Mar. 2, 2005

Jonathan Katz, Secretary
U.S. Securities and Exchange Commission
450 Fifth St. NW
Washington D.C. 20549
By Email to rule-comments@sec.gov

Proposed Rule: Fair Administration and Governance of Self-Regulatory Organizations, File No. S7-39-04

Concept Release Concerning Self-Regulation, File No. S7-40-04

To the Commissioners:

I write this letter concerning the Commission's above-captioned rule proposal concerning SRO governance, and the related concept release concerning self-regulation. I am a partner at the law firm of Bingham McCutchen LLP, where I represent broker-dealers, investment advisers and investment companies, and other participants in the securities markets. Bingham recently served as independent compliance consultant to an SRO as part of an enforcement settlement with the SEC, and the firm regularly represents clients before other SROs. I was previously the Commission's Assistant General Counsel for Market Regulation, and later I was General Counsel for a major national broker-dealer which was then a member of every major U.S. SRO. I submit this comment letter solely on my on behalf, and not on behalf of any current or former clients, my law firm, or any partners or associates at my law firm.

The Commission Should Not Force the Smaller Exchanges Out of Business, As These Releases Would Do

The issues presented by these releases are very important. However, I believe the real issues are somewhat different than those articulated in the releases themselves. At bottom, a key issue is whether the SEC should by force out of business many of the current SROs. For that is the inevitable, inexorable effect of a combination of steps the Commission is taking: those contemplated in these releases, the changes proposed in Regulation NMS, and changes being imposed on SROs as part of the Commission's examination and enforcement program. I believe the competition provided by multiple exchanges benefits American public companies and investors, and the Commission should not choose winners and losers in the market for trade execution services.

As I discuss further below, the Proposing Release here will substantially increase the cost structures of SROs, particularly the smaller and regional exchanges. The market data provisions of Regulation NMS (by awarding market data revenues based on quotes rather than trades) will reduce the revenues of most if not all the smaller and regional exchanges. Equally as significant, in the past two years the Commission's Division of Enforcement and Office of Compliance, Inspections and Examinations have (without benefit of any rulemaking) have dramatically reinterpreted the mandate in Section 19(g)

of the Exchange Act that SROs enforce their members' compliance with the federal securities laws and rules, and the SROs' own rules. Previously, the Commission's interpretation of this section required SROs to make reasonable efforts, through reasonably designed surveillance and examination programs, to prevent, or to detect and sanction, violations by its members. SROs were expected to detect significant systemic problems, and serious outliers among its member firms; however, SROs were not expected to replace or duplicate the supervisory and compliance processes of the member firms themselves. In the past two years, OCIE and the Division of Enforcement have reinterpreted this mandate to one in which any undetected violation by a member firm (or an individual employee at a member firm), is presumptively a violation by the SRO of its duty to enforce compliance by that firm or individual. This reinterpretation (without benefit of any public notice and comment) also has had the effect of dramatically increasing the expenses of SROs.

It is a matter of common knowledge in the securities industry that the financial viability of the regional equity exchanges hangs by slender threads. Indeed, the Pacific Exchange has already jettisoned its equity floor in favor of all-electronic operations, and is in the process of selling its options operations for a similar conversion to all-electronic status. Nasdaq recently sold the American Stock Exchange to its members because it could not find any way to make the Amex economically viable. The other regional floor-based equity exchanges all are struggling financially even without the threat of diminished revenues and increased expenses. Even several of the electronic equity SROs (including the National Stock Exchange and Nasdaq itself) either currently have highly problematic finances, or will have highly problematic finances if the market data reallocation in Regulation NMS is adopted. If the Commission continues on its present path of significantly increasing the SROs' expense base, while diminishing their revenue base, the inexorable result will be that in the relatively near future many of the smaller and regional exchanges will go out of business.

The SEC's role is not necessarily to protect permanently every SRO. Some exchanges have merged or gone out of business since the adoption of the Exchange Act; it is not clear that American investors are appreciably worse off because there is no longer an exchange in Spokane, Washington. What is different today is that the smaller exchanges will be forced out of business not because of extrinsic economic, business and competitive factors, but by a series of deliberate SEC policy decisions. If the Commission has made and can justify a decision to put these exchanges out of business, it should be honest about what it is doing, it should state and justify its reasons, and it should be willing to take the political heat for its decision. The Commission should not, as it is doing now, simply pretend it is doing something else when it knows the necessary and inevitable result of its decisions.

