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SELF-REGULATORY ORGANIZATIONS: EXPLORING THE NEED FOR REFORM

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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SELF-REGULATORY ORGANIZATIONS: EXPLORING THE NEED FOR REFORM

Thursday, November 17, 2005

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:33 p.m., in Room 2128 Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Kelly, Fossella, Biggert, Kennedy, Feeney, Sherman, Clay, and Wasserman-Schultz.

Also Present: Maloney.

ChairmanBAKER. I will go ahead with my opening statement, and then we will proceed as members arrive.

Today, the Capital Markets Subcommittee meets to continue its examination of the regulatory structure of our Nation's securities markets.

Over the past several Congresses, our committee has hosted a number of hearings on issues relating to the structure of markets, including the recently adopted Reg NMS.

Today, we return our focus to a review of the self-regulatory organizations, generally known as SROs. Self-regulation of the securities markets and market participants is an essential cornerstone of our Federal securities law and market function. All broker-dealers are required to be a member of an SRO, and many SROs also operate and regulate market centers.

SRO regulation, as opposed to direct SEC regulation, helps provide efficient and cost-effective oversight to markets.

Thousands of market participants would make it cost prohibitive for the SEC alone to provide the necessary regulatory presence, in my opinion.

While SROs provide benefits to the markets, there has been some concern expressed that conflicts of interest now exist in the regulatory regime when the SRO represents the competitive interests of its members and market center while, at the same time, regulating their conduct.

Partially in response to those stated concerns, the SEC, in a November 2004 rule, required enhancing transparency and the corporate governance standards at SROs. In addition, the SEC also issued a concept release discussing various alternative regulatory models.

Our markets and the manner in which trading is conducted continues to evolve at an ever accelerated pace and is very innovative, and the competition resulting is forcing change in the way these markets are regulated as well.

As order flow migrates across multiple SRO market centers, broker-dealers are subjected to burdensome and duplicative rule books, inspections, and enforcement actions which cause both regulatory redundancies, ambiguities, and enhanced costs.

Several SROs have taken the initiative to self-reform. The New York Exchange has already adopted many of the corporate governance enhancements in the proposed SEC rule. In addition, the NYSE and the NASD recently announced the possible pursuit of a partnership to share regulatory duties to reduce burden on the 180 members of both SROs.

The CBOE has also taken the initiative to allocate its sales practice examinations to the NASD to reduce duplicative regulation.

I welcome all of these steps as appropriate and proper.

The core mission of our Nation's securities regulators is the protection of investors and the fostering of efficient and transparent markets.

Today, I look forward to hearing from our distinguished witnesses who have their particular insights to receive their thoughts on the current environment and their ideas as to the future of SRO regulation, and where appropriate, suggested steps that may be taken to further advance a more efficient and effective system of self-regulation.

[The prepared statement of Hon. Richard H. Baker can be found on page 42 in the appendix.]

ChairmanBAKER. Couldn't have said it better if I had said it myself.

Mr. Feeney, do you have an opening statement?

Mr.FEENEY. I do not, Mr. Chairman. You said it all for us.

ChairmanBAKER. Thank you very much.

At this time, I will proceed, pursuant to additional members' arrival, who may wish to make additional statements, but it is my pleasure to welcome back the chairman and chief executive officer of the NASD, Mr. Robert Glauber, who has appeared here many times, and as is the usual custom, your full statement will be made part of the official record.

Please proceed as you wish.

STATEMENT OF ROBERT R. GLAUBER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, NASD

Mr.GLAUBER. Thank you very much, Chairman Baker, Congressman Feeney.

Good afternoon.

I am Robert Glauber, chairman and CEO of NASD, the private sector regulator of the U.S. securities industry.

I am grateful to the subcommittee for inviting me to testify on the current and future state of the self-regulatory system.

This is a terribly important subject, and the committee is to be commended for addressing it.

This is a time of immense change in the securities industry, and regulation must not only keep pace, but stay ahead of that change.

To do less would badly serve investors. Their protection is our number one goal.

Mr. Chairman, the SEC's November 2004 concept release quoted some alternatives to the present SRO system.

They range from making some moderate adjustments to scrapping the whole system and replacing it with a so-called universal non-industry regulator along the lines of PCAOB that would oversee everything—brokers, firms, markets, and exchanges.

NASD firmly believes in preserving a securities industry regulatory model that encompasses self-regulation supervised by the SEC. Self-regulation is a key component of the effective regulation, growth, and vitality of the U.S. securities markets, offering a range of benefits that non-industry or Government regulation alone could not provide.

At the same time, there are inherent conflicts and inefficiencies present in the current regulatory environment. NASD believes that these shortcomings would be best addressed by adopting a form of the hybrid models set forth by the SEC in its concept release.

Adopting this model would enhance efficiency by eliminating inconsistent member rules, eliminating redundant infrastructure, strengthening inter-market surveillance, and meaningfully reducing the current conflicts in the self-regulatory system.

As you know, NASD was the creator, owner, and regulator of NASDAQ.

By the late 1990s, NASD had created a separate subsidiary to house its regulatory activities, much as the New York Stock Exchange has done now, but in 2000, when NASDAQ decided to become a shareholder-owned publicly traded exchange, NASD determined that the existing subsidiary structure did not afford sufficient protection for investors.

Operating an exchange to maximize profits for shareholders and simultaneously managing regulatory activities to fully protect investors could not be conducted under the same corporate structure without unmanageable conflicts, in our view.

We, therefore, restructured NASDAQ and NASD as two wholly separate companies, with separate managements, separate funding sources, and separate non-overlapping boards of directors.

This separation is complete except for the SEC designation of NASDAQ as an exchange and the sale of NASD's remaining minority share ownership in NASDAQ, which we are seeking to complete within a year of NASDAQ exchange registration.

NASD still monitors all trading on NASDAQ, and will continue to do so, pursuant to a contract, after NASDAQ becomes an exchange.

Today, the New York Stock Exchange finds itself in a similar position as it merges with Archipelago and moves towards going public.

Whether it should continue operating as a regulator after it begins operating as a for-profit company has been the subject of a great deal of healthy and needed debate in our industry. The concern is that for-profit publicly-traded exchanges will be faced with the conflicting goal of having to maximize profits while not compromising regulation.

To solve this conflict, I believe that we should change how securities firms are regulated.

The SEC's hybrid model contemplates one self-regulatory organization that would be responsible for member regulation of all securities broker-dealers.

A mechanism to bring that model to life would be to have the NYSE and NASD handle, in partnership, the regulation of the 180 firms that are members of both organizations. Under such an arrangement, firms would be regulated according to one rule book, instead of two, examined by one corps of examiners, and disciplined by one set of enforcement attorneys.

To best serve investors, Mr. Chairman, any new structure would have to solve the conflict inherent in both being a regulator and managing a for-profit exchange.

It would also have to eliminate the redundancies and inefficiencies of having two regulatory groups performing the same functions.

This would result in clear and consistent regulation of securities firms, regulation that provides more effective protection of investors.

Mr. Chairman, that concludes my statement. I, of course, want to thank the committee again for inviting me, and I will be happy to answer any questions.

[The prepared statement of Robert R. Glauber can be found on page 87 in the appendix.]

ChairmanBAKER. I thank the gentleman for his testimony.

I understand that Mr. Fossella wishes to be recognized to make a comment at this time.

Mr.FOSSELLA. Thank you, Mr. Chairman.

I want to welcome the panel, all three gentlemen, especially Mr. Brodsky—good to see you again—and it is my pleasure to also welcome Mr. Ketchum, the chief regulatory officer for the New York Stock Exchange since 2004.

Mr. Ketchum has spent 12 years at the National Association of Securities Dealers and NASDAQ. He served as president of NASDAQ for three years and as president of NASD for seven.

Prior to that, he was at the SEC for 14 years, eight of those years as director of market regulation.

So to all three gentlemen, I say welcome, and thank you for your testimony in advance, and it is my pleasure to welcome, as well, Mr. Ketchum.

Thank you, Mr. Chairman.

ChairmanBAKER. Thank you, Mr. Fossella.

Please proceed at your leisure, Mr. Ketchum.

STATEMENT OF RICHARD G. KETCHUM, CHIEF REGULATORY OFFICER, NEW YORK STOCK EXCHANGE, INC.

Mr.KETCHUM. Thank you.

Chairman Baker, Congressman Fossella, and distinguished members of the subcommittee, I am Richard Ketchum, chief regulatory officer of the New York Stock Exchange, and I first want to commend you, Mr. Chairman, for holding this hearing on the important issues relating to securities self-regulation.

Protecting investors and preserving confidence in market integrity is critical to the success of our securities markets, and the New York Stock Exchange is extremely proud of our role in contributing to that effect.

New York Stock Exchange regulation has primary responsibility for regulating the activities of our members, member firms, and listed companies, as well as enforcing compliance with NYSE rules and Federal securities laws. Our nearly 400 firms, among the largest in the world, maintain 84 percent of the total public customer accounts, with assets of over $4 trillion.

In that connection, the SEC has appointed New York Stock Exchange regulation as the designated examining authority for financial and operational issues for nearly all of the 170 firms that are members of both the New York Stock Exchange and the NASD. Here there is no overlap or duplication.

In this regard, we believe it is essential, regardless of how the duplication issues that we discuss here today are resolved, that the expertise provided by the NYSE staff in ensuring the financial and operational soundness of the largest firms be maintained.

Last year, the SEC issued a concept release that raised a series of thoughtful questions regarding the costs and benefits of possible changes in the present self-regulatory system.

Underpinning those questions were concerns regarding both the management of conflict of interest and the impact of regulatory duplication in the present system. I would like to briefly address both of those concerns.

As much as we believe in the wisdom of self-regulation, we believe just as passionately that independence is critical to our operations.

In December of 2003, the New York Stock Exchange implemented, with the SEC's approval, sweeping changes to its governance structure. The NYSE became the only SRO to require that all members of its board of directors, with the exception of CEO John Thain, be independent.

NYSE regulation was also separated from market operations.

A new position of chief regulatory officer, of which I am the first, was created.

I report directly to the board of directors through its regulatory oversight committee.

The result is that our decision making is independent from the business and market side.

Once the merger of the New York Stock Exchange and the Archipelago is approved and a new for-profit publicly-traded holding company known as NYSE Group is created, the independence of NYSE regulation will be strengthened again.

NYSE regulation will have its own board of independent directors, a majority from the NYSE Group, the remaining directors unaffiliated and independent from the marketplace, with the exception of myself.

We will be self-funded from regulatory fees and from contractual commitments from the New York Stock Exchange and Archipelago.

No NYSE regulation staff will receive stock or options from the New York Stock Exchange or otherwise be financially incented by the financial performance of the New York Stock Exchange.

Because the conflicts of marketplace self-regulation have and can in the future be addressed, we feel strongly that the possibility raised in the concept release of the creation of a universal regulator or full dependence on Government regulation would be a tragic mistake.

In simplest terms, self-regulation offers the benefit of greater expertise, the ability to leverage Government resources, and impose higher ethical standards than are required under Federal law.

It should remain the cornerstone for the regulation of broker-dealers and the securities markets.

The SEC also, in the concept release, properly expresses concerns identified by the securities industry regarding duplication.

Many of these concerns stem from an important increase in the breadth and aggressiveness of both our program and the NASD's, as well as the CBOE's and other self-regulatory organizations.

The committee should know—and I appreciate, Mr. Sherman, your acknowledging—that there are many ways in which New York Stock Exchange regulation and the NASD have already been coordinating efforts.

Coordination of exams, rulemaking, and enforcement are three areas that have had the greatest impact in reducing regulatory duplication.

With the tremendous support and leadership of Bob Glauber and Mary Shapiro at the NASD, our efforts to coordinate and eliminate duplication are improving constantly, but we understand the industry's continuing concerns and recognize that more must be done.

We understand that the SIA and some members of the securities industry favor the creation of a separate hybrid SRO that would oversee all broker-dealers doing business with the public.

We believe that concept is a constructive proposal that we are willing to explore. However, we fear that the creation of a new separate hybrid regulator risks losing much of the expertise critical to self-regulation.

Market surveillance and examination functions work closely together to ensure complete coverage of trading and market abuses.

NYSE regulation brings unique credentials and market oversight knowledge to its regulatory efforts, just as the NASD and CBOE possess unique understanding of NASDAQ and derivative trading issues, respectively. Separating examination of market regulation, therefore, risks a less effective system.

Nevertheless, we recognize our responsibility to aggressively expand our efforts with our regulators to further reduce or eliminate duplication. We believe that a dialogue among the SEC, securities industry, and self-regulatory organizations would be an important next step, and we stand ready to actively participate.

Thank you, and I would be happy to answer any questions you may have.

[The prepared statement of Richard G. Ketchum can be found on page 94 in the appendix.]

ChairmanBAKER. I thank you for your comments, sir, and at this time, I recognize Mrs. Biggert to make any introductory comments.

Mrs.BIGGERT. Thank you very much, Mr. Chairman.

I am very happy to introduce William J. Brodsky, who is the chairman and chief executive officer of the Chicago Board of Options Exchange.

We are very proud in Illinois of all of our capital markets, and he has an outstanding career, serving more than 36 years in the securities industry, began as an attorney with Moddell Rowan & Company in 1968, then joined the American Stock Exchange, where he became head of options trading, and then served as executive vice president for operations, and then served as the AMEX representative on the board of the Options Clearing Corporation, and joined the Chicago Mercantile Exchange in 1982 as executive vice president and chief operating officer, and was then president and chief executive officer, and served in that capacity until joining the CBOE in February of 1997.

So he has certainly had the experience on all of the exchanges.

He also serves as a director of People's Energy Corporation, Futures Industry Association, Swifts Futures and Options Association.

We are very happy to welcome him.

He holds an A.B. degree and J.D. degree from Syracuse University.

Welcome.

Mr.BRODSKY. Thank you.

ChairmanBAKER. Let me add, certainly no stranger to the committee.

Welcome back, sir.

STATEMENT OF WILLIAM J. BRODSKY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CHICAGO BOARD OPTIONS EXCHANGE, INC.

Mr.BRODSKY. Thank you very much, and Mr. Chairman, I congratulate you and your fellow committee members for having hearings like this.

I think this is a very constructive way of having the committee do oversight in terms of what is going on in the industry, and as my colleagues have said, this is a very significant time in our industry.

Congressman Biggert makes me feel much older than I probably am, but I must say that, in my tenure in the business, the changes that we are undergoing now are probably more rapid and more significant than we have had in 25 years, and as my colleagues have said—and I want to mention both Bob Glauber and Rick Ketchum.

We have been colleagues in many different ways, even as we have changed our careers along the way.

These two gentlemen are the most dedicated professionals that you will find, and I think we agree on more things than we do not agree with and that the opportunity for a dialogue like this is very constructive.

Let me start by mentioning that CBOE, which was the creator of the listed option business, is really a small player in this bigger conversation that we are having.

We have 1,400 members. We have regulatory responsibility over a certain amount of firms, but in reality, we are really specialists in the option business and believe that where you can eliminate

duplication, it's a good thing, but this should not be done in a hasty way, and I am concerned that the proposals that the SEC promulgated, in some cases, a year ago, in two different releases, were in reaction to some of the events that recently occurred, and our view is—and I know, Mr. Chairman, our formal comments are in the record. Our view is that we should not proceed with haste here, because we are dealing with a very delicate balance.

Let me explain a little bit about our regulatory program.

We have and did establish a regulatory oversight committee composed solely of independent directors of ours. The committee is composed of four independent directors and is chaired by Susan Philips, who happens to be currently the dean of the George Washington School of Business but was formerly chair of the Commodity Futures Trading Commission and then served with great distinction on the Federal Reserve Board. We have other people of significant caliber who serve as an independent board committee overseeing our regulatory efforts, and we believe that this structure strikes a very healthy balance.

Our chief regulatory officer reports to this group on a very regular basis, and this group actually meets with the SEC on an annual basis.

So we believe that, although we don't have the total separation that some people have advocated, that we have found a way to deal with the potential for conflicts of interest and that the opportunity that we have had to make this work along with SEC oversight is an effective way of dealing with our role as a self-regulatory organization.

What I am advocating is that there should not be a once-size-fits-all solution to all these situations. It is important also to recognize that in the option business it is very important that there be the specialization because this is a very unique business, and since we have been the leaders in this realm since the creation of the industry, we take our responsibility very seriously.

We believe that the existing model of multiple SROs, where each is responsible for regulating its own market, has been, for the most part, successful, and this model has permitted the specialization of knowledge that each exchange or SRO has in interpreting its own rules and procedures which can be brought to bear on the regulation of its markets.

This also fosters competition in the development of new and more efficient regulatory systems, which benefits the overall quality of regulation.

Congress has demonstrated its belief that, with appropriate safeguards, self-regulation can lead to better regulation of the securities markets by permitting this specialized knowledge and experience of those closest to the markets to be brought to bear through self-regulation.

We do not think that a single SRO is the answer at this time.

We believe that you should balance the pluses and minus of multiple SROs, and we believe that the best answer is not to delegate market regulation to a sole or single regulator that would be independent of and would not be involved in the operation of the markets.

While delegation of regulatory responsibilities to a sole single regulator might well avoid some of the problems cited in the SEC's concept release, the consequence of following this approach would be to destroy one of the major advantages of self-regulation.

There are other choices for regulation.

There are better ways to reduce duplicative costs and inefficiencies from multiple SROs. We are intrigued by the approach of the SIA, which would consolidate regulation and members into a single SRO but leaving regulation of trading to each individual market.

The SIA's proposal is designed to eliminate duplication by regulation of multiple SROs at the level where such regulation overlaps but maintain specialized regulation at the trading level where it is most needed.

While the SIA approach is one way of achieving greater efficiencies, there are other alternatives which SROs can and do utilize.

One approach is the use of SEC Rule 17D2 agreements, which are used by SROs to allocate regulatory responsibility with respect to common members.

Another alternative that has great potential at eliminating duplication and increasing efficiency and enhancing overall quality of regulation is the use of a national market system plan to conduct regulatory functions that are common among SROs.

For example, five U.S. options exchanges recently filed with the Commission a proposed options regulatory surveillance authority, which we call ORSA. The purpose of this plan is to enable the five exchanges to act jointly with respect to insider trading investigations involving options at any of the five participant exchanges.

The functions that would govern ORSA could be expanded in the future.

The core part of the plan, as currently proposed, is the delegation to the CBOE of a joint surveillance and enforcement facility for detecting and investigating possible instances of insider trading.

By sharing the cost of these investigations and by sharing the regulatory information generated by ORSA, the five exchanges will be able to support a regulatory program that is comprehensive and eliminates duplicative efforts and costs.

Under the plan, the five exchanges will establish a policy committee to oversee the operation of the plan. Thus, the governance of ORSA will remain with the five exchanges, and enforcement actions conducted will be done by each exchange as appropriate.

The conduct of regulatory functions through ORSA would also eliminate concerns of uneven regulation among markets. ORSA shows that SROs working together can preserve the benefits of multiple SROs while reducing the cost of the regulation.

I want to make one other comment as I wrap up, and that is that we think there is one area where the SEC could help improve its general oversight role, and that would be to have the Commission make clear written statements of the standards and best practices it believes it should apply to specific regulatory matters across all markets where it concludes that such clarification is warranted.

In our view, too often, there are disparities in the way in which certain regulations are interpreted and applied from one exchange to another because of the absence of clear guidance from the Com-

mission. We believe that if the SEC were to make its views known in such matters to all SROs in a clear and consistent way and to do so promptly upon the determination that such guidance is needed, SROs would have a better understanding of what is required of them and would be in a better position to regulate their markets and their members accordingly and in a uniform way.

We had the pleasure of having a breakfast with Chairman Cox in Florida last Friday, and interestingly, without even hearing this particular concern, he was concerned about clarity and consistency of regulations.

So I would hope that, in his new tenure, Chairman Cox may be able to address this issue, and I wanted to bring this issue to the committee's attention.

So I would like to thank the committee for holding this hearing. I think it, again, is very constructive, and I would be happy to answer your questions.

[The prepared statement of William J. Brodsky can be found on page 78 in the appendix.]

ChairmanBAKER. Thank you very much.

I will start with you, Mr. Brodsky.

I think I understand your concern with a pure, sole, self-regulatory structure is the potential loss of specialization in an area where you feel it is important to the applicability of your industry and that a line could be drawn, in your mind, as to where the rules and constraints and regulatory oversight that is applicable to all market participants would be at one level, but then at a—I do not want to say B-level, another level—there would be a specialized market function applicable, perhaps, only to your organization that would be maintained for adequate regulatory involvement.

Do you think—and I am sure you—I know the answer before I ask, but I have to ask.

Obviously, my concern is duplication of regulatory requirements and then the cost to do business. Does that really net us a gain in the elimination of duplication and fee-based relief for market participants?

Mr.BRODSKY. I think that we can distinguish between those functions that are common to all firms and the trading on different markets.

In our industry—when I say "our industry," we are all in the securities industry, but the options business now includes six exchanges, where there is very intense competition. Each exchange does not have the same trading model as each other, and, therefore, the rules are different, and the SEC understands that.

I think it is very important to have the expertise close to where the trading is done at the marketplace level for people who have that expertise to understand how those rules are designed and how the trading should occur in a proper fashion. I do not think that that has to be done at, what I will call, the super-regulator level.

On the other hand, as we filed our comments to the SEC's release back in March—and I will quote—we say here the SEC should encourage SROs to establish joint and coordinated regulatory efforts where it makes sense to reduce unnecessary costs and efficiencies.

I think that we can sit around a table and figure out a way to avoid the duplication of effort and cost and still have a very effective program, and that is really what we are advocating most.

ChairmanBAKER. Thank you.

Mr. Glauber, from your perspective as a sole regulator of an independent entity for a period of time, do you have a countervailing view that a single regulator provides value added to the market in a consolidated regulatory function, or do you have an understanding that this bifurcated system offers some advantages?

Mr.GLAUBER. I think, Mr. Chairman, you raise exactly the right question.

My view is that there are conflicts that exist when regulation is embedded in a for-profit exchange, different from a not-for-profit exchange. But at the same time, that has to be weighed against the value of having, as Mr. Ketchum said, and Mr. Brodsky, regulation close to markets where it counts, and I think you have made exactly the right distinction, as has the SEC, at the layer of or level of what we call firm regulation, the regulation of what goes on in firms, as contrasted with the regulation of what goes on in markets, on the floor of Mr. Brodsky's exchange or Mr. Ketchum's exchange. There really is an important distinction.

At the level of firm regulation, we think that we have—and have had since we were founded—enough knowledge of what goes on in firms to perform that regulation.

I think, there, as it was suggested by the SEC, the values of eliminating obvious duplication and relieving these kinds of conflicts that I discussed, clearly outweigh any argument of being necessarily attached to a market.

So as you have and as the SEC has, we would make the distinction and say the right place to start is with firm regulation, and to worry there about duplication, and try and construct the mechanism that would have a single regulator deal with all of these firms at once, and not have, as we have with the New York Stock Exchange, two regulators dealing with them twice.

ChairmanBAKER. Understood.

Mr. Ketchum, as sort of the group in transition, and particularly since I believe the merger approval is imminent, if not done, where do you see the regulatory function going, given the transitions the exchange has already gone through with Archipelago addition coming on?

Mr.KETCHUM. Well, Chairman Baker, it is a great question, and we do still await SEC approval with respect to the merger, so there is still—as well as, perhaps most importantly, approval by the membership on a vote. So there are steps still to go.

As I briefly alluded to in my comments, I am absolutely confident that—that we can create an environment that builds on where we are today that ensures absolutely the independence of decision-making by New York Stock Exchange regulation.

We will operate as a separate, discrete corporation, with board members both of the holding company, to ensure that they buy into the importance of regulation, and unaffiliated board members to raise their hand if they have any concerns.

I have found, with my connection with New York Stock Exchange board members, that they are passionately concerned about the in-

tegrity of the markets. I would be shocked to find that that passion, concern, or the belief that that integrity is critical to the future and success of the New York Stock Exchange would change.

So I think we will build in numerous means to protect and ensure that New York Stock Exchange regulation decisions are independent, while we continue to have access into the knowledge of how the exchange market really works, but none of that is to suggest that there is not more that must be done with respect to reducing duplication.

It has been a pleasure to work with Bob Glauber—he is a great leader—in trying to identify ways—and I think we need to step back, each of our organizations, and look at means, even out of the box, to do far, far more, but I do confidently believe that the Exchange will be able to meet its regulatory obligations on the other side of the merger with Archipelago.

ChairmanBAKER. Let me quickly add, because my time has long expired, I do not want to mislead that I have concerns about the adequacy of current regulatory structure. It is just that confidence of markets in the regulatory regime is extraordinarily important as we see more baby boomers seeking retirement and the growth in investment opportunities enormous on the horizon that if there is any hint of impropriety, the economic consequences for capital markets are significantly adverse. So I know we are all united in this.

The difficulty is trying to figure out which model makes the most sense in the current environment.

Mr. Clay?

Mr.CLAY. Thank you, Mr. Chairman, and thank you for conducting this hearing.

I thank the witnesses for being here.

I have a couple of questions that I would just like to ask all of the witnesses to attempt to answer, starting with Mr. Glauber and moving down the table.

Of the options for regulation contained in the SEC's concept release, tell me which ones you think are the worst, which ones are the best, and are there any other options that they may not have suggested?

ChairmanBAKER. We can guarantee nobody at the SEC is listening.

Mr.CLAY. I am certain.

Mr.GLAUBER. Thank you for the question, and I can answer, I think, with confidence because the SEC has proposed these as just issues to discuss.

My view is that the options that involve a layer of industry-based regulation, in particular, in the options they put forward, the hybrid model is the one that I think makes most sense.

Models which would involve no industry involvement, either something like the PCAOB or direct regulation by the SEC, I think, are far less preferable, and they are, first, because as Mr. Ketchum said—and he knows very well because he has been a regulator in this industry for a number of years and an outstanding one—having industry involved in the regulation brings an expertise, brings a focus on ethics, brings a level of resources, non-taxpayer resources, to the job which I think is invaluable.

So I think industry regulation should be preserved. Therefore, I prefer that to a PCAOB model or a non-industry model or direct SEC model, and as I have said before, I think the place to start in dealing with conflicts and with duplication is in trying to find a mechanism, as we are now discussing with the New York Stock Exchange, of uniting firm regulation so that we do not do the regulation of firms twice.

Mr.CLAY. How about you, Mr. Ketchum?

Mr.KETCHUM. I have found in many things over the years that I have agreed with Bob Glauber, and I certainly agree with him on what is worst here.

As Bob indicates, I have been both an SEC regulator and a proud alumni of that agency and a self-regulator for some years, and I believe that the combination of strong and focused and stern SEC oversight with self-regulatory organizations that provide access, while making independent decisions, provides access for the industry to effectively raise issues, try to address concerns with respect to the burden or sense of particular regulations makes a great deal of sense.

I've seen it work—not to suggest it has always worked perfectly, but I've seen it effectively work for my entire career, and I think a movement to full Government regulation or a single regulator that is removed from the industry is not a good idea.

I believe the best approach would be, out of the SEC choices, to adopt, hopefully with care to reduce some duplicative and burdensome parts of it, their particular proposed specific rules that ensure a minimum level of independence and corporate governance of SROs and enhance their oversight of our activities, and at the same time, as Bill Brodsky mentioned, to provide the self-regulatory organizations continued time to work, as Bob indicates we continue to try to do together, to address issues of duplication.

If we cannot demonstrate our ability to operate separate, completely separate from any conflicts and effectively, Chairman Baker made the right point. The most important thing is public investor confidence, and we must preserve that, but I am confident we can.

Mr.CLAY. Thank you for that response.

How about you, Mr. Brodsky?

Mr.BRODSKY. I am in agreement with my colleagues that the least desirable alternative would be to have direct Government regulation: (a) It would be costly; (b) it would be terribly bureaucratic, and we do lose, as Bob Glauber said, the expertise from the industry.

