Securities Industry Association
1425 K Street, NW
Washington, DC 20005

The Bond Market Association
360 Madison Avenue
New York, NY 10017

February 2, 2006

Nancy M. Morris
Secretary
Securities and Exchange Commission
Station Place
100 F Street, N.E.
Washington, DC 20549-9303

Re: File No. SR-NYSE-2005-77, Notice of Filing of Proposed Rule Change and Amendment Nos. 1, 2, 3, 4, 5 and 6 Relating to the New York Stock Exchange's Business Combination with Archipelago Holdings, Inc.

Dear Ms. Morris:

The Bond Market Association[1] ("TBMA") and the Securities Industry Association[2] ("SIA" and, collectively, the "Associations") appreciate this opportunity to comment on the proposed rules and by-law amendments ("Proposal") of the New York Stock Exchange ("NYSE" or "Exchange") concerning the governance of the NYSE and

[1] TBMA is a trade association that represents approximately 200 securities firms, banks and asset managers that underwrite, trade and invest in fixed-income securities in the United States and in international markets. Fixed income securities include U.S. government and federal agency securities, municipal bonds, corporate bonds, mortgage-backed and asset-backed securities, money market instruments and funding instruments such as repurchase agreements. More information about TBMA and its members and activities is available on its website www.bondmarkets.com.

[2] The Securities Industry Association brings together the shared interests of approximately 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. 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. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated $236.7 billion in domestic revenue and an estimated $340 billion in global revenues. (More information about SIA is available at: www.sia.com.)

its market and regulatory affiliates following the conversion of NYSE to a for-profit entity. The transaction will result in a publicly held company, NYSE Group, Inc. ("NYSE Group"), that will wholly own New York Stock Exchange LLC ("NYSE LLC"), a new entity that in turn will house the actual Exchange facility. Under the Proposal, the current market and regulatory business of the Exchange would be conducted by two subsidiaries of NYSE LLC, NYSE Market, Inc. ("NYSE Market") and NYSE Regulation, Inc. ("NYSE Regulation"). As of the date of this letter, the Commission has published for comment the NYSE's application and amendment nos. 1 through 5. This letter also takes into account amendment no. 6, which is available on the NYSE's website, but has not been published on the Commission's website or in the Federal Register.

Overview of Association Comments

The Associations recognize that there is a strong economic justification for the Exchange's transition to for-profit status. This is an appropriate development, the economic terms of which the Associations do not challenge. At the same time, however, the proposed NYSE merger has opened a window of opportunity to act proactively and in the best interests of investors and the industry which serves them. Now is the time to address regulatory duplication and possible conflicts of interests. Within a defined period of time, such as 60 to 90 days following Commission approval of the Proposal, the NASD and NYSE should be required to present to the SEC a plan for regulatory consolidation.

Other exchanges in markets around the world, responding to the same economic and competitive pressures, have demutualized in recent years. Every exchange that has become for-profit over the past decade has also taken steps to ensure "structural separation between the supervisory authority and the management of the exchange or

market."[3] Most of our comments are aimed at ensuring that the NYSE also provides this critical separation.

Many aspects of the corporate governance system described in the Proposal are similar to those in the NYSE governance package that was approved by the Securities and Exchange Commission ("SEC" or "Commission") two years ago.[4] However, the demutualization of the NYSE raises fresh policy concerns. Specifically, firms will find that they are often either competitors with or customers of the NYSE as a for-profit entity while at the same time being regulated by it, raising a much greater need to ensure distance between the NYSE's business functions and its regulatory functions. The Proposal, which is summarized in Attachment A, therefore requires greater scrutiny than the 2003 Governance Proposal.

The Associations have concerns with four aspects of the Proposal:

- Amendment No. 6 to the Proposal raises the critical issue of member-firm regulatory duplication, but fails to take this unique opportunity to combine the duplicative functions of NYSE and National Association of Securities Dealers ("NASD") broker-dealer regulation into one entity. Such a "hybrid" broker-dealer self-regulatory organization ("SRO") could address both business conflict and regulatory duplication concerns.

- The conflicts of interest inherent in a for-profit entity regulating its competitors and customers are accentuated by provisions of the Proposal that are likely to give directors of NYSE Group control of the board of the Exchange itself – NYSE LLC. NYSE LLC is the registered exchange and is therefore subject to the conflict of interest and fair representation concerns reflected in the Exchange Act.[5] The Proposal also provides a major role in the governance of NYSE Regulation by directors of NYSE Group.

- The Proposal excludes from the boards of NYSE LLC and NYSE Regulation anyone associated with a member firm, thus depriving member firms of fair

[3] Jonathan R. Macey & Maureen O'Hara, From Markets to Venues: Securities Regulation in an Evolving World, 58 Stan. L. Rev. 563 (hereinafter cited as "Macey & O'Hara")(surveying the Australian Stock Exchange, Deutsche Borse, Euronext, Hong Kong Exchange, London Stock Exchange, OM (Stockholm), Singapore Stock Exchange and Toronto Stock Exchange).

[4] *See* Release No. 34-48946 (December 17, 2003)(the "2003 Governance Proposal"), 68 Fed. Reg. 74678 (Dec. 24, 2003).

[5] We assume the NYSE is not taking the position that NYSE Regulation is a stand-alone securities association that could be registered under Section 15A of the Exchange Act.

representation in the governance of the Exchange or NYSE Regulation. The Proposal also excludes meaningful member firm involvement in the funding and rulemaking processes of NYSE LLC and NYSE Regulation. In the opinion of the Associations, representation on purely advisory committees is not sufficient to provide fair representation in the administration of the affairs of an exchange.

- The Proposal does not address the need for an independent market data utility housed outside the for-profit entity in order to provide transparency as well as fair and equal access to market data.

At pages 21-25 below we offer specific alternatives to the Proposal that address each of these concerns.

For all these reasons, and as more fully set forth below, we urge the Commission to require two basic changes to the NYSE's governance proposal. First, require a firm commitment by the NYSE to work with the NASD to arrive at an agreement, within a set time period such as 60 to 90 days and subject to SEC approval, to form a structure for combined regulation of dually-registered broker-dealers. Second, in order to deal with concerns about the conflict of interest between NYSE Group's for-profit status and the power of its regulatory affiliates over competitors, create greater structural separation between NYSE Group and those affiliates, by reducing or eliminating NYSE Group representation on the boards of NYSE LLC and NYSE Regulation, and by permitting member firm broker-dealers to maintain, through their officers or employees, direct "fair representation" on those boards.

