March 8, 2005

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 5th Street, NW
Washington, D.C. 20549-0609

Re: Fair Administration and Governance of Self Regulatory Organizations; Disclosure and Regulatory Reporting by Self-Regulatory Organizations; Recordkeeping Requirements for Self-Regulatory Organizations; Ownership and Voting Limitations for Members of Self-Regulatory Organizations; Ownership Reporting Requirements for Members of Self-Regulatory Organizations; Listing and Trading of Affiliated Securities by a Self-Regulatory Organization; Release No. 34-50699; File No. S7-39-04

Dear Mr. Katz:

Philadelphia Stock Exchange, Inc. ("Phlx" or the "Exchange") welcomes the opportunity to offer its comments to the Securities and Exchange Commission ("SEC" or "Commission") on the above-referenced proposed rules ("Proposed Rules").

As a general matter, Phlx supports the guiding principles embedded in the Proposed Rules, and shares the Commission's goals of improving the governance, regulatory function and overall transparency of registered national securities exchanges and exchanges and national securities associations.[1] We believe that many of the Proposed Rules will enhance public understanding of, and confidence in, our markets. However, we believe that a number of the elements of the Proposed Rules would be somewhat burdensome, and that substantially the same benefits may be achieved by alternative means, as discussed more fully below.

Our comments fall into the following broad areas: exchange ownership; board and committee structure, and new "independent director" concept; independence requirements for the regulatory function; new reporting, auditing, certification and recordkeeping requirements; and compliance dates.

[1] Although the Proposed Rules generally apply both to registered national securities exchanges and national securities associations, for ease of reference, we refer herein to both exchanges and associations as "exchanges."

A. Exchange Ownership

1. Limitations on Ownership

The Proposed Rules require the rules of an exchange to prohibit members who are brokers or dealers, together with their "related persons," from "beneficially" owning, directly or indirectly, any interest in the exchange that exceeds 20 percent of any class of securities or other ownership interest of such national securities exchange.[2] There is also a requirement that exchange rules must prohibit such persons "directly or indirectly voting, causing the voting or giving any consent or proxy with respect to the voting of, any interest" in an exchange or a facility that exceeds "20 percent of the voting power of any class of security or ownership interest."[3] Further, exchange rules must provide "an effective mechanism to divest" any member or its related persons of interests that violate these restrictions.[4]

As the Commission is aware, the Exchange completed its demutualization in 2004, following a lengthy and detailed dialog with the staff of the Division of Market Regulation. Although the restriction in the Proposed Rules is similar to the member ownership and voting restrictions contained in the post-demutualization certificate of incorporation and by-laws of the Exchange, there are several notable differences. In contrast to the Exchange's post-demutualization charter and by-laws, the Commission is not proposing to require exchange rules to restrict ownership or voting by persons other than broker or dealer members (and their related persons). Currently, the Exchange prohibits such persons from owning more than 40 percent or exercising voting rights with respect to more than 20 percent of the Exchange's common stock, absent a by-law amendment that has been approved by the Exchange's Board of Governors ("Board") and the SEC.

The Exchange unequivocally agrees with the Commission that a significant shareholder could use its voting power to influence the operations of an exchange in a way that adversely affects the mission, integrity or regulatory capacity of the exchange, or otherwise is detrimental to the public interest. However, we think that the potential for this type of inappropriate influence exists irrespective of whether the shareholder is a member or related to a member. For example, given developments in technology and arrangements that have developed among exchange members and their trading customers, it is possible that a person or firm could be a highly active indirect user of an exchange, by means of an indirect access arrangement, but not qualify as a "member" (and therefore not be subject to the restriction on ownership by broker-dealer members). Similarly, other types of shareholders, such as technology providers, foreign exchanges, or venture capital funds, could, for their own business reasons, seek to use their voting control in ways that are deleterious to the exchange's regulatory mission. We believe that it may be too narrow a view for the Commission to look at the specific conflict that may arise if an

[2] Proposed Rule 6a-5(o)(1)(i).
[3] Proposed Rule 6a-5(o)(1)(ii). There is a limited exception for the solicitation or receipt of revocable proxies under certain circumstances.
[4] Proposed Rule 6a-5(o)(3).

exchange were to be a regulator of a controlling shareholder or its related persons. Other important conflicts could also be present where an exchange is dominated by any shareholder or small group of shareholders. The Commission should have at its disposal the tools necessary to address the broader potential range of conflicts.

The Exchange recognizes that the Commission cannot in its rulemaking necessarily anticipate all of the types of relationships between large shareholders and exchanges. Therefore, the Commission should have broad flexibility to approve or disapprove large shareholding and other control relationships on a case-by-case basis, crafting limitations on ownership and controlling influence by shareholders, whether or not members or their related persons, in a manner appropriate to the potential conflicts presented by a particular investment or transaction.

Most of the significant required (and prohibited) contents of exchange rules are generally prescribed in Section 6(b) and 15A(b) of the Securities Exchange Act of 1934 (the "Act"). However, the very important question of ownership of exchanges – whether by members or others – is not addressed at all in the Act. The Exchange is of the view that the proper approach would be for Congress to amend the Act to give the Commission the flexibility to approve, disapprove or impose conditions upon **any** material ownership, voting or other relationships that might influence adversely the policies, financial condition or regulatory program of an exchange and perhaps to prescribe the criteria to be considered by the Commission in issuing such orders. [5]

2. Restrictions on Ownership of Facilities

The Proposed Rules' limitations relative to ownership by broker-dealer members would apply to "facilities" of an exchange through which such the members may trade, and not just to the an exchange itself.[6]

In our view, to impose ownership restrictions on "facilities" would be unduly restrictive on potential Exchange businesses and unnecessary. If broadly applied, such a restriction would limit the flexibility of exchanges to negotiate innovative business arrangements with facility operators. There would be no incremental public benefit in that an SRO retains full regulatory responsibility and can control operation of facility via rules and contract provisions.

