March 8, 2005

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

Re: File No. S7-39-04; Self-Regulatory Organizations

Dear Mr. Katz:

The International Securities Exchange, Inc. ("ISE") is pleased to comment on the Commission's comprehensive proposal ("Release") regarding the governance and operation of self-regulatory organizations ("SROs"). We appreciate the Commission's desire to enhance the governance and regulatory oversight of SROs, and we agree with the Commission's goals, as well as some of the specific proposals. However, we believe that many of the Commission's proposals go well beyond what is required to address the deficiencies the Commission describes. We also believe that, in certain cases, the Commission is not following the rule-making procedures mandated by the Securities Exchange Act of 1934 ("Exchange Act"). We can summarize our comments as follows:

- SRO Governance: We have a majority of independent directors and "Standing Committees" comprised entirely of independent directors.[1] We also have a non-executive Chairman. While this form of governance has worked well for us, we question whether such a structure is necessary for all SRO's. We also have policy concerns regarding certain of the specific governance proposals, as well as legal concerns regarding the Commission's failure to follow the procedures required under Section 19(c) of the Exchange Act to change SRO rules. Similarly, by mandating that SROs adopt their own rules, the Commission is placing SROs in a position of possible irreconcilable conflict with state law.
- SRO Regulatory Functions: While we recognize that there have been a number of recent SRO regulatory deficiencies, we do not believe that there is a single remedial approach for all SROs. While some SROs may find it appropriate to separate regulatory and business functions, we do not believe such separation is appropriate for all SROs. We believe that having our Chief Executive Officer ("CEO") ultimately responsible for regulatory matters enhances our regulatory program. We further believe the proposed jurisdiction of the Regulatory Oversight Committee ("ROC") infringes on what is appropriately a management function and will make it

[1] The Commission would require SROs to have the following "Standing Committees": Audit; Compensation; Nominating, Regulatory Oversight and Governance.

exceedingly difficult for SROs to recruit high-quality individuals to serve as board and committee members.

- Limits on SRO Ownership and Voting: We support limiting member ownership and voting control over SROs. However, as with SRO governance, we believe that the Commission can achieve this result only pursuant to Section 19(c) rulemaking. Moreover, SROs may have difficulty imposing these limits on their members under state law, thus potentially placing SROs in violation of Commission rules despite their best efforts to comply.
- SRO Regulatory Reporting Requirements: The Commission is proposing that we provide its staff with copious amounts of data on a quarterly and annual basis. We believe that the proposal is overly broad, and should be more narrowly tailored to provide the Commission with useful information in a more efficient manner. The current proposal will entail significant costs that are well in excess of any potential benefit. We also believe that the proposed annual audit of electronic systems is discriminatory to automated markets and will cost many multiples of the Commission's estimated $15,000 cost, with little or no benefit. We further believe that requiring SRO to describe their "internal controls" addressing potential regulatory and business conflicts of interest improperly places a reporting obligation on SROs without specifying the substantive requirements.
- SRO Financial Reporting: We support requiring SROs to provide the public with financial reports similar to companies with reporting obligations under the Exchange Act. However, we believe that certain aspects of the proposed requirements actually are inconsistent with reporting company obligations and will pose significant compliance difficulties for SROs that also are reporting companies. In addition, certain proposals have compliance costs that would outweigh any possible benefits that the financial reporting could provide to the Commission or the investing public.

A. SRO Governance

The ISE currently complies with virtually every corporate governance standard the Commission is proposing: a majority of independent directors;[2] Audit, Compensation and Corporate Governance Committees consisting entirely of independent directors; and at least 20 percent of our Board elected by our members. While believe that these are proper governance procedures for us, we are not in a position to determine whether there are policy reasons to require all other SROs to adopt these same requirements.

There also are a few proposals with which we currently do not comply. In some cases, we have no objection to the proposal. However, we do have policy concerns with: the requirement for issuer and investor representation on our Board; the requirement that at least 10 percent of the members be able to petition to nominate directors; and the requirement that a majority of directors voting on the recommendations of a Standing Committee be independent. In addition, we do not

[2] While a majority of our directors meet the Commission's proposed definition of "independent director" in proposed Rule 6a-5(a)(12), our definition of "independence" does not exactly track the Commission's proposed definition. Thus, if the Commission adopts this proposal, it may be necessary for us to amend our definition of "independence" to conform to the rule. Similarly, we would need to codify in our rules that a person subject to a statutory disqualification could not serve on our Board. This would raise the procedural issues we discuss in detail below.

believe the Commission has used the proper legal procedures to propose the SRO corporate governance requirements.