Historically, smaller exchanges have pioneered many innovations that have benefited investors, for example immediate electronic access to orders; electronic access to depth-of-book orders; after-hours trading, and a single-priced opening for Nasdaq securities. Competition among market centers encourages such innovative ideas and has

the potential to lower costs and provide valuable new services for investors. Moreover, allowing competing marketplaces increases the overall pool of liquidity available to US investors, and this increased liquidity effect lowers the cost of capital and benefits public companies, their investors and the economy as a whole.

The increased costs and burdens resulting from the Commission's SRO governance proposal may not seem extreme. But when considered with the Commission's other recent initiatives, I predict they will have a much more dramatic impact than the proposing release suggests. In my view it would be a bad policy decision for the Commission to put the smaller SROs out of business, and it would be inconsistent with the Commission's statutory mandate in Section 3(f) of the Exchange Act to promote efficiency, competition and capital formation.

The Commission Does Not Have Unfettered Authority to Dictate the Governance Structure of SROs

The Commission's proposing release proceeds on the apparent assumption that the SEC can impose whatever changes it pleases in the corporate governance of SROs. This assumption is a misreading of the Exchange Act. Corporate governance - including the governance of SROs - is primarily an issue of state law. This fact is why the SEC correctly deferred to the New York Attorney General the issue of whether former NYSE Chairman Richard Grasso's compensation was excessive: the issue is one of state law, not a matter of federal securities law. When the SEC attempts to usurp the state law role of dictating permissible corporate governance structures - as it often has been tempted to do[1] - it acts beyond its authority. *See Business Roundtable v. SEC,* 905 F.2d 406 (D.C. Cir. 1990). The Exchange Act sets certain baseline standards for SRO governance - for instance, Section 6(b)(3) of the Act requires that an exchange must assure fair representation for its members in the selection of directors and the administration of its affairs, and must provide that one or more directors shall represent issuers and investors.[2] But these are minimum standards, and the Act leaves SROs free to meet these standards in a variety of different ways. The SEC's proposing release would impose a series of governance restrictions: a majority of independent directors, a separate CEO and Chairman, and fully independent committees for a variety of functions (nominating, governance, compensation, audit, and regulatory oversight). Quite simply, while these restrictions may (or may not) be desirable as an abstract policy matter, they are simply not consistent with the statute. The Commission has no authority to impose a "one-size-

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[1] As two Commissioners noted in their dissent, the same lack of authority affects the Commission's recent mutual fund governance rule - an issue now pending in the D.C. Circuit.

[2] Section 15A provides similar protection for the right of the NASD (the sole national securities association) to choose its own corporate structure.

fits-all" governance model on the SROs, in direct contradiction to the flexibility guaranteed to the SROs by the Exchange Act.[3]

I recognize that the Commission has already approved governance changes at the NYSE that closely mirror those contained in the proposing release. However, it is one thing to approve a governance change proposed by an SRO - to do so, the Commission simply must find that the exchange's proposed governance changes are consistent with the minimum standards of the Exchange Act. The Commission's order with respect to the NYSE found that its proposal was consistent with the Act. It is another thing for the Commission to mandate that every exchange adopt exactly the same changes. Such a rule would impermissibly eliminate all SROs' ability to experiment with different governance structures, many of which may satisfy the minimum standards of the Exchange Act. The Commission's approval of the NYSE's governance proposal does not justify requiring every other SRO to adopt identical rules.

