

14 July 2006

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F. Street, NE
Washington, D.C. 20459

Re: Concept Release Concerning Self-Regulation (File. No. S7-40-04)

Dear Ms. Morris:

The CFA Centre for Financial Market Integrity¹ appreciates the opportunity to provide comments on this Concept Release that raises a number of questions relating to the future of self-regulation in the U.S. securities markets. We strongly support this undertaking, as we believe that a number of areas have evidenced strain that threatens to undermine the integrity of the system and raise issues of investor confidence.

In particular, we believe that the current SRO system has not kept pace with developments—technologically or in terms of products—and thus has been unable to fully achieve the objectives the SRO system was originally designed to meet. In order to meet the needs of both the marketplace and investors, the current system of self-regulation must be overhauled or risk extinction. It is with this belief that we urge the SEC to adopt the “hybrid model” as the most viable system of self-regulation for today’s securities markets.

General Comments

As an organization, we have long supported measures that contribute to the sound functioning of the financial markets, while safeguarding important investor protections. We also recognize that achieving and maintaining these objectives is often a delicate balance. Attempting to build in adequate investor safeguards without quashing the competition that has fueled the vibrancy of our securities markets requires a careful weighing of all components. However, in light of the questions being raised about the current SRO system, we believe that an overhaul is in order.

¹ The CFA Centre for Financial Market Integrity is part of CFA Institute®. With headquarters in Charlottesville, VA and regional offices in New York, Hong Kong and London, CFA Institute, formerly the Association for Investment Management and Research®, is a global, non-profit professional association of more than 83,000 financial analysts, portfolio managers, and other investment professionals located in 129 countries of which more than 69,000 are holders of the Chartered Financial Analyst® (CFA®) designation. CFA Institute has 132 affiliated Member Societies and Chapters in 55 countries and territories.

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

14 July 2006

Page 2

In particular, we believe that inadequate governance standards have allowed favoritism and inconsistency to threaten the integrity of the self-regulatory system. A decreasing number of member firms has resulted in a disproportionate amount of power resting in the hands of a few members, who often control the actions of the board. This misalignment/lack of power balance has allowed a few to subvert the regulatory and enforcement powers of an SRO to further their own interests.

In addition, increased competition among markets for listing and order flow has exacerbated the situation as SROs have felt market demands begin to override the regulatory mandate. As a result, some of the conflicts of interest that are inherent in traditional SROs appear to have exceeded the original restraints that may have been adequate in the past.

As also discussed in the Concept Release, we recognize that the proliferation of regulations, complex product lines, and complicated investment strategies has resulted in a maze of duplicative and sometimes conflicting rules. This has resulted not only in inefficiencies and unnecessarily high compliance costs but also in the risk of regulatory arbitrage, where issuers “shop” regulatory systems to find the most appealing one.

Summary Conclusions

For all of these reasons, and as discussed further below, we support creation of a Single Member SRO that would assume responsibility for member regulation. We believe that this new hybrid structure would remove a number of obvious conflicts and alleviate existing tensions between SROs’ regulatory functions and market operations. Specifically, the creation and enforcement of regulations need to be the jurisdiction of an entity that stands apart from, and remains uninfluenced by, business concerns, particularly in an era of increased competition for order flow.

As noted in the Release, however, implementation of the hybrid model still leaves a number of concerns about market operations unanswered. As originally envisioned, SROs operating markets would continue to retain responsibility for regulating that market, including the creation and enforcement of market rules, as well as surveillance actions. We question whether maintaining this status quo is reasonable in light of the range of conflicts identified in the Release and the rapidly changing market conditions. Instead, we suggest an arrangement that provides uniformity and impartiality with respect to the enforcement of market rules, so that investors are assured that market participants are treated fairly.

To that end, we encourage the SEC to vest the Single Member SRO with authority for enforcement and surveillance functions. Alternatively, we urge consideration of another option whereby enforcement of market rules would be separate from market operations, with ultimate oversight responsibility retained by the Single Member SRO. Either alternative would help ameliorate the conflicts in having the business-oriented side of the SRO police its own members.