1. Policy Issues

a. Issuer and Investor Board Representation

Based on Section 6(b)(3) of the Exchange Act, the Commission proposes to require SROs to adopt rules mandating that at least one director represent issuers and one represent investors. At the ISE, at least two of our directors currently must be "representatives of the public," which we believe satisfies this proposed requirement. However, it is unclear from the Commission's proposal whether this would be sufficient since the Commission does not define "representative of investors." We ask that the Commission provide more specificity as to how it expects SROs to comply with this requirement. With respect to an issuer representative, we trade only standardized options thus have only one "issuer" related to the ISE: The Options Clearing Corporation ("OCC"). We do not believe it is appropriate for a representative of OCC to be on our Board since, as the Commission notes,[3] OCC is not a traditional issuer.[4]

We believe that the Commission has significant flexibility in how it administers the "fair representation" requirement of the Exchange Act. In approving our exchange registration, the Commission found that "the ISE has been structured in such a manner as to satisfy the principles of fair representation as required by Section 6(b)(3) of the Exchange Act."[5] Thus, we do not believe that one "issuer representation" standard is needed for all SROs. Rather, we believe the Commission should continue to review all SRO governance structures to see if, given the particular facts and circumstances of each SRO, that SRO's structure provides for fair representation.

b. Nominations by Petition

The Commission proposes that SROs adopt rules providing members an ability to nominate candidates for director, while restricting SROs from requiring nomination petitions to contain more than 10 percent of an SRO's "total number of members." We believe that this requirement is unnecessarily strict and is inappropriate as an across-the-board solution. We ask that the Commission review individual SRO proposals without mandating a single means of "fair representation" in this area. At the ISE, each of our three classes of members elects two directors. Members can nominate directors by submitting a petition signed by members representing no more than 10 percent of the shares of a class as long as there are at least 40 shares of that class outstanding. However, if there are less than 40 shares outstanding, we require a petition to represent 25 of the shares. While we have two membership classes with more than 40 shares outstanding, we only have 10 Primary Market Maker ("PMM") memberships, resulting in a 25 percent petition requirement for that class.

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[3] *See* footnote 260 in the proposing release ("Release") regarding proposed Regulation AL.

[4] The Commission also proposes to bar representatives of SROs from serving on the Board of a listed company. Because we trade securities (options) issued by OCC, it could be deemed a "listed company," and five options exchanges currently have a representative on the OCC Board. Due to the unique nature of OCC, and because the exchanges own OCC, we believe that such representation is appropriate and does not raise the regulatory conflicts.

[5] Exchange Act Release No. 342455, February 24, 2000 (65 F.R. 11388 (March 2, 2000)).

A literal reading of this proposal would require us to permit each of our PMMs to nominate its own Board candidate. We view that as inappropriate.[6] Indeed, we adopted the current petition requirement because we permit members to own up to two PMM memberships, and requiring petitions from 25 percent of such members ensures that no PMM can nominate its own candidate without support from at least one other member. The Commission has cited neither abuses nor policy reasons for such a stringent requirement. We thus ask the Commission to provide SROs with flexibility in this area by reviewing nomination proposals on a case-by-case basis under the Exchange Act.

c. Voting by Independent Directors

The Commission proposes that SROs have Standing Committees comprised solely of independent directors. The Commission also proposes to require that "a majority of the directors who vote on the matter must be independent directors." If there are more industry than non-industry directors present at a board meeting, the rule would require that the SRO establish procedures to bar industry directors from acting on the matter.

We are unaware of any precedent under state law for such a limitation on Board action, and we view it as unnecessary from a policy perspective. An SRO must give board members adequate notice of all meetings, as well to provide the board with a meeting agenda. Directors generally can participate in meetings either in person or via conference call. The Commission has not raised any policy concerns indicating why these existing protections are insufficient to ensure appropriate director participation in board meetings. We believe that the Commission should not adopt rules that pose such fundamental conflicts with state law unless there are specific issues it can identify issues justifying such extraordinary action.

2. Legal Issues

Apart from our policy concerns with the Commission's proposals, we believe that the Commission is, in effect, proposing to amend the rules of SROs. Under the Exchange Act, the Commission can accomplish this only by instituting rulemaking proceedings pursuant to Section 19(c) of the Exchange Act. Below we outline the procedural deficiencies of the Commission's proposal, state law preemption concerns, and a practical solution by which the Commission could achieve its goals.

a. Procedural Deficiencies

The Commission has general authority under Section 28(a) of the Exchange Act to adopt rules and regulations "as may be necessary or appropriate to implement the provisions of the [Exchange Act]." However, Congress recognized that special procedural protection is needed for the Commission to amend an SRO's existing rules. In such cases, Section 19(c) of the Exchange Act provides that the Commission must specify the specific text of the SRO rule the Commission is proposing to amend, and must provide interested persons an opportunity to give oral presentations on the proposal. The current rulemaking proposal does not comply with these requirements. We believe that the Commission can mandate a change to an SRO's rules only by providing SROs with the required procedural protections of Section 19(c). Indeed, with

