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February 16, 2006

**VIA MESSENGER**

Nancy M. Morris  
Secretary  
Securities and Exchange Commission  
100 F Street, NE – 10<sup>th</sup> Floor  
Room 10915 – Mailstop 1090  
Washington, DC 20549-1090

**Re: File No. SR-NYSE-2005-77**, Notice of Filing of Proposed Rule Change and Amendment Nos. 1, 2, 3, 4, 5 and 6 Relating to the Exchange’s Business Combination with Archipelago Holdings, Inc.

Dear Ms. Morris:

In its response to comments on its proposed organizational and governance structure (“Proposal”)<sup>1</sup> upon completion of the proposed merger between the New York Stock Exchange, Inc. (“NYSE”) and Archipelago Holdings, Inc., the NYSE suggests that rule harmonization will effectively address the conflicts between its for-profit trading market and its member regulatory function.<sup>2</sup> NASD staff is compelled to address these views about effective self-regulation asserted by the NYSE in that response. Rule harmonization has superficial appeal. In fact, however, rather than resolving the commercial conflicts that arise from both operating a for-profit securities exchange and regulating the entities that may choose to generate profits for that trading market by using its facilities, the Proposal exacerbates those conflicts and the magnitude of regulatory duplication. In stark contrast, the hybrid model of self-regulation would resolve the conflicts and eliminate duplication. Accordingly, we wish to amplify our earlier

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<sup>1</sup> See Securities Exchange Act Release No. 53073 (Jan. 6, 2006), 70 Fed Reg. 2080 (Jan. 12, 2006) (File No. SR-NYSE-2005-77). The comments provided in this letter are solely those of NASD staff; the NASD Board of Governors has not considered or endorsed them. For ease of reference, this letter may use “we,” “NASD,” and “NASD staff” interchangeably, but these terms refer only to NASD staff.

<sup>2</sup> See Letter dated February 7, 2006 from Mary Yeager, Assistant Secretary, NYSE, to Ms. Nancy Morris, Secretary, SEC.

recommendation for the Securities and Exchange Commission (“SEC” or “Commission”) to adopt a hybrid model of self-regulation.<sup>3</sup>

***The NYSE Proposal Maintains the Conflict Inherent When a Regulator Operates a Market***

This letter does not comment on the corporate or governance structure of the NYSE; those matters are best decided by that self-regulatory organization (“SRO”). However, irrespective of the presence of independent directors, the NYSE Proposal would establish a for-profit corporate structure. In light of that for-profit status, the regulatory entity cannot be wholly independent from its trading market and, thus, would maintain that sinew of conflict between the exchange and its regulator. Absent complete separation of trading market and regulator, as will be the case between NASD and The Nasdaq Stock Market, Inc. (“Nasdaq”) upon the latter’s registration as a national securities exchange,<sup>4</sup> there is an unavoidable inherent conflict that regulation of member conduct may be influenced by its pecuniary impact on the for-profit, affiliated trading market, since the regulator will have rule writing authority for sales practices, financial operations and transaction routing decisions. The NYSE contends that its proposed corporate structure will minimize the likelihood of such conflicts. Even if that is the case, the proposed structure remains wholly unsatisfactory because there is an alternative that completely erases any probability of conflicts: the hybrid model of self-regulation.

As explained in more detail in our March 15, 2005 comment letter on the SEC’s Concept Release Concerning Self-Regulation,<sup>5</sup> NASD believes that it makes eminent sense to pull all regulation of broker-dealer interaction with the public away from the trading market governance apparatus and unify such regulation under a single SRO, free from the commercial conflicts attendant to owning and operating a trading market, with fair representation from the industry and a single set of rules. Meanwhile, regulation of exchange operations – promulgation and enforcement of trading rules, market surveillance and listing standards – can be left to separate trading market self-regulatory organizations that can draw on specialized knowledge of their respective markets to ensure overall market integrity.

The NYSE Proposal would require that those firms and individuals that wish to avail themselves of access to the liquidity and trading-related services of the NYSE market facility obtain a trading license from the NYSE. However, to obtain a trading license, the NYSE Proposal would require an applicant to be a member of the NYSE and subject to the full scope of NYSE rules. It is this requirement that triggers – unnecessarily, in our view – duplicative and conflicted regulation for firms that engage in broker-dealer activity with the public, because all such firms already must be a member of NASD and subject to NASD rules. Indeed, the Proposal would

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<sup>3</sup> See Letter dated March 15, 2005 from Robert R. Glauber to Jonathan G. Katz re: Concept Release Concerning Self-Regulation (File No. S7-40-04).

<sup>4</sup> See *infra* note 8 and accompanying text.

<sup>5</sup> See *supra* note 3.

exacerbate the extent of duplicative regulation, as firms that previously could not obtain trading privileges without incurring the considerable expense of purchasing a seat on the exchange will now be able to seek annual trading licenses at a comparatively modest cost. Those firms will swell NYSE membership and consequently the number of dual members of the NYSE and NASD.

NASD staff believes that there is no public policy reason to require a firm that merely chooses to utilize the services of a particular securities exchange facility to be subject to the member regulatory scheme of that SRO with respect to its broker-dealer conduct with the public. In contrast, there are compelling public policy reasons – elimination of conflicted regulation and duplication – not to impose such a requirement. The hybrid model of self-regulation recognizes this reality.<sup>6</sup> It would create a single SRO to regulate all broker-dealer activities other than trading on an exchange, such as licensing registered representatives, net capital requirements, sales practices, supervision, communications with the public, margin, account statements and securities distributions. Under the hybrid model, all broker-dealers doing business with the public would have such activities governed by the same set of rules, the same teams of examiners and the same enforcement attorneys. And each broker-dealer that chooses to subscribe to the services of a given market would be regulated separately by that specific trading market SRO with respect to trading rules and market surveillance. Each trading market would allow an access permit to create membership for the purpose of use of its market, and each permit holder would be subject to that trading market's trading rules.

