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PACIFIC EXCHANGE
STOCK & OPTIONS

S7-40-04

PHILIP D. DEFEO
CHAIRMAN
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VIA OVERNIGHT DELIVERY

March 8, 2005

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

Re: File Nos. S7-39-04 and S7-40-04

Dear Mr. Katz:

The Pacific Exchange ("PCX") is pleased to submit comments on the proposed rules regarding the governance, administration, transparency, and ownership of self-regulatory organizations (SRO's), as well as on the Commission's related Concept Release. As noted in previous correspondence with the Securities and Exchange Commission, the PCX has been proactive in its governance policies and practices. The Exchange believes that sound governance and proactive regulation is in the best interest of public investors and, therefore, in the best interest of our business. We fully intend to remain at the forefront of industry efforts on these issues.

Consistent with our leadership in this area, we support both the overall concept and principles underlying the Commission's proposal, as well as the preponderance of the Commission's specific proposals. This letter reviews the steps the PCX has already taken in this area, identifies the proposals we support, and offers suggestions for strengthening and clarifying others. It also discusses elements of the rule proposals that we cannot support in their current form.

With respect to the Concept Release, most fundamentally we believe the Commission should obtain experience with the rules we hope it will adopt under its proposing release, before it does any further study of the need for more fundamental reform of the SRO system. We do offer, however, a few very preliminary views on some of the ideas that have surfaced in the Concept Release.

I. The Proposing Release

A. The PCX Experience with SRO Governance Changes

The Pacific Exchange has implemented a number of significant governance rules and practices over the past several years. Most of these changes were effective when the Exchange operated as a traditional membership organization, which it had been since its founding in 1882. In 2001, the PCX demutualized its equities business, establishing PCX Equities, Inc. ("PCXE") as a wholly owned subsidiary of the Exchange.

In 2004, the PCX demutualized the balance of its operations, and the Exchange became a wholly owned, for-profit subsidiary of PCX Holdings, Inc. ("PCXH"). Each of the three corporations has a separate board of directors.

B. Extent of Public Representation on Boards and Key Board Committees

Public Representatives on Boards – The PCX was the first exchange with a board composed of 50 percent public members. That standard was retained in the two corporate restructuring initiatives noted above. Six of the nine members of the PCX Holdings Board are public directors. Five of the ten directors of the Pacific Exchange are public, as are five of the 10 directors of PCX Equities. (The Chairman/CEO of each entity is the same, serves on all three boards, and is counted as a non-public director.)

Each board is by charter mandated to include at least 50 percent public directors. At PCXH, the independent directors cannot have a material business relationship with the Exchange or its affiliates, unless as an Options Trading Permit Holder. At PCX and PCXE, public directors cannot be broker-dealers, cannot be affiliated with a broker-dealer firm, and cannot have a material business relationship with the Exchange or any of its affiliates. Thus, the public directors serving on the Pacific boards are truly independent.

Public Representatives on Key Committees – The SEC's proposed rules for SRO governance would apply to several board committees in place at the Exchange and its affiliates. The existing composition of these bodies is described below.

PCX Holdings Committees – The Audit and Compensation Committees currently are composed entirely of public directors. The four-member Nominating Committee has three public directors, as well as the Chairman/CEO.

Pacific Exchange Committees – The Audit and Compensation Committees are composed entirely of public directors. Five of the seven members of the Board Appeals Committee are public directors; two represent trading permit holders, as required by the Commission to fulfill our fair representation mandate.

Our Regulatory Oversight Committee (ROC) was the first of its kind. Established in 1999, it includes all (and only) the public directors of the PCX Board. It meets every Board meeting to review the independence of the regulatory process and the adequacy of regulatory resources, as well as whether management is sufficiently supporting the regulatory staff. It meets with our regulatory staff in executive session, i.e., without the presence of non-regulatory staff or executive management. The ROC insulates our regulatory staff from the business interests of the Exchange and our customers, ensuring that our regulatory efforts are effective and independent.