Discussion

I. Comments of the Associations on the Proposal

A. The Proposal Should Provide for Regulatory Consolidation with the NASD.

Rather than continue to hold out its own "brand" of member firm regulation, NYSE should move ahead with regulatory consolidation with the NASD's broker-dealer regulation entity. As NYSE Chief Executive Officer John Thain recently said:

> "With respect to member firm regulation, that's the piece where there is the most concern about duplication of efforts and overlap…. specifically as it relates to the

> New York Stock Exchange and the NASD . . .. There are lots of ways that we could work together to eliminate the duplication on the examination side. … We could create a joint venture to do it together. We could do a number of different things, such as alternating who examines a firm in any particular year. Frankly, it's really much more a question of resolve…. It will have to include the SEC, but there's no reason why we cannot reduce some of the duplication and burden on the member firms, and I'm committed to help to do that."[6]

Amendment No. 6 to the Proposal includes a new paragraph in the "Purpose" section to the effect that NYSE LLC will continue to work with the NASD to address 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."[7] This statement, while welcome, falls far short of addressing the inefficient duplication of NYSE and NASD regulatory efforts that now exists.

Most major broker-dealer firms' compliance resources currently are devoted to complying with rules of multiple SROs. For example, conduct rules – the area of the most duplicative SRO rules – have the same regulatory purpose but require different compliance efforts.[8] To their credit, senior staffs of both the NYSE and NASD have recently shown a strong commitment to work together to eliminate unnecessary duplication and conflict. However, despite their best efforts, problems continue to arise because of the structural flaw in existing broker-dealer regulation: the more regulatory bodies that exist performing largely the same regulatory function over the securities industry, the more their efforts will inevitably result in unnecessary duplication, conflict and contradiction, notwithstanding the good-faith efforts of their senior staffs to avoid such difficulties. What is needed is a commitment to regulatory consolidation. At pages

---

[6] Keynote Address of John Thain, 34th SIA Annual Conference, available at http://www.nyse.com/Frameset.html?displayPage=/about/viewpoints.html.

[7] Amendment No. 6, available at http://apps.nyse.com/commdata/pub19b4.nsf/docs/EC15739AE7AC3A50852570F C007BF6FA /$FILE/NYSE-2005-77%20A-6.pdf, at 6.

[8] 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.

21-23 below we outline some of the key elements of that regulatory consolidation. Attachment B to this letter is a statement of goals and principles for regulatory consolidation recently issued by SIA.

B. The Proposal Heightens the Conflict of Interest Between a For-Profit Exchange and its Regulatory Function.

The NYSE proposal does not adequately address the fundamental conflict between the interests of a for-profit exchange and the members that it regulates, and it may even exacerbate that conflict by placing the directors of its parent in *de facto* control of the board of NYSE LLC and in a dominant position on the board of NYSE Market and NYSE Regulation. The issue here is the potential conflict between an exchange's role as both market operator and regulator, and the potential for the profit motive of a shareholder-owned exchange detracting from self-regulation. As a General Accountability Office report on this subject noted, "Heightened competitive pressures have generated concern that an SRO might abuse its regulatory authority – for example, by imposing rules or disciplinary actions that are unfair to the competitors it regulates."[9] The SEC has stated that it shares this concern:

> "As intermarket competition increases, regulatory staff may come under pressure to permit market activity that attracts order flow to their market. . . . Also, SROs may have a tendency to abuse their SRO status by over-regulating members that operate markets that compete with the SRO's own market for order flow…. SRO demutualization raises the concern that the profit motive of a shareholder-owned SRO could detract from self-regulation. For instance, shareholder-owned SROs may commit insufficient funds to regulatory operations or use their disciplinary function as a revenue generator with respect to member firms that operate competing trading systems or whose trading activity is otherwise perceived as undesirable."[10]

---

[9] "Securities Markets: Competition and Multiple Regulators Heighten Concerns about Self-Regulation," General Accounting Office, May 2002, GAO-02-362, available at http://www.gao.gov/new.items/d02362.pdf, at 1-2 ("GAO SRO Report").

[10] Concept Release Concerning Self-Regulation, 69 Fed. Register 71256, 71262-63 (Dec. 8, 2004) ("SEC SRO Concept Release").

This conflict has been a subject of public discussion ever since the NYSE first raised the idea of demutualizing in the late 1990s. For example, NYSE Group would have an interest in promoting trading products offered by it, and discouraging broker-dealers from offering competing products. Similarly, NYSE Group would have a strong interest in promoting trading on its exchange, and discouraging broker-dealers or their affiliates from offering, or routing trades to, competing platforms. These types of conflicts have long been an issue between exchanges and their members even when exchanges are not for-profit, and have grown as exchange members have become competitors by, for example, internalizing order flow and offering alternative trading venues that compete with the Exchange for third party order flow.[11] Once an exchange or its parent gains for-profit status, this conflict of interest becomes much more acute.[12] In addition, as the NYSE Group or its subsidiaries enter into a broader array of businesses, or add to their trading products, as they have stated they plan to do,[13] the opportunities for conflicts will multiply.

The Proposal aggravates the conflict of interest between NYSE Group's business interest as a for-profit entity and the interests of the firms regulated by NYSE Group's subsidiaries. It does this by structuring the boards of NYSE LLC and NYSE Regulation so that these boards are heavily represented, if not dominated, by the directors of the for-profit parent, NYSE Group, while offering the firms with which it competes no direct representation on these boards.

---

[11] "[S]elf-regulation now poses massive agency-cost problems because exchanges are seeking to regulate members who are, in fact, competing firms rather than firms with whom the exchanges' interests are aligned with respect to most regulatory issues." Macey & O'Hara at 578. For an illustration of the long history of competitive issues between the NYSE and its members s*ee, e.g*, The Structure of the Securities Market – Past and Future, Thomas A. Russo and William K.S. Wang, 61 Fordham L. Rev. 1, 42 (1972) ("The New York Stock Exchange has taken every opportunity to fight competition…." (citing then-current illustrations)).

[12] Macey & O'Hara at 581.

[13] Interview by CNBC News with NYSE Chairman Marshall N. Carter and NYSE CEO John A Thain (April 8, 2005)(quoting Mr. Thain as stating "Well, as I`ve said before, I think we would like to see some derivative trading, some options trading, and certainly some fixed income trading."), available at http://www.nyse.com/Frameset.html?displayPage=/about/1113302992920.html.

C. The Proposed Governance Structure Ignores the fact that NYSE LLC is the Exchange and has Plenary Authority Over NYSE Regulation.