[6] We have eight member firms that operate 10 PMM memberships. With staggered terms, at any given election only seven PMMs can nominate a candidate. Assuming each PMM supported its own candidate, the election could turn on the vote of the one PMM without a candidate.

one exception, we are not aware of the Commission ever claiming this authority in the past, nor are we aware of any court finding that the Commission has such authority.[7]

The Commission's proposed use of this "mandate" approach to SRO rulemaking effectively vitiates Section 19(c) of the Exchange Act. For example, the Commission used Section 19(c) to adopt Rule 19c-5 (regarding multiple listing of options), rather than simply adopting a rule mandating that exchanges adopt a multiple listing rule. Similarly, if the Commission has the power it now is asserting, it could have adopted similar rules regarding off-board trading in lieu of adopting Rules 19c-1 and 19c-3. While the Commission has general rulemaking authority to regulate the manner in which SROs operate, absent extraordinary Congressional authorization such as in SOX, the only way in which the Commission can require SROs to amend their own rules is by complying with the procedural requirements of Section 19(c).

b. Practical Issues and State Law Preemption

As the Commission noted, SROs will need to comply with state law requirements in adopting these corporate governance requirements.[8] It will be difficult, and in some cases potentially impossible, for SROs to do so. Because these rules generally are in the organizational documents of an SRO, approval will require not only board, but also owner (that is, either member or stockholder) approval. An SRO cannot ensure that its owners will approve these requirements. The effect of such a vote will be to ask owners whether to comply with Commission requirements or, effectively, to risk Commission sanctions – including deregistration – for failure to comply. Putting SROs at risk of administrative sanctions due to matters outside of management control makes little policy sense.

We believe that the Commission can avoid this result by adopting these rules under 19(c). While we have not undertaken an extensive analysis of state law issues, as a Delaware corporation we did consult with our Delaware counsel on preemption issues. Counsel advises us that there is no exemption under Delaware law to avoid the need for stockholder approval simply because a Federal regulatory agency has mandated that a corporation change its certificate of incorporation. Thus, the only way to effect these changes without such approval would be by the Commission taking action under Section 19(c) to preempt state law.

c. A Practical Solution

We recognize that SROs have varying forms of organization and that each SRO has unique constituent documents. Thus, a "one-size-fits-all" rule under Section 19(c) to conform SRO governance structures to the Commission's paradigm is not practical. We thus propose that the Commission reissue the Release in the form of a policy statement specifying the minimum corporate governance requirements that it expects SROs to adopt. The Commission could then work individually with SROs to develop a plan to implement those requirements in a manner tailored to particular SROs. For any SRO

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[7] As discussed in footnote 250 of the Release, the one time the Commission mandated that SROs adopt certain rules was in the context of the Sarbanes-Oxley Act of 2002 ("SOX"). However, in so doing, the Commission was following the specific Congressional directive in Section 10A(m)(1)(A) of the Exchange Act, which directed the Commission to require exchanges to adopt modified listing rules. That Congressional directive clearly preempted the more general language of Section 19(c) and gave the Commission direct authority for that limited rule-making. There is no such preemptive authority for the current rulemaking.

[8] *See* Proposing Release at Note 239.

that does not – or cannot – implement such a plan, the Commission could institute individual Section 19(c) proceedings to conform each non-complying SRO's organizational documents to the required minimum standards.

This approach provides an SRO with the opportunity to tailor its constituent documents themselves to comply with the Commission's requirements. It also provides the Commission with the opportunity to preempt state law when necessary, but only after an SRO has proven unable or unwilling to adopt minimum governance standards. This approach allows the Commission to achieve its policy goals in a manner consistent with the requirements of the Exchange Act, without putting SROs in a potentially impossible conflict with state law.

B. SRO Regulatory Functions

The Commission proposes that SROs separate their regulatory functions from their business functions through the appointment of a Chief Regulatory Officer ("CRO") that reports directly to a ROC. The Commission further proposes detailed minimum responsibilities for ROCs. We believe that the Commission's proposal for the separation of business and regulatory functions fails to recognize the important role a CEO can play in assuring that an SRO maintains a sound regulatory program. We further believe that the Commission is proposing responsibilities for ROCs that better belong to management, and that will make it extremely difficult for SROs to recruit qualified independent directors.