We believe the governance model developed here over the past several years, in close consultation with the SEC staff, is progressive, sound, and continues to improve. We are particularly pleased that others have adopted the structure of our innovative Regulatory Oversight Committee. We are fortunate to benefit from the time, effort, and commitment of an exceptional group of public directors, who understand full well the importance of their role and responsibilities as guardians of investor interests. The PCX Boards and management are keenly interested in strengthening our governance model and practices even further, and we welcome the SEC proposed rules for the helpful guidance they provide.

C. Specific Comments

1. Commission Proposals Supported by the PCX

We fully support the following elements of the Commission's proposed rule[1]:

a. The requirement that a majority of an SRO's board(s) (including those of its trading facilities and any subsidiaries, hereinafter "SRO Board") be independent directors;
b. The requirement that 20 percent of an SRO Board be selected by members;
c. The requirement that one issuer and one investor representative serve on each SRO Board;
d. The process for nomination of alternative candidates, including the 10 percent petition threshold;
e. The prohibition on statutorily disqualified directors serving on SRO Boards;
f. The requirement that there be executive sessions of independent directors at each SRO Board meeting;
g. The lack of a requirement that the offices of SRO CEO and Chairman be separated;
h. The proposed definition of independence;
i. The requirement to have Audit, Compensation, Nominating, and Regulatory Oversight Committees composed exclusively of independent directors;
j. The elimination of the current requirement to have a member Advisory Committee;
k. The requirement that each disciplinary panel be composed of at least 20 percent members;
l. The required legal or functional separation of regulation from commercial operations;

[1] We have not attempted to specifically list all details regarding these matters, nor have we attempted to list all aspects, major and minor, of the SEC proposal. We, nonetheless, support all these additional aspects of the Commission's proposal, except as noted below.

m. The requirement that a member alone (or with affiliates) owns or votes no more than 20 percent of the interest in an SRO;
n. The elimination of the 40 percent ownership limit on non-members;
o. The requirement that a member owning more than five percent file notice of that ownership with the SEC;
p. The required adoption of Ethics Code and Governance standards;
q. The required self-listing procedures and reporting; and
r. The requirement to keep books and records in the U.S.

In regard to the requirement that 20 percent of an SRO's Board be selected by members, the Commission should make it clear that this requirement may be satisfied by having the nomination of 20 percent of the Directors controlled by members, while allowing SRO's owned by shareholders to have their shareholders elect these nominees. Requiring that members, instead of shareholders, actually vote on the member nominations may be difficult to structure for publicly-held corporations as a legal matter (the types of voting agreements closely-held corporations can and do use for this purpose are, as a practical and probably as a legal matter, not available to publicly-held companies), and, in any event, would be consistent with the intended fair representation purpose, so long as members control the nomination of these directors. We also suggest that the Commission clarify that an SRO that operates multiple markets – e.g., one for options and another for equities – be allowed to allocate these dedicated board seats among or between representatives of the different markets.

We would also suggest that the Commission go beyond its proposal with respect to an SRO's audit and complaint processes. Specifically, we believe that not only is an Audit Committee necessary to ensure appropriate controls over the integrity and independence of regulation, but that an internal audit function should be required as well. In addition to periodically auditing regulatory operations, an SRO's internal auditor should be available and required to serve as an ombudsman, accepting complaints from members, investors, and/or other SRO employees regarding the conduct of regulatory staff – either that violations are not being investigated or that improper motives may be affecting decisions to investigate or not investigate – or other matters that affect the integrity of regulation or other aspects of the operation of the SRO.

Finally, we believe that SRO's should be specifically encouraged to seek to achieve diversity among the members of their boards of directors, in order to more fairly and appropriately represent the diversity of investors our markets serve.

2. Commission Proposals Not Supported by the PCX

a. ROC Reporting and Mandate

The proposal calls for the Chief Regulatory Officer (CRO) to report to the ROC, rather than to the CEO. It defines such a broad mandate for the ROC that it may substantially discourage independent director participation on that body, and will impose costs on SRO's that are not justified by any regulatory benefit that may result. Specifically, we believe the proposal would require the ROC to become the regulatory management Board of the SRO; service on the ROC would become virtually a full-time position. In order to recruit and retain qualified individuals to serve in this critical role, substantial compensation and directors insurance would have to be provided. As proposed, the ROC would effectively usurp the CEO's job with respect to regulation. We believe this is both inefficient – CEO by committee will never be as effective as by an individual – and not as effective, since, by definition, the ROC members cannot be members of the industry and would not have the business insights into the regulation business that an SRO CEO can be expected to have.

