The Chicago Stock Exchange

March 8, 2005

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

Re: File Nos. S7-39-04 and S7-40-04
Proposed Rules Re: Governance, Administration, Transparency and Ownership of Self-Regulatory Organizations ("SROs"); Concept Release Concerning Self-Regulation

Dear Mr. Katz:

The Chicago Stock Exchange (the "Exchange" or the "CHX") welcomes the opportunity to submit the following comments on the proposed rules relating to the governance, administration, transparency and ownership of SROs. The Exchange believes that the far-reaching proposals set out by the Commission properly recognize that SROs must adhere to principles of good governance and must have an unflinching focus on their regulatory roles. The Exchange is dedicated to fulfilling those objectives.

At the same time, however, the Commission's proposals set out a series of one-size-fits-all solutions – based, at least in part, on standards set in place for some of the most highly capitalized companies in the United States – that, in some respects, are more comprehensive than they need to be to ensure that SROs are functioning properly. Among other things, the Exchange believes that some of the proposals' provisions would require SROs to develop documents for public disclosure that would not be particularly useful to the public. Additionally, some of the governance provisions would bar SRO members from providing input that might prove essential to both an SRO's regulatory work and its business operations. Any of these requirements, standing alone, might seem to be a reasonable and appropriate attempt to help SROs adhere to principles of good governance. The Exchange believes, however, that some of these requirements are better proposed as voluntary initiatives, allowing SROs to put measures in place when they believe it is appropriate, either because they believe that these measures will enhance their governance work or because they believe it is necessary for competitive reasons. The Exchange's ideas for modifying the proposals to address these and other concerns are described below.

On a more fundamental level, the Exchange believes that the proposals likely will have a particularly substantial impact on smaller SROs that often find it increasingly difficult to compete with larger self-regulatory organizations. These larger SROs have extensive cash reserves, in addition to the robust listing programs and healthy market shares that help account for their significant annual revenues. The Exchange currently is a smaller player in the national market system and as a result, it does not have those same financial resources to tackle the many new projects imposed by the proposals.[1] Moreover, the Exchange already is committed to making significant improvements to its regulatory programs, as the result of its settlement with the Commission in September 2003. The Exchange encourages the Commission to minimize the potential impact of these proposals on competition by adopting only the parts of the proposal that are necessary to address concerns about SRO governance and transparency, leaving other aspects of the proposals as voluntary market initiatives.

The Exchange recognizes that any attempt to raise concerns about these proposals might be viewed as a form of heresy – people might charge that the statements are being made by an entity that is not committed to being a good corporate citizen or a fully-functioning SRO. That is not the case. The Exchange simply believes that it is more important to ensure that SROs are substantively doing their jobs than it is to spend a lot of resources to create the impression that they are doing so.

I. Proposals Relating to SRO Governance[2]

Proposed Rules 6a-5 and 15Aa-3 set out a number of new requirements relating to the governance of SROs. As described below, the Exchange believes that these proposed rules should be modified to allow SROs broader discretion in determining the role that members should play on SRO committees and in putting in place other governance-related policies and practices.

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1 The Exchange, for example, had gross revenues of approximately $45.7 million in 2003, compared to NYSE revenues in the same period of over $1 billion.

2 In this section of the comment letter, the Exchange addresses the governance proposals relating to the board and its committees (except the regulatory oversight committee), the appropriate role of the CEO and chairman and the requirements for written governance guidelines and codes of ethics. Proposals relating to the operation of an SRO's regulatory programs – including the role of its regulatory oversight committee and the separation of regulatory and business functions within an SRO – are addressed in Section IV, below.

A. The Commission's proposal appropriately gives SROs the choice to have both independent and member directors on their governing boards.

The Exchange's board currently consists of seven public (or independent) directors, six participant directors and the Exchange's chief executive officer.[3] This board composition – and other governance standards set out in the Exchange's bylaws and rules – are designed to ensure that the interests of public investors, as well as the interests of the Exchange's members, are represented in key areas of the Exchange's corporate structure.

The Exchange believes that this careful balancing of member and public interests is an important feature of the structure of a self-regulatory organization. The Exchange's public directors are leading members of the civic and business communities who give countless hours of their time, at nominal compensation and with no personal financial interest, to help the Exchange serve the public interest by providing a competitive alternative to the primary markets. At the same time, the Exchange's member directors bring an important perspective to the work of the board – not only do they represent firms that, until the Exchange's recent demutualization, owned one or more memberships in the Exchange, but they also share with the board's public members their knowledge of the securities industry and of the trading that occurs on the Exchange. Their perspective is a vital element in the discussion of many topics that are presented to the board for its review or approval.[4]

Of course, the Exchange understands that conflicts of interest – or at least the perception of them – can arise between an SRO and the persons and firms that the SRO regulates.[5] While the Exchange has not found that those conflicts actually interfere with its role as a regulator, the Exchange applauds the Commission's decision to provide SROs with the flexibility to decide for themselves how to address those situations, including giving SROs the ability to determine whether or not members should serve on their boards.

