Testimony of
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Hearing on

"Regulation NMS and Recent Market Developments"

I. Introduction

Chairman Shelby, Senator Sarbanes, 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 the implementation of Regulation NMS, as well as on issues related to the proposed mergers between the New York Stock Exchange ("NYSE") and Archipelago Holdings, Inc., and The Nasdaq Stock Market ("Nasdaq") and Instinet, LLC.

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. Indeed, we only have to look at developments over the last month to see that this continues to be the case. Both the NYSE and Nasdaq proposed major restructurings and the Securities and Exchange Commission ("SEC" or

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1 The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. At its core: Commitment to Clarity, a commitment to openness and understanding as the guiding principles for all interactions between investors and the firms that serve them. 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 an estimated $227.5 billion in domestic revenue and $305 billion in global revenues. (More information about SIA is available at: www.sia.com.)

“Commission”) adopted Regulation NMS after a vigorous and healthy debate over the future trading structure of our securities markets.

SIA does not have a position on the proposed mergers, but we strongly believe they raise two critical regulatory issues that the Commission should address. First, they highlight the need, and present the opportunity, to bring the structure of self-regulation into the 21st century. Although the current model of self-regulation has generally worked well to protect investors, we believe the time has come for a major restructuring of the self-regulatory system. SIA supports the adoption of a hybrid self-regulatory model, which would embody regulation into two types of organizations that would be divided by function. 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. 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.

Second, the proposed mergers 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. We have urged the SEC to address market data issues comprehensively, and we are disappointed that the SEC has not done this yet. The Commission has indicated, however, that it intends to address the remaining issues in the context of SRO reform. We urge the Commission to consider the recent plans for consolidation of market centers in addressing the outstanding market data issues.

The periodic re-evaluation of market structure is vital to maintaining our global preeminence and to ensuring that investors are fully protected. SIA commends the Commission and its staff for tackling such difficult issues and for their continued efforts to engage all market participants in the debate. The SEC has acted diligently and in good faith to explore reforms that will strengthen the U.S. capital markets. Although many of the solutions are controversial and not necessarily what SIA would prescribe, the policy debate has been necessary and productive. The trade-through rule was particularly divisive, as evidenced by the unusual 3-2 split among the Commissioners on final adoption of the rule. However, it is important to note that the issues raised in Regulation NMS are inherently complex, and finding consensus is an enormously difficult task.

Since the text of Regulation NMS has not yet been released, we have not identified the full range of implementation problems yet. We are in the process of forming working groups with our member-firms to address all operational and compliance implementation issues, and plan to work with the self-regulatory organizations ("SROs") over the next 14 months. Given the significant systems and other changes that will be necessary to implement the new rules, we are grateful that the Commission has provided lengthy implementation periods for most of the rules.

II. Regulation NMS

Guiding Principles.

SIA believes any regulatory approach to market structure should:

- Protect investors.
- Ensure the markets are fair, orderly, and honest.
- Be sufficiently flexible to adapt to the development of new trading practices and technological innovations by competing market centers.
- Foster effective intermarket executions and enhance market access to ensure that all investors' orders – both retail and institutional – are executed in the manner most beneficial to the investor.
- Assure equal, fair, and consistent regulation across market centers.
- Ensure quality, fairly priced, cost-effective market data**.**

The SEC's Action on Regulation NMS.

The newly adopted Regulation NMS includes new or revised rules for trade-through regulation, intermarket access, quoting in sub-penny increments, and market data reforms. Although we agree with many of the SEC's decisions, there are a few significant areas where we differ and/or had offered refinements.

Intermarket Price Protection (Trade-Through Rule). The Commission proposed two alternatives for the trade-through rule, a "top-of-book" option and a voluntary “depth-of-book” alternative. SIA member-firms were not convinced that either approach was appropriate and recommended putting in place the National Best Bid and Offer (“NBBO”) model before considering implementing either of the options. The SEC, however, adopted the top-of-book approach, which will protect the best bids and offers of each exchange, Nasdaq, and the NASD’s ADF. Trading centers will have to establish and enforce written policies and procedures that are reasonably designed to prevent trade-throughs.

