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March 9, 2005

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

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

Dear Mr. Katz:

The Securities Industry Association[1] ("SIA") appreciates the opportunity to comment on the Securities and Exchange Commission's ("SEC" or "Commission") Self-Regulatory Organization ("SRO") Governance and Transparency Proposal ("SRO Rulemaking")[2] and its Concept Release Concerning Self-Regulation ("Concept Release")[3] under the Securities Exchange Act of 1934 ("Exchange Act"). SIA commends the Commission and its Staff for their efforts to engage market participants in this dialogue about the complex issues concerning self-regulation. The SRO Rulemaking and Concept Release provide SIA with the valuable opportunity to comment on self-regulatory issues that are critically important to public investors, SIA's membership and the securities industry overall.

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[1] The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. At its core is our Commitment to Clarity, a commitment to openness and understanding as the guiding principles for all interactions between investors and the firms that serve them. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry employs 790,600 individuals, and its personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated $213 billion in domestic revenues and an estimated $283 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

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

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

I. Executive Summary

Any analysis of reforming self-regulation should begin by considering the ultimate goal of self-regulation, and then assessing how best to reach that goal. We believe self-regulatory reform should seek to achieve goals that accentuate the key benefits of self-regulation, while addressing its shortcomings. These benefits include:

- Bringing the expertise of industry professionals to bear on complex issues;
- Applying standards of just and equitable principles of trade; and
- Supplementing the resources of the SEC.

The shortcomings of self-regulation as currently practiced include:

- Duplicative and sometimes inconsistent regulation and examination by multiple SROs, resulting in the inefficient use of compliance resources; and
- Instances of conflicts of interest between, *inter alia*, an SRO's regulatory functions and its business interests or the business interests of its members.

The best way to realize the benefits of self-regulation while addressing its shortcomings is twofold: (i) preserve the "self" in self-regulation, and (ii) eliminate the duplication, inefficiencies, and conflicts of interest that abound with multiple SROs that both regulate broker-dealers and operate markets. SRO governance reform and the future structure of self-regulation are not separate topics, but are in fact inextricably linked. Both should be driven by a vision of a system of self-regulation that is optimal for investors and for the markets. Here is our vision of what that system should look like, in the near future:

1. We believe that the Hybrid model described in the Concept Release offers the best structure for minimizing regulatory duplication, addressing conflicts of interest, and maintaining the prominence of the U.S. capital markets globally. Under this model, self-regulation should be embodied in two types of organizations, divided by function. Each marketplace would have its own SRO, which would regulate and enforce all aspects of trading and markets, as well as listing requirements. The other type of organization would be a Single Member SRO that would handle regulations relating to the operations of broker-dealers (sales practice, financial responsibility requirements, qualification of personnel, recordkeeping, etc.).

2. The SEC, aided by rules providing for increased transparency, would be in a position to ensure appropriate delineation of responsibility, and to ensure there are no gaps in regulation, as between the marketplace SROs and the Single Member

SRO. For example, the SEC would be actively involved in reviewing and commenting on the regulatory budget for each SRO, particularly for the Single Member SRO. Each SRO also would have SEC reporting requirements along the lines proposed in the SRO Rulemaking release.

3. To ensure that the SROs are appropriately funded, the Single Member SRO would obtain a substantial portion of its funding through membership and regulatory fees. Market data fees would no longer be used to fund regulation. The marketplace SROs would assess trading and listing fees, both to fund their own operations and to partially fund the Single Member SRO. The SEC would oversee the funding mechanisms of the SROs to ensure that they are applied in a nondiscriminatory manner, and that they fairly apportion the cost of regulation among market participants. We recognize that member firms may have to pay increased regulatory fees – the industry is willing to pay for the benefits of a more efficient and transparent self-regulatory system.

To strike an appropriate balance between the benefits of independent Board of Director ("Board") member perspectives and member expertise, and to achieve a regulatory structure that is more consistent with the Exchange Act and the underlying bases for self-regulation, we recommend that virtually all Board committees be comprised of a simple majority of independent directors and substantial direct member representation. Direct member representation on committees that address SRO governance, rulemaking, disciplinary, and funding-related issues will be particularly important in managing potential issues associated with the concentration of power and authority in a Single Member SRO under a Hybrid self-regulatory model.

II. SIA's View of the Status of Self-Regulation and SRO Governance

The legitimacy of today's self-regulatory governance is directly related to member involvement in the process.[4] As the Commission is well aware, the genesis of self-regulation was a combination of practical concerns and the political climate of the 1930s. After balancing the pros and cons of various regulatory schemes, Congress concluded that, despite the inherent conflicts presented by an industry regulating itself, self-regulation was the best approach. The legislators emphasized the value of industry experience and resources in the regulation of the industry. In later reaffirming its endorsement of self-regulation, Congress believed that any conflicts of interest created by this structure could be controlled by SEC oversight.[5] The

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[4] *See generally* S. Rep. No. 94-75, at 22 (1975) (*accompanying* S. 249, 94th Cong., 1st Sess. (1975)) ("In enacting the Exchange Act, Congress balanced the limitation and dangers of permitting the securities industry to regulate itself against 'the sheer ineffectiveness of attempting to assure [regulation] directly through the government on a wide scale.'"); SEC Report of Special Study of Securities Markets, H.R. Doc. No. 88-95, Part 4 (1963) ("Special Study").

[5] *See* S. Rep No. 94-75, at 29-30 (1975) (*accompanying* S. 249, 94th Cong., 1st Sess. (1975)).

Commission also has noted that "[n]otwithstanding the inherent potential for self-regulation to favor the interests of the securities industry over those of the investing public, self-regulation "has been viewed as having certain advantages over direct governmental regulation" because "[i]ndustry participants bring to bear expertise and intimate knowledge of the complexities of the securities industry."[6] SROs also "supplement[] the resources of the government and reduce[] the need for large government bureaucracies" and "can adopt and enforce compliance with ethical standards beyond those required by law."[7]

While we acknowledge the shortcomings of self-regulation, this approach to regulation – and the historical level of member involvement in particular – generally has been successful in protecting investors. For example, member expertise and involvement in SRO rulemaking processes, in our view, clearly has led to more effective SRO rules than otherwise would have been the case. Although SIA welcomes the Commission's efforts to improve the self-regulatory process in an ever-changing regulatory environment, we are concerned that if the SEC moves toward a structure that relies on professional SRO staff devoid of member involvement it will deprive SROs of the industry expertise and guidance that is at the root of their own legitimacy as self-regulators. SIA is deeply worried that independent governance is being purchased at the cost of expertise and fairness.[8] In sum, we maintain that the combination of true self-regulation, characterized by meaningful member involvement, and Commission oversight works, and works well, for the investing public, SRO members, and the U.S. capital markets overall.