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3 Before the Exchange's demutualization, which was effective as of February 9, 2005, the Exchange's board consisted of a similar ratio of governors – twelve non-industry (or public) governors, ten member governors, the Vice Chairman (a representative of a member firm) and the Exchange's CEO.

4 The Exchange recognizes that at least one other SRO allows members to provide input to a fully-independent board through the work of an advisory committee. While that structure – and the periodic joint meetings of the board and advisory body – seem to provide an opportunity for members to share ideas with the board, members' role in the governance of the SRO is significantly limited.

5 *See* Concept Release Concerning Self-Regulation ("Concept Release") at 16-35, Release No. 34-50700, File No. S7-40-04 (November 18, 2004).

B. The Commission's proposed definition of an "independent" director should be slightly refined.

As noted below, the Exchange has a few comments about the Commission's proposed rules relating to the definition of an independent director. In many ways, however, the proposed rules are somewhat similar to concepts used by the Exchange in determining whether or not a person is a "public director."[6]

The proposed rules define an independent director as, among other things, a person who has not (or whose immediate family member has not) been employed by the exchange with the past three years. This broad definition would prevent a person from serving on the board of directors of an SRO if his son had worked in an exchange's mailroom two years before – an outcome that would not even be required for a company that lists stock on either the NYSE or Nasdaq.[7] The Exchange encourages the Commission to revise this rule to only bar a person from being a director if his or her immediate family members had served as executive officers of an exchange within the past three years.[8] That test captures the primary situations in which a director or family member might have had such a material relationship with an exchange that their independence could be questioned.

Additionally, the proposed rules contain too broad a definition of the payments that a person could receive from an exchange or an exchange member before triggering a finding that a potential director lacks the necessary independence. Specifically, the proposed rules note that a person would not be considered independent if he or she received, during any 12-month period within the past three years, more than $60,000 in payments from an exchange (or any exchange affiliate) or an exchange member or any affiliate of a member. Although several exceptions are provided to this general rule, the proposed rule does not provide an exception for payments arising solely from

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6 Under the Exchange's bylaws, a public director is a person who (i) is not a participant, or an officer, managing member, partner or employee of a participant; (ii) is not an employee of the Exchange or any of its affiliates; (iii) is not a broker or dealer or an officer or employee of a broker or dealer; and (iv) does not have any other material business relationship with (x) the Exchange, CHX Holdings or any of their affiliates or (y) any broker or dealer.

7 *See* NYSE Listed Company Manual Section 303A(2)(b)(i)(confirming that a person would not be considered independent if his or her immediate family member recently had been an executive officer of the company); and NASD Rule 4200(a)(15)(stating that a person would not be considered independent if his or her "family member" was recently employed as an executive officer by the company (or any parent or subsidiary).

8 This outcome may have been intended by the proposed rules, but just needs to be clarified – the definition of an independent director later notes that a director is independent so long as an immediate family member has not received more than $60,000 in payments from, among others, an exchange, but excludes from this impermissible compensation any compensation paid to an immediate family member who was not an executive officer of the exchange. *See* Proposed Rule 6a-5(b)(12)(iii).

investments in the member's (or the exchange's) securities. This type of exception is set out in the rules that apply to companies listing on Nasdaq and is identified in the interpretation of a similar NYSE listing standard.[9] The Exchange believes it would be appropriate to provide that type of exception for evaluating the independence of potential directors of SROs.

C. The Commission should replace its proposed requirement that an SRO's nominating, governance and audit committees be composed entirely of independent directors with a requirement that those directors constitute 50% or a majority of those committees.

The member directors on the Exchange's board – like those at many other SROs – wear many hats. They are stakeholders in the enterprise, customers of the Exchange's trading facility and entities subject to the Exchange's regulatory review. In these roles, member directors have developed significant knowledge of the securities industry and of the operations of the Exchange that can be quite important to the board and its committees. Balancing the value of that knowledge with the SRO's need to be a strong regulator is an important task.

In striving to ensure that not even an appearance of a potential conflict of interest arises between an exchange and its members, however, the Commission has proposed rules for standing committee composition that go too far in barring members (and other directors who are not considered "independent") from participating in committee activities. Specifically, the Exchange believes that the Commission should allow member directors to serve on the nominating, governance and audit committees of an SRO.