Questions Posed in the Release

Before further discussion of a particular framework for reform, we first offer our thoughts below on a number of the questions raised by Staff in the Release.

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

14 July 2006

Page 3

Inherent Conflicts with Members

- To what extent are the conflicts caused by member funding of SRO operations a concern? Has consolidation within the securities industry, and the dependence of SROs on a relatively small number of firms for the bulk of their funding, or other developments exacerbated this conflict? Is it possible to minimize these conflicts through SRO governance initiatives that are designed to ensure greater independence of the board and key committees of regulated members?

In any business, over reliance on one group of customers or on a select few poses risks and affects the balance of power those customers have. Similarly, we believe that SRO reliance on increasingly smaller numbers of members/participants to generate revenue makes the current system more vulnerable than in the past to the influence those members can wield.

This concern seems to be borne out by numbers. In its 2004 annual report, Archipelago commented that eight of its ten top customers were also shareholders and that those customers contributed almost 50% of that year's revenues. Transaction fees from one particular customer alone accounted for 27.7% of those revenues. Similarly, NASDAQ's 2004 annual report documents that three members and one ECN reported the majority of inter-market trades.

The decline of transaction and data fees, when combined with this emerging reliance on key customers for revenue generation, provides additional cause for concern as it further threatens the balance that an SRO must maintain between its business and market operations. For example, while Archipelago's total share volume of U.S. market transactions grew by an average annual rate of 67.3% between 2001 and 2004; its transaction fees grew by 41.1%. This growth rate in transaction fees reflects a 15.6% decline on a per share basis. Perhaps more startling is the fact that liquidity payments rose from zero in 2001 to 41.4% of transaction fees by 2004. Thus, transaction fees net of liquidity payments actually declined on a per share basis by 29.4% between 2001 and 2004.

These numbers raise issues about the business pressures facing SROs and their ongoing need to fund regulatory activities in a time of shrinking market share and reliance on select members. Consequently, the impartiality of regulatory functions that rely on the revenues generated by those members may come under pressure. Whether those members actually bend the process to their benefit or only appear to wield such power, the effect on the integrity of the system may be similar; to investors and the markets—the system may appear to benefit those members with the most market share.

- To what extent are member governance conflicts a concern? Have governance changes made by SROs (NYSE, etc.) to enhance independence been effective in reducing conflicts? What other governance changes could reduce conflicts?

Conflicts due to lack of appropriate governance practices clearly has undermined the level of trust in the SRO system—by both investors and oversight bodies. To the degree that recent governance measures increase the independence of board and committee members, and thus dilute the ability of certain participants to act in their own self-interests, the system regains a measure of integrity. As an additional step, we believe that it is

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

14 July 2006

Page 4

important to ensure full and complete disclosure of operating and financial data by all trading facilities (including all Exchanges, ECNs, and electronic trading networks) and consider whether such disclosure should exceed what is currently required by GAAP or SEC requirements.

Inherent Conflicts With Market Operations

- To what extent do conflicts exist between SRO regulatory and market functions? Has increased inter-market competition exacerbated the potential conflict? Are markets attempting to use “lax regulation” as a means to attract business? Are they attempting to use “aggressive regulation” as a weapon against competitors? Is it unrealistic to expect a “cost center”, such as regulation, to resist pressure from a function that generates business revenue?

We believe that with most commercial enterprises, concerns about revenue and revenue-generating activities have at least a “trickle-down-effect” on other divisions that are cost centers, absent a clear separation of the two, or a separate funding mechanism for the cost center. Thus, we strongly support full separation of business and regulatory activities as an important means of establishing a system that functions without undue conflict. Precisely because it may be difficult for a cost center to resist pressure from a function that generates business revenue, there must be organizational and regulatory structures in place that safeguard an SRO’s regulation and enforcement processes. If these functions can be compromised due to market operation pressures, the integrity of investor protections and the SRO’s fundamental ability to govern itself, monitor and oversee market operations, and police its members fails.

