



THE NASDAQ STOCK MARKET
ONE LIBERTY PLAZA, 50TH FLOOR
NEW YORK, NY 10006

February 2, 2006

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: File No. SR-NYSE-2005-77; Notice of Filing of Proposed Rule Change and Amendment Nos. 1, 2, 3, 4, and 5 Relating to the New York Stock Exchange's Business Combination with Archipelago Holdings, Inc.

Dear Ms. Morris:

The Nasdaq Stock Market Inc. ("Nasdaq") appreciates the opportunity to submit comments on the governance changes proposed by the New York Stock Exchange (the "NYSE") in the above-captioned filing.

Timetable

As stated in our previous comment letter on the filing,¹ however, we share the concerns expressed by the Securities Industry Association² and the Bond Market Association³ that the 21-day comment period for a normal Form 19b-4 filing is not adequate to allow interested parties to address fully the public policy issues raised by the massive NYSE proposal. The significant scope of issues raised by the filing is evidenced by two major securities industry trade associations going on the record with expressions of concern on behalf of their wide membership. Moreover, the NYSE amended its filing

¹ Letter from Edward Knight, Executive Vice President and General Counsel, Nasdaq, to Nancy Morris, Secretary, SEC (January 25, 2006).

² Letter from George Kramer, Deputy General Counsel, Securities Industry Association, to Nancy Morris, Secretary, SEC (January 18, 2006).

³ Letter from Marjorie E. Gross, Senior Vice President & Regulatory Counsel, The Bond Market Association, to Nancy Morris, Secretary, SEC (January 23, 2006).

as recently as January 20, 2006.⁴ It is unfortunate that the Commission has not chosen to extend the comment period to allow a full examination of such critical issues. We hope that the Securities and Exchange Commission (the “SEC” or the “Commission”) will consider these important issues carefully and will not rush towards approval.

Notwithstanding our concerns about process, we submit our substantive comments based on the limited time available to review the filing.

Overview

Nasdaq welcomes competition and appreciates that the NYSE is taking steps to modernize its organization and trading platforms so that it can remain a formidable competitor both domestically and internationally. Although there are critical differences between Nasdaq and the NYSE’s new proposed market structure, we note that NYSE is seeking to follow a trail that Nasdaq already blazed, *i.e.*, the move, at least in part, to an electronic trading platform that Nasdaq pioneered since 1971 and the move to a for-profit entity, which Nasdaq also pioneered in 2000.⁵ Nasdaq believes that competition among trading platforms is in the best interests of investors and the U.S. economy. We do not quarrel with the efforts of the NYSE or other market centers to compete for listings and order flow. Specifically, we are not commenting at this juncture on the market structure aspects of the NYSE’s proposed hybrid market or its business relationship with Archipelago Holdings, Inc. (“Archipelago”) and its subsidiaries.

Instead, our concerns focus on the regulatory issues that the NYSE proposal presents. As discussed in more detail below, we believe that the proposal is fraught with conflicts and diminishes the benefits of self-regulation. Nasdaq believes that investor protection is a shared responsibility, not a competitive issue, and that the NYSE proposal does nothing to improve the *status quo*. Indeed, in our view the proposal exacerbates the problems with the current system. We strongly urge the Commission to consider these issues and to examine the NYSE’s proposal from the perspective of strengthening the self-regulatory system and improving investor protection.

Structural Concerns

As expressed in our prior letter,⁶ our concerns with the NYSE proposal are with the quality and efficiency of the regulatory oversight that the NYSE will provide to its market and members. A narrow view of our competitive interests might lead some to expect us to welcome a proposal that appears likely to perpetuate or worsen conflicts of

⁴ See Amendment Number 6 to SR-NYSE-2005-77 (January 20, 2006) (“Amendment No. 6”). Although the amendment can be found on the NYSE’s website, as of this writing it is not posted on the SEC’s website.

⁵ See Nasdaq Timeline at <http://www.nasdaq.com/newsroom/presskit/timeline.stm>.