As an initial matter, the work of the nominating, governance and audit committees is not integrally related to the regulatory work done by an SRO and thus should not be the focus of efforts to limit member involvement. An audit committee, for example, typically assists a board of directors in monitoring the integrity of a company's financial statements, its systems of internal control and the qualifications, independence and performance of the Exchange's internal auditor and independent public accountant. An audit committee also may assist a board in monitoring compliance with legal requirements that may have a material impact on the company's financial statements. Although important principles are served by ensuring that audit committee members are not closely aligned with management, those principles do not require the Commission to

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9 *See* NASD Rule 4200(a)(15)(B)(ii)(excluding, from the independence analysis, payments arising solely from investments in the listed company's securities). NYSE Listed Company Manual Section 303A(2)(b)(ii) – which relates to direct compensation from a listed company – does not reach situations associated with investments in a listed company because of its focus on employment-related compensation. *See also* NYSE Listed Company Manual Section 303A Frequently Asked Questions, Section C(8).

bar SRO members from serving on an SRO audit committee.[10] Similarly, those principles do not require that SRO members (and stakeholders) not participate in the work of a governance committee.[11]

Moreover, the proposed rules tacitly recognize the importance of member participation in the nominating process by requiring that members are involved in the selection of at least 20% of an SRO's board members. Instead of simply allowing members to serve on the nominating committee, however, the proposed rules require SROs to develop a less direct method for providing member input.[12] The proposing release suggests that an SRO could meet this requirement by forming an advisory panel of members that reports to the nominating committee "and that is directly responsible for nominating member candidates for the board."[13] According to the proposed rules, then, SRO members cannot participate on the committee itself, but must serve on an advisory committee that has all of the committee's powers in selecting member representatives. This convoluted result seems to focus more on the perception it creates than on the substance of the work that will be done. The Exchange encourages the Commission to avoid requiring SROs to establish unnecessarily convoluted structures by allowing direct member service on the nominating committee.

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10 As the Commission noted in the release accompanying the final rule relating to listed company audit committees ("Audit Committee Release"), directors who are not affiliated with management are "better situated to assess objectively the quality of [a company's] financial disclosure and the adequacy of internal controls than a committee that is affiliated with management." *See* Release Nos. 33-8220, 34-47654, File No. S7-02-03 (April 9, 2003) at 7. Focusing on the pressures facing management for short-term performance (either from the market or from the use of incentive-based compensation plans), the Commission noted that "an independent audit committee with adequate resources helps to overcome this problem and to align corporate interests with those of shareholders." SRO members are "independent" of an SRO's management – they are not affiliated with SRO management, or even with the SRO itself (unless they are significant shareholders), in a way that would permit improper influence on an audit committee's work. Indeed, the Commission's own rules relating to audit committees do not prohibit shareholders from serving on audit committees, unless those shareholders have a controlling interest in the company. *See* Audit Committee Release at pp. 15.

11 SRO members are "independent" of SRO management to an extent that is perhaps most evident only to people who have worked at an SRO. To the extent that the Commission is concerned that an SRO's management might seek to use its regulatory authority to push member directors who serve on committees to align themselves with management – an almost impossible-to-imagine abuse of regulatory authority, in the Exchange's opinion – the Exchange believes that the Commission could temper that possibility by allowing members to serve on specific board committees, but not constitute a majority of the committee members.

12 *See* Proposed Rule 6a-5(f)(3).

13 Proposing Release at 50.

Finally, the Exchange is somewhat concerned that the Commission's proposals would burden the Exchange's public directors by significantly increasing the amount of time and effort that they must devote to Exchange matters. The Exchange's public directors are current and former leaders in the business community who already dedicate a relatively significant amount of time to the Exchange's board and committee meetings.[14] Increasing the number of committees on which these directors must serve (by reducing the number of other board members who can share that obligation) may make it much more difficult (or costly) for the Exchange to attract and retain qualified and dedicated public directors.[15] Although the Exchange cannot quantify this risk, the Exchange believes it to be quite real.

D. The Commission's proposals relating to committee charters, annual performance evaluations, governance guidelines and codes of ethics should be voluntary efforts by SROs to enhance governance, not mandatory requirements.

Proposed Rule 6-a5 sets out new requirements that SROs draft, update and make publicly available committee charters, governance guidelines, codes of ethics and other corporate governance materials.[16] As noted above, each of these requirements, standing alone, could be viewed as a reasonable attempt to help SROs adhere to principles of good governance. The Exchange believes, however, that SROs should be given the flexibility to decide whether and how to put these kinds of measures into place, either because they believe that these measures will enhance their governance work or because they believe it is necessary for competitive reasons.

Identifying these measures as voluntary initiatives would serve an important purpose – recognizing that there is not a one-size-fits-all standard to ensure that a company governs itself well. The solutions described throughout the Commission's proposal are designed for large organizations – indeed, they are based on the listing standards that apply to publicly-traded companies. Smaller organizations are not bound to adopt these measures, although they might choose to do so. One reason for this

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[14] Although the Exchange's committees tend to meet regularly, some committees (like the regulatory oversight committee) have more meetings than others.

[15] The Exchange currently pays each public director a quarterly retainer of $1,000, plus $1,000 for each board meeting that the director attends. Additional fees are paid for each committee meeting that the director attends. Participant (member) directors are not paid a quarterly stipend, but do receive $800 for each meeting that they attend. If the Exchange's board and its committees are required to meet the composition (and other) requirements of a publicly-traded company, the Exchange is concerned that it might need to compensate its board members as if they were serving on a public company board.