Consequently, any changes to the current system of self-regulation must be consistent with the Congressionally-mandated balance between Commission oversight and regulation guided, in part, by the direct involvement of industry participants in SRO and market functions. This balance stresses the importance of public participation in SRO decision-making processes at the same time that it reflects a healthy skepticism of attempts to force all SROs into the same decision-making model without member participation.[9] SIA urges the Commission to approach its proposed changes to self-regulation with this balance in mind.

SRO governance reform also should not be considered in a vacuum apart from broader structural reform. The two issues are closely linked. Maintaining an adequate level of member involvement is not just a statutory requirement, it also is a necessary functional precondition to structural reform. The most plausible structural reform models laid out in the SEC's Concept Release, including the Hybrid model (which we strongly favor, as discussed below), and the

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[6] Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Stock Market (Aug. 8, 1996), *available at* http://www.sec.gov/litigation/investreports.shtml.

[7] *Id.*

[8] *See* SIA, *Reinventing Self-Regulation: White Paper for the Security Industry Association's Ad Hoc Committee on Regulatory Implications of De-Mutualization* (Jan. 5, 2000 *updated* Oct. 14, 2003), *available at* http://www.sia.com/market_structure/html/siawhitepaperfinal.htm ("White Paper").

[9] *See* S. Rep. No. 94-75, at 29 (1975) (*accompanying* S. 249, 94th Cong., 1st Sess. (1975)).

Universal Industry Self-Regulator, will require strong member involvement in order to succeed. If member involvement in SRO governance is largely eviscerated before the SEC moves to consider SRO structural reform, the Commission effectively will have left itself few options for meaningful structural reform other than to eliminate the vestiges of self-regulation entirely and internalize the regulatory function of SROs within the SEC.

III. SRO Governance and Transparency Rulemaking Proposals

A. Members Should be More Involved in SRO Governance and Rulemaking.

SIA strongly believes that if members are removed from the decision-making and general governance processes of SROs, the SROs will lose the very valuable benefit of member market experience and knowledge. Member involvement will allow a Board and its committees to assess the feasibility and effectiveness of proposed policymaking and rulemaking early in the decision-making process. Such involvement will minimize the time and resources spent in pursuing rules or policies that, because they are prohibitively costly or otherwise have a significant negative impact on firms and the markets, are not practicable. Given the unprecedented pace of change in the structure of the capital markets, member involvement is essential for SROs to ensure the continued growth and success of the markets while they design rules that achieve regulatory policy goals and encourage investor confidence. Those within the industry best understand which rules will increase transparency and liquidity while deterring undesirable behavior. In addition, members should be involved in SRO governance and rulemaking because those processes both directly impact and are funded by SRO members.

We also believe that the exclusion of members from, or even significant limitations on their participation in, the self-regulatory process runs counter to the basic requirements of the Exchange Act. For example, excluding members from governance and rulemaking determinations is contrary to the Exchange Act's fair representation requirement, which requires the fair representation of an SRO's members in the selection of its directors and administration of its affairs. This language was designed to ensure members "reasonable representation in all phases" of an SRO's operations,[10] not to transform SRO governing bodies into predominantly public forums. The SEC has recognized this aim in the past,[11] and Congress affirmed this determination by expressly eliminating a legislative provision that would have required SROs to increase dramatically public representation on their Boards.[12] The "fair representation"

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[10] S. Rep. No. 75-1455, at 7 (1938) (*accompanying* S. 3255, 75th Cong., 3d Sess. (1938)); H.R. Rep. No. 75-2307, at 7 (1938) (*accompanying* S. 3255, 75th Cong., 3d Sess. (1938)).

[11] *See, e.g.*, Special Study at 610 (stating that the SEC and NASD interpreted fair representation to mean consideration of various member attributes including size of firm and kind of business).

[12] *See* H.R. Rep. No. 94-229, at 98 (1975) (*accompanying* S. 249, 94th Cong., 1st Sess. (1975)). For the House of Representative's proposed provision, see H.R. Rep. No. 94-123, at 15 (1975) (*accompanying* H.R. 4111, 94th Cong. 1st Sess. (1975)).

requirement serves to protect member participation, not to mandate exclusive public representation on key components of the governing bodies of SROs.

In addition, removing members from SRO governance processes weakens the legitimacy of SROs enforcing "just and equitable principles of trade" under the Exchange Act.[13] "J&E" principles are, in many ways, at the core of SRO rules, encompassing not only those actions that are specifically proscribed by rule, but also imposing accountability on member firms even for practices that are not specifically addressed by rule, but which nonetheless are inconsistent with the industry's notions of fundamental fairness – whether to customers or competing firms – and professionalism.[14] By definition, these higher ethical standards are justified only by virtue of the fact that they are imposed on members by SROs informed by the collective views and experience of industry members as to what is appropriate conduct within the trade. Simply put, if members have no meaningful involvement in SRO governance, the basis and legitimacy of just and equitable principles of trade no longer exists. Congress' inclusion of these principles in the Exchange Act adds further support for the need for continued active member participation in the governance of SROs.

The absence of member involvement in SRO governance not only undermines just and equitable principles of trade, in our view it also raises more fundamental issues about whether SROs operating under such circumstances should continue to be viewed as outside legal requirements applicable to government actors. Specifically, SROs operating under the detailed rules set forth in the SRO Rulemaking and without meaningful member input may be effectively viewed as agents of the SEC. Under such circumstances, it would be entirely appropriate to conclude that protections and requirements of the Administrative Procedures Act, Paperwork Reduction Act, Government in the Sunshine Act, and Freedom of Information Act, among other federal statutes and rules, should be afforded to SRO members.

