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SEC Proposes Overhaul of Self-Regulatory Oversight System

Introduction

On November 9, 2004, the Securities and Exchange Commission ("SEC" or the "Commission") approved the publication of a release[1] that proposes sweeping changes to the rules governing self-regulatory organizations ("SROs") and approved the publication of a concept release regarding self-regulation.[2] The SEC is proposing changes not only to the specifics of self-regulation but also to the fundamental concepts underpinning this unique form of regulation.

Background

It is well known that the federal securities laws create a system of self-regulation for the oversight of markets and their member firms. For example, as an alternative to SEC rules, the SEC encouraged the New York Stock Exchange ("NYSE") to reform its governance structure, which it completed in 1938. The changes provided for greater representation on its Board of Governors by "upstairs" firms rather than by floor brokers, added a minority of public representatives on the Board, and provided for a paid president and professional staff.[3] With respect to the over-the-counter market, Congress recognized the difficulty of imposing direct government regulation on such a dispersed marketplace, particularly in the pre-computer era. Dean Joel Seligman quoted SEC Chairman William O. Douglas, who stated that it was:

> "impractical, unwise, and unworkable" for the SEC directly to regulate the six thousand or so O-T-C brokers and dealers trading in 1938. Since they were not centralized on a few stock exchange floors, but could "make a market" in an over-the counter security anywhere in the country, "the problem of direct government regulations of the over-the-counter market," [SEC Commissioner George] Matthews would explain, "is a little bit like trying to build a structure out of dry sand...."[4]

Instead, Congress enacted the Maloney Amendments of 1938, amending the Securities Exchange Act of 1934 (the "Exchange Act"), to facilitate the registration of a securities association to oversee the OTC market. The 1963 Special Study notes that the regulatory objectives of the Maloney Act were:

> First, to bring about self-discipline in conformity to law—"voluntary law obedience so complete that there is nothing left for government representatives to do" and secondly to "encourage obedience to ethical standards beyond those any law can establish."[5]

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1 Fair Administration and Governance of Self-Regulatory Organizations, etc. Rel.34-50699, Nov. 18, 2004 ("Fair Administration Release").

2 Securities and Exchange Commission, "Concept Release Concerning Self-Regulation," Exchange Act Release No. 50700, November 18, 2004 ("Concept Release").

3 Seligman, *The Transformation of Wall Street* (3rd ed. 2003) at 162-174. *See also* Report of the Special Study of Securities Markets of the Securities and Exchange Commission 88th Cong. 1st Sess., H. Doc. 95 (1963) pt. 4 at 506 *et seq* (the "1963 Special Study").

4 *Id.* at 185. *See also* 1963 Special Study at 604.

5 1963 Special Study at 605-6, citing S. Rept. 1455 75th Cong. and other sources.

Of course, self-regulation always has contemplated effective SEC oversight. In the oft-quoted comment of Chairman Douglas, "Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope that it would never have to be used."[6]

But inherent in the ideals of self-regulation was the notion that securities industry executives, as knowledgeable experts, would govern themselves, supplemented only by a paid, professional staff. The 1963 Study notes:

> Self-regulation depends on the efforts of part-time volunteers who can be expected to sacrifice only a limited amount of their time and energy otherwise available for private pursuits. Since there is necessarily a continuous turnover among member-volunteer participants, they must operate in the framework of institutions so organized and with the assistance of such full-time staffs, as to render the efforts effective to the maximum degree.[7]

Absent from the early descriptions of self-regulation is the idea of significant public participation in the self-regulatory process. Although the goal of self-regulation was investor protection, self-regulation, as originally contemplated, did not include the material involvement of disinterested public participants. Indeed the very notion of self-regulation was synonymous with the idea of the industry policing itself, subject only to SEC oversight.

