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THE NASDAQ STOCK MARKET
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March 8, 2005

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

Re: Proposed Rulemaking on SRO Governance (File No. S7-39-04); Concept Release Concerning Self-Regulation (File No. S7-40-04)

Dear Mr. Katz:

The Nasdaq Stock Market, Inc. ("Nasdaq") commends the Securities and Exchange Commission (the "SEC" or "Commission") for its comprehensive examination of the self-regulatory structure of our financial markets. The SEC's new Proposal regarding the governance, transparency, and ownership of self-regulatory organizations ("SROs"),[1] and a companion Concept Release regarding a possible restructuring of the self-regulatory system,[2] are the most recent of a series of actions by the SEC, the NASD and Nasdaq, and other SROs aimed at ensuring that investors are protected through effective oversight and the vigorous enforcement of regulatory obligations by SRO officials. The Commission should also be commended for undertaking this effort in the context of prospective rulemaking, rather than in response to a regulatory emergency.

Nasdaq is firmly committed to fulfilling its statutory and regulatory SRO responsibilities. In particular, Nasdaq understands that the self-regulatory system that Congress established assigns a critical role to Nasdaq and all of its employees in the mission of protecting investors. Accordingly, Nasdaq appreciates the opportunity to comment on these important Commission releases. Nasdaq's comments have been reviewed by, and reflect the views of, both its board of directors and its senior management.

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[1] Securities Exchange Act Release No. 50699 (November 18, 2004), 69 FR 71126 (December 8, 2004) (S7-39-04) (the "Proposal").

[2] Securities Exchange Act Release No. 50700 (November 18, 2004), 69 FR 71256 (December 8, 2004) (S7-40-04) (the "Concept Release").

I. Introduction

There are many aspects of the Proposal that would enhance the quality of governance and transparency at many SROs. To some extent, the Proposal would merely require that all SROs adhere to standards similar to those followed by public companies such as Nasdaq. Unfortunately, the Commission's extensive Proposal does not adequately explore the existing governance and disclosure practices of Nasdaq or consider their efficacy in achieving the goals of the Proposal. The Commission explains that the rulemaking has been shaped principally by recent events at the New York Stock Exchange (the "NYSE").[3] As a result, less recent events that have shaped the governance of Nasdaq and the NASD are not extensively analyzed, and several important initiatives that have served to improve Nasdaq's and the NASD's governance practices would be superseded by the Proposal without consideration of the comparative merits of the Nasdaq/NASD model and the new NYSE model. Although the Proposal, unlike the NSYE model, does not go so far as to exclude members and issuers from the governing boards of SROs, it would force their removal from key board committees and would mandate a degree of regulatory separation that may diminish regulatory effectiveness.

The Proposal does not accord sufficient recognition to the Commission's groundbreaking investor protection efforts that resulted in the restructuring of Nasdaq/NASD. The Commission should recognize that the Proposal is designed to achieve goals that, to a large extent, have already been achieved by Nasdaq through implementation of other initiatives and policies. In particular, Nasdaq has achieved:

- a high level of transparency through its compliance with disclosure requirements applicable to public companies under the Securities Act of 1933, as amended (the "1933 Act") and the Securities Exchange Act of 1934, as amended (the "1934 Act");

- decision-making by a board of directors that is independent of management yet well-informed about matters of concern to the securities industry and public companies, as a result of Nasdaq's ability to comply with the strict standards of independence imposed by the Sarbanes-Oxley Act ("Sarbanes-Oxley") and Nasdaq's own listing standards while maintaining meaningful representation of members and issuers;

- a regulatory structure that separates investigatory and disciplinary authority from Nasdaq's commercial endeavors while underscoring the regulatory obligations of

[3] "Recent developments have prompted the Commission to review aspects of its oversight and regulation of national securities exchanges and registered securities associations and to consider whether changes are necessary to respond to these developments." Proposal, 69 FR at 71129. The Commission then goes on to describe in the immediately succeeding section of the Proposal certain "governance concerns" at the NYSE, including the employment agreement of its then Chairman and Chief Executive Officer ("CEO"), and a series of governance changes that followed his resignation. These changes are fully accommodated in the thrust of the Proposal. Id.

all Nasdaq employees, including the CEO and other senior commercial executives, implemented in compliance with the Commission's 1996 21(a) Report Regarding the NASD and the Nasdaq Market (the "1996 21(a) Report")[4] and its 2005 21(a) Report Regarding Nasdaq, as Overseen By Its Parent, the NASD (the "2005 21(a) Report");[5] and

- sound corporate and financial governance, as the result of compliance with Sarbanes-Oxley and Nasdaq's listing standards.

Simply put, the SEC should reexamine the Proposal in light of the experience with the Nasdaq/NASD model and allow enough flexibility in the rule to permit that model to continue to evolve and serve the public interest.

In the wake of the 1996 21(a) Report, the SEC wisely did not undertake a rulemaking to impose the Nasdaq/NASD model on every other SRO. Such a response would have imposed a one-size-fits-all solution on all SROs. Similarly, it would be a mistake at this time to impose the essential elements of the NYSE model on other SROs, particularly after the Commission has carefully overseen a complete revision of the Nasdaq/NASD structure and after Nasdaq has undertaken the reporting responsibilities of a public company.

In fact, Nasdaq believes that the Commission should consider whether the Nasdaq/NASD model – especially post-exchange registration, which appears to be imminent[6] – already achieves the goals of the Proposal and indeed may be reflected in final rules as one of several models that could be selected by other SROs. The alleged wrongdoings that precipitated the overhaul of the NYSE's governance structure are unlikely to have occurred within the Nasdaq/NASD structure, for the simple reason that the structure works as the Commission intended it to work when it devised it. Alternatively, if the Commission believes that the Nasdaq/NASD model fails in some respect to achieve the goals underlying the Commission's Proposal, the Commission should identify these shortcomings and impose upon Nasdaq only such additional measures as are necessary to achieve the Commission's goals.

More specifically, the SEC should reconsider the Proposal in the following areas:

- Nasdaq has found that its issuer and member board members have contributed greatly to the independence of its governance and overall strength of its board.

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4 See www.sec.gov/litigation/investreport/nd21a-report.txt.

5 See www.sec.gov/litigation/investreport/34-51163.htm.

6 See Securities Exchange Act Release No. 50845 (December 13, 2004), 69 FR 76022 (December 20, 2004) (SR-NASD-2004-181); see also Remarks of Commissioner Roel C. Campos and Annette L. Nazareth, Director, Division of Market Regulation, Commission, at December 15, 2004 Open Meeting of Commission.

Accordingly, Nasdaq believes that the definition of "independent director" under the Proposal would needlessly constrain the ability of SROs to draw upon the talents and insights of directors who are employed by listed issuers and members. While such directors are, and should be, barred from considering particular matters that directly affect their employers, they should not automatically be considered "insiders." Specifically, the definition of independence for purposes of the population of an SRO board should not contain a per se exclusion of listed company or member company executives, as long as:

(1) the SRO listing and delisting adjudications are administered through an independent process;

(2) member regulation is accomplished through a functionally separate entity or a functionally separate regulatory operation;

(3) all SRO issuer directors commit to recusal from any particular listing or delisting decision affecting his or her company that might reach the board on appeal; and

(4) all SRO member directors commit to recusal from any particular member matter affecting his or her company.

Such directors would also have to be found to be independent on an annual basis by the majority of the board, applying a test that considers the actual materiality of their employers' relationship to the SRO in accordance with standards such as those found in NASD Rule 4200(15). These safeguards will ensure independence in the composition of an SRO board while allowing the "self" in "self-regulation" to be meaningful.