So to me, that would be, by far, the worst, and I think some variation of the hybrid is where we should strive to reach. In some respects, we have that now.

I think what we are all trying to do, as Rick Ketchum said, is we want to maintain the public confidence and the output of what we have, but it is very important that we should let—there has been a lot of change that has occurred in all our organizations over the last couple of years.

I think the SEC should give it a chance to work.

The SEC should be the organization to whom you in Congress look to for oversight of the markets and their accountability to you. I do not think that some of the changes that have been brought

about, either at the New York Stock Exchange or at our exchange, over the last couple of years have really been given a fair chance, and I feel that that should be done because we are very sensitive to the potential and real conflicts of interest. I, quite frankly, do not know whether it makes a difference whether you are for profit or de-mutualized or public as it relates to this issue.

The goal in all our organizations is to have the confidence of investors, and if you do not have the confidence, it does not matter what form you are in, and we all are very conscious of these potential conflicts and are bending over backwards to make sure that the substance of what we do is much more important and contemplates the conflicts and overshadows them, and it is really for the SEC to make those evaluations and report back to you on that.

Mr.CLAY. I thank each of you for your responses, and I appreciate your attendance at the hearing.

Thank you, Mr. Chairman.

ChairmanBAKER. I thank the gentleman.

Mr. Feeney?

Mr.FEENEY. Well, thank you, Mr. Chairman, and thank you to all of our witnesses.

I especially want to thank Mr. Brodsky, who was my host as I went out to Chicago to tour the exchange, when I was out there.

I hope you put your colleagues from the north side and south side back together again. The weekend I was out there, the White Sox fans were euphoric and the Cubs fans were just sort of disoriented watching the White Sox still playing at that time of year.

Maybe you could give us an update on the transition that the Chicago Board of Options Exchange is making, where you are in your transition.

Mr.BRODSKY. Well, thank you, and I was very glad to host you, and I will tell you that it will be interesting to see whether the White Sox are able to fill the stadium at each game next year, the way the Cubs do, whether they win or lose.

We are actually moving in the same direction that some of the other exchanges around the country have done, and that is to move to a for-profit model. This change really relates more to governance and changing the way we operate, and we are beginning in January with the first part of that, and that is to go for-profit. Hopefully, later in the year, we will de-mutualize.

The New York Stock Exchange is actually doing that in a different sort of way by merging with a public company. They're skipping the pain and heartache that others have gone through.

To the point of this program, I can only reiterate that we are very, very aware of the importance of regulation in what we do, and I think what is very important, some of which has been lost over the last few years, is that there are times when the relationship between the SEC and the SROs has become adversary, and it is very important for us to maintain the regulatory partnership that must exist because the Government, quite frankly, does not have the resources nor the expertise to do the front line work that the self-regulatory organizations must do.

Mr.FEENEY. Do you anticipate any changes in your conflict of interest rules, your independence requirements for members of your SRO as a consequence of your likely change to for-profit status?

Mr.BRODSKY. We have gone through dramatic changes. The SEC has a proposal out called Reg SRO which actually will have impact on what we do going forward. The problem, quite frankly, is that it was put out a while ago. We have all filed our comments, and we have not heard anything.

So at a certain point, as Mr. Cox said to us recently at the Securities Industry meeting, so ably chaired by Mr. Lackritz, who is next on your witness list, and that is that we need clarity.

The SEC can come out with lots of different things and we all can respond to them, but at a certain point in time, we say, ″just tell us what the rules are.″

Mr.FEENEY. This was the best practices that you are advocating that would be applied across the board to the different exchanges.

Mr.BRODSKY. Well, the SEC has proposed things that relate to the governance of the organization.

When I talk about best practices, I am saying that, in a competitive marketplace—in our case, it is options and in Mr. Ketchum's, it is stocks—the SEC has established what we believe are standards or expectations, but we do not believe that they have enforced them evenly among the exchanges, and we have sought clarification on that, and I am hoping that, with new leadership with the SEC, we might actually obtain it.

Mr.FEENEY. I would like to ask all the members of the board to tell us, as we contemplate certain changes to enhance investor confidence and do away with superfluous and duplicative regulations, what are our foreign competitors doing, and what is it that you worry about that we have in place now that is putting you at a competitive disadvantage or that we might do that would put you at a competitive disadvantage.

Mr. Glauber, maybe we will start with you.

Mr.GLAUBER. Well, again, let me start by saying that we do not, as you know, own an exchange—well, we own a minority interest in NASDAQ as an exchange, but we are selling that, and we will own none.

So I cannot speak from the perspective of an exchange as well as Mr. Ketchum can, or Mr. Brodsky, but clearly, what has gone on in other countries is those exchanges have become publicly owned, shareholder-owned entities and, therefore, have access to the capital markets and can invest in technology and compete more effectively. I think that has been very important, and that is why I think it is a very good thing that both the exchanges that are represented here on this panel, as well as NASDAQ, have moved to public ownership, shareholder ownership, so that they have access to the capital markets and the benefits of being able to compete with capital in a robust way.

I think that is as important as anything that can be done.

The challenge they are going to face in Europe and the challenge we face here is adapting the regulatory model, the regulatory structure, to account for that very marked change in the way exchanges are owned and overseen. As I say, when NASDAQ did that, we separated completely from NASDAQ, and this is really the issue that is before you and before the SEC and that we are discussing.

Mr.KETCHUM. I think Bob is absolutely right, that the primary challenge we must respond to in the United States—and let me

say, I say this as an observer who has lived in both the regulatory and the market side of the U.S. securities industry for some time, because we really do mean the thing about separation between regulation and markets at the New York Stock Exchange, but without doubt, the European exchanges, in particular, are ahead of us from the standpoint of operating as public companies. That has enhanced their funding, has created a level of discipline that is important in their ability to compete.

They are able, through their regulatory system, to get quick answers with respect to being able to make changes in how their trading systems operate, and I think those are all things that are important for exchanges and for the SEC to respond to in the United States.

Mr.BRODSKY. I would add that we are at a great competitive disadvantage to our European exchanges for two reasons.

One, the rules under which we operate in terms of making changes to our business are subject to great delays at the SEC, under the rules that have been in place for 30 years, when there were many exchanges but we weren't really competing.

We really compete now, and the system that we have is a disincentive to innovation and competition, and again, these are issues that we raised with Chairman Cox at the SIA meeting this past Friday. That is how recent we have had this conversation.

The second is that, at least in my side of the business, which is the derivative business, in the United States, we have the bifurcated situation of having futures under the ag committees and under the CFTC and securities under the SEC and this committee, and as you well know, this raises issues of jurisdiction intramurally within this country and puts us, again, at a disadvantage to others because sometimes we end up spending time sparring with each other when other countries—England, for example, they have the FSA, where it is all combined.

In fact, in virtually every country in the world except the United States, regulation is combined. I recognize that the solution is not so simple, but I am just trying to answer your question.

ChairmanBAKER. No, my solution is real simple.

The gentleman's time has expired.

Mrs. Maloney.

Mrs.MALONEY. A lot of us have been talking about that for a long time, but to get Congress to change, that is a real challenge.

I really want to thank Chairman Baker for calling this, and as a representative of New York City, that has many financial institutions and markets there, I am particularly delighted to welcome to this hearing and to congratulate both the New York Stock Exchange and NASDAQ on the Justice Department's approval yesterday of both of your proposed acquisitions, and of course, this development makes this hearing all the more important on reforming the SROs that govern the markets, and it makes it more timely.

I also would like to welcome, also, Mr. Brodsky. You have hosted me in Chicago, and I had the pleasure of having one of your nephews work in my office for a while. So it is a delight to see you, also.

Yesterday we passed out of this committee a regulatory relief bill, and we really tried to streamline some of the regulations on financial institutions. We had a lot of hearings and testimony

where a lot of the paperwork was really a duplication, and if anything, it loaded down the system, and the real goal of looking for any type of corruption or money laundering was hindered. The law enforcement came in and testified in support of our reforms.

So I would like to ask you if there are any duplications that are in the regulations that are just loading you down and not really helping in any way, in fact you would be more efficient and better able to serve our constituents without them, and I would also like to ask Mr. Ketchum and Mr. Glauber to comment further on the differences between the present regulatory structures of their two markets and which features of each they would point to as best addressing the potential for conflicts of interest in the SRO framework and anything else you would like to talk about.

Mr.GLAUBER. Well, let me take them in the order in which you asked.

First, on duplication, certainly the focus that I have, I think Mr. Ketchum has, Mr. Brodsky, all of us have, is on the way we implement the self-regulatory structure, and indeed, the thrust of my comments and Mr. Ketchum's comments, and Mr. Brodsky's, is on how we can handle duplication.

One obvious place is in the way we presently regulate, self-regulate firms, and firms are presently regulated by both Mr. Ketchum and the New York Stock Exchange and by us, and we are talking about what we can do.

We think a great deal can be done to coordinate, as Mr. Ketchum has said, and since his arrival, the level of coordination has gone way up. It is a model, I think, for coordination. Nevertheless, I think it would be best for investors if we spent all of our resources on examining and enforcing and regulating and less of them on the need for coordinating. That is why we are engaged in a discussion of whether there isn't a structure that we could employ that would provide that coordination and rid us of the duplication that exists.

On conflicts, I have made the point a number of times—and just let me say it one more time. We decided at NASD, when NASDAQ became a for-profit shareholder-owned exchange, that the best way to deal with conflicts was total separation. We thought that, for a director of the exchange who is also a director of the regulatory operation, that that director would have what I would characterize as unmanageable conflicts to deal with. They would owe a duty of loyalty to both a profit-making entity that has to provide for profits for shareholders and, of course, to the public as a regulator.

We thought the best way of managing those conflicts was total separation, and I think, as you can understand, at this stage, the New York Stock Exchange has taken a different approach.

That, I think, is a major focus of the issue of conflicts.

Mr.KETCHUM. Congresswoman Maloney, your questions, as always, are both incisive and broad. Let me try to answer them, again, in pieces.

First, I think the questions of regulatory reform that this committee has been so good at focusing regulators on remain important at multiple levels.

From a rulemaking standpoint, we still have miles to go, where the SEC has shown leadership in rationalizing our financial regula-

tion into a global world and a world in which the products range beyond registered broker-dealers.

Steps were made with respect to major firms in net capital. Additional steps probably need to be made.

Additional steps need to be made in things like portfolio margining that stretch across our marketplaces, and we are absolutely committed to work with the SEC and other regulators, on all of those issues.

The rule-filing process, as we mentioned earlier, must be faster, must be quicker, and allow markets to compete, and allow regulatory changes necessary to protect investors to be implemented and implemented quickly, and finally, steps must continue to be taken with respect to removing duplication.

I do draw a slightly differently line than Bob from the standpoint of the uniqueness of an exchange trading environment.

It is absolutely critical, after the exchange in Archipelago merger occurs, for us to protect the independence of New York Stock Exchange regulation, absolutely critical. We need a separate board. We need separate oversight. We need my reporting directly to that.

It is also important for me and for my organization to have a special understanding of how the exchange operates, particularly as the exchange market structure changes, to be involved in those changes, to identify regulatory concerns, and make sure they get fixed up front.

So I think there is a way to balance it, but you are asking absolutely the right questions.

Mrs.MALONEY. Thank you very much.

ChairmanBAKER. I thank the gentlelady.

Mr. Fossella.

Mr.FOSSELLA. Thank you, Mr. Chairman.

Specifically, Mr. Ketchum, and anybody else who wants to answer, with respect to the non-independent directors on the board, what percentage of your boards are now independent?

Mr.KETCHUM. Our entire New York Stock Exchange board, which was an innovation made by John Reed, as he shifted the governance in 2003, is independent, with the exception of John Thain.

So in other words, each of those members are not affiliated either with a broker-dealer or with a listed company.

Mr.FOSSELLA. How would you characterize that transformation?

Mr.KETCHUM. I think it has been excellent. I think it is, to me, the new and appropriate balance of self-regulation.

The beauty of self-regulation is a passion and fascination of what makes the industry and markets tick and an ability to provide access to the industry, to issue, spot, and identify areas where rules or interpretations need to change.

It should not be about decision making. Decision making should be about independent persons that do not have the conflict space of being both representing the industry and representing the public interest.

So I am very happy and I have been very impressed at how the New York Stock Exchange Board operates with that independence.

Mr.FOSSELLA. Mr. Glauber or Brodsky, do you care to weigh in?

Mr.BRODSKY. Yes, I would be happy to. Where we are right now is that our board is 50 percent independent and 50 percent mem-

ber, and while I understand what caused the New York Stock Exchange to become 100-percent independent—and there were many things that were in the newspapers, and you know about that—I think that we have to recognize that our business, by its nature, is a very complex business, and we have, we think, a good balance, and the balance we have is 50-percent independent, 50-percent industry, because it is very difficult for independent directors who are truly independent to have the feel for the activities that go on in the market and the changes that are occurring, and I know the New York Stock Exchange has a separate—I call it a shadow board of industry people who advise the board of directors.

I do not know if—without the issues that the New York Stock Exchange had two-and-a-half years ago—you would have ended up with what they have today.

I think it has a very good ring to it, but I think there are practical ramifications, and so, in our case, we have half industry, half public, where in their case, they have a full independent board, but then they have a separate board that meets apparently prior to when the other board meets.

What exists today is similar to our Federal system when Congress watches the States experiment as laboratories on similar issues.

I think it is very important for SROs to be able to have a certain amount of flexibility provided that there is integrity in what they do.

Mr.GLAUBER. Our board is presently about 60-percent independent, 40-percent industry, and it has been a majority independent or non-industry, public, for about 8 years.

As Bill Brodsky just said—I guess it is a nice way of characterizing it. New York has taken a little different approach. It has what Mr. Brodsky called a shadow board, which is all industry, and its main board all independent, and that is a way of involving both points of view.

We have chosen to put them in the same place on the board, with a majority always independent, so that our board is controlled by the independent members of the board, which is as it should be, and we provide the perspective of the industry in the board room, rather than through what Mr. Brodsky characterizes as a shadow board.

Mr.FOSSELLA. Okay.

Another question—Mr. Brodsky, you talked in, I guess, your testimony—to use your words, an adversarial approach to SROs from the SEC.

What recommendations would you make specifically to strengthen this partnership that serves both the regulator and yourself and, ultimately, investors to improve not just communications but the overall relationship as we move forward to the reform itself?

Mr.BRODSKY. Well, over the years, the relationship has been a very good one between the SEC and the SROs. We have been through a very difficult period that I do not have to recount to this group, over the last 5 or so years of scandals. This has created an atmosphere where the SEC has, I think, been—in their dealings with us—very different than they had in the past, not because we had done anything wrong, but because they felt under a certain

amount of pressure, and, therefore, you could feel the change in the relationship.

I am hoping that, with a new chairman and new members of the Commission—the Commission has now two members it did not have a few months ago—and the fact that things have settled down, that we can get back to what's normal.

So I do not think it is anything that has to be done other than the passage of time and some new members in the leadership of the Commission.

That is my hope.

Mr.FOSSELLA. I will just throw it out there, and if you have a quick response—you all talk about the competitive disadvantage about the lack—because of the lack of clarity, because of other sort of over-arching issues.

What does that all mean? I mean, at the end of the day, how do you quantify what that means to our economy, what that means to the market, what it means to investors, to best articulate—other than the frustration everybody shares, acknowledging that it is self-evident that we are at a competitive disadvantage?

Mr.BRODSKY. There is a cost in innovation and there is a cost in flexibility and there is certainly a cost among the exchanges of some people not being able to take advantage of or wanting to make a change quickly. If you look back to the Commodity Futures Modernization Act that passed this Congress 5 years ago, the futures exchanges, which again are much more closely related to my business, have the ability to make changes in their business and introduce new products virtually by filing with the CFTC and it is approved effective on filing.

We could make an exactly comparable filing for a similar product or a similar rule change and have it languish at the SEC for a year.

What is the cost in that?

It is hard for me to tell you in dollars and sense, but there is clearly a cost.

Mr.KETCHUM. I think Mr. Brodsky makes an excellent point.

Again, the SEC is blessed in its staff with extraordinarily knowledgeable people who do an excellent job at identifying issues, but the process itself built into the rule-filing process—I do not know how to quantify it, Congressman Fossella, but it does impact the ability to quickly react, either for marketplaces or for regulators, and it is something that I believe would be a very good thing for Chairman Cox and the Commission to focus on in the coming year.

Mr.BRODSKY. If I could, I would like to underscore what Rick is saying.

This is not in any way directed in a negative way to the SEC staff.

This is a statute that was passed by this Congress in 1975 in a very, very different competitive environment.

Mr.FOSSELLA. Fair enough.

Thank you.

ChairmanBAKER. The gentleman yields back.

Mrs. Biggert?

Mrs.BIGGERT. At least we did not pass it.

For all of you, the three witnesses on our second panel today, the Securities Industry Association and Bloomberg and Ryan Beck, oppose using market data fees to fund regulation. Could you comment on this and talk about support for a cost-based approach to market data fees?

Mr.KETCHUM. Congresswoman Biggert, you raise two important and discrete points that are raised by them.

First, I can speak for the New York Stock Exchange. New York Stock Exchange regulation is not directly funded from market data fees. We are funded—and we will move to the other side of becoming a public company to be funded directly by regulatory fees and by contracts with the marketplace.

Of course, it is important that the marketplace be profitable and be able to meet its obligations for us from a contract standpoint, and that comes to your second point with respect to cost-based fees.

Again, I speak only as an observer, emphasizing that it is best for the New York Stock Exchange market people to respond to that, but I do think the existing environment, where the SEC reviews any fees and identifies whether those fees are reasonable or not, does provide protections to ensure that those fees are appropriate, and it is, I guess, not clear to me personally that change really is required.

Mrs.BIGGERT. Thank you.

Mr. Glauber?

Mr.GLAUBER. I think my perspective is the least valuable on this panel because we do not manage an exchange. I think the position of the exchange that we regulate, which we do as a separate entity under contract—that is, NASDAQ—ought to be provided you by NASDAQ. So let me defer both to Mr. Ketchum and to Mr. Brodsky.

Mrs.BIGGERT. Mr. Brodsky, do you have any comment on that?

Mr.BRODSKY. I would say, in the options industry, the market data fees are not nearly as substantial as they are on the stock side, but the SEC, in its request for comments, has taken up this issue, and this is something that the SEC currently is studying.

It is obviously an important issue. We feel that it should be part of the work that the SEC is doing now. We look forward to discussing it with them.

Mrs.BIGGERT. Thank you.

Mr. Brodsky, I remember at one point we were discussing portfolio margining, and I think that you were—there was a problem with two regulators. Is that still an issue? Do you think that a single regulator will solve that?

Mr.BRODSKY. Well, we will not have the luxury of having a single regulator in time to solve that.

You may or may not be aware, but there is a bill that exists in the Senate side—and I know this will eventually happen in the House side, at the ag committee—to re-authorize the CFTC. Part of the reauthorization of CFTC deals with work that should have been done between the SEC and the CFTC over the last 5 years to achieve portfolio margining in single stock futures and options.

Unfortunately, those agencies did not get it done, and the result of that is that now the presidential working group has directed the SEC and the CFTC to get it fixed, and the upshot of that is that,

hopefully, the New York Stock Exchange and the CBOE will take the lead in proposing rules that will allow for portfolio margining on the securities side. Once those rules are clarified, there will be, hopefully, counterparts on the CFTC side.

It is complicated by the fact that you do have two agencies, but I would say that, in this particular realm, and I appreciate the lengthy introduction that you gave to me, I did spend almost 15 years on the futures side, and I will tell you that the futures industry is at least a decade ahead of the securities industry in portfolio margining, and all we are trying to do at the CBOE, in leading the six options exchanges, is to give us a chance to catch up because competitively, we are being harmed by the fact that we do not have portfolio margining available to customers, as the futures industry does. Again, this is one of those intramural things that we have to deal with, but this can be solved by not only the New York Stock Exchange and the CBOE working together, which we are, but with the leadership of the SEC in working with the CFTC.

So I am hoping that sometime between now and the end of the year, there will be some rules filed for the SEC to approve.

Mrs.BIGGERT. Thank you.

Thank you, Mr. Chairman.

I yield back.

ChairmanBAKER. I thank the gentlelady.

Mrs. Kelly

Mrs.KELLY. Thank you, Mr. Chairman.

I would like to ask our panelists—the SEC recently published Regulation SHO on naked short selling, and they are collecting the first information on the effectiveness of this rule. I would like each of you to explain to the committee how each structure that you recommended in your testimony is best able to stop illegal naked short selling and cut the incidence of failed trades down to the lowest possible level, and I do not care where you want to start, but I would really like to hear from each one of the three of you.

Mr.KETCHUM. Congresswoman Kelly, let me start and be identified with your concern.

Improper naked short selling, indeed, is a concern and a bad thing for efficient markets and something that we at the New York Stock Exchange and I know the NASD, with the SEC, are absolutely committed to ensuring strict enforcement.

We have worked with the SEC, after the adoption of Reg SHO, which substantially tightened up the requirements for being able to ensure that you locate securities and do not engage in improper naked short selling. We worked in a sweep exam, which was a good example of coordination among the regulators, where we, the NASD and the SEC, split up firms across the entire industry.

We have completed that.

We have found generally strong compliance with the rules, but also instances of problems that we will address in a variety of ways, as will the NASD and the SEC, and I can just underline to you that we are absolutely committed to the strict enforcement of Reg SHO and believe in it very, very strongly.

Mrs.KELLY. Thank you.

Mr. Glauber?

Mr.GLAUBER. Thank you.

I am speaking to you now from our position as the contract regulator of the NASDAQ market.

First, I would endorse exactly what Mr. Ketchum has said.

Further, what we have done is submitted to the SEC a rule which would extend the mechanisms of Reg SHO to non-listed pink sheet securities. We submitted the original rule back in March. We amended it a couple of months ago, and, in fact, the SEC has now just put it out for comment. I assume that once the comment period expires, it will make whatever changes are necessary, and then that rule will become effective.

So the protections of Reg SHO will be extended to the pink sheet securities, as well, and I think they are important protections.

Mrs.KELLY. I agree.

Mr. Brodsky.

Mr.BRODSKY. Yes.

First of all, I agree with the concept or the objective of Reg SHO, and that is that people who sell stock short must be in a position to borrow that stock before they sell the stock.

That is a fundamental concept, and I agree with my two colleagues here, but this is an SEC rule. The SEC, I think, is in a good position to deal with this. I would say, Congresswoman Kelly, having come from New York and now living in Chicago for many years, I will tell you that we take a much more free market approach to short selling in general, and that is that the whole concept of having to sell at an up-tick is an anathema to free markets, and I cannot resist the opportunity to make this comment, but if you do sell short, you should be in a position to borrow the stock, and I, therefore, support the goal of Reg SHO.

Mrs.KELLY. Good.

Thank you very much.

Mr. Glauber—

Mr.GLAUBER. Yes.

Mrs.KELLY. I have just had a very interesting experience with regard to fast-growing equities markets, and I do not think a lot of people really are aware that the fastest growing ones really are not in the United States or even in the Far East. They seem to be in Arabia and the Arabian Peninsula.

I recently had an opportunity to visit that region, and I saw firsthand a commitment to professionalism in both men and women doing trading.

These young traders were there actively engaged and working the world market.

I understand that NASD has been working with some of these emerging exchanges, and I would really like you to share with the committee your experience in working with the emerging markets in the Middle East and the export potential of the professional market regulation services that you might have.

Mr.GLAUBER. Thank you.

We have, indeed.

We have worked with the regulators in Jordan and in Saudi Arabia.

We have done so because we have been told by them and we believe we do possess an expertise in regulation that they have sought. And we think that it is an appropriate responsibility for us

to share that expertise when it is asked. We ask only that our costs be paid. We are not going to make any profit from this.

We do so because we think that developing safer and better regulated markets in these countries is likely to foster the growth of capitalism and better provide a platform for democracy in these countries. We believe—more generally—that our markets will be better if they exist in a broad network of markets around the world that are safe, well regulated capital markets.

So we have done that. It has provided us, I think, a useful opportunity. We have learned from it. I believe that our clients have learned from it, and we will continue to do it on a limited basis when markets come to us and tell us we can be helpful to them.

Mrs.KELLY. Anyone else want to comment about that?

Mr.BRODSKY. I would comment that CBOE has, in the last 12 months, signed five memoranda of understanding with Chinese exchanges which provides for information sharing and cooperation in derivative markets. I will tell you that, having been to China a year ago, it is breathtaking the progress that has been made in that country. I must say the potential there is so enormous because of the size of the market, the industry of the people, and their love for trading.

Mrs.KELLY. Thank you very much.

It is an interesting experience to go to these markets, and I am delighted to hear that we are talking about having an impact on making sure that there is a professional regulation that is understood across the board.

So thank you both.

I yield back.

ChairmanBAKER. I thank the gentlelady.

Before I ask the panel to step aside, I would just observe that, in a world where digitalization is taking place enormously rapidly, and if it can be digitalized, it can be shipped anywhere, and if we currently have a market reg environment where there is the potential for market arbitrage to evade cost and enhance efficiency, we have got to be very sensitive to where we are going with this, and I know you are, but it bothers me greatly unless we can get our house in really top shape order.

Let me express to each of you my appreciation for your appearance, your assistance.

We know this is complicated business, but it is essential business, and we want to be a partner going forward, to be helpful as best we can.

Thank you very much.

I would ask now that, as appropriate, our members of the second panel come forward.

ChairmanBAKER. Let me welcome each of the panelists here this afternoon.

As you are familiar, we will ask that you attempt to keep the remarks to 5 minutes. Your formal statement will be made part of the record.

We certainly appreciate the courtesy of your participation, and I welcome back, after many prior appearances, Mr. Marc Lackritz, president of the Securities Industry Association.

Please proceed at your leisure.

STATEMENT OF MARC E. LACKRITZ, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr.LACKRITZ. Thank you, Mr. Chairman, and members of the subcommittee.

I appreciate the opportunity to testify this afternoon on reforming the securities industry self-regulatory system.

Our Nation's securities markets, as you well know, are the most transparent, liquid, and dynamic in the world. New forms of competition, technological advances, globalization, and broader investor participation have driven phenomenal changes in the capital markets and securities industry over this past decade, further strengthening our capital markets' global preeminence.

Self-regulation has been a key ingredient in the regulatory framework in which our markets have thrived. The extensive expertise of members and their involvement in the rulemaking process has led to more effective and less costly self-regulatory rules. This tiered regulatory system, supplemented by Government oversight, has provided a greater level of investor protection than Government alone might have been able to achieve, but self-regulation does have significant drawbacks.

First, conflicts of interest, which we just heard about, between SROs' roles as both market operators and regulators, and second, regulatory inefficiencies resulting from duplication among multiple SROs.

The proposed mergers between the New York Stock Exchange and Archipelago and the NASDAQ stock market and Instinet's network add an additional concern about the profit motive of a shareholder-owned SRO detracting from self-regulation.

We strongly believe that the proposed mergers present a unique opportunity now to address these concerns and to bring the structure of self-regulation into the 21st century.

The SIA strongly supports adoption of the hybrid self-regulatory model as the best alternative to the current structure of self-regulation.

The hybrid self-regulatory model would split regulation into two functions.

Each marketplace would have its own SRO which would regulate and enforce all aspects of trading, markets, and listing requirements, but there would also be a single-member SRO that would handle regulations relating to the operations of broker-dealers.

This body would be transparent to both the investing public and to its members. Both the public and broker-dealers would be involved in its governance, and the SEC would oversee its budget, funding, and performance.

Combining the SRO broker-dealer regulatory programs into one centrally managed entity, the hybrid SRO, would eliminate the duplication, inefficiency, and redundancy that occurs with rulemaking, data reporting, examinations and enforcement actions.

These regulatory inefficiencies consume time, energy, and money, thereby stunting innovation and growth.

In addition to the waste of regulatory resources, the cost on broker-dealers, and especially the smaller firms, is heavy. Uniform efficient regulation would allow firms to use their internal compli-

ance resources much more effectively, further strengthening investor protection.