⁶ See *supra* n.1.

interest within the NYSE's regulatory structure, since regulatory lapses on the part of the NYSE might lead more issuers to move their listing to Nasdaq and more broker-dealers to decide that NYSE membership is unnecessary and unduly burdensome.⁷ We strongly believe, however, that ensuring effective and efficient regulation of all markets and market participants is in everyone's interest, because it is key to ensuring investor confidence in our capital markets. Investors should not have to concern themselves with the quality of regulation at particular self-regulatory organizations ("SROs") or whether their broker-dealer is a member of the NYSE or the National Association of Securities Dealers, Inc. ("NASD") or both. Rather, regulation should be uniformly excellent across the industry. In the recent past, NYSE officials have indicated a willingness to work toward allowing the NASD to increase its role as the focal point for member regulation, thereby reducing conflicts of interest and regulatory burdens. Unfortunately, the NYSE proposal makes no meaningful progress toward these goals.

The NYSE proposes to form a public holding company, NYSE Group, Inc. ("NYSE Group"), that would own two SROs: New York Stock Exchange LLC ("NYSE LLC") and, through Archipelago, the Pacific Exchange ("PCX") (NYSE LLC and PCX collectively, the "NYSE Group SROs"). Through NYSE LLC, NYSE Group also would own NYSE Regulation, Inc. ("NYSE Regulation"), a new regulatory subsidiary that would regulate both of the NYSE Group SROs and their members.⁸ We summarize the NYSE organization briefly:

- **NYSE Group** – would be the for-profit, publicly-traded company that would be the holding company for the businesses of NYSE and Archipelago. All members of the board would be independent directors,⁹ except for the chief executive officer.
- **NYSE LLC** -- would hold the NYSE's registration as a stock exchange. NYSE Group would own NYSE LLC. All independent directors of NYSE Group would be directors of NYSE LLC. At least 20% and not less than two persons (who satisfy the proposed Independence Policy) would be non-affiliated NYSE LLC directors.
- **NYSE Market, Inc. ("NYSE Market")** -- would be a wholly owned subsidiary of NYSE LLC and would hold the NYSE's current assets and liabilities regarding the NYSE's securities exchange business. The CEO of

⁷ As a case in point, The Charles Schwab Corporation has moved its listing exclusively to Nasdaq, while Charles Schwab & Co., Inc., its broker-dealer subsidiary, has terminated its NYSE membership.

⁸ The following description is based on Securities Exchange Act Release No. 53073 (January 6, 2006) (SR-NYSE-2005-77) (the "Proposing Release").

⁹ See Exhibit 5J to the Proposing Release for the proposed Independence Policy of the NYSE Group Board of Directors.

NYSE Group would be a director of NYSE Market. A majority of the directors would be directors of the NYSE Group board and at least 20% and not less than two directors would be non-affiliated market directors, who would not need to be independent directors.

- **NYSE Regulation** – would be a New York State Type A not-for-profit corporation. It would perform regulatory functions for both NYSE LLC and PCX. NYSE LLC would be the sole voting equity holder of NYSE Regulation. Its board would include the chief executive officer of NYSE Regulation. A majority of the board would be directors who are not NYSE Group directors, but who qualify as independent. The remainder would be NYSE Group directors.¹⁰

Other highlights include the following:

- In an effort to comply with the fair representation requirement of Section 6(b)(3) of the Securities Exchange Act of 1934, the proposal includes a complex mechanism to place individuals on the boards of NYSE LLC and NYSE Market, who are not NYSE Group directors and who would be chosen by special committees or by a petition process.¹¹
- The proposal also includes amendments to corporate charters and by-laws that require consideration of investor protection concerns. For example, NYSE Group's proposed certificate of incorporation would require each director of NYSE Group to take into consideration whether a proposed action would promote just and equitable principles of trade.¹²
- The NYSE has prepared a proposed Delegation Agreement that would allocate regulatory and other responsibilities among the various affiliates.¹³

We do not doubt that the NYSE offered these proposals in a good faith effort to achieve their investor protection goals while seeking to modernize the NYSE's structure, including making the change to for-profit status. Nonetheless, we do not believe that the proposal will withstand scrutiny for a number of reasons.

