MEMO# 16902

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SEC APPROVES NYSE PROPOSED RULE CHANGE RELATING TO THE EXCHANGE'S CORPORATE GOVERNANCE AND MANAGEMENT STRUCTURE

[16902] December 19, 2003 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 40-03 SEC RULES MEMBERS No. 192-03 RE: SEC APPROVES NYSE PROPOSED RULE CHANGE RELATING TO THE EXCHANGE'S CORPORATE GOVERNANCE AND MANAGEMENT STRUCTURE The SEC has issued an order approving a proposed rule change filed by the New York Stock Exchange reforming the governance and management structure of the Exchange.1 The most significant aspects of the order are summarized below. The proposed rule change amends and restates the NYSE's Constitution to modify the NYSE's corporate governance structure. Most significantly, the proposal places responsibility for governance, compensation, internal controls and supervision of regulation in the hands of a Board of Directors that is independent from NYSE management, NYSE members, member organizations and listed companies. The proposal also creates a Board of Executives, consisting of a mix of representatives from the major broker-dealers, the "floor," lessor members, institutional investors and large public funds, individual investors and listed companies, that will advise the CEO in his management of the operations of the Exchange. The Adopting Release states that commenters broadly supported the proposed governance changes, at least to the extent that the changes are considered a positive initial step toward reform, but that many commenters believed the proposals did not go far enough. In particular, some commenters expressed concerns about the adequacy and effectiveness of the NYSE's revisions to its governance, particularly with respect to the composition of the Board of Directors, the establishment of the Board of Executives, and the structure of the regulatory function. I. Board of Directors The Adopting Release states that a number of commenters, including the Institute, criticized the proposed composition of the Board of Directors for failing to include investor representatives on the Board. In contrast, one commenter criticized the proposed Board composition for excluding industry representatives from serving as directors. Other 1 Securities Exchange Act Release No. 48946 (December 17, 2003) ("Adopting Release"). The Adopting Release can be found on the SEC's website at http://www.sec.gov/rules/sro/34-48946.htm. 2 commenters questioned the independence of the directors or the ability of the reconstituted Board to operate effectively. In response to issues raised by commenters, the NYSE submitted a letter to the SEC and took issue with the view that the Board should include one or more individuals to represent the interests of public investors. In particular, the NYSE stated that "[a]s the Exchange's fiduciaries, our directors will not have the agenda of a customer, an owner or user, and will not represent any single constituent group" and that it would therefore "be

inappropriate to seek to specifically include [Board] members that are representative of the buyside or of any particular constituent group.” The NYSE added that “individual investors trading on the Exchange through broker-dealers in small volumes have interests that conflict with other individual investors who participate in the market through public or private funds trading in larger volumes” and therefore the “hard-won lesson is that the only way to sort out these issues without bias or conflicts is through an independent board whose primary goal is to ‘do the right thing’ for the individual investor as such.” The SEC stated that it believes that completely replacing the previous NYSE Board with a smaller board composed of independent directors should increase the likelihood that the directors will be free of any relationship that might impair, or appear to impair, their ability to make judgments in the best interests of the Exchange and investors. In response to commenters’ concerns regarding the composition of the Board, the SEC stated that, at this point, the NYSE has taken steps designed to assure that the concerns of investors are adequately represented on the Board. The SEC also stated that, by making its new board independent of specific constituencies, the NYSE intends the Board to be able to consider the needs of the entire exchange community, including large and small investors, issuers, and securities firms. II. Board of Executives The Adopting Release states that several commenters disputed the efficacy of having the proposed Board of Executives while others, including the Institute, criticized the proposed composition of the Board of Executives for not having adequate buyside representation. The SEC stated that it believes that the NYSE’s creation of a Board of Executives, composed of individuals from the various Exchange constituencies, is reasonable in the context of an independent Board of Directors. The SEC further stated that it believes that the Board of Executives is designed to strike an appropriate balance by allowing representatives of those groups that have a day-to-day stake in the affairs of the NYSE to continue to have a voice, but not the leading role, in the Exchange’s governance. III. Structure of Regulatory Function The Adopting Release states that a majority of commenters called for greater independence of the regulatory function from the business operation of the NYSE, with most of these commenters advocating a complete separation of the regulatory function from the Exchange. The SEC stated that, in its view, the proposed amendments to the NYSE’s governance and management architecture are designed to advance the goal of assuring that the NYSE’s regulatory function is strong, vigorous, and sufficiently independent and insulated from improper influence from management or any regulated entity. In addition, the SEC stated that it believes that the proposed amendments to the NYSE's governance structure, and in 3 particular, the creation of a Chief Regulatory Officer reporting directly to an independent Regulatory Oversight & Regulatory Budget Committee, adds a significant degree of independence that should insulate regulatory activity from economic pressures and potential conflicts of interest. The SEC stated, however, that the revised NYSE governance structure is one, but not the only, model for SRO governance that would provide independence between the business side of the Exchange and its regulatory operations and that other self-regulatory structures or allocations of regulatory duties among SROs may offer advantages and disadvantages in terms of expertise, effectiveness, responsiveness, costs and, ultimately, investor protection. Ari Burstein Associate Counsel