Even more directly contrary to the Exchange Act is the Commission's proposed marginalization of member-affiliated directors. As discussed above, the Exchange Act *guarantees* fair representation of members in the governance of SROs. By contrast, the Commission's proposal would *eliminate* the ability of any member to participate in the many of the most important functions of the SRO, by requiring that the function be performed by committees consisting exclusively of non-member directors.[4] The Commission's proposal on these points is inconsistent with Congress' concept of "self"-regulation. By forbidding industry members to serve in these functions, the Commission is taking the SRO members completely out of the self-regulatory process. This judgment is inconsistent with Congress' basic premise of the Maloney Act: that knowledgeable industry participants themselves would be the most effective regulators. I agree with the Commission that there has been a very troubling history of abuses or neglect in SRO governance. But this history is not a warrant for the Commission to override the judgments of Congress.[5] Perhaps Congress was wrong when it passed the Maloney Act,

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[3] Moreover, it will be difficult and costly for the smaller and regional exchanges to find enough qualified independent directors to serve on all of these committees, and to find separate CEOs and Chairmen. The result is likely to be directors who do not have sufficient understanding about the operations of the securities markets to provide effective leadership for these exchanges.

[4] The proposing release preserves the right of members to petition for the nomination of different independent directors from those nominated by the nominating committee. As a practical matter, this right is unlikely ever to be used. Even if it were practical, such a right is not a fair substitute for the ability of members actually to serve on the critical board committees of an SRO.

[5] I do not here challenge the Commission's ability to negotiate governance provisions as part of an enforcement settlement, where it can demonstrate a link between the violation and the remedy requested. However, even in that context the Commission's current position does not deserve deference on the basis of a long-standing or consistent position - as recently as September 2003, the SEC negotiated a settlement with the Chicago Stock Exchange that allowed member

and if the Commission believes this is so, then it should make the case to Congress for a change in the law. But the SEC may not impose SRO governance requirements that are directly contrary to the express terms of the Exchange Act.

The Current System of Multiple SRO Regulatory and Enforcement Schemes Does Not Protect Investors Well

The Commission's concept release seeks comment more broadly on the regulatory structure of the SROs. For the reasons discussed below, I support the SIA's white paper on the Hybrid Single SRO. I was a member of the SIA's Ad Hoc Committee on Regulatory Implications of SRO Demutualization, which supervised the creation of that white paper.

The current SRO structure is not working well to provide investors with consistent levels of protection at all brokerage firms. Today, the SROs make little effort to harmonize their customer protection rules. To cite but a few examples involving the two largest SROs, the NASD has a suitability rule, while the NYSE has a "know your customer" rule which it does not interpret in the same way as the NASD interprets its rule. The NASD and NYSE have different standards for who must be subject to fingerprinting and background screening at a brokerage firm. The NASD and NYSE have different standards on the permissible size of markups. The NASD and NYSE have different standards on communications with the public, and could not even fully harmonize their research analyst independence rules. The NASD and NYSE have different standards for what constitutes an impermissible price projection. The NASD and NYSE have different standards for when an associated person must seek approval before engaging in business activities for an affiliate of the broker-dealer. The NYSE requires reporting of oral customer complaints; the NASD requires reporting only of written complaints. The NYSE and the NASD have different registration and examination standards for who can serve as a branch manager. The NYSE does not recognize the NASD's "order-taker" examination. These differences could be multiplied many fold, especially when one considers the smaller and regional exchanges. The NYSE issues scores of Information Memos and the NASD issues hundreds of Notices to Members, and there is no apparent effort to harmonize them, or ensure that compliance with one SRO's position will constitute compliance with others'.

These differences in member firm regulation can result in meaningful differences in the protection of investors. But brokerage firm customers have no way to evaluate whether NASD or NYSE protection is superior, and customers are unable to pick brokerage firms on this basis. Brokerage firm customers expect and deserve a consistent level of investor protection at whatever firm they choose to do business with. Moreover, these differences in regulation impose significant costs on the brokerage industry itself -

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governors to serve on the CHX's Regulatory Oversight Committee. *See* Exch. Act Rel. No. 48566 (Sept. 30, 2003).

costs which ultimately are borne by investors in the form of higher commissions, higher account fees or higher minimum balance requirements. There is no regulatory justification for these differences in investor protection.

I agree with the Commission that different market structures will necessarily result in some differences in SRO rules. A floor-based exchange has different conflicts of interest that must be addressed in different ways than an all-electronic exchange. Differences in order-handling procedures among exchanges allows beneficial innovation and competition in determining the best ways to execute customer orders. I do not advocate (and would oppose) a "one-size-fits-all" approach to SRO market structure rules. However, there is no similar justification for differences in SRO investor protection rules. Investor protection rules, examination programs and enforcement should be consistent across all markets - and the Hybrid Single SRO approach is the best way to achieve this result.

