



Securities Industry Association

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June 27, 2003

By Hand and Via Electronic Mail

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: SEC Concept Release on Nasdaq Petition Concerning the
Regulation of Nasdaq-Listed Securities (Release No. 34-47849;
File No. S7-11-03)

Dear Mr. Katz:

The Securities Industry Association (“SIA”)¹ welcomes the opportunity to comment on the important market structure and self-regulatory issues raised in the above referenced Concept Release. The Release solicits comment on a petition by the Nasdaq Stock Market, Inc. (“Nasdaq”) calling for the Securities and Exchange Commission (“SEC”) to take certain actions to respond to the greater fragmentation of trading in Nasdaq-listed securities across various markets. Nasdaq believes that this increased fragmentation has caused the regulation of Nasdaq trading to become uncoordinated and that there are harmful disparities in the markets’ abilities to regulate the trading of Nasdaq-listed securities.² In the petition, Nasdaq asks the SEC to consider uniform trading, surveillance and enforcement rules for all markets, reallocation of regulatory costs among markets, and the closing of markets that do not have the required uniform

¹ The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member firms (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 more than 700,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated \$214 billion in U.S. revenue and \$285 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

² Securities Exchange Act Release No. 34-47849 (May 14, 2003), 68 FR 27722, at 27723.

rules. The Commission solicits comment on the Nasdaq petition and also on whether similar actions would be appropriate for exchange-listed markets.

We commend the SEC for its renewed focus on market structure and self-regulatory issues.³ Particularly because of ever-expanding technological capabilities and the related, dramatic innovation in our markets in the last few years, the time is right to address the difficult and complex issues concerning the structure of the U.S. securities markets. SIA believes the Nasdaq petition presents an opportunity to share the industry's views on key market structure issues that the Commission will confront in the coming months. Accordingly, our comments relate more to market structure and regulatory functions in general, rather than the specific issues put forth in the Nasdaq petition.

I. Overview

SEC Chairman William Donaldson and Annette Nazareth, Director of the SEC's Division of Market Regulation, have stated recently that the SEC will take a comprehensive look at market structure. According to Ms. Nazareth, "Today, the Commission is at a crossroads in its oversight of the U.S. markets, and is faced with a range of decisions that will fundamentally impact the structure of our markets for years to come. Significant issues include: (1) what it means to be an exchange; (2) the self-regulatory model of market supervision; (3) access to markets; and (4) the proper regulatory framework for market data."⁴ The issues are complex and must also be considered in the context of global markets and cross-border trading activities.

SIA concurs with Ms. Nazareth, and also supports the core principles of our National Market System as outlined recently by Ms. Nazareth: (1) transparency of information regarding quotes and trades; (2) economically efficient execution of securities transactions; (3) ease of obtaining best execution; (4) fair competition among markets and intermediaries within markets; and (5) the opportunity consistent with the aforementioned goals for investor orders to be executed without the participation of a dealer.⁵ One of SIA's primary goals is to foster public trust and confidence in our markets. Fair and efficient markets will attract both issuers, who will use the markets to raise capital, and investors, who will buy and sell securities of these issuers.

³ See, e.g., Market Structure Hearings conducted by the SEC, October 29, 2002 and November 12, 2002 ("Market Structure Hearings"); Remarks before the American Enterprise Institute by Commissioner Paul S. Atkins, SEC, May 7, 2003; Remarks before the New York Financial Writers Association by Chairman William H. Donaldson, SEC, June 5, 2003; and Remarks before the Fourth Annual Securities Industry Association Conference on Market Structure by Annette L. Nazareth, Director, Division of Market Regulation, SEC, June 13, 2003 ("Nazareth Speech").

⁴ *Id.* Nazareth Speech at 2.

⁵ *Supra* note 3, Market Structure Hearings at 25 of October 29, 2002 transcript.

It has been a long-held belief of SIA that free-market competition will produce the best market structure.⁶ SIA believes competition will promote innovation and continued evolution of efficient market structure. At the same time, there must be a regulatory framework, fashioned by the SEC, within which market participants can compete on a level playing field. We believe the Commission has acted judiciously by ensuring that markets compete fairly pursuant to guidelines established under Section 11A of the Securities Exchange Act of 1934 (“Exchange Act”), rather than by *directing* the evolution of the market through rulemaking. As Ms. Nazareth stated, “[e]ffective regulation alone cannot cause markets to succeed; ineffective or inadequate regulation can, however, obstruct their success, particularly if it contributes to an investor perception that markets are inefficient or unfair.”⁷ Because of the significant changes in the markets over the last several years, SIA believes the time is right to consider the appropriate role of the Commission in facilitating fair and efficient markets.

