



July 31, 2013

Via [Electronic Mail and Courier]

Chair Mary Jo White
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Self-Regulatory Structure of the Securities Markets

Dear Chair White:

The Securities Industry and Financial Markets Association (“**SIFMA**”)¹ submits this letter to request that the Securities and Exchange Commission (the “**Commission**”) conduct a review of the regulatory structure of broker-dealers and exchanges, and the self-regulatory model. Recently, a distinguished group of legislators, regulators, and industry experts has called for a holistic review of U.S. equity market structure. These calls reflect the fact that regulatory developments combined with innovations in business and technology have brought significant changes to the equity markets. SIFMA supports a holistic review of equity market structure.

In that context, the self-regulatory model is a crucial area for immediate attention, and SIFMA believes a discrete review of the regulatory structure of broker-dealers, exchanges should be carried out now because that structure is widely viewed to be outdated and in need of reconsideration and reform. The largest U.S. securities exchange operators have evolved from member-owned utilities to for-profit business enterprises. At the same time, technological advancements have changed the way the securities markets and market participants operate, with securities exchanges and non-exchange venues operated by broker-dealers performing essentially identical functions in certain respects. Nonetheless, the status of exchanges as self-regulatory organizations (“**SROs**”) has not changed, even as the exchanges have become active competitors with the broker-dealer members they are charged with regulating. This inconsistency has led to tensions, anomalies, and conflicts in the structure, operation, and regulation of the securities markets.

¹ SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

SIFMA supports effective regulation of the securities markets, and we believe that, properly structured, strong self-regulation must continue to be an integral part of the oversight of the market and its participants. However, the current self-regulatory structure is outdated and in great need of rethought and reform. In this context, SIFMA believes that the Commission and Congress should consider whether exchanges should continue to be subject to the responsibilities and obligations of being SROs, or enjoy the protections and benefits that flow from that status.

At the same time, SIFMA supports competition, and we believe that the securities markets have greatly benefitted from the innovation brought about by vigorous competition among market participants. However, functionally similar businesses are now subject to different regulatory structures and different regulatory responsibilities, resulting in inappropriate competitive imbalances. A result of this structure is that one group of businesses is empowered to oversee and regulate the business and activities of its competitors. Conflicts of interest in this model abound and only worsen as they are left unresolved.² SIFMA notes that these concerns are not new, and the Commission conducted a review of the self-regulatory structure in 2004.³ As time has passed, however, issues with the self-regulatory status quo have become even more acute.

As a first step in this process, SIFMA joins your colleague, Commissioner Daniel Gallagher, in calling for the Commission and its staff to engage in a “comprehensive market and regulatory structure review, including a review of the self-regulatory paradigm as a whole,” with “no sacred cows.”⁴ SIFMA urges the Commission to implement and recommend changes necessary to rationalize the structure and system of self-regulation.

This letter describes some of the major issues that we believe the Commission should consider in a review of the self-regulatory structure. That being said, this is a complicated topic, and SIFMA expects that a complete analysis ultimately will include detailed consideration of these and a number of additional issues. As such, this letter is

² See, e.g., Luis A. Aguilar, Commissioner, Commission, The Need for Robust SEC Oversight of SROs, *available at* <http://www.sec.gov/news/speech/2013/spch050813laa.htm> (“[T]here continues to be inherent conflicts of interests between the SROs’ regulatory functions and its members, market operations, issuers, and shareholders.”).

³ See generally Concept Release Concerning Self-Regulation, Exchange Act Release No. 50700 (Nov. 18, 2004).

⁴ Daniel M. Gallagher, Commissioner, Commission, Market 2012: Time for a Fresh Look at Equity Market Structure and Self-Regulation, Remarks to SIFMA’s 15th Annual Market Structure Conference (Oct. 4, 2012), *available at* <http://www.sec.gov/news/speech/2012/spch100412dmg.htm>.

not intended to provide an exclusive list of the topics that should be considered in a review of SRO structure.

SIFMA hopes these views will be helpful to you and the Commission in what SIFMA believes would be a meaningful and productive review of the self-regulatory structure.