Given the vital importance and the extreme complexity of the trade-through rule, we argued that it would be more prudent to take a methodical approach to implementation to ensure we get it right from the start. Using the NBBO model as a first step would strengthen existing trade-through protection and extend it beyond the listed market to cover the entire Nasdaq market as well. Such a strategy would provide greater investor protection and facilitate competitive, innovative markets while avoiding the unnecessary, burdensome regulatory effects or unintended consequences that could result from the more extensive trade-through rules.

SIA supported the adoption of many of the Commission’s proposed exceptions to the trade-through rule and offered some fine-tuning of others. Although the rule did not contain a general “opt-out” exception that would have allowed market participants to disregard displayed quotations, the rule included several exceptions to help ensure its workability with, among others, intermarket sweep orders, quotations displayed by markets that fail to meet the response requirements for automated quotations, and flickering quotations with multiple prices displayed in a single second.

The Commission did not adopt, however, our suggestion for a new liquidity exception for the most actively traded, highly liquid securities. We recommended this exception because the manner in which these securities trade already affords investors with effective protection. Trade-through regulation should be focused on those securities for which it would have the greatest benefit in protecting investors – less liquid securities, for example. The adoption of such an exception would have allowed the SEC to study the effect of having a trade-through rule versus not having one for a specified period of time (such as a year). The SEC would then have been able to consider the necessity for any further action, in much the same manner as it plans to do with the pilot program for Regulation SHO (short-sale rule).

We are also concerned about the treatment of manual quotes in the new trade-through rule, and discussed these concerns and our recommendations for addressing them in our comment letters.

Intermarket Access. SIA supported adoption of the Commission's proposed access standards for private linkages and the proposed rule to minimize locked and crossed markets. The private-linkage approach establishes uniform market access for all by promoting non-discriminatory access to quotations displayed by SRO trading centers. We suggested, however, that the anti-locking and anti-crossing rule include two of the proposed exceptions to the trade-through rule – flickering quotes and systems malfunctions.

SIA supported the Commission's efforts to craft a market-wide solution to the access fee problem, but we still have concerns about excessive fees related to unprotected quotations, the administrative difficulties of tracking whether quotations are protected or not, and the broad definition of access fees.

Sub-Penny Quoting. We endorsed the Commission's ban on sub-penny pricing as a way to help prevent "stepping-ahead" of customer limit orders for an economically insignificant amount. This practice, over time, could discourage investors from placing limit orders, an important source of market liquidity.

Market Data. We are deeply disappointed that the SEC did not deal with all of the market data issues in the context of the Regulation NMS debate, but the Commission has indicated it intends to address the remaining issues in the context of SRO reform. We strongly believe the resolution of these issues – sooner than later – is of the utmost importance for the integrity of the markets, particularly now in light of the proposed NYSE and Nasdaq mergers.

The Commission adopted rules to revise formulas for the allocation of market data revenues to: create advisory committees to the joint industry plans composed of non-SRO representatives; authorize markets to distribute their own data independently, while still providing their best quotations and trades for consolidated dissemination through the plans; and, streamline the requirements for the display of market data to investors. According to the SEC, these changes will help correct the flaws of the current formulas, reward SROs that contribute to public price discovery by dividing market data revenues equally between trading and quoting activity, and improve the transparency and effective operation of the plans.