It is important to recognize that the problems with potential domination of the NYSE regulatory function by its for-profit parent cannot be fixed just by providing direct broker-dealer member representation on the NYSE Regulation board, although that must be done. The problem will not be fully addressed unless the NYSE LLC board is included in the solution. This is because the Proposal gives the NYSE LLC board plenary power to review any action by NYSE Regulation. The delegation agreement between NYSE LLC and NYSE Regulation states that NYSE LLC "shall have ultimate responsibility for the operations, rules and regulations developed by NYSE Regulation…. Actions taken by NYSE Regulation … remain subject to review, approval or rejection by the board of directors" of NYSE LLC.[14]

The delegation agreement purports to exclude NYSE Regulation's disciplinary actions from review by NYSE LLC, stating that "action taken upon review of disciplinary decisions by the board of NYSE Regulation shall be final action of New York Stock Exchange LLC."[15] Other documents filed with the Commission indicate that NYSE LLC will in fact be able to review disciplinary actions. Specifically, the Proposal states that "[t]he Exchange rules are proposed to be amended to reflect the ability of such [Committee of Review members] and Executive Floor Governors to require review by the board of the New York Stock Exchange LLC of disciplinary decisions pursuant to NYSE Rule 476 and 476A, acceptability of committee decisions pursuant to NYSE Rule 308, and decisions resulting from summary proceedings pursuant to NYSE Rule 475."[16] Moreover, on January 13, 2006 the Commission approved a change to NYSE Rules 475 and 476 that, among other things, provides for review of summary suspension hearings

[14] Amendment No. 5I, at 286, available at http://www.sec.gov/rules/sro/nyse/34-53073ex5i.pdf.

[15] *Id*.

[16] 71 Fed. Reg. at 2086.

by the current NYSE Board of Directors.[17] The Proposal does not seek to abrogate this rule change, which presumably will cover NYSE LLC as the successor to the current NYSE exchange license.

The requirement that all NYSE Group directors but one (the Chairman) must be directors of NYSE LLC effectively means that nothing precludes a majority or even supermajority of NYSE LLC directors to be interlocking directors of the for-profit parent, and that will in fact be the case unless the NYSE LLC board is at least twice the size of the NYSE Group board. Given that NYSE LLC is the sole owner of NYSE Regulation, and that the proposal provides that all of NYSE Regulation's actions, except disciplinary actions, are reviewable by the NYSE LLC board,[18] this alone places directors of NYSE LLC that are also directors of the for-profit parent in position to control the entire regulatory function. With regard to NYSE Regulation, the proposal permits a substantial minority of the NYSE Regulation board to consist of members of the parent NYSE Group board. Given the currently-proposed make-up of the remaining directors, the Associations believe that the directors of NYSE Group will have practical control of the board of NYSE Regulation. [19]

The result is troubling. NYSE Group board members have a fiduciary duty to advance the interests of NYSE Group, a for-profit entity. Its business interests may conflict with those of the broker-dealers that are members of NYSE Regulation. The proposal tries to address this conflict of interest through language in the Certificate of Incorporation for NYSE Group, requiring *inter alia* that its board members must "take into consideration the effect that NYSE Group's actions would have on the ability of the

---

[17] Rel. No. 34-53124, File No. SR-NYSE-2005-37 (Jan. 13, 2006).

[18] Amendment No. 5I, at 286. available at http://www.sec.gov/rules/sro/nyse/34-53073ex5i.pdf.

[19] Even if NYSE Regulation's board met the fair representation standard, the fact that LLC has plenary power to review NYSE Regulation's actions means that both bodies must meet the fair representation requirement. While NYSE LLC is itself technically the SRO, the proposal's only passing attempt at providing "fair representation" is through a nomination process that is too complex to be feasible (see pages 18-19 below), and in any event would produce candidates that are not representative of the industry because, as with NYSE Regulation "fair representation" directors, they cannot be associated with members.

Regulated Subsidiaries[20] to carry out their responsibilities under the Exchange Act"[21] and "shall give due regard to the preservation of the independence of the self-regulatory function of the Regulated Subsidiaries, and shall not take any actions that … would interfere with the ability of the Regulated Subsidiaries to carry out their respective responsibilities under the Act."[22]

It is not clear why these precatory assertions would carry more weight in the mind of a NYSE Group director than his or her fiduciary obligation to maximize the profitability of NYSE Group. Just as the NYSE has been seeking to foster more assertive and less conflicted boards for the companies that it lists, it should recognize the conflict that NYSE Group directors may bring to the boardroom when they serve as directors of the subsidiaries that regulate NYSE Group's competitors. At pages 23-25 below we offer suggestions for better ways of addressing the conflict.

D. The Proposal Does Not Provide Fair Representation for Members.

It is true that the Exchange already crossed the bridge of excluding direct representation of members on its board when it adopted its current governance structure in 2003, which established a board of directors for NYSE Group that is entirely independent (apart from the CEO of NYSE Group, who serves as a board member).[23] While it is unknown if that step would survive a legal challenge, we have not and do not object to keeping the current independence framework for NYSE Group. Our concern is that, in an environment where the parent is for-profit, if NYSE is to retain a regulatory function there must be sturdy firewalls between the governance of the regulatory arm and the parent – especially regarding the regulatory functions that control potential

[20] The Regulated Subsidiaries include NYSE LLC, NYSE Market, NYSE Regulation, ArcaEx and PCX equities.

[21] 71 Fed. Reg. at 2083.

[22] 71 Fed. Reg. at 2084.

[23] SEC Approval Order, Rel. No. 34-48946 (Dec. 17, 2003), available at http://www.sec.gov/rules/sro/34-48946.htm.

competitors of the exchange. Fair representation for members in the governance of the regulatory functions, together with barring or restricting the number of NYSE directors that can also serve on the boards of the regulatory arms, provide such a firewall. Fair representation is therefore not just a statutory requirement, but it is essential as a matter of public policy in the context of a for-profit exchange.

The Associations are not suggesting that the securities industry should have a majority of the directorships of NYSE Regulation or any other SRO. Rather, to maintain the strengths of self-regulation and prevent it from becoming a mere appendage of the SEC, a reasonable level of direct industry representation is required. This is especially true in the context of a for-profit exchange regulating its members, and in particular if the for-profit parent has representation on the regulatory board.

1. *The Proposal Does Not Meet the Statutory Requirement*.

The requirement that all NYSE LLC and NYSE Regulation board members, including the 20 percent selected by the membership, be "independent," as well as the way that independence is defined, does not satisfy the fair representation requirement of the Exchange Act.[24] The Associations believe that this requirement does not meet the statutory obligation of an SRO to "assure a fair representation of its members in the selection of its directors and administration of its affairs."[25] Congress intended to protect broker-dealers' ability to participate in the self-regulatory process by assuring that

[24] The Proposal, however, does permit "fair representation" directors of NYSE Markets to be associated with member firms. This authority is complicated by the requirement that they must meet an unspecified "status or constituent affiliation qualifications prescribed by NYSE Market rule or policy." 71 Fed. Reg. 2080, at 2085 and 2088. We assume that such "status or constituent affiliation qualifications" refer to the qualifications that applied to member directors of the NYSE before 2003, e.g. (1) persons associated with member organizations that engage in a business involving substantial director contact with securities customers; (2) specialists that spend a substantial part of their time on the floor; (3) non-specialists whose business is not national in nature; (4) a member who spends a majority of his or her time on the floor. We believe examples of such qualifications should be specified.

[25] Section 6(b)(3) of the Exchange Act.

members have "reasonable representation in all phases of [the Exchange's] operations."[26] Its intent was clearly not the opposite – to exclude from the category of "fair representation directors" precisely those who had an affiliation with members of the Exchange.