I. What Is an Exchange and Why Is It an SRO?

Under the Securities Exchange Act of 1934 (the “**Exchange Act**”), an exchange has two primary functions: First, an exchange acts as a marketplace for the trading of securities; second, an exchange acts as a self-regulatory organization overseeing its members. In this way, the Exchange Act defines an exchange by reference to its market function,⁵ but it additionally requires an exchange to act as a self-regulatory organization that enforces securities law compliance on its members.⁶ Exchanges are among several groups of entities designated as SROs by statute, along with registered national securities associations, registered clearing agencies, and the Municipal Securities Rulemaking Board.⁷ However, the essential nature and purpose of a national securities exchange—operating a market—does not inherently require it to act as an SRO.

The dual functions of an exchange are not mutually reliant and, in recent years, they have been separated in practice, if not in form. Notably, both exchanges and alternative trading systems (“**ATSs**”) (which are operated by broker-dealers) perform the market functions that meet the technical definition of an exchange. The primary distinction between an exchange and an ATS is that an ATS does not set rules for its subscribers’ activity outside of the ATS or discipline subscribers other than by excluding them from the ATS⁸—*i.e.*, an ATS does not act as an SRO. As exchanges have divorced the regulatory function from their market function by outsourcing their SRO responsibilities, the distinction between the activities performed by an exchange compared to an ATS lacks functional difference.

⁵ An “exchange” is defined as an organization that “constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities.” Exchange Act § 3(a)(1). Rule 3b-16 under the Exchange Act interprets an organization to meet this definition if it both (i) “brings together the orders for securities of multiple buyers and sellers,” and (ii) “uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade.” *See* Exchange Act Rule 3b-16; Exchange Act Release 40760 (Dec. 8, 1998).

⁶ *See* Exchange Act §§ 6(b), 19(g).

⁷ *See* Exchange Act § 3(a)(26).

⁸ *See* Regulation ATS Rule 300(a).

While the role of the exchange as an SRO overseeing the conduct of its members traces its foundations to the very beginning of the U.S. securities markets and predates the Exchange Act and the Commission,⁹ the federal codification of this role in the Exchange Act was intended to serve two primary purposes: First, it relieved the government of some of the burden of regulating the securities markets by instead delegating to and leveraging its oversight of the SROs. Second, it was thought that regulation was more effective when conducted by an organization, such as an exchange, more familiar with the nuances of the business.¹⁰ However, with exchanges having outsourced and delegated a substantial majority of regulatory functions to the Financial Industry Regulatory Authority (“**FINRA**”), neither reason justifies why exchanges should continue to act as SROs. Were FINRA to be the only SRO, the Commission would still be relieved of “front-line” regulation and could still leverage its oversight of FINRA. Additionally, with FINRA already performing the SRO functions for exchanges, those exchanges no longer deploy any of their specialized industry knowledge for purposes of self-regulation.

In reality, the interests, incentives and functions of the member-owned cooperative exchange of 1934 bear little resemblance to those of the for-profit publicly traded exchange of today. Since the wave of demutualizations, exchanges have rightly focused their efforts on the part of their business that earns profits to maximize the return for their shareholders, and, in some cases, minimized their actual performance of regulatory functions. Today, FINRA conducts virtually all member regulation for the securities markets, and FINRA performs market regulation for more than 90% of equity market trading (including the NYSE Euronext, NASDAQ OMX, and Direct Edge exchange complexes).¹¹

Now that they have become for-profit entities, exchanges face an irreconcilable conflict of interest in the performance of their SRO responsibilities.¹² On the one hand, they are bound by a fiduciary duty to maximize profits for their corporate shareholders. On the other hand, they are required to be fair and impartial regulators of the broker-

⁹ See Concept Release Concerning Self-Regulation, Exchange Act Release No. 50700 (Nov. 18, 2004) at text accompanying n.17.

¹⁰ See, e.g., *id.* at text accompanying n.28; see also Exchange Act Release No. 50699 (Nov. 18, 2004) (proposing SRO governance rules).

¹¹ See Press Release, FINRA, Direct Edge Selects FINRA for Market Surveillance (May 22, 2013), available at <http://www.finra.org/Newsroom/NewsReleases/2013/P265419>.

