is frequent and necessary overlap between "member rules" and "market rules." For example, rules relating to order handling have components that are related to member firm regulation and components that are related to market surveillance; in connection with these areas, both the "Member SRO" and the "Market SRO" could have legitimate interests in the development and maintenance of applicable rules. Similarly, in connection with investigations of trading violations (a market surveillance function), the NYSE routinely examines the quality of supervision by the member firm (a member firm regulation function). As a result, it may not be possible or beneficial to accomplish the bright-line division of labor contemplated by the Member SRO model.

The Member SRO model also fails to address key logistical points about creating a "Member SRO" that is separate from the "Market SROs", such as how widely disparate examination structures would be physically or organizationally integrated; how today's experienced regulatory staffs would be effectively integrated into the new structure without undue loss of expertise and institutional memory; what rules the new SRO would apply; and what precedential value (if any) that interpretations and disciplinary decisions of pre-consolidation SROs would be given. For example:

Merging and integrating existing regulatory staffs: We assume that in any Member SRO model, the existing member-firm regulation staffs from the various exchanges and associations would form the core regulatory staff of the new entity or entities, since practically speaking, there is a finite number of qualified staff who could perform such jobs. This raises a number of logistical and practical considerations, not the least of which is where a membership SRO would be geographically based, and where existing regulatory staff would be located. Currently, the NYSE's division of member firm regulation, which conducts annual financial and operational examinations of most major firm, as well as regular sales practice examinations and special examinations dictated by risk assessment, has a centralized organizational structure that is based in New York. This structure differs substantially from the regulatory program of the NASDR, which is based on a decentralized regional office structure. Similarly, the NYSE rotates its examination staff among member firm offices throughout the country, while each NASD Regional Office generally has responsibility for examining member firm offices within its region. If a Member SRO model were adopted, would the more than 300 NYSE examiners have to relocate to district offices, or would the Member SRO be located in New York? Such a radical combination of examination staffs and geographic consolidation might very well exacerbate the turnover and training expenses of examiners – already a problem for SROs.

Determining what rules would apply: Under the Member SRO model, a newly-created Member SRO would be required to promulgate membership rules, since attempting to draft a completely new set of rules based on "best practices" in the self-regulatory community would be an impossibly complex and unwieldy process that could take years to complete. We assume that those rules would not be fashioned out of whole cloth, but rather would borrow from existing rules. But

this raises a number of concerns about the appropriateness and efficiency of that process. For example, simply adopting the rules of one existing association or exchange would mean that similar rules from other exchanges or associations would be abandoned, without regard to whether those rules are better suited to their purpose than the rule that is being adopted. Similarly, years of accumulated interpretations, knowledge and precedent relating to "discarded" rules would be rendered instantly useless. Moreover, to the extent that the rules of the "prevailing" exchange or association contain shortcomings, those shortcomings would merely be transported to the new Single Member SRO, rather than improved upon.

Duplication of functions: While the Concept Release assumes that there would be no duplication between a Single Member SRO and the various market SROs, the reality is that duplication of certain functions is inevitable.[9] Indeed, this is one of the lessons that may be drawn from the Commission's recent Section 21(a) report criticizing the Nasdaq Stock Market, Inc. and the NASD in connection with violations by MarketXT, an ECN that uses Nasdaq facilities to trade. The NASD's experience with Nasdaq has often been cited as the exemplar for separating markets and regulation. In connection with the MarketXT action, however, the Nasdaq was found not to have properly alerted its regulatory affiliate, NASDR, of certain abuses by MarketXT, and as a result, Nasdaq has undertaken to recreate a regulatory structure within Nasdaq itself, the "Nasdaq Regulation Group". The Nasdaq Regulation Group will have, as a principal part of its responsibilities, "the interpretation of regulatory issues and the communication of information to NASD" – that is, the same type of duplication that the Member SRO model purports to eliminate.

As these examples demonstrate, we believe that the Member SRO model creates as many issues as it resolves with few of the benefits for investors or the strength of the regulatory framework overall.