1. Member Involvement on Committees.

SIA believes the SRO Rulemaking goes too far in prohibiting any member involvement on each of the key SRO committees – the Nominating, Governance, Compensation, Audit, and Regulatory Oversight Committees ("ROC") – and instead requiring that all members of such committees be "independent directors." With the exception of the Compensation Committee,[15]

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[13] *See* Exchange Act §§ 6(b)(5), 15A(b)(6).

[14] *See* S. Rep. No. 75-1455, at 3 (1938) (*accompanying* S. 3255, 75th Cong., 3d Sess. (1938)); S. Rep. No. 94-75 (1975) (*accompanying* S. 249, 94th Cong., 1st Sess. (1975)).

[15] The recent controversy surrounding the NYSE's compensation arrangements illustrates the need for independence on the Compensation Committee. *See, e.g.*, NYSE Press Release, NYSE Board Asks SEC and NYS Attorney General to Pursue Webb Report Findings of Unreasonable Compensation of Grasso (Jan. 8, 2004); Landon Thomas, Jr., and Jenny Anderson, Report Details Huge Pay Deal Grasso Set Up, New York Times, Feb. 3, 2005, *available at* 2005 WLNR 1474921.

we believe that members should have representation on each of these Standing Committees.[16] We are particularly perplexed at the proposal to deny any membership representation on the ROC.

In order to provide robust regulatory oversight, an ROC must have a thorough and detailed understanding of how the markets function, how broker-dealers operate, strategies and motivations for trading, and the effect that rulemaking and other regulatory decisions will have on market participants. The ROC will be responsible for the regular monitoring and review of an SRO's surveillance unit, for instance.[17] To effectively discharge these duties, the ROC first must have the benefit of member experience and direct involvement in the promulgation of SRO rules.[18] To rely solely on a professional staff or independent directors in rulemaking simply leaves too much on the table; in this case the varying perspectives and experiences of industry participants that, when mixed with the views of securities regulators and the investing public, yield effective and efficient SRO rules.

Similarly, the ROC must understand the trading activities of the members of an SRO and the potential for abuse based on these activities, as well as the SRO's surveillance capabilities and resources. Who better than members will have the firsthand experience and knowledge instrumental to understanding these trading strategies, their potential effects, and the likely impact that the ROC's decisions will have on such strategies? Member input is essential to the ROC's effective oversight of the markets.

Furthermore, SIA is concerned that without direct member participation on its Standing Committees, an SRO's reliance on its professional staff may not produce the most efficient or effective decision-making. The knowledge and experience members can provide through their involvement on committees will allow more targeted and streamlined decision-making because members can better assess the potential impact an SRO's decisions may have earlier in the process. SIA also is concerned that an SRO's sole reliance on professional staff, without

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[16] Members have an interest in the affairs of each of these committees. For example, the Audit Committee will be responsible for, among other items, determining the budget of the internal audit department and overseeing financial statement compliance with legal and regulatory requirements. And one of the Governance Committee's duties will be to develop a set of governance principles for the SRO. Members, who are responsible for the detailed analysis necessary to determine financial compliance and budgeting needs and who engage in the practical strategic assessments necessary to develop effective governance principles for their own business activities, have the skills these committees require. In addition, as entities regulated by the SROs, members are familiar with the issues particular to SRO oversight. Similarly, member understanding of how SROs function and the sort of unique needs they possess also is necessary for the Nominating Committee to identify individuals who will best serve the SRO as directors.

[17] *See* proposed Rule 6a-5(j)(2) and proposed Rule 15Aa-3(j)(2).

[18] The extent to which the ROC will be directly involved in SRO rulemaking is unclear to us. While the SRO Rulemaking contemplates some role for members in providing advice as to trading rules, the proposing release clearly indicates that any SRO committee that includes members will be required to report to the independent ROC. SRO Rulemaking at 71140.

industry involvement, would deprive SROs of the full benefits of collaborative and innovative approaches to regulatory issues. Direct member involvement on key committees can continually revitalize SRO thinking about capital markets.

We note that the SEC's proposal allows members to continue to participate on SRO advisory committees. SIA believes that such SRO advisory committees can serve a useful purpose in providing member input in areas that require particularly specialized product knowledge or expertise, and we endorse their use for that purpose. Member involvement on advisory committees, however, does not substitute for participation on Standing Committees that are directly involved with the execution of key SRO functions.

In light of the benefits direct member participation can offer, SIA proposes that the SEC replace the 100% independence requirement for SRO Standing Committees with a requirement for majority independence. A simple majority rule for Standing Committees would safeguard against concerns about member dominance and impartial decision-making, while allowing the Committees to profit directly from significant and relevant member experience. Requiring such majority votes would allow members to offer valuable experience and knowledge directly to the process while further safeguarding the integrity of Committee decisions on specified matters by ensuring critical agreement by a majority of the independent directors.[19]

2. Member Involvement in Decision-Making on Specific Issues.

In addition to member representation in the governance structure of the SROs, members should participate actively in other important decision-making at the SROs. For example, members should be actively involved in overseeing the budgeting and revenue-raising processes. Members contribute a large portion of SRO revenue through membership and trade activity fees. Because members account for so much of an SRO's revenue, it is both appropriate and necessary that members participate in decisions regarding the use and allocation of those funds. In addition, members can act as a check on excessive fees and overblown budgeting demands without raising the concern that they will impair an SRO's governance practices. If Standing Committees and the Board are comprised of a majority of independent directors, members will not dominate the process so that regulatory funding needs, for example, will not be compromised.

The SEC has proposed a rule requiring SROs to provide for at least 20% member involvement on non-standing committees that are responsible for providing advice with respect

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[19] We believe that a similar balance of different perspectives is important for the operating committees of the joint industry market data plans ("Plans"). Currently, such operating committees consist solely of representatives from the SROs. As a result, no broker-dealer, independent or other views are included in the Plans' decision-making processes. We do not believe that the SEC's proposed non-voting, non-binding advisory committee is the appropriate answer to the Plan governance issues. In contrast, we recommend that the SEC broaden the composition of the Plan operating committees to include broker-dealer, vendor and independent representation. *See* Letter from Marc Lackritz, President, SIA, to Jonathan Katz, Secretary, SEC (Feb. 1, 2005), *available at* http://www.sia.com/2005_comment_letters/4601.pdf ("Regulation NMS Letter").

to a trading or disciplinary rule.[20] As noted above, it is critical that members have direct involvement with the promulgation of all SRO rules, including rulemaking concerning sales and operational practices, as well as conduct rules that affect trading and disciplinary issues. In addition, SIA is concerned that the 20% minimum proposed by the Commission will become the default level of member participation. Instead, SIA recommends that the SEC require SROs to maintain an appropriate level of member involvement on non-standing committees without specifying a percentage.