It is even more important to ensure fair representation of member firms in the governance of an exchange when the exchange is for-profit and owned by shareholders. In this situation, the need for fair representation of those who understand the day-to-day issues of the securities business is heightened by the new for-profit nature of the Exchange. This makes direct representation by members in the governance of the regulatory functions of the exchange more important than ever before, to act as a check against the Exchange misusing its regulatory power to gain advantage over its competitors.[27]

Indeed, the question of whether "self-regulation" continues to be a viable concept was posed by the Commission in its Concept Release.[28] Approval of the Proposal in its current form would be tantamount to a conclusion by the Commission that member firms should not exercise a meaningful voice in regulating their business activities through existing self-regulatory bodies. This is true both because of the primacy of the Exchange as a self-regulatory authority, and because it could prove practically difficult and cumbersome to reverse course on the Exchange's regulatory structure once the Proposal is approved.

Exchange applications or modifications recently approved by the SEC in connection with the demutualization of three other exchanges provide instructive paradigms for fair representation of members in the regulatory arm of a for-profit

---

[26] S. Rep. No. 75-1455, at 7 (1938) (accompanying S. 3255, 75th Cong. (1938); H.R. Rep. No. 75-2307, at 7 (1938).

[27] With regard to NYSE Market, the Proposal specifically provides that at least 20 percent of the board will be persons who are not NYSE Group directors and who may be associated with member firms. 71 Fed. Reg. at 2085. This measure does not go far enough to provide fair representation, since it does not provide broker-dealer members with representation where it is most needed – on the boards of the regulatory affiliates that directly regulate potential competitors of the Exchange.

[28] Concept Release Regarding Self-Regulation, 69 Fed. Reg. 71256 (Dec. 8, 2004).

exchange. In the case of the Philadelphia Exchange, the Commission found that the fair representation requirement was satisfied by providing that 10 of the 22 governors of the regulatory body were industry representatives, with no restriction that the representatives of the industry could not be officers or employees of broker-dealer members of the Philadelphia Exchange.[29] When the Pacific Stock Exchange adopted a for-profit structure, the Commission again specifically found that the fair representation requirement was satisfied by a structure under which between 20 and 50 per cent of the regulatory board consisted of representatives of broker-dealer members, again with no restriction on the ability of officers or employees of broker-dealers to serve as industry representatives.[30] Most recently, on January 13, 2006 the SEC approved the Nasdaq Exchange application in connection with Nasdaq's conversion to a for-profit entity. The SEC approval order indicated that twenty per cent of the Nasdaq Exchange's board would be "Member Representative Directors," with no limitation that they cannot be persons associated with member broker-dealers.[31] In addition, an unspecified number of other directors could be "Industry Directors," specifically defined as a director "that is, or has been an officer, director, employee, or owner of a broker-dealer."[32] No provision is made to reserve any board seats for directors of the Nasdaq Exchange's for-profit parent, though this does not appear to be specifically prohibited either.

Two other factors also make it more important that the Commission adhere to the historical reading of the fair representation requirement here. First, as discussed at page 9 above, the need for fair representation in the regulatory governance structure is

---

[29] File No. SR-PHLX-2003-73, Rel. No. 34-49098 (Jan. 16, 2004), available at http://www.sec.gov/rules/sro/34-49098.htm, at 27. Interestingly, the SEC took pains to explain that it was not a violation of fair representation for the PHLX to exclude holders of foreign currency options participations from representation on the board or its committees due to the fact that, among other things, "members holding solely FCO participations represent a de minimis amount of the membership." *Id.* In contrast to this *de minimis* exception for one subcategory of exchange members, all of the members of the NYSE are excluded from being directly represented on the NYSE's regulatory boards under the current proposal.

[30] File No. SR-PCX-2004-08, Rel. No. 34-49718 (May 17, 2004), available at http://www.sec.gov/rules/sro/pcx/34-49718.pdf.

[31] Rel. No. 34-53128, File No. 10-131 (Jan. 13, 2006) at 13.

[32] *Id*. at n. 45.

heightened by the substantial presence, and likely control, by the board of the for-profit parent. Second, as discussed below, the Exchange places such emphasis on the total "independence" (except for independence from the for-profit parent) of the regulatory boards that absent industry representation, the board will be populated by directors whose experience with the markets they oversee will be from the perspective of NYSE Group's interests. The Commission should affirm that a total exclusion from the NYSE LLC and NYSE Regulation boards of directors associated with member firms does not satisfy the fair representation requirement.

2. *The Proposed Independence Requirement is Bad Public Policy.*

Even aside from the statutory requirement, fair representation of broker-dealers is an important public policy, in that an appropriate level of industry representation in the regulatory governance of the Exchange ensures that this regulatory function is informed and flexible – the essential virtues that make a "just and equitable principles of trade" style of self-regulation possible, and that distinguish it from direct governmental regulation.

Of course, fair representation should not equate with domination. To avoid domination of the regulatory function by any constituency, whether the for-profit exchange, member firms, or other parties with a vested interest, strong representation of differing perspectives on the regulatory aspects of the Exchange is critical, notwithstanding that independent directors may not be deeply knowledgeable about the regulatory or business issues facing member firms or other market participants. Moreover, it is appropriate for a majority of the board overseeing the regulatory function to be independent.[33] But the Proposal is problematic because it: (i) considers directors of the for-profit parent to be "independent;" and (ii) offers an independence requirement that excludes nearly any relevant experience or knowledge among directors of the regulatory

[33] See File No. File No. SR-PCX-2004-08, Rel. No. 34-49718 (May 17, 2004), available at http://www.sec.gov/rules/sro/pcx/34-49718.pdf (Commission finds that the fair representation requirement was satisfied by a structure under which between 20 and 50 percent of the regulatory board consisted of representatives of broker-dealers members, with no restriction on the ability of officers or employees of broker-dealers to serve as industry representatives).

boards about the subjects being regulated except for knowledge of the financial interests of NYSE Group.

Independence is defined in such a way in the Proposal that it will exclude anyone with significant and recent industry experience from the board. Specifically, the definition of independence would exclude anyone from the NYSE board, including the "fair representation" slots, who, *inter alia*

- within the last three years was employed by a member, received more than $100,000 per year in direct compensation or more than 10 per cent of their annual gross income from a member, or is otherwise affiliated "directly or indirectly" with a member;
- has "an immediate family member" who is or within that past 3 years was an executive officer of a member;
- or "is employed by or affiliated, directly or indirectly, with a Non-Member Broker-Dealer;" or
- is an executive officer of an issuer listed on the NYSE or the Pacific Exchange.

