



March 8, 2005

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

Re: Fair Administration and Governance of Self-Regulatory Organizations; File No.

S7-39-04; Release No. 34-51019; 17 CFR Parts 240, 242, 249

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

Dear Mr. Katz:

The Boston Stock Exchange (“BSE” or “Exchange”) appreciates the opportunity to submit its comments in response to the Securities and Exchange Commission’s (“SEC” or “Commission”) Rule Proposal, File No. S7-39-04, entitled: “Fair Administration and Governance of Self-Regulatory Organizations; Disclosure and Regulatory Reporting by Self-Regulatory Organizations; Record Keeping Requirements for Self-Regulatory Organizations; Ownership and Voting Limitations for Members of Self-Regulatory Organizations; Ownership Reporting Requirements for Members of Self-Regulatory Organizations; Listing and Trading of Affiliated Securities by a Self-Regulatory Organization.”

Pro-Active Measures

Over the last two years there has been an unprecedented focus on industry and corporate governance matters as well as our system of self-regulation. While the industry collectively works through and resolves these issues, the Exchange is proud to have taken a leadership role and pro-active steps to address these issues including the: separation of business and regulatory operations; creation of a Chief Regulatory Officer (“CRO”), responsible for all regulatory matters, who reports directly to the Exchange Board of Governors (“BOG”) through its recently formed Regulatory Oversight Committee (“ROC”); creation of a majority of independent members of the BOG; and the increases in representation of independent members of policy-setting committees such as our Audit and Compensation committees. We will continue this leadership role as additional industry best practices are adopted for self-regulatory organizations (“SRO”).

Measured Approach

Self-regulation efforts have been extremely valuable to the SEC and industry over the years, providing frontline surveillance and compliance safeguards not found anywhere else. Although there is a need to address some of these issues and enhance best practices, the Exchange believes the Commission should take a measured approach to changes in SRO governance and best practices. Whatever the final outcome of these proposed measures, the actions taken should be practical from an administrative, regulatory and cost standpoint. The proposed changes are extensive and will involve significant administrative and financial burdens. We also believe that SROs with regulatory mandates, are different and unique trading venues and should not be treated as if they were the same. There is a need for a flexible approach to instituting best practice measures, including the use of some of the traditional corporate best practice measures.

Fair Administration and Governance of SROs

A. SRO Board Structure

The Commission is proposing reforms to the SRO board structure, including the requirement that the entity be comprised of a majority of *independent* directors. The term independent is similar to what is required for publicly traded companies under Sarbanes Oxley – an individual that has no material relationship with the SRO, any member of the SRO or an issuer listed on the SRO.

The Exchange fully supports this general proposition – that a majority of the SRO board be independent of its members. However, we believe that there should be practical considerations taken into account when defining the restrictions of an “independent” director. SROs perform dual capacities - operating market centers and performing regulatory oversight in a highly technical and complex industry – and require input of knowledgeable management, board and committees. They act as a quasi-public entity responsible for oversight of the market and its participants. SRO boards are charged with ultimate oversight of this very technical and complicated entity and industry – one that few individuals in the “independent” business world, as defined in the Rule Proposal, have had experience. Taking into account the unique nature of the entity and the SRO board’s charge, it is important that informed individuals are serving on the Board. It is important to the soundness of the SRO that board members and certain of the policy-setting committees have not only an understanding of general best practices but also of the industry as well.

Keeping in mind the talents required to ensure the board is effective and responsive to its regulatory mandate, the limited number of qualified individuals with knowledge of and experience, and the current general atmosphere that has limited the number of individuals willing to serve on SRO boards, it is important that SROs be allowed flexibility in determining what individual would qualify as independent. For example, a board member that is employed by a listed company, should not automatically be disqualified from being considered as independent solely because of his or her employment status –

absent the presence of material conflicts that would lead to disqualification. Similarly, there may be certain members of the Exchange that are members but do not transact business on the Exchange - there should not be an automatic disqualification solely because of his or her membership status.

We agree that the board should be comprised of a majority of independent members, but the Commission should allow the SROs to make “independence” determinations that will ultimately accomplish the stated goal of a strong SRO board. There should not be “bright line tests” instituted to determine independence of SRO board and committee members, because of the material differences between SROs and the likely consequence of precluding qualified candidates that did not comply under these narrow requirements. If practical guidelines are enumerated, the SRO could make independence decisions based on a combination of these guidelines and use of good corporate governance practices. Such determinations could be subject to regular SEC oversight. Absent this ability, SROs will find it increasingly difficult to secure board members that understand the industry, the SRO and the regulatory and business issues that arise.

B. Policy-Setting Committees

The Commission’s Rule Proposal would require SRO policy-setting committees to be comprised of fully independent directors. The committees that the SEC is proposing include: Audit, Compensation, Governance, Nominating and Regulatory Oversight.

