TESTIMONY OF
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BEFORE THE
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A REVIEW OF SELF-REGULATORY ORGANIZATIONS IN THE SECURITIES MARKETS

Introduction

Mr. Chairman and members of the Committee, I am Marc E. Lackritz, President of the Securities Industry Association.[1] We commend you for holding this hearing and appreciate 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. The mergers between the New York Stock Exchange ("NYSE") and Archipelago Holdings, Inc., as well as the Nasdaq Stock Market ("Nasdaq") merging with Instinet, LLC, are a natural and healthy outgrowth of these trends.

Our markets' advantages are also grounded in their structural framework. Self-regulation – and the historical level of member cooperation in particular – has been a key ingredient to our success. For example, the extensive expertise of members and their involvement in the rule-making process has undoubtedly led to more effective, less costly self-regulatory rules. As the

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1 The Securities Industry Association brings together the shared interests of approximately 600 securities firms to accomplish common goals. Our primary mission is to build and maintain public trust and confidence in the securities markets. Our 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.)

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]

Despite these compelling benefits, self-regulation has two significant drawbacks: (1) conflicts of interest between SROs' roles as both market operators and regulators, and (2) regulatory inefficiencies resulting from duplication among multiple SROs. In addition, the regulatory environment in which the securities industry operates has undergone a profound transformation in recent years, resulting in dramatically higher compliance costs.[4] One industry observer noted the confluence of these issues, saying, "Tighter regulation and more disclosure and compliance give investors the feeling that they are better off and safer, but that's only true when each level of compliance adds to the others, rather than overlapping significantly."[5]

The Committee's interest today in these developments is timely, as the mergers present the perfect opportunity to undertake structural reform and address the aforementioned drawbacks. However, if no action is taken these deficiencies will redouble as conflicts of interest and regulatory duplication extract an ever-increasing cost on industry and investors.

To address these concerns, we support consolidation of the broker-dealer regulatory functions for firms that are dually regulated by both the NYSE and the NASD in accordance with the following objectives:

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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*.

[4] We recently issued a report demonstrating that the cost of compliance for the securities industry has nearly doubled over the past three years. *The Costs of Compliance in the U.S. Securities Industry*, SIA Research Reports, Volume VII, No. 2 (Feb. 22, 2006), available at http://www.sia.com/research/pdf/RsrchRprtVol7-2.pdf.

[5] Jaffe, *Commentary: Added Regulation Bringing Few Benefits,* MarketWatch.com, (March 1, 2005), available at http://www.marketwatch.com/News/Story/Story.aspx?guid=%7B46193141%2D1FB2%2D4506%2D852C%2D984A40692178%7D&siteid=google.

- There should be one principles-based rulebook for broker-dealer activities, and one source of interpretations, examinations and investigations for compliance with that rulebook;
- Broker-dealers should have fair representation in the governance of the SRO that oversees their affairs;
- Broker-dealers should pay fees for regulation of broker-dealer activities through a transparent fee-setting process, and fees for specific services or products should be designed to recover costs, but not to subsidize the general cost of regulation or to cross-subsidize other products or business lines;
- The SRO's costs should be contained in a budget that is subject to independent review; and
- Examination programs and queries for trade information should be structured to eliminate duplication.

These objectives should be embodied in a single organization for those broker-dealers currently subject to duplicative regulation by the NYSE and the NASD. 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. A principles-based rulebook would strengthen the competitiveness of our markets by capturing the benefits of risk-based regulation now increasingly practiced in other major markets around the world. Except for regulation of trading on an exchange, all activities of broker-dealers that are currently regulated by both the NYSE and the NASD– encompassing licensing of individuals, sales practices, supervision, communications with the public, net capital and margin requirements, account statements and securities distributions -- would be handled by one body. This consolidation would not apply to each exchange's trading rules, market surveillance or listing standards, which should remain separately administered by their respective marketplace SROs, so as to draw on specialized knowledge of their own market.

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.[6] Self-policing by professionals who have the requisite working

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6 *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").

knowledge and expertise about both marketplace intricacies and the technical aspects of regulation creates a self-regulatory system with valuable 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 generally exceeds the anti-fraud requirements of securities statutes and SEC rules.