Initially, SIA believes the Commission should ensure parallel and consistent regulation across markets by establishing certain minimum standards for all trading venues. Further, we believe the cost of regulation should be transparent and equitably allocated across all markets. Alternative models that improve upon the existing self-regulatory scheme should be explored. As the Commission considers these important issues, SIA would be happy to assemble a Joint Industry Advisory Group of compliance, legal and business professionals representing a cross-section of firms to assist the staff in its deliberations. Such a collaborative effort, we believe, will foster constructive, balanced, resource-efficient regulation that ultimately benefits all segments of the industry. Our specific comments are set out below.

II. Parallel and Consistent Regulation

Nasdaq is concerned that investors are potentially harmed by the lack of uniform trading rules and from unequal surveillance and enforcement of those rules. Nasdaq states that it attempted, unsuccessfully, to persuade the other exchanges that trade Nasdaq stocks to act jointly to adopt uniform market rules and surveillance and enforcement mechanisms to eliminate regulatory disparities. They recommend that there be uniform trading rules relating to, among other activities, market manipulation, illegal short selling, insider trading, fraud, front running, marking the open or the close, and non-compliance with the limit order display rule and firm quote rule, and that the Commission ensure equal surveillance and enforcement of those rules.

SIA strongly supports the core set of principles for our markets outlined by Ms. Nazareth. Under such guiding principles, we believe that trading rules and surveillance and enforcement mechanisms should meet certain minimum standards set by the SEC.

⁶ See Letter to Jonathan G. Katz, Secretary, SEC, from Mark B. Sutton, Chairman, SIA Market Structure Committee, dated May 5, 2000, responding to Commission Request for Comment on Issues Relating to Market Fragmentation.

⁷ *Supra* note 3, Nazareth Speech at 1.

SIA notes that the Commission approves self-regulatory organization (“SRO”) rules and inspects SROs to see that rules are implemented and enforced effectively. We trust that the Commission will continue to act appropriately to ensure a level playing field and regulatory integrity at each market. The Commission should ensure that SRO rules are effective and consistent, while allowing the markets to implement rules necessary to offer unique execution services that are at the heart of exchange competition.

As a threshold matter, SIA generally opposes duplicative and unnecessarily inconsistent rulemaking across markets. SIA has long advocated harmonizing SRO rules and, indeed, has provided extensive comments to the National Association of Securities Dealers, Inc. (“NASD”), both in the form of written submissions and individual dialogue with the regulatory staff, in connection with the NASD’s “rule modernization” initiative.⁸ Generally, duplicative and unnecessarily conflicting regulations among SROs, as well as government regulators, yield little benefit while depleting valuable administrative and economic resources from all segments of the securities industry. This includes not only the cost of compliance and supervision by broker-dealers, but needless expenditure of valuable staffing and operating resources by regulators to monitor and examine broker-dealers for compliance with differing regulations across markets.

This is not to say, however, that we favor *identical* rules under all circumstances. Rather, we believe that there should be consistent minimum standards that allow for regulatory flexibility. For example, inconsistencies in rules that exist because of different business models may be necessary and appropriate.

SIA believes the best way to achieve effective regulation and surveillance programs is for the SEC, pursuant to its guiding principles, to define minimum standards for all trading venues without prescribing specifics for each market and business model. Each market would retain the flexibility to craft its own rules and regulatory programs to meet those minimum standards. Markets would thus be free to innovate and compete based on the quality of executions and services they provide. Floor-based auction markets, electronic order books, and competing market making systems all provide benefits to the National Market System and the SEC should facilitate these various models subject to certain minimum standards.