This definition is so far-reaching that it eliminates anyone with significant and recent industry experience from being on the boards of NYSE LLC or NYSE Regulation. The exclusion of any executive officer of a NYSE-listed company further reduces the ranks of potential candidates, due to the large number of companies listed on the Exchange. The only realistic candidates for directorships are going to be academics or persons who fall outside the proposed three-year look-back period. Although three years may seem like a reasonably short time frame and may be appropriate for listed companies, the rapid pace of change in U.S. capital markets renders such a person's industry knowledge and experience stale for the purposes of rulemaking and oversight of the Exchange's members. Sacrificing this experience will result in inferior regulatory oversight. Therefore we question the implicit assumption of the Proposal that a board composed of independent directors with essentially no relevant experience or knowledge will provide a more effective oversight mechanism than a board that includes some persons affiliated with member firms.

The challenge of having to populate not one but three boards with such persons means that the candidate pool for the non-NYSE Group slots is going to be thin, making

each of the boards even less likely to identify or deal effectively with regulatory problems. This makes fair representation of members on the regulatory boards even more important. Moreover, not only are persons associated with NYSE members barred from being directors of the regulatory boards, even directors affiliated with a non-member broker-dealer are barred from holding NYSE LLC or NYSE Regulation directorships. Such a person would at least provide some of the expertise that would otherwise be lacking from the regulatory boards. The exclusion from the definition of "independent" of persons with expertise concerning securities firms and securities markets from recent experience with a securities firm is unfortunate in itself. Moreover, they are part of a structure that on the one hand requires that a substantial portion (probably a majority in the case of NYSE LLC) of the NYSE regulatory boards consist of directors who are manifestly not independent because of the fiduciary duty that they will owe to the parent exchange, and on the other hand excludes entirely from representation on the board persons associated with any members. This seems unbalanced on its face, and the Exchange should bear the burden of explaining why this is appropriate. However, we cannot find anything in the underlying material for the Proposal supporting this approach. At a minimum, if any NYSE directors at all are permitted to serve on either the NYSE LLC or NYSE Regulation boards, they should be counterbalanced with at least the same number of directors that are affiliated with member firms.

3. *The Exchange's Corporate Governance Scheme Should Provide for Member Involvement in SRO Rulemaking and Funding.*

While the Proposal excludes members from any direct representation on the boards of NYSE LLC and NYSE Regulation, it offers them guaranteed seats on a "Regulatory Advisory Committee" ("RAC") of NYSE Regulation. This committee and members' role in it is insufficient to ameliorate the conflict of interest or fair representation problems described above. First, a non-voting "advisory" role is insufficient, since any actions or recommendations of the RAC are nonbinding on either the NYSE LLC or NYSE Regulation boards or their staffs. Second, the mandate of this committee is too narrow. Specifically, it has no authority over rulemaking, or spending, funding, or

budget decisions of NYSE Regulation.[34] Whether through this committee or otherwise, some mechanism should be built into the charter of the NYSE's regulatory structure to ensure member representation in these functions.

a. Rulemaking. Member involvement in rulemaking is essential to counter the conflicts of interest posed by the for-profit exchange regulating its members. As stated by Professors Macey and O'Hara in their recent critique of the NYSE's regulatory function, "[c]ompetitors who have the ability to promulgate rules that harm their competitors inevitably will have incentives to develop new rules and enforce existing rules that provide competitive advantages for themselves and impose asymmetrical costs on their competitors."[35] Without any direct involvement by members in the rulemaking process there is no meaningful check on this conflict.

In addition, member involvement can provide more robust oversight. This is especially important in the context of a for-profit exchange, for which "competitive conditions provide incentives for exchanges to refrain from enforcing their own investor-protection rules for fear of losing market share."[36] The exchange's regulatory function requires, at both the staff and board level, 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. Similarly, the board must understand the trading activities of Exchange members, and the potential for abuse based on these activities, as well as the Exchange'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 regulatory decisions will have on such strategies? The benefit of member experience and direct involvement in the

[34] In contrast, the SEC's rule proposal on SRO governance suffered from the exact inverse problem. It proposed a "Regulatory Oversight Committee" of SRO boards that would have excluded any membership involvement, but that could make binding decisions, and that did have budget authority. *See* Proposed Rules 240.6a-5(j), 240.15Aa-3(j), 69 Fed. Reg. 71126 at 71216-17, 71221-22 (Dec. 8, 2004).

[35] Macey & O'Hara at 581.

[36] Macey & O'Hara at 580.

promulgation of rules on these subjects is irreplaceable. To rely for rulemaking solely on a professional staff overseen by a board dominated by directors who owe a fiduciary duty to the profit-making parent, without at least adding to the mix the varying perspectives and experiences of industry participants, may lead to rules of suboptimal effectiveness and efficiency, or that may be used by the Exchange to put competitors at a disadvantage.

b. Funding. Member involvement in SRO funding is also essential. Of course, independent directors – not directors that owe allegiance to the for-profit parent of the Exchange – should control the process. However, member representation is an appropriate safeguard against excessive fees and budgeting demands. Because members account for so much of an SRO's revenue, through membership and trading activity fees, it is appropriate and necessary that members participate in decisions regarding the use and allocation of those funds. Member involvement is also necessary to ensure that market data fees or other fees for service are cost-justified and not used to cross-subsidize other products or services, including general regulatory costs.[37]

E. The Candidate Recommendation Process is Unclear.

The "fair representation" candidate recommendation process for NYSE LLC is extremely complex and confusing and, we suspect, will fail to yield candidates that are fairly representative of members. In particular, NYSE LLC is "obligated to designate as Non-Affiliated LLC Director Candidates those Fair Representation Candidates … who are recommended jointly by the director candidate recommendation committee of NYSE Market … and the director candidate recommendation committee of NYSE Regulation…." No explanation is given as to what happens if these two committees cannot agree on joint recommendations. Who is authorized to resolve their differences? Can NYSE LLC choose between the two slates? The lack of clarity suggests that the

[37] *See* pages 19-20 below for a discussion of other concerns that we have about the need a market data utility independent from the Exchange's other business and regulatory interests.

Commission needs to pay careful attention to the details of fair representation in approving the Proposal.

F. The Proposal Does Not Provide Appropriate Treatment of Market Data.

1. *The Market data utility must be independent*.

The Proposal does not address how the market data utility functions of the Exchange – that is, the ownership, management, administration, and fee-setting for required market data (NBBO for equity and Automated Bond System prices for debt) -- will be handled. It is critical that this function fall outside of NYSE Group's control, so that the market data utility is not driven to engage in profit-motivated market data pricing, and is motivated to achieve and maintain efficiency in producing and disseminating market data.

SRO status currently conveys monopoly control over access to information regarding depth-of-book market data. Due to the size of the NYSE's trading volume, this monopoly control has been, and is likely to continue to be, a very lucrative revenue source. With the demutualization of the NYSE, continuation of this monopoly in its current form will therefore amount to a substantial and unjustifiable government subsidy to a profit-making entity. It is questionable whether the public interest in market transparency and equal access to information is well-served by this arrangement.