[5] For example, a regulatory structure such as that established, in the case of U.S. banking organizations, in the Bank Holding Company Act.

[6] Proposed Rule 6a-5(o)(1). The term "facility" has the meaning set forth in Section 3(a)(2) of the Act, which provides that a "facility" of an exchange includes:

> "… its premises, tangible or intangible property whether on the premises or not, any right to the use of such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service."

In the last decade, U.S. exchanges have had, and have exercised, considerable flexibility in choosing to outsource, license and otherwise enter into collaborative arrangements with third-parties in connection with software and other technology, exchange operations, regulatory programs and trading platforms that provide for order matching or other execution functionality. We believe that exchanges should continue to have the flexibility to enter into such contractual or other arrangements to enhance their profitability or competitiveness, including with respect to "facilities," irrespective of the formal ownership thereof. Since one of the main sources of potential partners or co-venturers is the broker-dealer community, where many firms have developed or conceived of the types of technologies and systems that could operate as exchange trading facilities, prohibiting exchanges from embarking upon contractual relationships with member broker-dealers (and their related persons) could drastically limit the pool of persons with whom such arrangements would be feasible. We believe that this would disparately impact smaller exchanges, such as the Phlx, which have limited resources and which might seek to leverage upon technology developed by co-venturers in order to provide competitive products in the marketplace.

Phlx has avoided inappropriate conflicts in relation to such arrangements in the past, and the restrictions proposed by the Commission concerning ownership of exchange facilities are not necessary. Potential conflicts resulting from trading on such facilities by member broker-dealers that may trade on such facilities can, and should, be dealt with through contractual provisions, Commission-approved rules, compliance procedures and/or technical functionality that prevents inappropriate conduct. Compliance with the restrictions that are put in place can be examined and inspected by the exchange and by the Commission in its oversight capacity.

B. Board and Committee Structure, and New "Independent Director" Concept

1. Determination of a Director's Independence

The Proposed Rules contemplate that each exchange will be required to have a board comprised of a majority of "independent directors."[7] The board must affirmatively determine that a director has no material relationship with the exchange or any affiliate upon the nomination of the director and thereafter "no less frequently than annually and as often as necessary in light of the director's circumstances."[8]

In the Exchange's view, the requirement concerning independence reviews would be met more efficiently and effectively by having the reviews conducted by the Nominating and Elections Committee (or another of the Standing Committees required by the Proposed Rules, such as the Audit Committee) of the board rather than by the board itself. The results can then be reported to the full board upon which the board may then act.

[7] Proposed Rules 6a-5(c) and 6a-5b(12).

[8] Proposed Rule 6a-5(c)(2). Exchanges will be required to adopt policies and procedures to require that directors inform the exchange of relationships or interests that may bear upon their independence.

2. Directors Representing “Investors” and “Issuers”

Under the Proposed Rules, at least one director must be "representative of investors" and one director must be "representative of issuers."[9] Neither of these directors may be associated with a member or broker or dealer.

The Exchange respectfully observes that Section 6(b)(3) and 11A(b)(4) of the Act only requires that the rules of an exchange “… provide that one or more directors shall be representative of issuers and investors.” This language would seem to imply that Congress did not consider it necessary that there be one director representative of issuers as well as one representative of investors. Also, in the case of an exchange such as the Phlx, which does not have an equity listings program,[10] it is hard to understand why it would be appropriate to require that there be a director that is representative of issuers.

Finally, the Exchange notes that the terms “representative of issuers” and “representative of investors” are not defined in the Proposed Rules or in the Act. We therefore find this requirement to be vague and would request that the Commission provide more guidance as to what is intended.

3. Director Consideration of Exchange Act Requirements

Under the Proposed Rules, directors would be required, in discharging their responsibilities, to "reasonably consider all requirements applicable to such exchange under the Act."[11]

We agree that, as a general proposition, exchange board members should act in a manner consistent with all applicable legal requirements binding upon them and the exchange – just as directors of any business should. Therefore, we do not oppose this requirement “in spirit.” However, we are unclear if it is intended by the Commission as an aspirational statement as a basis for liability? If the former, then perhaps this has no place in the statute; if the latter, then the standard of conduct required, the basis for liability and the consequences of noncompliance must be clearer.

If this requirement is to be retained in the Proposed Rules, when and if adopted, the Commission should give compliance guidance to exchange board members not merely by clarifying the standard of behavior required, but also by providing a forum in which board members from all exchanges can be trained in a uniform way as to the proper meaning and application of the requirement.

[9] Proposed Rule 6a-5(c)(5).
[10] Almost all of the stocks that trade on the Phlx do so pursuant to “unlisted trading privileges” under Section 12(f) of the Act. Therefore, the Exchange has no real connection to issuers who would have an interest in being represented on the Phlx Board of Governors.
[11] Proposed Rule 6a-5(l).

Moreover, if this requirement is retained in the final rules, the rules should be explicit that board members are entitled to rely on the institution's staff, and outside counsel and other advisors who are more expert in these matters, for guidance. This is a basic principle of corporate law that should not be inadvertently overridden here.[12]

We believe that, absent clarification and training, as well as an express statement regarding permitted reliance upon staff and outside counsel, qualified candidates for independent (and other) director positions may be unwilling to serve for fear of violating rules with which they may not be fully expert. In such event, imposing this type of requirement will make it difficult for exchanges to find qualified directors.