A. Conflicts of Interest.

In spite of how well self-regulation has worked, market participants, governmental bodies, scholars and investor advocates have recognized in recent years a growing need for structural reform of self-regulation. The main concern revolves around the potential conflicts of interest due to the SROs' roles as both market operators and regulators.[7] The profit motive of a shareholder-owned SRO further heightens the concern that self-regulation could be impaired.[8]

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7 "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").

8 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.

Moreover, as discussed at pages 15-16 below, the current lack of transparency and competition in setting market data fees is heightened with just two consolidated for-profit market centers.

This conflict between operating and regulating a market has been publicly discussed since the NYSE first raised the idea of demutualizing in the late 1990s. For example, NYSE Group (the for-profit parent) would have an interest in promoting trading products offered by it, and discouraging broker-dealers from offering competing products. Similarly, NYSE Group would have a strong interest in promoting trading on its exchange, and could discourage broker-dealers or their affiliates from offering, or routing trades to, competing platforms. These types of conflicts have long been an issue between exchanges and their members, even pre-dating for-profit exchanges. Conflicts have grown as exchange members have become increasingly competitive with the NYSE. For example, NYSE members have been internalizing order flow and offering alternative trading venues that compete with the NYSE for third party order flow.[9] Once an exchange or its parent gains for-profit status, this conflict of interest becomes much more acute.[10] In addition, as the NYSE Group or its subsidiaries enter into a broader array of businesses, or add to their trading products (as they have stated they plan to do)[11] the opportunities for conflicts will multiply.

The SEC recently approved a restructuring of the NYSE regulatory function in connection with the Archipelago merger.[12] We think that the proposal approved by the SEC falls

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9 "[S]elf-regulation now poses massive agency-cost problems because exchanges are seeking to regulate members who are, in fact, competing firms rather than firms with whom the exchanges' interests are aligned with respect to most regulatory issues." Jonathan R. Macey & Maureen O'Hara, *From Markets to Venues: Securities Regulation in an Evolving World*, 58 Stan. L. Rev. 563, 578 ("Macey & O'Hara"). For an illustration of the long history of competitive issues between the NYSE and its members s*ee, e.g*, *The Structure of the Securities Market – Past and Future*, Thomas A. Russo and William K.S. Wang, 61 Fordham L. Rev. 1, 42 (1972) ("The New York Stock Exchange has taken every opportunity to fight competition…." (citing then-current illustrations)).

10 Macey & O'Hara at 581.

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

12 Exchange Act Rel. No. 34-53382 (Feb. 27, 2005), available at http://www.sec.gov/rules/sro/nyse/34-53382.pdf ("SEC Approval Order").

short of the degree of separation that is necessary to insulate regulation from the business interests of a for-profit parent.[13] However, we do not wish to disturb the finality of the SEC's decision, on which the NYSE's legitimate and urgent business plans rest. Rather, we hope that the Commission, with the support of this Committee, will continue to address this issue by ensuring that the NYSE and NASD finalize their stated intentions to move the regulatory functions that are the primary source of the conflict – regulation by the NYSE of its competitors[14] -- out of the sole control of the NYSE and into an entity that consolidates the overlapping regulatory programs of the NASD and NYSE.

B. Duplicative and Inconsistent Regulation.

Another major concern is duplicative and inconsistent regulation among multiple SROs, as well as redundant SRO regulatory staff and infrastructure.[15] 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 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"). Another area of significant and rising redundancy concerns trade reporting. Currently, the trade information requested and the formats may be different for each SRO. Since the information requested could go back many years, firms must maintain access to all the old historical data while allowing the flexibility to augment the data with today's newly

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[13] Letter to Nancy M. Morris, Secretary, Securities and Exchange Commission, from Marc E. Lackritz and Micah S. Green, (Feb. 2, 2006), available at http://www.sec.gov/rules/sro/nyse/nyse200577/melackritz020206.pdf. ("SIA-TBMA comment letter"). The SEC Approval Order, while noting our main concerns, took few steps to address the concerns raised by many commenters on the lack of sufficient separation between NYSE Group and its regulatory affiliates.

[14] 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.

[15] "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.

requested and created fields of information resulting from new regulation. This process is extremely difficult and costly to manage. A consolidated SRO would more easily be able to work with the industry to develop a system that would submit all order and execution data in a standardized format to an industry data warehouse. This will eliminate a key unnecessary redundancy in the current SRO system.