We believe that it would be more appropriate for the market data utility functions to be housed inside one of the regulatory affiliates, provided that the affiliate is truly independent of NYSE Group, the market data is cost-based and there is no cross-subsidization of regulatory costs. However, unless the Proposal is modified to provide real independence between NYSE Group and its regulatory affiliates, the interests of investors and market participants will make it necessary to create a separate independent affiliate to house the market data utility.

Explicitly tying market data fees to the cost of producing the data, while keeping the costs of regulation separate, will enable full and transparent funding of regulatory needs without over-charging for market data. The Associations believe that a transparent,

cost-based fee structure for market data in no way will undermine the funding for regulation. Transparent accounting for regulatory costs and fees will only enhance the funding of regulation by clarifying those regulatory costs that must be met.

2. *Market data should not be confidential*.

The proposed delegation agreement between NYSE LLC and NYSE Regulation provides that trading data that comes into the possession of NYSE Regulation from either NYSE LLC or NYSE Markets shall be treated as confidential and not be made available to the public. This provision should be modified to clarify that it is not intended to restrict access to market data, and that all trading data (other than names of counterparties) should be available at cost after some brief period of time.

G. The Proposal Does Not Provide Fair Representation of Debt Dealers in the Allocation of Trading Licenses.

The proposal provides for only one type of trading license – a full license to use all facilities of NYSE Market. It states that NYSE Market may decide in the future to issue separate licenses for electronic only access or access limited to particular products. The NYSE has a pending application for exemptive relief to trade unlisted debt securities on its Automated Bond System.[38] Many smaller broker-dealers of debt securities do not also trade equity securities and therefore are otherwise not interested in obtaining a trading license. Such dealers will be presented with the choice of either applying for equity trading rights they do not need or not obtaining direct access to the NYSE ABS system. We believe that the Commission should not approve the Application (or, at a minimum, the Exemption Application), unless the NYSE makes provision for fair access to debt dealers who are not also equity dealers.

[38] 70 Fed. Reg. 40748 (July 14, 2005).

II. Steps to Remedy Proposal's Shortcomings

The Associations offer the following suggestions for remedying the issues we have identified above.

A. NYSE should move ahead with regulatory consolidation with NASD Regulation. Professors Macey and O'Hara recently noted that "[a] distinct disadvantage of the approach being taken by the NYSE in its proposed merger is that it retains multiple regulators at competing exchanges…."[39] As discussed at pages 4-6 above, rather than continuing to hold out its own "brand" of member firm regulation, the NYSE should move ahead with regulatory consolidation with the NASD's broker-dealer regulation function. SIA has proposed, and TBMA has supported, one such approach, a "hybrid SRO" in which one regulator would combine the broker-dealer regulatory functions of the NASD and NYSE, such as financial condition, margin, registered representative qualification testing, customer accounts, sales practices, and supervision, while the Exchange and Nasdaq would still be responsible for the oversight of their own market operations regulation (*e.g.*, trading rules and listing standards), including enforcement of those trading rules. A variation on this would be to create a joint venture of the NYSE and NASD to regulate the roughly 180 broker-dealers that are dual members of both organizations. There are a number of other variations that might be formulated. The Associations are not wedded to any particular approach, as long as the SROs move forward with an approach that embodies certain key goals and principles, including:

- One SRO rulebook for broker-dealer activities and one source for interpretations, examinations and investigations related to that rulebook.

- Fair representation of members in the governance of the SRO that oversees their affairs. Specifically, there should be significant but non-majority member representation on the SRO's board of directors and, at a minimum, on its regulatory oversight committee.

[39] Macey and O'Hara, at 598.

- Broker-dealers should pay fees for regulation of broker-dealer activities, through a transparent fee-setting process, to one SRO rather than multiple SROs. Fees for specific services or products, such as market data fees, should be designed to recover the cost of creating that service or product, but should not subsidize either the general cost of regulation or the cost of other services or products.

- The SRO's costs should be contained in a budget that is subject to independent review, such as approval by the SEC after notice and comment.[40]

The report promised in Amendment No. 6 of the Proposal commits the NYSE "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."[41] This contains the seed of a good idea. The only problem with that approach is that there will still be two rulebooks to be checked for inconsistencies, and new inconsistencies between the rules of two SROs that perform the same function will continue to arise, as they have arisen in the past,[42] requiring enormous effort on the part of the two regulatory staffs and member firms to reconcile differences.[43] A one-time report is therefore merely a "good start." It would be better to broaden the scope and accelerate the timing of this report, so that it is a commitment by the NYSE to work with the NASD to report to the SEC in the near future on a specific set of joint recommendations, and timetable for achieving each

[40] Attachment B to this letter contains a more complete statement of goals and principles for regulatory consolidation recently publicly released by SIA. The statement is also available at http://www.sia.com/press/2006_press_releases/21845530.html.

[41] Amendment No. 6 at 6, available at http://apps.nyse.com/commdata/pub19b4.nsf/docs/EC15739AE7AC3A50852570F C007BF6FA /$FILE/NYSE-2005-77%20A-6.pdf.

[42] While many examples could be offered, one current illustration is contained in a recent joint report by the NYSE and NASD on their research rules. The report includes instances where the two SROs take divergent approaches regarding some issues, notwithstanding that they have worked together to harmonize these rules from the rules' inception in 2002. Joint Report by NASD and the NYSE on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules (December 2005), at 34-37, available at http://www.nyse.com/pdfs/rajointreport.pdf.

[43] For example, the Associations understand that recently announced new rule proposals by the NYSE and NASD on gifts and entertainment expenses for clients resulted from a collaborative effort lasting over a year, and requiring board-level consideration by both SROs. An approach involving one organization writing a single rule would certainly have required far less time and effort.

of the recommendations, to consolidate as many of their regulatory functions over broker-dealers as possible. Given the amount of thinking that has recently gone into this topic at the senior-most levels of the NYSE and NASD,[44] it should be possible to prepare these recommendations and timetable within a few months at the most. The Associations do not wish to delay approval of the NYSE's Proposal while the NYSE and NASD work to address this larger problem, but we believe that it would be appropriate for the Commission to ask the NYSE to formally commit itself to work with the NASD with a goal of developing, within a set timeframe (such as 60-90 days) of approval of the Proposal by the Commission, recommendations and an implementation timetable for appropriate consolidation of the broker-dealer regulatory functions of the two SROs.

B. The number of Regulated Subsidiary Directors that may also be directors of NYSE Group should be no greater than the number of "Fair Representation" directors. Permitting domination of the NYSE Regulation and NYSE LLC boards by interlocking directors of the NYSE Group board undermines self-regulation and builds in the possibility that NYSE Group may misuse the Exchange's regulatory role over its members. We cannot find a single sentence in the proposing release that even attempts to offer a justification for having any representation of the for-profit parent on the regulatory boards. In light of the significant regulatory power that the NYSE holds over its members, the Commission should insist that none of the regulatory directors have an affiliation with NYSE Regulation's or NYSE LLC's parent, unless, at a minimum, there are an equal number of "fair representation" directors – individuals that represent, and are potentially associated with, broker-dealer member firms – as there are NYSE Group directors.