¹² The Commission has previously acknowledged that conflicts could become particularly acute when an ATS member is regulated by an SRO that operates a competing market. See Concept Release Concerning Self-Regulation, Exchange Act Release No. 50700 (Nov. 18, 2004) at text accompanying n.112.

dealers with which they compete. The conflict inherent in the dual role of regulator and competitor has also led to inconsistencies in the manner in which exchanges regulate their members, and in today's highly complex markets, the investing public would benefit from regulators whose mission and duty are focused on regulation.¹³ This conflict can be resolved by simply eliminating the obligation for exchanges to act as SROs. It is easy to envision what an exchange would look like without its SRO status, because it is how most exchanges look today in all practical effect. Exchanges have already greatly eliminated their SRO function through outsourcing, leaving themselves as a trading venue with the powers and competitive benefits (such as limitation of liability and ability to design market structure changes) of being an SRO, though few of the actual responsibilities.

The elimination of exchanges' SRO status would in large part codify existing practice, while eliminating the remaining competitive imbalance. The status quo results in exchanges that conduct very little regulation, but enjoy the benefits of SRO status. These benefits can be significant and, in an environment where exchanges fiercely compete with broker-dealers, provide unfair advantages that can no longer be justified. To the extent that exchanges are still involved in regulation, their activities create unnecessary duplication and overlap of FINRA's oversight. Eliminating exchanges' SRO status would streamline regulatory processes and make self-regulation more efficient through centralization of SRO functions at a single regulator. Of course, if all of the exchanges' regulatory functions migrated to FINRA, then it would be appropriate for the Commission to adapt its oversight of FINRA accordingly. For example, the Commission could enhance the requirements around FINRA's proposed rules that would substantively affect member firm conduct or activities.

II. Exchanges and Broker-Dealers Actively Compete with Each Other

Changes to the equity market structure spurred by Regulation NMS, along with the evolution of automation technologies for processing securities transactions, have changed the way all market participants operate, blurring the distinctions between services provided by an exchange and those provided by a broker-dealer.¹⁴ Combined with the transformation of exchanges into for-profit enterprises in search of ways to expand their business and grow, exchanges and broker-dealers have become direct competitors in many aspects of their businesses. Most prominent is the competition for order flow between exchanges and broker-dealers. In this regard, exchanges and many

¹³ See *In the Matter of Chicago Board Options Exchange, Incorporated and C2 Options Exchange, Incorporated*, Exchange Act Release No. 69726 (Jun. 11, 2013).

¹⁴ See, e.g., *Concept Release on Equity Market Structure*, Exchange Act Release No. 61358 (Jan. 14, 2010).

broker-dealers offer functionally equivalent securities transaction services and fiercely compete for orders to execute.

Competition between the parties exists in other services as well, and has been accelerating. For example, broker-dealers have traditionally offered order routing services with which exchange-operated routing brokers now compete. While exchanges use routing brokers to facilitate compliance with the Order Protection Rule, exchange routing brokers increasingly offer additional services that compete with the routing services offered by non-exchange broker-dealers. For example, several exchanges earn revenue through their routing brokers by sending orders to non-exchange trading venues before trying to access protected quotations at other exchanges.¹⁵ In addition, an exchange has sought to offer order types that provide algorithmic trading services indistinguishable from those traditionally provided by broker-dealers.¹⁶ In all of these businesses, exchanges and broker-dealers are competing for the same limited business, notwithstanding their different regulatory status. In this regard, SIFMA is concerned that when exchanges compete with broker-dealers, the role of exchanges as SROs creates regulatory disparities and competitive anomalies.

III. Competitive Benefits of SRO Status

SIFMA acknowledges that there are distinctions in the *way* in which exchanges and broker-dealers are regulated. For example, exchanges are required by the Commission to submit rule changes for many of their business practices for review and approval by the Commission before those practices can be put in place. In addition, exchanges are subject to access requirements and ownership restrictions. At the same time, however, regulation as a broker-dealer entails regulatory requirements not applicable to exchanges, such as best execution, supervisory controls, and financial responsibility. This disparate regulatory oversight of exchanges and broker-dealers should be considered from both perspectives as part of a comprehensive review, and we welcome a discussion of the issues from both perspectives. For purposes of this letter, however, SIFMA would like to draw your attention to key competitive advantages

¹⁵ It is worth noting that these exchange routing brokers in some cases qualify for an exemption from compliance with Rule 15c3-5, the Market Access Rule, while non-exchange affiliated broker-dealers must generally comply with the rule in full. *See* Exchange Act Rule 15c3-5(b) (providing that a broker-dealer that routes orders on behalf of an exchange or alternative trading system for the purpose of accessing other trading centers with protected quotations in compliance with Rule 611 of Regulation NMS for NMS stocks, or in compliance with a national market system plan for listed options, is not required to comply with Rule 15c3-5 with regard to such routing services, except for the requirement to prevent the entry of erroneous orders).