The concept of self-regulation began to change in 1996 when the SEC settled with the NASD and Nasdaq market to revamp their governance structures. Among other things, the SEC required separating the functions of self-regulation and markets as well as greater public participation in the governance process.[8] More recently, many observers expressed concern about the compensation arrangements for NYSE Chairman and CEO Richard Grasso. According to the SEC, the NYSE paid Mr. Grasso $139.5 million in compensation. In response to this news, the SEC initiated an investigation in September of 2003 to determine the legality of this package.[9] SEC Chairman William H. Donaldson stated that "the approval of Mr. Grasso's pay package raises serious questions regarding the effectiveness of the NYSE's current governance structure."[10] Chairman Donaldson subsequently noted:

> Where self-regulation has not worked, this often is a result of the inherent tension between an SRO's role as a regulator and as the operator of a market, and between its role as a regulator and as a membership organization. Two key factors in addressing these conflicts are the independence of the SRO board from the interests of specific members, or even specific users, of the SRO's market; and the independence of the regulatory function of the SRO from the self-

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6 Seligman at 185, citing Douglas, *Democracy and Finance* at 82.

7 1963 Special Study at 503. *See also* Securities Acts Amendments of 1975 (the "1975 Acts Amendments") and S. Rep. 94-75 (1st Sess.).

> The securities industry's unique system of self-regulation has shown great strength in some areas and, in general has served the industry well. It has also, however, displayed serious deficiencies and has not operated as effectively or fairly as it should. S. 249 contains a number of provisions which would clarify the scope of the self-regulatory responsibilities of national securities exchanges and registered securities associations *** and the manner in which they are to exercise those responsibilities. The bill would also clarify and strengthen the Commission's oversight role with respect to the self-regulatory organizations.
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> *See also* Securities Acts Amendments S.249, Conf. Rep. 94-229 ("Conference Report").

8 *Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934, Regarding the NASD and the NASDAQ Market*, [1996-1997 Transfer Binder] Federal Securities Law Reporter (CCH) 85,824.

9 *See* letter from The Honorable William H. Donaldson, Chairman, SEC, to The Honorable H. Carl McCall, Chairman, Human Resources and Compensation Committee, Chairman, Special Committee on Governance, NYSE, September 2, 2003 http://www.sec.gov/news/speech/spch090203whd.htm ("Donaldson letter") and accompanying Questions. Questions Regarding *the Pay Package for NYSE Chairman and CEO*, Sept. 2, 2003, http://www.sec.gov/news/extra/questionsnyse090203.htm. On January 8, 2004, the "Commission announced that it has authorized the Commission staff to conduct a formal investigation of matters raised in a December 2003 report to the NYSE's Board of Directors prepared by outside counsel Dan K. Webb. The NYSE has referred the Webb report, which focuses on the compensation of former NYSE Chairman and CEO Richard Grasso and the process by which the compensation was determined, to the Commission and the New York Attorney General." SEC News Digest, Issue 2004-6, January 9, 2004, http://www.sec.gov/news/digest/dig010904.txt. As of this date, no one has proven that Mr. Grasso has done anything illegal or improper under relevant statutes or rules.

10 Donaldson letter.

interest of the members or the business interest of the market itself.[11]

As a consequence of these concerns, the NYSE radically altered its governance structure. The revamped NYSE creates a Board of Governors that excludes *any* industry representatives—a far cry from the original notion of an industry policing itself.[12] Yet these changes constitute an effort to retain the essential characteristics of self-regulation—industry involvement with establishing regulatory norms and review of allegations of misconduct—even if persons unaffiliated with the securities industry have ultimate authority.

In light of these developments and controversies, the SEC proposed an overhaul of the regulatory framework that governs SROs. The Commission also is considering more fundamental changes to self-regulation in the Concept Release. This memorandum summarizes the more significant aspects of these proposed changes.

The Fair Administration Release

Overview

In the Fair Administration Release, the Commission proposes to adopt new rules (and amend existing rules) for the purpose of improving the governance, administration, transparency, and ownership of SROs.[13] The proposed rule changes also seek to modify forms, improve the periodic reporting of information by these SROs, and modify the listing and trading by SROs of their own or affiliated securities.

If adopted as proposed, the Commission will mandate a new governance standard for SROs. This governance initiative would require a majority of the members of the SRO's board of directors to be independent, as well as require that key committees of such boards be composed solely of independent directors. These proposals would further require SROs to establish policies to maintain a separation between their regulatory functions and their market operations and other commercial interests, and require that monies received from regulatory fines, fees, and penalties be used for regulatory purposes. According to the Commission, the corporate governance proposals are designed to strengthen the administration of SROs and address conflicts of interest created by the concentration of ownership by member firms.