SIA appreciates the SEC's efforts to involve members in disciplinary matters through its proposed rule requiring that at least 20% of the members of any committee, subcommittee, or panel responsible for conducting hearings, rendering decisions, and imposing sanctions concerning disciplinary matters must be members of the SRO.[21] We are concerned, however, that the fully independent ROC retains final jurisdiction over any such committee, subcommittee, or panel.[22] Excluding members from the disciplinary decision-making process by retaining final determinative power in an ROC composed entirely of independent directors denies members the assurance that experienced input, judgment and fairness will be factors in the ROC's final disciplinary decisions.

3. Member Ownership and Voting.

On a related point, SIA believes the SEC's proposed 20% ownership and voting restriction that would be imposed on members and their related persons may be unnecessary given the enhanced role in SRO governance the SEC would give to independent directors. Such a restriction also may be less important if a member with an ownership interest in an SRO is subject to the primary oversight of an unaffiliated SRO. As a result, SIA recommends that ownership and voting interest determinations be left to the discretion of SROs rather than be subject to the wholesale limitations proposed in the SRO Rulemaking.

B. The Proposed Definition of Independence May Eliminate Too Many Experienced and Knowledgeable Candidates.

In conjunction with increased member participation on Standing and other committees, SIA believes the independent directors who serve on an SRO's Board and its committees must possess relevant and relatively current experience in order to effectively govern that SRO. The SEC has proposed a definition of who may qualify as "independent" for the purposes of Board and committee membership, stating that it has based its definition on the requirements SROs

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[20] *See* proposed Rule 6a-5(k)(2) and proposed Rule 15Aa-3(k)(2).

[21] *See* proposed Rule 6a-5(j)(3) and proposed Rule 15Aa-3(j)(3). SIA agrees that member participation in disciplinary matters is essential. Moreover, the officials comprising any panel evaluating or reviewing a disciplinary matter should include individuals with experience directly relevant to the particular issue under consideration.

[22] *See* proposed Rule 6a-5(j)(4) and proposed Rule 15Aa-3(j)(4).

have set forth for listed companies.[23] As a preliminary matter, SIA does not believe that the same independence requirements that apply to listed companies are appropriate for SROs. While listed companies operate for a wide variety of business purposes, an SRO exists to provide oversight of its members. This oversight process necessitates member involvement in order to function effectively. As a result, SROs should be subject to requirements that reflect their inherent differences from listed companies.

In addition, SIA is concerned that the breadth of the proposed definition of independence will generate only a narrow pool of possible directors who can qualify as independent. The broad reach of the independence definition also may put many Boards and committees in a constant state of flux as relatively peripheral connections between family members affect the qualification of proposed or existing directors. SIA considers the burdens of such a broad-reaching definition of independence on directors, their families, and on the SROs' ability to engage successfully in their mandated activities to far outweigh the very small incremental gains to be made by eliminating all possible connections between a director and an SRO, member, or issuer. We urge the Commission to focus its proposed definition of independence so that it only captures relationships that pose significant conflicts of interest.

C. The Proposed Transparency and Periodic Reporting Obligations Will Increase SRO Accountability and Investor Confidence.

The SEC's proposed transparency and reporting rules, if adopted, would require SROs to submit additional disclosures concerning various aspects of their regulatory operations. Revised Form 1 and new Form 2 would conform the registration requirements of exchanges and associations, and would require disclosure of items such as an SRO's regulatory program and regulatory budgeting.[24] The SEC also has proposed that SROs file annual and quarterly reports with the SEC with respect to their regulatory programs. These reports would contain information relating to, for example, an SRO's surveillance program, customer complaints, investigations, examinations, Board meeting minutes, internal controls, and independent third-party assessments of whether electronic trading facilities comply with the rules governing such facilities.[25]

SIA agrees that regulatory transparency is vital to increasing SRO accountability and fostering investor confidence in self-regulation and the U.S. capital markets in general. We commend the Commission for its efforts in proposing these additional disclosures. As we discussed in our recently submitted comment letter concerning reproposed Regulation NMS,[26]

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[23] *See* SRO Rulemaking at 71136.

[24] *See* proposed Exhibits to revised Form 1 and new Form 2.

[25] *See* proposed Rule 17a-26.

[26] *See* Exchange Act Release No. 50870 (Dec. 16, 2004), 69 Fed. Reg. 77424 (Dec. 27, 2004) ("Regulation NMS").

however, we do not believe that these proposed disclosure requirements would provide sufficient detail about market data-related issues to allow market participants to understand the use of and rationale for market data fees. In particular, a significant informational gap is created by the fact that the disclosure requirements apply only to the SROs, and not to the joint industry market data plans ("Plans"). Therefore, we recommend that the Commission require additional transparency with respect to the derivation and use of, and justification for, market data fees by both the SROs and the Plans.[27]

IV. Self-Regulation Concept Release

As noted above, it is important that the SEC recognize that the SRO Rulemaking and the Concept Release are inextricably linked. The proper balance of independence and member expertise will be key to both efforts, and a determination by the SEC to impose governance structures on SROs devoid of member involvement on SROs will limit the Commission's flexibility to restructure self-regulation more generally in the future.

A. The Hybrid Model is the Best Alternative to the Current Self-Regulatory Structure.

In its Concept Release, the SEC describes a number of issues and conflicts characterizing self-regulation today that have been exacerbated by increased competition for market share, a shift to for-profit SRO status, and regulatory lapses by SROs. More specifically, the Commission notes conflicts between an SRO's regulatory obligations and its market operations; between regulation and the desire for more listings; intermarket surveillance gaps; inefficient and potentially conflicting regulation by multiple SROs; and concerns about the appropriate level of SRO funding. To address these issues and conflicts, the Commission seeks comment on a series of self-regulatory models as possible alternatives to the current structure of self-regulation.