The benefit of imposing these increased responsibilities is not at all clear, nor is the need for them. The PCX ROC does not have this type of executive management responsibility. Rather, like an audit committee for regulation, it meets regularly with the CRO, in executive session, to discuss the regulatory program and to ensure that we are providing the resources needed to fulfill our regulatory responsibilities and that regulation is not being interfered with by the CEO or anyone else involved in the commercial aspects of the Exchange. This approach has worked very effectively at the PCX. It has attracted qualified independent directors to our boards and has separated the regulatory function and regulatory decisions from our commercial interests. It has also allowed the CEO to contribute to the regulatory unit's development as a business. We believe that these benefits could be lost under the SEC's proposed ROC mandate. Furthermore, we cannot identify any offsetting benefits for the potential loss and/or increased costs of securing the services of qualified individuals willing to assume the full-time assignment of supervising and directing an SRO regulatory staff.

Therefore, we recommend that the Commission revise its proposal with respect to the ROC's mandate to make it clear that the ROC would not have any management functions – would not in any way be responsible for the day-to-day operations of the regulatory staff or for particular regulatory decisions, either with respect to funding or regulatory actions – and would instead be responsible for ensuring the independence of the regulatory functions, by whatever means it and its Board deem appropriate, including regular executive sessions with the CRO to verify the adequacy of available resources and lack of interference with regulation. Consistent with this, we also recommend that the Commission eliminate the requirement that the CRO report to the ROC instead of the CEO. While the CRO should provide regular executive session reporting to the ROC, and, in this sense, should report to the ROC, we believe the CRO should report to, and be supervised by, the CEO.[2]

We would add that the proposal to have a CRO reporting to a ROC, instead of a CEO, seems particularly troubling for an SRO that has chosen to adopt a legal separation, rather than a functional separation, of regulation from commercial operations. In particular, if an SRO has chosen to legally "ring fence" the regulatory operations from the commercial operations via separately incorporated companies with their own boards, it would be unnecessary to require the regulatory entity's CRO to report only to the board of that entity and not to its CEO, even if that CEO is also the CEO of the SRO's holding company.

b. SRO Transparency

The Pacific Exchange completely supports increased SRO transparency. We believe, however, that much more work needs to be done before any specific regulatory financial disclosure requirements are established. We share the SEC's interest in disclosing appropriate information that can inform and educate market participants about SRO responsibilities and operations. But, as proposed, this initiative may mislead those participants, rather than enlighten them, particularly as the information disclosed is used to compare the regulatory commitments of various market centers.

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[2] We also recommend that the Commission clarify, if it does not eliminate, one other aspect of the ROC proposal, specifically the mandate that the ROC be ultimately responsible for an SRO's disciplinary process. We are not entirely sure what this really means – would it require that the ROC have a call for review opportunity with respect to all settled or litigated decisions? – and in any event we believe it is entirely appropriate for an SRO to have, as does the PCX, a Board Appeals Committee, comprised of a majority of public directors but with OTP and ETP Holder representation, that is ultimately responsible for the disciplinary process including appeals and settlements of individual cases.

Rather than adopt the transparency proposals as written, we instead urge the SEC to direct the SRO's to work together with representatives of the public, Commission staff, and other experts to develop financial disclosure standards and requirements that have a better and more realistic chance of meeting the desired objectives. The Commission could then issue revised transparency standards, using this group's work as it sees fit, that would have benefited from a more careful analysis. There are several reasons behind this recommendation.