Inherent Conflicts with Issuers

- To what extent have conflicts arisen between SRO regulatory and issuer listing functions? Has the recent increase in competition among SRO markets for listings created incentives to admit issuers that fail to satisfy initial listing standards or delay the delisting of issuers that no longer satisfy maintenance standards? To the extent increased competition for listing has caused SROs to waive or lower listing fees, has this negatively impacted regulatory funding and further inhibited enforcement of listing standards?

As competitive pressures mount, it is understandable that the business pressures of SROs would begin to influence various prongs of an SRO’s regulatory scheme. One such offshoot could be lower listing standards, or failure to enforce compliance with listing standards, which presumably would be driven by concerns to increase revenue or market share. However, if investors lose confidence in the integrity of the system, as a result, the cost of capital will rise. In some cases, this could, in turn, produce inefficient capital allocation as the market with lower standards and thus less participation by investors loses market share or even eventually goes out of business.

Maintaining high quality listing standards helps to support investor trust and confidence in that marketplace and improves capital allocation. Moreover, issuers that have met higher listing standards may resist allowing lower standards for new entrants and even move to another market. All of these possibilities inject an element

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

14 July 2006

Page 5

of uncertainty and risk into the marketplace, which argue against a system that allows lower listing standards to be used as an accommodation for boosting revenue or market share.

Inherent Conflicts with Shareholders

- What are the conflicts between a demutualized SRO's regulatory responsibilities and the profit-making orientation of its shareholders? To what extent do they heighten the inherent SRO conflicts with members, market operations, and listed issuers discussed above?

We believe that the conflicts are similar. How these conflicts are handled, through independent boards, separate funding sources, or other methods is vitally important. Regulatory functions, like economic goods, may result in higher revenues for an industry due to greater trust and confidence (and thus greater participation) in the markets. However, this benefit may be difficult to quantify. Costs, on the other hand, are more quantifiable, resulting in actions that are intended to reduce costs. Consequently, particular firms may use their power as shareholders or customers to pressure an SRO to reduce its regulatory fees. This may be particularly acute in light of the intense competition to gain new listings or increase market share from other trading facilities resulting in falling transaction fees, rising liquidity payments, and falling market data fees.

Inefficiencies of Multiple SROs

- Is the lack of inter-market rules across markets trading the same type of securities causing regulatory arbitrage, and, if so, what is the impact of this on the SRO system? Should this issue be addressed through changes at the SRO system level, rather than at the individual SRO level?

Just as investors seek the best price, whether buying or selling, issuers typically seek the lowest costs of doing business while increasing revenue. Thus, when given a choice companies/issuers most likely will choose a regulatory scheme that imposes the least restrictions or costs. The inconsistency in regulations among various SROs invites this very practice of allowing a company to "shop" for membership in the SRO that offers the most favorable deal. Such an option is contrary to a primary purpose of our securities laws, which is to protect investors.

As noted in the Concept Release, competition for order flow and reliance on a smaller number of members has dramatically increased among SROs. As SROs strive to retain or gain members, there may be a tendency to accommodate them at the expense of inconsistent application of the rules. We believe that reforming the system to require a uniform set of rules, regulations and enforcement procedures will significantly reduce the opportunity for regulatory arbitrage and help restore integrity to the system.

Inter-market Surveillance

- To what extent does our market model of multiple competing SROs create gaps in inter-market trading surveillance? What types of illicit trading activity in particular can be hidden from regulators by dispersing trading across multiple markets?

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

14 July 2006

Page 6

We believe that the lack of a coordinated surveillance system is potentially one of the more significant problems facing our markets. As trading strategies become more sophisticated across multiple markets and national borders, the potential for sophisticated fraud also increases. Creation of a single overseer that coordinates this effort may at first blush seem appealing; we suggest, however, that such body must be able to avail itself of a wide range of industry expertise that is capable of distinguishing complex but legitimate market trading strategies from illegal activity. We also encourage a continued surveillance function by each individual trading market.