A hybrid SRO would also remove the potential conflicts of interest between an SRO's regulatory duties and its market functions by splitting regulation into two functions. Such a revamped self-regulatory structure will strengthen investor protection and increase the competitiveness of the U.S. capital markets.

For the hybrid model to function effectively, however, the SEC will have to provide attentive, cost-effective regulatory oversight that includes vigilant review of the single-member SRO's costs and fee structures. Strong public and member involvement will become even more important to prevent a single-member SRO from becoming an unresponsive bureaucracy with prohibitive cost structures.

We also recommend that the SROs define the costs necessary to meet their self-regulatory obligations, prepare and make public a budget to meet those obligations, and then fairly apportion those costs among members.

Regardless of the outcome of regulatory consolidation, the SEC should deal immediately with longstanding concerns by market participants about the opaque and non-accountable way in which market data fees are currently set. Congress certainly never intended for market data to generate revenues for SROs to subsidize their regulatory obligations or to fund competitive business activities in the manner that it does today.

The purpose of disseminating market data is to create transparency in the prices that investors receive for buying and selling securities and, where there are competing market centers, to increase investor choice and opportunity.

For that reason, we have advocated that the SEC adopt a narrow, cost-based approach for funding regulation that does not depend on revenue from market data fees. Our approach does not put the SEC in the role of rate-maker for data fees but, instead, encourages the agency to rely on its oversight role to ensure that access to this information is available on a fair and reasonable basis.

Importantly, a cost-based approach will minimize the conflicts of interest that arise from control over a monopoly product with the ability to use the resulting revenue to subsidize other activities.

We have reached the ideal moment now for implementing significant structural reform of self-regulation that will strengthen our global preeminence and ensure that investors are fairly protected.

SIA is eager to work with Congress, this committee and subcommittee, the SEC, the SROs, and all interested parties to take advantage of this very unique opportunity to bring the structure of self-regulation into the present.

In doing so, we will ensure our markets remain the most transparent, liquid, and dynamic, with unparalleled levels of investor protection.

Thank you very much, Mr. Chairman.

[The prepared statement of Marc E. Lackritz can be found on page 107 in the appendix.]

ChairmanBAKER. Thank you for your testimony, sir.

Next, we welcome Mr. Kim Bang, president and chief executive officer of Bloomberg Tradebook.

Welcome, sir.

STATEMENT OF KIM BANG, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BLOOMBERG TRADEBOOK, LLC

Mr.BANG. Thank you, Mr. Chairman and members of the committee.

My name is Kim Bang. I am pleased to testify on behalf of Bloomberg regarding self-regulatory organizations, exploring the need for reform.

Bloomberg L.P. provides multi-media analytic and news services to more than 250,000 financial professionals in more than 100 countries worldwide. Bloomberg News is syndicated in over 350 newspapers and on 550 radio and television stations worldwide.

With the approval of the mergers and with major market structure initiatives pending, this is a good time to hold this hearing.

The most significant consequences of the proposed New York Stock Exchange-Archipelago merger is, in fact, that the New York Stock Exchange will now become a for-profit entity. As a for-profit entity, a regulator, a marketplace, and a beneficiary of a Government-sponsored information monopoly, the New York Stock Exchange is playing a lot of roles, and many of them conflicting.

As a for-profit entity, the New York Stock Exchange will have an incentive to extract maximum benefit for shareholders.

The ramifications are substantial, and the need for regulatory and congressional oversight will be, as well.

There are many perspectives from which to look at the SEC Reg SRO and the issue of how SROs should be governed and how they should act.

Our preferred vantage point is how they will distribute market data and how much they will charge for this market data.

Market data, as you know, is the oxygen of the financial markets.

There are critical priorities here. Market data must be available and affordable for retail investors, and market participants must have the widest possible latitude to see best execution and add value to that data by devising analytics, databases, and other innovations.

Before the New York Stock Exchange-Archipelago and NASDAQ-Instanet mergers were announced, the SEC launched a public discussion of market data revenues and whether they should be cost-based.

Bloomberg joined the SIA in strongly supporting cost-based limits on market data fees and believes the for-profit status of the SROs lends greater urgency to this initiative.

In its 1999 concept release on market data, the Commission noted that market data should be for the benefit of the investing public.

Indeed, market data originates with specialists, market makers, broker-dealers, and investors, and the exchanges in the NASDAQ marketplace are not the sources of this market data but, rather, the facilities through which market data are collected and disseminated pursuant to regulatory fee and without compensation to investors or their brokers.

In its 1999 release, the SEC proposed a cost-based limit to market data revenues.

A cost-based approach would not require the New York Stock Exchange and NASDAQ to sell data at cost. Instead, it would require the charges to be reasonably related to the costs of collecting and disseminating this data with a reasonable profit.

Today, as not-for-profit entities, the SRO network spends approximately $40 million on collecting and disseminating this data, and they receive over 10 times that much, $424 million in revenue.

Yet, a detailed accounting of these revenues, including the underlying costs to the SROs and an account of the use of these revenues, has been unavailable.

Would the State and local public service commissions that regulate other type of public utilities, those that supply us with electricity, gas, telephone, rail service—would they tolerate the idea of a 1000-percent markup over the cost? Hardly, but the Congress told the SEC in 1975 to regulate these data monopolies, including the New York Stock Exchange and NASDAQ, as public utilities.

Market data revenues come from investors. If investors were paying roughly 10 times the cost when dealing with not-for-profit entities, where significant competing venues were potentially restraining costs by giving away this market data, what will investors be paying now that the New York Stock Exchange and NASDAQ will no longer face that competition?

On the best execution obligations, moreover, each broker-dealer and fiduciary is required by law to ascertain what trading venue has the best price in every stock, every millisecond.

If having complete access to this data is effectively required by law, broker-dealers and fiduciaries have absolutely no capacity to bargain over the price of this data.

Access to information will also be a challenge. Bloomberg L.P.'s 3-year-long conflict with the New York Stock Exchange over Liquidity Quote and Open Book illustrate this point.

With Liquidity Quote and Open Book, the New York Stock Exchange attempted to exploit its powers as a Government-sponsored monopoly to require certain vendors to sign contracts that would place severe restrictions on the use of this critical data. Those restrictions would have required vendors like Bloomberg to, one, refrain from integrating the Liquidity Quote data with data from other market centers; two, advantage the New York Stock Exchange over competing market centers when it came to display; and three, refrain from building value-added analytics using this data.

In short, the New York Stock Exchange proposed to leverage its monopoly over market data downstream to unfairly disadvantage not only exchange and ECN competitors but also competitors in the information space.

To its credit, the SEC unanimously struck down the New York Stock Exchange restrictive contracts.

Tying regulatory powers to for-profit incentives will invite this kind of abusive behavior that undermines the goal of the national market system.

While talking about market information, I would like to add that many market problems, especially the obstacles of meeting best executions, could be resolved in the event of display and limit order rules if they were simply updated for a decimalized environment.

Decimalization has been a boon to investors. They have dramatically reduced spreads. However, the rules governing the display of this market data, rules that were crafted in an era of eights and sixteenths, have never been updated to reflect decimalization.

Since decimalization induced 100 price points to the dollar in place of the previous eighth or sixteenth, the amount of liquidity available now at the national best bid and offer is so much smaller than it was before. As a result, there has been a dramatic diminution in transparency and liquidity at these inside quotations.

The SIA, in commenting on Reg NMS, accurately observed, quote, "The value of the NBBO, the cornerstone of the market data, is less than it was before decimalization. We believe the SEC has the responsibility to address this issue," end of quotation.

The simplest resolution would be to require exchanges, market makers and other market centers to publish customer limit orders within five cents of their best published quotations.

This is a modest proposal.

The impact would only restore the transparency that has been lost as an unintended and unforeseen result of decimalization.

As a policy matter, it is hard to argue that decimalization should leave the public with less transparency.

I conclude by noting that the major market changes we are witnessing create enormous challenges for SROs and for the public they serve.

We believe equal and fair access to market data and liquidity at a reasonable cost for all market participants is necessary for reforming self-regulatory organizations.

This must be coupled with congressional and regulatory vigilance.

Thank you, Mr. Chairman and committee members. I am happy to answer any questions.

[The prepared statement of Kim Bang can be found on page 48 in the appendix.]

ChairmanBAKER. Thank you, sir.

Our next witness is Mr. Ben A. Plotkin, chairman and CEO of Ryan Beck & Company.

Welcome, sir.

STATEMENT OF BEN A. PLOTKIN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, RYAN BECK & CO.

Mr.PLOTKIN. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, I am chairman and chief executive officer of Ryan Beck & Company, a 60-year-old NASD member firm based in New Jersey. We have about 1,200 employees, 38 offices in 13 States, including Florida and New York City. We have a number of offices in each of New York and Florida.

I am also chairman of the Securities Industry Association's regional firms committee, and I thank you, Mr. Chairman, and the entire committee, for the opportunity to testify on issues relating to need for structural reform for self-regulation, and especially to present the regional firms committee's support of the hybrid self-regulation organizational model. These hearings are very timely, in light of the proposed merger involving the New York Stock Exchange.

Regional securities firms play an important role in the U.S. markets. Many of the so-called regional firms, like Ryan Beck, do business from coast to coast. We are simply smaller and much more focused to serve clients in a way that larger national firms often cannot.

Our client base, in many respects, are typical individual investors looking for quality advice, small businesses looking to access the capital markets, or municipalities with financing needs below the radar of large national firms.

Our clients expect us to provide the full complement of services offered by national firms but on a personalized cost-efficient basis.

Unlike national firms, we do not have the size to readily absorb the cost of regulatory duplication. Recently, 16 of the largest regional firms around the country signed a letter urging regulatory reform. These firms hailed from across the United States.

Most regional firms are members of two national SROs, the New York Stock Exchange and the NASD. In addition, we are regulated by the SEC and, in the case of most regionals, 50 State regulators.

All these regulators, for legitimate reasons, have been much more active in their rulemaking, examination, and enforcement initiatives in recent years. The cost of increased regulation presents significant challenges to regional firms in continuing to attract and retain a loyal client base with cost-competitive services.

If left unaddressed, high regulatory costs will drive continued consolidation among regional firms, leading to fewer investor choices.

Some firms, like Ryan Beck, have chosen to access the New York Stock Exchange through other broker-dealers to avoid duplicate regulation. These results are demonstrative of a situation that should not persist. All firms should be subject to the same regulatory process, one that is efficient and non-duplicative.

Regulatory duplication can undermine investor protection because it means a firm's compliance efforts are refocused towards complying with two sets of substantive standards, rather than focusing on monitoring and preventing conduct that could harm investors.

While the industry is certainly appreciative of the regulators' efforts to mitigate the negative effects of duplicative regulation, no amount of regulatory coordination can fully counteract the inefficiencies that are inherent in the current structure.

In short, we believe in two strong regulators, not three.

We are not advocating less in overall supervisory resources, instead that the same resources be allocated in a more efficient manner.

Self-regulation has worked incredibly successfully over the years.

Self-regulation and governmental regulation are, together, capable of achieving a level of expertise in investor protection that is truly greater than the sum of its individual parts. Given the current proposed mergers, now is the appropriate time to restructure and revitalize the self-regulatory system and truly bring it into the 21st century.

In order to effectively and efficiently address these concerns, the hybrid model proffered by the SEC in its SRO concept release presents an appealing and practical alternative to the current model.

The hybrid model would minimize inconsistent regulation that results from duplicative SRO regulatory oversight. Regulatory resources would be expended more efficiently, as the regulators would have to spend less time writing or reconciling inconsistent rules or conducting duplicative examinations.

There would also be benefits from concentrating regulatory expertise so that single-member SROs could maintain a talented, experienced regulatory staff, rather than having that talent and expertise fragmented across multiple SROs.

In order to protect the interests of all member firms, the single-member SRO would require significant involvement from both the investing public and broker-dealers. While non-industry representatives should comprise a majority of the SRO board of directors, adequate industry representation is essential to ensuring that a single-member SRO is embedded with the expertise necessary to efficiently regulate both large national firms and small regional firms. In short, we must keep the self in self-regulatory organizations.

In conclusion, let me say that the U.S. securities markets are still the most efficient, transparent, and liquid in the world, but we cannot grow complacent.

The implementation of the hybrid model will help to ensure that U.S. markets preserve their reputation in the years to come.

I appreciate the opportunity to speak to you today and am prepared to answer any questions.

[The prepared statement of Ben A. Plotkin can be found on page 119 in the appendix.]

ChairmanBAKER. Thank you, sir.

Mr. Lackritz, in Mr. Bang's testimony, he went on at length concerning the troublesome aspects of market data, the fees associated with it.

I would assume you would share his general observations about market data concerns?

Mr.LACKRITZ. Yes, absolutely.

In fact, I think we highlighted those in our longer written testimony.

ChairmanBAKER. My point in raising this is to use that as the issue in discussing regulatory structure.

Clearly, if there is the traditional SRO, which has conflicting task masters with shareholders on the one side and regulatory responsibility on the other, the ability of that regulator to assess the validity of the charges associated with market data would appear to me to be slightly impaired.

How does the hybrid model markedly improve on that, even recognizing that an independent regulator might have the tendency to threaten more bureaucratic structure with less specialization of regulatory capability?

What is more important, getting efficient value from market data and other lower-cost regulatory assessments or having an entity that is more specialized and, quote, "market sensitive" that is closer to you?

I am having trouble figuring out where that animal lives.

Mr.LACKRITZ. I think the answer to your question is yes, that we can walk and chew gum at the same time, and I think that what

we are trying to do in the proposal, in the hybrid SRO, is to talk about both raising the quality and improving the quality and efficiency of regulation by making it cost-based so that, in fact, you would have a proposed budget for this regulator that would be open, transparent for the public, for the SEC, and for the industry to look at, and when there is an understanding of what is appropriate in terms of the level of regulation, that cost would be assessed across the membership, on a per-member basis, appropriately.

At the same time we are saying that currently, under the current structure, market data fees are cross-subsidizing regulation because, as pointed out in Kim Bang's testimony, they are 10 times the cost, roughly, of collecting the data.

So rather than having market data cross-subsidize regulation—

ChairmanBAKER. Are we even sure that is where the money goes?

Mr.LACKRITZ. Well, it certainly goes—you know, I heard Mr. Ketchum's testimony that market data fees do not finance regulation, but at the same time, they are providing an enormous amount of revenue to the exchange, and the exchange has a variety of functions that it uses revenue for, and so, from the standpoint of improving market data dissemination, that also should be based on a cost-based formula, so that the cost of collecting the data should be what the markets charge for that data, and that is where the SEC really would come into effect as the overseer of that market data structure, but it needs to be cost-based, not whatever the traffic will bear or not what the monopolists would like to charge.

ChairmanBAKER. Well, I also heard Mr. Brodsky make the case that we need people closer to us who share the specialization of talent that is necessary to understand our activity, which may be different from the equity side. What is your reaction to that necessity?

Mr.LACKRITZ. Well, he is right, and our hybrid SRO model would provide for that because you would have—on the one hand, you would still have market-based surveillance activities, enforcement activities, trading regulation based on the marketplace.

The hybrid member—single-member SRO would only do inspections, examinations, and audits and regulations of the broker-dealer at the member level, at the broker-dealer level, not at the market—not market-based.

ChairmanBAKER. So you share the view that there can be a line drawn between the regulatory responsibilities that are applicable to all markets while recognizing the specialty skills for individual markets that can be transparent in its assessment of fees that is justifiable in light of the client use.

Mr.LACKRITZ. Basically, yes. Yes, that is correct. You know, I think what we are trying to do is get the best of both possible worlds, you know, get centralized expertise, on the one hand, for operations that are similar across the board, at the member level, at the broker-dealer level, and that would be the single-member SRO, and at the same time, leave market-based surveillance, market-based expertise in the marketplaces to enforce the rules and regulations in those marketplaces.

ChairmanBAKER. Mr. Bang, do you share that general perspective?

Mr.BANG. Yes. I am not going to repeat everything that Marc said because obviously we agree with everything that he laid out, but to give you a little bit of perspective, you know, we have, in the past, heard justification for charging these—what we consider very large market data fees on the necessity of funding regulatory oversight.

It was interesting to hear today from Rick Ketchum and also Mr. Glauber that, indeed, they are not—they do not believe that market data is being used to fund the regulatory oversight, and that seems to be sort of a change, a bit of a change, because historically, we have sort of heard different.

ChairmanBAKER. I think I also heard him indicate that it was not that significant either.

Mr.BANG. Right.

ChairmanBAKER. Okay.

Mr.BANG. So the question is, you know, what is a fair charge for this market data, and the costs that I quoted to you today is really just the cost for the NBBO, you know, the top-of-file dissemination, and as you can hear, we believe that we really should make—restore the sort of transparency that we had at the time of—in predecimalization, and, indeed, that is what the NASDAQ and New York Stock Exchange is in the process of doing with the—providing New York Open Book available in the marketplace for real time, which is essentially depth of book, and the NASDAQ has a program—I believe it is called Total View—which is also a depth of book program, which is really essentially in a—in this sort of marketplace that we operate in, because it is decimal pricing and that we have fiduciary obligations to seek best execution for our clients.

So we need to consume that data; we need to buy the data. And that data is now being sold at an additional cost that I did not quote to you, right?

This is on top of it, and it is coming as a result now of the mergers, because in the past, Archipelago, Instanet, Island, all of these ECNs—they did not charge for the data.

It was made available free of charge.

Now that it is going to be merged into these entities and they are going for profit, they are going to charge separately for providing this depth of data, and they are probably going to charge approximately the same that they charge for the current data.

So essentially, you are going to get a doubling of data fees, close to a billion dollars in cost to the market participant and investor public, which we find is quite excessive.

ChairmanBAKER. I want to do one more because Mrs. Kelly is here, and I have gone way over my time, but Mr. Plotkin, you have talked about the regulatory burden, the cost of compliance, particularly for a smaller firm, in managing business in the market.

There was mention earlier of the growth of foreign exchanges and investment opportunities there.

From your view, given the limitations that you face now, is that potentially something of concern to the Congress, that unless the regulatory burden is addressed, that we are going to see folks making decisions to move elsewhere?

Mr.PLOTKIN. I think it is a good question.

I mean what happens from a CEO's seat is we do have choices.

Companies can decide to either consolidate, go out of business, and there has been an increase in consolidation of regionals because the burdens are too high, or they can decide to choose regulatory bodies, which is not necessarily a good result, as well.

So it is definitely possible in the way this is set up right now.

ChairmanBAKER. Is the regulatory cost that is of concern to you principally market data, or is it the broader regulatory duplication and other issues?

Mr.PLOTKIN. It is currently the redundancy. I mean, from my seat, we have—we have gone from about five people in compliance and legal to about 25 in the last 4 years, and we are a relatively clean firm in terms of, you know, supervisory issues.

You know, my choice as the CEO is to have people focus internally to make sure we do not have a bad apple, that we are doing right by our customers, or to respond—or, often, they are spending their time responding to multiple regulatory inquiries. So that is the real issue.

The market data issue is a separate question for us, because it is all about clarity.

As a businessman, if I cannot measure it, I cannot manage it.

I want to know my data cost, just like I want to know what my health care cost is, etcetera, etcetera, and that is the real issue on the market data, that it is very obfuscated right now.

ChairmanBAKER. I would assume you would share Mr. Lackritz's view about the advisability of the hybrid model. Or do you have other views?

Mr.PLOTKIN. Well, the regional firms around the country support the hybrid model.

We believe that what that means is consolidation of the broker-dealer regulation so we will have two strong regulators, an SRO, as opposed to multiple SROs, and the SEC, along with 50 State regulators. We think that is plenty cops on the beat.

ChairmanBAKER. Yeah. I do not disagree.

Mrs. Kelly?

Mrs.KELLY. Thank you.

I would like to ask Mr. Lackritz a question.

Mr. Lackritz, on page 10 of your testimony, you talk about the issues that are conflicts between shareholders' interests and the regulatory authority, and you talk about the New York Stock Exchange, and mention that they are going to move employees into a separated, affiliated—separate, affiliated, nonprofit entity, and I am quoting here, and you go and say, moreover, the very fact that the New York Stock Exchange apparently seeks to maintain regulation of its broker-dealer members under the NYSE name, with the oversight of some of its directors, rather than spin it off into a separate entity under a different name, with entirely separate directors, suggests that the New York Stock Exchange sees value in continued branding of its regulatory authority over broker-dealers.

You know, the stock exchange has had over 200 years in self-regulation.

It has not been all bad, and the experience level—the regulation—the members know what the regulations are, and that is what they use.

They rely on it.

I do not quite understand how this is different, actually, from the SIA branding that you have in your testimony you have provided here, using your own market success as an association to promote this in your own testimony.

So maybe you could define for me, how is this different?

Mr.LACKRITZ. Sure.

Thank you.

That is a good question.

I think that the point we are trying to make is not that self-regulation has not worked.

The point we are really trying to make, I think, is that in this new environment, as markets are evolving, as mergers are happening, as ECNs are competing with existing exchanges, as technology is dramatically changing the entire trading environment, what is the structure of self-regulation going forward that is going to be most effective for protecting investors and preserving our preeminence globally, and certainly the New York Stock Exchange has been extraordinarily effective in terms of its self-regulation. At the same time, it has imposed a huge amount of costs on the industry from duplication, redundancy, and inefficiency that we have talked about before.

So we are not talking about taking regulation out of New York completely.

We are saying keep market surveillance, keep trading, keep all the activities that you are doing in the marketplace that you have been doing, continue to do those, but at the same time, move the member regulation, the broker-dealer regulation, into one organization so you are not competing, providing conflicting interpretations, providing redundant rules with the NASD that is also regulating and overseeing that same group of firms. Let's come up with a more efficient and a more effective structure without undermining any kind of self-regulation that is at the exchange or has been at the exchange for 200 years.

Mrs.KELLY. When you are talking about redundant regulations, many of these regulations may be redundant, but are they essentially identical? Because that is what the need is.

Mr.LACKRITZ. If they were identical, I don't think we would have a problem.

I think the difficulty is that they are very rarely identical.

There are separate interpretations.

They are somewhat different, you know, a little change here and a little change there.

What we have found recently is we have made some progress with the two SROs combining to work on rules, for example, with respect to business entertainment gifts and travel, those kinds of things, but at the same time, those resources that are going toward coordination really shouldn't go to coordination.

They should really go to an effective examination, audit, and regulation.

Those resources that are diverted toward coordination really can't go to the regulation. If you had one body, you could effectively align those resources and have a much more effective and efficient regulatory structure.

Mrs.KELLY. Thank you for clarifying.

Thank you. I will yield back.

ChairmanBAKER. I thank the gentlelady.

Mr. Lackritz, I just want you to help me with sort of a forward-looking statement.

With the move by the New York Exchange to engage in the merger with Archipelago and my view that the electronic trading platforms, because of speed, efficiency, and reliability, tend to grow in acceptability, that as I look at what has happened at the CBOE and other exchanges, maybe not tomorrow but somewhere down the road, we are looking at electronic transactions of significant proportion in relation to what we now call the specialist system.

Doesn't the applicability of electronic platforms diminish the necessity for a specific market-based supervisory function where the economic exchange, despite whether it is a future, option, or an equity, begins to merge here a bit, and doesn't that really lend itself to the single regulatory model where we can get at all this duplication because the nature of the entity being regulated is, in essence, losing that uniqueness as we move forward into electronic markets? Explain to me why that doesn't work.

Mr.LACKRITZ. I think I understand what you are saying, and I think that the—you are absolutely right that technology is obviously playing a much more significant—

ChairmanBAKER. That is running everybody right now.

Mr.LACKRITZ. Right.

So then the question becomes how do you most effectively provide for market regulation in the marketplace as it evolves technologically, and certainly, technology is going to play a much more important role in providing that surveillance, and the question is whether you want to locate that centrally in one organization that is going to be immune from basically a monopoly organization or whether you are going to decentralize that in the different marketplaces because of the algorithms that are written, because of the software and the programming and everything else that is going into the marketplace.

I think what our proposal says is it is better to have that surveillance closer to the market, in the marketplaces, where they are familiar with the technology and familiar with the trading patterns and the liquidity and the movement back and forth on the marketplace, rather than having it in a single SRO that is removed, really, from the marketplace, that maybe is gathering up information but doesn't have the market expertise, doesn't have familiarity with the trading patterns or the flow of volume during the course of the day, and so, I think I understand your point, but I think that, from the standpoint of effective and efficient regulation, by leaving that kind of surveillance of the marketplace in the marketplaces themselves, that provides the best solution, as long as you move the broker-dealer regulatory functions to a single member.

ChairmanBAKER. Well, I just need to understand better because that would seem to argue that the SEC, as a single regulatory securities entity, would be better served by having divisions that sit in particular locations with expertise geographically located close to Chicago or wherever the trading platform might be.

My understandings of how markets are merging and where our regulatory system currently stands is there is an extraordinary di-

vergence, which I think is reflected by the concerns about duplication, cost, and so forth, but to get us back together again, I am not convinced yet that the hybrid model is responsive to the concerns that you have identified or at least I am not understanding how the hybrid model is appropriately responsive, and we may only pass this way once. Whatever we do I have a suspicion is going to be around for a while. When I look at Gramm-Leach-Bliley and other things of modest consequence that have occurred around here, you know, we are talking decades, and we are in a very formative, pivotal period in our securities market formation, and I think we owe it to our future investors and stakeholders to ask every possible question we can, knowing we won't get it exactly right, but we need to get as close as we can.

Mr.LACKRITZ. Mr. Chairman, I appreciate your comment. I think that we completely agree this is a very unique moment, and we would like to make sure we get it right.

Five years ago, we commissioned a white paper to explore each different alternative idea for self-regulation, going from completely done by the SEC to a PCAOB-type model to everything in between, and we went through the pluses and the minuses, the costs, the benefits, and came out saying that this hybrid model really makes the most sense from the standpoint of investor protection, from the standpoint of efficiency in terms of costs, and from the standpoint of maintaining market expertise and surveillance in the marketplaces themselves without creating a large bureaucracy on the one hand but also without duplicating inspections, examinations and audits which the firms have complained about for a number of years and which are getting better, but they are not getting better fast enough.

ChairmanBAKER. Sure.

Well, I am with you on the PCAOB. We can start that one off without disagreement.

I am just not sure single regulator versus hybrid has yet emerged in my mind clearly enough to make an informed decision, but the meeting today was to bring to the committee's attention the various perspectives, and certainly, we want to be open to your professional view.

As stakeholders, you certainly understand market function much better than those of us on the committee, but we will have some partnership in this as we go forward, and we want to make sure we fully understand it.

Unless there is further comment—yes, sir.

Mr.BANG. Maybe I could make a comment on the hybrid for a moment.

You may have suggested that the markets become more electronic, they start to look more alike, and perhaps they sort of operate in a more similar fashion and, therefore, maybe a single regulator could perhaps regulate efficiently all of these markets.

I think when you get into the granular details, even though they are electronic, you can still find very significant different rules and competitive practices within those electronic venues.

If you look at the ISE options exchange, it is quite different from the Chicago Board of Options Exchange versus the Boston BOX Exchange.

There is probably more similarities on the cash side in terms of an Archipelago ECN and an Instanet ECN, but it doesn't preclude in, you know, sort of future development that certain exchanges will have—like, for instance, the NASDAQ market has market opening crosses, end of day crosses that the others don't have, or they have, but they operate somewhat differently. So having that expertise and understanding more on a local level doesn't necessarily have to be on a physical presence, but people—that sort of oversight—overseeing those particular exchanges and those—the way they operate, I would say are significant benefit.

The other thing is, having the SEC actively involved as oversight to the regional SROs, let's say, is clearly critical. You know, in our citation on the Liquidity Quote and this Open Book, I think, illustrates that well, because the exchanges obviously, especially the for-profit, will have incentive to further their profitability and so forth.