C. Solutions.

In addition to the waste of regulatory resources, the impact on investors from unnecessary compliance costs, in terms of either increased costs or reduction in choices of products and services, should not be minimized. Fortunately, the senior staffs of both the NYSE and the NASD are signaling a clear intention to address these issues. We are greatly heartened, for example, by recent remarks by senior officials of both organizations indicating a commitment to combine their regulatory functions (albeit with different points of view on how that should occur).[16]

It is important to emphasize that some form of regulatory consolidation of NYSE and NASD rules into one risk-based rulebook, rather than merely seeking to "harmonize" two separate rulebooks, is the only approach that makes sense in the long term. We have worked with both SROs on specific discrepancies between their rulebooks and interpretations, and many of these issues have been resolved through great effort.[17] A recent regulatory effort on business entertainment is a good illustration of why this approach is only a stopgap solution that is far less desirable than one consolidated rulebook. In the past year both the NYSE and the NASD have considered new rules on gifts and entertainment given by broker-dealers or their employees to employees of customers. Initially, the two SROs considered vastly different approaches. After we raised concerns about the inconsistent approaches, the two SROs worked with each other and with our industry to devise a single, principles-based approach that is now in the process of being

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16 *NYSE Seeks a Regulatory Alliance*, Wall Street Journal, C-3 (Feb. 23, 2006).

17 We have also 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.

adopted. Even now, however, there are small but substantive differences in the key proposed definitions of "business entertainment" and "customer."[18]

In its recent regulatory filing, the NYSE committed itself to continuing to work with the NASD to address inconsistent rules and duplicative examinations, and "to use its best efforts, in cooperation with the NASD, to submit to the Commission within one year proposed rule changes reconciling inconsistent rules and a report setting forth those rules that have not been reconciled."[19] Although this determination to address inconsistencies and duplication as they arise is praiseworthy, it is not a satisfactory long-term solution. First, as the business entertainment example illustrates, it requires continual senior-level effort to reconcile new discrepancies as they arise, and even then the resulting rules may have some discrepancies in nuance or interpretation. Second, harmonization does not resolve the concern about conflicts when a for-profit exchange has regulatory power over its competitors. Third, no matter how capable the regulators or how valiant their efforts to reconcile their rules, in light of the variations in institutional culture, history and constituency among the NYSE and NASD, just synthesizing their rules will be inferior to what could be produced by a single regulator. Think of the result if Hemingway and Faulkner sought to "harmonize" their work. This is particularly true given that rule interpretation is as important to the outcome as the literal wording.

Rather than trying to pick and choose between existing SRO rules, or splitting the difference between two separate rules addressing the same conduct, investors, issuers, and the industry would benefit greatly from the more "prudential" regulatory approach followed by other financial service regulators. A principles-based rulebook – one that abjures the temptations to

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18 For example, the NASD definition requires that to be considered as "business entertainment" rather than under its different limitations for "gifts," it is necessary that a person associated with the broker-dealer "accompanies and participates" with the customer's employee in the event, "irrespective of whether any business is conducted." The NYSE definition requires that an employee of the broker-dealer "accompanies" the customer's employee, without the added nuance of "participation." Unlike the NASD, the NYSE waives the accompaniment requirement if "exigent circumstances make it impracticable" for the broker-dealer's employee to attend. *See* Proposed NASD IM-3060, NASD Notice to Members 06-06, January 2006 (available at http:www.nasd.comhttp://www.nasd.com/web/groups/rules_regs /documents/notice_to_members/ asdw_015876.pdf); Proposed NYSE Rule 350A, File No. SR-NYSE-2006-06, Feb. 15, 2006 (available at SEC Public Information Office).

19 Amendment No. 6 to SR-NYSE-2005-77, available at http://www.sec.gov/rules/sro/nyse/34-53382amend6.pdf.

write highly proscriptive and inflexible rules, then use examination and enforcement programs to set unwritten policies that the rules fail to articulate – will benefit investors and the U.S. capital markets alike. It will foster an atmosphere in which broker-dealers will be more likely to take the initiative and approach regulators with issues they have self-identified in order to seek a rational solution, rather than simply self-police for compliance with highly technical, and possibly outdated, rules.

In short, duplication and inefficiency 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 best elements of the existing SRO broker-dealer regulatory programs in one centrally-managed entity that is responsive, accountable, transparent and well-funded.

II. Significance of the NYSE-Archipelago Merger

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 implications of the merger.