SIA believes that such minimum regulatory standards should be developed by the SEC in consultation with the SROs and the industry. We believe a recommendation by the General Accounting Office (“GAO”), made in connection with a review of the current self-regulatory structure,⁹ would be particularly useful in this regard. GAO

⁸ See SIA comment letter to NASD regarding Notice to Members 01-35, July 31, 2000, a copy of which is available at SIA’s website at <http://www.sia.com>. The letter discusses, among other things, the difficulties that continue to arise due to unnecessary, slight variations of language in certain parallel rules and regulations. In such instances, there can be uncertainty, confusion or even discrepancies not just for member firms but also for investors active in multiple markets. In addition, and particularly in connection with customer protection and client communication rules, inconsistencies result in different regulatory schemes based solely upon a firm’s SRO affiliation.

recommended that the SEC work with the SROs and broker-dealer community to implement a formal process for systemically identifying and harmonizing material regulatory inefficiencies caused by differences in rules or rule implementation among SROs.

The Commission notes that exchange-listed securities and securities options may be traded on more than one market and, therefore, the same regulatory issues raised by the Nasdaq petition could arise. SIA agrees, and believes any SEC recommendations should cover exchange-listed securities and options as well and that cross-market standards should be product neutral as well as market neutral. Parallel and consistent regulation for Nasdaq-listed and exchange-listed securities and options will create equal regulation, strengthen investor protection, and help to restore public trust and confidence in our markets.

A. Specific Rules

1. Audit Trail Requirements

The Nasdaq petition states that several exchanges do not have rules approved by the Commission for gathering the detailed trading data necessary for the detection of fraud, manipulation, insider trading, and other violations. Nasdaq notes that it collects order audit trail information through its Order Audit Trail System ("OATS") and through its Automated Confirmation Transaction service, and asks the Commission, at a minimum, to add to the rules of all SROs of markets that trade Nasdaq-listed securities rules requiring an electronic audit trail identical to the NASD's OATS Rules.

SIA notes that many SROs already maintain audit trail data, and that these regulatory/surveillance programs have been approved by the Commission and remain subject to continuing Commission oversight. Presumably, the SEC has assessed each market's ability to regulate and has mandated changes as appropriate. To that point, the presence or lack of an audit trail at an individual exchange reflects SEC judgments about what information each exchange needs to conduct surveillance effectively.

The SEC should continue to review the type and amount of audit trail information needed for both market regulation and member firm regulation. When considering the appropriateness of extending OATS-like audit trail requirements to a given market center, the SEC should carefully consider the cost to broker-dealer firms of supplying part of the audit trail data. SIA believes that firms are already required to maintain all of the information relating to their customers and transactions that regulators might ever want or need under the current books and records rules.¹⁰ Most firms believe that there is no justification for requiring firms to spend the additional sums necessary to create

⁹ See Report of the U.S. General Accounting Office entitled *Securities Markets: Competition and Multiple Regulators Heighten Concerns about Self-Regulation* (May 2002).

¹⁰ 17 C.F.R. 240.17a-3 and 17a-4.

information feeds to be able to send all of this information to every market center where an order may be routed.¹¹

On the other hand, to the extent that the SEC determines that the need for a particular SRO to have enhanced audit trail information outweighs the costs to member firms, SIA recommends that the SROs coordinate efforts to reduce duplication of systems and regulatory efforts. It is essential that firms not be burdened with creating customized data feeds for each SRO. To this end, some firms suggest that OATS could become a utility with development and maintenance costs shared by the industry.

2. Intermarket Trading Rules

The National Market System objectives embodied in Section 11A of the Exchange Act, enacted by Congress in 1975, have provided competing marketplaces with the ability and incentive to develop less costly and more efficient trading vehicles. This in turn has resulted in unprecedented levels of competition for customer order flow. New methods of trading, however, produce new regulations. Markets that compete for customer order flow through technological enhancements generally benefit investors; however, markets may compete through customized trading rules that have the opposite effect. It is incumbent upon all market participants, and the SEC in particular, to ensure that regulation, or the lack of it, is not unfairly used as a means for attracting order flow to one market at the expense of the National Market System.

Currently, trading rules differ among markets in many respects. In some cases, the need for different rules is obvious and understandable. For example, the NYSE is an auction market and therefore has a particular focus on matching orders with as little principal participation as possible. Nasdaq has a focus on negotiated trading and, not surprisingly, is more likely to have principals provide the contraside to customer orders. These differences serve the investing public by providing alternative trading models.