4. Member "Fair Representation"

The Proposed Rules contemplate that, in deference to the "fair representation" standards set forth in Section 6(b)(3) of the Act, at least 20 percent of the total number of directors must be selected by members.[13]

It is the Exchange's position that 20 percent is arbitrary and too high with respect to Board selection. The Exchange firmly supports the right of members to be represented in the affairs of the exchange insofar as their interests are affected. However, particularly given the diversity of exchange ownership arrangements that are possible in a post-demutualization era, we believe that the requirement of fair representation could be met in various ways, including via participation in key committees, and that enshrining a right to vote for a certain number or percentage of board members could be problematic in an era where exchanges may be public entities, or wholly-owned by one or many non-members.

A separate provision of the Proposed Rules provides that at least 20 percent of the members of any committee, subcommittee, or panel that is responsible for conducting hearings, rendering decisions, and imposing sanctions with respect to disciplinary matters must be members of the national securities exchange.[14] The Phlx has no objection to this requirement. However, we note there is no statutory requirement that the conducting of hearings, rendering of decisions, and imposing of sanctions with respect to disciplinary matters be performed by "a committee, subcommittee, or panel." We suggest that the Commission's adopting release should clarify that such hearings may be conducted,

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[12] Indeed this is a fundamental premise embedded in state corporation laws. For example, Section 141(e) of the Delaware General Corporation Law provides that:

> A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.

[13] Proposed Rule 6a-5(k)(2).

[14] Proposed Rule 6a-5(l)(3)

decisions rendered and sanctions imposed by the exchange staff (or staff of a regulatory affiliate or entity to which SRO functions have been delegated), and not necessarily by a committee on which members are represented.

Also, the Exchange believes that it should be clear that the member representation may be satisfied by the participation of any person associated with a member, even if that person is not a "member" of the exchange under the exchange's rules.

Another related point concerns the requirement in the Proposed Rules that the Exchange must adopt "rules establishing a fair process for members to nominate an alternative candidate or candidates for the board by petition," and the percentage of members that is necessary for such a petition may not exceed 10 percent of the total number of members.[15] This percentage is too low. It is important in establishing an orderly and efficient nomination and election process to discourage "frivolous" candidates. To permit too facile an entry into the election process would arguably permit candidates that are either self-interested or represent fringe interests within the membership rather than the interests of the membership as a whole, to easily become candidates and create fragmented, disorderly election processes. This would not further the goal of ensuring that an exchange's membership has a voice in governance.

5. Standing Committees

a. Exclusively Independent Directors

The Proposed Rules mandate that an exchange must, at a minimum, have the following "Standing Committees" of the board, or their equivalent: Nominating Committee, Governance Committee, Compensation Committee, Audit Committee, and Regulatory Oversight Committee.[16] Each Standing Committee must be comprised exclusively of independent directors.

The Exchange's does not believe that it is advisable for the Standing Committees to be comprised exclusively of independent directors, except in the case of the Audit Committee. To impose this requirement on all Standing Committees would potentially exclude persons with the most experience and knowledge from serving on these committees. In particular, in our view, it does not make sense to assume that a conflict exists or does not exist merely by virtue one's status as a member or person associated with a member of an exchange. We believe that it would be better to permit some degree of minority participation by non-independent board members on the Standing Committees (other than the Audit Committee) and deal with any actual conflicts that may exist through codes of conduct and recusal procedures. In the Phlx's experience, non-industry board members benefit very greatly from the industry expertise and viewpoints of their fellow board members from the industry and the exchange membership, and we

[15] Proposed Rule 6a-5(c)(7). The Exchange notes that it is not clear, given the Act's definition of "members" whether, in the case of the Phlx, this requirement would be applied based upon the total number of individual permitholders or based upon the total number of member organizations.

[16] Proposed Rules 6a-5(f)(1), (g)(1), (h)(1), (i)(1) and (j)(1). Also Proposed Rules 6a-5(b)(21) and (e)(1).

believe that the work of the Standing Committees, including the Regulatory Oversight Committee, could well be hampered by limiting the participation of board members who are affiliated member organizations.

b. Voting by Board of Standing Committee Matter

The Proposed Rules further contemplate that when the board considers any matter that is recommended by a Standing Committee or is within the jurisdiction of a Standing Committee, a majority of the directors who vote on the matter must be independent directors.[17]

The Phlx believes that this requirement is unnecessarily drastic and would be extremely hard to administer in practice. This provision could in certain instances, operate to require the exclusion of board members from a vote merely because of their status. Doing this does not necessarily imply greater fairness with respect to the vote. Moreover, as there could clearly be subjectivity regarding the selection of which non-independent director to exclude from a particular vote, this process would offer the opportunity to manipulate the outcome of a vote rather than make it more equitable. [18]

We further believe that there are Delaware General Corporation Law ("DGCL") considerations that the SEC will need to reconcile with this proposal. While the DGCL does not specifically provide that directors are entitled to vote at meetings, sections of the DGCL suggest such a right. Section 144 of the DGCL permits interested directors to vote so long as, among other things, the director's interest is disclosed to and approved by the board, including a majority of the disinterested directors. In addition, Delaware case law suggests that a director is entitled to notice of meetings, which notice (pursuant to Section 229 of the DGCL) can be waived only by a writing signed by such director or such director's attendance at the meeting (unless such attendance is for the purposes of objecting at the beginning of such meeting to any business to be conducted thereat). In addition, directors may not vote by proxy. Because directors are elected by the stockholders to serve as their representatives (and fiduciaries), the exclusion of directors would affect the representation of the stockholders which raises further DGCL implications.