- The SEC should recognize that needed regulatory separation and independence may be achieved through the combination of legal and functional separation that currently exists in the Nasdaq/NASD model. Nasdaq has placed front-line authority to investigate and discipline members in a separate, non-commercial entity while reinforcing the obligations of all Nasdaq employees to refer regulatory concerns to NASD or the Commission for investigation and to establish the quality of regulation as an overarching corporate goal. Moreover, although Nasdaq's Chief Legal Officer ("CLO"), the officer charged with overseeing Nasdaq's regulatory responsibilities, reports to the CEO, he also has clear and confidential channels of communication with the board and its audit committee, and regularly meets with the audit committee in executive session. The Commission's Proposal, however, gives no weight to the independence achieved through the use of a separate entity, and instead appears to require a further separation within Nasdaq between "regulatory employees" reporting to a regulatory oversight committee and other employees reporting to a CEO. Nasdaq is concerned that this approach may impose managerial responsibilities on members of the regulatory oversight committee and may also undermine the regulatory accountability of employees that do not report to the proposed regulatory oversight committee, a result that is seemingly inconsistent with the SEC's recent pronouncements in the 2005 21(a) Report that all SRO employees share regulatory responsibilities. An internal bifurcation might be an element of the reformed NYSE model, since it has chosen not to adopt the substantial legal separation that the NASD and Nasdaq have achieved. However, imposing additional divisions on Nasdaq will serve no practical purpose and could actually harm investors by, among other things, obscuring the regulatory accountability of the Nasdaq CEO and employees reporting to him.

- The Proposal imposes significant new reporting responsibilities. Nasdaq believes these requirements can be streamlined and that the existing reporting requirements of SROs that are also public companies should be given more weight in determining whether new requirements are needed. In addition, the Commission should consider the possibility that it will receive duplicate reports from the NASD and Nasdaq. Is that the desired result? Will the proliferation of reports prove practically useful to the Commission and its staff? Finally, the Commission should express a willingness to review the utility of the new reports on a regular basis and eliminate aspects of the new reporting regime that do not provide useful information to the Commission and its staff.

- The Commission should clarify the definition of regulatory revenues. Specifically, although Nasdaq collects some regulatory fees through, for example, its program for reviewing decisions to delist an issuer, most of the types of charges mentioned by the Commission in the release – member dues and regulatory fines or penalties – are assessed by the NASD but not by Nasdaq. Nasdaq does, however, use substantial amounts of its commercial revenues to fund regulation. The Commission must make it clear that the use of a particular revenue source, such as market data revenue, to fund a portion of an SRO's regulatory costs does not transform that revenue source into regulatory funds.

- In light of the Proposal's exclusion of member representatives from important board committees, it is unclear whether the Proposal's guidelines for member input in director selection truly result in fair representation of members. Moreover, the Proposal does not adequately explain the integration of the member selection process in the structure of a public company.

- Exchange-traded funds ("ETFs") sponsored by SROs should not be subject to additional regulation simply because of their relationship to an SRO. The market for ETFs is robust and highly competitive, and ETFs are subject to substantive legal protections that guard against improper influence by an SRO sponsor.

Finally, the Proposal fails to take account of the possibility that the Commission may ultimately pursue certain of the alternative regulatory approaches discussed in the

Concept Release. As discussed in greater detail below, Nasdaq would support the adoption of a "hybrid" model of self-regulation in which a single SRO would perform member regulatory functions while individual SROs would retain regulatory responsibility with respect to the markets that they operate. The adoption of such an approach would, however, require its own substantial adjustments to SRO governance. SROs would be required to restructure first to implement the Proposal and then again to implement any rulemaking stemming from the Concept Release. Accordingly, the Commission should defer adoption of any of the Proposal until it has determined whether it will proceed with more a comprehensive restructuring of the self-regulatory system, and if so, where the Proposal fits within a revised structure.

II. Nasdaq's Corporate Structure

Nasdaq is currently subject to a set of robust and overlapping rules and procedures regarding board governance, composition, and independence, many of which were developed in coordination with, or at the behest of, the SEC. As a result, Nasdaq has a corporate structure that is uniquely suited to achieve a balance between board independence, regulatory quality, and meaningful involvement of members and listed companies. The principal rules governing Nasdaq's structure are found in:

- The by-laws of Nasdaq, which were reformed in principal part in 1997 in response to Commission direction as a result of the 1996 21(a) Report;
- The 1996 Order of the SEC issued in conjunction with the 1996 21(a) Report;
- Nasdaq's Certificate of Incorporation, which was restated and approved by the Commission in 2000 as Nasdaq separated from the NASD to improve regulatory independence;
- The listing rules of Nasdaq, which Nasdaq chose to apply to itself in 2003, and which became mandatory as the result of Nasdaq's listing on the Nasdaq National Market on February 10, 2005; and
- Sarbanes-Oxley, the provisions of which became effective in late 2002 and 2003.

The 1996 21(a) Report addressed one of the major concerns of the Proposal, the inherent conflict between an SRO's market function and its self-regulatory function. The 21(a) Report led to a separation of Nasdaq and NASD, with the majority of regulatory functions performed by NASD, and a board structure under which the Nasdaq board of directors and its committees are required to maintain a balance between "industry directors" (i.e., directors who are employed by members or otherwise substantively associated with members) and "non-industry directors," which include both "public directors" with no relationship to Nasdaq and directors who are affiliated with public companies whose stock is listed on Nasdaq. As would be required by the Proposal, the

Nasdaq board is required annually to certify the status of directors based upon up-to-date information regarding each director's employment status and business and familial relationships. In addition, Nasdaq's Certificate of Incorporation requires its directors to consider the requirements of the 1934 Act in their deliberations; the Nasdaq board conducts an annual board assessment/evaluation; executive sessions are on the agenda for every Nasdaq board committee; and the Nasdaq Chairman and CEO are separate, with the Chairman as an independent director.

Committees of Nasdaq's board of directors include:

- an audit committee that, as required by Sarbanes-Oxley and Nasdaq's listing standards, is composed entirely of independent directors;

- a nominating committee that is composed of individuals who are <u>not</u> directors unless they are directors who are in the final year of their term and who will not stand for reelection, and who also satisfy the definition of independence in NASD Rule 4200;

- a corporate governance committee composed entirely of independent directors; and

- a management compensation committee composed entirely of independent directors.

Each committee has a charter detailing its authority that it reviews annually, and committees have the ability, and the funding, to seek outside assistance.

Nasdaq's status as a public company and a company subject to SEC-approved listing standards address other concerns underlying the Proposal, including director independence, financial controls, and disclosure of material information. Like all public companies (but unlike most SROs), Nasdaq prepares and files proxy statements and annual, quarterly, and current disclosures on SEC Forms 10-K, 10-Q, and 8-K, thereby disclosing to the Commission, investors, and interested members of the public detailed information about its financial condition, operations, and executive compensation.

The listing standards applicable to Nasdaq include both "quantitative" and "qualitative" standards. Quantitative standards focus on indicia of the financial health of listed companies, such as stockholders' equity and net income: thus, Nasdaq and the Commission benefit from a structure in which Nasdaq's financial ability to meet its regulatory obligations is under continuous review. Qualitative standards focus on a range of governance requirements, including director independence, audit committee composition and duties, review of "related party transactions" to ensure appropriate resolution of potential conflicts of interest, and the maintenance of a code of conduct. In particular, adherence to Nasdaq's own listing standards results in a board structure in which a majority (indeed, a substantial majority) of its directors satisfy the SEC-approved definition of independence in NASD Rule 4200.[7] Under this definition, which applies to all companies listed on Nasdaq, a director may not be considered independent if he or she

[7] NASD Rule 4200(15) provides that:

> "Independent director" means a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship which, in the opinion of the company's board of directors, would interfere with the exercise of independent judgement in carrying out the responsibilities of a director. The following persons shall not be considered independent:
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> (A) a director who is, or at any time during the past three years was, employed by the company or by any parent or subsidiary of the company;
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> (B) a director who accepted or who has a Family Member who accepted any payments from the company or any parent or subsidiary of the company in excess of $60,000 during any period of twelve consecutive months within the three years preceding the determination of independence, other than the following:
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> (i) compensation for board or board committee service;
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> (ii) payments arising solely from investments in the company's securities;
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> (iii) compensation paid to a Family Member who is a non-executive employee of the company or a parent or subsidiary of the company;
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> (iv) benefits under a tax-qualified retirement plan, or non-discretionary compensation;
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> (v) loans from a financial institution provided that the loans (1) were made in the ordinary course of business, (2) were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with the general public, (3) did not involve more than a normal degree of risk or other unfavorable factors, and (4) were not otherwise subject to the specific disclosure requirements of SEC Regulation S-K, Item 404;
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> (vi) payments from a financial institution in connection with the deposit of funds or the financial institution acting in an agency capacity, provided such payments were (1) made in the ordinary course of business; (2) made on substantially the same terms as those prevailing at the time for comparable transactions with the general public; and (3) not otherwise subject to the disclosure requirements of SEC Regulation S-K, Item 404; or
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> (vii) loans permitted under Section 13(k) of the Act.
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> Provided, however, that in addition to the requirements contained in this paragraph (B), audit committee members are also subject to additional, more stringent requirements under Rule 4350(d).
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> (C) a director who is a Family Member of an individual who is, or at any time during the past three years was, employed by the company or by any parent or subsidiary of the company as an executive officer;
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> (D) a director who is, or has a Family Member who is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the company made, or from which the company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year, or $200,000, whichever is more, other than the following:
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> (i) payments arising solely from investments in the company's securities; or

has, or during the prior three years had, certain categories of relationships to Nasdaq or its affiliates, including employment relationships or financial relationship in excess of certain stated amounts.