1. Separation of Functions

We recognize that there have been recent breakdowns in the SRO regulatory process. However, we see these as failures of processes at particular SROs and not indicative of any structural problems. We recognize that some SROs have addressed these problems by hiring a CRO that reports to a Board committee. While this may be appropriate for some SROs, we believe it is premature to conclude that all SROs must adopt this structure. In particular, we believe that, at least for the ISE, having the CEO ultimately responsible for our regulatory program enhances that program and should be encouraged, rather than prohibited. We do not believe that one size fits all SROs when structuring regulatory programs. In this regard, we note that fully separating regulatory and business functions raises problems of its own, such as the possible lack of communication between these responsible for the separate functions.[9]

The ISE has a somewhat unique regulatory structure. We have limited regulatory authority over members since we are neither the Designated Examining Authority ("DEA") nor the Designated Options Examining Authority ("DOEA") for any of our members. Thus, we focus on the surveillance of trading in our market and bringing disciplinary actions when there are violations of our rules and related Federal securities laws. Our CRO also serves as General Counsel and Secretary and reports directly to the Chief Executive Officer, while also reporting informally to our Corporate Governance Committee, which has oversight responsibility for the regulatory program.

We believe that our regulatory structure is appropriate for the ISE. We fully agree that all SROs should appoint a CRO, and that this officer should have responsibility for the operation of the SRO's regulatory function. We also believe that it would be appropriate to require SROs to have ROCs (subject to the discussion below)

[9] *See* Release No. 34-51163, regarding a Report of Investigation involving the NASD and Nasdaq.

that have oversight responsibility for the regulatory function. We believe that concentrating regulatory responsibility in the CRO, subject to ROC oversight, will fully address the Commission's concerns.

We see no conflicts in having a CRO report to the CEO, while also having the ROC perform its oversight function. The Commission's proposal implies that inherent conflicts between business and regulatory functions require removing the CEO from the regulatory reporting line. We disagree. In fact, we believe that good business supports good regulation. At the ISE our CEO has made regulation an absolute priority for the exchange, and he believes that ensuring the highest quality regulatory program is a strong competitive advantage to us. Removing the CEO from the regulatory function will weaken our program since the CRO's reporting line would be to directors who (1) serve part-time, (2) do not have management responsibility, and (3) due to their "independence" are not employed in the industry and thus are not fully versed in the nuances of the SRO regulatory process. Removing the most senior officer – the CEO – from the regulatory function ultimately will harm, not help, the regulatory process.[10]

2. Regulatory Oversight Committees

We support having ROCs serve as a regulatory oversight body. However, the specific Commission proposal would require a ROC to take an active management role in regulatory matters, which we believe is inappropriate for a board-level committee. The proposal would require a ROC, among other things: to *assure* adequacy and effectiveness of an SRO's regulatory program; to *determine* a regulatory plan, budget and staffing; and to *assure* that the SRO's disciplinary and arbitration proceedings are conducted according to approved policies. "Assuring" and "determining" are management functions. In contrast, the Commission proposes that the other Standing Committees perform traditional oversight functions: the Audit Committee must "*assist* the Board in oversight of the integrity" of the SRO's financial statements; and the Corporate Governance Committee must "*develop and recommend* to the Board" governance principles and "*oversee*" the evaluation of the board and management.

The CEO, as the SRO's senior management official, should have ultimate responsibility for the regulatory function, subject to the oversight of the ROC. The Commission recognizes this in proposing that the CEO sign and take responsibility for an SRO's annual regulatory report. We fail to see how the Commission can expect the CEO to accept this responsibility – and liability – if the CEO cannot have management responsibility for the regulatory function. In addition, asking a board committee to play a more active management role gives rise to committee members' potential liability for failing to meet those obligations and will hamper the ability of SROs to recruit and retain strong and effective outside directors. We especially believe that imposing these obligations on Board members who, by definition, have, at best, limited experience or expertise in regulatory matters is inappropriate.

[10] Although the Release is not clear on the matter, we are assuming the Commission is proposing that the regulatory *function* report to the ROC. We further assume that, if adopted, the CRO would need to report to the ROC only regarding his or her regulatory duties, but could report to the CEO for other functions. If this is not the case, then the proposal raises significant additional issues since we – and presumably other smaller SROs – would need to hire additional, duplicative, personnel and we would lose considerable expertise in our other program areas.

C. Limits on SRO Ownership and Voting

We have no policy objections to the Commission's proposal to limit member ownership and voting control over SROs. Indeed, we believe that this proposal is a marked improvement over the restrictions the Commission staff has asked us to include in our constituent documents as part of our recent restructuring.[11] In particular, we support limiting the restrictions to ownership and control by members, rather than applying such restrictions to all potential investors in an SRO. This provides SROs with flexibility, yet recognizes the unique conflicts that could arise if a member were to own a controlling interest in an SRO with regulatory responsibility for the member.

