ISE
INTERNATIONAL SECURITIES EXCHANGE.

March 8, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: File No. S7-40-04; Self-Regulatory Organizations

Dear Mr. Katz:

The International Securities Exchange, Inc. ("ISE") appreciates the opportunity to comment on the Commission's concept release ("Concept Release") on self-regulation. The Concept Release raises thought-provoking questions on the nature of self-regulation and the role of self-regulatory organizations ("SROs") in today's securities markets. We believe that the self-regulatory system, subject to Commission oversight, works remarkably well. Indeed, we believe that the success of the self-regulatory system is one reason why our nation's securities markets are the model and the envy of the world. We have the deepest, most liquid and best regulated securities markets of any country. We urge caution when tampering with this success.

We do not mean to imply that the current system is perfect and cannot be improved. However, rather than jettisoning the current self-regulatory system for something unproven we believe that the Commission should build on the strengths of the current self-regulatory system. In this regard, the single biggest fault with the current system is that it results in some unnecessary duplication of functions and thus imposes unnecessary costs on the industry. We support a system similar to the "Competing Hybrid Model" the Commission discusses in the Concept Release. In this model there would be at least two SROs offering "member regulatory services." In addition, each SRO operating a market would be responsible for its own market regulation. We believe that such a system would retain the benefits of today's self-regulatory system (including competition), improve the quality of regulation, and reduce industry costs.

The Commission does not have to take our word on the benefits of this regulatory approach. As part of our extensive research in preparing this comment letter, we stumbled upon a "hole in time" that provided us access to a history book of securities regulation written in the year 2105. This book has a short chapter chronicling various attempts at self-regulation in what we would call the future. Remarkably, this chapter shows how the competing hybrid model worked well, while other models the Commission discusses in the Concept Release had inherent flaws. We have attached this chapter for your review. Hopefully by heeding the message of this chapter the Commission can learn from – and perhaps even change the course of – history.

We thank the Commission for the opportunity to comment on the Concept Release. If you have any questions on this letter, or if you would like other chapters of this book, please do not hesitate to contact us.

Sincerely,

Michael J. Simon
Secretary

cc: Chairman Donaldson
Commissioner Atkins
Commissioner Campos
Commissioner Glassman
Commissioner Goldschmid

Annette Nazareth
Robert Colby

INTERNATIONAL SECURITIES EXCHANGE.

Attachment

Chapter Seven of: "The History of Securities Regulation in the Pre-Modern Era" by David St. Hubbins and Nigel Tufnel.

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Chapter Seven: The Death and Rebirth of Self-Regulation

Between 1934 until 2005 each U.S. exchange and association operated both a market place and a "full service" regulatory department. While there always had been tensions in the self-regulatory arena, a series of events in the early 21st century led the SEC (one of the predecessors to our current Market Oversight Commission) to begin an evolutionary process that has resulted in our current "Competing Hybrid" system. We can describe these stages as: the "Independent Subsidiary" period; the "Direct SEC Regulation" period; the "Universal Non-Industry Regulator" period; the "Universal Industry Regulator" period; the "Hybrid" period; and our "Competing Hybrid" system that has served us well for over 25 years. While it now is easy to see the inherent limitations of the failed systems, it is only with hindsight that matters look so clear to us.

The Independent Subsidiary Period

The years 2004 and 2005 were strange in many ways. Most of us remember 2004 from the history books as the last time the Boston Red Sox won the World Series, beginning the third-longest non-championship streak in current history, behind only the hapless New York Yankees and Washington Nationals. Perhaps it was due to that anomaly that many odd events followed, including the SEC's decision to abandon a successful self-regulatory system by requiring markets to separate business and regulatory functions into separate corporate entities. The result was not pretty.

The most immediate effect of requiring separate regulatory and market corporate entities was (obvious in retrospect) massive duplication. Ten equity and option SROs became 20. Members needed to join both. SRO infrastructures and costs mushroomed. SEC processing and oversight burdens increased. Of more concern, regulation got worse, not better. Multiple SROs continued to provide membership regulatory services, such as financial and operational regulation, requiring continued cooperation by the regulatory SROs. On the market regulation side, the regulators lost touch with trading and market realities, one of the strengths of self-regulation. This resulted in friction and a lack of coordination within SRO complexes that quickly translated into regulatory uncertainty for members. Ultimately investors paid the price as broker-dealers increased their fees and provided less liquid and competitive markets.

The Independent Subsidiary Period did not last long. Faced with a popular uprising in the financial markets, within 10 years the SEC issued a new series of concept releases and rule proposals. Late in the second term of the Hillary Clinton presidency, just before the election of Jeb Bush, the SEC made its most radical regulatory decision: it took back full regulatory responsibility for the markets.