¹⁶ *See, e.g.*, Exchange Act Release No. 68629 (Jan. 11, 2013) (disapproving NASDAQ proposed algorithmic “Benchmark Order” type).

flowing not from the way exchanges or broker-dealers are regulated, but from exchanges' status as SROs.

A. Judicially-Created Absolute Immunity

As SROs, exchanges are insulated from private liability for damages they cause, based on both a judicially-created doctrine of "absolute immunity" and limitations on liability codified in their rules. Broker-dealers performing similar services, of course, are subject to private liability.

Courts have held that an exchange "steps into the shoes" of the Commission with respect to the regulatory functions delegated to it under the Exchange Act, and is therefore entitled to absolute immunity from private liability with respect to those activities.¹⁷ Courts reason that because the Commission is entitled to sovereign immunity with respect to its own activities, SROs should be entitled to the same immunity when performing quasi-governmental functions that the Commission would otherwise undertake.

While these protections were understandable when exchanges were not-for-profit, member-owned utilities that actually performed regulatory functions, they have become less so as exchanges have outsourced most regulatory functions to FINRA. Additionally, as exchanges have converted into for-profit enterprises, most, if not all, of their activities have become commercial in nature and not deserving of immunity. To the extent that exchanges have retained regulatory functions, those functions generally consist of surveillance and oversight for their marketplace rules and, therefore, in most material respects, are not unlike the types of responsibilities that broker-dealers must satisfy when functioning as ATS or in respect of order handling on behalf of their customers.

Further, the doctrine is only sensible when claimed and applied *strictly* to an exchange's regulatory functions such as the conduct of disciplinary proceedings. But the line between where regulatory functions end and commercial activities begin has never been clearly drawn.¹⁸ As a result, exchanges have claimed a right to immunity even in

¹⁷ See, e.g., *Barbara v. NYSE*, 9 F.3d 49 (2d Cir. 1996) (granting exchange absolute immunity with respect to disciplinary functions); *D'Alessio v. NYSE*, 258 F.3d 93 (2d Cir. 2001) (extending absolute immunity to exchange's actions in interpreting securities laws); *DL Capital v. Nasdaq Stock Market*, 409 F.3d 93 (2d Cir. 2005) (finding immunity applied in connection with exchange's alleged delayed announcement of its cancellation of clearly erroneous trades).

¹⁸ Compare *Weissman v. NASD*, 500 F.3d 1293 (11th Cir. 2007) (declining to extend immunity to exchange's allegedly false public statements that stocks trading on the exchange meet specified listing standards) with *In re NYSE Specialists Litigation*, 503 F.3d 89 (2d Cir. 2007) (applying absolute immunity in the case of an exchange's alleged fraud and active encouragement of fraudulent activities by its members) and *Standard Investment Chartered v. NASD*, No. 10-945-cv (2d Cir. Feb. 22, 2011) (finding an SRO's (...continued)

connection with damages flowing from activities that appear to be commercial in nature.¹⁹

With exchanges seeking to engage in more broker-dealer-like activities, the risk grows that exchanges will claim that more of these commercial ventures are entitled to immunity based on some incidental regulatory aspect. A broker-dealer cannot fairly compete with a party that offers the same services but does not face the same risk of liability.

Of course, the Commission cannot alter judicially-created doctrines. However, because courts have based exchanges' immunity on their SRO status, the Commission's support for an eventual legislative end to this status would undermine the basis for the doctrine. In the meantime, there are steps that the Commission can take to guide courts and lessen the burden on competition. These include, for example, publicly clarifying more precisely which activities of an exchange the Commission views as "standing in its shoes" and entitled to immunity.²⁰ Additionally, the Commission could require exchanges to adopt rules that disclaim any immunity in connection with their commercial offerings as well as any regulatory functions that have been outsourced and are not actually performed by the exchange.