Like other public companies (but again, unlike most other SROs), Nasdaq is also subject to Sarbanes-Oxley, the most sweeping overhaul of corporate governance in recent memory, which establishes governance requirements unparalleled in this or any other country. The centerpiece of Sarbanes-Oxley is Section 404, which requires management to assess the effectiveness of a public company's internal control structure and procedures, and which requires the company's auditors to attest to management's assessment. Among other things, Sarbanes-Oxley also mandates the independence of a public company's audit committee, establishes a structure for "whistleblowing" by company employees, enhances the responsibility of corporate officers for the accuracy of financial reporting, and imposes reporting obligations on attorneys that work for public companies.

As a consequence of these requirements, Nasdaq has a corporate governance structure that combines both an independent self-regulatory structure and the transparency of a public company. The SEC, Nasdaq, NASD, member firms, listed companies, and investors have worked for many years to create this unique structure, one that Nasdaq seeks to complete in the near term through its final separation from NASD.

III. Board Independence

One of the primary goals of the Proposal is to ensure the independence of SRO boards of directors. To that end, the Proposal notes that

> Rules 6a-5 and 15Aa-3 would impose a series of substantive requirements with respect to the composition of the exchange's and association's board that are designed to assure the independence of the board and the fair administration and governance of the exchange or association. To this end, the Commission proposes that the board of each exchange and association be composed of a majority of independent directors. This provision would further the statutory

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(ii) payments under non-discretionary charitable contribution matching programs.

(E) a director of the listed company who is, or has a Family Member who is, employed as an executive officer of another entity where at any time during the past three years any of the executive officers of the listed company serve on the compensation committee of such other entity; or

(F) a director who is, or has a Family Member who is, a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor who worked on the company's audit at any time during any of the past three years.

(G) in the case of an investment company, in lieu of paragraphs (A)-(F), a director who is an "interested person" of the company as defined in Section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors or any board committee.

> goals that an exchange and association be so organized and have the capacity to carry out the Exchange Act's purposes and to comply, and enforce compliance by members and their associated persons, with the Exchange Act and rules thereunder and the SRO's own rules [footnotes omitted].[8]

Proposed Rules 6a-5(c)(1) and 15Aa-3(c)(1) provide that "the Board … must be composed of a majority of independent directors." Proposed Rules 6a-5(e) and 15Aa-3(e) would provide that

> [The SRO], at a minimum, must have the following Standing Committees of the Board, or their equivalent: Nominating Committee, Governance Committee, Compensation Committee, Audit Committee, and Regulatory Oversight Committee. Each of these Standing Committees must report to the Board.[9]

The Proposal would require that each of these committees[10] be composed solely of independent directors.[11]

As detailed in Section II above, Nasdaq already complies with these aspects of the Commission's Proposal to a substantial extent. Indeed, the Commission's proposed definition of independence has been based in substantial part on NASD Rule 4200. The

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8 Proposal, 69 FR at 71134.

9 Proposal, 69 FR at 71216.

10 Proposal, 69 FR at 71216.

Rules 6a-5(k)(1) and 15Aa-3(k)(1) provide that:

> [The SRO] may establish such other committees of the Board as it deems appropriate. However, if such committee has the authority to act on behalf of the Board, the committee must be composed of a majority of independent directors. [The SRO] may not delegate to any committee not consisting solely of independent directors the authority to act on matters that otherwise are within the jurisdiction of a Standing Committee.

Rules 6a-5(c)(6) and 15Aa-3(c)(6) would provide that:

> When the Board considers any matter that is recommended by or otherwise is within the authority or jurisdiction of a Standing Committee, a majority of the directors who vote on the matter must be independent directors.

11 Proposed Rules 6a-5(b)(12) and 15Aa-3(b)(12) would provide that:

> The term *independent director* means a director who has no material relationship with the [SRO] or any affiliate of the [SRO], any member of the [SRO] or any affiliate of such member, or any issuer of securities that are listed or traded on the [SRO] or a facility of the [SRO].

The proposed definition then includes a number of clarifications and exclusions, many aspects of which are similar to NASD Rule 4200(15).

definitions deviate in one key respect, however: the Commission has proposed a per se exclusion of individuals who are affiliated with members of the SRO or issuers whose stock is listed on the SRO. The Commission bases this exclusion on a supposition that such circumstances "could challenge the impartiality of the director."[12] As a result, although members and issuers could continue to serve on the Nasdaq board, their representation as a percentage of total directors would decrease and they would be excluded altogether from important board committees.

There is no reason to define members and issuers as "insiders," however, if the regulatory structure of an SRO does not allow them to make decisions that directly affect the regulation of their employers. Such is clearly the case at Nasdaq. Member regulation is conducted entirely by the NASD, while issuer regulation is conducted through an adjudicatory process that never involves the Nasdaq board. Even after exchange registration, when the Nasdaq board will become Nasdaq's "court of last resort" for member and issuer proceedings, all aspects of such proceedings except final appeal will continue to be conducted through processes not subject to board influence, while improper member or issuer involvement in final appeals will be eliminated through strict recusal requirements.

Nasdaq strongly believes that member and issuer directors are not only capable of serving with impartiality, but that the ability to draw upon the member and issuer community assists Nasdaq's nominating committee in identifying highly talented and highly motivated individuals to serve as directors, to the benefit of investors and Nasdaq's stockholders alike. Member representatives allow the board to draw upon the insights of the securities industry, while issuer representatives are culled from the ranks of the dynamic corporations that list securities on Nasdaq and offer the board a greater understanding of the concerns facing public companies. In both cases, such directors can offer Nasdaq and its board specialized knowledge drawn from individuals' backgrounds in fields such as finance, accounting, computer technology, and the development and marketing of innovative products. Moreover, the idea that members and other interested constituencies should shape SRO policies (as contrasted with SRO adjudications) is inherent in the very notion of self-regulation that has been adopted by Congress. Congress valued that input when it enacted the fair representation of members and issuer representation requirements of Sections 6 and 15A of the 1934 Act. If the Commission's goal is to minimize industry participation, it may be better to seek a legislative, rather than a regulatory, solution.[13]

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[12] Proposal, 69 FR at 71136.

[13] Nasdaq respectfully questions the validity of the Commission's assumption that an SRO board may be composed entirely of non-member directors. The Proposal, 69 FR at 71138, provides:

> The Commission notes that it recently approved the NYSE's proposal to establish a fully independent board, finding that such a board could be consistent with the Exchange Act and the fair representation and issuer and investor representation requirements. As discussed above, the Commission only is proposing to require exchanges and associations to elect majority-independent boards, although an SRO may elect to impose a more rigorous requirement. The Commission believes that an exchange's

By contrast, although the Commission has stated that the NYSE's recent decision to relegate member and issuer representatives to an advisory Board of Executives will "ensure that NYSE constituents continue[ ] to have a meaningful voice in the affairs of the exchange,"[14] we are concerned that the NYSE's bifurcated board structure will either marginalize members and issuers or result in an unwieldy and excessively bureaucratic decision-making process that is ill-suited to a public company such as Nasdaq. In

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or association's board could be wholly-independent based on the independence criteria contained in the proposed governance rules, provided that its rules satisfy the fair representation requirement and issuer and investor representation requirements (*i.e.*, by requiring that at least 20% of the independent directors are selected by members, that at least one independent director is representative of issuers, and at least one independent director is representative of investors) [footnote omitted].