However, as with the proposed corporate governance requirements, we believe that the Commission can effect these changes only through either voluntary SRO action or Commission rulemaking under Section 19(c) of the Exchange Act. As discussed above, because the Commission effectively is amending SRO rules, we believe the Commission needs to comply with Section 19(c).

State law preemption issues are a particular concern when imposing limits on ownership or voting. We note that for Delaware corporations, Section 202(b) of the Delaware General Corporate Law provides that no restriction on the transfer or ownership of shares "shall be binding with respect to securities issues prior to the adoption of the restriction unless the holders of the securities are parties to an agreement or voted in favor of the restriction." Thus, any SRO subject to this law – or any similar law in other jurisdictions – cannot effectively impose transfer restrictions on its shares unless the current holder of the shares agrees to the restrictions. Without complete stockholder agreement, we believe the only way to impose such restrictions is through Commission action pursuant to Section 19(c), preempting state law.

D. SRO Regulatory Reporting Requirements

We support a critical reexamination of SRO reporting requirements. There is increasing automation of the markets and a continuing evolution of the Commission's inspection and oversight functions. Thus, a periodic reevaluation of SRO reporting is advisable. However, we believe that the current proposals would unduly burden SROs, without providing the Commission with useful information. We also believe the requirement that SROs with electronic trading systems engage an outside firm to conduct an annual "audit" of such system is overly burdensome and unfairly discriminatory against electronic markets. Finally, we do not believe that the Commission has adequately explained the nature of, and the reason for, its proposal that SROs describe their "internal controls" implemented by the SRO to detect or prevent any conflicts of interest between regulatory and business functions.

1. Detailed Regulatory Reporting Requirements

The Commission proposes that SROs submit quarterly and annual regulatory reports including, among other things: all alerts and exception reports we generate (and actions we take on them); all complaints we received; and information on all our investigations, examinations and enforcement cases. The reporting requirements are extensive, frequent and extremely detailed. We believe that the requirements are overly broad and not designed to provide the Commission with useful information. Rather, the detail and frequency of the reports reflects what we view as potential Commission mirco-

[11] *See* File No. SR-ISE-2004-29; Exchange Act Release No. 51029 (January 12, 2005).

management of SROs regulatory programs, which we believe is an over-reaction to recent lapses in some SRO programs.

While it is understandable for the Commission to adjust its oversight approach in reaction to changes in the marketplace, we do not believe it is necessary for the Commission to abandon a periodic inspection program in favor of monitoring the details of each SRO's program on an almost real-time basis. Rather, we believe the Commission's recent move towards topic-based SRO examinations or "sweeps" has been quite effective in addressing problem areas. Moreover, we believe that any attempt by the Commission to manage SRO regulatory programs this closely will have a negative effect on their effectiveness, as SROs will be focused on producing good reports rather than performing their regulatory obligations in a manner best suited to their markets.

Under the proposal, the Commission would require SROs to provide the Commission, on a quarterly basis, information related to its surveillance program, including the number of exception reports and alerts generated sorted by applicable rule or category. The proposal would further require an SRO to indicate the number of exception reports and alerts that were "reviewed" by the SRO and the number of exception reports and alerts that were referred for further investigation or for an enforcement proceeding. As an electronic market, we capture all market information in our automated surveillance system. That system then produces automated alerts pursuant to established system parameters. Our analysts also can produce individualized reports when examining market actions. In most cases, alerts cannot be so narrowly tailored as to only identify when a rule has been violated. Moreover, the raw numbers of alerts can be skewed by such things as unusual market conditions, system errors, or inappropriate system parameters. Providing the Commission staff with the raw numbers of alerts and reports would serve little purpose, since it is only after our analysts review this data that we can determine whether an alert is valid and only after further investigation can we determine whether a member may have violated a rule.

We do not believe that compiling this data on a quarterly basis will provide the Commission with any useful insight into "novel or recurring issues," nor will it help the Commission identify "matters that need urgent attention." Moreover, we do not believe measuring the numbers of alerts or reports reviewed is particularly relevant when considering whether an SRO has an effective surveillance process. Rather, focusing on raw numbers of alerts and reports generated and reviewed will serve to discourage SROs from designing systems that are efficient in screening-out false-positives before producing an alert in the first place, and discourage SROs from running an efficient surveillance program designed appropriately for its market and regulatory obligations.

The proposal also would require SROs to provide, on a quarterly basis, information regarding investigations, examinations and enforcement actions. This would include a count of the number of open, closed and pending investigations, as well as an objective summary of the facts and circumstances of each investigation. The detail of this "summary" includes, among other things: the member firm and any associated person(s) under review using a unique identifier specific to the member and any associated(s); a factual description of any alleged rule violations; the dates on which the alleged violation occurred, was detected, and an investigation was opened; and the length of time the investigation has been open.