B. Rules-Based Limitations on Liability

In addition to judicially-created absolute immunity from liability for regulatory activities, each exchange has adopted rules that limit its liability to members in any other circumstance. These limits are set at levels that bear no relation to the substantial costs that an exchange could impose on the public.²¹ In addition, these limits are legally

(continued...)

corporate proxy solicitation to members was "incident[al]" to regulation and entitled to immunity from claims for alleged fraudulent misstatements).

¹⁹ See, e.g., Exchange Act Release No. 67507 (July 26, 2012) (containing statements by NASDAQ describing its Facebook IPO malfunctions and the resulting losses to members as flowing from the exercise of its regulatory oversight obligations as an SRO).

²⁰ An interim step of publicly stating which exchange activities and functions are regulatory in nature would help mitigate other problematic effects of exchanges' dual role as regulator and business enterprise. For example, an exchange may view a dispute over exchange fees as a matter for regulatory enforcement, while a broker-dealer member views it as a commercial disagreement.

²¹ See, e.g., BATS Exchange, Inc. Rule 11.16 (limiting liability to an aggregate of \$500,000 per month); EDGX Exchange Rule 11.12 (limiting liability to an aggregate of \$500,000 per month); NASDAQ Stock Market Rule 4626 (limiting its liability "in no event" during a single calendar month to more than \$3 million, or any available insurance); NYSE Rules 17–18 (limiting liability to an aggregate of \$500,000 per month); NYSE ARCA Rule 13.2 (limiting liability to an aggregate of \$500,000 per month).

protected and strictly enforced through the Commission's approval of the exchanges' rulebooks and through the statutory requirement that exchanges comply with their own rules.²² In fact, in a recent case where an exchange proposed compensation far beyond the scope of its limitation of liability, the Commission had to specifically approve the compensation and the terms of the payment before the exchange could offer additional compensation.²³

Should a broker-dealer wish to limit its potential liability, it must negotiate the limitation with a customer. A customer can reject any requested limitation, or take its business elsewhere if an agreement cannot be reached. In addition, a broker-dealer's contractual limitation on liability is always subject to being overturned in litigation. In contrast, by adopting limitations in their rulebooks, exchanges are able to unilaterally impose their limits on anyone doing business on the exchange. This creates a fundamental and untenable regulatory disparity: Regulation NMS requires broker-dealers to route orders to the exchange displaying the best available quotation. A broker-dealer is therefore legally obligated to do business with an exchange, even if the broker-dealer would not willingly accept the exchange's limitation on liability.

Even more problematic than absolute immunity, the limits on liability apply without regard to the regulatory or commercial nature of the activity involved. As the services offered by broker-dealers and exchanges have begun to converge, exchanges' immunity and non-negotiable limitations on liability provide exchanges with an competitive advantage. SIFMA is encouraged that the Commission recently disapproved an exchange's proposed new order type (that the exchange acknowledged was intended to compete with similar services offered by broker-dealers) based on, among other things, the burden on competition that the exchange's immunity and rules-based limitations of liability would impose.²⁴ But this was just one example of this issue.

As part of a comprehensive review of the SRO structure, the Commission should reconsider whether exchanges (whether or not they remain SROs) should be permitted to maintain limitations on liability in their rulebooks. Rules-based limits on liability effectively externalize the costs of an exchange's missteps onto its loss-suffering members. This externalization may have made sense in a time when exchanges were actually utilities owned by those members, but not when exchanges are for-profit businesses competing against those members that are forced to absorb losses the

²² See Exchange Act § 19(g)(1).

²³ See Exchange Act Release No. 69216 (Mar. 22, 2013) (order approving NASDAQ "accommodation" payments relating to Facebook IPO in excess of its liability limitation).

²⁴ See Exchange Act Release No. 68629 (Jan. 11, 2013) (disapproving NASDAQ proposed "Benchmark Order" type).

exchange causes. SIFMA recognizes that being at risk of unlimited liability for its failures could lead to an exchange being liable for a potentially catastrophic loss. But the same is true for broker-dealers and other private businesses. Though exchanges are an important part of our financial markets, with 17 registered national securities exchanges, it is hard to argue that any single exchange remains essential to the fair and orderly operation of the markets. If any one were to fail, trading could migrate to another exchange, and the failure would not risk the overall stability of the financial markets.