In addition to implementing a corporate governance standard, the Fair Administration Release also proposes new ownership requirements. One proposal would require an SRO to prohibit any member that is a broker or dealer from owning and voting more than 20% of the ownership interest in the SRO, or a facility of the SRO. Another proposal would require each member of an SRO that is a broker or dealer to file a report with the Commission when the member acquires ownership of more than 5% of any interest in the SRO, or any facility thereof. Furthermore, the Commission has proposed to require SROs to maintain their books and records in the

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[11] Testimony Concerning Improving the Governance of the New York Stock Exchange, by William H. Donaldson, Chairman, U.S. Securities & Exchange Commission, Before the Senate Committee on Banking, Housing, and Urban Affairs November 20, 2003 http://www.sec.gov/news/digest/dig010904.txt. (This portion of Chairman Donaldson's comments referred to self-regulation in general and did not refer specifically to the NYSE.)

[12] Art. IV Sec. 2 of the revised NYSE constitution provides that:

> The Board shall consist of the Chairman of the Board, the Chief Executive Officer (if such individual is not also the Chairman), and such number of directors elected by the members of the Exchange as is fixed from time to time by resolution of the Board, provided that such number shall not be less than six nor more than twelve. The directors elected by the members shall be independent of management of the Exchange, the members, and issuers of securities listed on the Exchange, and shall include directors who will enable the Exchange to comply with the requirements of Section 6(b)(3) of the Act. Among other things, no director elected by the members shall be (a) a member, allied member, lessor member or approved person; (b) an officer or employee of the Exchange; (c) a person employed by or affiliated, directly or indirectly, with a member organization, or with a broker or dealer that engages in a business involving substantial direct contact with securities customers; or (d) an executive officer of an issuer of securities that are listed on the Exchange. In addition, no director shall qualify as independent unless the Board affirmatively determines that the director has no material relationship with the Exchange.

http://www.nyse.com/pdfs/ProxyStatement110403.pdf. *See also* Dechert Update, New York Stock Exchange Approves Governance Changes and New Board of Directors; Awaits SEC Final Approval, Dec., 2003 / No. 79 http://www.dechert.com/library/FS_Update_2003-79.pdf

[13] We refer to exchanges and associations collectively as "SROs." *See also* n. 14 *infra.*

United States.[14] The amendments are designed to strengthen the governance and administration of SROs and address the possible concentration of ownership by member firms.[15]

The Fair Administration Release proposes to improve transparency by requiring enhanced disclosure of information regarding their governance, regulatory programs, finances, ownership structure, and other matters. The Commission would require more frequent updating of this information and posting of it on their websites. The Commission also would require filing of information with the Commission in electronic format.[16]

The Commission believes that these proposals will provide greater transparency to key aspects of governance, ownership structure, and regulatory operations of SROs.

Finally, the Commission is proposing requirements on SROs that list or trade their own securities, the security of any trading facility, or the security of an affiliate of itself or a facility. The Commission states that these proposals are intended to assure that SROs are able to enforce effectively their listing standards with respect to such securities.

Capacity to Comply

The Commission has proposed new Rules 6a-5 and 15Aa-3 under the Exchange Act. The rules would require an SRO to have rules that comply with, and have the capacity to carry out, the purposes of the provisions of the applicable governance rules. Certain provisions of the rules would apply to any "regulatory subsidiary" of the SRO in the same manner as they would to the SRO itself.

Board Provisions

Proposed new Rules 6a-5 and 15Aa-3 would require an SRO's governing board to be composed of a majority of independent directors, with key board committees to be composed solely of independent directors. According to the Fair Administration Release, the proposed rules would help insulate the regulatory activities of an exchange or association from the conflicts of interest that otherwise may arise by virtue of its market operations.

Determination of Independence

To qualify as an independent director, the proposed rules would specify that the board first affirmatively determine that the director has no material relationship with the exchange or association. Under the proposal, 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, and broadly includes relationships with any exchange member or issuer of securities traded on the exchange. The board would be required to make this independence determination upon the director's nomination and thereafter every year and

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14 Proposed Rule 17a-1(b) provides that:

> Every national securities exchange, national securities association, registered clearing agency, and the Municipal Securities Rulemaking Board shall keep all such documents for period of not less than five years at a place within the United States, the first two in an easily accessible place, subject to the destruction and disposition provisions of §240.17a-6.