Another important benefit of the Hybrid Single SRO approach would be improved inter-market surveillance. Today, with increased competition among market centers, it is quite possible that no single market might detect suspicious trading activity (whether it be insider trading, marking the close, or patterns of wash sales) that is occurring across multiple markets. Centralization of market surveillance would better detect (and deter) illegal trading activity - and once again, will better protect ordinary investors.

Finally, relieving SROs of their investor protection examination and enforcement responsibilities would alleviate much of the concern raised in the first section of this letter concerning the economic viability of the smaller and regional exchanges. This step would allow the markets to continue to compete vigorously and innovate to improve customer trade executions. I urge the Commission to seek approval from Congress to move towards a Hybrid Single SRO structure.[6]

How Should Self-Regulation Be Funded?

The Commission understandably inquires how a Hybrid Single SRO would be funded. I believe the short answer to this question is that it should be funded by a small, uniform fee on the brokerage industry. This fee could take the form of an annual charge per registered representative (a type of fee already assessed by most SROs). Or this fee could take the form of a charge on securities transactions, similar to the Section 31 fees already levied, although it would be important to keep such a fee low so as not to provide incentives to move trading overseas. Or there could be some combination of the two, perhaps together with small fees on other types of regulated brokerage firm activity (such as on M&A advisory services and fairness opinions). Some of the fee could be levied at the SRO level (based on trading volume) in return for the removal of some of the SROs'

[6] I do not believe the Commission could or should attempt to adopt the Hybrid Single SRO structure without new enabling legislation.

current regulatory responsibilities, although in all likelihood the fee would then simply be passed on to the members of that SRO (and their customers).

However, a Hybrid Single SRO is likely to be more efficient than the current system of requiring each SRO to fund redundant regulatory functions. Both brokerage firms and their customers should incur reduced costs if the current state of inconsistent and overlapping SRO regulation is harmonized. Since the Hybrid Single SRO is needed to regulate the brokerage industry, it is fair for the brokerage industry (as opposed to issuers, for example) to bear the cost of that regulation. While it is important to keep the fee low (because ultimately it will be passed on to investors), I believe the industry can bear the cost of such a fee.

The Commission Should Reform the Market Data System

The concept release spends substantial space defending the current status quo on the regulation of market data revenues. As the concept release recognizes, today market data provides a substantial amount of revenue to SROs. This is possible because of the market data monopoly created by the SEC's own rules: brokerage firms are required to give their transaction data to the SROs for free (by the Commission's Quote Rule), and then are required to repurchase it, at the monopoly price charged by the SROs, so that the brokerage firms can satisfy their regulatory obligation (under the SEC's Display Rule) to distribute that data to their customers. As a result, SROs are able to extract monopoly prices for that data. The SEC, which is required by the 1975 Act Amendments to regulate the prices charged by this market data monopoly, has almost entirely failed to do so. The Commission's own data show that market data is marked up some 900% over the cost of administering the three market data plans (the CTA Tape A and Tape B for listed securities, Nasdaq for Nasdaq-listed securities, and OPRA for options). Even allowing for some additional cost for producing market data at the SRO level, this markup is far too excessive - as the NASD itself testified at the Commission's recent market structure hearings.

To the extent the concept release implies that the SROs currently are using market data revenues to subsidize their regulatory functions, this implication is not factually supportable. Most SROs are using their market data revenues to subsidize directly their competition for order flow, by rebating that revenue directly to their order providers. These rebate programs (which have in recent years spread from the equities markets to the options markets) lead to abusive market activity such as tape-shredding and wash sales. Indeed, within the last month the SEC sanctioned Nasdaq for looking the other way while a market participant engaged in tens of thousands of wash sales in return for market data rebates.[7] Nasdaq appears to have looked the other way because it gained

[7] See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 ("Exchange Act") Regarding The Nasdaq Stock Market, Inc. ("Nasdaq"), as Overseen By Its Parent, The National Association of Securities Dealers, Inc. ("NASD"), Exchange Act Rel. No. 51163 (Feb. 9, 2005).

financially and in terms of reputation by appearing to have a larger share of trading in the securities at issue. Other SROs have used their market data monopoly rents in part to help subsidize lavish television advertising campaigns (to attract order flow and listings - areas in which they do face competition). In the case of the NYSE, we now know that the market data monopoly rents helped in part to subsidize grotesquely excessive executive compensation. Money is fungible - it is simply impossible to say that market data revenues subsidize the cost of regulation as opposed to these other uses. Indeed, it is fair to say that the excess monopoly rents resulting from the current market data system are at least indirectly responsible for many of the SRO conflicts of interest and abuses that the Commission is now trying to address.