C. Market Data Revenue

By virtue of their SRO status, exchanges receive significant revenues from their unique right to sell market data to broker-dealers, information vendors, investors, and others. Rule 602(b) of Regulation NMS requires broker-dealers to report their bids, offers, and quotation sizes to an exchange or FINRA. The exchanges receive this valuable data for free, aggregate it, and then sell it back to broker-dealers and others for a profit. In its 2010 Concept Release on Equity Market Structure,²⁵ the Commission presented data that showed that, in 2008, for consolidated or core data alone (best bid and offer quote and last sale price in the market for a security known as the “consolidated quote”), revenue for the exchanges and FINRA was 31 times greater than aggregation and distribution expenses.²⁶ The exchanges also use the same infrastructure to distribute non-core data (comprising all current bid and offer quotes, known as “depth of book”), thereby creating additional profits from sales to broker-dealers and investors, who must buy the data simply to access the markets on an informed basis.²⁷

Congress recognized concerns with this arrangement when it amended the Exchange Act in 1975 – back at a time when the exchanges still were non-profit organizations run by their members – to require that market data fees be “fair and reasonable” and not unfairly discriminatory. The Court of Appeals for the District of Columbia Circuit has recognized that, in order for market data fees to be fair and

²⁵ Concept Release on Equity Market Structure, Exchange Act Release 61358 (Jan. 14, 2010).

²⁶ *Id.* at 25, table 1. As this data is not generally made available on an ongoing basis, the public has no ongoing transparency into the market data cost structure or revenues so as to consider the reasonableness of fees.

²⁷ While broker-dealers are required to buy core data by Regulation NMS Rule 603(c), as a practical matter, they must also buy non-core data. This is because core data only shows the current best bid or offer price for a few hundred shares in the market at a time. Seeing the depth of the market for a security is essential to inform investors and traders of the prices at which their orders will be actually executed when order sizes are larger than the few hundred share consolidated quote.

reasonable, consideration must be given to the cost of producing the market data.²⁸ But without providing transparency into those costs, exchanges receive a substantial and exclusive source of revenues. As part of a comprehensive review of the SRO structure, the Commission should consider revisiting Regulation NMS to eliminate this competitive advantage.

D. Exchanges as Designers of Market Structure

The status of the exchanges as SROs provides exchanges with an important but often overlooked competitive advantage over broker-dealers, the ability to design and implement market structure initiatives. In this regard, the Commission frequently turns to the exchanges—whether or not their actual regulation is outsourced—along with FINRA to design vital market structure reforms that will ultimately be binding on the entire marketplace, including broker-dealers.²⁹ This places exchanges in a unique position to influence the outcomes on market structure, despite their own competitive interests as market participants.

In recent years, this delegation has included the adoption of single-stock circuit breakers, the modification of clearly erroneous execution rules, the elimination of market maker stub quotes, the adoption of the Limit Up-Limit Down Plan, and the modification of the market-wide circuit breakers.³⁰ To be clear, SIFMA supports the goals behind these initiatives. However, these initiatives could have been designed more effectively and at lower cost to the broker-dealer community if they had received the benefit of true industry feedback and analysis through the Commission's rulemaking process.

²⁸ See *NetCoalition v. Commission*, 615 F.3d 525 (D.C. Cir. 2010), *but see NetCoalition v. Commission*, No. 10-1421 (D.C. Cir. Apr. 30, 2013) (finding that amendment to Exchange Act precluded court from jurisdiction to hear challenge at particular procedural posture).

²⁹ In addition to the impact on competition discussed below, SIFMA also urges the Commission to consider whether this delegation of market structure design to SROs is appropriate as a general matter, or should be passed upon more fully and directly by the Commission through its formal rulemaking process. For example, SIFMA notes that the legal standards that the Commission must consider in reviewing SRO market structure proposals is either consistency with the Exchange Act (for exchange rules) or the standards under Regulation NMS Rule 608 (for NMS Plans). Formal rulemaking by the Commission, in contrast, requires a more comprehensive inquiry and review, including among other things, detailed cost-benefit and economic analysis.

³⁰ See Exchange Act Release No. 62251 (June 10, 2010) (single-stock circuit breakers); Exchange Act Release No. 62886 (Sept. 10, 2010) (clearly erroneous transactions); Exchange Act Release No. 63255 (Nov. 5, 2010) (market maker stub quotes); Exchange Act Release No. 67091 (May 31, 2012) (Limit Up-Limit Down); Exchange Act Release No. 67090 (May 31, 2012) (market-wide circuit breakers).

