

MEMO# 18389

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SEC PROPOSALS RELATING TO SELF-REGULATORY ORGANIZATIONS

[18389] January 6, 2005 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 2-05 SEC RULES MEMBERS No. 3-05 RE: SEC PROPOSALS RELATING TO SELF-REGULATORY ORGANIZATIONS

The Securities and Exchange Commission has proposed new rules and amendments to existing rules and forms under the Securities Exchange Act of 1934 relating to: (1) the governance, administration, transparency and ownership of self-regulatory organizations (“SROs”) that are national securities exchanges or registered securities associations; (2) the periodic reporting of information by SROs regarding their regulatory programs; and (3) the listing and trading by SROs of their own or affiliated securities.¹ The Release states that developments involving SRO governance, as well as concerns raised by recent enforcement actions and inspections involving SROs, have prompted the Commission to consider new regulatory measures with respect to SROs. The most significant aspects of the proposals are summarized below.

Governance Standards The proposals would impose new governance standards on national securities exchanges and registered securities associations. In particular, the proposals would require an exchange’s or association’s board of directors to be composed of a majority of independent directors. The proposals would specify that no director may qualify as an independent director unless the board affirmatively determines that the director has no “material relationship” with the exchange or association.² The term “material relationship” would be defined as a relationship, whether compensatory or otherwise, that reasonably could affect the independent judgment or decision making of the director. The proposals would require the board to make this independence determination upon the director’s nomination and thereafter no less frequently than annually and as often as necessary in light of the director’s circumstances. In 1 Securities Exchange Act Release No. 50699 (November 18, 2004), 69 FR 71126 (December 8, 2004) (“Release”). Comments on the proposals are due to the SEC no later than January 24, 2005. The Release can be found on the SEC’s website at <http://www.sec.gov/rules/proposed/34-50699.htm>. ² A director also must not have any material relationship with any affiliate of the exchange or association, any member of the exchange or association or any affiliate of such member, or any issuer of securities that are listed or traded on the exchange or a facility of the exchange or association. ³ In addition to the general requirements regarding material relationships, the proposed rules identify certain specific circumstances when a director would not be considered independent.³ The proposals would require that each exchange and association have several standing committees of the board including, at a minimum, the following committees: Nominating Committee; Governance Committee; Compensation Committee; Audit Committee; and Regulatory Oversight Committee (“Standing Committees”). Each Standing Committee would be composed solely of independent directors. In addition, each Standing Committee, other than the Governance Committee, would be required to conduct an annual

performance self- evaluation. The Governance Committee would be required to conduct an annual performance evaluation of the governance of the exchange or association as a whole, including the effectiveness of the board and its committees. The proposals would not require that an exchange's or association's Chairman of the board be an independent director in all circumstances. However, if the exchange's or association's CEO also is not the Chairman, the proposals would require that the Chairman be an independent director. If the Chairman and CEO were the same individual, the board would be required to designate an independent director as a "lead director" to preside over executive sessions of the board.

Separation of Regulatory Functions and Market Operations The proposals would require that each exchange and association separate its regulatory function from its market operations and other commercial interests in order to help insulate its regulatory activities from conflicts of interest that may arise by virtue of its market operations. Specifically, the proposals would require that the exchange's or association's regulatory program be either: (1) structurally separated from the exchange's or association's market operations and other commercial interests by means of separate legal entities; or (2) functionally separated within the same legal entity from the exchange's or association's market operations and other commercial interests. In either case, the proposals would require that the board appoint a Chief Regulatory Officer to administer the regulatory program and that the Chief Regulatory Officer report directly to the proposed independent Regulatory Oversight Committee.

Use of Funds from Regulatory Fees, Fines or Penalties The proposals would require that an exchange or association direct funds collected from regulatory fees, fines or penalties exclusively to fund the regulatory operations and other programs of the exchange or association related to its regulatory responsibilities. Regulatory fees would include all member fees, dues and assessments charged and collected by an exchange or association that are assessed for the purpose of funding the operation of the regulatory program. Regulatory fines or penalties would include any revenue received from fines or penalties resulting from disciplinary or enforcement actions. 3 The proposals also would require that at least 20 percent of the total number of directors be selected by the exchange's or association's members and that at least one director be representative of issuers and at least one director be representative of investors. 3

Ownership Restrictions The proposals would require that an exchange or association prohibit any member that is a broker or dealer from owning and voting more than 20 percent of the ownership interest in the exchange or the association, or a facility of the exchange or association. The proposals also would require each member of an exchange or association that is a broker or dealer to file a report with the Commission when the member acquires ownership of more than 5 percent of any interest in the exchange or association, or any facility thereof.

Code of Ethics The proposals would require that the rules of each exchange and association provide for a code of ethics for directors, officers and employees, and provide that any waiver of the code of ethics must be approved by the board, or the appropriate board committee. The code of ethics, at a minimum, would establish policies and procedures regarding: conflicts of interest; corporate opportunities; confidentiality; fair dealing; protection and proper use of the exchange's or association's assets; compliance with laws, rules, and regulations by directors, officers and employees; and the reporting of illegal or unethical behavior. The proposals also would require that each exchange and association adopt governance guidelines that, at a minimum, establish policies regarding: director qualification standards; director responsibilities; director access to management and independent advisors; director compensation; director orientation and continuing education; management succession; and annual performance evaluations of the board.

Disclosure by SROs The proposals would amend the forms for registration as an exchange or association to require that these SROs file with the Commission and publicly disclose enhanced information relating to their governance, regulatory programs, finances, ownership structure, and other matters.

Specifically, the rules governing the procedures for filing amendments to these registration forms would be revised to require more frequent updating of the required information and the posting of the required information on the SROs' web sites. Exchanges and Associations Listing Affiliated Securities The proposals would prohibit an exchange or association from approving for listing an affiliated security unless the exchange's or association's Regulatory Oversight Committee certified that the security satisfies the exchange's or association's rules for listing. In addition, if an affiliated security is listed on, approved for trading on, or trades pursuant to the rules of, an exchange or association, the proposals would impose reporting and notice obligations on the exchange or association. Specifically, the proposal would require the exchange or association to file a quarterly report with the Commission summarizing its monitoring of the affiliated security's compliance with its listing rules. The exchange or association would be required to include in the quarterly report a summary of its surveillance of the trading of affiliated securities by its members. Finally, the proposals would require the exchange's or association's Regulatory Oversight Committee to approve the report before it is filed with the Commission. In addition to the quarterly report, the exchange or association would be required to file with the Commission annually a report prepared by a third party analyzing compliance by the affiliated security with applicable listing rules of the exchange or association. Periodic Reporting Obligations In order to enhance the oversight of SROs' compliance with, and enforcement of, federal statutory and regulatory provisions, as well as SROs' own rules, the proposals would establish a system of quarterly and annual reporting by exchanges and associations with respect to key aspects of their regulatory programs. The information required by the proposals would encompass all surveillance, examination, and disciplinary programs. In addition, the proposals would compel exchanges and associations to review, on a quarterly and annual basis, the operation and performance of their regulatory programs. Ari Burstein Associate Counsel