We welcome the Commission's willingness to consider whether major structural changes are necessary to improve the efficacy and efficiency of self-regulation. The current issues noted in the Concept Release with respect to self-regulatory structure, such as the conflicts of interest the SEC has identified and the inefficiencies involved in having multiple regulators with inconsistent or redundant rules,[28] require consideration of such sweeping changes. However, improvements in these areas need not and should not come at the cost of competitive and innovative markets. Accordingly, SIA believes the Hybrid self-regulatory model offers the best alternative regulatory structure.

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[27] Specifically, we would include, at a minimum, detailed financial data itemizing the revenues earned from market data fees, and the expenses associated with the collection and dissemination of market data. Regulation NMS Letter at 29.

[28] For instance, we note the industry's longstanding concern about duplicative examinations as well as duplicative registered representative and other fees.

The Hybrid model would require the SEC to designate a Single Member SRO to regulate all SRO members with respect to membership rules such as financial condition, margin, registered representative qualification testing, customer accounts, sales practices, and supervision. Each SRO operating a market would be responsible for the oversight of its market operations regulation (*e.g.*, its trading rules), including enforcement of those trading rules. The creation of the Single Member SRO addresses the two primary areas of weakness in the current self-regulatory structure. It eliminates the inefficiencies in rulemaking and examinations, and the potential for inconsistent regulation that exist in a multiple SRO system. It also eliminates conflicts of interest between an SRO's regulatory and market functions with regard to membership rules. We note that most broker-dealer compliance resources currently are devoted to complying with such rules as the conduct rules of multiple SROs. This area also is where the most duplicative SRO rules lie, many of which have the same regulatory purpose but require different compliance efforts.[29] By eliminating this duplication, the Hybrid model would strengthen the effectiveness of compliance resources through the creation of a comprehensive regulatory oversight structure with which members can more easily comply. At the same time, the existence of multiple market SROs, each with responsibility over those regulations applicable to their unique trading structures, will keep market expertise where it is most useful. Much of the innovation that makes the U.S. markets so strong occurs in the market operations, so the maintenance of separate market SROs will foster continued competition and innovation and preserve U.S. capital market dominance.

We also take note that the SEC has been moving toward more universal capital market rules generally. For instance, Regulation SHO creates a uniform definition of what constitutes ownership of securities, specifies aggregation of long and short positions, and requires broker-dealers to mark sales in all equity securities "long," "short," or "short exempt" to establish a uniform system across markets.[30] Parts of Regulation NMS, such as the proposed ban on sub-penny quotations for securities priced over one dollar,[31] also reflect a convergence of rules. Consolidating regulatory functions into a single entity as contemplated in the Hybrid model will continue this consolidation and streamlining of regulations to increase efficacy and efficiency, and to eliminate redundancies and gaps in regulatory coverage.

We are not unmindful of the concentration of regulatory power and authority that would attend the Single Member component of the Hybrid model. Therefore, and notwithstanding our advocacy of the Hybrid model, this regulatory structure will function effectively only if the SEC

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[29] For example, the NYSE and NASD have different order audit trail requirements, each of which requires unique programming and compliance efforts that are costly, and both of which are intended to provide similar information for surveillance purposes.

[30] *See* Exchange Act Release No. 50103 (Jul. 28, 2004), 69 Fed. Reg. 48008 (Aug. 6, 2004) ("Regulation SHO").

[31] *See* Regulation NMS.

provides attentive and cost-effective regulatory oversight. This oversight should include the SEC's vigilant review of the Single Member SRO's costs and fee structures to ensure that the SRO is providing sufficient regulatory oversight without imposing excessive fees and budget demands. Similarly, the Commission's robust review of the Single Member SRO's final disciplinary proceedings will counter any possible self-serving interest by the Single Member SRO in excessive levying enforcement fines that would be paid into its own coffers.

Another essential element in ensuring the Hybrid's effectiveness is strong member involvement to prevent the Single Member SRO from becoming an unresponsive entity with prohibitive cost structures. Member involvement will become even more important than under the current SRO structure to develop rulemaking at an appropriate cost level in the absence of competitive forces. Member involvement in governance also becomes more important because the Single Member SRO would be overseeing regulation across a diverse group of members with divergent needs and business models.[32] In order to understand and adequately consider those needs, especially those of smaller members who may be particularly cost-sensitive, the Single Member SRO will need substantial member input.

SEC and member involvement in the governance of a Hybrid SRO also will be necessary to address any "boundary" concerns between conduct rules subject to the Single Member SRO's regulatory oversight, and market rules subject to the continued oversight of the various market SROs. While these issues are not insurmountable – the success of Nasdaq and the NASD in delineating such distinctions is illustrative here – collaboration between the SEC and a member-informed SRO governing body will facilitate the identification and harmonization of any boundary issues.

In addition, the Commission should develop increased transparency requirements for the Single Member SRO, particularly concerning funding and budgetary issues. Increased disclosure in these areas will enhance the Single Member SRO's accountability to its constituents. Furthermore, it will place appropriate checks on the Single Member SRO by making its operations transparent to both members and the investing public.

To further foster the regulatory efficiency offered by the Hybrid structure, market SROs should be permitted to continue to outsource their market enforcement activities. We understand that the ability to outsource such activities, while retaining ultimate responsibility as an SRO, has worked well for various existing SROs.[33] As the February 2005 SEC 21(a) Report involving the

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[32] The needs of fixed income markets differ from those of equities markets, for instance. The knowledge members have about the ramifications of these differences is essential to ensure that a self-regulatory system works well for all participants.

[33] For example, the American Stock Exchange ("Amex") and Nasdaq have delegated regulatory activities to the NASD. *See, e.g.*, Exchange Act Release No. 37107 (Apr. 11, 1996), 61 Fed. Reg. 16948 (Apr. 18, 1996) (creating the NASDR and Nasdaq as two operating subsidiaries of NASD); SEC Set to Release Proposals on SRO Governance, But Details Are Still Thin, Securities Week, Nov. 8, 2004, *available at* 2004 WLNR 14154116 (quoting NASD chairman and CEO Robert Glauber's statement that the NASD "will continue to regulate Nasdaq and Amex under contract.").