The Exchange remains concerned that the “independent” requirement, as defined in the Rule Proposal, would have a negative impact on the effectiveness of some of these committees, from a practical, cost and regulatory perspective.

The trend in the size of SRO boards is toward a smaller entity that can maximize performance and be more engaged than a larger, unwieldy body. The pool of board candidates that would qualify under the proposed definition, particularly under the current environment of corporate mistrust and increased responsibility of board members, would be reduced significantly for SROs. The limited number of candidates qualified to represent the BSE as independent members on its board and/or any of the five proposed policy-setting committees would make serving extremely difficult and demanding.

Generally, such individuals are carving out a portion of his or her full-time responsibilities to commit to multiple tasks of an SRO board or policy-setting committee. Practically speaking it would be difficult to conceive that level of participation from even the most committed board or policy-setting committee member.

The Exchange has also performed a preliminary analysis of the costs involved, if required, to limit participation on policy-setting committees to independent board members. Contrary to what has been stated in the Release, the costs would be significant on SROs – including increased director and officer insurance coverage, additional compensation for individuals because of the need for greater commitments of time and effort, as well as the related staff reporting and record keeping requirements. Keeping

in mind that all SROs are not the same, the quasi-public nature of the entities, and the fact that some operate at a breakeven level, we are expecting a material financial strain on some SROs in their attempts to meet all of the proposed SEC requirements.

There are certain regulatory concerns to consider as well. The Regulatory Oversight Committee (ROC), responsible for assuring the adequacy and effectiveness of an SRO's regulatory programs, the regulatory plan, the CRO's performance, and assuring hearings are conducted properly, among others, is the primary overseer of a SRO's regulatory program. Currently the Exchange's ROC consists of a majority of independent members. If the Rule Proposal requires a totally independent committee, it is difficult to conceive how such individuals, with limited understanding of the industry, SRO structure and complex regulatory matters, would be able to understand and evaluate whether the BSE's regulatory mandate is being met.

There is a need to provide flexibility to the Exchange to determine the qualifications of independent members, appropriately document the independence determination for SEC review and to address conflicts in a corporate best practice manner – including recusal from discussions in which a conflict exists. The SROs should not be required to populate these committees (Compensation, Governance, Nominating, Regulatory Oversight) with totally independent members. We must be able to provide institutional knowledge of the markets and its operations at the highest possible level of understanding and experience. A majority of independent representation would maintain sufficient

safeguards with clear conflict of interest procedures, to ensure fair administration of policy matters. Absent such experience, the unintended consequence of a loss of an effective oversight program exists.

C. Separation of Regulatory and Market Operations

The Commission's Rule Proposal would require SROs to separate regulatory and business functions and require funds received from regulatory fines to be used for purely regulatory purposes. The proposal calls for the creation of a CRO position to report directly to the SRO board through the ROC.

The Exchange has been pro-active in its governance effort and created a CRO and ROC, during 2004.

We believe that this separation is important from a corporate governance and regulatory perspective, but it raises additional concerns in the process. First, we reiterate our concern for a requirement of totally independent members comprising the ROC. Due to the nature of the items discussed and the committee's charge, it is important to maintain industry expertise and representation (e.g. majority independent). Secondly, we refer specifically to the recent Section 21(a) report (Release No. 34-51163, February 9, 2005). In this report the Commission criticized a market center that operates its business and regulatory entities separately for failure of the business entity to assist the regulatory entity in carrying out its SRO duties. A concern that has been raised, is that if the

regulatory and business entities are separate and distinct, conflicts may be avoided.

However, regulatory oversight could be negatively affected because of the potential for a total disconnect between the business and regulatory entity. There is support in this fact scenario, for both a majority independent ROC, as well as for regulation by the “local cops on the beat” – those that are close to the market centers that can detect violations and take appropriate action.

As traditional SRO models adapt to a rapidly changing industry, the SRO should have some flexibility in the use of regulatory fines. For example, as the Exchange moves toward an all-electronic format, our regulatory oversight is changing as well – from taking action after a violation has occurred to functionally building our rules and regulations into our trading system to preclude such violations from occurring. A good example of such progress is the changes the Exchange has made to its system over the last year that restrict the ability of a firm to trade ahead. The SRO that is proactively regulating its market via its trading system should not be precluded from applying regulatory fines to enhance its trading system for these purposes. Again, guidelines would be more prudent than any bright line test.

D. Separation of Chairman and CEO

The Commission’s Rule Proposal states that it is not required that an exchange Chairman be an independent director in all circumstances, but if the exchange CEO is not also the Chairman, the Chairman must be an independent director. It states that if the CEO and

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Chairman are the same individual, then that person would be prohibited from participating in any executive sessions of the board and from serving on the Standing Committees (policy-setting committees). Finally the Proposal states that if the CEO and the Chairman are the same individual, the board would be required to designate an independent director as a “lead director” to preside over executive sessions of the board.