- **Conflicts of Interest** – Although the NYSE has tried to build many protections into the complex arrangement of subsidiaries and boards, the fact

¹⁰ This description is based on Amendment 6.

¹¹ See Proposing Release at 29 and Amendment 6 at 5.

¹² Proposing Release at 14.

¹³ See Exhibit 5I to the Proposing Release.

remains that NYSE's primary and exclusive regulatory unit, NYSE Regulation, would still be an indirect and controlled subsidiary of the NYSE Group, a for-profit corporation. We believe that the structure presents conflicts on two levels:

- It is inappropriate to have all front-line member regulatory responsibilities housed within the overall entity that operates the trading facility; and
- It is fundamentally inconsistent with the mission of a for-profit entity for the entire regulatory apparatus to exist within the framework of a for-profit entity.

Although the proposed structure features many disparate corporate entities with complex rules governing the composition of each entity's governing board, the complexity should not cause the Commission to lose sight of NYSE Group's direct control of NYSE Regulation. Specifically, although the directors of NYSE Regulation are intended to be "independent" by virtue of an absence of direct ties to the NYSE Group SROs and their affiliates, members, and listed companies, their selection is ultimately controlled by the NYSE Group. These directors will, in turn, select the officers who will be making the front-line regulatory decisions for both of the NYSE Group SROs.

Directors of NYSE Group would have a fiduciary duty to maximize profits. Inevitably there will be a temptation to overlook violations that regulatees may have committed to avoid hurting the business of NYSE Group. Further, there is a risk that heightened regulatory scrutiny could be used either as an implicit threat against the member firms to avoid criticizing the NYSE or to discourage members from using different markets for executing transactions. The existence of such a possibility undermines investor confidence.

The SEC's Section 21A report¹⁴ with regard to NASD and the more recent grant of exchange registration to The NASDAQ Stock Market LLC ("NASDAQ LLC"),¹⁵ show that the SEC has recognized the value of true regulatory separation. These actions do not reflect a formulaic approach in which regulators are merely housed in different divisions or corporations, but rather a functional approach to these issues that ensures that those responsible for operating the market are in a legally separate entity and not in a position to influence decisions about which members to investigate, charge, or sanction. NASDAQ LLC will achieve this separation through an arm's length

¹⁴ In the Matter of National Association of Securities Dealers, Inc., Exchange Act Release No. 37538 (August 8, 1996) (Administrative Proceeding File No. 3-9056).

¹⁵ Securities Exchange Act Release No. 53128 (January 13, 2006) (File No. 10-131) ("Exchange Registration Order").

regulatory services agreement with NASD and an agreement under Exchange Act Rule 17d-2 that will vest substantial responsibility for many NASDAQ LLC rules in the NASD.¹⁶ We believe that the reasons for such a structure are strengthened when the market intends to operate on a for-profit basis. The NYSE proposal is markedly deficient in this regard and thereby stands in stark contrast with the Commission's policy with regard to Nasdaq over the past ten years.

- **Minimizes the Benefits of Self-Regulation** – The proposed structure of the various NYSE boards systematically excludes meaningful input from members of the securities industry. The 1963 Special Study of the Securities Markets notes that:

Members of the affected business can bring to bear on the problems of regulation a degree [sic] of expertness, and in many circumstances expedition, not to be expected of a necessarily more remote governmental agency. It is a truism that the securities business is highly complex, involving "intricate merchandise" and delicate and changing market mechanisms. Putting aside for the moment questions of motivation and adequate concern for the public interest, persons on the scene and familiar with the intricacies of securities and markets from daily and full-time pursuit of the business can more readily perceive and comprehend some types of problems and more promptly devise solutions than a governmental agency which, however great its collective knowledge and skill, may be able to concern itself only intermittently with specific problems, may become aware of them only after the event, and often must defer decision and action until thorough investigation or study has been completed.¹⁷

Nasdaq does not mean to suggest that SROs should return to the days of industry domination of SRO boards and committees. We fully recognize that industry majorities on all SRO boards and committees are no longer appropriate or acceptable. But we do believe that it is possible to reach a balanced solution: to seek the input of knowledgeable industry experts in an environment in which independent directors or committee members have the final say on critical governance and regulatory matters. NYSE Group's Board, which would be ultimately responsible for the operation of the NYSE complex, lacks any industry input. Other boards or committees may have only token participation. We think

¹⁶ NASDAQ LLC's retained self-regulatory functions will be subject to oversight by its Regulatory Oversight Committee. Exchange Registration Order at 21-28. NASD will provide the overwhelming majority of front-line regulatory oversight for NASDAQ LLC.