NASD's delegation of certain of its statutory SRO responsibilities to Nasdaq has highlighted, we recognize that outsourcing can raise its own problems concerning the appropriate discharge of an SRO's statutory obligations.[34] SIA believes, however, that any such problems may be addressed by the trading markets and the Single Member SRO. For example, in response to the concerns cited in last month's 21(a) Report, the NASD and Nasdaq implemented several remedial efforts, including specifically charging a Nasdaq Board committee with responsibility for Nasdaq's regulatory functions, requiring direct input by the NASD into the Nasdaq Board nominating committee process, and establishing an NASD risk oversight committee to ensure information concerning regulatory risks flows properly to the NASD Board. We note that the 21(a) Report indicates such remedial actions taken by the NASD and Nasdaq have addressed the SEC's concerns about oversight.

Although the other potential self-regulatory models mentioned in the Concept Release offer some advantages, either they do not address the areas of weakness SIA has identified as most in need of reform as well as the Hybrid model does, or their drawbacks outweigh the advantages they offer. The SRO Rulemaking and improved intermarket surveillance, for instance, or the division of regulatory and market operations into separate subsidiaries, would neither eliminate conflicts of interest between an SRO's regulatory and market operations, nor address the regulatory redundancies and inconsistencies involved in the existence of multiple regulatory SROs. The Competing Hybrid model, involving multiple regulatory and multiple market SROs, would not address regulatory redundancies and inconsistencies but instead could compound them. At the other end of the spectrum, the creation of a universal industry self-regulator ("UISR") or a universal non-industry self-regulator ("UNISR") to which the current SROs would transfer regulatory authority and with which all markets would be registered as non-SROs, could well stifle development and innovation by removing regulatory control over a trading market from those most knowledgeable about the market – the markets themselves. These approaches also threaten to become inflexible and excessively bureaucratic due to the absence of competitive forces, reducing their responsiveness to rapidly changing market situations. Direct SEC regulation similarly poses the threat of a single regulator subject to no competitive forces becoming unresponsive and ineffective in maintaining the prominence of the U.S. capital markets. Direct SEC regulation would have the added disadvantage of being more subject to political elements than the other alternative self-regulatory models.[35] Consequently,

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[34] *See* Exchange Act Release No. 51163 (Feb. 9, 2005), *available at* http://www.sec.gov/litigation/investreports/34-51163.htm ("2005 21(a) Report").

[35] SIA does note that there appears to be a trend among non-U.S. jurisdictions, such as the U.K., to implement a system of direct regulation of securities professionals. These jurisdictions appear to have done so as part of a larger consolidation of regulatory authority over financial products more generally (*e.g.*, securities, banking, and insurance), however, as opposed to the consolidation of securities regulation only. *See, e.g.*, Eilis Ferran, Do Financial Supermarkets Need Super Regulators? Examining the United Kingdom's Experience in Adopting the Single Financial Regulator Model, 28 Brooklyn J. Int'l L. 257, 257-58 (2003); Heidi Mandanis Schooner and Michael Taylor, United Kingdom and United States Responses to the Regulatory Challenges of Modern Financial Markets, 38 Tex. Int'l L.J. 317, 340 (Spring 2003). Thus, it is unclear whether such an approach would yield benefits on the more limited scale direct SEC regulation of broker-dealers contemplates. Although the time eventually may arrive when broad financial services regulatory consolidation should be considered as an option, see

SIA endorses the Hybrid model as the superior alternative and strongly urges the Commission to consider the implementation of this model in the near future.

B. Funding for the Hybrid Model Should Be Apportioned Appropriately and Readily Transparent to SRO Constituents.

A final issue that the SEC must resolve is how the Single Member SRO would be funded. As we have stated previously, SIA believes that any future self-regulatory structure must be adequately funded and that fees for regulation should be apportioned to the industry on a fair and reasonable basis and should be unbundled and cost justified whenever possible.[36] Imposing regulatory fees on the securities industry that exceed the true costs of regulation acts as a tax on capital and imposes undue harm on the capital raising system.[37] Moreover, these fees – which by definition are not controlled by the forces of competition – should be carefully monitored and controlled to guard against the risk that they will fund inappropriately high costs or promote inefficiency. Therefore, SIA recommends that the SROs define costs necessary to meet their self-regulatory obligations, prepare and make public a budget to meet those obligations, and then fairly apportion those costs among members by making periodic filings with the Commission subject to public notice and comment.

In view of these concerns, we reiterate our conviction, expressed in our recent comment letter concerning reproposed Regulation NMS, that market data fees should not be used to fund regulation and should instead fund only the collection and dissemination of market data.[38] By advocating for cost-based market data fees, SIA in no way is advocating for reduced regulatory funding – just greater accountability and transparency in the way market data fees are assessed and self-regulation is funded. Explicitly tying market data fees to the cost of producing the data, while requiring the SROs to prepare public regulatory budgets and charge specific fees for regulation, will enable full and transparent funding of regulatory needs without over-charging for market data.

Government Accountability Office, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure* (October 2004), *available at* http://www.gao.gov/new.items/d0561.pdf, SIA views it as beyond the scope of the self-regulatory reforms to be considered currently.

[36] *See* Regulation NMS Letter. *See also* letter from Marc Lackritz, President, SIA, to Jonathan Katz, Secretary, SEC (June 30, 2004) *available at* http://www.sia.com/2004_comment_letters/1824.pdf.

[37] *See* White Paper.

[38] *See* Regulation NMS Letter at 25. In 2003, the Plans spent $38 million on Plan expenses and collected $424 million in market data revenue. The revenue exceeds costs by a significant margin. *See* Exchange Act Release No. 49325 (Feb. 26, 2004), 69 Fed. Reg. 11126 (Mar. 9, 2004) (initially proposing Regulation NMS).