The Exchange respectfully submits that if, in an extreme and isolated instance, particular actions of an exchange board are unlawful or inappropriately tainted by self-interest in violation of applicable corporate law, and exchange by-laws and codes of conduct, there are other remedies that can be imposed after the fact to cure the problem. The provision proposed will create confusion and difficulty in administration in ordinary course situations that far outweigh its supposed prophylactic effect.

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[17] Proposed Rule 6a-5(c)(6). Therefore, in practice, non-independent directors could be excluded from participation in board votes where there is an insufficient number of independent directors present at the meeting to constitute a majority.

[18] For example, taken to its logical extreme, a particular non-independent board member could be excluded over another for inappropriate reasons related to the outcome of the vote in order to influence its outcome.

c. Committee Self-Evaluations

The Proposed Rules also would require that all Standing Committees perform annual self-evaluations.[19]

First, the process and content contemplated for the self-evaluation are not specifically prescribed in the Proposed Rules and we are therefore unclear as to what is actually intended. However, we feel that the annual self-evaluation by standing committees is unnecessary. It is difficult for us to determine how this requirement would be applied and what the practical benefit would be. Our board members are very busy executives whose time is scarce and valuable, and we would discourage adding additional burdens that will distract them from their commitments to the Exchange and add to the requirements of their service unless it is for matters of vital importance; we do not view the conduct of these performance reviews as adding significantly to the public good.

6. Other Committees

The Proposed Rules further dictate that an exchange may establish such other committees 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.[20]

In our view, if the board, composed itself of a majority of independent directors, sees fit to delegate certain authority to a committee, it is redundant and impractical to require yet another level of independence.[21] At a minimum, this requirement should only be imposed in specified circumstances that contemplate major changes to an exchange, i.e., where a rule change would be necessary.

C. Independence Requirements for the Regulatory Function

1. Separation of Regulatory Function from Commercial Interests

Another theme of the Proposed Rules is the preservation of independence of the regulatory functions. The Proposed Rules specify that each exchange "must establish policies and procedures to assure the independence of its regulatory program from its market operations or other commercial interests."[22] In addition, an exchange's regulatory program must be "structurally separated from the market operations and other commercial interests of the exchange, by means of separate legal entities" or

[19] Proposed Rule 6a-5(g)(6).
[20] Proposed Rule 6a-5(k)(1).
[21] For example, there may be a circumstance where the board, seeking to draw on particular expertise of specific board members, or to conduct a factual inquiry, creates a sub-committee of experts to address an issue. The full board, with its independent majority, will always have oversight over the sub-committee providing the protections that the Commission contemplates.
[22] Proposed Rule 6a-5(n)(1).

"functionally separated within the same legal entity from the market operations and other commercial interests of the exchange."[23]

We request further guidance from the Commission as to what "policies and procedures" would be required or what steps would be required to ensure that the requisite degree of functional separation is achieved.

2. Regulatory Oversight Committee ("ROC")

a. Role of the ROC

The role of the ROC is pivotal in the governance scheme envisioned by the Proposed Rules. The Proposed Rules indicate that the charter of the ROC must address the following, at a minimum: "assure the adequacy and effectiveness of the regulatory program of the national securities exchange; assess the exchange's regulatory performance; determine the regulatory plan, programs, budget, and staffing for the regulatory functions of the exchange; assess the performance of, and recommend compensation and personnel actions involving, the Chief Regulatory Officer and other senior regulatory personnel to the Compensation Committee; monitor and review regularly with the Chief Regulatory Officer matters relating to the exchange's surveillance, examination, and enforcement units; assure that the exchange's disciplinary and arbitration proceedings are conducted in accordance with the exchange's rules and policies and any other applicable laws or rules, including those of the Commission …."[24] Further, the Chief Regulatory Officer ("CRO") reports to the ROC and not to the CEO or other management official.[25]

The Exchange has serious concerns about the proposed degree of separation of the CRO and the regulatory function from exchange management; particularly from oversight by and management control of the CEO. To impose such a separation will make it very difficult for an exchange to manage and set budgetary and strategic priorities. While we understand that the Commission seeks to mitigate the inherent conflicts of "exchange as regulator" versus "exchange as business" in the self-regulatory model, and to insulate the regulatory process from inappropriate member influence, there is no evidence that a proposal this extreme is necessary to rectify or alleviate potential conflicts. In fact, to separate the management and budgeting process for regulation (which would include allocation of limited staff and financial resources and prioritization of limited technology resources, completely from the rest of the institution) would make for a very daunting management challenge. Unless there is some ultimate central decision point for the establishment and coordination of priorities, budgeting and project management will become extremely difficult. In the structure envisioned in the Proposed Rules, it would be possible to have a result where the market and business functions of the exchange are pursuing a new business model (say, moving from floor-based trading to off-floor electronic trading) and predicating their budgets and staffing on that business

[23] Proposed Rule 6a-5(n)(2).
[24] Proposed Rule 6a-5(n)(3)
[25] Id.

plan, whereas the regulatory functions, reporting to the Regulatory Oversight Committee, creates plans and budgets with an entirely different set of priorities. This could easily lead to a situation of where the regulatory environment and infrastructure gets increasingly out of step with the exchange's actual business.