(1) There is strong economic justification for the NYSE's transition to for-profit status, and none of our comments today should be taken as opposition to the merger with Archipelago. The merger both illustrates and accelerates the trend toward increased consolidation of, and competition between, market centers around the globe. This competition is, on balance, a very healthy development.

(2) This global competition applies not just to market centers, but to all types of financial intermediaries. Unnecessary regulatory duplication and failure to embrace risk-based regulation are weights 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 these disparities.

(3) The merger raises the exact issues that both the SEC and SIA have identified previously concerning conflicts between shareholders' interests and regulatory authority. In general, to the extent that self-regulatory conflicts are seen to have contributed to lapses in

oversight in recent years, the incorporation of the regulatory function in a for-profit exchange structure can only heighten those concerns. A number of stock exchanges around the world have become for-profit over the past decade, and all of them have taken steps to ensure "structural separation between the supervisory authority and the management of the exchange or market."[20]

In fairness, the NYSE proposes some steps to address this conflict. 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 certainly necessary, it is not sufficient. We have expressed concern[21] that the new entity, titled "NYSE Regulation," will be under the control of a board of directors that will include a number of its members drawn from the NYSE parent's own board. Moreover, the NYSE itself, which will have plenary authority to review actions of NYSE Regulation, will be controlled by directors of the for-profit parent. Just as the NYSE has made solid efforts to foster more assertive and less conflicted boards for the companies that it lists, we had hoped that it would recognize the conflict that NYSE Group directors may bring to the boardroom when they serve as directors of the subsidiaries that regulate NYSE Group's competitors. While the SEC secured some modest adjustments to the NYSE's proposal to address these concerns, they stopped well short of what we thought was desirable.

The SEC's approval order illuminated another potential conflict between the NYSE for-profit parent and its regulatory affiliate: the potential for misuse of NYSE Regulation's ability to impose fines and penalties to benefit the parent's business. The NYSE's proposal states that such monies cannot be used for commercial purposes or distributed to any entity other than

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20 Macey & O'Hara, note 9, *supra*, at 581 (surveying the Australian Stock Exchange, Deutsche Borse, Euronext, Hong Kong Exchange, London Stock Exchange, OM (Stockholm), Singapore Stock Exchange and Toronto Stock Exchange).

21 SIA-TBMA comment letter, note 13, *supra*, at 9.

NYSE Regulation.[22] However, even if penalties or fines cannot be diverted to directly benefit the parent's bottom line, the possibility still remains that NYSE Group directors participating in the oversight of the regulatory function could encourage heavy reliance on fines and penalties, most or all of which would come from NYSE Group competitors, to sustain the regulatory budget. The SEC appears to have concerns in this area, since as part of the approval process it asked for and received from the NYSE a commitment to file a separate proposed rule on NYSE Regulation's use of regulatory fees, fines, and penalties.[23]

The most effective way of dealing with the conflict between the NYSE's regulatory authority and its business interests, as well as with duplicative regulation, is to combine the overlapping broker-dealer regulatory functions of the NYSE and NASD in a separate entity. 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."[24]

This convergence of views suggests that this is an ideal moment for implementing significant structural reform to self-regulation. Unfortunately, the NYSE and NASD seem to be at an impasse on turning their shared views into reality. From recent public statements, the NYSE appears to favor a true "joint venture," controlled by both the NYSE and the NASD, to regulate the firms that are currently dually regulated, while the NASD seems to seek to move the NYSE regulatory functions into itself, or possibly to create an entirely new regulatory entity totally separate from either existing SRO. We think any of these approaches could achieve the five goals that we outlined on page 3 above.

For example, a joint venture by the two SROs for dually regulated firms could be structured so that it alleviates the conflicts inherent in a for-profit parent regulating its

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22 SEC Approval Order, note 12, *supra*, at 46,

23 *Id*. at n. 231. The SEC has previously warned that "shareholder-owned SROs may… 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, n. 7 *supra*, at 71263.

24 *NYSE Seeks a Regulatory Alliance*, Wall Street Journal, C-3 (Feb. 23, 2006). *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).

competitors by providing (i) a single principles-based rulebook, (ii) a single examination staff (e.g., by contracting the examination function out to one of the SROs, or by seconding examination staff from the NASD or the NYSE) so that the purpose of a single rulebook is not undermined by duplicative or inconsistent examinations by two sets of regulators, (iii) the protections that we discuss below regarding public and industry involvement in its oversight, and (iv) restrictions on the use of market data fees or enforcement penalties to fund its operation. Since the NASD arguably does not face conflict of interest issues to the same degree as the NYSE,[25] a structure involving folding dual-registrant regulation into an arm of the NASD, or into a new entity entirely independent of either SRO, could be at least as effective a means to satisfy the conflict of interest concerns.