1. Market Data Fees.

The purpose of disseminating market data under the Exchange Act is to create transparency in the prices that investors receive for buying and selling securities, and, where there are competing market centers, to increase investor choice and opportunity. Congress did not intend for market data to generate revenues for SROs to subsidize their regulatory obligations or to fund competitive business activities, as it does today. To address this divergence from the basic intent of the Exchange Act, we provided the SEC with a cohesive structural framework for ensuring that market data fees are "fair and reasonable" and "not unfairly discriminatory" in our comment letter on reproposed Regulation NMS.[39] We supplement this analytical framework here with greater detail regarding (i) specific costs to be included in a cost-based assessment of market data fees; (ii) limitations of access caused by current market data policies; and (iii) the effect of a reduction in market data fees on self-regulatory conflicts.

SIA supports a simple and straight-forward cost-based approach to market data fees.[40] Under this approach, the fees charged for market data would be based on SRO and Plan costs relating to aggregating and disseminating securities pricing information. Specifically, the type of costs that should be considered in setting market data fees would include: (i) collecting and aggregating quote information from SRO members; (ii) storing and processing that data (including back-up systems) for purposes of consolidation; (iii) transmitting and receiving data to and from the securities information processors ("SIP") (including communications charges); (iv) other technology and R&D costs, if not included in the above; and (v) costs of the SIP (shared by the SRO members of the Plans), including data processing, ticker network (computer hardware and software) and administrative costs.[41] General regulatory costs of the SROs would not be included in this calculation.

We do not believe this approach would place the Commission in the role of "rate-maker." The Exchange Act does not envision that the SEC will set rates, but rather that, through its oversight of SROs, the SEC will use its powers under the Exchange Act to ensure that the SROs themselves set "fair and reasonable" rates.[42] It would be up to the SROs, working through the

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[39] *See* Regulation NMS Letter at 25-31.

[40] There is broad industry interest in urging the Commission to reform the way market data fees are established and charged to assure that they are reasonably related to the cost of producing the data. Concept Release at n. 261.

[41] SIA members also have suggested that the Commission consider whether it would be appropriate to have a narrow cost-plus approach that would require cost-based fees and a reasonable return of, perhaps, 10%.

[42] Section 11A(c)(1)(C) clearly articulates that the Commission's role in policing the rates exclusive processors charge is to:

> [A]ssure that all securities information processors may, for purposes of distribution and publication, obtain *on fair and reasonable terms* such information with respect to quotations for and transactions in such

Plans, to publish their costs as a basis for the market data fees they charge. As the Commission has stated, "the fees charged by a monopolistic provider of a service (such as the exclusive processors of market information) need to be tied to some type of cost-based standard in order to preclude excessive profits."[43] The narrow cost-based approach is the most straight-forward method to accomplish this, and it is the method most closely aligned with the congressional purposes underlying the Exchange Act.[44] Of course, in determining the reasonableness of fees under the cost-based approach, the SEC also must consider whether the fee limits fair and reasonable access to market data, particularly where such access is imperative for compliance with regulatory requirements, such as proposed Regulation NMS.[45]

The adoption of a cost-based approach will provide additional benefits to the markets and investors. The reduced market data fees will increase investors' access to high quality market data, a primary goal of the Exchange Act. The current level of fees is sufficiently high that it effectively limits such access.[46] One factor in the high level of fees is the fact that, although the price of consolidated market data has remained the same, the value of such data has decreased substantially since decimalization. Prior to decimalization, the consolidated data reflected in the NBBO signaled the depth in the market up to 12 cents. Today, the depth of the market reflected in the NBBO is only a penny or two, generally representing very few shares. The valuable data that used to be reflected in the NBBO is now in the non-consolidated data that the SROs are distributing on their own, at an additional charge. Furthermore, because the SROs use the same

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securities as is collected, processed, or prepared for distribution or publication by any exclusive processor of such information acting in such capacity. [emphasis added]

[43] Exchange Act Release No. 42208 (Dec. 9, 1999), 64 Fed. Reg. 70613 (Dec. 17, 1999), at 70627 ("Market Data Concept Release").

[44] SIA is opposed to the SEC's proposed "flexible" cost-based approach. *See* Market Data Concept Release at 70629-32; Concept Release at 71273-74. Determining "common costs" related to market and regulatory operations and allocating them across the various SROs is at best an invitation to double-counting and cost inflation, and, at worst, a nearly impossible task. In addition to the overwhelming complexity of the task, such an approach runs counter to our position that market data fees should not be used to fund regulation.

[45] As we stated in our comment letter on Regulation NMS, we believe that the SEC's market data policies must "further the important goals of the national market system, including market transparency, a level playing field among market participants, and best execution of investors' orders." Regulation NMS Letter at 24, n.78.

[46] For example, receiving market data in a streaming format necessary to view fast-moving quotes in this age of decimalization costs a non-professional $4 per month and a professional $209.95 per month in a worst case scenario. For a non-professional, the $4 a month reflects $1 charges each from Nasdaq, CTA Tape A (NYSE listed), CTA Tape B (Amex listed), and OPRA. In addition, Nasdaq Level II data, showing the best bid and offer from each quoting market maker or ECN in the OTC market, is a $9 per month charge for non-professionals. Furthermore, Nasdaq has made its depth-of-book product, TotalView, available to non-professionals at $14 per month and to professionals at $70 per month, and NYSE offers its depth-of-book product, OpenBook, for $50 per month for both professionals and non-professionals. Such prices can be prohibitive for all but the most active non-professional traders. Indeed, many members ration the real-time market data they make available to their clients because of the cost of the data.

systems to aggregate data from their markets for both the consolidated NBBO and the non-consolidated depth-of-book products, the market data fees for consolidated data are likely subsidizing the SROs' new data products.[47] Such subsidization (which SIA does not support) exacerbates further the cost of market data. The ready availability of both depth-of-book and NBBO information – at a reasonable cost – is critical to the market, and a cost-based approach to all market data would help ensure such availability.