[16] *See* Proposed Rule 6a-5(f)-(j) and (p)-(q) and Exhibits E and F to the revised Form 1. Proposed Rule 6a-5 also would require certain SRO committees to conduct annual self-evaluations.

outcome is focused on the costs associated with developing and updating all of these documents – smaller organizations often do not have the resources available to larger companies.[17] Moreover, while these types of initiatives – developing written committee charters, codes of ethics and governance guidelines (and conducting annual committee self-evaluations) – can prove helpful to companies, these measures do not, on their own, protect against bad conduct. For all of these reasons, the Exchange asks that the Commission promote, not burden, competition by making voluntary the currently proposed requirements for committee charters (and annual performance evaluations), codes of ethics, governance guidelines and associated public reports.

III. Proposals Relating to SRO Ownership

The Exchange demutualized on February 9, 2005, becoming a for-profit stock subsidiary wholly-owned by CHX Holdings, Inc. ("CHX Holdings")[18] Each person or firm that owned a membership in the Exchange received stock in CHX Holdings. Each person entitled to trade on the Exchange on the date of demutualization received a trading permit to allow continued access to the Exchange's trading facilities. In connection with this transaction, the Exchange's bylaws were revised – and new bylaws were drafted for CHX Holdings – which contain ownership and voting restrictions similar to, or even more stringent than, the restrictions proposed by Rule 6a-5(o). The Exchange voluntarily imposed those restrictions so that it could move forward more quickly with its demutualization.

Proposed Rule 6a-5(o), however, seeks to enshrine in law many of the restrictions that were voluntarily implemented by the CHX. In general, the proposed rule would limit a member firm from beneficially owning or voting more than 20% of the outstanding stock of an SRO or of an SRO-related trading facility. Because of the proposed rule's focus on direct and indirect ownership and voting rights, the Commission has specifically noted that the restrictions also apply to any holding company of an exchange.[19]

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[17] The Exchange, for example, will bear somewhat significant costs in its initial efforts to comply with these requirements. Although the proposing release suggests that many SROs will not have additional costs in preparing these materials because they will use in-house counsel for that purpose, the Exchange does not see that outcome as a cost-less one. *See* proposing release at 279. In the Exchange's experience, new tasks that must be performed by in-house counsel (or other staff) necessarily push other tasks to the side. Those tasks, in turn, might either be assigned to outside firms, at an identifiable additional cost, to ensure prompt completion of all work or might be delayed, at a less easily estimable (but no less real) cost to the SRO.

[18] *See* Release No. 34-51149 (February 8, 2004); 70 FR 7531 (February 14, 2004).

[19] *See* Proposing Release at 75-76.

These proposed voting and ownership restrictions, however, place SROs at a competitive disadvantage to trading venues that have chosen not to (or are not required to) become SROs. Specifically, trading systems that operate as electronic communications networks ("ECNs") or alternative trading systems ("ATSs") – and markets that trade single-stock futures – will not be bound by these restrictions. Moreover, there are numerous large Nasdaq market-making firms that trade as much or more volume than some exchanges. Broker-dealers and other qualified trading firms can own up to 100% of these trading venues, while still sending trades to these venues to be executed. While the Exchange agrees that it is appropriate to limit the ownership of SRO members in the SRO itself, it does not believe that its members should be similarly restricted, by Commission rule, in their ownership of the stock of a holding company that owns an SRO (and one or more other operating subsidiaries) or the stock of an SRO-affiliated company that operates a trading system. The need to protect the independence of the SRO from member interference is not a tension – in the context of an SRO trading facility – that merits new regulation.[20] Placing these mandatory burdens on the development of SRO trading facilities could cause member investments (and, ultimately, trading volume) to migrate to facilities operated by entities other than SROs.

IV. Proposals Relating to the Operation of SRO Regulatory Programs

The proposed rules would require an SRO to separate its regulatory unit from the remaining business operations and to establish a fully independent regulatory oversight committee ("ROC"). The stated purpose of these changes is to insulate regulatory decision-making from supposed business pressures. While this objective is an important one, the Exchange questions whether a rigid separation requirement is warranted. We are concerned about the unintended consequences of making the ROC the supervisor of our regulatory unit. The requirement that the ROC be fully independent would prevent the Exchange from tapping the knowledge base of its members, which is one of the primary justifications of self-regulation. This requirement would also prevent the staff from using the ROC as a means of communicating its views on regulatory matters and educating members as to regulatory trends.

To fully separate its regulatory unit from its business operations, the release suggests two alternatives: to house its regulatory unit within a separate entity or to have this unit report directly to the ROC, and not to the Exchange's CEO.[21] The first alternative does not appear to be practical for smaller SROs, such as the Exchange.

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[20] The Commission's concern that a person controlling a trading facility might direct its operation so as to cause the facility to neglect its regulatory or compliance obligations should extend to all trading venues, not just to SROs.

[21] While the release does not limit an SRO to either of these alternatives, it is not clear whether there are any additional structures that would accomplish the Commission's objective.