Most critically, the Commission recently largely delegated to the SROs the power to design and dictate the structure and functions of a new consolidated audit trail (the “CAT”), subject to Rule 613 of Regulation NMS under the Exchange Act and the Commission’s approval.³¹ SIFMA has strongly supported the CAT as a critical market structure and regulatory oversight improvement and believes that it is necessary to build and operate the CAT. To be sure, the CAT will involve significant new systems capabilities and require structural changes to both exchange and broker-dealer operations, and command significant investment and ongoing costs on both sides. However, the authority to decide how the CAT system will operate and how its costs will be allocated among market participants has been delegated to the exchanges. SIFMA has expressed significant reservations about this process. More broadly, SIFMA questions the public policy rationale behind the Commission’s decision to ask one group of competitors over another to direct such an important and costly project, with broad implications for the entire securities business.

Viewing exchanges as independent regulators that will design and implement the Commission’s market structure initiatives without considering their own competitive interests is no longer realistic. As for-profit businesses, exchanges should no longer be entrusted with such important public functions and expected to act as if they are disinterested parties acting in the public interest.

IV. Funding of Self-Regulation

As part of a comprehensive review of the self-regulatory structure, the Commission should review and reconsider the way in which self-regulation is funded. Regulatory fees and charges from the exchanges abound, and SIFMA is concerned that, in some cases, fees are either duplicative or unnecessary in light of existing revenue streams that should be used to support regulatory functions. There is little transparency into the magnitude of regulatory and related fees received by SROs and the amounts the SROs spend on regulatory activities. This lack of transparency makes it impossible for SRO members to consider the reasonableness of fees or to be confident that regulatory fees are actually necessary to fund regulation, rather than protect an exchange’s profit margins.

SIFMA members generally pay membership fees to FINRA, along with trading activity fees, testing fees, personnel fees, and branch fees. At the same time, the exchanges also charge their members various regulatory fees. For many exchanges, the regulatory fees are, in large part, intended to cover the exchanges’ costs of outsourcing regulation to FINRA—duplicating costs on member firms.

³¹ See Exchange Act Release No. 67457 (July 18, 2012).

Chair Mary Jo White
Securities and Exchange Commission
SIFMA Letter on Self-Regulatory Structure of the Securities Markets
July 31, 2013
Page 13

As a general matter, SIFMA is concerned that existing regulatory fees collected by exchanges become part of their baseline revenue and contribute to exchanges' regularly anticipated profit margins. Therefore, whenever new regulatory requirements are imposed, rather than looking to existing regulatory fees, the exchanges pass on the new cost to their members as a new or increased regulatory fee. When this occurs, for-profit exchanges are effectively able to shift these overhead costs onto the broker-dealers with which they compete.³²

For example, it is expected that the SROs will propose new regulatory fees to offset their costs related to building and operating the CAT. There is no way for the public to assess the reasonableness of any new proposed fee without greater transparency into SROs' existing regulatory fees as well as their actual regulatory expenses. SIFMA urges you to consider, as part of the Commission's comprehensive review, requiring SROs to make this important information publicly available on a regular basis.

* * *

SIFMA again urges the Commission to undertake a comprehensive review of the market and self-regulatory structure, and greatly appreciates your consideration of its views in connection with this matter. We would greatly appreciate the opportunity to meet with you to discuss these issues with you in greater detail. If you have any questions, please contact me at (202) 962-7383 or tlazo@sifma.org.

Sincerely,

A handwritten signature in blue ink, appearing to read "Theodore R. Lazo", with a long horizontal flourish extending to the right.

Theodore R. Lazo
Managing Director and
Associate General Counsel
SIFMA

³² The Commission has also recognized the concern that shareholder-owned SROs could 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. *See* Concept Release Concerning Self-Regulation, Exchange Act Release No. 50700 (Nov. 18, 2004).

Chair Mary Jo White
Securities and Exchange Commission
SIFMA Letter on Self-Regulatory Structure of the Securities Markets
July 31, 2013
Page 14

cc:

Luis A. Aguilar, Commissioner
Daniel J. Gallagher, Commissioner
Troy A. Paredes, Commissioner
Elisse B. Walter, Commissioner

John Ramsay, Acting Director, Division of Trading and Markets
James R. Burns, Deputy Director, Division of Trading and Markets
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