Apparently, this is the only instance in which the Commission is amending rules for SROs in addition to exchanges or associations.

15 In the Concept Release, the Commission states that:

> Pressures that inhibit effective regulation and discourage vigorous enforcement against members can arise for a variety of reasons, including member domination of SRO funding, member control of SRO governance, and member influence over regulatory and enforcement staff. In addition, the economic importance of certain SRO members may create particularly acute conflicts, especially in light of the consolidation of some of the largest securities firms.

69 FR at 71259.

16 *See also* Rel. 34-50486 in which the Commission modernized filing requirements for SROs. Among other things, the Commission: adopted rule amendments that require SROs to file proposed rule changes electronically with the Commission, rather than in paper form. In addition, the Commission required SROs to post all proposed rule changes, as well as current and complete sets of their rules, on their Web sites. The Commission also required all participants in National Market System Plans ("NMS Plans") to arrange for posting on a designated Web site a current and complete version of the NMS Plan. Finally, the Commission made certain technical amendments to the requirements for SRO rule changes. The Commission states that:

> Together, the amendments are designed to modernize the SRO rule filing process by making it more efficient and cost effective. The amendments also should improve the transparency of the rule filing process and assure that all SRO members and other interested persons have ready access to an accurate, up-to-date version of SRO rules.

as often as necessary in light of the director's circumstances, such as a job change or marriage.

Certain Conditions Negating Independence

The Commission has outlined several circumstances in which a director would automatically be deemed to be not independent, such as the following:

- the director, or an immediate family member, is, or within the past three years was, employed by or otherwise has or had a material relationship with the SRO or any affiliate of the SRO;
- the director is, or within the past three years was, a member or employed by or affiliated with a member or any affiliate of a member, or the director has an immediate family member that is, or within the past three years was, an executive officer of a member or any affiliate of a member;
- the director, or an immediate family member, has received during any 12-month period within the past three years more than $60,000 in payments from the SRO, any affiliate of the SRO or from a member or any affiliate of a member; however, payments received in the form of compensation for board or board committee services, compensation to an immediate family member who is not an executive officer of the exchange or association, any affiliate of the exchange or association or of a member or any affiliate of a member, and pension and other forms of deferred compensation for prior services, not contingent on continued service, would not disqualify a director as independent;
- the director, or an immediate family member, is a partner in, or controlling shareholder or executive officer of, any organization to which, or from which, the SRO or any affiliate of the SRO made or received payments for property or services in the current or any of the past three full fiscal years that exceed 2% of the recipient's consolidated gross revenues for that year, or $200,000, whichever is more, other than certain payments arising solely from investments in the securities of the SRO or any facility or affiliate of the SRO or payments under non-discretionary charitable contribution matching programs;
- the director, or an immediate family member, is, or within the past three years was, an executive officer of an issuer of securities listed or primarily traded on the exchange or a facility of the exchange or association;
- the director, or an immediate family member, is, or within the past three years was, employed as an executive officer of another entity where any of the SRO's executive officers serve on that entity's compensation committee;
- the director, or an immediate family member, is a current partner of the outside auditor of the SRO or any affiliate of the SRO, or was a partner or employee of the outside auditor of the SRO or any affiliate of the SRO who worked on the audit of the SRO or any affiliate of the SRO, at any time within the past three years;
- in the case of a director that is a member of the Audit Committee, such director (other than in his or her capacity as a member of the Audit Committee, the board, or any other board committee), accepts, directly or indirectly, any consulting, advisory, or other compensatory fee from the SRO, any affiliate of the SRO, or a member or any affiliate of a member, other than fixed amounts of pension and other forms of deferred compensation for prior service, provided such compensation is not contingent in any way on continued service.