Those revised reallocation formulas, however, do not address a number of other critical market data issues – such as opaque fee-setting practices – that have resulted in unwarranted and excessive market data fees. We had recommended that the Commission consider all of the following market data related issues as a whole:

(i) Current and future fees should be accounted for transparently, and supported by independent audits of the Networks and annual filings that cover expenses, revenues, and projections;

(ii) Unlike the SEC's rule filing process, fees should be set and changed through a collective process that involves market participants, operates transparently and permits real challenge;

(iii) Fees should be limited to the cost of collecting and disseminating market data, thereby rendering rebates unnecessary;

(iv) The Networks' contractual and usage requirements should be reduced, streamlined, and made uniform, which will assist in lowering fees and associated administrative burdens;

(v) Plan governance also should be transparent, with any advisory committee structured to reflect industry and investor involvement and empowered beyond the merely cosmetic;

(vi) Most firms believe that information should be channeled through a single securities information processor ("SIP");

(vii) Any fees chargeable for non-core data such as depth-of-book should be subject to market forces;[2] and,

(viii) Market data provisions, including definitions and applications of fee categories such as "professional" and "non-professional" and limitations on the redistribution of data, should be the subject of a fresh review and uniform rulemaking.

We believe Congress did not intend for market data to generate revenues for SROs to subsidize their regulatory obligations or to fund competitive business activities, as 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 advocated 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 relies upon 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."

Our proposed cost-based approach will minimize many of the conflicts of interest related to market data fees that SRO members of the Plans face now. The conflicts arise from control over a monopoly product with the ability to use the monopoly revenue to subsidize other activities. By limiting the market data revenue, the business incentive to seek greater data revenue is restricted as well. 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.

Of course, in determining the reasonableness of fees under the cost-based approach, the SEC also must consider whether the fee limits fair and reasonable access to

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[2] The SIA believes, however, that the Commission should undertake a study of the impact of different levels of transparency among market participants (e.g., between retail and institutional investors) in this era of decimalization where depth of book data is not readily available to all.

market data, particularly where such access is imperative for compliance with regulatory requirements, such as proposed Regulation NMS. We need to recognize that decimalization has decreased the value of consolidated market data even though the price has remained the same. Prior to decimalization, the consolidated data reflected in the NBBO signaled the depth in the market up to 12 cents. Today, the depth of the market reflected in the NBBO is only a penny or two, generally representing very few shares.

The valuable data that used to be reflected in the NBBO is now in the non-consolidated data that the SROs are distributing on their own, at an additional charge. This trend is continuing and, indeed, sanctioned by the Commission's recent amendments. The Commission should not only look at the high cost of producing such data, but also whether market data fees are in fact cross-subsidizing the production of proprietary market data products. We believe a cost-based approach to all market data would ensure the availability of both depth-of-book and NBBO information at a reasonable cost.

The proposed NYSE and Nasdaq mergers only heighten our concerns in these areas. Indeed, some member-firms are apprehensive that the SROs will have an even greater monopolistic hold on market data with the consolidation of the markets, which could work toward the detriment of both our markets and investors. We therefore strongly encourage the Commission to review all of these market data issues with these new concerns in mind.

III. The Need for Structural Reform of Self-Regulation

Guiding Principles.

The proposed NYSE-Archipelago merger further heightens the importance of examining the securities industry's self-regulatory system. SIA has thought a great deal about the structure of self-regulation over many years. Five years ago, when the NYSE and Nasdaq first proposed to become for-profit entities, SIA commissioned a White Paper titled "Reinventing Self-Regulation." The White Paper examined the effectiveness of self-regulation in a rapidly changing environment, and considered the advantages and disadvantages of different models for regulation of our nation's securities markets.[3]

Our reviews of self-regulation include a set of guiding principles, many of which are listed in the previous section addressing market structure issues. Two additional principles, however, should be considered in the debate over the self-regulatory system. First, the regulatory system should ensure the primacy of the SEC as a strong national regulator, but should include appropriate roles for, and coordination with, the SROs, the states, and market participants, to achieve uniform national standards. Second, the regulatory staff overseeing day-to-day activities must possess the requisite expertise necessary to perform their duties. This can best be achieved if the regulator has: (i) effective industry input into the regulatory process; (ii) the power and prestige to attract talented staff; and (iii) the ability appropriately to tailor regulation to fit the diversity of entities that it regulates, rather than relying upon a "one-size-fits-all" approach.