On the other hand, markets have other differences that seem unnecessary. For example, Nasdaq and NYSE do not share the same short sale rule.¹² “Locate” rules are distinguishably different. Each market has a different (and arguably inadequate) way to resolve trade-throughs and locked markets for their respective issues.¹³ Although Nasdaq market makers in listed securities are subject to Intermarket Trading System (“ITS”)

¹¹ We note that at least one member firm believes that there should be a single audit trail that can detect fraud and manipulative activities across all markets.

¹² Short sales may be an area, in particular, where standardization makes sense. We note that the SEC issued a concept release in 1999 on short sale regulation, and encourage the SEC to take action on this issue in the near future.

¹³ We have seen a proliferation of locked and crossed markets since the implementation of SuperMontage. This is in large part due to the differing regulatory schemes governing each of the various venues in which Nasdaq-listed securities are traded. Many firms agree that the prevalence of locked markets, in particular, needs to be addressed by the SEC as soon as possible.

rules, Nasdaq non-market maker proprietary traders are not. One market has a 3:40 PM cut-off for proprietary trading in facilitation of closing price guarantees and market-on-close/limit-on-close (“MOC/LOC”) orders, while the other does not. In one market, you can print a trade based on a prior reference price or as a volume weighted average price (“VWAP”), while on the other market you cannot. While the list of different trading rules between the NYSE and Nasdaq is extensive, the list expands further when regional exchanges and options markets are taken into account.¹⁴

Each technological enhancement or new method of trading fuels the debate over best execution. Undoubtedly, certain customer orders would do better with a quick electronic execution while others would do better in a negotiated or auction environment. Yet each market has an interest in seeing a more standard definition of best execution that favors doing business on its own market. Consequently, without such a best execution definition, markets could attract order flow by adopting trading rules that rely on the current vagueness of the best execution definition. Even in the case where the best execution debate over electronic markets and auction markets has led some markets to recreate themselves more as hybrid markets (*e.g.*, auction markets instituting electronic components), many trading rules still vary significantly without due consideration for the need, cost, or implications of maintaining differing rules. The SEC should re-evaluate existing rules by reference to a core set of minimum standards, and should be ever more diligent in the rule approval process to ensure that trading rules are not adopted to favor one market over the interests of the National Market System.

B. Intermarket Linkages and Access

SIA believes the SEC should develop minimum standards that allow for a fair and efficient system of intermarket access. Where there are multiple competing markets, broker-dealers must be able to identify the location of the best available prices and must be able to access those prices quickly and efficiently.¹⁵

SIA understands that the SEC will be reviewing the operation of the NASD’s Alternative Display Facility (“ADF”) pilot, where access is provided through the establishment of standards for all participants for dissemination of information, electronic access and immediacy of execution rather than through a dedicated ITS-type linkage.¹⁶ We encourage the SEC’s review of this new approach, and look forward to its determination of whether the goals of the National Market System can be furthered by the

¹⁴ Other examples of differences include the use of subpennies in some markets but not in others, and the internalization of order flow in certain markets but not others.

¹⁵ SIA expects that the SEC will issue in the near future a concept or rule proposing release on the subject of ECN access fees, and that this will provide an appropriate forum for commenting on such fees as well as on other kinds of “access” fees. Our initial view is that this is another area where minimum standards could be imposed.

¹⁶ See NASD Rule 4300A, which requires electronic delivery of orders among ADF participants and an electronic response to such orders within two seconds.

establishment of such standards as opposed to dedicated linkages. At the same time, SIA encourages the SEC also to review ITS to determine if it remains a viable system that could be made more so through certain improvements. For example, some firms believe that the existing flaws in the ITS system lie not in the original concept, but rather in how participant markets handle the orders that are shipped to them through the ITS system. These firms suggest that the SEC, as it has done with the ADF, establish minimum standards within the ITS plan for, among other things, maximum allowable turnaround time and adherence to firm quotes. These firms believe that, if the ADF standards were applied to ITS market participants, the ITS system would be much stronger.

In conjunction with its review of access standards, SIA believes the Commission should consider whether a "trade-through" rule is appropriate for either the exchange-listed or Nasdaq markets. We believe that broker-dealers should have the flexibility to set their own execution priorities based on each customer's unique preference for his or her orders, whether it is best price, speed, cost, or liquidity. Consequently, we believe that the Commission should examine this issue and make a determination whether a trade-through rule remains the best method for ensuring execution quality at the point of sale. If the Commission should conclude that it is, we believe that the Commission should ensure that there are minimum trade-through standards across all markets.