The SEC believes that these standards are analogous to SRO listing standards for issuers. In addition, the SROs' rules would have to prohibit any person subject to a statutory disqualification under Section 3(a)(39) of the Exchange from becoming a director or officer of the SRO.[17]

Other Board Composition Requirements

The proposed rules also would require that at least 20% of the total number of directors be selected by members of the SRO. In addition, the proposed governance rules would require that at least one director be representative of issuers and at least one director be representative of investors and, in each case, such

[17] 69 FR 71140.

director must not be associated with a member, broker, or dealer.[18]

The proposed governance rules would require that when the SRO board considers any matter that is recommended by or is otherwise with the authority of a Standing Committee (discussed below), a majority of the directors who vote on the matter must be independent.

Rules 6a-5(f)(3) and 15Aa-3(f)(3) would provide that the Nominating Committee must provide members with the opportunity to select at least 20% of the total number of directors. Proposed Rules 6a-5(c)(7) and 15Aa-3(c)(7) further would require SROs to adopt rules to establish a process for members to nominate alternative candidates through a petition process. The percentage of members that is necessary to put forth such alternative member candidates, as specified in an exchange's rules, could not exceed 10% of the total number of members.

The SRO's Nominating Committee would have to nominate at least one director who is representative of issuers and at least one director who is representative of investors. These directors may not be associated with a member or broker or dealer.[19]

The Fair Administration Release notes that the SEC recently approved the NYSE's proposal to establish a fully independent board, finding that such a board could be consistent with the Exchange Act and the fair representation and issuer and investor representative requirements. The Commission states that "it only is proposing to require exchanges an associations to elect majority-independent boards, although an SRO may elect to impose a more rigorous requirement."[20] In other words, provided that the SRO's rules satisfy the fair representative requirements (including that one director represent investors and that at least one director represent issuers), the 20% figure is a "floor" and not a "ceiling."

Standing Committee Requirements

The Commission is proposing that each SRO, at a minimum, have the following standing committees, or their equivalent:

- Nominating Committee;
- Governance Committee;
- Compensation Committee;
- Audit Committee; and
- Regulatory Oversight Committee.

Each standing committee, as a "key committee," would be required to consist solely of independent directors.

Each Standing Committee would have the authority to direct and supervise inquiries into any matter brought to its attention within the scope of its duties and to obtain advice and assistance from independent counsel as it deems necessary, 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 SRO as a whole.

Any panel that is responsible for conducting hearings, rendering decisions, and imposing sanctions with respect to disciplinary matters would be subject to the jurisdiction of the Regulatory Oversight Committee. However, any such panel hearing disciplinary matters must meet the fair representation requirement and least 20% of the panel must be members of the SRO.

Other Board Committees

If any committee has the authority to act on behalf of the board, that committee would be required to be composed of a majority of independent directors. For example, if the exchange or association has established an Executive Committee that is empowered to act on the board's behalf, such committee would be required to be composed of a majority of independent directors. Further, the SRO could not delegate to any committee not consisting solely of independent directors the authority to act on matters that otherwise are within the jurisdiction of a Standing Committee (discussed *infra*).

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18 For example, Section 6(b)(3) of the Exchange Act provides that:

> The rules of the exchange assure a fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer.

19 The Commission states that this provision codifies existing law in SEC rules. *See* n. 18 *supra*.

20 69 FR at 71138. The Conference Report added the "fair representation" language regarding members, issuers, and investors. *Id.* at 10.

Independent Directors

The Commission is proposing that the independent directors of the SRO should meet regularly without the presence of management. However, the Commission is not proposing a minimum frequency for such meetings.[21]

The proposed governance rules also would require that independent directors have the authority to direct and supervise inquiries into any matter brought to their attention within the scope of their duties, and to obtain advice and assistance from independent legal counsel and other advisors, as they determine necessary to carry out their duties. Accordingly, the proposed governance rules would require that the SRO provide sufficient funding and other resources, as determined by the independent directors, to permit the independent directors to fulfill their responsibilities and to retain independent legal counsel and other advisors.