In addition, we believe that too complete a divorce of regulatory from market functions would result in the outcome that our entire system of self-regulation was designed to avoid: regulation that is not well informed by market knowledge. We do not believe that it is the Commission's intent in the proposal of these rules, to in effect, eliminate the SRO structure, nor do we believe that to do so would be in the public interest.

We suggest as an alternative that the CRO have a dual reporting line to the CEO and the ROC. The ROC and the CEO would jointly approve the regulatory agenda and plan formulated by the CRO. The ROC would also perform the following functions: review tracking and statistical data from the CRO and monitor regulatory performance; review effectiveness of the system for monitoring compliance with laws and regulations related to the SRO function of the Exchange; and review findings of any examinations by regulatory agencies such as the SEC. The CRO would report to the ROC any disagreements with management and any issues where the CRO feels pressure from management. In our proposed alternative, the CEO would select the CRO with the advice and consent of the ROC and the Compensation Committee and ultimately the exchange's board. The CEO would have the power to terminate the CRO with approval from the ROC and the board. The compensation of the CRO would be set by the ROC in conjunction with the Compensation Committee and with the ultimate approval by the board. Finally, the ROC would work in coordination with the Finance Committee in formulating the regulatory budget, based on the Regulatory Plan, which the Finance Committee would then present and recommend to the full board for their approval.

b. Other Jurisdiction of the ROC

Under the Proposed Rules, any committee, subcommittee, or panel that is responsible for conducting hearings, rendering decisions, and imposing sanctions with respect to disciplinary matters must be subject to the jurisdiction of the ROC.[26]

We observe that the application of this proposal to various aspects of the Phlx's operation is not entirely clear. For example, it is uncertain whether floor official actions, including the issuance of citations and appeals thereof would be covered.

In addition, we believe that the proposal would have the potential to raise due process concerns as it relates to the Phlx's current Business Conduct Committee. This Committee both authorizes statements of charges and renders decisions based upon the recommendations of hearing panels. Under the Proposed Rules, the Business Conduct Committee would probably have to report or be subject to the jurisdiction of the ROC. However, the ROC is charged with overseeing the regulatory function, including the

[26] Proposed Rule 6a-5(j)(4).

enforcement function. Therefore, they would have responsibility for oversight of both the "police," the "prosecutor" and the "judge." Since the ROC would be responsible for the success of the regulatory function, some might argue that they have a vested interest in the successful outcome of prosecution of enforcement cases. Accordingly, Phlx believes that it might be advisable for the Commission to reconsider the advisability of the requirement set forth in Proposed Rule 6a-5(j)(4).

3. Dissemination of Regulatory Information

Under the Proposed Rules, an exchange must establish policies and procedures reasonably designed to: prevent the dissemination of regulatory information to any person other than an officer, director, employee, or agent of the exchange directly involved in carrying out the exchange's regulatory obligations under the Act; prevent the use of regulatory information for any purpose other than carrying out the exchange's regulatory obligations under the Act; and maintain the confidentiality of any information required to be submitted to effectuate a transaction on or through such exchange or its facilities, unless such information is aggregated to such an extent that no person whose information is included in the aggregated information can be identified, or unless the person has consented to the dissemination and use of its information by the exchange.[27] An exchange's policies and procedures must require its officers, directors, employees, and agents to agree to comply with these requirements.[28]

It is our view that the scope of information subject to this provision needs to be limited. Many types of information that are currently received or collected by an exchange, beyond those specified in the release, could arguably fall within the very broad definition of "regulatory information."[29] These provisions may create tensions with business operations, such as strategic planning, public relations and marketing, since definition of regulatory information and the ambit of "information required to be submitted to effectuate a transaction on or through such exchange or its facilities" are quite broad and the permitted scope of distribution of this information, both inside and outside the exchange, very narrow. Also requiring formal agreements by staff to abide by this provision is unnecessary. We believe that it would be sufficient, for example, in the case of the Phlx, to include it in our Code of Conduct for employees, as we do with most other requirements related to the conduct of our staff.

[27] Proposed Rule 6a-5(b)(17) (definition of "regulatory information") and Proposed Rule 6a-5(n)(5)(i).
[28] Proposed Rule 6a-5(n)(ii).
[29] The Rule Proposal provides that: "Examples of such regulatory information would include, for instance, information relating to an on-going disciplinary investigation or action against a member, the amount of a fine imposed on a member, financial information, or information regarding proprietary trading systems gained in the course of examining a member." (Release No. 34-50699, pg. 69, footnote 208.).

D. New Reporting, Auditing, Certification and Recordkeeping Requirements

1. New Quarterly, Annual and Interim Reports to Be Filed

The Proposed Rules contemplate that extensive quarterly, annual and interim reports concerning regulatory matters and other specific information will need to be filed.[30]

In principle, we do not object to the concept of periodic reporting, although there are aspects of the proposed new reporting requirements that are unclear or excessive.

Our first comment relates to procedure. We assess that the costs related to the implementation and ongoing administration of this reporting are projected by our staff to be substantial.[31] Although some of the costs will be unavoidable, it will assist exchanges greatly in controlling their expenditures and complying with the strict submission deadlines, and in promoting a usable information stream in which information from all exchanges is comparable, if the Commission staff implements a formalized, uniform and consistent filing mechanism so that all the exchanges provide the same information in a uniform manner. We would suggest that the Commission work with the exchanges to devise an efficient submission process.

a. Quarterly Reports to be Filed

i. Summary of Complaints

Among those items to be reported upon are a summary of all complaints relating to the exchange's regulatory program received during the reporting period from any source, and a factual description of any response or action taken by the exchange or association in response to the complaint, including any disposition of the matter and the date of any response.[32]

It is our position that for any organization to comply with this proposed requirement "complaint" must be clearly defined. An attempt to constrain the requirement to complaints relating to the exchange's regulatory program is insufficient. An exchange receives many complaints in many forms and it is unclear where the rule would draw a line between complaints related to the regulatory program and those not related to the regulatory program. The openness of this proposed requirement would make it very difficult to comply, or it would potentially delay the resolution of immaterial administrative complaints as each SRO may have to establish a centralized process for tracking and handling any compliant. It is important to have a uniform definition with which all exchanges and associations will comply.