Separation into a distinct legal entities would require the regulatory entity to create its own corporate infrastructure to dispose of routine matters such as legal, real estate, payroll, insurance, retirement plans, physical security and the like. For an organization such as ours with under 200 employees, the inefficiencies of this approach make it cost prohibitive.

While requiring the regulatory unit to report to the ROC within the existing corporate structure would avoid the difficulties noted above, new problems arise with this approach. By forcing the regulatory unit to report to the ROC, the rule proposal essentially transforms the ROC into "supervisors" for state employment law purposes. The requirement that ROC charter mandate that it "determine" the regulatory plans, program, budget and staffing appears to impose the unwanted and unnecessary responsibility of direct management upon the ROC. As an alternative, we suggest that the proper role of the ROC should be to oversee or review and approve the plans, program, budget and staffing of the Exchange, without mandating any particular reporting lines. While board members are the ultimate fiduciaries for the Exchange, senior management, usually the CEO, has traditionally assumed the responsibility (and any attendant liabilities) for supervising the other senior executives and business operations of the company. Coupled with the stricter limitations on who qualifies as a public director, the imposition of supervisory liability on the ROC will act as a powerful disincentive to persons considering service as a director and/or ROC member. Given that the ROC itself reports to the full board, which may contain member directors, the Exchange questions whether the reporting requirement will even have the intended insulating effect.

The Exchange suggests that SROs be permitted to maintain a structure that requires the ROC to oversee, rather than manage and supervise, the activities of an SRO's regulatory body. In place of a rigid reporting requirement, we recommend that the Commission propose rules requiring that SROs create a ROC which should focus on the review and oversight of the regulatory function.[22] We believe that this approach would have the salutary effect desired by the Commission, and avoid the deterrent effect on potential ROC members as discussed above. This structure would be far more consistent with the manner in which boards and board committees have normally discharged their duties. We note that the Sarbanes-Oxley Act of 2002 did not disrupt normal business reporting lines, such as by making Chief Financial Officers report directly to an audit committee.

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[22] We recommend that oversight of the regulatory function be the sole province of the ROC. The proposed rules provide that the charter of the audit committee require it to assist the board in oversight of the Exchange's "compliance with related legal and regulatory requirements." Proposing Release, Section II.B.3. Obligating the audit committee to oversee the Exchange's regulatory function is duplicative of the ROC's efforts and may create situations in which the board and regulatory staff will receive contradictory advice and direction.

Additionally, SROs should be required to put in place rules that preclude the CEO from authorizing or participating in the review of disciplinary charges against members. Finally, we would concur in the recommendation that the ROC and/or the independent directors on the Exchange's compensation committee participate actively in the hiring of the Chief Regulatory Officer ("CRO") and approve the CRO's ongoing compensation. Together, we believe that these requirements satisfy the Commission's objective that SROs have a structure that facilitate a fair, vigorous and effective oversight program.

The proposed rules also call for a "fully independent" ROC. The Exchange has had an ROC in place for several years to better monitor its regulatory operations. In 2004, our ROC met on no fewer than ten (10) occasions to discuss regulatory matters. By the terms of our settled administrative order with the Commission, the Exchange's ROC is composed of seven governors, five of which must be public governor, with one floor governor and one member, non-floor based governor. The chairman of the ROC must be a public governor. The minimum quorum requirement for the ROC is at least three public governors. Thus, the member governors can never have a majority in ROC meetings. We believe that these requirements satisfy the Proposing Release's purpose of avoiding member domination of the regulatory program.

The experience of the Exchange is that there is a substantial benefit in having members involved in regulatory benefit. By virtue of being "in the arena" on a daily basis, members are usually very well informed on emerging trends and viewpoints in the industry, both on business and trading issues. The presence of members on the ROC creates a forum in which the staff, public directors and members of the Exchange can freely and frankly discuss issues of regulatory policy. Effective regulation depends, to a great extent, on the cooperation and partnership with the industry. To exclude the members of the Exchange from having any say in the discharge of its regulatory obligations will drive a wedge between the regulatory staff on the one hand and the membership on the other.

We also have concerns about certain other specific proposals relating to the separation of powers between the business and regulatory interests of SROs. While the Exchange agrees that it should be required to adequately fund its regulatory program, the requirement to direct regulatory fines to fund its regulatory program appears to create an accounting burden with little tangible benefit, since all money is fungible. This obligation could create the negative perception that Exchange was taking disciplinary action to increase its budget. Finally, it is unclear what the result should be if the amount of fines collected exceeded the Exchange's regulatory budget. In place of this requirement, we recommend that SROs be required to adequately fund their regulatory programs, as determined by the nature and scope of member activities that it oversees.