B. The Independent Regulatory and Market Corporate Subsidiaries Models

The proposed Independent Model, in which regulatory structures would be spun off from markets into independent corporate entities or subsidiaries, arguably is a viable structure, since it preserves many elements of the existing SRO system. Even so, it does not effectively address a number of the issues that the Commission has identified in the Concept Release. These are discussed briefly below:

Reduced expertise: Distancing regulation from the business side of a market would almost inevitably reduce the knowledge and expertise of regulating that market. The further the separation between the market and its primary regulators, the greater the likelihood that the regulator would lose proficiency in its particular market, a factor that has always been a hallmark of efficient securities regulation.

Sharing of regulatory information: Even in the Independent Model, there would need to be controls to guard against improper sharing of regulatory information. A subsidiary regulatory entity necessarily has contacts with the business corporation that requires the sharing of regulatory information. For example, if a market surveillance division is to regulate trading, it will communicate with the trading side of the business. Thus, just as under the existing SRO system,

[9] *See* Exchange Act Rel. No. 34-51163.

the independent subsidiary's market surveillance unit would need controls in place to monitor the sharing of regulatory information.

Business pressure: Entities in the Independent Model would still be subject to the possibility of undue business pressure. As long as there exists a related business entity, the regulatory side, even if structurally an independent corporation, will be subject to similar concerns regarding its motives for regulatory action. NYSE Regulation has long had in place practices that shield it from influence from the business side, which the NYSE reviews and updates as necessary to reflect new developments in the marketplace. The Independent Model would have to compensate for these same pressures because, among other things, the independent entity would still need to be funded by the business entity, and as such, would be subject to influences from its constituents.

Duplication: The Independent Model would require funding for duplicative corporate departments, including finance, human resources, corporate services, and many other functions that are currently shared. This model, with two entities dedicated to the trading market, necessarily has redundancies that are not cost efficient. Such expenses would ultimately be passed on to member firms and investors.

As these examples demonstrate, we believe that the Independent Model, while a viable possible alternative, is by no means a panacea for securities regulation. Similar benefits of independence – a functional separation of business and regulatory interests, independent Board oversight and an independent attitude toward regulation – can and have been achieved within the NYSE model, but without the corresponding costs associated with creating and running an independent entity.

IV.
Conclusion

The regulatory structure of the financial markets in the United States must continue to place the protection of investors as its highest priority. One key element in the unprecedented success of U.S. capital markets has been the ability of markets to innovate and diversify, providing the broadest range of choice to investors and ensuring that the markets benefit from technological change. In our view, the current SRO system, with Commission oversight, best responds to the needs of investors and markets today, and is best equipped to adapt to changes in the future.

Congress, the Commission and the public have been mindful and aware of the conflicts inherent in SRO structures before and after the present federal scheme of regulation was devised in 1934. There is nothing in the management of conflicts or the streamlining of regulation that dictates either that the self-regulatory apparatus of a market center be in a separate corporation – legal separation beyond functional separation – or that the market center be a public or for-profit organization.

In the end, the NYSE's position conforms to the view of many, including past studies by the Commission. In a 1971 staff report, the Commission rejected calls for a universal regulator for the securities markets because a single regulator would be no more efficient or capable than multiple regulators working in conjunction with the Commission:

> A suggestion has been made for the creation of one overall self-regulatory organization. The notion that a single organization could be representative of and a spokesman for the hydra-headed securities community appears to present an oversimplified solution to a very complex sets of facts. The primary reason advanced for creating such a new self-regulatory entity is that it could coordinate the activities of the existing self-regulators, ameliorate differences between them and generally provide unified direction. However, the existing self-regulatory bodies, with direction from the Commission, can achieve as much cohesion and direction as presently organized, as they could through the offices of a parent organization.[10]

The Commission was correct in 1971, and we believe, after careful consideration of alternative models, that the Commission's position remains correct today.

If you have any questions, please feel free to call Regina C. Mysliwiec, Regulation, at (212) 656-4831, or Linda Rich, Government Relations, at (212) 656-8749 or (202) 661-8979.

Sincerely,

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Commissioner Cynthia A. Glassman
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Ms. Annette Nazareth
Mr. Robert L. D. Colby
Mr. Christopher B. Stone

[10] *Study of Unsafe and Unsound Practices of Brokers and Dealers*, Commission Staff Study (December 1971).