There are similar requirements for closed cases, including the average elapsed time, in days, for investigations closed during the quarter. As with the alert and report

information discussed above, information on the investigations is not necessarily relevant. It is only after an investigation is completed that a conclusion about whether a rule violation potentially exists can be reached. Moreover, calculating the average age of a group of investigations over such a short time period is not probative, as certain types of investigations take longer than others, and some investigations are larger in scope, and thus more lengthy than others. Again, the detailed reporting requirements may inappropriately influence the criteria and procedures used by SROs to open and close cases.

In addition to detailed quarterly reports regarding surveillance alerts, reports, investigations and enforcement actions, the proposal would require SROs to notify the Commission within 10 business days of any material changes to or material developments that affect an SRO's regulatory program, including any changes to its surveillance parameters. We believe this requirement is unnecessary and would have a severe dampening effect on SRO innovation and efficiency. SROs will be discouraged from experimenting with different parameter levels as they will likely be asked to justify changes before the results can be evaluated by the SRO. SROs must analyze surveillance parameters within the context of the particular surveillance program to be meaningful. This proposal will make changes to parameters so burdensome that surveillance parameters will likely become static and thus potentially less effective.

We would need to hire an additional staff person solely to gather the data, prepare it for transmission to the Commission and interface with the Commission staff in interpreting the data. We also would need to do extensive programming to gather this information in the required format. We estimate that our initial implementation cost for providing this data would be in the tens of thousands of dollars. The ongoing annual costs in complying with this new regulation would be well in excess of $100,000. We view this as an inefficient use of resources that would add little value to the regulatory or oversight process.[12] The Commission itself would need to hire additional staff to review the detailed reports provided by the SROs in a timely manner. We fail to see how such duplicative regulation would enhance the self-regulation process.

The Commission already has the right to access any and all information from SROs on an as-needed basis. The proposal places substantial burdens and costs on SROs, but is not tailored to provide the Commission with useful information. More importantly, the detailed reporting requirements may have a negative effect on the effectiveness of an SRO's regulatory program.

2. System Audits

The Commission proposes to require SROs that operate electronic trading facilities to undertake an annual "independent audit" designed to assess whether the operations of the facility comply with the rules governing the facility. The Commission states that such an audit "would help assure that such facilities are operated in compliance with all applicable legal and regulatory requirements." The Commission estimates that such an audit by an independent third party would cost $15,000 (100 hours at $150 an hour). We believe that this proposal both unfairly discriminates against

[12] In discussing the costs and benefits of this proposal the Commission notes that it has had conversations with two "of the larger SROs" and that these unnamed SROs currently maintain "much" of the required information. We do not know with whom the Commission spoke nor whether their experiences would be typical for all SROs. We generally question basing cost/benefit decisions on informal conversations with only two large SROs.

electronic markets and imposes a cost on SROs far in excess of the Commission's estimate and any potential benefits this may bring to the market. We believe that the Commission itself, through its inspection staff, is best able to review electronic systems to ensure that they operate according to an SRO's rules. Alternatively, an SRO's internal auditing department could perform these reviews periodically, although even that approach would result in significant costs to an SRO.

We first fail to understand why such an audit would be limited to electronic systems. Indeed, we believe that there is much greater potential for a manual market to operate inconsistently with its rules than for an electronic market to do so. For example, the ISE "facilitation rule" permits a member to provide liquidity for their customer orders, providing the member preference for up to 40 percent of the order.[13] Our trading algorithm automatically matches orders and allocates the trade according to our rules. While Floor-based exchanges operate pursuant to similar rules,[14] they rely on market participants to allocate trades according to published rules, giving rise to possible errors. Such a situation is impossible in our market. We thus see no basis for the Commission to impose on electronic markets the substantial costs of this type of audit, let alone imposing those costs on electronic, but not floor-based SROs.

We also believe that the annual audit would cost many multiples of the estimated $15,000. Neither public auditing firms nor consulting firms have ever performed these types of audits, and do not currently have the necessary regulatory expertise to do so. Just preparing for these audits would require a significant investment of time and money. We have discussed possible structures of such an audit with a large accounting firm that has performed certain information technology ("IT") audits for us. They had difficulty in providing an estimate for such an audit because it is unclear what level of assurance the Commission would be seeking in their review. While the proposed rule speaks of preparation of a "report," it also requires the report to be prepared by a party qualified to issue an "opinion on such matters." It was unclear to them – and to us – exactly what these terms mean in areas where there has never been a review or audit requirement.