Additionally, the Proposing Release's broad requirement of confidentiality could harm regulatory and compliance efforts. Proposed Rule 6a-5(n)(5) mandates that SROs establish policies and procedures reasonably designed to prevent the dissemination of regulatory information to any person other than SRO directors, officers, employees and agents who are *directly responsible* for carrying out regulatory obligations. This requirement is substantially overbroad. The Exchange's Market Regulation Department, the unit that is directly responsible for ensuring regulatory compliance, often reaches out to other departments within the Exchange to ascertain or validate facts, process data or develop and maintain surveillance and other systems in pursuit of its regulatory objectives. This interaction normally involves disclosure of specific information relating to our regulatory program. Also, regulatory complaints may reach the Market Regulation Department via other Exchange personnel. The proposed rule would appear to preclude such persons from taking complaints, which is impractical and undesirable. The text of rule would even appear to preclude sharing of information with other SROs, the SEC and law enforcement agencies. Finally, the language appears to preclude the Exchange from publicizing disciplinary actions, which is a standard SRO practice. To the extent that the Commission believes that restrictions on regulatory information are necessary and appropriate, we believe that such restrictions should be limited to the use of such information and not to who may use it. *See, e.g.,* Proposed Rule 6a-5(n)(5)(i)(B), as an appropriate guide.

V. Proposals Relating to SRO Public Disclosures

Proposed Rule 6a-2 sets out a series of new obligations for SRO reporting. As further described below, the Exchange believes that some of these proposals – particularly those relating to disclosures that detail the Exchange's organizational structure and the work of its regulatory programs, as well as the intricacies of its financial status and its ownership structure – provide far more information than the public will use, at a potentially significant cost. The Exchange encourages the Commission to draw a meaningful distinction between the information that it might require, on a periodic basis, to understand how the Exchange fulfills its regulatory role and the information that the Exchange would be required to assemble and share with the general public.[23]

A. The proposed rule requires public disclosure of proprietary information about SROs that is not routinely disclosed by most companies.

Among other things, Rule 6a-2 would require SROs to make public information about their organizational and governance structure, regulatory programs and financial condition. On the surface, these types of disclosures seem reasonable. When reviewed

[23] The Exchange does not have any objection to the disclosure of information about the Exchange's governance structure (including the detailed information about the board and board committees required by Exhibits C, D and E, to the extent it is required to be prepared).

more closely, however, it becomes clear that SROs would be required to disclose information that many companies might consider to be proprietary or otherwise confidential.

Some of the potentially proprietary disclosures include those relating to an SRO's organizational structure and those arising from the proposed financial disclosure rules. For example, the proposed rules would require an SRO to post, on its website, a complete organizational chart of the company, including a description of the responsibilities of each division or department. Other disclosures, required by new Exhibit I to Form 1, would obligate an SRO to disclose details about its regulatory-related technology expenses, breaking those expenses down by categories, including data center costs, systems hardware and software expenses, systems consultant fees and costs associated with the development and maintenance of electronic surveillance systems. Another provision would require an SRO to identify market data revenues it received, itemizing those revenues by product. The Exchange believes that it is unreasonable to require SROs to provide the public (and their competitors) with a relatively detailed itemization of expenses and revenues.[24] This kind of information could be used by other SROs, or by other entities, for purposes that are not at all in line with the Commission's stated goal of better informing market participants and investors about the scope and cost of SRO activities.

Other provisions of the rule appear to require disclosure of otherwise confidential information relating to non-officer employees. For example, the proposal would require an SRO to disclose detailed compensation information about senior regulatory staff, potentially including compensation information about persons who are not officers of the Exchange.[25] Additional provisions would require SROs to provide a description of instances in which the SRO's code of conduct and ethics was waived for any person, including non-executive officer employees.[26] While the Exchange has no particular objection to providing this type of information for its senior officers or directors (in the case of code of ethics waivers), it seems inappropriate to require these disclosures with

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[24] Few other businesses provide the kind of product-by-product description of any particular part of their revenues that is required in Exhibit I with respect to an SRO's receipt of market data. If the proposed rule truly requires a list, by security, of the market data revenues that the Exchange receives, the proposal is akin to requiring Kraft Foods to separately describe the revenue it receives from each of its shredded cheese products.

[25] *See* the requirements relating to proposed Exhibit I to revised Form 1. Although a footnote in the proposing release states that SROs would not be required to identify these regulatory staff members by name, their positions would be required to be publicly identified. This "shield" affords no meaningful protection; the disclosure would effectively publicize otherwise confidential salary information to all who can readily identify the person occupying that job.

[26] *See* the requirements relating to proposed Exhibit G (organizational chart) and Exhibit F (waivers of the code of conduct) to revised Form 1.

respect to non-officers. These employees do not hold the sort of high-level positions that ordinarily merit public scrutiny.[27]

B. The financial disclosures required in Exhibit I – which are drawn, at least in part, from public company disclosure requirements – are extraordinarily burdensome for a small company.

As part of its recent demutualization, the Exchange prepared a detailed information memorandum that described not only the demutualization proposal itself, but also the Exchange's business activities, its financial status, and its governance and ownership structure. The financial statements included in this document contained a lengthy section devoted management's discussion and analysis of the Exchange's financial results; other provisions in the document addressed executive compensation, regulatory issues and other matters. The effort, and expense, associated with preparing this document was a significant expenditure for the Exchange.[28]

Even after all of that work, however, the Exchange still would not have met all of the requirements of the new Form 1 disclosures. Much additional work, for example, would have been needed to prepare the detailed breakdown of regulatory and non-regulatory expenses and revenues required by proposed Exhibit I.[29] Significant work also would have been required to address the new regulatory disclosures mandated by proposed Exhibit H, particularly relating to the potential effect that any material events or trading/ technology issues might have on the Exchange's regulatory programs.