---

[44] *See* Keynote Address of John Thain, 34th SIA Annual Meeting, available at http://www.nyse.com/Frameset.html?displayPage=/about/viewpoints.html, Address by NASD Chairman and CEO Robert Glauber to the Securities Industry Association Annual Meeting (Nov. 11, 2005), available at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE &ssDocName= NASDW_015519.

C. At least 20% of the directors of the Regulatory Subsidiaries should be chosen by members, and these directors should be permitted to be associated with a member. [45] The reasons why this is necessary are discussed at pages 10 to 16 above.

D. The boards of the Regulatory Subsidiaries should have standing committees with responsibilities for rulemaking, assessing the adequacy and effectiveness of the regulatory program, determining program, budget, and funding, and assuring that disciplinary and arbitration programs are conducted in accordance with applicable rules, policies and laws.[46] **Broker-dealer members should be represented on these committees, as well as on the nominating, governance and audit board committees**. The securities industry has legitimate interest in the affairs of each of these committees. 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 that these committees will require. In addition, as entities regulated by the SROs, members are familiar with the issues particular to SRO oversight. Member involvement in the budget and audit committees is especially critical. Because members will account for so much of the NYSE Regulation's revenue, it is both appropriate and necessary for members to be involved in decisions regarding use and allocation of these funds. As long as members have substantial but non-majority representation in these

[45] The SEC's approval order for the Nasdaq Exchange application noted that Nasdaq was specifically permitting persons associated with broker-dealer members to serve on its board. At the same time, that board reserves no seats for its for-profit parent. SEC Approval Order, Rel. No. 34-53128, at 13-16 (Jan. 13, 2006). The SEC's approval order of the PHLX governance restructuring in connection with its demutualization noted that PHLX had provided 5 seats on its 22-seat Board of Governors for the parent, and 10 for members. SEC Approval Order, Rel. No. 34-49098, at 26-28, available at http://www.sec.gov/rules/sro/34-49098.htm.

[46] The NYSE Proposal already provides direct broker-dealer representation in one instance where a majority of the board of one of its affiliates comprises NYSE Group members. In the case of NYSE Markets, which would have a majority of NYSE Group members on its board, the Proposal appears to say that at least 20 percent of the board may consist of members who are associated with broker-dealers. While this does not go far enough, it seems to tacitly concede the point that direct representation of broker-dealers on the board of an NYSE affiliate is necessary if NYSE Group members are also represented on the board.

processes, they can provide these safeguards without raising a concern that they will dominate the process or inappropriately compromise regulatory funding needs.

E. The certificate of incorporation and by-laws of NYSE Regulation should clarify its approach to funding. Specifically, these should provide that its funding will be based on: (i) fees paid by members;[47] (ii) a portion of listing fees and trading fees paid by other market constituents that receive the benefit of regulatory oversight of broker-dealers and the various examination and continuing education; and (iii) contractual agreements for regulatory services to other SROs. NYSE Regulation should exclude from its funding formula market data fees or any other fees charged for specific services or products. Instead, those fees should be set at levels reasonably designed to recover the costs of providing the service or product, with member representation in the process of setting these fees.

F. The Proposal needs to be modified to clarify how market data utility functions will be handled. As discussed at page 19 above, the market data utility could be housed in one of the regulatory affiliates if recommendations A, B and C above are adopted. Otherwise, the regulatory affiliates will not have sufficient independence from NYSE Group, and a separate non-profit entity should then be created to house the Exchange's market data utility, so that it is not controlled by the for-profit parent and can become the true cost-based utility that investors and markets deserve.

CONCLUSION

As discussed above, at a minimum we urge the Commission to require at least two basic changes to the NYSE's governance proposal. The first of these is an express commitment by the NYSE to work with the NASD to arrive at an agreement, within a fixed time period such as 60 to 90 days, and subject to SEC approval, to form a structure

[47] The Associations note that the Proposal assumes that member fees should be assessed as a simple percentage of gross revenue. We question the implicit assumption that gross revenue, to the exclusion of other factors such as number of registered representatives, number of branch offices, or the nature of a member's business, is the best proxy for the amount of regulatory effort required to oversee a given entity.

for combined regulation of dually-registered broker-dealers. The second is to address concerns about the conflict of interest between NYSE Group's for-profit status and the power of its regulatory affiliates over competitors by creating greater structural separation between NYSE Group and those affiliates. This should be done by reducing or eliminating NYSE Group representation on the boards of NYSE LLC and NYSE Regulation, and by permitting "fair representation" members of those boards to be associated with member firm broker-dealers.

The Associations appreciate the opportunity to comment on this critical rule proposal, and we look forward to working with the Commission, the Exchange, and other market participants on resolving the vitally important underlying public policy issues. If you have any questions concerning these comments, or would like to discuss these issues further, please contact George Kramer of SIA at gkramer@sia.com or 202-216-2047, or Marjorie Gross of The Bond Market Association, at mgross@bondmarkets.com, or 646-637-9204.

Sincerely,

/s/ G. Kramer
Marc E. Lackritz
President
Securities Industry Association

/s/ G. Kramer
Micah S. Green
President and CEO
The Bond Market Association

Attachments A and B

Cc (w. attachments):
Chairman Christopher Cox
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Annette L. Nazareth
Robert L.D. Colby, Acting Director, Division of Market Regulation
Richard Bernard, Executive Vice President and General Counsel, New York Stock Exchange
Richard G. Ketchum, Chief Regulatory Officer, New York Stock Exchange
Mary L. Schapiro, Vice Chairman and President, Regulatory Policy & Oversight, National Association of Securities Dealers

ATTACHMENT A

Summary of the Proposal

The Proposal contemplates that the NYSE Group board will have at least 11 directors, one of whom will be the CEO of NYSE Group. Although that board will consider shareholder and public investor recommendations, all members of the NYSE Group board (other than the CEO) must satisfy requirements for independence from management, member organizations and listed companies. Preferred shareholders potentially have the ability to elect additional directors, with no limitation that those directors be independent.[48]

The Board of the Exchange -- NYSE LLC -- will include all of the independent directors of the NYSE Group. At least 20% of its members (not less than 2) will not be NYSE Group directors, but will otherwise qualify as independent. They will be chosen by Group's Nominating and Governance Committee, but that committee will be obligated to designate the "Fair Representation Candidates" recommended jointly by the "Director Candidate Recommendations Committees" of NYSE Market and NYSE Regulation. NYSE LLC will not have its own Board Committees. NYSE LLC has plenary authority to review actions of NYSE Regulation.[49] Any necessary audit, compensation or nominating and governance functions of NYSE LLC will be performed by the relevant committees of Group.