ChairmanBAKER. That is what led me to this questioning along the line of single regulator versus an SRO model, and that really is what started me, and then thinking through market function and where we are likely headed, it just seemed to be a logical question to ask.

Let me suggest this, going forward.

The committee's work will continue for some time. We are not near any meaningful decision. We are just kind of foundering around. Please forward your own opinion and analysis; feel free, totally unsolicited, if necessary, but the committee would very much appreciate additional information going forward, as we discuss these issues into the coming months and perhaps years.

Thank you very much for your kind participation.

Our meeting stands adjourned.

[Whereupon, at 4:26 p.m., the subcommittee was adjourned.]

A P P E N D I X

November 17, 2005

Prepared, not delivered

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Self-Regulatory Organizations: Exploring the Need for Reform
November 17, 2005

Good morning. Thank you, Chairman Baker, for holding this very timely hearing on the self-regulation of the securities markets.

Congress determined over 70 years ago that self-regulation was the most efficient and effective regulatory system for the securities industry. The self-regulatory organization, with its deep knowledge of both the business practices of its members and the operations of its market centers, would be able to monitor and more easily adapt to the ever-evolving securities industry. Self-regulation has worked reasonably well.

The Securities and Exchange Commission, in its supervisory role, has taken care through oversight and enforcement actions that SROs adequately manage the conflicts of interest inherent in a scheme where an SRO both regulates and represents the competitive interests of its members and market center. When regulatory lapses have arisen, Congress and the Securities and Exchange Commission have worked together to strengthen and improve this system.

About a year ago, in the midst of the market structure debate addressing the changing nature of our equity markets, the Commission issued both a Proposed Rule to enhance governance and transparency at SROs and a concept release proposing alternative models to the current SRO system.

Since the issuance of those releases, much has happened in the securities markets. The New York Stock Exchange and Archipelago are set to merge and become a for-profit entity. Nasdaq, waiting for the Commission's approval to be an exchange, intends to acquire Instinet's INET ECN.

The self-regulatory system has not been unaffected by these changes. Upon acquiring exchange status, Nasdaq will be completely severed from its regulator, NASD. With the completion of the NYSE-Archipelago merger, the NYSE's regulatory unit will be housed separately in a not-for-profit subsidiary of a new NYSE holding company.

In addition to these operational changes, we confront a rapidly evolving marketplace. Because of the fragmentation of order flow across multiple market centers, regulatory redundancies have appeared: broker-dealers may be subject to duplicate rulebooks, examinations, sanctions, and enforcement actions. Although the costs may be minimal for the largest broker-dealers, the smaller broker-dealers bear a disproportionate burden.

Because of complaints about such redundancies, last week, the NYSE and NASD announced a possible joint venture on regulation. The NASD has estimated a $100 million cost savings for members if the NASD and NYSE partner to regulate the approximately 180 firms belonging to both SROs. Although this announcement seemed to catch many off-guard, I believe it shows the adaptability of industry regulation and the benefits that Congress foresaw when it initially determined to sanction the self-regulation of the securities markets.

I want to commend Chairman Baker for putting together these two distinguished panels and I look forward to hearing their testimony. I yield back.

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Statement of Chairman Richard H. Baker

Subcommittee on Capital Market, Insurance, and Government Sponsored Enterprises

Hearing Entitled – Self-Regulatory Organizations: Exploring the Need for Reform

November 17, 2005

Today the Subcommittee meets to continue its examination of the regulation of our nation's securities markets. Over the past two congresses, the Capital Markets Subcommittee has hosted a series of hearings on issues relating to the structure of U.S. markets, including the recently adopted Reg NMS.

Now we turn our focus to a review of Self Regulatory Organizations or SROs. Self-regulation of the securities markets and market participants is a cornerstone of federal securities laws. All broker-dealers are required to be a member of an SRO, and many SROs also operate and regulate market centers.

SRO regulation, as opposed to direct SEC regulation, helps provide efficient and cost effective oversight to the markets. Thousands of market participants would make it cost-prohibitive for the SEC alone to provide the necessary regulatory presence.

While SROs provide benefits to the markets, there has been concern that conflicts of interest exist in a regulatory scheme where the SRO represents the competitive interests of its members and market center while at the same time regulating these entities. Partially in response to these types of concerns the SEC, in November 2004, issued a proposed rule enhancing transparency and corporate governance at SROs. In addition, the SEC also issued a concept release discussing alternative regulatory models.

Our markets and the manner in which trading is conducted continues to evolve at an accelerated pace and so innovation and competition are forcing change in the way these markets are regulated as well. As order flow migrates across multiple SRO market centers, broker-dealers are being subjected to burdensome and duplicative SRO rulebooks, inspections, and enforcement actions, which cause both regulatory redundancies and ambiguities.

Several SROs have taken the initiative to self-reform. The NYSE already adopted many of the corporate governance enhancements in the proposed SEC rule. In addition, the NYSE and the NASD recently announced the possible pursuit of a partnership to share regulatory duties to reduce the burden on the 180 members of both SROs. The CBOE has also taken the initiative to allocate

its sales practice examinations to the NASD to reduce duplicative regulation.

The core mission of our nation's securities regulators is the protection of investors and the fostering of efficient and transparent markets. I look forward to hearing from our distinguished witnesses today their thoughts on the current environment and future of SRO regulation and what steps may be taken to further advance a more efficient and effective system of self-regulation.

Michael N. Castle

Statement of Michael N. Castle
Capital Markets Subcommittee, Financial Services Committee
House of Representatives
November 17, 2005

Mr. Chairman, I thank you for hosting this important hearing today. Self-regulation is an important part of many industries -- including those represented here today. Securities markets and market participants have a long history with self-regulation. Self Regulatory Organizations have many advantages -- not the least of which is the creation and maintenance of a culture that advances solid business practices and ethos.

I have a couple of areas of interest today, and, let me state them this way:

First, there has been some discussion about the conflicts of interest that exist in some self-regulatory structures. One of these conflicts relates to non-independent directors that serve on boards. What is being done to avoid these conflicts?

The second is consolidation of certain regulatory functions in an effort to minimize duplication. How much of this can be done when you have organizations with different roles -- the New York Stock Exchange, and the NASD and the firms that represent investors, for example?

Mr. Chairman, these are areas of interest to me and I hope our witnesses will be able to address these areas of inquiry, and others, here today. While I may not be able to be here for most of this hearing today, I will look over the hearing record and look for comments related to the topics I've raised here this afternoon. Thank you.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON SELF-REGULATORY ORGANIZATIONS: EXPLORING THE NEED FOR REFORM

THURSDAY, NOVEMBER 17, 2005

Mr. Chairman, more than two years ago, our subcommittee first met to examine issues related to self-regulation in our securities markets. In the many months since that hearing, we have examined other important matters affecting the industry, focusing considerable time on the adoption of revisions to the Securities and Exchange Commission's rules governing the National Market System. The Commission, like us, has now returned to studying how our self-regulatory system actually works and whether there is a need for reform.

As we begin today's proceedings, I want to reiterate my thoughts on the issue of self-regulation. In short, I continue by and large to favor industry resolving its own problems through the use of self-regulation.

Since the enactment of our federal securities laws, U.S. stock exchanges have served both as marketplaces for securities trading and as regulators of their member companies. For more than seventy years, this system, on balance, has worked remarkably well in protecting the integrity of our markets. In order for self-regulation to endure, however, the system must maintain the confidence of investors.

We developed the self-regulatory model under the stewardship of William O. Douglas, who before he became a Supreme Court justice determined that it was "impractical, unwise and unworkable" for the federal government to try to regulate our decentralized securities markets directly. In order for self-regulation to work, he also determined that the Securities and Exchange Commission needed to keep a "shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use, but with the hope it would never have to be used."

As my colleagues well know, I have made investor protection one of my top priorities for my work on this committee. Consequently, I share your concerns, Mr. Chairman, that our committee must conduct vigorous oversight to examine whether the regulatory system for the securities industry is working as intended and to determine how we could make it stronger.

The recent decisions of our exchanges and market centers to become for-profit entities have also resulted in a need to reexamine the self-regulatory model. Some have questioned whether a profit motive will result in the diversion of much-needed resources away from a robust self-regulatory system. This issue, in my view, deserves thorough and careful study.

In closing, I want to assure each of our witnesses that I approach these examinations with an open mind, but with a strong desire to protect investors in our evolving capital markets. I also look forward to continuing to work closely with you, Mr. Chairman, and with others as we address these multifaceted, complicated and important matters.

TESTIMONY OF KIM BANG,

PRESIDENT AND CHIEF EXECUTIVE OFFICER

BLOOMBERG TRADEBOOK LLC,

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, & GOVERNMENT SPONSORED ENTERPRISES OF THE COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

REGARDING

"SELF-REGULATORY ORGANIZATIONS: EXPLORING THE NEED FOR REFORM"

NOVEMBER 17, 2005

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, MY NAME IS KIM BANG, AND I AM PLEASED TO TESTIFY ON BEHALF OF BLOOMBERG TRADEBOOK REGARDING "SELF-REGULATORY ORGANIZATIONS: EXPLORING THE NEED FOR REFORM."

BLOOMBERG TRADEBOOK IS OWNED BY BLOOMBERG L.P. AND IS LOCATED IN NEW YORK CITY. BLOOMBERG L.P. PROVIDES MULTIMEDIA, ANALYTICAL AND NEWS SERVICES TO MORE THAN 250,000 FINANCIAL PROFESSIONALS IN 100 COUNTRIES WORLDWIDE. BLOOMBERG TRACKS MORE THAN 135,000 EQUITY SECURITIES IN 85 COUNTRIES, MORE THAN 50,000 COMPANIES TRADING ON 82 EXCHANGES AND MORE THAN 406,000 CORPORATE BONDS. BLOOMBERG NEWS IS SYNDICATED IN OVER 350 NEWSPAPERS, AND ON 550 RADIO AND

TELEVISION STATIONS WORLDWIDE. BLOOMBERG PUBLISHES MAGAZINES AND BOOKS ON FINANCIAL SUBJECTS FOR THE INVESTMENT PROFESSIONAL AND NON-PROFESSIONAL READER.

BLOOMBERG TRADEBOOK IS A GLOBAL ELECTRONIC AGENCY BROKER SERVING INSTITUTIONS AND BROKER-DEALERS. WE COUNT AMONG OUR CLIENTS MANY OF THE NATION'S LARGEST INSTITUTIONAL INVESTORS REPRESENTING — THROUGH PENSION FUNDS, MUTUAL FUNDS AND OTHER VEHICLES — THE SAVINGS OF MILLIONS OF ORDINARY AMERICANS.

THIS IS A FORTUITOUS TIME TO HOLD THIS HEARING. THERE ARE MANY PIECES TO THE MARKET STRUCTURE PUZZLE — REG SRO, REG NMS, THE NYSE'S OPEN BOOK PROPOSAL, THE NYSE'S HYBRID MARKET PROPOSAL AND THE PROPOSED MERGERS. EACH HAS THE POTENTIAL TO HAVE AN ENORMOUS IMPACT ON INVESTORS AND THE ENTIRE CAPITAL-FORMATION PROCESS. HAVING ALL THESE PIECES ADD UP TO AN OPTIMAL MARKET STRUCTURE WILL BE AN ENORMOUS CHALLENGE FOR THE MARKETS AND FOR POLICY MAKERS.

I. SRO REFORM AND THE IMPLICATIONS OF A FOR-PROFIT NYSE

THE NYSE ENJOYS ENORMOUS MARKET SHARE IN ORDER FLOW AND COMPLETE CONTROL OF THE FUNDAMENTAL RAW MATERIAL OF TRADING, MARKET DATA. THAT MARKET SHARE AND CONTROL ARE

LARGELY THE RESULT OF GOVERNMENTALLY CONFERRED PRIVILEGES, NOT THE RESULT OF COMPETITIVE EXCELLENCE.

NOW, INVESTORS ARE BEING CONFRONTED WITH A PLAN TO TURN THE NYSE INTO A FOR-PROFIT ENTITY THROUGH A MERGER WITH ONE OF ITS ONLY COMPETITORS FOR ORDER FLOW, THE ARCHIPELAGO EXCHANGE. THIS CURRENT ROUND OF PROPOSED MERGERS TAKES PLACE ON TOP OF AN ALREADY SIGNIFICANT ROUND OF CONSOLIDATIONS, INCLUDING NASDAQ'S PURCHASE OF BRUT. ARE THESE DEVELOPMENTS GOOD OR BAD FOR INVESTORS AND THE MARKETS? THAT DEPENDS ON THE STEPS TAKEN BY POLICY MAKERS HERE ON THE HILL, AT THE SEC, AND ELSEWHERE.

PERHAPS THE MOST SIGNIFICANT CONSEQUENCE OF THE PROPOSED NYSE/ARCHIPELAGO MERGER IS THE FACT THAT THE NYSE WILL NOW BECOME A FOR-PROFIT ENTITY. AS A REGULATOR, A MARKETPLACE, AND THE BENEFICIARY OF A GOVERNMENT-SPONSORED INFORMATION MONOPOLY, THE NYSE IS PLAYING A LOT OF ROLES, MANY OF THEM CONFLICTING. AS A REGULATOR AND A MARKETPLACE, THE NYSE HAS A STATUTORY DUTY UNDER THE EXCHANGE ACT TO SERVE THE PUBLIC INTEREST AND TO PROTECT INVESTORS AGAINST FRAUD, MANIPULATION, DEFALCATIONS BY ITS MEMBERS AND DEPARTURES FROM JUST AND EQUITABLE PRINCIPLES OF TRADE. AS A FOR-PROFIT ENTITY, HOWEVER, THE NYSE WILL HAVE A FIDUCIARY OBLIGATION TO

EXTRACT MAXIMUM BENEFIT FOR ITS OWN SHAREHOLDERS. THAT MAY SUGGEST COST CUTTING, EVEN IN VITAL AREAS OF REGULATION AND PUBLIC PROTECTION. WHAT ARE THE REAL-WORLD IMPLICATIONS OF AN ENTITY THAT ENJOYS MONOPOLY POWERS SUDDENLY BEING CHARGED WITH MAXIMIZING BENEFIT FOR SHAREHOLDERS? WILL SUCH AN ENTITY EXPLOIT ITS REGULATORY POWERS TO AID ITS FOR-PROFIT ARM TO THE DISADVANTAGE OF INVESTORS? THE POLICY RAMIFICATIONS ARE SUBSTANTIAL AND THE NEED FOR VIGILANCE — ON THE HILL AND AT THE SEC — WILL BE AS WELL.

II. THE OTC MARKET AS A MODEL FOR A COMPETITIVE MARKET

IN THE RECENT SCANDALS INVOLVING THE NYSE SPECIALISTS, THE SEC TOOK A SIGNIFICANT STEP FORWARD FOR INVESTOR PROTECTION — ALL SEVEN SPECIALIST FIRMS WERE FOUND TO HAVE DAMAGED INVESTORS BY TRADING AHEAD OF THEIR ORDERS AND ENGAGING IN OTHER ILLEGAL CONDUCT AS A ROUTINE COURSE OF BUSINESS. THE SPECIALISTS WERE FINED A QUARTER OF A BILLION DOLLARS AND THEY FACE ADDITIONAL REGULATORY SANCTIONS. THE NYSE ITSELF WAS CENSURED FOR FAILURE TO ENFORCE THE LAW — WHICH IS REMINISCENT OF THE SANCTIONS IMPOSED ON THE NASD IN 1996. THAT FAILURE UNDERSCORED THE WEAKNESS OF THE NYSE'S SELF-REGULATORY SYSTEM AND DEMONSTRATED THE NEED FOR SUBSTANTIAL REFORM. AS WAS THE CASE IN THE NASDAQ MARKET, THE

PROBLEM IN THE NYSE WAS WITH THE SYSTEM, NOT THE PEOPLE. IF WE GET THE STRUCTURE RIGHT, THERE WILL SIMPLY BE LESS OPPORTUNITY FOR ABUSE.

THE NASDAQ MARKET SINCE 1996 PRESENTS A DIFFERENT PICTURE — IT IS A MARKET INTO WHICH REGULATION INTRODUCED AND ENCOURAGED REAL COMPETITION, A MARKET THAT QUITE OBVIOUSLY HAS NOW GROWN BEYOND THE NASDAQ PRICE-FIXING SCANDAL OF THE MID-1990S. THAT SCANDAL, OF COURSE, RESULTED IN THE SEC'S 1996 ISSUANCE OF THE ORDER-HANDLING RULES. THE SEC'S RULES ENHANCED TRANSPARENCY AND COMPETITION IN THE NASDAQ MARKET AND PERMITTED ELECTRONIC COMMUNICATIONS NETWORKS — ECNS — TO LEVEL THE PLAYING FIELD BETWEEN INVESTORS AND INTERMEDIARIES BY GRANTING INVESTORS DIRECT MARKET ACCESS TO THE NATIONAL MARKET SYSTEM.

INDEED, THE INCREASED TRANSPARENCY PROMOTED BY THE SEC'S ORDER-HANDLING RULES AND THE SUBSEQUENT INTEGRATION OF ECNS INTO THE NATIONAL QUOTATION MONTAGE NARROWED NASDAQ SPREADS BY NEARLY 30% IN THE FIRST YEAR FOLLOWING ADOPTION OF THE ORDER-HANDLING RULES. THESE, AND SUBSEQUENT REDUCTIONS IN TRANSACTIONAL COSTS, CONSTITUTE SIGNIFICANT SAVINGS TO INVESTORS, SAVINGS THAT FREE UP MONEY FOR FURTHER INVESTMENT, FUELING BUSINESS EXPANSION AND JOB CREATION.

FOR THE LAST DECADE, THE NASDAQ MARKET HAS BEEN CHARACTERIZED BY FIERCE COMPETITION AND EXTRAORDINARY INNOVATION. ELECTRONIC INNOVATIONS INCORPORATED INTO THE BLOOMBERG TRADEBOOK SYSTEM INCLUDE SMART ROUTING; RESERVE; DISCRETION; TRIGGER PEGGING; BUY-SIDE ALGORITHMIC TRADING; IMMEDIATE-OR-CANCEL ORDERS; SINGLE-LEVEL VS "EFFECTIVE SPREAD" TRADING CALLED (CALLED "BANG STYLE"); AND ANONYMITY.

THE PRESSURE OF THE COMPETITION OF A DOZEN ECNS HELPED PROD THIS INNOVATION. IS CONTINUED INNOVATION POSSIBLE IN A MORE CONCENTRATED MARKET? THE ANSWER IS "YES" -- IF POLICYMAKERS REMAIN VIGILANT REGARDING POTENTIALLY ANTI-COMPETITIVE ACTIONS BY THE SROS.

III. REG SRO

IN NOVEMBER OF 2004, THE COMMISSION INVITED RESPONSES TO ITS PROPOSALS ON A WIDE RANGE OF ISSUES WITH RESPECT TO THE SELF-REGULATORY SYSTEM. I WILL FOCUS PRINCIPALLY ON THE GENERAL ISSUE OF FUNDING SELF-REGULATION, THE METHODS BY WHICH MARKET DATA FEES ARE DETERMINED — WHICH IS OF PRIME IMPORTANCE TO US AS A DATA VENDOR AND TO OUR CLIENTS — AND THE BASIS ON WHICH THE COMMISSION SHOULD DETERMINE WHETHER AFFILIATES OF SELF-REGULATORY ORGANIZATIONS ("SROS") WILL OR

WILL NOT BE SUBJECT TO THE REGULATORY REQUIREMENTS IMPOSED ON THE SROS THEMSELVES.

THE ULTIMATE OBJECTIVE OF OUR SYSTEM OF REGULATION OF THE SECURITIES INDUSTRY SHOULD BE A BALANCE BETWEEN FEDERAL AND INDUSTRY REGULATION BASED UPON THE CONVICTION THAT FAIR AND ORDERLY MARKETS AND THE PROTECTION OF INVESTORS ARE THE BEST GUARANTORS OF CONFIDENCE IN THE SECURITIES MARKETS. WE SUPPORT THE ROLE OF SELF-REGULATION IN ACHIEVING THAT GOAL.

WE AGREE WITH THE COMMISSION THAT THERE ARE CONFLICTS OF INTEREST INHERENT IN SELF-REGULATORY ORGANIZATIONS ("SROS") THAT REQUIRE VIGILANCE, PERIODIC REVIEW AND ADJUSTMENT. ON THE WHOLE, HOWEVER, WE THINK THE SROS HAVE DEMONSTRATED THEIR CAPACITY – WHEN PRODDED BY THE SEC AND THE HILL — TO MAKE NECESSARY CHANGES.

THE SYSTEM CAN BE IMPROVED. WE DO NOT BELIEVE IT SHOULD BE REPLACED. ONE IMPROVEMENT WOULD BE TO SEPARATE THE FOR-PROFIT ARM FROM THE REGULATORY FUNCTIONS. ANOTHER WOULD BE TO ENHANCE TRANSPARENCY.

THE COMMISSION ITSELF NOTES IN THE MARKET DATA CONCEPT RELEASE, GREATER TRANSPARENCY IS ESSENTIAL TO THE INTEGRITY AND FURTHER EVOLUTION OF THE SYSTEM. WE AGREE.

GREATER TRANSPARENCY CONCERNING THE REVENUES AND EXPENSES OF SROS IS ESSENTIAL. IN THIS RESPECT, WE FULLY SUPPORT THE COMMISSION'S PROPOSAL IN THE SRO GOVERNANCE AND TRANSPARENCY PROPOSAL[1] TO REQUIRE EACH SRO TO PROVIDE THE COMMISSION WITH ANNUAL AND QUARTERLY REGULATORY REPORTS REGARDING KEY ASPECTS OF THE SRO'S REGULATORY PROGRAM, INCLUDING GREATER DISCLOSURE REGARDING REVENUES AND EXPENSES AND STAFFING OF ITS REGULATORY PROGRAM. THE VERY ABSENCE OF INFORMATION FROM THE SROS CONCERNING EXPENSES AND THE ALLOCATION OF REVENUES MAKES IT DIFFICULT TO REACH DETAILED CONCLUSIONS ABOUT MANY OF THE ISSUES THE COMMISSION HAS RAISED IN THE CONCEPT RELEASE AND HOW BEST TO ADDRESS THEM. UNTIL WE KNOW MORE ABOUT HOW THE SROS GENERATE REVENUES AND HOW THEY SPEND IT, IT IS DIFFICULT TO REACH ANY DEFINITIVE JUDGMENTS ABOUT HOW MUCH MONEY THEY SHOULD RECEIVE AND HOW THEY SHOULD SPEND IT. NONETHELESS, SOME JUDGMENT CAN BE REACHED ON THE BASIS OF WHAT IS KNOWN.

THE COMMISSION WAS NOTABLY ON THE RIGHT TRACK IN PROPOSING LIMITATIONS ON THE VOTING POWER ANY SINGLE PERSON COULD AMASS IN THE NYSE OR OTHER SROS. THAT STEP SHOULD

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[1] Securities Exchange Act Release No. 50699 (November 18, 2004).

USEFULLY PREVENT ANYONE FROM TAKING A DOMINANT OR CONTROLLING INTEREST IN ANY OF OUR MAJOR MARKET CENTERS.

IV. MARKET DATA REVENUES — THE COST OF INFORMATION

MARKET DATA IS THE "OXYGEN" OF THE FINANCIAL MARKETS. ENSURING THAT MARKET DATA IS AVAILABLE IN A FASHION WHERE IT IS BOTH AFFORDABLE TO RETAIL INVESTORS AND WHERE MARKET PARTICIPANTS HAVE THE WIDEST POSSIBLE LATITUDE TO ADD VALUE TO THAT DATA MUST BE CRITICAL PRIORITIES.

BEFORE THE 1970S, NO STATUTE OR SEC RULE REQUIRED SROS TO DISSEMINATE MARKET INFORMATION TO THE PUBLIC OR TO CONSOLIDATE QUOTES OR LAST-SALE DATA WITH INFORMATION FROM OTHER MARKET CENTERS. INDEED, THE NYSE, WHICH OPERATED THE LARGEST STOCK MARKET, CLAIMED AN OWNERSHIP INTEREST IN MARKET DATA, SEVERELY RESTRICTING ACCESS TO MARKET INFORMATION. MARKETS AND INVESTORS SUFFERED FROM THIS LACK OF TRANSPARENCY. ALSO, INTER-MARKET COMPETITION WAS STIFLED.

AT THE URGING OF THE SEC, CONGRESS RESPONDED BY ENACTING THE SECURITIES ACTS AMENDMENTS OF 1975. THESE AMENDMENTS EMPOWERED THE SEC TO FACILITATE THE CREATION OF A NATIONAL MARKET SYSTEM FOR SECURITIES, WITH MARKET PARTICIPANTS REQUIRED TO PROVIDE — IMMEDIATELY AND WITHOUT

COMPENSATION — INFORMATION FOR EACH SECURITY THAT WOULD THEN BE CONSOLIDATED INTO A SINGLE STREAM OF INFORMATION.

AT THE TIME, CONGRESS CLEARLY RECOGNIZED THE DANGERS OF DATA-PROCESSING MONOPOLIES. THE REPORT ACCOMPANYING THE 1975 AMENDMENTS EXPRESSLY WARNS THAT:

> "PROVISION MUST BE MADE TO INSURE THAT THIS CENTRAL PROCESSOR IS NOT UNDER THE CONTROL OR DOMINION OF ANY PARTICULAR MARKET CENTER. ANY EXCLUSIVE PROCESSOR IS, IN EFFECT, A PUBLIC UTILITY, AND THUS IT MUST FUNCTION IN A MANNER WHICH IS ABSOLUTELY NEUTRAL WITH RESPECT TO ALL MARKET CENTERS, ALL MARKET MAKERS, AND ALL PRIVATE FIRMS." Report of the Senate Comm. on Banking, Housing, and Urban Affairs To Accompany S.249, S. Rep. No. 94-75, 94th Cong., 1st Sess. 11 (1975).

TODAY, UNDER THE NEW WORLD OF REG NMS, THE VERY SAME CONCERNS APPLY TO EXCLUSIVE SECURITIES INFORMATION PROCESSORS, SUCH AS THE NYSE, THAT COLLECT AND DISTRIBUTE INFORMATION ON AN EXCLUSIVE BASIS. THE COMMISSION SHOULD NOT BE ANY LESS VIGILANT IN POLICING THE CONDUCT OF SUCH EXCLUSIVE PROCESSORS TO GUARD AGAINST THE ABUSES THE CONGRESS SO APTLY WARNED AGAINST.

EVEN AS NOT-FOR-PROFIT ENTITIES, SROS HISTORICALLY HAVE EXPLOITED THE OPPORTUNITY TO SUBSIDIZE OTHER COSTS (E.G., EXECUTIVE COMPENSATION, COST OF MARKET OPERATION, MARKET REGULATION, MARKET SURVEILLANCE, MEMBER REGULATION) THROUGH THEIR GOVERNMENT-SPONSORED MONOPOLY ON MARKET INFORMATION FEES. WHILE THIS SUBSIDY IS TROUBLING ENOUGH, THE INCENTIVE TO EXPLOIT THIS MONOPOLY POSITION WILL BE EVEN STRONGER AS SROS ENTER THE FOR-PROFIT WORLD AND CONTEMPLATE NEW LINES OF BUSINESS.

BEFORE THE NYSE/ARCA AND NASDAQ/INET MERGERS WERE ANNOUNCED, THE SEC LAUNCHED A PUBLIC DISCUSSION OF MARKET DATA REVENUES AND WHETHER THEY SHOULD BE COST-BASED. BLOOMBERG STRONGLY SUPPORTS COST-BASED LIMITS ON MARKET INFORMATION FEES AND BELIEVES THE IMPENDING FOR-PROFIT STATUS OF THE NYSE LENDS GREATER URGENCY TO THIS INITIATIVE.