We strongly urge this Committee and the SEC to take the lead in capitalizing on the opportunities created by these developments. The differences between the NYSE and NASD are much less significant than their agreement with the principle that consolidation should occur, and as long as the SEC and this and other Congressional oversight committees stay engaged, these differences should be bridged in short order. With the help of this Committee and the involvement of the SEC, SROs, market participants and investors working together, one of these forms of a "hybrid regulator" could be the vehicle for driving self-regulation into the 21st century.

III. Structural Reform of Self-Regulation

Consolidating broker-dealer regulation 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

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[25] The NASD does have a potential conflict due to its contract to provide regulatory services to Nasdaq, but this appears much less significant than the conflict faced by the NYSE's regulatory function, which is wholly owned by the for-profit parent and contains substantial representation of the for-profit parent's independent directors on its oversight boards.

to attract talented staff. 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.

In general, the SEC has already begun moving toward more universal capital market rules. For instance, parts of Regulation SHO[26] and Regulation NMS[27] reflect a convergence of rules. Regulatory consolidation will build on this streamlining of regulations while eliminating redundancies and gaps in regulatory coverage.

A. Overseeing a Consolidated Regulator.

We realize that SRO regulatory consolidation would concentrate regulatory power and authority in one entity. Therefore, this regulatory structure will function effectively only if the SEC provides attentive oversight that includes the vigilant review of the consolidated regulator's costs and fee structures. Similarly, the Commission should review the consolidated regulator's final disciplinary proceedings in order to counter any self-serving interest by the regulator 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 consolidated regulator from becoming an unresponsive entity with prohibitive cost structures. While the consolidated regulator 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.[28] Member involvement and SEC oversight of the hybrid SRO also will be necessary to identify and harmonize any "boundary" issues between conduct

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

[27] *See* Regulation NMS.

[28] 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.

rules subject to the consolidated regulator's oversight, and market rules subject to the continued oversight of the various market SROs.

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

B. Funding the Regulator.

Another significant issue is how best to fund the consolidated regulator. The goal of the consolidated regulator 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. 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. We recommend that the consolidated regulator be required to define the costs necessary to meet its 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 consolidated regulator 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 consolidated regulator. Such regulation and education initiatives foster the market integrity and investor confidence that bring so much business to the U.S. capital markets. 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.[29] Combining the broker-dealer regulatory functions of the NASD and NYSE

[29] 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).

should result in savings for the SROs 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, the industry is willing to pay higher regulatory fees to the consolidated regulator than it now pays to the NYSE and NASD. For member firms, higher fees would be offset by 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, allocated with the SEC's assistance and in a manner that does not place an undue burden on smaller firms.[30]

IV. Eliminating Excessive Market Data Fees

Regardless of the outcome of regulatory consolidation, it is vitally important that the SEC deal with longstanding concerns by market participants about the opaque and non-accountable way in which market data fees are currently set.[31] 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, regulation should not depend on revenue from market data fees. The current approach to market data fees hurts the transparency of prices and imposes unjustifiable costs on market participants and, ultimately, investors.

The conflicts arise from the danger that that the current lack of transparency and competitiveness in setting market data fees will foster monopolistic behavior, with the ability to use the monopoly revenue to subsidize other activities. The proposed NYSE and Nasdaq mergers heighten this danger, by creating the prospect of an oligopoly over market data controlled by just two consolidated for-profit market centers. A cost-based approach will minimize many of the conflicts of interest related to market data fees that SROs face now.

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[30] 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.

[31] For a more detailed discussion of our 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

Market participants are legally required to provide certain specific market data to the SROs. Market participants should not be required to relinquish any additional rights to market data as a condition of membership in an SRO. Indeed, an SRO should not be permitted to condition access to the exchange on the acceptance of terms that seem designed primarily to advance the commercial interests of the exchange.

We applaud the SEC's expressed intention to address many open issues concerning market data fees in the context of SRO reform.[32] We strongly believe the resolution of these issues – sooner than later – is of the utmost importance for the integrity of the markets.

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. We are 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.

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