Independent Chairman

The SEC is not proposing to require that an SRO's chairman be an independent director "in all circumstances." However, if the SRO's chief executive officer is not also the chairman, the proposed rules require that the chairman be an independent director. If the SRO has one individual as chairman and CEO, that person could not participate in any executive session of the board and could not serve on the Nomination, Governance, Compensation, Audit, or Regulatory Oversight committees. In the event that the chairman and the CEO are the same person, the Commission proposes that the board designate an independent director as "lead director" to preside over executive sessions of the board.[22]

Separation of Regulatory and Market Operations

The proposed rules would require SROs to establish policies that provide for the independence of their regulatory programs from the operation or administration of their trading facilities and other businesses. Specifically, the exchange's regulatory program must be either: (1) structurally separated from the exchange's market operations and other commercial interests, by means of separate legal entities; or (2) functionally separated within the same legal entity from the SRO's market operations and other commercial interests. The proposals also seek to require the appointment of a Chief Regulatory Officer ("CRO") to assure that all regulatory matters are subject to oversight by a person independent of the SRO's commercial interests. The CRO would report directly to a committee composed solely independent directors.[23]

Regulatory Fees, Fines, and Penalties

The Fair Administration Release outlines additional governance rules that would require an SRO to direct monies collected from regulatory fees, fines, or penalties exclusively to fund the regulatory operations and other programs of the SRO related to its regulatory responsibilities. The proposed rule would require an SRO to keep such books and records as are necessary to evidence compliance with this requirement. The Commission is not proposing to require the SROs to institute the equivalent of a Fair Funds provision.[24]

Confidentiality Requirement

Proposed Rules 6a-5(n)(5)(i)(A) and 15Aa-3(n)(5)(i)(A) would require SROs to establish policies reasonably designed to prevent the dissemination of regulatory information to any person other than those officers, directors, employees, and agents of the exchange or association directly involved in carrying out the SRO's regulatory obligations under the Exchange Act. Other rule proposals would require SROs to have policies reasonably designed to maintain the confidentiality of information that must be submitted to the exchange to

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21 69 FR at 71140.

22 69 FR 71141.

23 69 FR 71142.

24 Section 308(a) of the Sarbanes-Oxley Act provides:

> If in any judicial or administrative action brought by the Commission under the securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934) the Commission obtains an order requiring disgorgement against any person for a violation of such laws or the rules or regulations thereunder, or such person agrees in settlement of any such action to such disgorgement, and the Commission also obtains pursuant to such laws a civil penalty against such person, the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation.

See also Testimony of Stephen M. Cutler, Director, Division of Enforcement SEC, Concerning Returning Funds to Defrauded Investors, Before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, February 26, 2003 http://www.sec.gov/news/testimony/022603tssmc.htm

effect a transaction on or through the exchange or a facility.

The Commission notes that it intends that these rules will held assure an independent and effective regulatory function within the SRO. The SEC also avoid a situation in which one member firm could exploit confidential information learned in connection with its participation in a regulatory committee. Such rules must strike the difficult balance between protecting the confidentiality of proprietary information while ensuring meaningful industry participation in SRO regulatory programs.

Ownership and Voting Limitations

The proposed rules also would require an SRO to establish ownership and voting limitations applicable to members that are brokers or dealers in the exchange, association, or a facility of the exchange or association through which the member is permitted to effectuate transactions. Specifically, proposed Rules 6a-5(o)(1) and 15Aa-3(o)(1) would require the rules of a national securities exchange and a registered securities association to prohibit any member that is a broker or dealer, alone or together with its related persons, from either:

(i) directly or indirectly beneficially owning[25] any interest in the exchange or association, or a facility of the exchange or association through which the member is permitted to effect transactions, that exceeds 20% of any class of securities or other ownership interest of the exchange, association, or facility; or

(ii) voting any interest in such exchange, association, or facility of the exchange or association through which the member is permitted to effect transactions, that exceeds 20% of the voting power of any class of securities or other ownership interest of such exchange, association, or facility.

The Commission notes that these proposals are less restrictive than existing provisions in some exchanges' rules. However, these rules would apply to all SROs, and not just demutualized SROs.

[25] For purposes of calculating a member's ownership and voting interests, the proposed rules would aggregate a member's ownership and voting interests with those of its "related persons." 69 FR 71144 at n. 227 and accompanying text.