This interpretation seems contrary to the plain meaning of the 1934 Act. For example, Section 6(b)(3) of the 1934 Act provides that:

The rules of the exchange assure a fair representation of its members in the selection of its directors and administration of its affairs <u>and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer</u> [emphasis added].

When Congress enacted this provision as part of the Securities Acts Amendments of 1975, it was altering access to exchanges and associations in the context of deregulation of commissions. The House bill included provisions for public directors on exchange boards. The House Report notes that some exchanges have governing boards that range from "half industry representatives and half public representatives, while others have no public representatives at all." It states that "the Committee believes that all exchanges should have some public representatives on their governing boards but realizes that the proportion of the public representatives to nonpublic representatives may vary from exchange to exchange because of differing circumstances. Thus, this subsection leaves to each exchange and the SEC the question of the number of public representatives which must be on the governing board of a particular exchange."

In the conference, the "Senate receded to the House with an amendment that the board of directors of an exchange or association must contain at least one individual who is not a broker, dealer, member, or person associated with a broker, dealer, or member." The Report further notes that "the conferees are aware that some exchanges, notably the New York and American stock exchanges, have structured their boards to balance their industry representatives with public governors. The conferees do not, by their decision to require only one or more public representatives on exchange boards repudiate a balanced board concept, nor do the conferees suggest that existing exchanges should reduce the number of such governors for which provision has already been made." Conference Report 94-229 (94th Cong. 1st Sess.) at 98. In other words, the operating premise of the Congress was that exchange and association boards were composed of representatives of their membership in accordance with the self-regulatory system. Some exchanges had sought to include public directors and the Congress felt it wise to require inclusion of at least one member of the public and one issuer representative. But it was axiomatic that exchange and association boards would include representatives of their broker-dealer members and that a majority of such was acceptable to Congress, even if the SEC and the exchanges and associations had flexibility to alter the formulation. Nasdaq respectfully suggests that the Commission's approval of completely independent boards and requirements that specified committees be composed exclusively of non-member directors may be at odds with Congressional intent.

[14] Concept Release, 69 FR at 71261.

particular, over time the NYSE may find it difficult to recruit high-level personnel from members and issuers to serve on its Board of Executives, given their advisory status. The Commission should not arbitrarily impose even a modified form of this structure upon other SROs, any more than it should mandate that the NYSE retain its current structure in perpetuity if it finds it unworkable.[15]

It is true that representatives of members or issuers should not be permitted to dominate an SRO's board of directors. It is for that reason that the SEC mandated balance when it oversaw the restructuring of the NASD and Nasdaq boards and by-laws during the 1990s. This balance, which has been consistently maintained by the NASD and Nasdaq, has worked extremely well in practice. Accordingly, there is no basis for concluding that that balance should be abandoned in favor of imposing even greater restraints on the ability of SROs to populate their boards with experienced, high-level representation of members or issuers.

It is also clear that member and issuer representatives should not be permitted to participate in decisions that directly affect their employer, a requirement that is embodied both in Nasdaq's Code of Conduct for its board of directors,[16] and even more important, in the allocation of responsibility for issuer and member regulation to adjudicatory bodies that are not controlled by the Nasdaq board of directors. The Commission could adopt requirements of recusal and regulatory independence similar to those reflected in Nasdaq's Code of Conduct and its decision-making structure in a final rule on SRO governance as a reasonable approach to avoiding conflicts of interest without adopting a per se exclusion from the definition of independence.

We can see no reason, moreover, why members or issuers should be barred from serving on the board committees that the Commission defines as "standing committees," such as

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[15] The Commission recently approved further amendments to the NYSE governance structure. Securities Exchange Act Release No. 51217 (February 16, 2005), 70 FR 9688 (February 28, 2005) (SR-NYSE-2004-54). The NYSE corporate governance structure is new, and there is very little experience with it. By contrast, the Commission mandated the restructuring of Nasdaq/NASD nine years ago, and it has the benefit of a solid track record. Nasdaq suggests that it would be unwise to dismantle a working governance structure that has met the Commission's policy concerns and replace it with an untested structure on an industry-wide basis.

[16] See www.nasdaq.com/investorrelations/NASDAQBoardCodeofConduct10-25.pdf. "The participation of a director who is affiliated with a regulated entity in a decision affecting a regulated entity has the potential for creating an appearance of a conflict of interest. Any director affiliated with a regulated entity should consult with the NASDAQ Office of General Counsel prior to participating in such a decision. It is expected that a director who is affiliated with a regulated entity will not participate in:

- any disciplinary action or investigation that involves the regulated entity, either as the subject matter of the investigation or action or as a victim or witness in the matter;
- any decision regarding an application by that regulated entity for an exemption or waiver;
- any consideration of a contract or other agreement between NASDAQ and such entity if the contract or agreement represents 5% or more of the regulated entity's annual gross revenues as of its most recent fiscal year."

the audit committee or corporate governance committee. The Commission's Proposal in this regard implies, but does not explicitly state, a concern that a member or issuer may be tempted to ignore accounting or governance lapses at an SRO in return for favorable regulatory treatment. It is Nasdaq's view, however, that qualified directors employed by members or issuers can and should be permitted to make their talents available to support the work of these important committees, as long as an appropriate degree of regulatory independence is achieved through the structuring of the SRO's regulatory program. Quite simply, if the director and the SRO's commercial officers cannot influence the outcome of regulatory decisions that affect the director's employer, the possibility of a conflict of interest, or even the appearance of a conflict, has no meaningful existence.

If the Commission adopts its restrictive definition of independence, Nasdaq will be faced with an unfortunate choice. Either Nasdaq will be required to terminate the service of a number of highly qualified directors, or Nasdaq will be forced to increase the size of its board dramatically to create enough board seats to maintain a majority of independent seats under the new definition. Such an increase would, unfortunately, be at odds with current views of corporate best practices because it would hamper efficient decision-making and dilute individual director involvement. In either event, Nasdaq would be required to exclude several qualified individuals from their current service on its audit committee, corporate governance committee, and management compensation committee. In addition, Nasdaq would be required to replace its current SEC-approved nominating committee framework, in which non-directors or retiring directors offer nominations, with a structure in which directors nominate their own replacements. In Nasdaq's view, the current structure enhances the independence of the nomination process beyond what is contemplated in the Proposal, and should therefore be recognized as the preferable course. Finally, any final rule should make it clear that a given standing committee can perform several functions (e.g., the audit committee could also perform the functions associated with regulatory oversight), and that a given director can serve on more than one committee. Otherwise, the standing committee requirement would result in an increase in the overall size of the board of directors to an unreasonable extent.

Nasdaq also questions the Commission's Proposal to require that a majority of the directors voting on a matter must be independent directors when the full board considers a matter recommended by or otherwise within the jurisdiction of a standing committee. If independent directors are absent when such a matter is considered, the restriction would require either abstentions by non-independent directors or rescheduling of the matter until a later date. Accordingly, this aspect of the Proposal is at odds with effective governance and may also run afoul of state corporate law principles regarding the powers and duties of directors.

Finally, in the event the Commission adopts the Proposal in its current form, Nasdaq strongly believes that the implementation period for the Proposal should be extended to take account of an SRO's normal annual meeting cycle. The Commission's proposed implementation period allows as little as two months' time following Commission approval of SRO rule changes needed to implement the Proposal. As a result, it is likely that SROs such as Nasdaq will be required to undergo the expense of holding at least one, and possibly two, special meetings of stockholders for the purpose of approving amendments to charter documents and electing directors in conformity with the new rule. Nasdaq believes that the implementation period for any changes mandated by the new rule should run to the later of four months following Commission approval of implementing SRO rule changes or the next regularly scheduled annual meeting of the SRO. A similar "cure" period tied to the annual meeting cycle should also be adopted for events such as director resignations that cause an SRO to fall out of compliance with the rule.