In attempting to evaluate the cost of such an audit, the accounting firm estimated that in 2005 the target hourly rate for such audits would be $225 an hour, not the $150 the Commission assumed in its cost-benefit analysis. In part, this cost increase reflects generally increased auditing costs resulting from SOX-related matters. Moreover, it will take longer to complete this audit than the Commission estimates. The accounting firm estimates that it will take approximately 400 hours to conduct an IT software quality management audit, which we believe is less complex and time-consuming than would be the proposed system audit. But even assuming the audit took only 400 hours, and even at a discounted rate of $200 an hour, we estimate that a system audit would cost each SRO with an electronic trading system at least $80,000, more than five times the Commission's estimate. In all likelihood, the actual cost of this audit would be significantly greater than this amount. We do not believe that any incremental comfort the Commission would receive from such an audit justifies imposing that cost on SROs.

3. Internal Controls

The proposal would require SROs to include in their annual reports a "discussion of the internal controls implemented by the [SRO] that are designed to detect, prevent and control for any conflicts of interest between the market operations and other

[13] ISE Rule 716(d).
[14] *See, e.g.* Rule 6.74 of the Chicago Board Options Exchange.

commercial interests of the [SRO] and its self-regulatory responsibilities, and to assure that the [SRO] appropriately carries out its self-regulatory responsibilities." We are not aware of any existing regulatory requirement that an SRO develop and maintain these "internal controls," so we assume that this "reporting" obligation is, in fact, a substantive obligation for SROs to establish these "controls." As such, we believe that the Commission neither has adequately explained the specifics of the proposed requirement nor presented a justification for this new substantive regulation.[15]

We note that in implementing Section 404 of SOX, the Commission engaged in extensive rulemaking that, among other things, resulted in the adoption of definitions of "internal controls" with respect to financial reporting.[16] The Commission requires reporting companies to provide a management report on internal controls over financial reporting[17] and provides detailed definitions of the required controls.[18] Those definitions include the requirement that the controls be designed to provide assurance that a company's financial statements are prepared in accordance with generally accepted accounting principles ("GAAP"). The rules also specify what the controls must cover.

In contrast, the Commission does not define self-regulatory "internal controls." Nor is there a self-regulatory equivalent to GAAP establishing principles against which SROs can establish controls. The Commission needs to define what "internal controls" mean in the self-regulatory context, incorporate into that definition a framework against which an SRO can develop its control system, and then define how an SRO can determine whether its controls are effective. The Commission also will need to analyze the impact that these new requirements would have on SROs – and identify the costs and benefits of the regulation – so that commentators can consider whether the requirement is cost effective.

E. SRO Financial Reporting Requirements

We support requiring SROs to provide financial information similar to that of Exchange Act reporting companies. In particular, we support requiring a registered public accounting firm to audit an SRO's financial statements and requiring SROs to disclose compensation information regarding top executives. However, the Commission is proposing financial reporting requirements for SROs that go beyond the requirements applicable to reporting companies. With respect to forward-looking statements, those requirements can actually be inconsistent with reporting company obligations.[19] The requirement that SROs file separate audited financial statements for "facilities" and subsidiaries also poses significant concerns. In addition, the break-out of certain regulatory costs would appear to impose costs on SROs far in excess of any potential benefits the financial reports would provide to the Commission or the investing public.

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[15] In discussing the costs and benefits of the reporting requirements, the Commission states that the obligation to report on such controls "should not impose significant costs on [SROs]." However, this Commission comment referred only to the costs of *reporting* on such controls, not the costs of actually *implementing* such controls, which the Commission is effectively requiring. Thus, we believe that the Commission does not properly identify the true costs of this proposal.

[16] Exchange Act Release No. 47986 (June 5, 2003).

[17] *See, e.g.*, Item 308 of Regulation S-X and Item 308 of Regulation S-K.

[18] *See* Exchange Act Rules 13a-15(f) and 15d-15(f).

[19] The ISE has filed a Form S-1 in anticipation of an initial public offering. *See* File No. 333-117145. Following such offering the ISE will be an Exchange Act Reporting Company.

1. Forward-Looking Statements

The Commission proposes that an SRO's annual financial information compare "the same figures for the prior year and estimated figures for the next fiscal year." This disclosure would be in the SRO's annual amendment to its Form 1, a public document. Thus, the Commission is requiring an SRO to provide "forward-looking statements" in a its public filing. We believe that this poses significant issues for SROs that are public companies or that are affiliates of a public company.

As the Commission is well aware, there is considerable history regarding the liability of companies that make "forward looking statements." Many companies traditionally had avoided such disclosure due to concerns that there could be liability for failure to meet stated projections or targets. To encourage greater forward-looking disclosure, the Private Securities Litigation Reform Act of 1995 codified a conditional safe harbor for companies that choose to make forward looking statements.[20] However, the Commission never has required a reporting company to make forward-looking statements. As now proposed, the ISE will be required to provide forward-looking information in its annual Form 1 amendment.