The proposed amendments to the procedures for exchange and association registration dealing with audited financial statements include provisions requiring a new, separate, and detailed accounting of market regulation revenue and expenses, the results of which must be publicly disclosed. According to the proposal:

> The proposed disclosure of this information would provide market participants, the public, and the Commission with an understanding of the primary sources of revenue for exchanges and associations and, in particular, would permit the assessment of the relative adequacy of an exchange's or association's expenditures on its regulatory program as a proportion of its overall revenues... (page 66)
>
> [M]arket participants, investors, users of the SRO's facilities, and the public generally, as well as the Commission, would be able to better assess, among other things, the adequacy of resources devoted by an SRO to its regulatory program and the way in which the exchange or association has utilized those resources. The assessment would be useful to the Commission and others in determining whether the exchange or association is meeting its obligations under Sections 6, 15A, and 19 of the Exchange Act, among other statutory provisions, and the rules thereunder and enforcing compliance by its members with the Exchange Act and rules thereunder and the SRO's own rules. (page 68)

Though the compilation, organization, and management of the requested data may not be difficult (albeit expensive), its disclosure and availability will not serve the purposes noted above. The financial statements for an SRO's regulatory activities, while perhaps interesting, do not permit the informed or uninformed to reach a determination that an SRO is funding its regulatory programs sufficiently, operating them effectively, or fulfilling its self-regulatory responsibilities.

One cannot look simply at the resources an SRO devotes to regulation and reach any substantive, meaningful conclusion about the adequacy and effectiveness of its oversight. One cannot assume, because an SRO devotes a certain percent of its revenue to regulation, that it is fulfilling its responsibilities.

If this information had been available several years ago, for example, the income statements for regulatory units of some markets would undoubtedly have been very impressive, at least in terms of the dollars attributed to market oversight. Yet, despite the many millions of dollars these markets devoted to regulation, we now know that they were providing ineffective regulation, particularly of their more important constituents, including specialists and market makers. The financial statements by themselves, therefore, would not have given the Commission, let alone the public, any indication of any regulatory problems or weaknesses at these markets.

There is also danger in comparing SRO regulatory budgets, which will surely follow their disclosure. Some markets could claim that they spend more on market surveillance and oversight than the regional stock exchanges combined, and argue implicitly that they are, therefore, "better" regulated and "better" regulators. But it would be naïve to assume (and clearly contrary to recent events) that, because one SRO spends more on regulation than others, or devotes a greater percentage of its operating budget to regulation than others, it is a "better" regulator, let alone an effective one. Regulatory financial statements disclose only what is spent and how it is accounted for. They do not indicate whether the resources are used effectively, or whether appropriate regulatory systems have been implemented to prevent systemic abuses.

It would also be deceptive to compare the regulatory budgets of one SRO to another without accounting for fundamental differences in market structure at each exchange or association. Fully electronic markets, such as the Archipelago Exchange, are much easier and less costly to regulate than markets that are dependent on manual transaction processes. The rules of an electronic market can be coded into the trading engine, so that the system precludes participants from violating rules. If a rule cannot be broken, the SRO will not incur expenses for surveillance, compliance, or enforcement. In some markets, for example, late trade reports are a common problem. On Archipelago, there are none. If there is a trade, a report is generated automatically. It is a single, seamless transaction. There are no specialists on Archipelago, and, therefore, no issues of professionals trading ahead of public investors or mishandling customer orders.

With fewer opportunities for mischief and miscreants, the cost of regulating an efficient electronic marketplace is much less than the cost of overseeing a traditional trading floor. But one would not see those differences in market structure simply from examining a financial statement or comparing financial statements.

The proposed rule provides no criteria or standards for market participants, the public, and the Commission to apply to the proposed regulatory financial disclosures, in order to assess whether an SRO is using its resources effectively or meeting its obligations in whole or in part. Greater transparency of SRO regulatory activities is a noble objective. The value of this financial information seems questionable, however. In fact, it may cloud, rather than clear, the picture the Commission seeks.

Again, we completely support the Commission's effort to increase SRO transparency. However, because of the fundamental concerns with the specific proposals the Commission has put forth, we believe the Commission should not adopt its proposal, but instead should charge the SRO's, with appropriate input from the public and disclosure experts, with the responsibility to design and recommend transparency standards that would better serve the goal we share with the Commission of educating and informing the public. An initial goal of such a group might be to develop a set of industry-wide measures of resources committed per trade or per violation or per complaint, or other standard ratios, allowing apples-to-apples comparisons of regulatory performance across SRO's, similar to those used in the finance world (e.g., revenue per share ratios) to compare financial performance across companies.

c. OCIE Reports

While we support the required periodic OCIE reports generally, the amount of detail required is not necessary to achieve the desired benefit, and will impose unnecessary costs on the SRO's. Specifically, while we support all the required aggregate statistical reporting, because it will assist OCIE in trend identification and in comparing regulatory effort and focus both within and across SRO's, the additional requirements for summary description of each investigation and enforcement action is unnecessary to this or any purpose, and will make these periodic reports extraordinarily expensive and burdensome to compile.