IV. Regulatory Separation

Regulatory independence and separation has been a critical goal at Nasdaq since at least 1996. The work of the NASD and Nasdaq boards in implementing the recommendations of 1996 21(a) Report, which focused on regulatory independence, was far-reaching and effective. Moreover, Nasdaq hopes to complete the legal separation from its regulator, the NASD, through exchange registration in the near term.

In addition, Nasdaq has completed the transition to a public company with the attendant reporting and accountability obligations that bring transparency and additional rigor to its regulatory obligations. These public company obligations include the requirements of Sarbanes-Oxley, which shares many of the same public policy goals as the Commission's Proposal. Finally, in 2003, Nasdaq completed a separation from its business lines of all regulatory functions that remain within Nasdaq (as distinguished from those being performed by NASD).

The Commission's Proposal requires each exchange and association to separate its regulatory function from its market and other commercial interests, through either functional or organizational separation. In this regard, the Proposal seeks to ensure that the self-regulatory process is not unduly influenced by the persons or entities being regulated. Nasdaq strongly supports the Commission's goals in this regard. We believe, however, that the Proposal needs substantial clarification to make it clear that there is not a single approach to achieving the regulatory separation contemplated by the Commission. In particular, it is Nasdaq's view that it has already achieved the separation that the rule would mandate, but it is unclear to us whether the proposed rule, in its current form, would require additional structural changes that may actually work to the detriment of regulatory effectiveness.

Nasdaq achieves the purposes of the regulatory separation provisions, including the independence of its regulatory operations, through a number of structural and governance improvements adopted over the past eight years, often in consultation and coordination with the SEC.

- All significant member-regulation of the Nasdaq market occurs in a legally separate entity. By a large margin, most of Nasdaq's regulatory dollars are spent to fund the work that the NASD performs for Nasdaq. Functions performed by the NASD include in-depth retrospective surveillance of member market activity and the initiation and prosecution of disciplinary actions. Exchange registration will complete the legal separation of the NASD and Nasdaq.

- All other regulatory operations at Nasdaq are functionally separated and report to the CLO, ensuring consistent legal interpretation and adherence to all statutory and regulatory obligations. Regulatory functions performed within Nasdaq include real-time market surveillance, application of listing standards to listed issuers, and providing legal advice to Nasdaq directors, officers, and employees regarding regulatory obligations. The separation of the legal/regulatory function at Nasdaq from the principal Nasdaq business lines of Transaction Services, Market Data and the Corporate Client Group was completed in 2003. The current CEO finalized this separation to ensure, in an efficient and clear manner, regulatory excellence and adherence to the highest legal standards.

- Although the Nasdaq employees that oversee application of listing standards report to the CLO, the adjudication of all listing and delisting cases at Nasdaq is conducted through independent panels and through appeals to the independent Nasdaq Listing Hearing and Review Council.

- The audit committee is explicitly charged by the board to oversee the regulatory operations of Nasdaq. This responsibility is clearly described in the audit committee charter.

- The CLO is required to provide a regulatory report to the audit committee at every regularly scheduled meeting of the committee. This report reviews all material regulatory issues. The CLO also meets with the audit committee in executive session at every regularly scheduled meeting of the committee.

- Nasdaq's internal auditor reports directly to the audit committee and conducts regular audits of the regulatory operations at Nasdaq.

- The Nasdaq corporate charter states that the company's economic interests do not take precedence over its regulatory responsibilities.[17]

[17] Nasdaq Articles of Incorporation, Article Eleventh: "In light of the unique nature of Nasdaq and its operations and in light of Nasdaq's status as a self-regulatory organization, the Board of Directors, when evaluating …any other issue, shall, to the fullest extent permitted by applicable law, take into account all factors that the Board of Directors deems relevant, including, without limitation, to the extent deemed relevant, (i) the potential impact thereof on the integrity, continuity and stability of The Nasdaq Stock Market and the other operations of Nasdaq, on the ability to prevent fraudulent and manipulative acts and practices and on investors and the public, and (ii) whether such would promote just and equitable principles of trade, foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to and facilitating transactions in securities or assist in the removal of impediments to or perfection of the mechanisms for a free and open market and a national market system."

The Commission's Proposal for separation, however, requires that the regulatory program either be: (i) structurally separated from the market operations and other commercial interests of the SRO by means of separate legal entities; or (ii) functionally separated within the same legal entity from the market operations and other commercial interests of the SRO. Moreover, the Proposal requires the appointment of a Chief Regulatory Officer ("CRO") who will administer the regulatory program and report directly to the regulatory oversight committee.[18] It is unclear how this template would be applied to the Nasdaq model, which involves elements of both structural and functional separation.[19]

First, regulatory functions that are performed for Nasdaq by NASD are currently subject to structural separation. Prior to Nasdaq's registration as an exchange, the rule would appear to require NASD to appoint a CRO to oversee these functions. Nasdaq expects that when it becomes registered as an exchange, however, it would continue to maintain structural separation through a contractual arrangement with NASD. This would result in an even higher degree of structural separation, yet it is unclear whether it would be found consistent with the reporting responsibilities of the Proposal. Specifically, the Proposal requires that the CRO manage the SRO's regulatory program. Would an arms' length contractual relationship with NASD be consistent with this aspect of the Proposal?

Second, regulatory functions that are performed by Nasdaq directly are currently subject to functional separation, in that they are administered by departments that are separate from Nasdaq's business operations and whose employees report to Nasdaq's CLO. The CLO in turn reports to the CEO and the audit committee of the Nasdaq board of directors. The Proposal, however, would appear to require the severing of ties between the CLO and the CEO. Nasdaq sees undesirable results stemming from an implementation of this aspect of the Proposal. First, the new reporting chain between a CRO and a regulatory oversight committee would remove the CEO from any involvement in the SRO's regulatory program. Second, by severing ties between legal officers responsible for regulatory functions and the CEO, the Proposal would deprive the CEO of the ability to obtain advice regarding his own regulatory obligations from the SRO employees who are best equipped to understand them.

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18 Proposal, 69 FR at 71142; proposed Rules 6a-5(n)(3) and 15Aa-2(n)(3).

19 Proposal, 69 FR at 71134 n. 81 provides:

> To date, the Commission has permitted an SRO to delegate its regulatory responsibilities only to a subsidiary of the SRO or to another SRO. The SRO that delegates such responsibilities, however retains primarily responsibility for ensuring compliance with the Exchange Act, and rules thereunder, and the rules of the SRO.

Our comments are based in large part on the understanding that the Commission would expect Nasdaq to meet all of the requirements in the Proposal, notwithstanding its unique arrangement with NASD, its other internal protections, and its status as a public company listed on Nasdaq.

While this structure may result in maximum functional separation, Nasdaq strongly believes that it would strike the wrong balance between separation and accountability. The Commission should consider the possible adverse consequences of a regulatory regime in which the CEO of an SRO, the individual primarily responsible for establishing the overall direction of SRO policies and ensuring its economic stability, has no contact with the regulatory program or the individuals that manage it. The Commission may be establishing a structure in which the CEO may conclude that he has no ability to enhance the quality of regulation and therefore no responsibility for it.

As the Commission has recently reminded Nasdaq and the NASD through the 2005 21(a) Report, however, "[t]he market professionals who are employed by Nasdaq play a meaningful role in effective regulation of the Nasdaq market center…. '[E]ffective regulation requires intimate knowledge of how the market works. This cannot effectively be acquired or maintained in isolation.'" (quoting Report of the NASD Select Committee on Structure and Governance (1995)). The Proposal's apparent requirement of total separation would appear to be at odds with these statements by the Commission. Even worse, the Commission may be establishing a "Catch-22" in which the CEO cannot influence the quality of regulatory functions yet can be assigned responsibility under Section 19(h) of the 1934 Act for any regulatory lapses that occur while he is in office. Moreover, it is difficult to understand how the CEO can make the certification contemplated by proposed rule 17a-26(c) if he can have no contact with the SRO's regulatory program. Nasdaq respectfully submits that the Commission cannot in fairness seek to have it both ways: either the CEO of an SRO is deputized under the 1934 Act to exercise regulatory authority subject to Commission oversight, or he is merely the head of a commercial enterprise that must pay a unique tax by funding an adjunct regulatory operation for which the CEO can be held responsible only to the extent that he deprives it of funding.