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[27] They have not sought (and are not compensated for) having a position with that level of public accountability. Moreover, it seems odd to require this level of disclosure with respect to SRO staff, but not for similarly-situated staff at other organizations. Broker-dealers, for example, do not publicize the salaries paid to their senior compliance staff, nor do companies with potential environmental exposure publicize the salaries of their senior staff members who are devoted to overseeing the environmental impact of the companies' operations.

[28] Although the Exchange did not separately account for the costs of preparing the information memorandum, the Exchange estimates that these costs included approximately $20,000 in outside accounting costs and approximately $130,000 in outside legal fees, not including the almost full-time efforts of several Exchange staff members over the course of the multi-week period during which the document was prepared.

[29] The Exchange does not formally track its expenses and revenues as falling into one of these two categories. Although the Exchange understands that some other SROs might already do so, it has not seen either a business or regulatory benefit to sorting its expenditures and revenues into these two buckets (or for engaging in the time-consuming work needed to allocate costs associated with employees who engage in both regulatory and non-regulatory work).

C. The Exchange does not believe that the burden of making these enhanced disclosures of proprietary and confidential information is outweighed by the public interest in the information.

Although the proposing release states that the disclosure of the new Form 1 information will allow market participants and investors to have more information about the operation of SROs, the Exchange is not certain whether the information will be particularly useful to them.[30] The primary justification for financial disclosure by publicly-traded companies is that those companies have taken funds from public shareholders, who therefore deserve information about the business results of the company so that they can evaluate the continuing soundness of their investments. This concern is not present for most SROs, since they have not availed themselves of the public capital markets.

Moreover, the most easily identifiable data contained in the new Form 1 disclosures – how much an SRO spends on its regulatory program – is not necessarily the hallmark of an efficient and effective regulatory program (or the hallmark of an efficient market). High costs, instead, could be indicative of highly manual trading or surveillance processes or inefficient workflow allocations. While the Exchange appreciates the Commission's statement that the amount that an SRO spends on its regulatory program is not, by itself, an indication of the quality of the SRO's regulation, that comment may be completely disregarded when any superficial comparisons among markets are made.

D. The due date for the new Form 1 should be extended to 90 days after the close of an SRO's fiscal year.

Under the proposed rules, each SRO would be required to submit Form 1 (and all of its exhibits, including an audited financial report) 60 days after the end of the SRO's fiscal year. The Exchange believes that it would be more reasonable to allow an SRO to make this quite detailed filing no more than 90 days after the end of its fiscal year. If the Commission believes it is appropriate to move toward a 60-day requirement, the Exchange encourages the Commission to consider imposing a phased-in approach to move SROs toward that goal over time, rather than imposing that very stringent requirement all at once.[31]

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[30] For example, with the new disclosures of organizational charts, the public can learn whether an SRO's chief financial officer reports to the Exchange's chief executive officer or to a chief administrative officer. It can learn how many customer service staff are employed by an SRO and whether they are part of a stand-alone department or a larger organizational division. With the new disclosures of regulatory and non-regulatory expenses, the public can learn how much an SRO spends on its data servers, on developing electronic surveillance programs and on regulatory (and non-regulatory) legal fees.

[31] This type of phased-in approach is consistent with the Commission's handling of new rules for reporting company filing deadlines. Until recently, the Exchange Act required reporting companies to file their annual reports within 90 days after the end of their fiscal years. In September, 2002, the Commission

VI. Proposals for Periodic SRO Reporting to the SEC on Regulatory Matters

Under the SEC's proposal, each SRO would be required to file specific quarterly and annual reports. Quarterly reports would need to be filed within 20 business days after the end of each calendar quarter and annual reports must be filed within 60 calendar days after the calendar year end. The information required to be disclosed is extensive and will require a great deal of time and effort to compile. While the Exchange recognizes the Commission's interest in obtaining complete information about an SRO's regulatory activities, the burdens associated with these reporting requirements should be taken into account as well. We note that the Commission's staff already possesses the authority to examine our regulatory program to obtain information. Ultimately, public investors and SRO members are not well-served by diverting resources to tracking and summarizing regulatory activity, rather than doing it.

The Market Regulation Department currently tracks certain statistics relating to its activities and provides those to its ROC as part of the regular review of the Exchange's oversight function. We have no objection to sharing this quantitative information, but believe that the requirement to create summaries of all examinations, enforcement inquiries and regulatory complaints received by the Exchange is excessively burdensome. Moreover, the requirement to create a publicly-available summary of open, closed and pending investigations presents additional problems. Particularly for a smaller SRO such as the CHX, it would be relatively easy for the member under investigation to identify the description of investigation that applies to them, even if the member is not identified by name. A summary of the preliminary findings and theories of the Exchange's Enforcement staff would potentially compromise the investigatory process. Since the confidentiality provisions of the Freedom of Information Act are not absolute, protection under that Act would not appear to be adequate to prevent any such harm. We therefore recommend that the requirement to create summaries of regulatory activity be removed from the proposed rules.