[30] Proposed Rules 17a-26(b)(3) and 17a-26(a)(2).
[31] Phlx management conservatively estimates that compliance with both the quarterly and annual reporting requirements could potentially cost the Exchange at least $5 million per year.
[32] Proposed Rule 17a-26(b)(2)(iii).

ii. Summary of Examinations

The Proposed Rules would require the submission of a list of member firms with net capital computation errors exceeding ten percent of excess net capital, using a unique identifier specific to the member firm to identify the member firm.[33]

We believe that it is impractical to require the production of a list of member firms with net capital computation errors exceeding ten percent of excess net capital, as the net capital computation itself is not a static process.[34] The exchanges and the SEC presently enforce Exchange Act Rule 17a-11, which requires the reporting of net capital deficiencies, failures to maintain accurate books and records, and declines in capital below established thresholds. Further, Exchange Act Rule 15c2-1(e) presently requires the reporting of certain withdrawals of capital.

b. New Annual Reports to be Filed

The Proposed Rules also contemplate that an annual report will need to be filed.[35] This reporting is to contain cumulative information of the type required in the quarterly reports as well as other very specific types of information.

i. Report of Independent Audit of Electronic SRO Trading Facilities

The Proposed Rules would require a report of an independent audit designed to assess whether the operation of any "electronic SRO trading facility" of the exchange complies with the rules governing such facility.[36]

This represents an enormous and potentially extremely expensive undertaking. Certainly, how burdensome it is really depends upon the level of review and testing that is done, the degree of which we would ask the Commission to clarify. If we take the proposal on its face and determine that tests must be devised and conducted for every rule to ensure compliance, the level of detail and the specific nature of each of the tests conducted, some of which, by their very nature, would require a potentially extensive series of tests, would make the cost of compliance at least several million dollars. Because the rules of an exchange are constantly changing and evolving, these tests would need to be conducted in this magnitude on an annual basis, thus compounding the

[33] Proposed Rule 17a-26(b)(2)(ii).

[34] A firm may have an administrative error (e.g. transposed numbers) or multiple errors, administrative or otherwise, that when viewed separately may exceed the reporting threshold or when viewed in the aggregate may have not exceeded the reporting threshold. In addition, a member firm could contemporaneously experience an error in both a trial balance entry and a required net capital calculation thus making it difficult to determine the applicability of the reporting requirement. A much more defined reporting requirement would need to be set forth in the rule or the release to give clear guidance on “errors” and the “ten percent” threshold.

[35] Proposed Rule 17a-26(b)(3).

[36] Proposed Rule 17a-26(a)(2). An "electronic SRO trading facility" is defined to mean "a facility of an exchange … that executes orders in securities on an electronic basis."

expense of annual compliance accordingly. Additionally, the Exchange feels that the public benefit of this requirement is very limited and certainly not sufficient to justify the extreme potential expense involved.

ii. Evaluation of Exchange's Regulatory Programs

The Proposed Rules would require an evaluation of the effectiveness of the exchange's regulatory programs in effect during the reporting period, including a discussion of the overall operation and effectiveness of the regulatory program; the particular strengths and weaknesses of the regulatory program; areas in which the regulatory program needs to be improved; and any planned revisions to the regulatory program in response to any weaknesses, including those weaknesses uncovered during the process of preparing the annual and quarterly reports required by this section.[37]

Requiring this reporting to be made on an annual basis is excessive and without much corresponding public benefit. In our opinion, such reviews should be required not more frequently than every 2 or 3 years.

iii. Certification by CEO

The Proposed Rules would require that the quarterly, annual and interim reports described above be accompanied by a certification, executed by the CEO, representing that the information contained in the respective report or amendment is current, true, and complete as of the date filed with the Commission.[38]

In our view, it is unfair and inconsistent to require that the CEO not have management oversight of the regulatory function, as is contemplated by the Proposed Rules, and yet require that the CEO sign to certify that the information in the quarterly and annual reports are current, true and complete. Understanding that this echoes similar requirements in the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), the main difference and inequity in this proposal is that the CEO would be by rule divorced from the oversight and management of the regulatory function and yet is made to place himself and the institution at peril in being compelled to certify to functions and information he cannot control.

3. Confidentiality of Information

The Proposed Rules provide that: "All information submitted pursuant to this section will be accorded confidential treatment "to the extent permitted by law."[39]

We believe that this provision is far too vague. It is important that exchanges have total assurance regarding the confidentiality of this information, given the

[37] Proposed Rule 17a-26(b)(3)(ii).
[38] Proposed Rule 17a-26(c).
[39] Proposed Rule 17a-26(e). Given the sensitivity of this information, commentators will be particularly focused on the absolute confidentiality, and non-discoverability, of these reports.

proprietary and highly sensitive nature of it. We believe that the Commission should, by whatever means necessary, ensure that the legal protections pertaining to confidentiality to be afforded all of the reports required by Proposed Rule 17a-26 are absolute.[40] We believe that any disclosure of such documents could expose exchanges to significant potential liability and provide the basis for substantial defenses in exchange (and SEC) enforcement proceedings. We respectfully submit that, unless confidentiality can be assured in all eventualities, exchanges will be very cautious in making these disclosures.