Funding

- Could enhanced transparency of SRO funding be used effectively to promote adequate SRO regulatory funding levels or would other steps be more effective in that regard? What measures could be used to promote adequate SRO funding levels?

We recognize the difficulty in prescribing specific funding and allocation levels for regulatory activities. First, an optimal level is hard to quantify. Second, the complexity of transactions, regulations, supervision, and enforcement vary among the SROs, depending on the focus of their members, adding to the difficulty of creating a standard approach to self-regulation. Of course, transparency is an important first step in determining whether this system lends itself to establishing specific funding levels. Information on the respective SRO's level of funding, the basis or formula for determining that level, and the apparent level of success it has achieved would arguably allow an analysis of regulatory spending across all SROs to develop a benchmark cost/benefit analysis. Ideally, funding of regulatory functions would be independent of, and not dependent upon, an SRO's business side. To the degree that any funding of regulatory operations is provided by the revenue-generating side of the SRO, mechanisms must be established to insulate the regulatory side from any undue influence or pressure.

Framework for Reform

We found this Concept Release to provide a thorough historical overview of the SRO system and a thoughtful analysis of the relevant issues that continue to threaten the system's integrity. We think that the most significant contribution of the release, however, is the consideration of alternatives to the current system. While recognizing that none provides a perfect solution to the underlying problems in the current SRO system, the Release does provide an important starting point for addressing solutions. It is on this aspect of the Release that we focus our comments below.

Fundamentally, we support self-regulation. Historically, the forces of market demand have proven to be effective in ferreting out detrimental practices and creating *de facto* standards through the competitive process. We also are strong advocates for investor protection, and believe that what is in the best interests of investors is ultimately good for the markets. Consequently, we prefer a system that allows self-regulation to operate effectively while maintaining adequate investor protections. If the appropriate balance can be achieved and adequately implemented, we believe that self-regulation of the securities markets can remain a vital and efficient alternative to government regulation.

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

14 July 2006

Page 7

In general, we believe that the benefits of a fully functioning SRO are many:

- **Flexibility and Efficiency:** An efficient self-regulatory system allows it to respond to market developments in quick and innovative ways that can yield positive returns for SRO participants and the investing public.
- **Expertise:** The specialized knowledge held by those within an SRO allows the creation of rules and regulations that may be better suited to that industry than those created by a more detached source. The danger, of course, is that vesting those within an organization with the power to regulate members of their own industry risks a certain myopia and increases the likelihood of regulations that may benefit the organization's members at the cost of investor protections.
- **Sustainability of Regulations:** We expect SRO members to offer less resistance to rules and regulations created by the SRO than to those imposed on them by an outside source. Less resistance arguably translates into less need for enforcement action, resulting in cost savings.
- **Higher Standards:** SROs can create standards that go beyond what is merely legal and touch upon areas that are implicated by self-interest and conflicts of interest. When this happens, all market participants benefit.
- **Competition:** At the heart of our market system is the competitive drive. Thus, the competitive forces that are fostered by an SRO system help to drive market efficiencies, spark new innovations, and overall add to the vibrancy of our financial markets.

Characteristics of a Successful Model

For self-regulation to work, participants must commit to the public good while believing that the compliance costs to them through self-regulation are less than what would be imposed through government regulation. Absent this "buy-in" by participants in a self-regulatory system, long-term success of the system is tenuous.

Participants in securities markets SROs must embrace additional overarching goals:

1. to preserve market integrity (through operation of a fair, transparent and efficient system);
2. to preserve financial integrity (by reducing systemic risk); and
3. to protect investors.

Any system that ignores or tries to override these goals compromises the foundations that support the operation of our U.S. securities markets.

In considering what contributes to a successful self-regulatory organization, we were able to identify a number of characteristics that support these overarching goals and without which an SRO is exposed to the conflicts of interest that ultimately erode investor confidence in the system. In addition to the buy-in noted above, a successful SRO first needs to retain certain powers in order to support such commitments, particularly

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

14 July 2006

Page 8

1. policy and rulemaking powers, and
2. supervisory and enforcement powers.