The Fair Administration Release also outlines rule proposals that would require an exchange to provide in its rules an effective mechanism to divest any member and its related persons of any interest owned in excess of the 20% limitation. Furthermore, the rules of an exchange would be required to be reasonably designed to not give effect to the portion of a vote by a member and its related persons that is in excess of the proposed voting limitation.

Code of Ethics

The proposed governance rules would require that the rules of each SRO provide for a code of conduct and ethics for directors, officers, and employees, and provide that any waiver of the code of conduct and ethics must be approved by the board or the appropriate board committee. The proposed rules also would require that the SRO prohibit any of its employees or officers from being a member of the board of directors of a listed issuer or member firm. The SROs would have some latitude on the contents of the code, but at a minimum the code should have policies and procedures regarding conflicts of interest; corporate opportunities; confidentiality; fair dealing; protection and proper use of the SRO's assets; compliance with laws, rules, and regulations by directors, officers, and employees; and the reporting of illegal or unethical behavior. In addition, the proposed rules would require that each SRO 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.

Exemption Procedure

An SRO may seek exemptions from the Commission from specific requirements of the proposed rules.

Proposed Regulation AL

The Commission has proposed another regulatory scheme to address concerns regarding "self-listed" securities, *e.g.,* a demutualized SRO that chooses to list its securities on its own market. The Commission believes such arrangements raise "questions as to an SRO's ability to independently and effectively enforce its own or the Commission's rules against itself or an

affiliated entity and thus comply with its statutory obligations under the Exchange Act."[26]

Initial Listing

Proposed Regulation AL would prohibit an SRO from approving for listing an affiliated security unless such SRO's Regulatory Oversight Committee certified that such security satisfies the SRO's rules for listing.[27]

Continued Listing and Trading

Regulation AL would impose continuing obligations on the SRO. The SRO would have to:

- file a quarterly report with the SEC summarizing its monitoring of the affiliated security's compliance with its listing rules.
  - The proposed requirement could require an SRO to evaluate an affiliated security's compliance with applicable listing rules more frequently than other listed securities.
  - The requirement includes a summary of its surveillance of the trading of affiliated securities by its members.
  - The SRO's Regulatory Oversight Committee would have to approve the report before the SRO files it with the Commission.
- file an annual report prepared by a third party analyzing compliance by the affiliated security with applicable listing rules of the SRO. Regulation AL also includes additional notice procedures, in the event of non-compliance.[28]

Proposed Regulation AL also would require generally that: (i) any action taken by the exchange or association with regard to the listing of an affiliated security, including the time period granted to the affiliated issuer to come into compliance with any listing standard, be in compliance with the existing rules of the SRO; and (ii) the SRO must not apply the same listing rules to affiliated securities in a manner materially different than the treatment afforded to other securities listed on the exchange or association. The Commission notes that this requirement would not preclude an SRO from amending its rules to apply stricter initial and continued listing standards to affiliated securities.

Form Amendments

The Fair Administration Release contains proposed amendments to Commission forms that apply to the registration of SROs. These form amendments, if adopted, will 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. Further, these rules would govern the procedures for filing amendments to these registration forms and would require more frequent updating of the mandatory information and the posting of such information on the Internet.

Harmonization of Forms for Exchanges and Associations

The proposed rules modify the form requirements to more closely align the regulatory disclosure framework

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[26] 69 FR at 71151 [footnote omitted].

[27] The Fair Administration Release notes at 71151 that:

> [T]he term "affiliated security" ... mean[s] any security issued by an affiliated issuer, except any option exempt from the Securities Act pursuant to Rule 238 under the Securities Act 259 and any security futures product exempt from the Securities Act under Section 3(a)(14) of the Securities Act.
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> The term "affiliated issuer" would be defined to mean:
>
> > (i) with respect to a national securities exchange, the national securities exchange, an SRO trading facility of the national securities exchange, an affiliate of the national securities exchange, or an affiliate of an SRO trading facility of the national securities exchange, and
> >
> > (ii) with respect to a registered securities association, the registered securities association, an SRO trading facility of the registered securities association, an affiliate of the registered securities association, or an affiliate of an SRO trading facility of the registered securities association.
>
> The term "SRO trading facility" would be defined to mean any facility of a national securities exchange or registered securities association that executes orders in securities and would capture Nasdaq's SuperMontage system, Arca-Ex and the NYSE floor. It would not, however, include the NASD's Alternative Display Facility ("ADF") because the ADF does not execute orders. Thus, Nasdaq would be considered an affiliated issuer of the NASD because it would be an SRO trading facility of the NASD, and Archipelago Holdings would be an affiliated issuer of PCX because it would be an affiliate of an SRO trading facility of PCX [footnotes omitted].