Direct SEC Regulation Period

You may sometimes see a reference to this period as the "second Dark Ages." That is only a mild exaggeration. At best, we can describe this as a well-meaning overreaction to the multiplicity of regulators in the Independent Subsidiary Period. The 10 regulatory bodies (the regulatory off-shoots of the old integrated SROs) became one:

the SEC itself. Because the SEC had been receiving copious amounts of surveillance information from the SROs under an ill-advised "corporate governance" initiative, the SEC staff believed that it could provide an efficient centralized regulatory function themselves. They were wrong. Indeed, it was during this time that the United States first lost its primacy in the financial markets to the then newly-reinvigorated European Union.

There were many problems with direct SEC regulation. Most fundamental was the inherent inability of a large governmental organization to react in a timely manner to changes in the market place. The pace of rulemaking was slow and required extensive statutorily-mandated procedures. Staffing the regulatory function was constricted by governmental hiring policies. Perhaps in retrospect it is easy to see how these problems resembled some of the same problems that doomed the so-called "SECO" direct-SEC regulatory program for over-the-counter trading in the late 1900's.

Also lost in this era was the benefit of having the SEC as the primary regulator, providing a critical level of regulatory review. Previously, aggrieved persons could appeal regulatory actions to the SEC, and the SEC could review and inspect SRO activities. No one had similar authority over the SEC. Unchecked regulatory authority is never good, and, over time, the SEC's regulatory program became bloated, inefficient and non-responsive to the changing market.

This structure also resulted in increased costs. As the SEC's unchecked regulatory program grew, it continued to increase the fee it charged industry participants to fund these activities, imposing burdens on broker-dealers who were still subject to trading fees on all the markets. Each market continued to operate under different rules, and the SEC staff had difficulty tailoring its regulatory program to accommodate the varying market structures. Similarly, separating regulation from the market left the SEC's regulatory staff removed from market realities. Ironically, just as the European markets were enhancing their self-regulatory processes the Americans were abandoning the same system. It is easy in retrospect to see how these changes set the stage for the European markets to catapult over the Americans for market supremacy.

Because it required legislation to establish the SEC as the sole regulatory authority, it also took legislation to undo that mess. By 2030, following the mid-term elections in the second "daughters' presidency" (Amy Carter as President and Chelsea Clinton as Vice President), Congress took the first step back toward self-regulation by implementing a universal non-industry regulator.

<u>Universal Non-Industry Regulator Period</u>

Based on the successful precedent of the Public Company Accounting Oversight Board that cleaned up the auditing mess over 100 years ago, the 2030 legislation created the Market Regulatory Board ("MRB"). Effectively the SEC offloaded its primary regulatory function to this non-industry regulator and reestablished its function as an oversight agency. At the same time, the market regulatory arms of the various oversight agencies, including the SEC, merged to form the Market Oversight Commission ("MOC"). While this approach eliminated some of the limitations inherent in the direct governmental involvement of the SEC Regulation period, it did not address the problems and inefficiencies of single-source regulation by a body with limited knowledge of the day-to-day workings of its regulated industry.

On the positive side, the MRB was able to attract and retain a stronger staff than the SEC. However, that also increased the costs on the industry due to "transaction tax" the MRB imposed on investors. While the MRB could react more quickly than the SEC could to market developments, there remained an inherent disconnect between the markets and the regulators. Differences in market structure confounded the MRB and frustrated innovation in the market place. Furthermore, as in any monopoly, there was a level of bureaucracy and inefficiency that grew over time as the MRB continually sought new functions, staffing and funding for itself.

The Republican landslide of 2040 then installed Jenna Bush as president in 2040. Immediately after lowering the minimum drinking age to 18 she moved to fulfill her campaign promise of restoring the primacy of the U.S. capital markets. Taking the first direct step back to self-regulation, she spirited through Congress legislation ushering in the Universal Industry Regulator Period.

Universal Industry Regulator Period

Despite the hype, the Industry Market Regulatory Board ("IMRB") differed little from the MRB. The various market places jointly operated, staffed and funded the IMRB, although funding came from a uniform "tax" on transactions on each market. The IMRB Board consisted of one representative of each market, plus a minority of non-industry representatives from the investor, issuer and academic communities. The IMRB improved the responsiveness of the regulator to industry needs. However, the Board still needed expertise in each of the different market structures in order to apply a market's rules to trading activity in that market. This continued the disconnect between the market and the regulator.

While the United States started to recapture lost market share, it never regained the market primacy that President Jenna Bush sought. The next logical step in the regulatory evolution did not occur until 2062, during the second term of William Jefferson Clinton Coulter. At that time, Congress moved market regulation back to the individual markets in a hybrid model.