Removing the CEO from the regulatory "reporting chain" may also have the effect of imposing de facto managerial duties on members of the regulatory oversight committee, since they will be the only individuals within the SRO to have responsibility with respect to both the commercial and the regulatory aspects of the SRO. Indeed, the Proposal to make a regulatory oversight committee directly responsible for budget, staffing, personnel, and monitoring imposes upon board members duties that are clearly managerial in nature. Paradoxically, this aspect of the Proposal would undermine the very regulatory independence it seeks to promote, since the most fundamental characteristic of an independent director is a separation from direct management of the corporation. Moreover, adoption of this aspect of the Proposal may be contrary to state corporate law and may increase the difficulty of recruiting and retaining qualified directors by making excessive demands on directors' time commitment and by blurring the line between board and management.

Instead, the Commission could reinforce a message of the accountability of the CEO and all other SRO employees by reiterating its own conclusions in the 2005 21(a) Report. The 2005 21(a) Report contains no suggestion that the CEO should be cut off from regulatory personnel. In this regard, the Proposal is also philosophically inconsistent with Congress's approach to regulatory accountability of public companies under Sarbanes-Oxley, which makes the CEO and other senior corporate officers jointly responsible for financial reporting and internal controls.

We note that in order to foster independent decision-making, the Commission maintained flexibility in its Proposal by not mandating the separation of the Chairman of the Board and CEO positions. Instead, the Commission preserves opportunities for efficiencies that some SROs might achieve with one person serving in both capacities. The Commission does impose additional independence requirements when one person serves as both Board Chairman and CEO. Similarly, we would suggest that the Commission adopt the same flexibility by deeming that the CRO may report to the CEO if the Board Chair and CEO are separate positions, if there is adequate opportunity (as there is at Nasdaq) for the CRO to report to the board and board committees having responsibility for regulatory oversight through clear and confidential channels of communication, and if the appropriate board committee has authority to review regulatory plans, programs, and effectiveness.

Nasdaq believes that the Commission should conclude that its current structure affords a level of independence of regulatory and market functions that amply protects investors. In particular, the Commission should not impose a strict model of functional separation on an entity such as Nasdaq that has already achieved substantial, but not total, structural separation. The Commission would be determining that the separation of most regulatory responsibilities into separate entities does not mitigate the need to establish an NYSE-style architecture within each entity, regardless of the scope of remaining responsibilities and other safeguards that exist within the entity. We hope that the Commission will instead recognize the success of the Nasdaq/NASD model in achieving the goals of the Proposal.

Nasdaq also questions the Commission's Proposal with respect to dissemination of "regulatory and trading information."[20] Although Nasdaq would support a clear prohibition on dissemination of information, such as Order Audit Trail System ("OATS") data, that is collected solely for regulatory purposes, the proposed rule does not clearly define the information that is subject to interdiction. In particular, it should be noted that trade reporting information is used for regulatory purposes but is also currently being used for legitimate commercial purposes, such as Nasdaq's PostData product and the

[20] "Proposed Rules 6a-5(n)(5)(i)(A) and 15Aa-3(n)(5)(i)(A) would require exchanges and associations to establish policies and procedures reasonably designed to prevent the dissemination of regulatory information to any person other than those officers, directors, employees, and agents of the exchange or association directly involved in carrying out the exchange's or association's regulatory obligations under the Exchange Act [footnotes omitted]." Proposal, 69 FR at 71142.

NYSE's Broker Volume product.[21] The rule should be drafted with sufficient precision to make it clear what types of information it does, and does not, cover.

The Commission's Proposal on regulatory separation also fails to account for the possibility that the Commission's Concept Release may ultimately lead to more profound changes in SRO structure and responsibility. In this regard, Nasdaq would support Commission efforts to enact through legislation or rulemaking the hybrid model described in the Concept Release, under which a Single Member SRO would surveil and enforce rules related to broker-dealers' non-market-specific activity, such as their financial condition and registered representative representation, while SROs that operate markets would regulate broker-dealers' activities within those markets. This approach would offer substantial benefits to broker-dealers and investors alike by eliminating the costs associated with duplicative member regulation. The Single Member SRO's dependence on regulatory fees (including membership fees) to fund its operations, moreover, would effectively ensure adequate funding for its activities, because broker-dealer membership in the Single Member SRO would be mandatory and regulatory fees could be structured accordingly.

At the same time, each market would be in the best position to surveil activity on its own systems and would therefore retain authority over market regulation. The quality of market regulation, moreover, could be enhanced through adoption of intermarket surveillance and audit trail enhancements, and through targeted Commission efforts to promote greater uniformity in SRO market rules in areas where problematic disparities exist. Because market SRO revenues would no longer be supporting a duplicative regime of member regulation, the Commission could take more decisive steps to promote greater competition between SROs and thereby reduce the cost of SRO services, particularly in the area of market data.[22]

In all events, if the Commission is seriously considering adoption of the hybrid model or any of the other alternative approaches discussed in the Concept Release, it should delay adoption of the Proposal until it can determine where the Proposal fits within an overarching plan for SRO reform. It makes little sense to require SROs to restructure as required by the Proposal if they will be required to restructure again to implement more thorough-going changes.[23] Moreover, the results of the Concept Release may affect the

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[21] These products provide detailed trade reporting information to subscribers on a delayed basis. Although Nasdaq recently announced plans to discontinue PostData, that fact does not diminish the need for clarity as to the commercial uses of trade reporting information.

[22] See Letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to Jonathan G. Katz, Secretary, Commission (January 26, 2005) and Letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to Jonathan G. Katz, Secretary, Commission (July 2, 2004) (comments on proposed Regulation NMS, advocating greater competition in the provision of market data as a means to reduce costs).

[23] Concept Release, 69 FR at 71278. The Commission discusses several different formulations for the allocation of regulatory responsibilities under the hybrid model. The Commission could reach a

advisability of aspects of the Proposal. For example, if the Commission moves to adopt the hybrid model and member regulation is vested in a non-market SRO, Nasdaq's arguments against a per se exclusion of member directors from the definition of "independent director" become all the more compelling. Similarly, efforts expended by market SROs to develop a reporting regime for their member regulation programs would be wasted, because the programs would be superseded by the centralized member SRO. Accordingly, just as the Commission extended the comment period for the Proposal to allow coordinated consideration of the Concept Release, likewise it should delay adoption of the Proposal until it can be coordinated with any rulemakings stemming from the Concept Release.

V. Fair Representation

Sections 6(b)(3) and 15A(b)(4) of the 1934 Act contain identical rules for exchanges and associations, respectively, to ensure that each provides for the fair representation of its members in the selection of its directors. The Proposal reflects the latest effort by the Commission to strike a balance between the statutory mandate to represent members in SRO governance and a concern that members should not be permitted to exercise excessive influence over SRO governance. Specifically, the Commission proposes that an SRO's nominating committee administer a process that provides members with an opportunity to select at least 20% of the total number of directors. Additionally, the Commission would require SROs to adopt rules to create a fair process for the nomination of alternative candidates by members through a petition process.

As a preliminary matter, Nasdaq questions whether the fair representation aspect of the Proposal is in tension with the Commission's proposed definition of "independent director." On the one hand, the Commission seeks to ensure that members have a substantial voice in the selection of directors; on the other hand, directors selected by the membership must either not be employees of members themselves, or must be barred from serving on important board committees. Thus, there is a question as to whether the complex member nomination process in the Proposal will actually result in meaningful member representation. That said, Nasdaq appreciates the need to ensure that members have a role in director selection, but Nasdaq seeks clarification on several aspects of the Proposal.

As currently drafted, the Proposal discusses only the nomination process rather than the actual election process. Nasdaq requests that the Commission clarify and expand its discussion in this regard. Nasdaq also requests that the Commission clarify whether members should interpret the phrase "selection by members" as having the same meaning as "election by members." The Proposal is also unclear as to whether members must separately vote to elect member directors (with stockholders electing the remaining directors) or whether the nomination by members is sufficient. As a result, this part of

variety of conclusions as to how an SRO should discharge its residual regulatory responsibilities under even just the hybrid proposal.

the Proposal appears to focus entirely on SROs with a non-profit structure and does not address the manner in which the fair representation requirement would be applied to a public company with stockholders or to an SRO that is a wholly owned subsidiary of a public holding company.