Through 2004, the Exchange, continuing its pro-active governance measures, separated its chairman and CEO positions. However, with its subsequent separation of business and regulatory operations, creation of a CRO position and ROC, and recent executive transition, the Exchange believes that the separation of business and regulatory operations is the key governance transaction.

The Exchange wishes to reiterate its support of the proposition that, while it is important from a governance standpoint to separate business and regulatory operations, there is not a need in all circumstances for the separation of the chairman and CEO positions. The establishment of a CRO reporting directly to an SRO board through the ROC is the appropriate solution. In addition, we believe that corporate best practices, including the chairman/CEO recusing himself or herself from discussions when necessary, can avoid any concerns with having one person serving in both capacities. We also have serious concerns about the restriction of an individual, serving in both chairman and CEO capacities, from participating in Standing Committees. Exchanges are a combination of a business and regulatory entity and although the combined chairman/CEO individual

would not participate as a committee member, he or she could provide valuable input into the Standing Committees, including Audit, Compensation, Governance, Nominating and ROC. He or she should be allowed to participate, when prudent and appropriate, due to his overall responsibility for the SRO. For example, the Exchange Audit Committee is charged with not only the review of the Exchange's financial statements but also the internal audit program of the SRO. If the Chairman/CEO was not allowed to participate in the internal audit program discussion, there could be a breakdown between deficiencies identified and actions taken to resolve open matters. Again, guidelines and standard corporate best practices, not bright line tests, would be the appropriate manner in which to address conflicts in these situations.

Disclosure By SROs

A. Form 1 and Form 2

The Commission's Rule Proposal would require SROs to amend their annual registration forms to provide additional information, including content relating to governance, regulatory programs, finance, ownership structure, etc For example, the Commission is requesting comprehensive information on SROs regulatory programs, material changes planned for regulatory programs, disclosure of material regulatory issues or events, a list of expenses related to regulation and sources of revenue, among others. The Commission is also requesting more frequent updating of this information as well as posting on the SRO website.

The Exchange is primarily concerned that the documents filed are public information.

We understand the request to provide information to the SEC for regulatory purposes, but do not agree with the public availability of this information for a number of reasons.

First, from a competitive point of view, the availability of such information could be detrimental to both the business and regulatory operations of an SRO, if such information was available to other market centers. Second, such information would be of a technical nature that could be subject to misinterpretation. Third, the administrative burden and associated costs to meet these requirements would far outweigh the benefit to the public.

We are requesting that such information be subject to SEC review only. We are also seeking clarification as to whether such standardized forms would minimize the need for ad hoc requests from the Commission. It is important that the appropriate balance between responding to requests for information and performing its regulatory function be met.

B. Quarterly, Annual, Interim Reports

The Commission is proposing to adopt new reports that would provide confidential information to the SEC on SRO regulatory programs. The Quarterly Report would require submission of complaints, investigations, examinations results and a summary of investigations. The Annual Report would require the filing of a report of an independent audit to determine whether an electronic SRO trading facility complied with SRO trading rules, a discussion of internal policies and procedures for regulatory programs, evaluation of the SRO regulatory program, and discussion of internal controls, among others.

Finally, Interim Reports would require the filing, within ten days after a material change to the regulatory program or department.

The Exchange believes that the increased costs, administrative burden to comply with these additional requirements and its overall regulation of the market would be much too great in order to run effectively. For example, the Rule Proposal recommends that every SRO that owns or operates an electronic SRO trading facility, submit an annual audit report of an independent third party that assesses whether the operations of the electronic SRO trading facility comply with the rules governing the facility. The Rule Proposal states that the independent third party would include a party not affiliated with the SRO that is qualified to render such opinion. Such parties would likely be limited to the hiring of outside legal or accounting counsel, other than the accountants and outside counsel currently used by the SRO, to perform this costly and time consuming process. It would seem more reasonable, if this process were ultimately required, to use the services of the ROC to perform the audit. There must be a balance between the need to provide information for oversight purposes, costs and performing the tasks that an SRO is charged including, regulatory review and enforcement of rules and regulations.

Conclusion

The Exchange remains committed to its regulatory mandate and has taken steps to proactively enhance governance and best practices. However, we urge the Commission to take a measured approach to these matters, taking into account costs, administrative

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burdens, practicality of instituting these recommended changes as well as the unintended consequences and ultimate benefits that could be gained from these recommendations. If you have any questions do not hesitate to contact me or John Boese, Chief Regulatory Officer.

Sincerely,

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