Hybrid Period

As a result of the 2062 legislation, the IMRB offered each market an opportunity to take responsibility for regulating trading in its own market. Every market immediately accepted this offer. The line of demarcation was clear: trading rules became the responsibility of the newly-rechristened SROs, subject to MOC review; the IMRB retained sole authority for financial and operational regulation, such as net capital, margin, operational and membership matters. The IMRB also was the sole prosecutorial SRO, bringing enforcement cases when members violated either the rules of the IMRB or, working in conjunction with the staffs of the market place SROs, when members violated trading market rules. In a nod to the past, the IMRB renamed itself the National Association of Securities Dealers, Inc. or "NASD."

This was the single largest improvement in securities regulation since the Securities Acts Amendment of 1975. By regaining SRO authority, the markets could closely coordinate trading with regulation. It may have taken over 60 years, but Congress and the regulators finally remembered that good business and good regulation are not only compatible, but also feed off of – and improve – each other. Within three years of restoring self-regulation, the U.S. markets regained global preeminence and embarked on the path that has led to the current U.S. dominance of world markets.

The system worked extremely well, with markets focused on regulating matters unique to them and the NASD focusing on industry-wide regulation. That avoided the duplication of generic regulatory work, while preserving and even fostering creativity and development of alternative trading structures. Perhaps it took 60 years of alternative regulatory structures to remind the regulators that the industry itself has strong incentives to provide for effective regulation. In turn, the MOC provided the independent review and oversight necessary to prevent abuses in the system.

The only problem with the hybrid model was the monopoly status the NASD enjoyed as the sole regulator of general regulatory matters. Over time, the NASD began to lose some efficiency, and also needed to focus on all types of broker-dealers, both large and small. This led to broadening support for alternative regulators. Following the election of Biff Clinton (son of Chelsea; grandson of Bill and Hillary) to the Presidency in 2076, Congress enacted legislation establishing our current competing hybrid regulatory model.

The Current Competing Hybrid Period

The Securities Acts Amendments of 2076, enacted 101 years after the seminal 1975 law, has aged well over the last 29 years and shows no signs of becoming obsolete. Unfortunately, the same cannot be said for Biff Clinton, who, of course, Congress impeached and removed from office in 2079 following those unfortunate events in Mexico City, preceding the election of Herbert Walker Bush Schwarzenegger (the son of Jenna Bush and the great-grandson of Arnold Schwarzenegger) in 2080.

The 2076 Amendments opened up limited competition in the area of financial and operational regulation. While Congress did not specifically impose a limit of two regulators, the high standards it set for this form of registration clearly was intended to accommodate only a single competitor to the NASD: an affiliate of the leading securities market place, the International Securities Exchange, LLC. Within a year of the passing of this legislation, the MOC approved the registration of ISER, LLC, a subsidiary of ISE Holdings, Inc., as a regulatory alternative to the NASD. All the markets continued to regulate their own trading activities.

The NASD and ISER work in both a cooperative and competitive environment. While the NASD is a member-owned not-for-profit entity, ISER is part of an organization that controls the most profitable financial markets in the world. Firms can choose membership in either of the two designated regulatory authorities (or "DRAs"), and can switch membership periodically. By rule, firms cannot switch more than once every three years, and higher fees imposed on new members limits such switching even further. Over the years, the larger broker-dealers migrated to the ISER, while the NASD has developed expertise in oversight of the smaller firms. While the rules of the two organizations remain fairly similar, ISER's rules have tended to focus on issues involving larger firms while the NASD has focused its rules on its broader, but smaller, base. Of course, both of these SROs remain subject to MOC regulation.

In retrospect, it is remarkable how self-regulation has come full-circle. After experimenting with various alternative approaches, the regulatory structure of 2105 looks remarkable the same as 2005: markets conduct surveillance and regulation of their own trading, while a smaller number of SROs have financial and operational regulatory authority. In 2005 it was the NASD and the New York Stock Exchange (now a subsidiary of ISE Holdings) as the two main financial and operational regulators; today it is the "new" NASD and ISER. Back in 2005 there was no formal demarcation between market-based regulation and financial and operational regulation. Rather, the markets entered into a complex series of so-called "17d-2 Agreements" to allocate regulatory responsibility. While the result was not pretty, it worked pretty well.

Looking back, it is easy to see how we could have avoided the regulatory agonies of the last 100 years, including the decline (and later rebirth) of the U.S. financial markets. We simply could have formalized criteria for an entity to register as a stand-alone financial and operational regulatory authority, with high enough standards to ensure that only one or two of the larger SROs would see a benefit in such registration. We then could have formally relieved the other SROs of this regulatory burden, letting them focus on regulating their markets. This would have lowered costs on members, avoided duplication of efforts, retained competition in all aspects of the market place, and ensured the continued protection of investors and the primacy of the U.S. markets. We got there eventually, but only after incurring high – and avoidable – costs.