Based on our experience with these issues, we have concluded that the time has come for a major restructuring of self-regulation. Although we believe the current model of self-regulation has generally worked well to protect investors, concerns about regulatory conflicts of interest and regulatory duplication have taken on new significance as market centers combine and competition – both domestically and internationally – intensifies. In that vein, we propose consolidating regulation of broker-dealers into one "hybrid" SRO, while each marketplace retains separate SROs to regulate and enforce all aspects of trading, markets, and listing requirements. We describe this proposal in more detail later.

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] For example, member expertise and involvement in SRO

[3] The White Paper is available at http://www.sia.com/market_structure/html/siawhitepaperfinal.htm.

rulemaking processes has led to more effective, less costly rules. In addition, 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 have an intimate knowledge of industry operations, trading, and sales practices, they can develop and revise rules more quickly and frequently. Similarly, self-regulation utilizes the insight of those who are on the frontline of marketplace developments, meaning they can be more forward-looking and up-to-date with market realities than traditional government regulators. In addition, SRO rules often are designed to set ethical standards that exceed the 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, both market participants and governmental bodies have recognized in recent years a growing need for structural reform of self-regulation. This view is based on three concerns: (1) increased competition among SROs and their members for customer orders could cause conflicts of interest due to the SROs' roles as both market operators and regulators;[5] (2) "multiple

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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

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;"[6] and, (3) the profit motive of a shareholder-owned SRO could detract from self-regulation.[7]

Significance of the NYSE-Archipelago Merger.

Because several of our large members have divergent views on the proposed NYSE-Archipelago merger, it would be inappropriate for us to comment on its merits as a business transaction. We do, however, strongly believe that the proposed merger represents an important opportunity to address the concerns outlined previously. 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 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. The very fact that NYSE apparently seeks to maintain regulation of its broker-dealer members under the NYSE name and 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

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Release Concerning Self-Regulation, 69 Fed. Register 71256, 71262 (Dec. 8, 2004) ("SEC SRO Concept Release").

[6] SEC SRO Concept Release at 71264. The GAO has noted similar "inefficiencies associated with SRO rules and examinations." GAO Report at 2.

SIA has recently had productive discussions with the NYSE and NASD, as well as the SEC's Office of Inspections and Examinations ("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.

[7] "Another significant conflict of interest for SRO responsibilities is with SRO shareholders. 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.

continued “branding” of its regulatory authority over broker-dealers. The measure of any value that may be perceived in retaining broker-dealer regulation within the NYSE brand is also the measure of the problem of the NYSE regulating potential competitors.

(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 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, it appears that the NYSE sought to address several of these issues in structuring the merger. The NYSE stated that it would take steps to separate the NYSE's regulatory arm from its business side, which should help ameliorate concerns about the possible misuse of the NYSE's regulatory authority to benefit its business side and its shareholders.[8] However, the NYSE's proposal does not appear to address the critical issue of regulatory duplication between itself and the NASD in regulating dually-registered broker-dealers. While the NYSE is, appropriately, focused on strengthening the competitiveness of its own business position, the proposed merger represents an opportunity to reconfigure the self-regulatory system so that the competitiveness of the overall U.S. capital markets is also strengthened.

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[8] Joint NYSE-Arca/Ex News Release, April 20, 2005, available at http://www.nyse.com/pdfs/joint_release.pdf, at 2.

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, SIA believes the Hybrid self-regulatory model offers the best alternative regulatory structure for preserving competitive, innovative markets while fostering more efficient and effective regulation. Under this model, self-regulation would be embodied in two types of organizations that would be divided by function. 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 (sales practices, financial responsibility requirements, qualification of personnel, recordkeeping, etc.).

The Hybrid model will require the SEC to designate a Single Member SRO to regulate all SRO members with respect to membership rules such as financial condition, margin, registered representative qualification testing, customer accounts, sales practices, and supervision. 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. First, it eliminates the inefficiencies in rulemaking and examinations, and the potential for inconsistent regulation that exists in a multiple SRO system. Second, it eliminates conflicts of interest between an SRO's regulatory and market functions with regard to membership rules.