IN ITS 1999 CONCEPT RELEASE ON MARKET DATA, THE COMMISSION NOTED THAT MARKET DATA SHOULD BE FOR THE BENEFIT OF THE INVESTING PUBLIC. INDEED, MARKET DATA ORIGINATES WITH SPECIALISTS, MARKET MAKERS, BROKER-DEALERS AND INVESTORS. THE EXCHANGES AND THE NASDAQ MARKETPLACE ARE NOT THE SOURCES OF MARKET DATA, BUT RATHER THE FACILITIES THROUGH WHICH MARKET DATA ARE COLLECTED — PURSUANT TO REGULATORY FIAT AND

WITHOUT COMPENSATION TO INVESTORS OR THEIR BROKERS — AND DISSEMINATED. IN ITS 1999 RELEASE, THE SEC PROPOSED A COST-BASED LIMIT TO MARKET DATA REVENUES.

THAT COST-BASED APPROACH WOULD NOT REQUIRE THE NYSE AND NASDAQ TO SELL THE DATA AT COST. INSTEAD, IT WOULD REQUIRE THE CHARGES TO BE REASONABLY RELATED TO THE COST OF COLLECTING AND DISSEMINATING THE DATA, WITH A PERMITTED PROFIT THAT, LIKE OTHER PUBLIC-UTILITY RATES, REFLECTS THE PROTECTED MONOPOLIES THE NYSE AND NASDAQ ENJOY. TODAY, *AS NOT-FOR-PROFIT ENTITIES* THE SRO NETWORKS SPEND ABOUT $40 MILLION ON COLLECTION AND DISSEMINATION AND RECEIVE OVER TEN TIMES THAT MUCH — $424 MILLION — IN REVENUES.[2] YET, A DETAILED ACCOUNTING OF THESE REVENUES, INCLUDING THE UNDERLYING COSTS TO THE SROS OF PRODUCING THE DATA, AND AN ACCOUNT OF THE USE OF THESE REVENUES HAS BEEN UNAVAILABLE.

THE PROPOSED MERGERS WILL, OF COURSE, SUBSTANTIALLY INCREASE THE AMOUNT OF MONEY THAT INVESTORS WILL BE PAYING FOR MARKET DATA. HISTORICALLY, ISLAND, INSTINET, BRUT AND

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2 *See*, Regulation NMS, Securities Exchange Act Release No. 50870 (December 16, 2004) in text accompanying n. 286:

> In 2003, the Networks collected $424 million in revenues derived from market data fees and, after deduction of Network expenses, distribute $386 million to their individual SRO participants. [footnote omitted].

ARCHIPELAGO HAVE MADE ALL MARKET DATA — NOT JUST THE NATIONAL BEST BID AND OFFER BUT THEIR ENTIRE BOOK — AVAILABLE FOR FREE. ALL OF THESE VENUES — AS INDEPENDENT ENTITIES COMPETING WITH NASDAQ AND THE NYSE — FOUND THAT MAKING THIS DATA AVAILABLE FOR FREE GENERATED SO MUCH PUBLIC TRADING THAT DOING SO WAS AN ECONOMIC WINNER. AS THESE COMPETITORS DISAPPEAR UNDER THE PROPOSED MERGERS, THE FREE DEPTH OF BOOK WILL ALSO DISAPPEAR. COUPLED WITH THE CHANGED INCENTIVES OF FOR-PROFIT EXCHANGES, THE PUBLIC MAY WELL BE LOOKING AT PAYING A BILLION DOLLARS IN ANNUAL MARKET DATA FEES.

THOSE REVENUES COME FROM INVESTORS. IF INVESTORS ARE PAYING ROUGHLY TEN TIMES THE COST OF CONSOLIDATION WHEN DEALING WITH NOT-FOR-PROFIT ENTITIES WHERE SIGNIFICANT COMPETING VENUES ARE POTENTIALLY RESTRAINING COSTS, WHAT WILL INVESTORS BE PAYING WHEN THOSE COMPETITORS CEASE TO EXIST AND THE NYSE AND NASDAQ ARE FOR-PROFIT ENTITIES CHARGED WITH MAXIMIZING SHAREHOLDER INTEREST?

UNDER "BEST EXECUTION" OBLIGATIONS, MOREOVER, EACH BROKER-DEALER IS REQUIRED BY LAW TO ASCERTAIN WHAT TRADING VENUE HAS THE BEST PRICE IN EVERY STOCK, EVERY MILLISECOND. AS HAVING COMPLETE ACCESS TO THIS DATA IS EFFECTIVELY REQUIRED BY

LAW, BROKER-DEALERS HAVE ABSOLUTELY NO CAPACITY TO BARGAIN OVER THE PRICE OF THIS DATA.

WE URGE THE SEC TO MOVE EXPEDITIOUSLY TO ADDRESS THE MARKET DATA ISSUE AS PART OF REG SRO, AND WE EMBRACE THE CALL BY THE SECURITIES INDUSTRY ASSOCIATION (SIA) FOR A COST-BASED APPROACH TO MARKET DATA FEES. INDEED, IT'S POWERFUL TESTIMONY WHEN AN ORGANIZATION LIKE THE SIA NOT ONLY OPPOSES THE EXPENDITURE OF MARKET DATA FEES FOR REGULATION BUT ALSO FAVORS THE IMPOSITION OF SEPARATELY CHARGED AND TRANSPARENTLY ACCOUNTED-FOR REGULATORY FEES, TO COVER THE REGULATORY COSTS.[3] IT SPEAKS VOLUMES ABOUT THE FEARS THAT INFORMED MARKET PARTICIPANTS HAVE ABOUT THE CURRENT MARKET DATA FEE STRUCTURE THAT THEY WOULD PREFER TO HAVE A SEPARATE FEE LEVIED ON THEM THAN TO CONTINUE WITH THE STATUS QUO.

THE SROS COLLECTIVELY ENJOY A GOVERNMENT-SPONSORED MONOPOLY THAT PROTECTS THEM FROM COMPETITION — AND FROM RISK. MARKET DATA FEES ARE NOT SET IN AN OPEN OR COMPETITIVE PROCESS. NEITHER THE ROLE OF THE NETWORKS IN NEGOTIATING FEES NOR THE NOTICE-AND-COMMENT PERIOD THE COMMISSION PROVIDES ON FEE FILINGS ARE AN EFFECTIVE SUBSTITUTE

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[3] SIA letter to SEC (June 30, 2004) in SEC File No. S7-10-04, at page 23.

FOR THE PRICE-FORMATION MECHANISM OF COMPETITIVE MARKETS OR FOR MORE VIGOROUS GOVERNMENTAL OVERSIGHT. WE NOTE THAT THE COMMISSION REMAINS CONCERNED ABOUT WHAT IT HAS CHARACTERIZED AS A "COST-OF-SERVICE RATEMAKING APPROACH" TO MARKET DATA FEES, BUT THE CURRENT SYSTEM DOES NOT ADEQUATELY PROTECT INVESTORS FROM OVERCHARGES.

THE EXISTENCE OF REBATING OF MARKET DATA FEES TO ATTRACT AND KEEP ORDER FLOW AND TAPE SHREDDING IS EVIDENCE ENOUGH THAT FEES ARE MUCH TOO HIGH. INDEED, IT'S QUITE POSSIBLE THAT THE DRAMATICALLY SHRINKING SIZE OF THE AVERAGE TRANSACTION IS A REFLECTION OF CHURNING TO GENERATE MARKET DATA REVENUES.

EVERY INVESTOR WHO BUYS AND SELLS STOCKS HAS A LEGITIMATE CLAIM TO THE OWNERSHIP OF THE DATA AND LIQUIDITY HE OR SHE PROVIDES TO MARKET CENTERS. FUNNELING EXCLUSIVE LIQUIDITY INFORMATION TO EXCHANGE MEMBERS AND FUNNELING MARKET DATA REVENUES TO EXCHANGES AND NASDAQ AND NOT TO PUBLIC INVESTORS SHIFTS THE REWARDS FROM THOSE WHO TRADE — THAT IS TO SAY, THE INVESTORS — TO THOSE WHO FACILITATE TRADING. THE BENEFITS OUGHT TO BE CONFERRED UPON THE PUBLIC.

WHILE THE COMMISSION DOES NOT HAVE THE ROLE OF A RATE SETTER, IT DOES HAVE A STATUTORY RESPONSIBILITY TO

VIGOROUSLY OVERSEE THE SROS AND TO BE CERTAIN THAT THE FEES THEY SET ARE FAIR, REASONABLE AND NON-DISCRIMINATORY. IN FACT, GREATER TRANSPARENCY AS TO THE EXCHANGES' COSTS AND MARK-UPS OVER THEIR COSTS WOULD ALLOW THE MARKET TO PROD THE COMMISSION INTO INSISTING ON RATES THAT ARE FAIR WITHOUT THE NEED FOR EXCESSIVE GOVERNMENT INTERVENTION.

V. MARKET DATA — ACCESS TO INFORMATION

AS POLICY MAKERS CONTEMPLATE REFORMING SROS, IT IS CRITICAL THAT THE FINAL STRUCTURE ENCOURAGE TRANSPARENCY AND ACCESS TO INFORMATION. THE ADVENT OF DECIMALIZATION HAS CREATED NEW CHALLENGES IN THIS REGARD.

DECIMALIZATION HAS BEEN A BOON TO INVESTORS, DRAMATICALLY REDUCING SPREADS, AND A SPUR TO MARKET EFFICIENCY. HOWEVER, THE RULES GOVERNING THE DISPLAY OF MARKET DATA — RULES CRAFTED IN AN ERA OF EIGHTHS AND SIXTEENTHS — HAVE NEVER BEEN UPDATED TO REFLECT DECIMALIZATION.

SINCE DECIMALIZATION INTRODUCED 100 PRICE POINTS TO THE DOLLAR IN PLACE OF THE PREVIOUS EIGHT OR SIXTEEN, THE AMOUNT OF LIQUIDITY AVAILABLE AT THE NATIONAL BEST BID AND OFFER IS MUCH SMALLER THAN BEFORE. AS A RESULT, THERE HAS BEEN

A DRAMATIC DIMINUTION IN TRANSPARENCY AND LIQUIDITY AT THE INSIDE QUOTATIONS.

THE SIA, IN COMMENTING ON REG NMS, ACCURATELY OBSERVED: "THE VALUE OF THE NBBO — THE CORNERSTONE OF THE MARKET DATA SYSTEM — IS LESS THAN IT WAS PRIOR TO DECIMALIZATION. WE BELIEVE THAT THE SEC HAS A RESPONSIBILITY TO ADDRESS THIS ISSUE IN LIGHT OF THE OPERATION OF ITS QUOTE AND DISPLAY RULES" [RULES 602 AND 603 UNDER EXCHANGE ACT REG NMS]. SIA, Comment letter on Regulation NMS (February 1, 2005) at p. 24, in SEC File No. S7-10-04.

THUS, BLOOMBERG L.P. WAS ENCOURAGED WHEN, LATE IN 2002, THE NYSE FILED WITH THE SEC A PROPOSED RULE CHANGE THAT WOULD PERMIT THE DISPLAY AND USE OF QUOTATIONS IN STOCKS TRADED ON THE NYSE TO SHOW ADDITIONAL DEPTH IN THE MARKET FOR THOSE STOCKS.

THE GOOD NEWS — THE NYSE'S "LIQUIDITY QUOTE" AND "OPENBOOK" PROPOSALS HOLD THE PROMISE OF ULTIMATELY RESULTING IN THE DISPLAY OF ADDITIONAL DEPTH. THE BAD NEWS — THE NYSE PROPOSED TO EXPLOIT ITS STATUS AS A GOVERNMENT-SPONSORED MONOPOLY TO REQUIRE SOME VENDORS TO SIGN CONTRACTS THAT WOULD HAVE PLACED SEVERE RESTRICTIONS ON THE USE OF THIS DATA. THOSE RESTRICTIONS WOULD HAVE REQUIRED

VENDORS TO ADVANTAGE THE NYSE OVER COMPETING MARKET CENTERS WHEN IT CAME TO THE DISPLAY OF DECIMALIZED DATA WHILE ALSO PRECLUDING BLOOMBERG FROM ADDING VALUE TO THIS DATA IN A WAY THAT BENEFITS INVESTORS AND THE MARKETS. THE NYSE'S ORIGINAL PROPOSAL WOULD HAVE PROHIBITED DATA VENDORS FROM INTEGRATING NYSE LIQUIDITY QUOTE DATA WITH DATA FROM OTHER MARKET CENTERS.

IN SHORT, THE PROMISE OF ENHANCED TRANSPARENCY AT THE HEART OF DECIMALIZATION WOULD HAVE BEEN THWARTED. INSTEAD, THE NYSE PROPOSED TO LEVERAGE ITS GOVERNMENT-SPONSORED MONOPOLY OVER MARKET DATA DOWNSTREAM TO UNFAIRLY DISADVANTAGE NOT ONLY COMPETITORS IN THE INFORMATION MARKET, BUT ALSO COMPETITORS IN THE TRADING MARKET. ALONG WITH OTHER MARKETS, TRADING VENUES AND MARKET DATA VENDORS, MIDDLE MARKET AND SMALLER INVESTORS WHO CAN'T AFFORD TO MAINTAIN THEIR OWN COMPUTER FACILITIES WOULD HAVE BEEN PARTICULARLY DISADVANTAGED.

AFTER EXTENSIVE REVIEW AND ANALYSIS, THE SEC ON APRIL 2, 2003 UNANIMOUSLY STRUCK DOWN THE NYSE'S RESTRICTIVE CONTRACTS. ON THE NYSE'S EFFORTS TO ESTABLISH BARRIERS THAT PREVENT VENDORS FROM INTEGRATING LIQUIDITY QUOTES WITH QUOTATIONS FROM OTHER MARKETS, THE COMMISSION HELD THESE

BARRIERS WOULD: "IMPOSE ON USERS INTEGRATION COSTS WITH RESPECT TO IMMEDIATELY EXECUTABLE, MARKET-WIDE QUOTATIONS IN A MANNER THAT WOULD: (1) BE INCONSISTENT WITH FOSTERING "COOPERATION AND COORDINATION WITH PERSONS ENGAGED IN PROCESSING INFORMATION WITH RESPECT TO SECURITIES"; (2) "BE DESIGNED TO PERMIT UNFAIR DISCRIMINATION BETWEEN CUSTOMERS"; AND (3) IMPEDE, RATHER THAN REMOVE IMPEDIMENTS TO, A "FREE AND OPEN MARKET AND A NATIONAL MARKET SYSTEM." Securities Exchange Act Release No. 47614 (April 2, 2003), SEC File No. SR-NYSE-2002-55.

ULTIMATELY, NUMEROUS MARKET PARTICIPANTS — INCLUDING THE U.S. CHAMBER OF COMMERCE, SIA, STA, AMERITRADE, THE PHILADELPHIA EXCHANGE AND OTHERS — ROSE IN OPPOSITION TO THE NYSE'S ANTI-COMPETITIVE CONTRACT AND IN FAVOR OF THE SEC'S ACTIONS.[4] THE NYSE HAS ATTEMPTED TO ENFORCE SIMILAR RESTRICTIONS ON COMPARABLE DATA IN THE PENDING OPEN BOOK CONTROVERSY.

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[4] The Commission appropriately blocked the NYSE's efforts to impose via contracts with market vendors improper limits on Liquidity Quote, which is substantially similar in operation to Open Book. These improper limits would have diminished the opportunity for competing market centers to offer comparable transparency. *Matter of Bloomberg*, Securities Exchange Act Release No. 49076 (January 14, 2004), avail. at: http://www.sec.gov/litigation/opinions/34-49076.htm. The NYSE has refiled its Liquidity Quote proposal with the Commission. There still are imperfections and shortcomings in Open Book. This issue continues to be under review at the Commission.

A FOR-PROFIT NYSE WILL HAVE AN EVEN GREATER INCENTIVE TO PUSH AGGRESSIVELY ON ISSUES LIKE LIQUIDITY QUOTE AND OPEN BOOK, WHERE THE NYSE'S IDEA OF COMPETITION WAS TO EXPLOIT ITS MONOPOLY TO BAN OTHERS FROM COMPETING. IF THERE IS CONSOLIDATION IN THE MARKET BECAUSE THE MARKET DEMANDS IT, THAT IS A GOOD THING. IF THERE IS CONSOLIDATION IN THE MARKET BECAUSE A GOVERNMENT-SPONSORED MONOPOLY IS ABLE TO LEVERAGE ITS MONOPOLY POSITION IN A MANNER THAT PRECLUDES INVESTORS FROM SEEING COMPETING MARKETS, THAT IS A BAD THING.

THE SEC IS TO BE COMMENDED FOR ITS EXTRAORDINARY COMMITMENT OF TIME AND EFFORT IN ANALYZING THIS ISSUE. THAT KIND OF OVERSIGHT WILL NEED TO BE THE MODEL IF WE ARE TO HAVE A REGULATORY SYSTEM THAT PROTECTS INVESTORS DESPITE INCREASINGLY CONCENTRATED AND CONFLICTED MARKETS.

I'D CONCLUDE MY DISCUSSION OF ACCESS TO INFORMATION BY NOTING THAT THE CURRENT PRICING PROPOSAL FOR REAL-TIME OPEN BOOK DATA – LIKE THE PREVIOUSLY PROPOSED PRICING ON LIQUIDITY QUOTE -- IS YET ANOTHER EXAMPLE OF THE ONGOING CONTROVERSY REGARDING SROs PROPOSING MARKET DATA FEES WITHOUT COST JUSTIFICATION. THE FEES THE NYSE PROPOSES TO CHARGE FOR ACCESS TO OPEN BOOK DATA ON A REAL-TIME BASIS ARE APPROXIMATELY EQUAL TO THE FEES THE NYSE CURRENTLY CHARGES FOR ACCESS TO ALL

OTHER NYSE MARKET DATA ON A REAL-TIME BASIS — ABOUT $50 A MONTH PER USER. THESE FEES WOULD EFFECTIVELY ***DOUBLE*** THE AVERAGE FEES INVESTORS PAY TODAY FOR NYSE REAL-TIME DATA IF THE INVESTORS SUBSCRIBE TO OPENBOOK. SINCE DECIMALIZATION HAS REDUCED THE VALUE OF THE EXISTING BBO DATA, THE INVESTORS WOULD EFFECTIVELY BE PAYING TWICE TO RECEIVE INFORMATION EQUIVALENT IN ECONOMIC VALUE TO WHAT THEY USED TO RECEIVE BEFORE DECIMALIZATION. THE NYSE SHOULD NOT BE ABLE TO EXTRACT THESE KINDS OF MONOPOLY RENTS FROM THE MARKETS AND INVESTORS WITHOUT JUSTIFICATION AND WITHOUT EVEN A CURSORY SHOWING OF THE COSTS INVOLVED IN PRODUCING THESE DATA.

VI. FUNDING MARKET REGULATION

EFFECTIVE SELF-REGULATION BY THE EXCHANGES COSTS MONEY. WHAT IS AT ISSUE IS HOW TO PAY FOR IT. SOME ARGUE THAT MARKET DATA FEES SHOULD BE USED TO CROSS-SUBSIDIZE SRO REGULATORY OPERATIONS. WE RESPECTFULLY SUBMIT THAT IT IS NEITHER NECESSARY NOR DESIRABLE THAT REGULATION BE PAID FOR WITH MARKET DATA FEES. THE ARGUMENT THAT DATA FEES SHOULD PAY FOR MARKET REGULATION BECAUSE MARKET REGULATION IS NECESSARY TO SAFEGUARD THE INTEGRITY OF THE TRADING AND THUS THE DATA IS UNPERSUASIVE AND INDEED ILLOGICAL. IT IS NO MORE TRUE THAN IT IS TRUE THAT OTHER ASPECTS OF SRO OPERATIONS ARE

ESSENTIAL TO THE CREATION OF DATA, SUCH AS EXECUTIVE COMPENSATION, OPERATING COSTS OF FLOOR FACILITIES AND GENERAL OVERHEAD OF VARIOUS KINDS WITHOUT WHICH AN SRO WOULD HAVE TO SHUT ITS DOORS. INDEED, THE COSTS OF MARKET SURVEILLANCE AND REGULATION, HOWEVER WORTHY AND NECESSARY TO AN SRO'S OPERATION, HAVE NO NECESSARY CONNECTION TO THE DATA THEMSELVES.

THE BEST WAY TO ENSURE TRANSPARENT ACCOUNTING FOR THE COSTS OF REGULATION IS THROUGH A SEPARATE AND DISTINCT ALLOCATION OF FUNDS TO PAY FOR REGULATION. THE SEC SHOULD APPLY RIGOROUS, COST-BASED ACCOUNTING IN ASSESSING THE REASONABLENESS OF MARKET DATA FEES. THE PUBLIC NEEDS A TRUE AND FAIR ASSESSMENT OF THE REASONABLENESS OF MARKET DATA FEES.

VII. EFFECTIVE REGULATION

THE ISSUE OF ADEQUATE FUNDING FOR SRO REGULATION GOES TO THE QUESTION OF PROVIDING ADEQUATE REGULATION. THE DISCUSSION OF ALTERNATIVES TO THE CURRENT STRUCTURE OF SROS CONSIDERS WHETHER ANY OF THE COMMISSION'S PROPOSED STRUCTURAL CHANGES WOULD INCREASE SRO REGULATORY INDEPENDENCE. WE DO NOT BELIEVE IT WOULD BE FEASIBLE OR DESIRABLE FOR THE SEC ITSELF TO BE SOLELY RESPONSIBLE FOR

MARKET AND MEMBER REGULATION. THE OTHER FOUR PROPOSALS ADVANCED BY THE COMMISSION IN THE SRO CONCEPT RELEASE ARE VARIATIONS ON TWO PROPOSALS: A HYBRID MODEL THAT WOULD SEPARATE MEMBER REGULATION FROM MARKET REGULATION AND A SINGLE REGULATOR, WHETHER AN INDUSTRY SELF-REGULATOR OR A NON-INDUSTRY REGULATOR MODELED ON THE PCAOB.

FORMING SEPARATE AND INDEPENDENT CORPORATE SUBSIDIARIES ON THE MODEL OF THE NASD CORPORATE STRUCTURE MERITS FURTHER CONSIDERATION, COUPLED WITH TRANSPARENCY AND DISCLOSURE. IF MARKET PARTICIPANTS ARE PROVIDED WITH GREATER TRANSPARENCY AND DISCLOSURE, THEY WILL BE EMPOWERED TO "WATCH THE WATCHERS" AND HELP ENSURE SUCCESSFUL SELF-REGULATION.

THERE ARE A COUPLE OF THINGS THAT CAN BE DONE EVEN BEFORE ADDRESSING THESE LARGER STRUCTURAL ISSUES. FIRST, EXISTING OPPORTUNITIES FOR REGULATORY ARBITRAGE BETWEEN AND AMONG REGULATORY SYSTEMS SHOULD BE REMOVED. THE MOST NOTORIOUS OF THESE IS THE EXEMPTION FROM SHORT-SALE REGULATION FOR TRADING NASDAQ SECURITIES ON THE REGIONAL EXCHANGES. SECOND, REGARDLESS OF ANY CHANGES TO THE STRUCTURE OF THE SELF-REGULATORY SYSTEM, WE BELIEVE THERE SHOULD BE A CONSOLIDATED INFORMATIONAL BASE THAT ALL REGULATORS SHOULD BE ABLE TO DRAW ON. HAVING SEPARATE AND

UNCOORDINATED REGULATORY DATA IS INEFFICIENT AND DETRACTS FROM THE QUALITY OF REGULATION. IT MAY BE, FOR EXAMPLE, THAT THE OATS SYSTEM AND THE NYSE'S ORDER-TRACKING SYSTEM WOULD PROVIDE A BASIS FOR CREATING A UNIFIED INDUSTRY UTILITY. THE COMMISSION ITSELF IS IN THE BEST POSITION TO MAKE THAT DETERMINATION. WHETHER ADDED TO THE PRESENT INFRASTRUCTURE OR USED FOR AN ENTIRELY NEW INFRASTRUCTURE, HOWEVER, WE BELIEVE UP-TO-DATE TECHNOLOGY SHOULD BE DEPLOYED TO MAKE REGULATION AND SURVEILLANCE BOTH EFFECTIVE AND COST-EFFICIENT. WE FULLY AGREE WITH THE SECURITIES INDUSTRY ASSOCIATION PROPOSAL FOR THE CREATION OF A NEUTRAL INDUSTRY UTILITY SUCH AS THE DEPOSITORY TRUST AND CLEARING CORPORATION TO MAINTAIN A CONSOLIDATED ORDER AUDIT TRAIL WITH THE COSTS OF DEVELOPMENT AND MAINTENANCE SHARED ACROSS THE INDUSTRY.

VIII. AFFILIATED ENTITIES

FINALLY, IN THE SRO GOVERNANCE AND TRANSPARENCY PROPOSAL, THE COMMISSION ASKS WHETHER ENTITIES AFFILIATED WITH AN SRO SHOULD BE SUBJECT TO THE SAME DEGREE OF REGULATION AS THE SROS THEMSELVES WITH RESPECT TO THEIR CHARTERS, BY-LAWS AND RULES. WE THINK THE COMMISSION TOOK THE CORRECT APPROACH TO THIS ISSUE IN ITS ORDER GRANTING NASDAQ TOOLS A CONDITIONAL EXEMPTION FROM VARIOUS FILING AND RULE-MAKING PROCEDURES.

ON MARCH 7, 2000, NASDAQ PURCHASED FINANCIAL SYSTEMWARE, INC., A MANUFACTURER OF SOFTWARE PRODUCTS, AND FORMED A WHOLLY OWNED SUBSIDIARY THAT HAS BEEN NAMED NASDAQ TOOLS, INC. ("NASDAQ TOOLS"). THROUGH A SERIES OF STEPS, THE COMMISSION GRANTED NASDAQ AN EXEMPTION (THE "FSI EXEMPTION") THAT ALLOWS NASDAQ TO AVOID TREATING FSI'S BUSINESS AS SUBJECT TO THE REGULATORY REQUIREMENTS, INCLUDING THE RULE-FILING REQUIREMENTS, APPLICABLE TO THE NASD AND NASDAQ THEMSELVES.[5]

IN GRANTING THE FSI EXEMPTION, THE COMMISSION RECOGNIZED THE DANGER OF NASDAQ'S LEVERAGING ITS TRADING MONOPOLY INTO A COMPETITIVE ADJACENT MARKET AND IMPOSED CONDITIONS TO PREVENT THAT LEVERAGING. IN PARTICULAR, THE COMMISSION CONDITIONED THE EXEMPTION ON THE PRESENCE OF EFFECTIVE COMPETITION IN THE PROVISION OF ORDER-MANAGEMENT SYSTEM SERVICES AND SOFTWARE TO MARKET MAKERS, AND REQUIRED THAT NASD ENCOURAGE THE DEVELOPMENT OF SOFTWARE BY NASD MEMBERS AND COMPETING SOFTWARE VENDORS. TO MAINTAIN THE OPPORTUNITY FOR WHAT IT CALLED FAIR COMPETITION, THE COMMISSION REQUIRED NASD AND NASDAQ TO CONTINUE TO PROVIDE

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[5] Securities Exchange Act Release No. 44201 (April 18, 2001).

OPEN-ARCHITECTURE SYSTEMS THAT ENABLE FULL PUBLIC ACCESS TO NASD'S FACILITIES.