Moreover, as I explained in my recent comment letter on Reg NMS, the current market data system has created grave inequities between retain investors and institutional investors.[8] Institutional and professional investors have access to very high quality market data: constantly updated real-time streaming market data showing depth-of-book trading interest on both sides of the markets. Retail investors do not have access to similar quality market data.[9] Rather, retail investors receive only a static "snapshot" consisting of the best bid, best offer (together, the "NBBO"), and last sale transaction for a security. Between the time that a retail investor receives that "snapshot" and the time they submit a trade, the market is likely to change substantially - but because the retail investor does not receive real-time streaming data, the retail investor will be unaware of those changes. And because the retail investor does not receive depth-of-book quote information, the retail investor never sees trading interest outside the NBBO.

Ten years ago, when most U.S. stocks were traded in one-quarter or one-eighth point increments, static "snapshot" quotes did not put retail investors at a substantial informational disadvantage. Retail investors' market orders were likely to be executed at the quotes they saw, because those quotes typically represented significant depth. Today, in decimalized markets, there is often little depth at the inside quotes, and those quotes change far more quickly than did fractional quotes. As a result, the likelihood is that even for a thousand-share order in a liquid stock, some or all of a retail investor's market order will not be executed at the "snapshot" quote he or she saw before submitting the order. An institutional or professional investor who receives real-time streaming, depth-of-book quotes has much more information about where their orders are likely to be

[8] My comment letter concerning Regulation NMS is available at http://sec.gov/rules/proposed/s71004/whcallcott123004.pdf. For ease of reference I will repeat my main points from that letter concerning the market data issue (and I apologize in advance to the few individuals who may have the misfortune of reading both letters).

[9] As a practical matter, the cost of streaming and depth-of-book market data products (hundreds of dollars per year for each of the three "tapes") precludes retail investors from purchasing them. Institutional investors typically get streaming depth-of-book market data products without any cost to themselves, by using their customers' assets (in the form of soft dollar commissions) to pay for them.

executed. A market data regime which may have been adequate before decimalization is no longer adequate today, because of the changes the SEC has driven in the markets during that time.

Similarly, because a retail investor today cannot see depth-of-book quote information, the retail investor has no idea where to place a limit order. The retail investor does not know whether a limit order three cents outside the NBBO is one hundred shares away from being executed (and thus very likely to be executed), or ten thousand shares away (and thus very unlikely to be executed). With a static quote, the retail investor cannot see if the market is moving toward his or her limit order (and thus is likely to be executed) or is moving away (and thus is not likely to be executed). By contrast, an institutional or professional investor has a very good idea exactly where to place a limit order to maximize its chances of execution. Moreover, it doesn't cost any more money for the SROs to produce this streaming, depth-of-book data for all investors than it does to provide it to the current sub-set of institutional and professional investors.

In short, the Commission should abandon the fiction that market data revenue is subsidizing regulation - demonstrably it is not doing so, and indeed if anything is contributing to market distortion. The Commission should move quickly to reform the current market data regime. First, the Commission should require that **all** investors - retail and institutional - receive streaming, real-time quotes with some basic depth-of-book information (for example, the first five "ticks" of order interest on both sides of the market). Second, the Commission should act decisively to lower the price of market data to something near its actual cost of production. Some markets have been rebating fully half of their market data revenues to subsidize their competition for order flow - this fact suggests that the cost of market data is too high by half. These steps would level the playing field between retail and institutional investors, and would substantially improve investor confidence in the fairness of the US equities markets.

I appreciate the opportunity to comment on these important issues, and would be happy to discuss these comments further or provide any other assistance the Commission or its staff may desire.

Sincerely,

W. Hardy Callcott