While we have not yet considered whether such disclosure would be appropriate, we see no basis for the Commission to require such disclosure – with the potential for liability – by one class of reporting company. We believe that the Commission could address this concern in a number of ways: (1) It could make forward-looking disclosure voluntary for all SROs, or at least SROs that are reporting companies; (2) It could provide a non-conditional and complete safe harbor from liability for such regulatorily-required disclosure; or (3) it could permit SROs that are reporting companies to submit such forward looking information in non-public exhibits to the Form 1.

2. Financial Statements of Facilities and Subsidiaries

The Commission proposes not only that SROs file audited financial information regarding themselves, but that they also file such information for "any facility that is a separate legal entity and any regulatory subsidiary" of the SRO. This requirement goes far beyond any obligation applicable to reporting companies, which generally provide consolidated financial information covering all controlled subsidiaries. Other than for regulatory subsidiaries, we fail to understand the basis for the proposed requirement to provide separate financial statement for other business facilities. [21]

As a reporting company we may prefer to provide our financial statements solely on a consolidated basis so that the investing public has a complete picture of the company as a whole. We fail to see how requiring us to disclose financial results of a particular business line that happens to be in a stand-alone subsidiary serves any regulatory purpose. Imposing this requirement likely will lead SROs to make decisions on whether to conduct activities through the parent company or affiliates based on Commission reporting requirements rather than for sound business reasons. The Commission has not provided a policy justification for these separate reports, and we ask the Commission to allow SROs to report consolidated financial information in a manner consistent with generally accepted accounting principles.

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[20] *See* Section 21E of the Exchange Act and Section 27A of the Securities Act of 1933.

[21] We can understand the basis for breaking out the financial information for regulatory subsidiaries as being consistent with the requirement that SROs provide enhanced disclosure of regulatory financial information.

3. Disclosure of Regulatory Financial Information

The Commission proposes that SROs publicly file detailed financial information regarding their regulatory programs. While we do not question the Commission's need and authority to receive financial information regarding an SRO's regulatory program, we believe that various aspects of the specific proposal either are unclear or will impose significant costs on SROs without providing any corresponding benefit.

a. Regulatory Costs

We believe that the public should review the results, not the expenses, of an SRO's regulatory program. SROs have varying market and regulatory structures, and the scope of their responsibilities differ depending on: the types of business they conduct; the number and type of members they regulate; and the extent to which they have entered into regulatory agreements under section 17d(2) of the Exchange Act. For example, we do not act as the DEA nor DOEA for any of our members, and therefore our program is not comparable to larger SROs, which conduct the majority of the examinations. We also have fewer members than other SROs, and as an all electronic market we may be able to use electronic systems to perform certain regulatory functions in a much less costly manner than floor-based exchanges. Because each SRO is unique, it is difficult to compare regulatory costs. While the Commission can appreciate these distinctions, the public is not sufficiently knowledgeable about regulatory structure and scope to draw any reliable conclusions from this information. Thus, we believe that public disclosure would be misleading and serve no regulatory purpose.

With respect the specific disclosure proposals, we would be able to report direct regulatory revenues and expenses. However, allocating indirect costs, such as systems support and data storage expense, will be much more difficult and somewhat arbitrary. Also, because the methods each SRO uses to allocate indirect costs likely will be somewhat different, it will not be possible for the Commission to compare regulatory financial information across SROs. Unless the Commission can provide a uniform methodology for such an allocation or can better justify the costs an SRO will incur in performing this allocation, we see no basis for requiring such an allocation.

b. Regulatory Personnel Compensation

Form 1 would require us to disclose "compensation schedules for the Chief Regulatory Officer and all other senior regulatory personnel, including bonus ranges." We do not understand this requirement. We do not know if the Commission expects the same disclosure in this area as it proposes for the "compensation table" for the five most highly compensated executives of the SRO. We also do not know who constitutes "all other senior regulatory personnel." We ask for more specificity on this proposal.

From a policy perspective, we have no concerns with publicly disclosing CRO compensation. However, we are concerned with publicly disclosing specific information regarding other personnel. Other than the CRO, senior regulatory staff members generally are mid-level managers. We believe that maintaining the confidentiality of this information is extremely important from a human resources perspective. Moreover, we fail to see how disclosing mid-level managers' salary serves a public purpose.[22] The Commission always has access to this information as part of its general oversight and

[22] In footnote 331, the Commission states that the schedule need not include an employee's name, but must include "identification according to position." We fail to see a meaningful difference between these two forms of disclosure.

inspection powers. Making this information public serves no useful purpose while creating significant internal problems for an SRO.

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We thank the Commission for the opportunity to comment on these important proposals. If you have any questions on this letter, 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