In a similar fashion, the requirement that each SRO create a written self-evaluation of the strengths and weaknesses of its regulatory program on an annual basis involves a substantial burden, particularly for smaller SROs. Having recently gone through such an evaluation, the Exchange appreciates the value of this type of review. However, we question whether it is necessary to have a regulatory mandate to perform self-evaluations on an annual basis and reduce the findings of those reviews into written reports. We would prefer to perform such reviews when a need becomes apparent.

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adopted amendments to these reporting rules which required "accelerated filers" – companies that, among other things, have a public float of $75 million or more – to move, in stages, to a new 60-day filing requirement. Release No. 33-8128, 69 FR 58480 (September 5, 2002). The Commission recently extended the phase-in period by another year to provide a longer transition period to the 60-day format. Release Nos. 33-8507, 34-50684, 69 FR 68232 (November 23, 2004).

Moreover, such disclosure may create unwanted and counterproductive exposure to litigation.

Finally, the time periods for creating and filing these reports needs to be extended, particularly to accommodate the required ROC review. We propose that the 20-day requirement on quarterly reports be revised to 45 days and that the 60-day period for annual report be extended to 90 days.

VII. Comments on SRO Concept Release

The CHX strongly believes in the central role that self-regulatory organizations hold in the operation of the U.S. markets. The self-regulatory framework appropriately gives SROs, which have in-depth knowledge of their rules and trading systems, the responsibility of working diligently to provide efficient trading venues that protect public investor interests. While there are conflicts of interest inherent in this regulatory system, the Exchange believes that SROs, with oversight by the Commission, offer the best mechanism for regulating the nation's securities markets.

The concept release proposes several alternatives to the current self-regulatory model – options ranging from giving some or all of an SRO's responsibilities to a single regulator through giving the Commission itself the responsibility for policing the markets on a day-to-day basis. The Exchange strongly believes that SROs can and should have the ability to voluntarily work together to fulfill their regulatory obligations and that one SRO should not gain a competitive advantage over others by choosing to not regulate its marketplace. The Exchange is concerned, however, that the alternatives suggested in the release may raise as many concerns as they try to resolve. For example, a Universal Industry Self-Regulator (particularly one that has historical ties to one specific trading market) could inadvertently, or even purposefully, impair the ability of a market to legitimately operate within the structure that it has chosen.[32] Even the division of oversight responsibilities among SROs – the Hybrid Model described in the concept release – could hinder a marketplace's ability to conduct strong market regulation by separating the regulation of traditional "member" rules from the oversight of the trading

[32] A single regulator would face the challenge of learning the trading rules of each market and structuring a surveillance and enforcement program appropriate for those rules. These different rules legitimately spring from differences in the ways markets are structured, not from a desire by any market to regulate itself less vigorously. Of course, the new regulator would have a much easier job if all of the markets had the same rules, the same structure and the same procedures. Indeed, it might be quite difficult, if not impossible, for a single regulator, even if it is well-intentioned, to resist the temptation to hold down its costs by "standardizing" the markets into a model of the regulator's own choosing. Even a regulator with the best of intentions, therefore, could innocently place burdens on legitimate competition among different types of markets. A regulator with bad intent – such as a desire to favor one market model over another – could effectively curtail or destroy a market's operations.

that occurs.[33] Whatever the real or perceived weaknesses of the current regulatory model, the Exchange believes that they can, and should be, resolved while allowing individual SROs – to the extent that they so choose – to retain jurisdiction over their members and over the trading that occurs in their markets.

Conclusion

The Exchange remains committed to fulfilling its obligation as a self-regulatory organization and remains optimistic about its ability to provide a competitive marketplace for the trading of securities. At the same time, however, the Exchange is concerned that some of the new disclosure and governance burdens may ultimately make it difficult for any but the largest SROs to survive. The Exchange would prefer to be judged by the market (and by the Commission) on its substantive work, not on whether it publishes well-crafted documents that provide the appearance of a strong structure. For that reason, the Exchange encourages the Commission to consider adopting the modifications to Rules 6a-2, 6-a5, 17a-26 and 17a-27 that are suggested above.

Sincerely,

David C. Whitcomb, Jr.
Senior Vice President
& Chief Regulatory Officer

Ellen J. Neely
Senior Vice President
& General Counsel

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[33] SROs regulating the trading activity of a member firm often bolster their reviews with information about a member firm that is learned during traditional "member" examinations – such as the firm's compliance with net capital requirements or the specificity of the firm's supervisory procedures. This cross-use of data would be difficult if the regulation of these activities were performed by separate corporate entities.