Within the exercise of those powers, we believe that the following characteristics are essential to creating a successful SRO:

- **Independent Board:** Creating and maintaining a board that is independent from the business interests of the SRO is important for creating a climate where member self-interest can remain aligned with the investor's need for a fair market. In addition, we advocate an election process where all stakeholders, including investors, provide the pool for board nominees.
- **Adequate Funding:** As noted throughout the Release, determining and implementing an adequate source for funding regulatory actions is an ongoing problem in the current SRO structure, exacerbating existing conflicts of interest between the regulatory and business sides. Funding sources must be separate from the business/operations side of the SRO to avoid the pressures that undermine the maintenance of an impartial and effective regulatory system.
- **Separate Regulator:** For SROs to reestablish themselves as viable entities and regain the confidence of investors and regulators, their regulatory operations must operate independently of the markets they regulate. Neither should the market (whether for-profit or not for profit) be allowed to unduly influence the regulator. The regulatory arm must have the resources and internal mechanisms to promulgate regulations, conduct sufficient surveillance, and pursue enforcement actions. A separate funding mechanism is important for achieving this balance. Internal structures must prevent larger or more influential members from subverting any process to their own gain.
- **Control/Flexibility:** To accomplish the purposes for which it was originally designed, an SRO must exert enough control over its participants to enforce compliance with rules and regulations that protect investors while allowing enough room for members to remain innovative and responsive to market changes.
- **Effective Enforcement:** To retain the trust of investors and governmental authorities, the SRO must be able to enforce its own regulations and sanction its members. To retain its credibility, the enforcement and disciplinary arm needs to derive its funding from sources that cannot, or even be perceived to, taint the integrity of the process.
- **Transparent and Accountable:** Rulemaking and enforcement functions need to be transparent so that investors and governmental authorities trust in the SRO's ability to self-govern. Providing opportunities for the public to engage in the rulemaking process (through public forums, submitting comments on rule proposals) increases benefits to all participants by allowing for the open exchange of ideas.
- **Surveillance Systems:** Given the extent and complexity of today's financial markets, the need for regulatory systems to oversee the activities of their participants has reached new levels and is a growing concern. The threat of illegal activities that can be disguised within the myriad of sophisticated trading strategies has escalated the need for SROs to develop effective networks with

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

14 July 2006

Page 9

similar bodies around the globe. The monitoring of cross-market and border activities requires coordinated efforts of communication, commitment and harmonization.

Model for Reform

The Concept Release's thorough discussion of the alternative models to the current U.S. SRO system highlights the complexities involved in revising this system. However, the range of enforcement actions brought as a result of SRO member activities, and additional conflicts of interest that reflect the increased competition in the marketplace for order flow make clear that changes are needed. Hence, we strongly recommend the adoption of a new model for continued self-regulation in the U.S. markets.

As recognized in the Release, this model does not solve all the problems with the current SRO system. Funding issues, inconsistent market rules and regulations, differing infrastructures and staffing arrangements, and a number of conflicts would remain with the market operations side. In addition, there is some concern that removing the single member SRO from market operations would eliminate an important source of expertise in understanding the business practices of market operations. While some of this may well occur, we believe that over time the market operations area will regain whatever industry expertise may be lost initially. In general, we believe that the advantages far outweigh potential shortcomings in the proposed hybrid model.

In particular, we believe that the hybrid model best meets the characteristics that are most important to revitalizing the SRO system and restoring it to the purposes for which it was originally created. The proposed Single Member SRO would significantly reduce a number of duplications and inconsistencies by establishing a uniform set of membership rules for all participating SROs. In addition to reducing costs associated with duplication, such a structure will help eliminate regulatory arbitrage. Moreover, we hope that with a centralized inspection and enforcement system in place, the hybrid model will extend and expand surveillance practices that reach across geographical borders and traditional product lines.