Under the Proposal, a majority of the Directors of NYSE Market will be NYSE Group directors. The CEO of NYSE Group will be a director. In addition, at least 20%

---

[48] The Certificate of Incorporation of NYSE Group authorizes the Board to issue up to 200 million in preferred stock and to give the holders of that stock voting rights that could greatly exceed the voting rights of common stock. The rights and powers that the board can attach to these shares include granting preferred shareholders "one vote or more or less than one vote per share [and] that the holders of such series shall be entitled to vote on certain matters as a separate class." Exhibit 5B to the Exchange Application, at 201-02.

[49] The delegation agreement between NYSE LLC and NYSE Regulation states that NYSE LLC "shall have ultimate responsibility for the operations, rules and regulations developed by NYSE Regulation. . . . Actions taken by NYSE Regulation . . . remain subject to review, approval or rejection by the board of directors" of NYSE LLC. Although the delegation agreement appears to exclude NYSE Regulation's disciplinary actions from review by NYSE LLC, other documents filed with the Commission indicate that NYSE LLC will in fact be able to review disciplinary actions as well. See discussion at pages 8-9 above.

(not less than 2) of the directors will be non-Group directors nominated by members. They will be nominated by the "NYSE Market Director Candidate Recommendation Committee," which will be appointed annually by the Board of NYSE Market. This committee will include representatives of upstairs firms, specialists and floor brokers.[50] In contrast to the boards of NYSE LLC and NYSE Regulation, the non-Group directors of NYSE Market need not be "independent," but must meet unspecified "status or constituent affiliation qualifications prescribed by NYSE Market rule or policy."[51] There will be no board committees (and the functions of the audit, governance and compensation committees will be performed by the relevant committees of Group). However, NYSE Market may have one or more advisory committees to provide input to the board and staff on policies, programs, products and services. A NYSE Market Performance Committee and an Allocation Committee will contain representatives of members.[52]

NYSE Regulation will be a not-for-profit corporation with a single voting member – NYSE LLC. As recently modified by Amendment No. 6 to the proposal, it initially will have nine directors, and may have as few as three directors, with the number to be determined solely by NYSE LLC. The CEO of NYSE Regulation will be a director of NYSE Regulation. A majority of the Board members will not be members of the board of Group and must qualify as independent under Group's independence policy, and the remaining directors will be members of the Group board.

NYSE Regulation will have a nominating and governance committee and a compensation committee, both of which will have a majority of Group independent directors. Committees of the NYSE Group Board will perform auditor committee

---

[50] An upstairs firm is one that conducts trading off the floor in the firm's "upstairs" offices. A specialist is a member of the Exchange who is obligated to maintain an orderly market in the stocks in which he is registered as a specialist. A specialist also acts as a broker's broker. A floor broker is a member of the Exchange who executes orders on the floor of the Exchange to buy or sell any listed securities.

[51] 71 Fed. Reg. 2080, 2085 (Jan. 12, 2006).

[52] The Market Performance Committee serves as a forum for discussing trading and market operations issues and developing trading rules and products. It also measures specialist performance and market quality on a periodic basis. The Allocation Committee allocates and re-allocates securities among specialists in accordance with policies established by the Exchange.

functions for NYSE Regulation. There will also be a NYSE Regulation Director Candidate Recommendation Committee comprised of representatives of upstairs firms, specialists and floor brokers. Candidates may also emerge from a petition process.

In addition, NYSE Regulation's board may create committees comprised in whole or in part of non-directors, including:

- a Committee for Review, that will review disciplinary decisions. This committee will include persons who are not directors (including representatives of upstairs firms, specialists and floor brokers), but a majority of the members will be directors of NYSE Regulation;

- a Regulatory Advisory Committee, which will include representatives of member organizations; and

- other committees with input to the NYSE Regulation Board on policies, programs, regulatory aspects of products and services.

The Proposal apparently eliminates the NYSE's Regulation, Enforcement and Listing Standards Committee, a committee with an independent voting majority that also has industry representatives. That committee conducts programmatic oversight of the Regulatory Group, Hearing Board, Arbitration and Listings and Compliance Unit, and acts as a "court of appeals" for disciplinary cases and delistings.

ATTACHMENT B

January 25, 2006

Goals and Principles That Should Underlie SRO Restructuring

I. Goals for Separating Regulation of Broker-Dealers from Marketplace Regulation.

a. One SRO rulebook for broker-dealer activities and one source for interpretations, examinations and investigations related to that rulebook.

b. Fair representation of members in the governance of the SRO that oversees their affairs. Specifically, there should be significant but non-majority member representation on the SRO's board of directors and, at a minimum, on its regulatory oversight committee.

c. Broker-dealers should pay fees for regulation of broker-dealer activities, through a transparent fee-setting process, to one SRO rather than multiple SROs. Fees for specific services or products, such as market data fees, should be designed to recover the cost of creating that service or product, but should not subsidize either the general cost of regulation or the cost of other services or products.

d. The SRO's costs should be contained in a budget that is subject to independent review, such as approval by the SEC after notice and comment.

II. Principles.

Investor Protection.

- Investors should be no less protected under a revised system than they are today.
- Core investor protection safeguards should not vary with the markets in which they trade or with the broker-dealer that handles their accounts.

Fair Competition.

- One competitor should not regulate another.
- Regulation should not stifle innovation.
- Regulatory system should not favor some types of firms over others, and should provide voice for cross-section of firms in SRO governance.
- Reforms should put markets on a level playing field with global competitors, without undoing protections that have made them safe and attractive trading venues.

Efficient Regulation.

- Avoid duplication of examinations, investigations and market sweeps.
- Harmonize rulebooks and end conflicting interpretations.
- Self-regulation should be in step with movement toward more universal market rules.

Expert Regulation.

- Encourage specialized knowledge in regulator.
- Provide effective industry input and resources, both through representation in governance and in advisory panels, focus groups, and industry assistance with staff training.
- Ensure that regulator's funding is sufficient to attract and maintain talented staff.
- Ensure that regulator has expertise and stature to be influential in larger domestic and global regulatory initiatives.

Reasonable and Fair Costs of Regulation.

- Ensure adequate funding.
- Cost of regulation should be equitably shared among all constituencies that benefit from it, including broker-dealers, issuers, investors and the markets themselves.
- Fees should be transparent, cost-justified, and should not exceed the cost of regulation.
- Regulatory budget-setting process should be transparent, subject to SEC oversight and input from the regulated community and the public.
- Enforcement fines should not be part of the regulatory budget.

Encourage Industry Participation in Self-Regulation.

- "Fair representation" of members in SRO governance is statutorily mandated, and should be encouraged.
- Adequate representation in setting regulatory standards is essential in order to keep the words "just and equitable principles of trade" meaningful.

Regulatory Accountability.

- Self-regulation should be structured so that the responsibilities of each regulator are separate and clear.
- There should not be gaps in regulatory coverage.