In addition, the required yearend third-party certification that a trading application is running in accordance with its rules seems unnecessary. In PCX's regulation of Archipelago, we participated directly in the design and application testing of functional changes to the trading engine (including a review of test scripts) that were involved in moving ARCA ECN onto the PCX platform in March 2002. Since then, we have run daily, automated reports to detect potential bugs that indicate the system may not be operating in accordance with certain key rules. For example, where the system is designed to prevent trade-throughs, we run daily reports to detect apparent trade-throughs. While we focus these exception reports only on key rules, not the entire trading algorithm, we believe this is entirely appropriate in view of our front-end testing involvement and because, like other SRO's, under the SEC's Automation Review Policy (ARP), we have periodic independent (in our case, outside audit) application controls and development reviews. Adding to this the extensive costs of an annual third-party review, in the absence of any evidence of the need for such reviews, seems unnecessary and excessive. We do believe, however, that the Commission should require all SRO's that operate (or are responsible for regulating) an automated trading or quoting system to have their regulatory group involved in the design and testing of such systems, both initially and when functional changes are made; to run daily exception reports designed to ensure key components of the trading engine are running consistent with the approved trading rules and algorithm; and to continue to obtain, under the ARP, periodic, independent, application controls reviews.

Additionally, we would note that this aspect of the Commission's proposal seems unfairly to single out automated trading systems for an additional regulatory burden. Interestingly, it seems to us that it is the semi-automated or non-automated systems that have a much harder time ensuring that trading within their markets complies with their rules and intermarket plans and rules.[3] We suggest, therefore, that the Commission consider imposing an annual, outside audit of trading systems' compliance with exchange rules on those exchanges operating on semi- or non-automated systems.

[3] See, e.g., letters from Philip D. DeFeo, CEO, PCX, to John Reed, Chairman, New York Stock Exchange, October 23, 2003, and John Thain, CEO, New York Stock Exchange, January 26, 2004, on trade-throughs of PCX marketplace.

II. The Concept Release

The Commission should obtain experience with whatever reforms it adopts under its proposing release, before it explores the more sweeping reforms discussed in its Concept Release. Adoption of the proposed rules (amended and clarified as noted above) should effectively address the conflicts of interest that may affect an SRO's performance of its regulatory mandate, as described in the Concept Release. We believe the PCX has been at the forefront in addressing these types of conflicts by having already proactively adopted many of the reforms proposed in the Proposing Release.

With that said, let us offer a few preliminary observations on some of the ideas and alternatives discussed in the Concept Release. First, as a very general matter, we believe that, with adoption of the Commission's proposal, the principal remaining concerns, with respect to the SRO system, relate to: (1) the inefficiency of multiple SRO's for member regulation; and (2) the need for market regulators to obtain and use consolidated equity and options market data in their market surveillance.

With respect to the first concern, we preliminarily support the so-called "Hybrid Model" described in the Concept Release. We believe this would make member regulation – as generally and appropriately defined by the Commission in its Concept Release to encompass matters, such as sales practices, margin requirements, financial responsibility, and handling of customer accounts – much more efficient by eliminating the multiple redundant rules and examinations in these areas, and the unnecessarily cumbersome 17d-1 and 17d-3 agreements that have been used to attempt to deal with some of these redundancies.[4] We also believe member regulation should be funded entirely by non-redundant or overlapping member fees, and that the Hybrid Model would allow for easy implementation of this funding approach.