A Hybrid Will Give Better Regulatory Mileage. Most broker-dealer compliance resources currently are devoted to complying with rules of multiple SROs. For example, conduct rules – the area of the most duplicative SRO rules – have the same regulatory purpose but require different compliance efforts.[9] The Hybrid model would strengthen

[9] For example, the NYSE and NASD have different order audit trail requirements, each of which requires unique programming and compliance efforts that are costly, and both of which are intended to provide similar information for surveillance purposes.

the effectiveness of compliance resources by creating a single comprehensive regulatory oversight structure. 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, Regulation SHO creates a uniform definition of what constitutes ownership of securities, specifies aggregation of long and short positions, and requires broker-dealers to mark sales in all equity securities “long,” “short,” or “short exempt” to establish a uniform system across markets.[10] Parts of Regulation NMS, such as the ban on sub-penny quotations for securities priced over one dollar,[11] also reflect a convergence of rules. The Hybrid model will continue this consolidation and streamlining of regulations to increase efficacy and efficiency, and to eliminate 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 and cost-effective regulatory oversight. This oversight should include the SEC’s vigilant review of the Single Member SRO’s costs and fee structures to ensure that the SRO is providing sufficient regulatory oversight without imposing excessive fees and budget demands. 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.

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

[11] *See* Regulation NMS.

Additionally, strong member involvement will become even more important to prevent the Single Member SRO from becoming an unresponsive entity with prohibitive cost structures. The Single Member SRO 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.[12] 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.

The Commission 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.[13]

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 and that fees for regulation should be apportioned to the industry on a

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[12] 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.

[13] 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.").

fair and reasonable basis. The fees should be unbundled and cost-justified whenever possible. Imposing regulatory fees on the securities industry 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.

As stated earlier, we are convinced that market data fees should not be used to fund regulation and should instead fund only the collection and dissemination of market data.[14] Cost-based market data fees will not reduce regulatory funding, but will provide greater accountability and transparency in the way market data fees are assessed and self-regulation is funded. Explicitly tying market data fees to the cost of producing the data, while requiring the SROs to prepare public regulatory budgets and charge specific fees for regulation, will fully meet regulatory funding needs without over-charging for market data.

Of course, eliminating market data fees as a source of regulatory revenue may produce a shortfall of regulatory funding.[15] To address this possibility, and to underscore how strongly we feel about (i) the need for a hybrid SRO approach, and (ii) the need to move away from market data fees as a source of regulatory funding, *the industry is willing to pay higher regulatory fees to the Single Member SRO than it now pays to the NYSE and NASD.* 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

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[14] In 2003, the Plans spent $38 million on Plan expenses and collected $424 million in market data revenue. The revenue exceeds costs by a significant margin. *See* Exchange Act Release No. 49325 (Feb. 26, 2004), 69 Fed. Reg. 11126 (Mar. 9, 2004) (initially proposing Regulation NMS).

[15] We note, however, that the increase may be less than one-for-one because, although SROs may use market data fees to fund regulation today, it is equally likely that SROs use market data revenues to fund competitive or proprietary activities such as rebates for trade prints, advertising and brand marketing, and to attract listings.

member firms such that there is not an undue burden on smaller firms.[16] Notwithstanding the potential for increased regulatory fees for members of the Single Member SRO, we believe the benefits of the Hybrid model should exceed the costs.

SIA also believes that a fair and reasonable portion of the Single Member SRO's funding should come from 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 the Hybrid model, markets would receive these benefits, and market SROs should assume some of the associated regulatory and administrative costs.

IV. Conclusion

America's securities markets are the envy of the world, but we cannot take it for granted that they always will be. Maintaining the preeminence of our capital markets in an increasingly globalized economy will require sustained efforts to remove unnecessary regulatory inefficiencies that hinder our ability to compete. 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.

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[16] 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.