THE COMMISSION ALSO REQUIRED THAT IT NOT BE NECESSARY, CURRENTLY OR IN THE FUTURE, TO USE THE SOFTWARE MARKETED BY FSI TO ACCESS NASDAQ OR ANY OTHER NASD MARKET-RELATED FACILITY AND THAT FULL AND FAIR PUBLIC ACCESS TO NASDAQ BE AVAILABLE. THUS, BROKERS AND DEALERS THAT WISH TO ACCESS NASDAQ ARE NOT TO BE FORCED TO PURCHASE OR USE FSI PRODUCTS OR SERVICES. NASD AND NASDAQ ALSO AGREED TO TREAT FSI IN THE SAME WAY AS ANY OTHER THIRD-PARTY VENDOR — AND NOT TO GIVE IT ANY SPECIAL ADVANTAGES REGARDING PLANNED OR ACTUAL CHANGES TO NASDAQ. SPECIFICALLY, FSI WOULD NOT BE GIVEN ANY ADVANCE OR PRIVATE KNOWLEDGE OF SUCH CHANGES. IN ADDITION, TO ENFORCE AND EMPHASIZE THE SEPARATION OF NASDAQ AND FSI, THE COMMISSION REQUIRED THAT THE TWO COMPANIES HAVE SEPARATE AND DISTINCT OFFICE SPACE AND PROHIBITED THEM FROM SHARING EMPLOYEES. THE COMMISSION ALSO SPECIFICALLY NOTED THAT NASD AND NASDAQ PROPOSED THAT NASDAQ WOULD OPERATE FSI AS A STAND-ALONE BUSINESS, CAPITALIZED SEPARATELY AND NOT SUBSIDIZED BY NASD MEMBERS OR OTHER REVENUES OF NASD OR NASDAQ.

WE BELIEVE THE FSI EXEMPTION PROVIDES BOTH A USEFUL MODEL AND PRECEDENT FOR THE STRUCTURAL SEPARATION OF AN SRO

AND AN AFFILIATE. IN EXCHANGE FOR FREEING SRO AFFILIATES FROM SRO-LIKE REGULATION, THE FSI EXEMPTION REQUIRES THAT AFFILIATED ENTITIES ARE EFFECTIVELY SEPARATE FROM THEIR SRO PARENTS AND ENSURES THAT SROS DO NOT LEVERAGE THEIR GOVERNMENT-CONFERRED MONOPOLIES TO SUBSIDIZE THEIR ENTRY INTO COMPETITIVE MARKETS.

IN 2002, BLOOMBERG L.P., IN CONSULTATION WITH TWO DISTINGUISHED ECONOMISTS — DR. GEORGE HAY, THE FORMER DIRECTOR OF ECONOMICS OF THE ECONOMIC POLICY OFFICE OF THE ANTITRUST DIVISION OF THE UNITED STATES DEPARTMENT OF JUSTICE AND DR. ERIK SIRRI, A FORMER CHIEF ECONOMIST OF THE SEC — SUBMITTED TO THE SEC A DISCUSSION PAPER ENTITLED "COMPETITION, TRANSPARENCY, AND EQUAL ACCESS TO FINANCIAL MARKET DATA". THE PAPER DELINEATED THE WAYS IN WHICH THE EXCHANGES, IN THE ABSENCE OF STRUCTURAL PROTECTIONS, MAY ABUSE THEIR MONOPOLY POWER OVER THE COLLECTION OF MARKET INFORMATION TO THE DETRIMENT OF CONSUMERS, COMPETITORS AND THE NATIONAL MARKET SYSTEM. THE PAPER PROPOSED STRUCTURAL CHANGES – MODELED ON THE FSI EXEMPTION -- TO ADDRESS THESE POSSIBLE ABUSES. THE CONCERNS EXPRESSED IN THE PAPER HAVE BEEN BORNE OUT BY BLOOMBERG L.P.'S THREE YEAR-LONG CONFLICT WITH THE NYSE OVER RESTRICTIONS THE NYSE HAD HOPED TO IMPOSE ON THE DISSEMINATION OF DECIMALIZED INFORMATION TO INVESTORS, DISCUSSED ABOVE. THIS

UNDERSCORES THE NEED FOR CONTINUED VIGILANCE BY POLICY MAKERS, ESPECIALLY AS WE ENVISION MARKETS CHARACTERIZED BY FOR-PROFIT EXCHANGES AND HIGH LEVELS OF CONCENTRATION.

IX. UPDATING THE VENDOR DISPLAY RULE FOR A DECIMALIZED WORLD

CONGRESS AND THE COMMISSION SHOULD GIVE STRONG CONSIDERATION TO UPDATING THE VENDOR DISPLAY RULE TO REFLECT THE REALITIES OF DECIMALIZED TRADING. THE VENDOR DISPLAY RULE WAS ADOPTED WHEN THERE WERE EIGHT PRICE POINTS TO THE DOLLAR AND IT REQUIRES CONSOLIDATED INFORMATION ONLY WITH RESPECT TO THE BEST BID AND OFFER. UNLESS THE VENDOR DISPLAY RULE IS UPDATED, INVESTORS RISK HAVING LESS USEFUL INFORMATION THAN EXISTED BEFORE DECIMALIZATION. SPECIFICALLY, WE WOULD URGE THE SEC TO CONSIDER:

- AMENDING THE LIMIT ORDER DISPLAY RULE, RULE 604 IN REG NMS, TO REQUIRE EXCHANGES, MARKET MAKERS AND OTHER MARKET CENTERS (INCLUDING ECNS) TO PUBLISH ANY CUSTOMER LIMIT ORDERS RECEIVED OR COMMUNICATED TO OTHERS WITHIN FIVE CENTS OF THEIR BEST PUBLISHED QUOTATIONS (THAT IS TO SAY, FIVE CENTS ABOVE THE BEST OFFER AND FIVE CENTS BELOW THE BEST BID).

- AMENDING THE VENDOR DISPLAY RULE, RULE 603 IN REG NMS, TO REQUIRE VENDORS, SUCH AS BLOOMBERG L.P., TO CARRY ON THE SAME TERMS AS TOP-OF-FILE QUOTATIONS ALL DEPTH-OF-BOOK QUOTATIONS PUBLISHED BY ANY MARKET CENTER, AS THAT TERM IS DEFINED IN REG NMS RULE 600, WITH THE POSSIBLE EXCEPTION OF MARKET CENTERS WHOSE SHARE OF VOLUME IS INSIGNIFICANT.

THIS IS A MODEST PROPOSAL. THE IMPACT OF THESE STEPS WOULD BE TO RESTORE THE TRANSPARENCY THAT HAS BEEN LOST AS AN UNINTENDED AND UNFORESEEN RESULT OF DECIMALIZATION. AS A POLICY MATTER IT IS HARD TO ARGUE THAT DECIMALIZATION SHOULD LEAVE THE PUBLIC WITH *LESS* TRANSPARENCY.

X. CONCLUSION

THIS IS A TIME OF ENORMOUS MARKET CHANGE. WILL THESE CHANGES PROVE TO BE IN THE PUBLIC INTEREST?

THAT ANSWER IS UP TO POLICYMAKERS HERE, AT THE SEC AND AT THE DEPARTMENT OF JUSTICE. THERE IS ENORMOUS POTENTIAL FOR ANTI-COMPETITIVE ABUSE, PARTICULARLY IN THE NYSE MARKET WHERE ONE ENTITY STANDS AS UMPIRE, REFEREE, AND HOME TEAM. THE CHANGE TO FOR-PROFIT STATUS — WHICH IS THE MAJOR CONSEQUENCE

OF THE PROPOSED MERGER WITH ARCHIPELAGO — RADICALLY ESCALATES THE POTENTIAL FOR ANTI-COMPETITIVE ACTIVITY.

THE SEC ROSE TO THAT CHALLENGE IN ADDRESSING THE NASDAQ SCANDALS OF THE MID-90S BY MANDATING TRANSPARENCY TO ADDRESS CONFLICTS. WE BELIEVE GREATER TRANSPARENCY, EQUAL AND FAIR ACCESS TO MARKET DATA FOR ALL MARKET PARTICIPANTS, AND REGULATION INDEPENDENT OF THE FOR-PROFIT ENTITY ARE – WHEN COUPLED WITH CONGRESSIONAL AND REGULATORY VIGILANCE -- THE INGREDIENTS FOR REFORMING SELF-REGULATORY ORGANIZATIONS.

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TESTIMONY OF WILLIAM J. BRODSKY
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
CHICAGO BOARD OPTIONS EXCHANGE, INCORPORATED

REGARDING SELF-REGULATORY ORGANIZATIONS:
EXPLORING THE NEED FOR REFORM

BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES
U.S. HOUSE OF REPRESENTATIVES

NOVEMBER 17, 2005

I am William J. Brodsky, Chairman and Chief Executive Officer of the Chicago Board Options Exchange, Incorporated ("CBOE"). CBOE was the first listed options exchange in the U.S., and we continue to be the largest options exchange in the United States. Our exchange trades options on individual stocks, stock indexes, exchange-traded funds, and debt securities. We also are one of the larger self-regulatory organizations (SRO") in the U.S., with oversight of the activities of over 1,400 members. I welcome the opportunity to present CBOE's views on the future of SROs.

A year ago the Securities and Exchange Commission ("SEC" or "Commission") issued two companion releases regarding SROs. The first was a release proposing a series of sweeping changes to SRO governance, transparency, and regulatory oversight in a new Regulation SRO.[1] The second was a Concept Release Concerning Self-Regulation ("Concept Release") that explored the changing role of SROs and a wide variety of possible "big picture" approaches to overhauling the SRO structure, ranging from incremental changes to complete assumption of SRO responsibilities by the SEC.[2] The two releases were prompted by the many major changes in the structure, ownership and operation of U.S. securities markets that have taken place over the past few years. Some of the recent structural changes that have the potential to impact self-regulation are the result of the Commission's decisions to permit SROs to organize as for-profit corporations and to demutualize so as to be owned by stockholders who are not necessarily members of the SROs. Other changes to securities markets arise from the fact that in recent years the securities markets have become increasingly electronic and in some cases are now structured as electronic communications networks that are not SROs and that rely on other SROs

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[1] Securities Exchange Act Release No.51019.

[2] Securities Exchange Act Release No. 50700.

for their regulation. These changes have raised questions for the SEC as to whether the conflicts that have always been inherent in self-regulation continue to be manageable.

CBOE takes great pride in its regulatory program and its leadership in options market regulation. We have taken a variety of actions over the past few years to address concerns about potential conflicts of interests in self-regulation. CBOE created a Regulatory Oversight Committee ("ROC") comprised completely of independent directors and chaired by Susan Phillips, former Chair of the Commodity Futures Trading Commission and Governor of the Federal Reserve Board. The ROC is responsible for overseeing the performance of CBOE's regulatory division and functions in much the same manner as an internal audit committee at a public company. During the course of the year, the ROC meets regularly with the head of the CBOE regulatory division, with other regulatory division staff, with CBOE systems staff, and with internal auditors of the regulatory division to manage and assess the workings of the regulatory division. The ROC in turn reports directly to the CBOE Board concerning its role in overseeing the division. The ROC also meets at least annually with senior staff of the SEC to address issues of mutual concern. This structure has facilitated the independence of CBOE's regulatory division without separating it completely from the exchange.

As described below, CBOE does not think a proper response to recent changes in the structure of SROs or to recent regulatory issues should be for the Commission to propose and adopt rules that would have the effect of eliminating self-regulation of securities markets entirely, or making radical changes to the way in which self-regulation operates. Rather, we strongly believe that the Commission should continue to evaluate Regulation SRO and the Concept Release in light of comments received and the changes many SROs, including CBOE as noted above, have already made to their governance structure and practices in recent years to

help assure that the SRO acts consistent with its self-regulatory obligations. Now is not the time for the Commission to discard or radically change the way in which self-regulation operates in U.S. securities markets.

Historically, self-regulation has been a cornerstone of securities markets regulation, and its removal or drastic alteration would affect the entire fabric of federal securities regulation. Recent structural changes to securities markets that may impact the conflicts of interests inherent in self-regulation do not alter this reality. Indeed, at the time the Securities Exchange Act of 1934 ("Exchange Act") was adopted, Congress recognized that self-regulation inherently involved conflicts between the public interest in having honest and regulated securities markets and exchange members' self-interest in avoiding what some of them may characterize as excessive regulation. At the same time, by choosing self-regulation as the model for the regulation of securities markets, Congress demonstrated its belief that, with appropriate safeguards, self-regulation could lead to better regulation of securities markets by permitting the specialized knowledge and experience of those closest to the markets to be brought to bear on the complex problems of how best to regulate them.

Clearly, among the safeguards embedded in SRO regulation has always been the role of the Commission as overseer of SROs (the proverbial "well-oiled shotgun behind the door"). This includes the Commission's rule-making authority to adjust and fine-tune the process of self-regulation as needed in response to changes in markets and newly identified problems. Regulation SRO was proposed in response to some of the very same structural changes and issues that are cited in the Concept Release as reasons for considering more fundamental changes to self-regulation.

While we have concerns with some aspects of Proposed Regulation SRO, overall, CBOE supports the underlying concepts and believes they will serve to enhance exchange governance structures and practices. Regulation SRO will increase the likelihood that SROs will serve to protect investors and the public interest, act consistent with their regulatory obligations, and be effective regulators. Such changes, however, are many steps removed from a paradigm shift in the way in which self-regulation applies to the securities markets. We question the wisdom of making the kinds of major changes that are discussed in the various approaches of the Concept Release until after the provisions of Regulation SRO as well as the enhancements exchanges have made independently have been in effect for a sufficiently long time to enable their impact on perceived regulatory problems to be evaluated. In addition to the governance changes that exchanges have made recently, there has also has been a paradigm shift away from manual handling of trades to more electronic trading which has the effect of dramatically changing the nature of securities regulation. We believe the impact of all these significant developments -- the adoption of Reg SRO, exchange governance changes, and the movement toward electronic trading – must be assessed before more drastic and potentially disruptive measures are adopted. After these developments have been evaluated, if further changes are deemed necessary, the SEC would be able to propose and adopt additional rule changes within its authority or, if more radical changes are believed to be called for, it could suggest legislation for this purpose.

Beyond its important oversight role, we believe there are other steps the Commission could take in order to improve the quality of self-regulation. One such step would be for the Commission to make available to all SROs clear written statements of the standards and best practices that it believes should apply to specific regulatory matters across all markets whenever it concludes that such clarification is warranted. In our view, too often there have been

disparities in the way in which certain regulations are interpreted and applied from one exchange to another because of the absence of clear guidance from the Commission. We believe that if the SEC were to make its views known on such matters to all SROs in a clear and consistent way, and do so promptly upon a determination that a need for such guidance is needed, SROs would have a better understanding of what is required of them and would be in a better position to regulate their markets and their members accordingly.

We recognize that the SEC has brought several actions against SROs over the past few years for failure to regulate their members adequately. We do not view the lapses in SRO performance as reason to gut a system of self-regulation that has been in operation for over seventy years. In fact, we believe the current system routinely detects and finds violations and other potential problems because of the familiarity of the regulators with the marketplace. It would be very difficult to duplicate this attention to the details of a particular market in a large single regulator whose management was removed from the marketplaces it regulates. On a day-to-day basis the SROs act as the SEC's frontline monitors of the markets. It would be hard to imagine how the SEC could operate if the system of self-regulation were eliminated. For much of my tenure as head of CBOE, the SROs and SEC have acted as partners in trying to ensure fair and honest markets. Recent events have caused the SEC to take a more adversarial approach toward SROs. I think it would benefit the markets if the SEC looked for ways to renew and strengthen this partnership.

We believe that the existing model of multiple SROs, each responsible for regulating its own market, has for the most part, well served the objective of sound regulation. This model has permitted the specialized knowledge that each SRO has concerning its own unique rules and procedures to be brought to bear to the regulation of its market. It also fosters competition in the

development of new, more efficient, regulatory systems, which also benefits the overall quality of regulation. On the other hand, we agree that the existence of multiple SROs can result in unequal regulation across markets. CBOE also recognizes that requiring each SRO to build and maintain its own regulatory systems and programs may result in unnecessary duplicative costs and other inefficiencies.

Nonetheless, in balancing the pluses and minuses of multiple SROs, we believe that the best answer is not to delegate market regulation to a sole or "single member" self-regulator that would be independent of, and would not be involved in, the operation of any market. While the delegation of regulatory responsibilities to such a sole self-regulator might well avoid some of the problems cited in the Concept Release that result from the operation of multiple SROs, the consequence of following this approach would be to destroy the major advantage of self-regulation. That is, to assure that persons involved in the regulation of securities markets are close to the markets they regulate, and therefore have an in-depth understanding of their rules and the ways in which they and their members operate. A single SRO also would be tantamount to a new mini-SEC. It is inevitable that a sole SRO would quickly evolve into a bureaucratic entity that functions as an adjunct arm of the SEC. Self-regulation would lose the "self" aspect. There are better means to reduce duplicative costs and inefficiencies from multiple SROs.

We are intrigued by an approach suggested by the Securities Industry Association ("SIA") that would consolidate regulation of members into a single SRO but leave regulation of trading to each individual market. Under that approach, a single SRO would be responsible for sales practice, financial responsibility, and business conduct examinations, but each market would retain the responsibility to regulate trading and other conduct on its marketplace. The SIA proposal is designed to eliminate duplication of regulation by multiple SROs at the level

where such regulation overlaps but maintain specialized regulation at the trading level where it is needed. While the SIA approach is one way to achieve greater efficiency, there are other alternatives which SROs can and do utilize to reduce costs and promote efficiency. One approach is the use of SEC Rule 17d-2 agreements which are used by SROs to allocate regulatory responsibility with respect to common members. Another new alternative that has great potential benefits in eliminating duplication, increasing efficiency, and enhancing the overall quality of regulation is the use of a National Market System Plan to conduct regulatory functions that are common among SROs. For example, five U.S. options exchanges recently filed with the Commission a proposed Options Regulatory Surveillance Authority ("ORSA") Plan. The purpose of the Plan is to enable the five exchanges to act jointly with respect to insider trading investigations involving options traded on one or more of the five exchanges. The regulatory functions governed by ORSA could be expanded in the future. The core part of the plan, as currently proposed, is the delegation to the CBOE to operate a joint surveillance and enforcement facility for detecting and investigating possible instances of insider trading. CBOE has already established a state-of-the-art automated facility for the surveillance of insider trading, and it has a fully staffed Office of Insider Trading that uses the facility for ongoing surveillance. Although CBOE would conduct the surveillance and analysis work, each exchange will remain responsible for regulating its market and for bringing enforcement proceedings whenever it appears from the ORSA information that persons subject to its jurisdiction may have engaged in insider trading. By sharing the costs of these investigations and by sharing the regulatory information generated by ORSA, the five exchanges will be able to support a regulatory program that is comprehensive and eliminates duplicative efforts and costs. Under the Plan, the five exchanges will establish a Policy Committee to oversee operation of the Plan. Thus, governance

of ORSA will remain with the five exchanges and enforcement actions would be conducted by each exchange. The conduct of regulatory functions through ORSA also would eliminate concerns of uneven regulation among markets. ORSA shows that SROs working together can preserve the benefits of multiple SROs while reducing the costs and eliminating duplication.

CBOE has taken other steps to reduce duplicative regulation among multiple SROs. Last year pursuant to our Rule 17d-2 agreement we reallocated to the NASD the responsibility for conducting sales practice examinations of the CBOE members that had been allocated to us under this agreement. As the NASD conducts sales practice examinations of the majority of broker-dealers, and has conducted specific options sales practice examinations, we determined that it would reduce costs if these sales practice examinations were consolidated into the NASD. We will continue to look for ways to work with other SROs to reduce overlapping regulation of our members.

Thank you for the opportunity to testify at this important hearing. CBOE strongly believes in the benefit of self-regulation and is pleased that the Committee is exploring this issue. We intend to continue to work with the other SROs and the SEC to provide the level of market oversight that all investors deserve.

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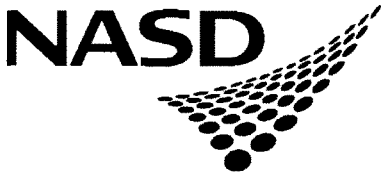

Testimony

of

Robert Glauber

Chairman and CEO

Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Committee on Financial Services

United States House of Representatives

Hearing on Self-Regulatory Organizations: Exploring the Need for Reform

November 17, 2005

Mr. Chairman and Members of the Subcommittee: NASD would like to thank the committee for the invitation to testify regarding self-regulation in the securities industry. NASD commends the Committee's efforts in beginning this review of the self-regulatory system. As a leading advocate of investor protection and market integrity, NASD welcomes the Committee's focus on possible enhancements to the current regulatory system that could strengthen its operation and efficacy.

Executive Summary

Founded in 1936, NASD is the world's pre-eminent private-sector securities regulator. In 1939, the SEC approved NASD's registration as a national securities association under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934. We regulate every broker-dealer in the United States that conducts a securities business with the public—about 5,200 securities firms that operate more than 108,000 branch offices and employ about 664,000 registered representatives.

Our rules regulate every aspect of the brokerage business. Our market integrity and investor protection responsibilities include compliance examinations, rule writing, enforcement, professional training, licensing and registration, dispute resolution and investor education. NASD examines broker-dealers for compliance with NASD rules, MSRB rules and the federal securities laws, and we discipline those who fail to comply. Last year, NASD filed a record number of new enforcement actions (1,410) and barred or suspended more individuals (830) from the securities industry than in any previous year. NASD has a nationwide staff of more than 2,400 and is overseen by a Board of Governors, more than half of whom are not in the securities industry.

During the last four years, NASD has been in the process of separating from The NASAQ Stock Market, which is now on an independent course under its own completely separate management and board. NASD still monitors all trading on NASDAQ and will continue to do so pursuant to a regulatory services agreement after NASDAQ becomes an exchange. The separation will be complete after the SEC grants NASDAQ exchange status, which we hope will happen by the end of this year.

The separation of NASD from NASDAQ became necessary when NASDAQ decided to become a for-profit, publicly-traded company. The conflicts from simultaneously running a for-profit market and regulating it were unmanageable and did not best serve investors. Thus, the separation has allowed NASD to realign as a private-sector regulator of the broker-dealer industry and, by contract, of exchanges and markets.

Today, the New York Stock Exchange finds itself in a similar position as it merges with Archipelago and moves toward going public. Whether it should continue operating as a regulator after it begins operating as a for-profit company has been the subject of a great deal of healthy and needed debate in our industry. The concern is that for-profit, publicly traded exchanges will be faced with the conflicting goal of having to maximize profits while not compromising regulation.

Earlier this year, the Securities and Exchange Commission (SEC) published a concept release examining the current self-regulatory organization (SRO) system and seeking public comment on a range of issues. As we told the SEC in our response, one glaring inefficiency in today's regulatory scheme is the dual regulation of firms that are members of both the NYSE and NASD. Currently these 180 firms are faced with dual rulebooks, dual examinations and enforcement, and dual fees.

A solution that makes sense is a partnership between the NYSE and NASD to jointly handle the regulation of the 180 firms that are members of both organizations. Under such a partnership, firms would be regulated according to one rulebook instead of two. They would pay one regulation fee instead of two and, we estimate, would collectively save about $50 million per year. Firms would have only one examination and enforcement staff to contend with and that would lower their compliance costs also by more than $50 million a year, by our estimate. These savings could then be passed on to investors, while the regulation of these firms would be more effective and efficient.

Alternating the examination of the jointly regulated firms on an annual basis as some have suggested is not the answer to the problem. An arrangement that calls for each regulator to examine the firms on an alternate yearly basis would result in inconsistent application of the rules. It is just not a workable solution, and investors would be ill-served. It would not answer any of the issues raised by the SEC, specifically conflicts of interests and duplicative regulation.

To best serve investors, any new structure would have to solve the conflict inherent in both regulating and managing a for-profit exchange. It would also have to eliminate the redundancy and inefficiency of having two regulatory groups performing the same functions.

Benefits of Self-Regulation

Self-regulation in the securities industry has a long and effective history. Congress designed the statutory scheme of self-regulation for the securities markets in the 1930s, envisioning that most of the day-to-day responsibilities for market and broker-dealer oversight would be performed by SROs under the SEC's direct oversight. The SEC was charged with supervising SROs and compelling them to act where they failed to provide adequate investor protection. Congress's preference for self-regulation over other forms of regulation was deliberate; Congress recognized that it was impractical for the government to provide the necessary resources to effectively regulate the securities industry. To that end, Congress opted to rely primarily on the resources and expertise of the industry itself, notwithstanding its awareness of the conflicting roles of SROs in the regulatory scheme.

This model of securities regulation has proven effective through nearly 70 years of regulatory experience. Both Congress and the SEC have periodically examined the role of self-regulation in the securities industry, and while each has taken steps in certain

instances to remedy shortcomings, the concept of self-regulation has been repeatedly reaffirmed and strengthened.

The self-regulatory model has many important benefits to investors and the markets. Self-regulation can and does extend past enforcing just legal standards to adopting and enforcing ethical standards (i.e., just and equitable principles of trade). Government regulation is well-suited for policing civil or criminal offenses, but less so for ethical lapses, which, while not necessarily illegal, may be unfair or hinder the functioning of a free and open market. Self-regulation is uniquely capable of protecting investors from those sorts of transgressions.

Private funding is another critical advantage to the self-regulatory model. Millions of dollars can be spent by SROs on examination, enforcement, surveillance and technology at no cost to the U.S. Treasury. In a self-regulatory system, the industry—not the taxpayers—pays for regulation by NASD. Regulators operating in the private sector also are better positioned to move quickly to address regulatory issues because, among other things, they are not subject to many of the spending restrictions of the federal government, and are better able to develop large-scale systems for important regulatory matters like market surveillance, broker registration and trade reporting.

Moreover, private-sector regulators are able to tap industry expertise in ways not readily available to the government and to use this expertise to better protect investors and ensure market integrity. Among other things, this expertise helps to make certain that rules are practical, workable and effective. Also, industry participants often are in the best position to identify potential problems, thus enabling regulators to stay ahead of the curve.

Need for Separation of Market and Regulator

This is not to say that self-regulation is free from conflicts. NASD's evolution into its current corporate structure and separation from NASDAQ illustrates the conflicts that exist when an entity both owns and regulates a market, and how NASD resolved those conflicts.

In the mid-1990s NASD faced a conflict that fundamentally altered its existence. That conflict was whether NASD's corporate structure was appropriate to manage both the regulation of 5,400 firms and their half-million securities professionals, and the operation of a trillion-dollar securities market with its own divergent constituencies.

In November 1994, the NASD Board of Governors appointed an independent committee to review NASD's corporate governance structure and recommend changes that would enable NASD to better meet its regulatory and business obligations, including oversight of The NASDAQ Stock Market. In September 1995, the committee recommended the establishment of two distinct subsidiaries: one to perform NASD's regulatory functions and the other to run NASDAQ. The committee recommended that

each subsidiary have a separate Board of Directors and that NASD remain as the parent corporation overseeing the operations of both subsidiaries.

Based on those recommendations, NASD formed two subsidiaries—NASD Regulation and NASDAQ. And, just as importantly, NASD implemented a new corporate governance structure that ensured a majority of NASD's Board of Governors would be from outside the securities industry. In 2000, NASD created another subsidiary for its mediation and arbitration functions, NASD Dispute Resolution.

In 2000, when NASDAQ decided to become a shareholder-owned, publicly traded exchange, NASD determined that the existing structure that placed regulatory activities in a subsidiary no longer afforded sufficient protection for investors. Operating an exchange to maximize profits for shareholders and simultaneously managing regulatory activities to fully protect investors could not be conducted under the same corporate structure without unmanageable conflicts, in our view. We therefore restructured NASDAQ and NASD as two wholly separate companies with separate managements, separate funding sources and separate, non-overlapping boards. This separation is complete except for the SEC designation of NASDAQ as an exchange and the sale of NASD's remaining minority share ownership in NASDAQ, which we would seek to complete within a year of NASDAQ exchange registration.

Moving forward, NASD has implemented a divisional structure. The first of the three divisions is Regulatory Policy and Oversight, which has primary responsibility for rule-making, member regulation, market surveillance and enforcement. A separate Markets Services and Information Division is responsible for NASD's information and market transparency facilities, including the Alternative Display Facility (ADF), the Trade Reporting and Compliance Engine (TRACE), the Over-the-Counter Bulletin Board (OTCBB) and the Central Registration Depository (CRD), as well as NASD's technology developments and operations. The third division is Dispute Resolution, which is responsible for arbitration and mediation services.