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[4] In this connection we note that it would also be desirable to include in the Hybrid Model insider trading surveillance and investigation. While this is arguably more "market" than "member" regulation, like sales practice, financial responsibility and many other "member regulation" rules, the insider trading rules are the same, regardless of the market. In this sense, insider trading lends itself to surveillance and investigation by one SRO, which can help ensure the consistent application of surveillance and investigative standards, as well as a consolidated view of markets and products in conducting this surveillance. We note that there are ongoing efforts to create a consolidated options market insider trading consortium, and the PCX, to date, has not supported such efforts, in part because the consolidated regulator would be a market competitor of the PCX and the other options markets; would be paid for by the markets rather than by members (thus raising an additional competitive concern); and would not be true consolidated insider trading regulation, because it would be options-market focused. As an alternative, the PCX has proposed to do enhanced insider trading examinations for its options market itself, with Commission funding, given the fact that most insider trading investigations result either in no action or in referrals to the Commission. See letter from Philip D. DeFeo, CEO, Pacific Exchange, to Lori Richards, Director, OCIE, dated August 27, 2004. The PCX acknowledges that this is not an ideal solution either, in part, because the Commission may not be able to fund such an effort without legislation, and, in part, because this would still leave insider trading surveillance fragmented and duplicative. Incorporating insider trading in the Hybrid Model would avoid the competitive, funding, and lack of consolidated view pitfalls of both the consortium approach and the PCX's proposed approach.

With respect to the second concern, we support full and immediate attention of all Intermarket Surveillance Group ("ISG") members to the development and use, in their own individual market surveillance processes, of a consolidated, across markets, equities and options trade, order, and quote audit trail. We believe market regulation should remain with each market, which will always be more knowledgeable about its own trading rules and procedures. We also believe that responsible and effective market surveillance cannot occur without taking into account activity across markets and across products. To take one obvious example, one particular market cannot effectively surveil for possible front-running without looking to see what activity might have occurred in markets other than its own. We believe the ISG markets should be fully responsible for funding the development of such a consolidated audit trail, and for funding whatever development efforts might be necessary to allow their own surveillance systems and databases to receive and use this new, consolidated audit trail information. We do not believe the ISG markets should wait for either the adoption and effective dates of the Proposing Release or further request for comment on the Concept Release to begin these changes. They should be implemented as quickly as possible, without waiting for Commission rulemaking.

As indicated above, our comment on the Concept Release is essentially to wait and see how the rules adopted under the Proposing Release actually work, both to address conflicts of interest and in other respects. Aside from immediate attention to the need for consolidated audit trail, we do not believe any of the other matters discussed in the Concept Release, including the funding issues, either merit or are ripe for Commission rulemaking, prior to experience with the rules the Commission may adopt under the Proposing Release. In this connection, and specifically with reference to the funding and market data issues discussed in the Concept Release, we also note that, under Proposed Regulation NMS, the Commission would amend the market data revenue allocation formula. While we believe there are better ways to amend this formula, as have been suggested in other comments[5], fixing that formula, together with the reforms proposed in the Proposing Release, are the appropriate way to address funding issues and need not and should not also be accompanied by more radical changes to market data fees at this time. Such additional changes could actually have unanticipated effects on the ability of market regulators to adequately fund their surveillance and other market regulation programs, including the consolidated audit trail initiative the PCX hopes will soon begin.

[5] See, e.g., letter from Kevin O'Hara, CLO, Archipelago Holdings, LLC, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated January 24, 2005.

III. Conclusion

With the support and guidance of the Commission, the PCX continues to improve its governance and independent self-regulation. Based upon core principles, such as significant board representation of public directors and the separation of regulatory functions from commercial operations via the Regulatory Oversight Committee, we believe we have in place at the PCX effective, model governance and independence structures. We commend and support the Commission's proposal to improve on that model and ensure that all SRO's operate in conformance to these principles. While certain specific parts of the Commission's proposal should be more narrowly tailored and focused, and adoption of the transparency provisions deferred for further study, with these few exceptions we support and agree with the Commission's proposal in concept and in detail and encourage the Commission to move quickly to adoption. We also encourage the Commission to defer any further action on the more fundamental reforms discussed in the Concept Release, but also are fully committed to working within ISG to develop a fully consolidated audit trail.

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Sincerely,

Philip D. DeFeo
Chairman and Chief Executive Officer

PDD/AA:cy

cc: Annette Nazareth, (SEC) Director, Division of Market Regulation
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