¹⁷ Report of the Special Study of Securities Markets of the Securities Exchange Commission, Part 4 at 694-695, available at http://www.sechistorical.com/collection/papers/1960/1963_SS_Sec_Markets/.

that the NYSE proposal has succeeded in maximizing the disadvantages of self-regulation, by minimizing input from industry representatives in appropriate circumstances while retaining all of the conflicts inherent in the commingling of markets and regulation. We also question whether the proposed structure would satisfy the fair representation requirement of Section 6(b)(4) of the Exchange Act if challenged in court.

The NYSE has proposed a structure that constitutes a legal *tour de force* with great complexity, including charters and by-law provisions, many affiliates, and lots of high-minded language. But for all its complexity, the proposal has not addressed the fundamental problem it purports to solve: the proposed NYSE Group remains an improperly conflicted for-profit entity with exclusive, primary regulatory oversight regarding its members, and minimal industry input.

Broader Context

The NYSE's proposal also fails to confront the broader question of whether the time has come to address self-regulation across the industry. The NYSE acknowledges that this problem exists, but offers only good intentions to address it. Amendment Number 6 states:

Finally, the Exchange is aware that member organizations are concerned with inconsistencies between the way the Exchange and the National Association of Securities Dealers ("NASD") apply or interpret similar rules, and that they also are concerned with duplicative oversight examinations. The Exchange has undertaken to the Commission that it will work with the NASD and securities firm representatives to eliminate inconsistent rules and duplicative examinations, and to use its best efforts, in cooperation with the NASD, to submit to the Commission within one year proposed rule changes reconciling inconsistent rules and a report setting forth those rules that have not been reconciled.¹⁸

We do not question the NYSE's commitment to this process, but it appears to be a minimal step to deal with a serious problem. It does not ensure that at the end of the process, we will be any closer to agreeing to a single rulebook than we are today. That is because the fundamental structure is inherently problematic. It has been Nasdaq's position for some time that a consolidated ("hybrid") SRO is in the best interests of investor protection.¹⁹ The NYSE's commitment to address the problem of overlapping and duplicative rules – however sincere – does nothing to address the structural problem

¹⁸ Amendment 6 at 6.

¹⁹ See Letter to Jonathan G. Katz, Secretary, SEC, from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq (March 8, 2005) (commenting on Proposed Rulemaking on SRO Governance (File No. S7-39-04) and Concept Release Concerning Self-Regulation (File No. S7-40-04)).

of multiple SROs with redundant rules imposing similar but not identical rules on the same member firms.

Perhaps, the NYSE suggests that it is not necessary to address these issues now. In effect, the filing asks why not approve the NYSE's proposal now and consider the broader public policy issues some other day? There are at least two responses.

First, the issues that the proposal raises go to the heart of investor protection for marketplace with a significant market share. As an SRO, the NYSE has the responsibility to address the question of whether the proposal provides effective investor protection and whether there are alternatives that might be more effective. As the investor's advocate, the SEC has a similar responsibility to ask, in effect, if this is the best we can do.

Second, the NYSE has itself already broached the issue of whether it has presented an effective cross-market SRO. The NYSE is proposing a model that includes the NYSE, Archipelago, and PCX. The proposed change directly presents the question of how best to regulate securities trading in multiple platforms across more than one SRO. In Nasdaq's view, the time has come to consider the question of whether the SEC, SROs, and securities industry should create a more effective SRO environment.

Candidly, we also believe that the NYSE will have greater willingness to reach an accommodation at this juncture, than it would after the SEC has approved the proposal. It is naïve to think otherwise.