Finally, the proposed cost-based approach will minimize many of the conflicts of interest related to market data fees faced by SRO members of the Plans today. The conflicts arise from control over a monopoly product with the ability to use the monopoly revenue to subsidize other activities. By limiting the market data revenue, the business incentive to seek greater data revenues is restricted as well.[48]

2. Other Sources of Revenue and Allocation of Regulatory Costs.

As noted above, SIA does not intend for this transparent method for setting market data fees to lead to reduced funds for self-regulation. SIA acknowledges that its position on market data fees likely will require an overall increase in regulatory fees for members of the Single Member SRO.[49] While we recognize this likelihood, we anticipate that the overall level of market data fees would decline under the approach outlined above, to the ultimate benefit of investors and market transparency. Moreover, any increase in regulatory fees on member firms could, with the SEC's assistance, be allocated in a fair manner among all member firms such that there is not an undue burden on smaller firms. For example, such fees might be based on any number of factors designed to approximate the degree of resources required of the Single Member SRO in overseeing a particular firm, such as the number of registered representatives of a firm, or the scope and nature of its customer base or operations. One thing is relatively clear: member involvement in the governance of the Single Member SRO, particularly concerning fee-setting and budgeting, and robust Commission oversight of the Single Member SRO's costs and

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[47] The controversy surrounding the NYSE OpenBook proposal illustrates why a cost-based system is essential. The NYSE proposed a rule change to convert its OpenBook market data service to real-time and to establish a $60-per-month terminal fee. As described in SIA's October 2004 comment letter on OpenBook, many SIA members were troubled by the NYSE's failure to provide any information to support its contention that this fee "reflects an equitable allocation of its overall costs associated with using its facilities," and also by NYSE vendor and subscriber agreements that would restrict redistribution and consolidation with other markets' data. *See* Letter from Christopher Gilkerson, Chair, SIA Market Data Subcommittee, and Eliot Wagner, Chair, SIA Technology & Regulation Committee, to Jonathan Katz, Secretary, SEC (Oct. 22, 2004), *available at* http://www.sec.gov/rules/sro/nyse/nyse200443/ewagner102204.pdf.

[48] *See, e.g.*, 2005 21(a) Report (finding that, because of market data revenues, Nasdaq failed to oversee adequately washed trades and matched orders of an NASD member who was reporting trades through Nasdaq in order to capture market data revenue rebates).

[49] We note, however, that the increase may be less than one-for-one because, although SROs may use market data fees to fund regulation today, it is equally likely that SROs use market data revenues to fund competitive or proprietary activities such as rebates for trade prints, advertising and brand marketing, and to attract listings.

fee structures are essential. Notwithstanding the potential for increased regulatory fees for members of the Single Member SRO, we believe the benefits of the Hybrid model should exceed the costs.

SIA also believes that a fair and reasonable portion of the Single Member SRO's funding should come from issuers and other constituents of the trading markets. Trading markets will benefit significantly from regulatory oversight of broker-dealers and the various examination and continuing education programs conducted by the Single Member SRO under a Hybrid model. Such regulation and education foster the market integrity and investor confidence that bring so much business to the U.S. trading markets. Under the Hybrid model, these markets would receive these benefits, and market SROs should assume some of the associated regulatory and administrative costs.

C. The Commission Should Continue to Promote Harmonization of SRO Regulatory Efforts While It Implements a Hybrid Self-Regulatory Model.

We strongly urge the Commission, while working to implement the Hybrid self-regulatory model, to work to harmonize present SRO rules and requirements. Specifically, SIA supports the development of a formal process for systematically identifying and addressing material regulatory inefficiencies caused by differences in rules or rule interpretations among SROs and by multiple examinations of broker-dealers.[50] At a minimum, SIA asks the SEC to promulgate rules harmonizing the NASD and NYSE inspection and examination programs in order to reduce inefficiencies, regulatory discrepancies, and redundancies in their rulemaking.

In addition, the Commission should expand the Designated Examining Authority ("DEA") program beyond its current financial compliance considerations to include sales practices – in effect, a single SRO examiner for each broker-dealer. SIA notes the SEC has opposed this approach in the past for equity markets based on concerns that the costs of one market monitoring trading in another market would be excessive, and that one market would have little incentive to enforce the rules of another market.[51] We believe, however, that an SRO would enforce another SRO's rules effectively because, as the monitoring SRO, it would be held

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[50] *See* U.S. General Accounting Office Report to Congressional Committees, *Securities Markets: Competition and Multiple Regulators Heighten Concerns about Self-Regulation* (May 2002) ("GAO Report") *available at* http://www.gao.gov/new.items/d02362.pdf. The GAO Report also recommends that the SEC explore with SROs and broker-dealer representatives methods for obtaining comprehensive feedback from market participants regarding efforts to address regulatory inefficiencies, including the collection and assessment of market participant views by a neutral party. *Id.*

[51] *Id.* at 25-26. The proposed expansion of the DEA program was included in the proposed Capital Market Deregulation and Liberalization Act of 1995 (H.R. 2131, 104th Cong. (1995)), which did not become law. The Commission previously has approved a plan for allocating regulatory responsibilities for certain options-related sales practice matters of broker-dealers that are members of more than one SRO to a designated SRO plan participant. *See* Exchange Act Release No. 20158 (Sept. 8, 1983), 48 Fed. Reg. 41265 (Sept. 14, 1983).

responsible, not only by the SEC and state regulators, but also by the media and the public at large, for failing to identify trading rule violations.

SIA also urges the Commission to encourage SROs to avoid using ex post enforcement actions to engage in de facto "rulemaking" and instead to set forth clearer conduct expectations ex ante. Such actions are not the most effective means of ensuring compliance because members and issuers learn only after the fact that their actions are noncompliant. In addition, such enforcement actions consume vast resources and time that could be better spent on prevention. Instead, SROs should make greater effort to set forth clear rule provisions, augmented by responsive and useful interpretive guidance, to members and issuers to better guide expectations, reduce the high cost burden of enforcement on the market, and bolster investor confidence. By this recommendation, SIA is not suggesting in any way that SROs should be less vigilant or vigorous in enforcing their rules. Rather, regulation functions most effectively and efficiently when it is forward looking rather than reactive.

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SIA appreciates this opportunity to address the issues the Commission has raised in the SRO Rulemaking and in the Concept Release. We look forward to working with the members of the Commission and the Staff to improve self-regulation in the months ahead. If you have any questions concerning these comments, or would like to discuss our comments further, please feel free to contact George Kramer (regarding SRO governance or structural reform issues) or Ann Vlcek (regarding market data issues) at 202.216.2000.

Sincerely,

Marc E. Lackritz
President

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
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