This model also would have the ancillary benefit of improving market efficiency by allowing smaller firms to have direct access to the NYSE exchange facility without subjecting themselves to a costly second regulatory regime. The fair access requirements of Regulation NMS evinces that connectivity is an essential part of the national market system.<sup>7</sup> NASD believes that, since unfettered indirect access is appropriately mandated in Regulation NMS, other regulatory policy that fosters direct access without unnecessary barriers should be promoted.

### ***Rules Harmonization is an Inferior Solution Compared to the Conflict-Free Hybrid Model of Self-Regulation***

The NYSE acknowledges the need to reduce duplicative regulation for dual members. In response, the NYSE has promised to use its “best efforts” to identify and reconcile inconsistencies between its member rules and NASD rules. Even if the NYSE follows through on such a costly and time-consuming undertaking, harmonized rules amount to a topical treatment of some – but not all – symptoms of a subdermal problem.

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<sup>6</sup> The access provisions of Regulation NMS further recognize this concept. See Rule 610(a) of Regulation NMS.

<sup>7</sup> See Rule 610 of Regulation NMS.

There are several reasons why harmonization of rules is a poor substitute for the hybrid model of self-regulation. First, harmonization does not resolve the inescapable conflict where an SRO both operates a trading market and regulates that market's participants, which in some instances may be competitors of that market. Under the hybrid model of self-regulation, the SRO that is responsible for member regulation has no incentive to promulgate rules that either drive business to a particular market center or otherwise protect the SRO's commercial interests; the NYSE model is unavoidably embedded with these conflicts because of its for-profit structure, and the answer does not lie in making the rulebooks of a conflicted SRO and a non-conflicted SRO look alike. Second, while harmonization could result in substantially similar rulebooks, it would not eliminate all duplicative costs and efforts associated with having two organizations, rather than one, write, administer and enforce those rules. And, as mentioned above, increased numbers of dual members resulting from the proposed NYSE structure will enlarge the existing overlap. Third, harmonization at the level of the SRO rulebook will inevitably not be sustainable as divergence will necessarily occur at the level of interpretation, examination and enforcement. Finally, forced harmonization of rules may disserve investors and the market by compelling an uneasy compromise between NASD rules, which currently govern approximately 5,100 brokerage firms, and NYSE rules, which apply only to a much smaller universe of firms. The result likely would be a set of rules that are less than optimal for either organization's members and necessarily would sacrifice some level of investor protection. Common sense dictates that more effective, efficient and evenhanded rules would result from a single rulemaking entity than from an arranged marriage of two distinct entities with differing institutional histories.

### ***NASD has Led the Way in Dealing with Conflicts***

NASD is in a unique position among U.S. securities SROs. Years ago, NASD began to separate its regulatory operations from any interest in a trading market and is in the process of divesting its ownership interest in any such market. NASD has fully divested itself of the American Stock Exchange, Inc., and with the SEC's recent approval of Nasdaq's application to become a registered national securities exchange, will complete the process of selling its remaining financial interest in Nasdaq before the end of the year.<sup>8</sup>

We also have taken effective actions to address member conflict issues, implementing rigorous corporate structure changes to prevent undue influence of regulated firms over boards, key committees and staff.<sup>9</sup> These actions reflect both structural and procedural changes to many of the core aspects of NASD operations and address the very conflicts of concern identified by the SEC in its review of self-regulation. With respect to funding, as noted earlier, virtually all

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<sup>8</sup> See Letter dated March 15, 2005 from Robert R. Glauber to Jonathan G. Katz re: Concept Release Concerning Self-Regulation (File No. S7-40-04); Letter dated March 8, 2005 from Robert R. Glauber to Jonathan G. Katz re: Notice of Proposed Rulemaking Concerning Governance, Administration, Transparency, and Ownership of SROs (File No. S7-39-04).

<sup>9</sup> For a comprehensive discussion of NASD's governance structure and its implementation of numerous safeguards to address potential concerns, see id.

broker-dealers are required to be NASD members. As a result, while NASD is dependent on its members for funding of its regulatory programs and operations, we do not face the same types of competitive pressures as other SROs to retain our members and are not reliant on the trading volume of any particular market or market participant for funding. In short, NASD does not face the same order flow, market competition and revenue dependency conflicts faced by SROs that own and run affiliated trading markets.

NASD urges the Commission to recognize that harmonization, contrary to any assertion that it is an answer to public policy regulatory problems raised herein, is in fact merely the solution to forestall remedying these problems. Accordingly, NASD urges the Commission to take the occasion of its consideration of the Proposal to address the substance of both the needless problems surrounding a conflicted for-profit trading market engaging in member regulation and the unnecessary and inefficient duplication of member regulation of broker-dealers that engage in a business with the public.

Very truly yours,



Barbara Z. Sweeney  
Senior Vice President and  
Corporate Secretary

cc: Chairman Christopher Cox  
Commissioner Paul S. Atkins  
Commissioner Roel C. Campos  
Commissioner Cynthia A. Glassman  
Commissioner Annette L. Nazareth  
Mr. Robert L.D. Colby