SEC Concept Release on Self-Regulation

Earlier this year, the SEC published a concept release examining the current SRO system and seeking public comment on a range of issues, including: (1) the inherent conflicts of interest between an SRO's regulatory obligations and the interests of its members, its market operations, its listed issuers and, in the case of a demutualized SRO, its shareholders; (2) the costs and inefficiencies of the multiple SRO model; (3) the challenges of surveillance across markets by multiple SROs; and (4) how SROs generate revenue and fund regulatory operations. The SEC also is examining and seeking comment on certain enhancements to the current SRO system and a number of regulatory approaches and legislative initiatives.

The SEC stated that the most controversial aspect of the current SRO system is the inherent conflicts of interest between an SRO's regulatory functions and its members, market operations, listed issuers and shareholders. Conflicts in the dual role of regulating

and serving members can result in poorly targeted and less extensive SRO rulemaking, and weak enforcement of SRO rules. To be effective, an SRO must be structured so that regulatory staff is unencumbered by inappropriate business pressure such as: (a) member domination of SRO funding; (b) member control of SRO governance; and (c) member influence over regulatory and enforcement staff. In addition, the economic influence of some members may create particularly acute conflicts, especially in light of the consolidation of some of the largest securities firms.

NASD Response to SEC Concept Release

NASD firmly believes in preserving a securities industry regulatory model that encompasses self-regulation supervised by the SEC. Self-regulation is a key component of the effective regulation, growth and vitality of the U.S. securities markets, offering a range of benefits that non-industry or government regulation alone cannot replicate.

At the same time, there are inherent conflicts and inefficiencies present in the current regulatory environment. NASD believes that these shortcomings would be best addressed by adopting a form of the "hybrid" models set forth by the SEC in its concept release. Adopting this model would enhance efficiency by eliminating inconsistent member rules, eliminating redundant infrastructure, strengtening intermarket surveillance, and meaningfully reducing the current conflicts in the self-regulatory system.

Accordingly, NASD agrees that a re-examination of the existing self-regulatory system is warranted, but we also strongly believe that the statutory scheme of self-regulation supervised by the SEC should be preserved. NASD believes that the substantial benefits of self-regulation, as illustrated recently by the response to the mutual fund breakpoint issues, continue to greatly outweigh any shortcomings.

Benefits of NASD Structure and the Pure Hybrid Model

In discussing how to enhance the self-regulatory system, the SEC Concept Release focuses on four perceived weaknesses of the existing model: (1) the inherent conflicts of interest between SRO regulatory operations and members, market operations, issuers and shareholders; (2) the costs and inefficiencies of multiple SROs, arising from multiple SRO rulebooks, inspection regimes and staff; (3) the challenges of surveillance of cross-market trading by multiple SROs; and (4) the funding SROs have available for regulatory operations and the way SROs allocate revenue to regulatory operations.

The SEC set forth several alternative versions of what it termed hybrid models, each containing a single member SRO to perform all regulatory activities overseeing firm behavior. Under the first option, the market SROs would maintain all the functions that SROs currently carry out with respect to their market operations, including promulgating market rules, conducting market surveillance and taking enforcement action against rule violators. Alternatively, the market SROs could retain responsibility for promulgating rules and conducting surveillance, but enforcement actions would be referred to the

single member SRO. Under a third option, the market SROs' responsibilities would be limited to market rule promulgation, and the single-member SRO would be responsible for market surveillance and enforcement.

NASD would support any of these hybrid models because they would significantly reduce the costs and redundancies in firm regulation and move to eliminate the conflicts cited earlier that arise when a for-profit, exchange conducts regulatory activities within its corporate structure.

Conclusion

Thank you for giving us the opportunity to testify on this important topic and for your timely review of the securities industry's self regulatory structure. NASD looks forward to working with Congress as it continues to review the changing regulatory landscape.

Testimo

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NYSE

Richard G. Ketchum

Chief Regulatory Officer
New York Stock Exchange, Inc.

On
"Self-Regulatory Organizations: Exploring the Need for Reform"

Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises

Committee on Financial Services
United States House of Representatives
Washington, DC

November 17, 2005

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On

"Self-Regulatory Organizations: Exploring the Need for Reform"

Committee on Financial Services

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

United States House of Representatives

Washington, DC

November 17, 2005

I. Introduction

Chairman Baker, Congressman Kanjorski and distinguished Members of the Subcommittee, I am Richard G. Ketchum, Chief Regulatory Officer of the New York Stock Exchange.

I want to thank the Subcommittee for providing this opportunity to address issues raised regarding the current structure of securities industry self-regulation, as well as to

discuss the SEC's November 2004 *Proposed Rule* on governance, reporting, recordkeeping, ownership and voting limitation requirements of self-regulatory organizations (Release No. 34-50699) and *Concept Release Concerning Self-Regulation* (Release No. 34-50700).

In this time in which America's securities markets are undergoing significant change, we applaud the idea of examining how self-regulation is operating and whether there are changes that would make it more effective in protecting investors. Stronger oversight of the securities industry is restoring investor confidence and leading to increased participation in the markets.

New York Stock Exchange Regulation ("NYSE Regulation") has primary responsibility to regulate our 400 member firms. These firms maintain 98 million customer accounts, or 84 percent of the total public customer accounts handled by broker-dealers, with total assets of over $4 trillion. They operate from 20,000 branch offices around the world and employ 144,000 registered personnel. NYSE Regulation serves a vital role in policing this market.

Self-regulatory organizations ("SROs") in general and NYSE Regulation in particular have increased our regulatory resources and invested in technology to provide more effective oversight of broker-dealers and protect investors. Today, investors have access to more objective research, new and meaningful sales disclosure and greater governance transparency among companies listed on our market. Yet we can always do better.

Before I explore the subjects of today's hearing with you, I would first like to tell you a little about New York Stock Exchange Regulation.

II. NYSE Regulation

Over 700 employees work for NYSE Regulation, which consists of the Market Surveillance, Member Firm Regulation, Enforcement and Listed Company Compliance divisions, as well as a Risk Assessment unit and Dispute Resolution/Arbitration. While the priority of the NYSE is to promote the fairest and most efficient trading market, the priority of NYSE Regulation is investor protection.

NYSE Regulation plays a critical role in monitoring and regulating the activities of its members, member firms and listed companies, as well as enforcing compliance with NYSE Rules and federal securities laws.

Significantly, the SEC has appointed NYSE Regulation as the Designated Examining Authority for financial and operational ("FINOP") issues for nearly all of the 170 firms that are members of both the New York Stock Exchange and NASD. Here there is no overlap or duplication.

The FINOP program of NYSE Regulation is focused on customer protection at the most fundamental level. Member Firm Regulation conducts annual examinations of brokers to make sure they are properly protecting customer assets and that they have enough net capital so that, if something goes wrong, customers will be protected. NYSE Regulation examiners have unique expertise to carry out this important mandate. Member Firm Regulation employs 125 financial and operational examiners who are trained to review for compliance with sophisticated and intricate SEC and NYSE Rules governing net capital and customer protection. In recent years, our FINOP examiners have uncovered numerous abuses including unauthorized use of customer securities, overcharging of interest on lending transactions and inappropriate short selling.

NYSE Regulation shares authority with NASD in sales practice oversight, as well as on a range of conflict issues, for the 170 firms that are dual members. It is here that the issue of regulatory duplication arises and where we and NASD have been most active in working to reduce overlap.

III. Governance Past and Present: Eliminating Conflicts of Interest

As much as we at NYSE believe in the wisdom of self-regulation, we believe just as passionately that independence is critical to robust self-regulation. In December 2003, the NYSE implemented—with the SEC's approval—sweeping changes to its governance structure. Among other things, the NYSE became the *only* SRO to demand that *all* members of its Board of Directors (with the exception of CEO John Thain) be independent of the interests of NYSE members, member organizations that it regulates and corporations that are listed on the market. NYSE Regulation was functionally separated from market operations. A new position of Chief Regulatory Officer ("CRO"), which I am privileged to serve as the first, was created. The CRO reports directly to the Board of Directors through the Board's Regulatory Oversight Committee. The most important result of these changes has been to ensure the independence of our decision-making.

The priority of NYSE Regulation is protection of the investor. There must never be the slightest doubt by anyone in the industry or investing public that NYSE Regulation's decisions—whether in rule making, surveillance of our marketplace, an examination or an enforcement action—are based on anything but our best judgment, not on whether a particular firm may be competing with or providing orders to a competitor of The New York Stock Exchange.

In the past 18 months, NYSE Regulation has increased staff and technology resources. New senior management in the Market Surveillance, Member Firm Regulation and Enforcement divisions was appointed. A new department within Market Surveillance was created to analyze surveillances and propose new or modified surveillances of trading activities on the floor. New regulatory technology has been installed to establish better controls and accountability on the Floor.

We believe that these changes have resulted in NYSE Regulation being an effective, strong and independent regulator.

IV. Governance of NYSE Regulation Post-Merger

Once the merger of the New York Stock Exchange and Archipelago is approved, and a new holding company known as NYSE Group is created, the independence of NYSE Regulation will be preserved and strengthened.

The NYSE Group (with its New York Stock Exchange LLC and NYSE Market subsidiaries) will be a for-profit, publicly-traded enterprise. NYSE Regulation will be a wholly owned subsidiary of NYSE Group, but will be registered as a not-for-profit corporation. It will contract to perform regulatory responsibilities for the New York Stock Exchange, the Pacific Exchange and Archipelago.

NYSE Regulation will have its own board of directors. A majority of the NYSE Regulation directors will be NYSE Group independent directors. The remainder of NYSE Regulation directors will be unaffiliated with NYSE Group and independent from the marketplace. The chief executive officer of NYSE Regulation will be a director of NYSE Regulation. NYSE Chief Executive Officer John Thain will not have a seat on the NYSE Regulation board, nor will Regulation report to him.

NYSE Regulation will have two primary funding sources: regulatory fees from member firms and contractual agreements for regulatory services with the New York Stock Exchange, Archipelago and the Pacific Stock Exchange. As a discrete corporate entity, NYSE Regulation will be self-funding.

To ensure their independence, employees of NYSE Regulation will never receive stock or options of the NYSE Group. There must never be a question in the minds of investors that our regulatory decisions are blind to the interests of the business side of the Exchange.

This design will achieve the goal of enhancing the separation and independence of NYSE Regulation, while maintaining its proximity to the marketplace, in order to preserve its expertise and strengthen its mission of investor protection.

V. Regarding the SEC's *Proposed Rule*

It is within the context of these changes that were made to the governance structure of the New York Stock Exchange in December 2003, and the changes that will occur after approval of the merger between NYSE and Archipelago, that I want to briefly discuss the SEC's *Proposed Rule*. Generally, we are supportive of the *Proposed Rule*. Our current governance structure meets, and in many aspects exceeds, the proposed standards. After the merger, that will still be the case.

For example, the *Proposed Rule* would require that SROs that are national securities exchanges and registered securities association have a majority independent board. In fact, none of the members of the NYSE board of directors or our various committees work in the securities industry today, with the exception of our chief executive officer. *They are completely independent.*

VI. The SEC's SRO Concept Release

The SEC's Concept Release raises a series of thoughtful questions regarding the ability of self-regulatory organizations to meet heightened responsibilities as presently organized. In particular, the Commission noted the inherent conflicts of interest that exist between the SROs regulatory functions and their members, market operations, listed companies and, in the case of demutualized SROs, shareholders. The SEC also noted securities industry concerns about oversight of market participants by multiple regulators. The SEC then set out a number of possible alternative approaches ranging from enactment of the *Proposed Rule*, to a hybrid examination self-regulator, all the way to a universal non-industry regulator along the lines of the Public Company Accounting Oversight Board.

The NYSE feels strongly that the creation of a universal self-regulator or full dependence on governmental regulation would be a tragic mistake. In simplest terms, self-regulation offers the benefit of greater expertise, the ability to leverage government resources, and the ability to impose higher ethical standards than are required under Federal law.

Self-regulation fundamentally is based upon the belief that the most effective regulation occurs when the regulator is as close as possible to the regulated activity, thereby gaining specialized knowledge in overseeing market operations specific to that exchange. I see the benefits of applying this specialized knowledge everyday and I know Bob Glauber and Bill Brodsky do, as well.

When examining a member firm, it is critically important to have examiners who understand how a securities firm operates, the particular conflicts it may face in serving

the firm. Self-regulation also provides an effective means to allow industry access without industry control. NYSE Regulation, NASD and CBOE all reach out to engage knowledgeable industry officials on new rule proposals and interpretations of existing rules. The result is a regulatory scheme that protects investors by leveraging the expertise of the industry and a regulator steeped in the nuances of the specific marketplace.

Self-regulation is particularly important in times of profound changes in market structure. For example, by NYSE Regulation operating as an independent part of the NYSE, we have the opportunity to participate directly in the design and technological implementation of the NYSE's proposed Hybrid Market System. This puts us in the position to identify investor protection concerns at the beginning—before the new trading system is rolled out.

Of course, none of these benefits would matter if the NYSE did not properly address the conflict issues that the SEC properly puts forward. It is important to acknowledge that the NYSE has not always lived up to our own high standards in ensuring investor protection and market integrity. We are absolutely committed to learn from the mistakes of the past. That is precisely why we have imposed industry independence standards upon all of our Board Members and why the Chief Regulatory Officer reports directly to the Board of Directors. Self-regulation should permit us to be close enough to the market to make knowledgeable decisions while zealously protecting our independence.

The SEC also properly expresses concerns identified by the securities industry regarding unnecessary duplication that result from the present self-regulatory design.

While many of these concerns stem from an important increase in the breadth and aggressiveness of our program, as well as NASD's and the SEC's, we recognize that it is our collective responsibility to strive wherever possible to reduce unnecessary duplication.

There are many ways in which NYSE Regulation and NASD have already been coordinating efforts. Coordination of exams, rule making, and enforcement are three areas that have had the greatest impact on reducing regulatory duplication.

A. Exam Coordination

Beginning in 2005, NYSE and NASD developed a coordinated plan of examination that divides responsibilities for each firm visited by both regulators in a given year. Each regulator uses similar examination questions. Fifteen areas of examination are now part of this coordinated effort. For example, when NYSE Regulation examines a firm for compliance with anti-money laundering rules, the NASD does not review this area in its exam of that firm. If NASD examines a firm's compliance with business continuity planning rules, NYSE Regulation does not cover that topic in our exam. Results of these exams are shared between the two regulators. The joint exam program has received positive feedback from the industry and is working well.

B. Rule Making

Over the past two years, NYSE Regulation and NASD have worked together to review rules for differences and similarities and to conform them when it makes sense. The goal of these coordinated efforts is to provide the industry with a single interpretation that avoids confusion. NYSE Regulation and NASD staffs have weekly, sometimes-

daily contact regarding these issues. There are many examples of rules that have been harmonized through this process. They include the Research Analysts Conflicts Rule, Uniform Definition of Branch Office and Internal Control Rules. We believe great strides have been made in this area. Yet we cannot lose sight of the fact that the profile of NYSE member organizations is often different than an NASD firm. Many of the differences that exist in our rules are due to higher standards appropriate to expect of firms with greater resources. For example, our capital rules allow flexibility to impose more stringent reporting requirements to protect the investing public and the member organizations that serve them. We would not want to see this type of rule requirement diluted in the interest of uniformity.

C. Enforcement

In the area of Enforcement, we have worked jointly with NASD and the SEC to attack industry-wide problems, such as undisclosed revenue sharing and research conflicts of interests. We divide up the investigation, share documents and testimony transcripts. This permits us to quickly and effectively address industry-wide problems and return money to customers who have been harmed. In cases involving one firm or one issue, we coordinate with other regulators to ensure we are not duplicating efforts. We will not squander our resources investigating a firm for misconduct that has already been addressed by another regulator.

D. Increased Intermarket Coordination

Another area of regulatory coordination is the Intermarket Surveillance Group ("ISG"). The ISG, which was created in 1983 in response to the growing need among U.S. securities exchanges to share surveillance information, is today comprised of 29 North American, Asian and European organizations that have a common interest in ensuring

that the securities and commodities marketplaces are regulated effectively and efficiently. With the enthusiastic support of NYSE Regulation, the ISG has recently undertaken to evaluate initiatives designed to further consolidate trading information in a more uniform manner thereby reducing the need, as well as associated costs, of firms to provide information to regulators in different formats. For example, although the ISG now has in place a consolidated audit trail for equities and a recently developed consolidated options audit trail, the ISG will evaluate the consolidation of the equities and options audit trails to address more comprehensively possible trading abuses.

The SEC requested comment on the desirability of a hybrid SRO that would leave oversight of the markets as is but take responsibility for regulatory oversight of all broker-dealers doing business with the public. While this is certainly a constructive proposal that we are willing to explore, it is not easily implemented without losing much of the expertise critical to self-regulation. Member firm regulation today is not simply a matter of enforcing financial responsibility or customer suitability rules. It can also involve issues relating to illegal short selling, manipulative trading around offerings or control systems on trading desks. NYSE Regulation's Market Surveillance and Examination functions work closely together to ensure complete coverage of the wide range of trading and market abuses. A good examination program cannot be effective without substantial sophistication regarding market issues and coordinated with other Exchange regulatory functions.

Nonetheless, NYSE Regulation recognizes its responsibility to expand its efforts to partner with other regulators to further reduce or eliminate duplication. For that reason, we are having an ongoing dialogue with our Board of Directors on these important issues. NYSE Regulation also is ready to meet with the SEC, NASD and other

self-regulatory organizations to identify how we might better protect investors and reduce unnecessary duplication.

VII. Conclusion

Let me end with a personal note. I joined the Exchange as its Chief Regulatory Officer, a newly created position, to affirm the NYSE's commitment to regulation and to a regulatory arm unencumbered by commercial interests. I assumed this position based on a lifetime of devotion to regulation, both as a government official and an NASD executive, based upon the pledge that I would be granted a free hand to create a regulatory body unique in sophistication, resources and passion to protect the public. I knew I was building upon a two-century old tradition of excellence. I am proud of what has been accomplished thus far and appreciate the miles we have to go before our task is complete.

The issues that beset us today are not drawn on a clean canvas. They have arisen time and again and form the predicate for much of the legislation that successfully governs our securities markets today.

I would respectfully suggest that the novelty and uniqueness of the reconstituted New York Stock Exchange Regulation be afforded an opportunity to develop and be tested over time. In the interim, we recognize our responsibility to vigorously pursue means to reduce unnecessary duplication. We remain committed to continue to work with the SEC, our fellow regulators and this committee to improve and strengthen the SRO system and build on the great strides we have collectively made to date.

TESTIMONY OF

MARC E. LACKRITZ
PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

BEFORE THE
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES
UNITED STATES HOUSE OF REPRESENTATIVES
NOVEMBER 17, 2005

HEARING ON
SELF-REGULATORY ORGANIZATIONS: EXPLORING THE NEED FOR REFORM

I. Introduction

Mr. Chairman and members of the Committee, I am Marc E. Lackritz, President of the Securities Industry Association.[1] SIA commends you for holding this hearing and appreciates the opportunity to testify on reforming the securities industry's self-regulatory system.

Our nation's securities markets are the most transparent, liquid, and dynamic in the world. New forms of competition, technological advances, globalization, and broader investor participation have driven phenomenal changes in the capital markets and the securities industry over the past decade. Our industry has embraced these changes, further strengthening the preeminent status of the U.S. capital markets across the globe.

Self-regulation – and the historical level of member cooperation in particular – has been a key ingredient in the regulatory framework within which our markets have thrived. For example, the extensive expertise of members and their involvement in the rule-making process has

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

undoubtedly led to more effective, less costly self-regulatory rules. As the SEC has noted, self-regulation "has been viewed as having certain advantages over direct governmental regulation" because "[i]ndustry participants bring to bear expertise and intimate knowledge of the complexities of the securities industry."[2] Self-regulatory organizations ("SROs") also "supplement the resources of the government and reduce the need for large government bureaucracies" and "can adopt and enforce compliance with ethical standards beyond those required by law."[3]

Notwithstanding these benefits, self-regulation has significant drawbacks: (1) major conflicts of interest between SROs' roles as both market operators and regulators, and (2) regulatory inefficiencies resulting from duplication among multiple SROs. The proposed mergers between the NYSE and Archipelago Holdings, Inc. and The Nasdaq Stock Market ("Nasdaq") and Instinet, LLC highlight the need, and present the opportunity, to bring the structure of self-regulation into the 21st century. They also heighten concerns about the potential for consolidated market centers to develop an unchecked monopolistic hold on market data to the detriment of investors and markets.

SIA supports the adoption of a hybrid self-regulatory model, which would split regulation into two functions. Each marketplace would have its own SRO, which would regulate and enforce all aspects of trading, markets, and listing requirements. The other type of organization would be a Single Member SRO that would handle regulations relating to the operations of broker-dealers. This body would be transparent to both the investing public and to its members. Both the public and broker-dealers would be involved in its governance, and the SEC would oversee its budget, funding, and performance. By eliminating unnecessary regulatory duplication and inherent conflicts of interest, a revamped self-regulatory structure can strengthen investor protection and increase the competitiveness of the U.S. capital markets.

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[2] Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Stock Market (Aug. 8, 1996), *available at* http://www.sec.gov/litigation/investreports.shtml.

[3] *Id.*

I. Strengths and Weaknesses of the Current SRO System

The success of today's self-regulatory governance is directly related to member involvement in the process.[4] Self-policing by professionals who have the requisite working knowledge and expertise about marketplace intricacies and the technical aspects of regulation creates a self-regulatory system with valuable proper checks and balances. Supplemented by government oversight, this tiered regulatory system can provide a greater level of investor protection than the government alone might be able to achieve.

Because self-regulators are on the frontline of marketplace developments, they have an intimate knowledge of industry operations, trading, and sales practices. As a result, they can develop and revise rules – which are typically forward-looking and up-to-date with market realities – more quickly and frequently than traditional government regulators. In addition, SRO rules often set standards that exceed statutory or common law legal minimums. For example, the NASD requires that its member firms adhere to "just and equitable principles of trade," a standard that in many instances exceeds the anti-fraud requirements of SEC statutes and rules.

In spite of how well self-regulation has worked, market participants, governmental bodies and investor advocates have recognized in recent years a growing need for structural reform of self-regulation. The main three concerns are:

(1) Potential conflicts of interest due to the SROs' roles as both market operators and regulators;[5]

(2) The profit motive of a shareholder-owned SRO detracting from self-regulation;[6]

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[4] *See generally* S. Rep. No. 94-75, at 22 (1975) (*accompanying* S. 249, 94th Cong., 1st Sess. (1975)) ("In enacting the Exchange Act, Congress balanced the limitation and dangers of permitting the securities industry to regulate itself against 'the sheer ineffectiveness of attempting to assure [regulation] directly through the government on a wide scale.'"); SEC Report of Special Study of Securities Markets, H.R. Doc. No. 88-95, Part 4 (1963) ("Special Study").

[5] "Securities Markets: Competition and Multiple Regulators Heighten Concerns about Self-Regulation," General Accounting Office, May 2002, GAO-02-362, available at http://www.gao.gov/new.items/d02362.pdf, at 1-2 ("GAO SRO Report"). The GAO also noted, "Heightened competitive pressures have generated concern that an SRO might abuse its regulatory authority – for example, by imposing rules or disciplinary actions that are unfair to the competitors it regulates." The SEC shares this concern. "As intermarket competition increases, regulatory staff may come under pressure to permit market activity that attracts order flow to their market. . . . Also, SROs may have a tendency to abuse their SRO status by over-regulating members that operate markets that compete with the SRO's own market for order flow." Concept Release Concerning Self-Regulation, 69 Fed. Register 71256, 71262 (Dec. 8, 2004) ("SEC SRO Concept Release").

(3) Duplicative and conflicting regulation among multiple SROs, as well as redundant SRO regulatory staff and infrastructure.[7]

While all three of these concerns are valid, SIA is particularly concerned with redundant regulation. Regulatory duplication can, and does, occur with rulemaking, data reporting, examinations, and enforcement actions. On the rulemaking front alone, both the NYSE and the NASD frequently adopt separate rules on similar or identical topics, leaving many firms to have to cope with two different standards, including different record-keeping, procedural and audit trail requirements for the same product or service. Similarly, on the examination front firms have expressed concern about a lack of coordination among the SROs, and between the SROs and the SEC's Office of Compliance Inspections and Examinations ("OCIE"). In addition to the waste of regulatory resources, the cost on broker-dealers, especially smaller firms, should not be minimized. As the NASD's Chairman and CEO Robert Glauber said last week at our annual meeting,

> "[m]ore and more regulations and higher and higher costs can put [smaller] firms in danger of failing, and that's a fate we don't want to impose on anyone. When firms go out of business, it is not only they and their employees that suffer, although that is bad enough. Investors are not well-served either, if the brokerage industry is effectively shrunken, and they are left with fewer choices."[8]

Fortunately, the senior staffs of both the NYSE and the NASD have been sensitive to these concerns in recent years. SIA has productively engaged with each SRO on specific problems that have surfaced. For example, in the past year both the NYSE and the NASD have

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[6] The SEC has stated that:

> "SRO demutualization raises the concern that the profit motive of a shareholder-owned SRO could detract from self-regulation. For instance, shareholder-owned SROs may commit insufficient funds to regulatory operations or use their disciplinary function as a revenue generator with respect to member firms that operate competing trading systems or whose trading activity is otherwise perceived as undesirable."

SEC SRO Concept Release, at 71263.

[7] "Multiple SROs can result in duplicative and conflicting SRO rules, rule interpretations, and inspection regimes, as well as redundant SRO regulatory staff and infrastructure across SROs." SEC SRO Concept Release at 71264. The GAO has noted similar "inefficiencies associated with SRO rules and examinations." GAO Report at 2.

[8] Address by NASD Chairman and CEO Robert Glauber to SIA Annual Meeting, November 11, 2005 (available at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_015519).

considered new rules on gifts and entertainment given by broker-dealers or their employees to clients. Initially, the two SROs considered approaches that were quite different from each other. When we raised our concerns about inconsistencies in approach, the two SROs worked with each other and with our industry to devise a single principles-based approach to gifts and entertainment. We understand that approach is now in the process of being adopted. We are also heartened that on the examination front the two SROs have committed themselves to improving coordination between each other (as well as with the SEC's OCIE).[9]

Although these developments are helpful, duplication and redundancy will continue to occur as long as two separate entities regulate the same conduct of the same firms. The only effective long-term answer is to combine the SRO broker-dealer regulatory programs into one centrally managed entity.

The NYSE proposes as part of its proposed merger to undertake to create some additional separation between its regulatory unit and its business side. The NYSE is taking this step in light of concern that a for-profit SRO might neglect its regulatory responsibilities. As one consumer advocate recently stated in connection with the NYSE-Archipelago merger, "[t]he for-profit environment adds to the pressures and potential conflicts of interest."[10] This step may not entirely address the concern about the temptation for a for-profit exchange to seek to either neglect or misuse its regulatory powers. More importantly, the NYSE's proposed restructuring of its regulatory program is an opportunity (which we hope the NYSE will seize) to eliminate regulatory duplication by combining its broker-dealer regulatory functions with those of the NASD.[11]

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[9] SIA has recently had productive discussions with the NYSE and NASD, as well as OCIE, on improving coordination among these three regulators' examination programs. An overview of the results to date of those discussions is available at http://www.sia.com/RegulatoryCoordination/index.html.

[10] "As Exchanges Become Profit-Seekers, Concerns Rise Over Risk to Investors", Wall Street Journal, November 8, 2005, at C1, C3, *quoting* Barbara Roper, Director, Consumer Federation of America.

[11] Similar concerns relating to Nasdaq becoming a for-profit company are less substantial due to the gradual shedding of the NASD's equity interest in Nasdaq. However, the NASD still has a stake in Nasdaq that it is trying to sell.