III. Fair Allocation of Regulatory Costs and Responsibilities

A. Funding and Fair Allocation of Regulatory Costs

Nasdaq recommends in its petition that the cost of regulation, such as costs associated with data collection, surveillance, and enforcement, be aggregated and deducted from the market data revenue collected pursuant to the Nasdaq Unlisted Trading Privileges Plan. Whether it is appropriate for market data fees to fund surveillance and enforcement efforts is unclear because there is inadequate transparency with respect to revenues and regulatory costs. At the very least, there should be greater transparency of all regulatory costs and SRO fees and revenues.

SIA believes the SEC should review costs across all markets to ensure that costs and responsibilities are fairly and equitably distributed. We note that member firms hold varying views on how regulatory costs should be funded and apportioned, and also on the role of market data revenue. For example, some firms believe that regulatory costs should be funded through transaction fees. Some SIA member firms recommend that the cost of regulation be borne equally among the markets based upon trading volume; others, however, disagree with using trading volume as a measure for apportioning regulatory costs. Most firms agree, however, that the regulatory burden should be shared by all SROs in a fair and non-discriminatory manner. We recognize that the regulatory expenses of a SRO need to be covered, but also believe that fees should be kept as low as possible. We believe the SEC is best suited to determine fair regulatory costs and to apportion them in a non-discriminatory manner across markets.

B. Reducing Costs of Regulation

Several years ago, SIA and others explored the concept of a hybrid SRO.¹⁷ Some firms now suggest that this concept is worthy of further review and/or that other potentially effective regulatory models should be explored. We note that the Commission may be exploring alternative models as well. Chairman Donaldson, in a recent interview, acknowledged that “We've had a long tradition, beginning in the 1930s, of self-regulation and embedding the regulatory operation inside the organization.”¹⁸ Donaldson noted that the Commission should reexamine this concept if there is public ownership of the exchange. He added, “...if you take the self-regulation out ...[and] the market buys its regulation from somebody else, that's a new model, and I'm not sure how well that works.”¹⁹

In the past, a number of SIA member firms supported a hybrid SRO with regulation bifurcated between market regulation and member regulation. For member regulation, or intermarket activities, there would be a separate, single regulator created for use by all markets so that broker-dealers would not be subject to duplicative examinations and overlapping or duplicative regulations, and regulatory costs would be fairly distributed among all market participants. For intramarket activities, each market could promulgate its own supervisory rules and levy fees to cover its own costs. Undoubtedly, other hybrid models may merit consideration as well.

Alternatively, the Commission should explore expanding the mission of the Intermarket Surveillance Group (“ISG”). ISG is a cooperative regulatory body responsible for coordination of market surveillance with an established surveillance infrastructure. ISG coordinates surveillance on cross-market issues through information sharing agreements and development of shared regulatory tools such as the ISG Quote and Trade Report. Market participants benefit from enhanced regulation at reduced costs. The ISG approach should be explored and perhaps built upon as a solution to the duplicative cost concerns resulting from the current regulatory scheme.

IV. Conclusion

SIA believes competition among markets will drive innovation and progress. The SEC can best facilitate the evolution of an efficient market structure by promoting its core principles through the establishment of minimum regulatory standards that apply across markets and allow different types of markets to compete for order flow based on the services they provide. Further, fair competition among markets demands that regulation be adequately funded and that regulatory responsibilities and costs be shared

¹⁷ See Reinventing Self-Regulation, White Paper for the SIA's Ad Hoc Committee on Regulatory Implications of De-Mutualization, January 5, 2000.

¹⁸ A Conversation with Bill Donaldson, Business Week Online, June 13, 2003.

¹⁹ *Id.*

equitably across markets. Finally, the current regulatory structure should be reexamined to determine if it continues to be the most efficient and effective model.

We appreciate the opportunity to share the views of the SIA and would welcome the opportunity to work with the staff as they consider these important market structure issues. If you have any questions concerning these comments, or would like to discuss our views further, please contact the undersigned at 212-608-1500, Ann Vlcek, Vice President and Associate General Counsel, at 202-296-9410, Amal Aly, Vice President and Associate General Counsel, at 212-608-1500, or Scott Kursman, Vice President and Associate General Counsel, at 212-608-1500.

Sincerely,

Donald D. Kittell
Executive Vice President

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