We believe that the most important benefit of a single set of regulations may well be the effect such a structure will have on the integrity of the system. With centralized member regulation, the pressures (whether overt or indirect) exerted by business concerns on the regulatory side will be lessened. Where now larger members can wield more influence on the process (sometimes to the detriment of smaller members or those perceived to be competitive), consistent member regulation will reduce the ability of any particular member to subvert this aspect of the regulatory process to its own needs/benefit.

As noted above, we strongly believe that the regulatory arm of SROs must operate independently of the markets they regulate. Creation of a market neutral organization vested with responsibility for regulating members, including inspection and enforcement duties, will be a significant step in creating an impartial system that does not favor certain members over other members or the interests of investors. To that end, we strongly advocate that any such structure be bound by a requirement that its governing body—including the board of directors and board committees—be composed solely of independent persons, bearing no material relationship to the SROs falling under its jurisdiction.

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

14 July 2006

Page 10

Structuring a system with one entity responsible for all member regulations while allowing the separate markets to function independently also accomplishes several objectives that are important to self-regulation. First, this structure allows each market to retain the expertise that allows it to respond to market developments in quick and innovative ways. This flexibility is an oft-cited benefit of self-regulation that distinguishes it from government regulation.

Second, such a structure continues to allow competition among the markets. It is this competitive drive that fosters the vitality upon which our financial markets are based, and which needs to be retained in our market system. While issues remain as to the duties of market SROs, these issues will require separate attention and not implicate the regulatory functions.

Third, we believe that the proposed hybrid system will increase the transparency and accountability of SRO functions. One central market-neutral SRO that oversees member regulation should be able to provide more direct and transparent information on member activities, the promulgation of rules, and the funding sources relevant to member regulation. We recommend that if this model is adopted, that there be a procedure for public input into the rulemaking process.

As noted above, we believe that while this hybrid model would alleviate a number of the more obvious conflicts in the self-regulatory structure, conflicts in the market operations side would remain. Thus, we urge the SEC to also consider alternative approaches that would remove the enforcement function from the market operations side of an SRO.

An option noted in the Release would limit the market operations side of the SRO to creating rules; enforcement and surveillance would be handled by the Single Member SRO. This option would at least remove the conflicts inherent in the current structure that allows this side to police its own operations without additional safeguards.

We realize that this structure may be criticized for vesting the authority to enforce market rules in those versed in membership rules, and thus losing the benefit of particular expertise. Given that industry expertise is a recognized benefit of our system of self-regulation, loss of in-depth understanding of the market/operations side may impede meaningful enforcement of the rules as they apply to that function. Thus, we suggest an arrangement whereby familiarity with business issues can co-exist with enforcement of rules relating to that business. A structure that allows separate markets to operate freely but that vests the oversight of enforcement in a branch that is independent of market operations (whether through a corporate structure or “independent” oversight) might prove effective for addressing such conflicts.

Conclusion

We support measures to retain a self-regulatory structure for the U.S. securities markets. However, in order to respond to the vast range of changes that have occurred since first implemented, this structure needs revamping. As discussed above, we believe that implementation of the hybrid model is most responsive to the conflicts that currently exist, particularly between the operations and regulatory arms of current SROs. While

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

14 July 2006

Page 11

the conflicts within an SRO's market operations side still need to be addressed, adoption of the Single Member SRO will go a long way in restoring confidence in the self-regulatory system.

We appreciate the opportunity to comment on this Concept Release and would be pleased to meet with staff to offer additional views. If you have any questions or would like to schedule a meeting, please do not hesitate to contact Rebecca McEnally at 434.951.5319 or by e-mail at rebecca.mcenally@cfainstitute.org; or Linda Rittenhouse at 434.951.5333 or by e-mail at linda.rittenhouse@cfainstitute.org.

Sincerely,

/s/ Rebecca T. McEnally

Rebecca T. McEnally
Director, Capital Markets Policy Group
CFA Centre

/s/Linda L. Rittenhouse

Linda L. Rittenhouse
Senior Policy Analyst, Capital Markets Policy Group
CFA Centre