The current structure of self-regulation does not work as well as it could. It wastes broker-dealers' resources to adhere to multiple sets of similar, but not identical, sets of rules. It wastes SROs' resources to have to maintain and interpret nearly similar rules and then have to coordinate among themselves in a perpetual effort to avoid inconsistent results. The same commitment of compliance resources might achieve better results in a different environment. Surely the investing public deserves better and certainly this filing presents an opportunity to make improvements.

Nasdaq urges the Commission to consider different models of self-regulation.²⁰ In the context of this filing, moreover, the Commission should insist that the NYSE rationalize inconsistent and duplicative regulation now, not at a distant future date.

Specific Issue

Nasdaq also wishes to highlight one allocation of responsibility within the new NYSE structure. The proposal notes that:

²⁰ The Commission began this process when it issued a concept release on the issue. Securities Exchange Act Release No. 50700 (November 18, 2004) (File No. S7-40-04).

NYSE Market's responsibilities include the operation of Market Watch, a unit whose functions include, among others, coordination with listed companies, floor officials, and regulatory staff of NYSE Regulation with respect to dissemination of news and trading halts. This unit is distinguished from the Stock Watch unit within NYSE Regulation, whose functions include review of exception reports, alerts and investigations. NYSE Market will establish the principles and policies under which trading on NYSE Market will be conducted, and those principles and policies will be codified by NYSE Regulation in the rules of New York Stock Exchange LLC. In addition, NYSE Market will be responsible for referring to NYSE Regulation, for investigation and action as appropriate, any possible rule violations that come to its attention.²¹

Nasdaq is concerned that this arrangement is symptomatic of the larger problem of the proposed NYSE structure. Nasdaq respectfully suggests that it may not be appropriate to include the Market Watch function with NYSE Market's responsibilities. Nasdaq appreciates the need for keeping some regulatory functions associated with the relevant marketplace. But we note that on April 15, 2005, the United States Attorney for the Southern District of New York indicted 15 individuals, seven of whom "served as NYSE floor officials and were responsible for supervising and regulating floor trading activities. [One individual] also served as one of twenty senior floor officials known as floor governors. These individual also worked as employees of specialist firms."²² The SEC also brought administrative cease and desist proceedings against some of the same individuals.²³

It is our understanding that these proceedings are still pending, and it would be improper to reach any conclusions prematurely. Nonetheless, we believe that it is troubling to learn that former NYSE floor officials were subject to criminal indictment and SEC cease and desist proceedings. We are concerned that a portion of the plan seems to replicate the very structure that led to these law enforcement actions.

Nasdaq respectfully suggests that a closer examination of the Market Watch function may be appropriate to avoid further difficulties in the future.

²¹ Proposing Release at n. 29.

²² Press Release, United States Attorney Southern District of New York, "15 Current and Former Registered Specialists on the New York Stock Exchange Indicted on Federal Securities Fraud Charges," April 12, 2005.

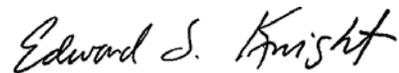
²³ "SEC Institutes Enforcement Action Against 20 Former New York Specialists Alleging Pervasive Course of Fraudulent Trading," Press Release 2005-54; and Administrative Proceeding File No. 3-11893 (April 12, 2005).

Conclusion

Nasdaq believes that this filing presents an excellent opportunity for the Commission to examine different aspects of the self-regulatory system. Nasdaq urges the SEC to seize this opportunity to look for ways of strengthening investor protection and rationalizing the current system. It would be unfortunate if the Commission were to approve the NYSE proposal without considering it in the broader context and ends up missing an excellent opportunity to strengthen SRO and broker-dealer compliance.

Nasdaq appreciates the opportunity to comment and would welcome further discussions with the Commission or the staff on these issues.

Sincerely,

Handwritten signature of Edward S. Knight in cursive script.

cc: The Honorable Christopher Cox, Chairman
The Honorable Cynthia A. Glassman
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Annette L. Nazareth
Robert Colby, Acting Director, Division of Market Regulation