Nasdaq believes that in the case of an SRO that is also a public company, the Commission should consider allowing all common stockholders of the SRO to vote for two slates of directors – one member-nominated and the other put forth by the nominating committee. Fair representation would be assured because stockholders would be required to elect a specified number of directors from the member-nominated slate. However, demutualized exchanges would not have to set up a complex capital structure by issuing to members a special limited right class of stock that allows voting but does not confer economic ownership. Allowing common stockholders to vote for the member-nominated slate would also avoid disenfranchisement of existing stockholders, who would lose their right to vote for all directors under a system of member voting.[24] The Commission should also clarify that if an SRO is a subsidiary of a non-SRO, the fair representation requirement applies solely to the SRO.

VI. Regulation AL – Listing of Affiliated Securities

Proposed Regulation AL concerns the initial listing, as well as the continued listing and trading, of securities issued by an SRO, the facility of an SRO, or an affiliate of either on an SRO. SRO listing rules currently allow these entities to list their own or "affiliated" securities. The Commission questions whether such arrangements raise conflict of interest issues that compromise an SRO's ability independently and effectively to enforce its own or the Commission's rules against itself or its affiliates.

While Nasdaq generally supports Regulation AL as proposed, it believes that it is critical to define the term "affiliated security" properly. The Commission has stated in the Proposal that the proposed definition of "affiliated security" is intended to cover the securities of any organization whose interests are "so closely aligned with the SRO's interests that the same concerns are raised about the ability of the SRO to oversee such security's listing and trading as are raised by the listing and trading of the SRO's own securities."[25]

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[24] See NASD Rule 4351. "Voting rights of existing shareholders of publicly traded common stock registered under Section 12 of the Act cannot be disparately reduced or restricted through any corporate action or issuance. Examples of such corporate action or issuance include, but are not limited to, the adoption of time-phased voting plans, the adoption of capped voting rights plans, the issuance of super-voting stock, or the issuance of stock with voting rights less than the per share voting rights of the existing common stock through an exchange offer."

[25] Proposal, 69 FR at 71152.

In this regard, the Commission requests comment on whether the proposed definition of "affiliated security"[26] should encompass ETFs. An ETFs is a type of investment company whose investment objective is to achieve the same return as that of a particular market index through primarily investing in the securities of companies that are included in the selected market index (either in all of the securities or a representative sample of the securities included in the selected market index).[27] Nasdaq strongly believes that an SRO-sponsored ETF should fall outside the scope of the term "affiliated security."

An ETF may be organized either as a unit investment trust ("UIT") or an open-end management company ("OEMC"). As explained below, these structures serve to mitigate the potential for a conflict of interest that may arise due to the SRO sponsor's obligation to "vigorously oversee the listing and trading of an affiliated security on its market,"[28] on the one hand, and its own commercial and economic interests on the other.

A UIT is an unmanaged portfolio of securities that is fixed at the UIT's inception and typically changes very little over the UIT's life. Unlike a mutual fund, a UIT is not actively managed and securities in the trust will not be sold to take advantage of market conditions to improve the trust's net asset value. It is organized under a trust indenture or similar instrument and does not have a board of directors, corporate officers or an investment adviser to render advice during the life of the trust. Also, the Investment Company Act of 1940, as amended (the "1940 Act") provides additional safeguards to protect against conflicts of interest and imposes restrictions so that a person (such as a sponsor) in a position to control or influence the fund does not, in fact, use the fund for its own benefit rather than for the benefit of shareholders. For these reasons, an SRO-sponsored ETF organized as a UIT is not subject to an SRO's influence or discretion in any material respect.

Similarly, an SRO-sponsored ETF that is organized as an OEMC should not be defined as an "affiliated security" for purposes of proposed Regulation AL. Although an ETF organized as an OEMC differs from an ETF organized as a UIT since it typically is managed by an investment adviser and overseen by a board of directors, the 1940 Act still affords the same protections designed to address conflict of interest issues between

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[26] The Proposal defines "affiliated security" to mean "any security issued by an affiliated issuer, except any option exempt from the Securities Act pursuant to Rule 238 under the Securities Act and any security futures product exempt from the Securities Act under Section 3(a)(14) of the Securities Act." Proposal, 69 FR at 71151.

[27] ETFs do not sell individual shares directly to investors and only issue their shares in large blocks that are known as "Creation Units," which investors generally purchase with a basket of securities that typically mirrors the ETF's portfolio. An SRO sponsor does not own an interest in an ETF.

[28] Proposal, 69 FR at 71151. Additionally, the Commission recently approved a rule change that, in part, for the purposes of new NASD Rule 4370 excludes from the definition of "Affiliate Security" both "Portfolio Depository Receipts" and "Index Fund Shares," which are securities that are types of ETFs. See Securities Exchange Act Release No. 51123 (February 8, 2005), 70 FR 6743 (February 5, 2005) (SR-NASD-2004-169).

the ETF and the SRO sponsor. Recently enacted heightened board independence requirements provide even stronger protections against a sponsoring SRO not acting independently and effectively to enforce its own or the Commission's rules with regard to the ETF.

Consequently, Nasdaq believes that an SRO-sponsored ETF's interests are not so "closely aligned" with those of the SRO's own interests and, thus, do not warrant additional regulation. Therefore, the Commission should define the term "affiliated security" to exclude SRO-sponsored ETFs.

VII. Periodic Reporting And Disclosure For Exchanges And Associations

Nasdaq understands and appreciates the Commission's desire "to bring greater transparency to the governance structure of SROs and to their regulatory programs and processes, and to provide the mechanism for more timely disclosure of the specified information."[29] Nasdaq believes, however, that a number of the Commission's proposals impose unduly burdensome reporting and disclosure responsibilities. Moreover, some of these reporting requirements are also duplicative of existing regulatory requirements. Nasdaq believes that certain of the proposed rules and requirements can be streamlined and that the existing reporting requirements of SROs that are also public companies should be given greater weight in determining whether new requirements are needed.

Proposed Rule 17a-26 under the 1934 Act would create a system of quarterly and annual reporting for exchanges and associations with respect to key features of their regulatory programs. The information in the proposed reports would include disclosure regarding surveillance, examination, and disciplinary programs of an SRO. Some of the proposed disclosure requirements would be duplicative of the existing disclosure requirements that Nasdaq already complies with on its existing periodic reporting forms under the 1934 Act in its capacity as a public company (*e.g.*, Nasdaq's Form 10-K already contains an assessment of internal controls for financial reporting purposes). Nasdaq is also now required to file monthly reports with the Commission under the new listing standards on trading in Nasdaq's own security.

Nasdaq believes that inefficiencies also will be created through the proposed requirements in instances where they may apply to both the NASD and Nasdaq and the likelihood that the Commission will receive duplicative reports from these organizations. Nasdaq is similarly concerned that the overall result of such regulatory overlap between the newly proposed rules and Nasdaq's existing regulatory obligations under the securities laws, Sarbanes-Oxley, and through other SEC-required reports would be onerous, costly, and unnecessary regulation. Additionally, the proposed time frame for providing the proposed quarterly reports (*i.e.*, within 20 business days after the calendar

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29 Proposal, 69 FR at 71154.

quarter end) is insufficient and should be more closely aligned with the current time frame for filing Form 10-Qs (*i.e.*, 40 days after the fiscal quarter for Form 10-Qs).[30]

Nasdaq does not oppose the Commission's stated goal of greater transparency, but it questions whether the proliferation of duplicative or unnecessary disclosure and reporting obligations would prove practically useful to the Commission and its staff or only serve to increase regulatory costs and burdens for exchanges and associations. Before the Commission imposes these additional reporting and disclosure requirements, consideration should first be given to the fact that Nasdaq already provides similar information through existing reporting requirements, submits to examinations and is, in general, subject to a high degree of oversight and reporting, including some requirements that are not evidenced in formal rules.[31] Nasdaq would prefer to work with the Commission to determine if there are any specific concerns not currently covered by current requirements that would necessitate Nasdaq routinely producing additional reports for the Commission.[32]

If the Commission does insist on imposing the proposed additional layers of periodic reporting and disclosure, Nasdaq believes the Commission should also give due consideration to the following recommendations. First, the Commission should adopt a two-year sunset provision with respect to these requirements. During the initial two-year period, exchanges and associations would comply with the adopted regulations, but after this period has expired the Commission would take that opportunity to reevaluate, revise and/or repropose those regulations that prove worthwhile based on its experience during that period. This would give the Commission the ability to review whether the goal of gathering pertinent information for oversight purposes has been properly balanced with the concerns of exchanges and associations in supplying the Commission with information that is informative, but not duplicative. Second, the Commission should establish in the final rule a streamlined process to enable exchanges and associations to obtain exemptive relief from duplicative or unnecessary disclosure and/or periodic reporting requirements.