4. Timing of Implementation

Exchanges must comply with the reporting provisions above beginning with the first full quarterly reporting period commencing 6 months from the date of publication of the final rule in the Federal Register.[41]

In terms of initial compliance with the reporting proposals, Phlx contends that the time period is far too short. There are specifications to be created, systems to be built, programs to be coded and the materials and information to be compiled. In our opinion, the first quarterly report should be required not sooner than one year following the approval of the Proposed Rules, to allow ample time for building and testing of systems. Also, with regard to quarterly compliance, the Proposed Rules would require quarterly reporting 20 days after the end of each calendar quarter.[42] Given the volume of information, such a timeframe would be untenable. We suggest that reporting for a given quarter should not be required less than a full quarter after the quarter being reported upon.[43]

5. Amendments to Form 1 Requirements

The Proposed Rules expand dramatically the Form 1 reporting requirements, and require the posting of all periodic and annual amendments to Form 1 on their web sites. In effect, the disclosure regime applicable to exchanges is proposed to be made very similar to the requirements applicable to publicly traded companies.

As a general matter, our primary concern regarding the amendments to Form 1 arises from the public nature of the disclosures. This information would be readily available to anyone instantly by virtue of being posted on a website. Much of this information, as discussed more fully below, is potentially highly sensitive and, in the case of certain information, potentially competitively damaging to exchanges.

[40] Protections that should be addressed explicitly include, but are not limited to, protection from disclosure under the Freedom of Information Act.
[41] Proposed Rule 6a-5(r).
[42] Proposed Rule 17a-26(a)(1).
[43] For example, the reporting for first quarter 2007 would be due on July 1, 2007.

a. Disclosures Regarding the Code of Conduct

The amendments to Form 1 further require a disclosure of any waivers of the code of conduct and ethics for directors, officers or employees.[44]

We believe that disclosure of Code of Conduct waivers, which occur with some regularity, could involve the unnecessary disclosure of personal, and in some cases private, information regarding a person's circumstances. As discussed below, we believe that such waivers should be granted by senior exchange staff, reported to the Audit Committee (and, where appropriate, the Regulatory Oversight Committee) and in significant cases, perhaps, advised to the Board; naturally, such waivers would be available for inspection by the SEC (as they are now) or even furnished confidentially. Another potential disadvantage of requiring such public reporting is that it may have a chilling effect on people, keeping them from coming forward to request guidance in the first place. As a result, it might have the practical effect of keeping conflicts hidden rather than opening up the process as people may fear the possibility that their personal concerns would be reported to the board and then to the public.

b. Disclosures Regarding the Regulatory Program

With regard to the exchange's regulatory program, the amendments to Form 1 require: a full description of the program, including member firm regulation, market surveillance, enforcement, listing qualifications, arbitration, rulemaking and interpretation, and the process for assessment and development of regulatory policy; a description of the independence of the regulatory program of the applicant from the market operations and other commercial interests of the exchange; a discussion of any significant changes planned for the regulatory program of the applicant; a discussion of any new significant regulatory issues that have arisen or any significant events that have taken place, including any technology or trading issues, that relate to or otherwise may affect the applicant's regulatory responsibilities or the operation of its regulatory program, and discuss the effect these significant issues or events may have on the mission, strategy, and future operations of the applicant's regulatory program.[45]

It is the Exchange's view that such reporting would be overly burdensome and potentially prejudicial to effective regulation. It would adversely impact an exchange's enforcement program in that it would significantly weaken an exchange's position as it attempts to administer its enforcement function, allowing the possibility for creative defenses based upon perceived inadequacies in the regulatory function. Further, it is the Exchange's view that this type of reporting carries with it a great risk of an exchange opening itself up unnecessarily, to exposure from litigation. We believe there is scant benefit to be had from public dissemination and availability of this information.

[44] Exhibit F to Proposed Form 1.
[45] Exhibit H to Proposed Form 1.

c. Disclosures Regarding Revenues and Expenses

The amendments to Form 1 require a list of detailed information concerning expenses related, directly and indirectly, to regulation, as well as extensive and very specific information regarding all of the exchange's sources of revenue. Also the amendments require an itemization of non-regulatory expenses, including, but not limited to, personnel expenses, program expenses, systems and other technology expenses, consultants and advisors, and overhead.[46]

Phlx believes that this requirement is very onerous and potentially prejudicial to an exchange's competitive position, business initiatives and actual and potential relationships with business partners. In disclosing such information in a public document, there is great risk of having such information be available to competitors and others whom an exchange, for various strategic reasons, might not want to have access to it, potentially giving the competition an idea of how to price their products and services to take business from that exchange. It would be as if an exchange would be publishing essential elements of its budget and business plan directly to the competition.

Additionally, there is considerable risk in publishing raw data and projections as are contemplated in this requirement. We feel that it is dangerous to give projections without including extensive discussions regarding the assumptions that naturally must accompany them. Further, there is the potential risk of exposure for making forward-looking statements regarding revenues and expenses if they differ materially from the actual.

In terms of disclosing the amounts allocated to the Exchange's regulatory function, we would propose that such expenditures might be better reported and framed as a percentage of the whole budget.[47] Further, there is, from our perspective, no discernable public benefit to these disclosures. As a general matter, it is our opinion that the costs associated with the reporting contemplated by Exhibit I to Form 1 would be extreme.[48]

d. Disclosure of Material Financial Information

The proposed amendments to Form 1 would require the following: a discussion of information necessary to an understanding of the financial condition of the applicant and

[46] Exhibit I to Proposed Form 1.