II. Structural Reform of Self-Regulation

The Hybrid SRO: Toward a Better System of Self-Regulation

Last winter, the Commission sought comment on a variety of self-regulatory models as possible alternatives to the current structure of self-regulation. Of the seven models the SEC proposed,[12] SIA believes the hybrid self-regulatory model offers the best alternative regulatory structure for preserving competitive, innovative markets while fostering more efficient, effective regulation. The hybrid model will require the SEC to designate a Single Member SRO to regulate broker-dealers with respect to membership rules.[13] Separately, each SRO operating a market would be responsible for the oversight of its market operations regulation (*e.g.*, its trading rules), including enforcement of those trading rules.

The creation of the Single Member SRO addresses the two primary areas of weakness in the current self-regulatory structure we identified previously – conflicts of interest and regulatory inefficiency. In addition, the proposal will likely provide better investor protection. Enhanced regulatory efficiency will allow both the SROs and firms to use compliance resources more effectively. Regulatory accountability will be bolstered as the result of one entity being responsible for overseeing broker-dealer activity at the SRO level. Finally, the regulatory expertise of the SRO staff will expand as a single SRO gains the resources, power, and prestige to attract talented staff, and keeping that expertise close to the markets whose day-to-day activities it regulates. At the same time, the existence of multiple-market SROs, each with responsibility over those regulations applicable to its unique trading structures, will keep market expertise where it is most useful. Much of the innovation that makes the U.S. markets so strong occurs in market operations, so the maintenance of separate market SROs will foster continued competition and innovation and preserve U.S. capital market dominance.

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[12] These ranged from a new system of competing broker-dealer SROs among which firms could periodically switch, to a single SRO to govern all broker-dealers and marketplaces, to simply moving all SRO functions into the SEC.

[13] Membership rules under the control of the Single Member SRO would include, for example, registered representative qualification testing, customer accounts, sales practices, supervision, financial condition and margin.

In general, the SEC has already begun moving toward more universal capital market rules. For instance, parts of Regulation SHO[14] and Regulation NMS[15] reflect a convergence of rules. The hybrid model will build on this consolidation and streamlining of regulations, further increasing efficacy and efficiency, while eliminating redundancies and gaps in regulatory coverage.

Overseeing the Hybrid. We realize the Single Member component of the hybrid model would concentrate regulatory power and authority in one entity. Therefore, and notwithstanding our advocacy of the hybrid model, this regulatory structure will function effectively only if the SEC provides attentive, cost-effective regulatory oversight that includes the vigilant review of the Single Member SRO's costs and fee structures. Similarly, the Commission's robust review of the Single Member SRO's final disciplinary proceedings will counter any possible self-serving interest by the Single Member SRO in levying excessive enforcement fines that would be paid into its own coffers.

Additionally, strong public and member involvement will become even more important to prevent the Single Member SRO from becoming an unresponsive entity with prohibitive cost structures. While the Single Member SRO should have a majority of non-member representatives on its board, it will need substantial member input – especially from smaller cost-sensitive members – to effectively oversee regulation across a diverse group of members with divergent needs and business models.[16] Member involvement and SEC oversight of the hybrid SRO also will be necessary to identify and harmonize any "boundary" issues between conduct rules subject to the Single Member SRO's regulatory oversight, and market rules subject to the continued oversight of the various market SROs.

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[14] *See* Exchange Act Release No. 50103 (Jul. 28, 2004), 69 Fed. Reg. 48008 (Aug. 6, 2004) ("Regulation SHO").

[15] *See* Regulation NMS.

[16] The needs of fixed-income markets differ from those of equities markets, for instance. The knowledge members have about the ramifications of these differences is essential to ensure that a self-regulatory system works well for all participants.

The SEC should develop increased transparency requirements for the Single Member SRO, particularly concerning funding and budgetary issues. Making the Single Member SRO's operations transparent to both members and the investing public will place appropriate checks on the Single Member SRO and will enhance accountability to its constituents.

To further foster the regulatory efficiency offered by the hybrid structure, market SROs should be permitted to continue to outsource their market enforcement activities. We understand that the ability to outsource such activities, while retaining ultimate responsibility as an SRO, has worked well for various existing SROs.[17]

Fueling the Hybrid. The final issue for the SEC to resolve is how to fund the Single Member SRO. SIA believes that any future self-regulatory structure must be adequately funded. The goal of the hybrid is not to stint on regulation, but to make each regulatory dollar more effective. At the same time, fees for regulation should be apportioned to the industry on a fair and reasonable basis, and should be unbundled and cost-justified whenever possible. Imposing regulatory fees that exceed the true costs of regulation acts as a tax on capital and imposes undue harm on the capital-raising system. SIA recommends that the SROs define the costs necessary to meet their self-regulatory obligations, prepare and make public a budget to meet those obligations, and then fairly apportion those costs among members by making periodic filings with the Commission subject to public notice and comment.

Regulatory funding for the Single Member SRO should come from regulatory fees assessed on broker-dealers, as well as from the issuers and other constituents of the trading markets. Trading markets will benefit significantly from regulatory oversight of broker-dealers and the various examination and continuing education programs conducted by the Single Member SRO under a hybrid model. Such regulation and education initiatives foster the market integrity and investor confidence that bring so much business to the U.S. capital markets. Under

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[17] For example, the American Stock Exchange ("Amex") and Nasdaq have delegated regulatory activities to the NASD. *See, e.g.*, Exchange Act Release No. 37107 (Apr. 11, 1996), 61 Fed. Reg. 16948 (Apr. 18, 1996) (creating the NASDR and Nasdaq as two operating subsidiaries of NASD); SEC Set to Release Proposals on SRO Governance, But Details Are Still Thin, Securities Week, Nov. 8, 2004, *available at* 2004 WLNR 14154116 (quoting NASD chairman and CEO Robert Glauber's statement that the NASD "will continue to regulate Nasdaq and Amex under contract.").

the hybrid model, markets would receive these benefits, and market SROs should assume some of the associated regulatory and administrative costs.

Market data fees should only fund the collection and dissemination of market data – not regulatory costs.[18] Combining the broker-dealer regulatory functions of the NASD and NYSE should result in savings that may offset much of the loss of market data fees as a revenue source. If there is still a shortfall due to the elimination of market data fees as a funding source, the industry is willing to pay higher regulatory fees to the Single Member SRO than it now pays to the NYSE and NASD in exchange for relief from the burdens of duplicative regulation and market data fees that vastly exceed their costs. Our only qualification is that any increase in regulatory fees on member firms should be, with the SEC's assistance, allocated in a fair manner among all member firms such that there is not an undue burden on smaller firms.[19]

Significance of the NYSE-Archipelago Merger

We strongly believe that the proposed NYSE- Archipelago merger represents an important opportunity to address the valid concerns raised by critics of self-regulation. The following are some observations about the NYSE-Archipelago merger.

(1). The merger both illustrates and accelerates the trend toward increased consolidation of, and competition between, market centers. While this competition is in most respects a very healthy development, it does raise conflict of interest questions about the NYSE's continued regulation of broker-dealers that could be potential competitors for order flow or for development of new investment products.

(2). The merger underscores the significance of increased competition, not just narrowly between U.S. market centers, but also globally among all capital markets. This competition applies to securities exchanges and financial intermediaries of all stripes. Unnecessary

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[18] The SEC estimates that in 2003 market data fees provided 18 per cent of the funding of the NYSE and NASD. SEC Concept Release Concerning Self-Regulation, 69 Red. Reg. 71256, 71270 (Dec. 8, 2004).

[19] For example, such fees might be based on any number of factors designed to approximate the degree of resources required of the Single Member SRO in overseeing a particular firm, such as the number of registered representatives of a firm, or the scope and nature of its customer base or operations.

regulatory duplication is a weight around the ankles of financial intermediaries in the United States that has a real cost in terms of the future competitiveness of our capital markets. The merger represents an opportunity to address this regulatory duplication.

(3). The merger raises exactly the issues about conflicts between shareholders' interests and regulatory authority about which the SEC and SIA have both voiced concerns.

In fairness, the NYSE proposes some steps to address several of these issues. Each of its regulatory divisions (Listed Company Compliance, Member Firm Regulation, Market Surveillance, Enforcement and Dispute Resolution/Arbitration) and its 700 employees will be moved into a separate affiliated non-profit entity, which will regulate all aspects of the NYSE parent's markets, as well as the activities of the Pacific Stock Exchange (which Archipelago now owns).

While moving regulation out of the parent organization is a necessary step, we doubt that it will be sufficient. Specifically, the new entity, titled "NYSE Regulation," will be under the control of a board of directors that will have an unspecified number of its members drawn from the NYSE parent's own board. Moreover, the very fact that NYSE apparently seeks to maintain regulation of its broker-dealer members under the NYSE name and with the oversight of some of its directors, rather than spin it off into a separate entity under a different name with entirely separate directors, suggests that the NYSE sees value in continued "branding" of its regulatory authority over broker-dealers.

The most important shortcoming is that the NYSE's proposal avoids the critical issue of regulatory duplication between itself and the NASD in regulating dually registered broker-dealers. Fortunately, senior NYSE officials in recent public statements have seemed to recognize this, and have suggested they are "open to the idea of a 'joint venture' with the NASD."[20] The NASD staff has also signaled that it is receptive to this approach.[21]

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[20] *Big Board and NASD Consider Merging Parts of Regulatory Units*, Wall Street Journal, C3 (November 11, 2005). Senior NASD officials have also signaled receptivity to a hybrid SRO. *See New Theorem for Merging Regulators: 1>2*, Wall Street Journal, C3 (November 14, 2005).

[21] *See* Address by NASD Chairman and CEO Robert Glauber, note 8 *supra*.

This convergence of views suggests that this is an ideal moment for implementing significant structural reform to self-regulation. We strongly urge the SEC to take the lead in pushing forward on the opportunities created by these developments. If the SEC, SROs, market participants and investors work together to refine the NYSE's proposal for spinning off its regulatory unit, this could be the vehicle for driving self-regulation into the 21st century.

III. Eliminating Excessive Market Data Fees

Regardless of the outcome of regulatory consolidation, it is vitally important that the SEC deal immediately with longstanding concerns by market participants about the opaque and non-accountable way in which market data fees are currently set.[22] It is doubtful that Congress ever intended for market data to generate revenues for SROs to subsidize their regulatory obligations or to fund competitive business activities in the manner that it does today. The purpose of disseminating market data is to create transparency in the prices that investors receive for buying and selling securities and, where there are competing market centers, to increase investor choice and opportunity. For that reason, SIA advocates a revised method for funding regulation that does not depend on revenue from market data fees. We do not believe our proposed cost-based approach for establishing market data fees puts the SEC in a role of rate maker, but instead encourages it to rely on its oversight role over SROs to ensure that access to this information is available on terms that are "fair and reasonable" and "not unreasonably discriminatory."

The current approach to market data fees hurts the transparency of prices and imposes unjustifiable costs on market participants and, ultimately, investors. We applaud the SEC's expressed intention to address many open issues concerning market data fees in the context of SRO reform.[23] We strongly believe the resolution of these issues – sooner than later – is of the utmost importance for the integrity of the markets. Our proposed cost-based approach will minimize many of the conflicts of interest related to market data fees that SROs face now. The conflicts arise from control over a monopoly product with the ability to use the monopoly

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[22] For a more detailed discussion of SIA's concerns about market data fee practices that we believe the SEC should consider reforming, *see* letter to Jonathan G. Katz, Secretary, SEC, from Marc E. Lackritz, SIA, (Feb. 1, 2005) at 24 *et seq.*, available at http://www.sia.com/2005_comment_letters/4601.pdf

[23] *See* SEC Release Adopting Regulation NMS, 70 Fed. Reg. at 37560 (June 29, 2005).

revenue to subsidize other activities. We believe the narrow cost-based approach is the most straightforward method to accomplish this, and is most closely aligned with the congressional purposes underlying the Exchange Act.

The proposed NYSE and Nasdaq mergers heighten the significance of this issue further by raising the danger that the current lack of transparency and competitiveness in setting market data fees will tilt toward an oligopoly controlled by just two consolidated for-profit market centers. Unless market data fees become cost-based, the SEC will find itself in the position of establishing the profitability of for-profit exchanges as part of its statutory duty to determine that the fees charged for this mandated product – which generate a substantial share of the NYSE's and Nasdaq's revenue – are "fair and reasonable."

Conclusion

America's securities markets are the envy of the world, but we must be vigilant about removing unnecessary regulatory inefficiencies if we are to maintain our international preeminence. SIA is eager to work with Congress, the SEC, the SROs, and all other interested parties to ensure that our markets remain the most transparent, liquid, and dynamic, with unparalleled levels of investor protection.

Thank you.

Testimony of Ben A. Plotkin
Chairman and CEO
Ryan Beck & Co.
before the
Committee on Financial Services

Subcommittee on Capital Markets, Insurance and

Government Sponsored Enterprises
United States House of Representatives
November 17, 2005

Hearing on

"Self-Regulatory Organizations: Exploring the Need for Reform"

I. Introduction

Mr. Chairman and members of the Committee, my name is Ben A. Plotkin, and I am Chairman and Chief Executive Officer of Ryan Beck & Co., a 60 year old NASD member firm based in New Jersey with 38 offices in 13 states. I am also Chairman of the Securities Industry Association's (SIA) Regional Firms Committee, which represents the interests of regional firm members of the SIA. I thank the Chairman and the Committee for the opportunity to testify on issues relating to the proposed mergers between the New York Stock Exchange ("NYSE") and Archipelago Holdings, Inc. and The Nasdaq Stock Market ("Nasdaq") and Instinet, LLC, and especially to present the Regional Firms Committee's support of the Hybrid self-regulatory organization ("SRO") model.

I am not here to advocate a business position on the two proposed mergers. Rather, I am here to emphasize the Regional Firm Committee's keen interest in the broader self-regulatory issues that currently face this industry. These regulatory considerations -- indeed, these challenges – are brought that much more to the forefront by the proposed mergers. We believe the time is ripe for sweeping self-regulatory reform and respectfully request that you to take

these considerations, and the unique challenges they present to the regional firms throughout this country, into account as you consider the implications of the proposed mergers.

The Role of the Regional Firm

Regional securities firms play an important and unique role in the U.S. markets. As a matter of definition, many of the so-called "regional" firms, like Ryan Beck, do business from coast to coast. We are simply smaller and much more focused on certain types of clients; we serve these clients in a way that larger, national firms often cannot. Our client base, in many respects, are more typical individual investors looking for quality advice. They are often small businesses looking to access the capital markets or municipalities with financing needs below the radar of large national firms. Our clients increasingly look to us – indeed expect us -- to provide the full compliment of services offered by the national firms but on a more targeted, cost-efficient basis. Many clients are drawn to regional firms precisely because of the smaller scale feel and more personalized attention we are able to deliver. Regional firms endeavor – and have thus far succeeded – in meeting these needs and expectations. Yet many of the same circumstances that have historically enabled regional firms to attract and retain a loyal client base can also present unique challenges when seeking to satisfy the increasingly complex, and often times duplicative or conflicting, regulatory framework within which we operate. If regional firms are to continue giving value to our client base -- the small businesses and families struggling to save for retirement or for their children's college education that we serve -- the enormous challenges posed to regional securities firms by the unnecessary costs of the current regulatory structure, needs to be considered and addressed.

Inefficiencies of the Current Regulatory Framework and its Impact on Regional Firms

The securities brokerage industry is one of the most heavily regulated in this country. Brokerage firms of every size and scope are subject to regulation and oversight at both the federal and state level, as well by at least one, if not multiple, self-regulatory organizations.[1] Most regional firms are members of multiple self-regulatory organizations ("SROs"), including the two national SROs – the NYSE and NASD. In addition, we are regulated by the SEC and, in the case of most larger regional firms, 50 state regulators. While the National Securities Markets Improvements Act of 1996 (NSMIA)[2] took measures to eliminate certain duplicative and competing regulations at the federal and state level, no comparable legislation has addressed the issue of multiple, and potentially conflicting, SRO rules aimed at the same substantive conduct.

Regional firms' resources can be hit particularly hard when forced to contend with duplicative rulemaking, examinations and enforcements, as well as duplicative registered representative and other fees. The ever-increasing demands of complying with different, and sometimes conflicting, rules can place regional firms at a competitive disadvantage to their national firm counterparts – an effect ultimately detrimental to investors generally. This is

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1 Pursuant to Section 15(b)(8) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), U.S. registered brokers and dealers are required to become members of at least one self-regulatory organization. *See* 15 U.S.C. § 78o(b)(8) and 17 C.F.R. § 240.15b9-1.

2 104 Public Law 290 (1996). For example, Section 15(h)(1) of the Exchange Act, which was adopted as part of NSMIA, provides that "[n]o law, rule, regulation, or order, or other administrative action of any State or political subdivision thereof shall establish capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting requirements for brokers, dealers, municipal securities dealers, government securities brokers, or government securities dealers that differ from, or are in addition to, the requirements in those areas established under [the Exchange Act.] The Commission shall consult periodically the securities commissions (or any agency or office performing like functions) of the States concerning the adequacy of such requirements as established under [the Exchange Act.]"

because the scale of national firms enables them to absorb the cost of unnecessary regulatory duplication better than regional firms can. Add to this backdrop the fact that the SROs have been particularly active in their rulemaking, examination and enforcement initiatives during recent years and the resulting impact on regional firms has become that much more acute. If left unaddressed, there will be continued consolidation among small and regional firms as they struggle to cope with high relative regulatory costs. This can only lead to less efficient capital markets as it relates to small business, small governmental entities and individual investors.

Today, even seemingly minor differences in the language or application of two different SRO rules aimed at the same substantive conduct can result in significant operational costs in an effort to ensure compliance. At the same time, duplicative and conflicting regulation – coupled with the associated confusion and economic burden it places on the industry, and regional firms in particular – fails to further the very investor protection goals that lie at the heart of each individual regulator's mandate. In fact, regulatory duplication can undermine investor protection, because it means that firms' compliance efforts are diverted to trying to reconcile and comply with two sets of substantive standards, rather than focusing on monitoring and preventing conduct that could harm investors.

While the SEC and the SROs have shown some recent efforts to address these concerns through increased coordination on rulemaking initiatives and examinations, there are practical difficulties and time delays, not to mention cost inefficiencies, in forcing such coordination across independently managed organizations simultaneously seeking to regulate and enforce multiple layers of rules directed at the same substantive conduct or activity. In short, the inefficiencies of the current model result in increased costs to investors, place regional firms (and the clients they continue to serve) at a disadvantage and indeed ultimately frustrate the very

purpose at which the rules are directed. While the industry is certainly appreciative, in the short term, of the regulators' efforts to mitigate the negative effects of duplicative regulation, it is unrealistic to expect that any of amount of regulatory coordination can fully counteract the inefficiencies that are inherent in the current structure.

II. The Time is Ripe for Self-Regulatory Reform

Much as I have critiqued the inefficiencies of the current, multiple SRO framework, I am not here to promote the abolition of SROs as a concept. Quite the contrary. The Regional Firms Committee continues to advocate the benefits and validity of self-regulation. Self-regulation has been an integral part of the securities industry since time immemorial and for many years it has worked incredibly successfully. In principle, self-regulation fosters efficiency and brings important expertise to the regulatory process. Self-regulation and governmental regulation are together capable of achieving a level of investor protection that is truly greater than the sum of its individual regulatory parts. The challenge is to continue to elicit those benefits by not clinging rigidly to a framework that, for various reasons, has become increasingly counterproductive. It is not enough for regulation to merely work. It must continuously evolve in order to preserve the U.S. securities markets' stature as the most transparent, dynamic, and competitive in the world.

Given the current proposed mergers, now is the appropriate time to restructure and revitalize the self-regulatory system and truly bring it into the twenty-first century. If handled appropriately, such reforms will (i) better protect investors, (ii) maximize the resources of all securities firms, (iii) avoid the potential conflicts of interest inherent in the current system and (iv) eliminate the inefficiencies that result from duplicative rulemaking and examinations.

In Support of the Hybrid SRO Model

In order to effectively and efficiently address concerns regarding conflicts of interests, regulatory duplication and the impact of inconsistent regulation, the Hybrid model proffered by the SEC in its SRO Concept Release[3] presents an appealing and practical alternative to the current self-regulatory model. Under the Hybrid model, the SEC would designate a single entity unaffiliated with any securities market (the "Single Member SRO") to regulate all SRO members with respect to broker-dealer oversight and cross-market rules, including rules governing members' financial responsibility requirements, sales practices, qualification and registration of personnel, cross-market trading, handling of customer accounts and recordkeeping. In addition, the Single Member SRO would be responsible for promulgating membership rules, inspecting members for compliance with those rules, and taking enforcement action against members that fail to comply.

In addition to the Single Member SRO, each securities market would have its own SRO (each, a "Market SRO") that would remain responsible for rules specific to that market, including rules governing the market's operation, regulation, listings, governance and market-specific trading, as well as enforcement of those trading rules.

Efficiencies and Other Benefits Furthered by the Hybrid Model

Elimination of inconsistencies and unnecessary duplication. The Hybrid model would minimize the opportunity for inconsistent regulation that results from multiple and duplicative regulatory oversight. Regional firms would therefore not be required to spend compliance resources attempting to monitor and comply with two or more inconsistent set of rules and rule

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

interpretations. Regional firms would instead have the ability to focus resources on achieving the highest level of compliance for the cross-market rules imposed by the Single Member SRO, thus lessening the risk of inadvertent violations of those rules. In addition, the Hybrid model would allow a firm to avoid positioning itself in a contradictory manner *vis a vis* its respective SROs due to resulting enforcement actions that may derive from inconsistent rules and interpretations.

Regional firms currently allocate a considerable amount of resources attempting to comply with the regulatory obligations imposed by multiple SROs rules having identical goals and underlying purposes but slightly different substantive requirements. Much of these costs and inefficiencies would be eliminated under the Hybrid model. The resulting savings would help to keep regional firms innovative and competitive, with all the benefits to investors and markets that this entails. In effect, the Hybrid model would place a regional firm at a leveled competitive playing field with its national firm counterpart by allowing resources to be distributed in a cost-effective and efficient manner across the entity in order to obtain the best results for the firm and investors alike.

The Hybrid model would also offer many advantages as compared to the increased cooperation and coordination efforts recently undertaken by the NASD, the NYSE and the SEC. Those efforts, while appreciated, are simply insufficient to address the needs of all securities firms. In addition, regional firms may also be members of one or more regional SROs that have not coordinated their efforts with the NASD and the NYSE, thereby resulting in continued inefficiencies and duplicative efforts for both the regional securities firms and the regional SROs. Continued reliance upon independent and often competing entities that focus on a limited number of areas does not result in efficient cross-market oversight. The Hybrid model would

eliminate these inefficiencies. Today, these problems are leading Regional Firms to seriously consider dropping NYSE membership simply to avoid redundant regulation. Some firms, like Ryan Beck, have chosen to access the NYSE market through other broker-dealers, in order to avoid duplicate regulation. This is demonstrative of a situation that should not persist. All firms should be subject to the same regulatory process; one that is efficient and non-duplicative.

Maximization of regulatory resources. The Hybrid model would also strengthen the effectiveness of the SEC and SRO regulatory oversight function by creating a single, comprehensive regulatory framework. The Hybrid model would substantially reduce, if not eliminate, inefficiencies that are born out of the current SRO rulemaking system. Under the current self-regulatory system, when there are substantially similar rules or interpretations that the SROs seek to adopt, generally each SRO submits a proposed rule change to the SEC for review and approval. The result is that not only are the SROs duplicating their own efforts, but the SEC's resources are also being inefficiently utilized and potentially drained. Every proposed rule change filed with the SEC requires that the SEC staff review proposed rule changes individually instead of having the ability to review and approve one filing submitted by the Single Member SRO that would apply to all broker-dealers. Similar inefficiencies born out of the current SRO examination and inspection process would be considerably diminished by the adoption of the Hybrid model.

Regulatory expertise. One of the many additional advantages of the Hybrid model is the concentration of regulatory expertise at both the Single Member SRO and the Market SRO level. In the SEC's SRO Concept Release, the SEC notes the potential for conflict that exists from the

current combination of regulation and market functions.[4] The Hybrid model would enable the Single Member SRO to maintain a talented and experienced regulatory staff that would be able to efficiently provide guidance as to the rules it imposes and enforces rather than having that talent and expertise fragmented across multiple SROs seeking to carry out the same substantive mandate. This is particularly important in the current environment where the availability to qualified staff to the SEC, SRO's and member firm compliance departments is very tight. In addition, the Market SROs would retain a specialized regulatory staff that understands the unique and specific trading rules under which the individual market center operates. The results are uniquely qualified regulatory staffs that are independent and free from conflicts in their understanding and regulation of the markets.

Minimizing conflicts of interest. Finally, the Hybrid model would eliminate many of the conflicts of interest inherent in the current SRO structure. The current self-regulatory model not only places burdens on the broker-dealer entities themselves—both national and regional—but also often leads to conflict of interests between an SRO's regulatory and market functions. The SEC has recognized that as a result of increased marketplace competition, an SRO's regulatory obligation may conflict with the interests of its own or its affiliates' market operations.[5]

Through the separation of regulatory and market operation functions, each marketplace and its corresponding Market SRO would be able to focus on their primary tasks and avoid potential conflicts of interest. The market center would be able to compete and innovate to produce a better marketplace for all investors. The Market SRO would act as an independent body without regard to the pressures of the need to attract order flow in order to maintain its

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4 *Id.*

5 *Id.* at 71261-2.

competitive advantage in the marketplace, thereby ultimately enhancing investors' confidence in the integrity of the securities market.

Oversight and Funding of the Hybrid SRO Model

In order to protect the interests of all member firms, the Single Member SRO would require significant involvement from both the investing public, and from the different member interests, based upon their size, client base, and overall business models. While non-industry representatives should comprise a majority of the SRO's board of directors, representation in the SRO's governance (e.g., on the board of directors and on advisory committees to the board) from the various segments of the industry would enable the Single Member SRO to successfully and efficiently regulate all member firms. Only through such representation can the Single Member SRO be embedded with the knowledge and expertise necessary to efficiently regulate both large national firms and smaller regional firms. Of equal importance, having participation in the Single Member SRO's governance by a broad range of industry firms will ensure that neither the rules nor the funding of the SRO is slanted in a way that unfairly disadvantages any type of firm. Through member involvement and cooperation, all securities firms would continue to protect their own interests, while simultaneously being cognizant of the unique aspects of other members' operations that benefits all market participants generally. In short, we must keep the "self" in Self Regulated Organizations.

Funding for the Single Member SRO should derive from two sources: (i) trading markets constituents within the marketplace SRO such as marketmakers and listed companies, and (ii) regulatory fees imposed by the Single Member SRO. Some level of funding from the marketplace SRO or its constituents is appropriate, since the increased efficiencies and burden reduced by the elimination of the duplicative and often times confusing current self-regulatory

model would benefit all market participants. However, the greatest level of funding for the Single Member SRO will likely have to come from regulatory fees borne by member firms. Since market data fees would no longer be used to subsidize SRO operations, it is likely that broker-dealers belonging to the Single Member SRO will experience a net increase in direct regulatory fees paid for SRO membership, even though they will eliminate the need to pay regulatory dues to two organizations. However, the long-term advantages of eliminating regulatory duplication (as well as the reduction in market data fees), outweigh the shorter-term monetary impact that may result. Of course, the regulatory fees associated with such sweeping reforms must be allocated on a fair and reasonable basis, such as a relative proportion of the costs to the Single SRO member to oversee a segment of the industry, in order to account for the diverse community of broker-dealers that service the securities markets.

Conclusion

The U.S. securities markets are still the most efficient, transparent and liquid in the world but we cannot grow complacent. The implementation of the Hybrid model will help to ensure that U.S. markets preserve their reputation in the years to come.

Mr. Chairman, I commend you for holding these hearings to discuss the impact of the proposed mergers on the U.S. markets and in particular the opportunity that has presented itself to create an efficient self-regulatory system that at its core ensures that investors are well protected and that the U.S. marketplace continues to function in a dynamic and competitive manner.

Thank you.

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