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[30] The time frame for filing Form 10-Qs will decrease to 35 days following the end of the fiscal quarter for fiscal years ending on or after December 15, 2006.

[31] For example, pursuant to the request of the Office of Compliance, Inspections and Examinations ("OCIE"), the Listing Qualifications office provides OCIE with a detailed quarterly report.

[32] Unlike other SROs, as a public company, Nasdaq has duties under the federal securities laws to disclose publicly, and not only to the SEC, material information to investors. Moreover, NASD Rule 4310(c)(16) provides that:

> Except in unusual circumstances, the issuer shall make prompt disclosure to the public through any Regulation FD compliant method (or combination of methods) of disclosure of any material information that would reasonably be expected to affect the value of its securities or influence investors' decisions. The issuer shall, prior to the release of the information, provide notice of such disclosure to Nasdaq's Market Watch Department if the information involves any of the events set forth in IM-4120-1.

Nasdaq would also like to comment on proposed Exhibit I of revised Form 1 and new Form 2. Proposed Exhibit I would require that exchanges and associations disclose revenues by fee categories, including regulatory fees. This proposal should be clarified in terms of how it would apply to Nasdaq. Although Nasdaq collects some regulatory fees through, for example, its program for reviewing decisions to delist an issuer, most of the types of charges mentioned by the Commission in the Proposal (*e.g.*, member dues and regulatory fines or penalties) are assessed by the NASD and not by Nasdaq. Nasdaq does, however, devote a considerable sum of its commercial revenues to fund its regulatory program. The Commission should clarify that the use of a particular revenue source, such as market data revenue, to fund a portion of an SRO's regulatory costs does not transform that revenue source into regulatory funds.

Nasdaq's final comment to this section concerns the Commission's estimate of costs incurred in connection with these proposals. Nasdaq believes that the costs associated with implementing proposed Rule 17a-26, as well as those in connection with the proposed amendments to the registration forms for exchanges and associations as outlined in the Proposal, are significantly underestimated.[33] The increased costs would

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[33] The Proposal states at 69 FR 71208:

> Proposed Rule 17a-26 would require national securities exchanges and registered securities associations to file quarterly and annual reports with the Commission. As discussed above in Section IX., the Commission believes that exchanges and associations would incur costs to comply with the proposed rule. In particular, based on information available to the Commission at this time, the Commission estimates that each national securities exchange and registered securities association would incur an average burden of 40 hours to prepare each quarterly report and 35 hours to prepare each annual report required by the proposed rule, for an annual burden of 195 hours per respondent. Accounting for nine national securities exchanges and one registered securities association, the total burden to comply with the quarterly and annual reporting requirements in proposed new Rule 17a-26 is therefore estimated to be 1,950 hours per year. Further, for purposes of this release, the Commission estimates that an exchange or association would incur a burden of 4 hours to prepare each interim updating amendment, which would likely be required, on average, 5 times per year for a total of 20 hours per respondent and 200 hours total for the nine exchanges and one association. Accordingly, as discussed above in Section IX., the total burden resulting from the proposed rule's quarterly and annual reporting provisions would be 2,150 hours and $60 to prepare and file with the Commission each report and interim supplement. [footnotes omitted].

result not only from the hiring of additional regulatory and compliance staff, but also from associated costs incurred in connection with developing new information systems. Lastly, it is important for the Commission to recognize, and factor into the overall regulatory equation, that many of these costs eventually could be passed along to investors and/or diminish resources available for direct regulation. The Commission must carefully weigh, in the case of each of these proposed rules or requirements, whether the benefits gained outweigh these eventual costs as well.

VIII. Member Voting and Ownership Limitations

Nasdaq generally supports the Commission's proposal to require an exchange or association to limit the ability of its members that are brokers or dealers to own or vote a significant interest in the exchange, association, or any separate facility. However, the Commission must be vigilant in ensuring that a relaxation of the member ownership and voting limit threshold to 20% does not give rise to undue influence concerns or unfairly tilt dealings towards larger shareholders.[34]

It is unrealistic to assume that Nasdaq could prepare and file the quarterly reports in 195 hours at an hourly rate of $60. We also disagree with the suggestion that Nasdaq could complete the interim updates in 20 hours per year. The Commission must recognize that Nasdaq, like other SROs, carefully prepares every document it submits to the Commission, assembling the required information (which often requires original research) and preparing reports that management, legal, and/or accounting professionals write, edit, and review. Nasdaq also believes that a $60/hour cost estimate is unrealistic and that an average cost of $350/hour for outside counsel and $80/hour for Nasdaq's internal cost would be more accurate. These costs, of course, are in addition to costs incurred in preparing the extensive materials that Nasdaq already provides to the Commission. Accordingly, Nasdaq questions whether the reporting obligations in the Proposal satisfy the legal standard that Congress articulated in Section 3(f) of the 1934 Act:

> Whenever pursuant to this title the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

34 For example, according to Archipelago Holdings, Inc.'s ("Archipelago") recently filed Form 8-K, The Goldman Sachs Group, Inc. (together with its affiliates, "GSG") indirectly owns approximately 15.5% of Archipelago's outstanding common stock through its subsidiaries. Archipelago is the owner and operator of the Archipelago Exchange; *see* Form 8-K, Archipelago Holdings, Inc., at 2 (January 4, 2005). GSG also provides investment banking and general financing and banking services to Archipelago and is a major customer of Archipelago. The proposal would allow GSG to increase its ownership stake of Archipelago to 20% while continuing its relationship with Archipelago in these various capacities. Nasdaq believes this relationship already raises conflict of interest issues between GSG and Archipelago at GSG's current ownership level and these concerns would be heightened if the permitted level of ownership increases. If the Commission determines to adopt this rule as proposed, it must remain vigilant in monitoring the exact nature of the Archipelago – GSG relationship, as well as other similar relationships, and view them in the context of full enforcement of the 1934 Act's restrictions on unfair discrimination by SROs.

Finally, Nasdaq would like to comment on proposed Rules 6a-5(o)(5) and 15Aa-3(o)(5) under the 1934 Act. The proposed rules would require an exchange or association to "provide an effective mechanism to obtain information relating to ownership and voting interests"[35] in the exchange, association or separate facility from any owner of any interest. Nasdaq believes that the responsibility and obligation to obtain and provide this information should rest primarily with the member since it is best situated to monitor and update this information.

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In sum, Nasdaq supports the goals articulated by the Commission in the Proposal and the Concept Release, but believes that rulemaking in this area should occur within the context of a clear understanding of what Nasdaq has already accomplished, as well as a clear vision of the overarching self-regulatory structure that the Commission seeks to achieve. We welcome the opportunity to discuss our comments with members of the Commission and its staff, and otherwise to assist the Commission in advancing these efforts. If you have any questions concerning Nasdaq's comments, you can reach me at (202) 912-3030.

Sincerely,

Edward S. Knight

Edward S. Knight
Executive Vice President and
General Counsel

cc: Chairman William H. Donaldson
Commissioner Paul Atkins
Commissioner Cynthia A. Glassman
Commissioner Harvey Goldschmid
Commissioner Roel Campos
Annette Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation

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[35] Proposed Rules 6a-5(o)(5) and 15Aa-3(o)(5).