[47] In other words, it would be potentially misleading to require disclosure in terms of actual dollars spent. An incorrect correlation might be drawn saying that because one exchange spends more money on regulation, that their program and function is therefore better. Less dollars spent could simply indicate that an exchange might manage the process better, or that the process is more efficient and therefore less expensive.

[48] Exchange management estimates that, provided the reporting is limited only to historical and current year information, the incremental cost of $1 to 2 million annually, excluding costs associated with trading systems and facilities of the Exchange as well as excluding allocated costs elated to the redeployment of existing resources, which is difficult to estimate. If reporting of forward looking estimates is required, management estimates that the expense could be several times the above estimate.

any material changes in its financial condition and a discussion of any unusual or infrequent events or transactions or any significant economic changes that have had a material effect on the financial condition of the applicant and any known demands, commitments, events or uncertainties that would result in or are reasonably likely to result in a material change in financial condition. The discussion should focus on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future financial condition as well as a description of any significant business development involving the applicant, including reorganization, merger or consolidation, acquisition or disposition of significant assets, or any other material change in the business or operations of the applicant. A description of all material contracts and all material related party transactions would also be required. In this context, "material" contracts and related party transactions are those to which the applicant or any facility or regulatory subsidiary of the applicant is a party; any director, nominee for director, officer, member, lessee, or any immediate family member of any of the foregoing is also a party; and either the amount involved exceeds $60,000 or it is not a contract made in the ordinary course of business of the applicant or any facility or regulatory subsidiary of the applicant.[49]

In our view, these provisions would be very costly and the burden of them not justified by sound policy benefit. They would also be potentially prejudicial relative to competitive position in much the same way as the revenue and expense reporting discussed above. Also, by reporting publicly matters or developments that we feel as a strategic matter are significant events might have the unintended consequence of giving a competitor an indication of where our business is vulnerable. Again, we feel that there is little corresponding regulatory purpose to be served by this reporting.

Further, we would request more guidance from the Commission as to what is a "material" event or uncertainty. We would also request further guidance as to what is meant by "significant business development."[50] Having such a broad requirement gives exchanges inadequate direction as to what the Commission expects and makes compliance difficult.

Finally, regarding financial information of affiliates, it is our view that this might result in considerable regulatory overlap and redundant reporting – at least in the case of affiliates that are otherwise regulated and subject to financial reporting already. [51]

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[49] Exhibit I to Proposed Form 1.

[50] For example, there might be an argument that the following might be considered a significant event: (i) the merger of members of our floor that might impact order flow; (ii) losing a member and transferring a book of business from one firm to another, (iii) the opening of a new competitor market, (iv) hardware acquisitions that became necessary were not anticipated or (v) any movement in market share.

[51] For example, one of the affiliates of the Exchange is the Philadelphia Board of Trade, which is registered with and regulated by the CFTC. Further, another Phlx affiliate is the Stock Clearing Corporation of Philadelphia which is independently regulated by the Commission and subject to periodic reporting on Form CA-1, making this reporting potentially redundant.

e. Waivers of Code of Conduct

The Proposed Rules would require that the Exchange's rules prescribe a code of conduct and ethics for officers, directors and employees, with certain minimum contents.[52] Waivers must be approved by the board (rather than management), and are among those matters that will be required to be disclosed in Form 1.[53]

As discussed above, it is our view that the waiver requirement as proposed is wholly excessive. Such waivers are granted in most cases for minor, personal matters that do not warrant the attention of the board (much less reporting to the general public). An alternative might be to provide that senior management of the exchange will have the authority to grant such waivers, subject to after-the-fact reporting to the Audit Committee and in appropriate cases the ROC.

E. Compliance Dates

The Proposed Rules provide that exchanges must file proposed rule changes within 4 months of the publication of the final rules. These rules must be approved within 10 months, and must be operative within 1 year[54].

This proposed time frame for compliance is insufficient. The time frame for implementation of these Proposed Rules should, at a minimum, be two years from the adoption of the Proposed Rules. Given the large number of by-laws and rules that will need to be modified, all of which require approval by exchange boards and their constituent committees, we believe that the task cannot be accomplished at the Phlx in the time frames proposed without diverting all available internal legal resources (to the detriment of the projects, including many of a regulatory compliance nature, already being handled by the relevant attorneys) plus hiring external resources and monopolizing the agenda of the Exchange's Board of Governors. Although these proposals are extremely important, and the Phlx will do what is necessary to comply in whatever time frame is incorporated into the final rules, we believe that it is not necessary to the fulfillment of the Commission's regulatory and policy objectives to force these changes to completion in an unrealistically short time frame.

[52] Among other things, the code must prohibit employees and officers from being board members of listed issuers or member firms.
[53] Proposed Rule 6a-5(p)(1) and Exhibit F to Proposed Form 1.
[54] Proposed Rule 6a-5(r).

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We appreciate the Commission's consideration of our comments. If the Commission or its Staff should have any questions regarding the matters discussed above, please contact Scott Donnini, Vice President and Counsel, at (215) 496-5358.

Respectfully submitted,

Meyer S. Frucher
Chairman and Chief Executive Officer

cc: The Honorable William H. Donaldson, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner
Annette Nazareth, Director, Division of Market Regulation
Robert Colby, Deputy Director, Division of Marker Regulation
Elizabeth King, Associate Director, Division of Market Regulation