[28] 69 FR 71153.

for exchanges to that of associations. Under the proposals, an applicant for registration as a national securities exchange or for an exemption from exchange registration based on limited volume, would be required to file revised Form 1, and an applicant for registration as a registered securities association or an affiliated securities association would be required to file new Form 2. The revised Form 1 and new Form 2 also would be used by an exchange or association, respectively, for submitting all amendments. Because new Form 2 would serve as the form for both initial registration of registered securities associations and for all amendments, the Commission proposes to repeal Forms X-15AJ-1 and X-15AJ-2.

Other Changes

The Commission has proposed many additional changes that would require greater public disclosure of the workings of the SROs. The disclosure provisions also implement many of the substantive provisions described above. For example, exhibits to revised Form 1 and new Form 2 would require the following:

- Proposed Exhibit E would require SROs to describe the structure, composition, and responsibilities of any executive board or committee of the SRO;
- Proposed Exhibit F would require SROs to provide a copy of their governance guidelines and the governance guidelines of any regulatory subsidiary;
- Proposed Exhibit G would require SROs to submit a chart or charts illustrating fully the internal organizational structure of the SRO;
- Proposed Exhibit H would require the SROs to describe fully their regulatory programs; and
- Proposed Exhibit I would require SROs to include their audited financial statements.[29]

Periodic Reporting Obligations

The Fair Administration Release proposes to enhance Commission oversight of the SROs' regulatory programs. For example, the SEC is concerned that it might be unaware that an SRO is not responding promptly and adequately to a new regulatory issue. To address this concern, the Commission proposes new Rule 17a-26, which would require SROs to file quarterly and annual reports with respect to key aspects of their regulatory programs. Such information would concern the regulatory programs of an SRO (which would include any regulatory subsidiary) and would encompass any surveillance, examination, and disciplinary programs.[30] The proposed rule would also compel exchanges and associations to review, on a quarterly and annual basis, the operation and performance of their regulatory programs.[31]

Quarterly Reports would have to include:

- manual and automated surveillance programs
- complaints received relating to the SRO's regulatory program
- all investigations, examinations, and enforcement cases opened, closed, and pending
- listings and delistings
- board meeting agendas

Annual Reports would have to include:

- cumulative summaries of the quarterly information
- reports of internal policies and procedures that the SRO uses to carry out its regulatory responsibilities
- an evaluation of the SRO's regulatory program
- a discussion of internal controls designed to address conflicts of interest and to assure that the SRO appropriately carries out its self-regulatory responsibilities
- employment arrangements with regulatory personnel

[29] 69 FR at 71157 - 71159. Exhibit I also would require SROs to "detail their revenue from fines and penalties resulting from disciplinary and enforcement actions," discussed above at n. 24 and accompanying text.

[30] In the event that one SRO (the "first SRO") has entered into a contractual relationship with another SRO (the "second SRO") pursuant to which the second SRO provides regulatory services to, or on behalf of, the first SRO, the first SRO would have to account for the regulatory services that the second SRO provides to the first SRO. 69 FR 71172. *See also* proposed Rule 17a-26(b)(1)(i) at 69 FR 71223.

[31] 69 FR at 71172.

- copies of standing committee self-evaluations
- information on efforts to comply with recommendations from examinations or inspections

In addition, Proposed Rule 17a-26 would require every SRO subject to the proposed rule that owns, operates, or sponsors an electronic SRO trading facility to file with the Commission, on an annual basis as part of the annual report, an audit report of an independent third party that assesses whether the operations of the electronic SRO trading facility comply with the rules governing the facility

Furthermore, all periodic reports filed under this rule would be required to be accompanied by a signed certification executed on behalf of the SRO by the CEO or an equivalent officer, representing that the information contained in the report is current, true, and complete as of the date filed with the Commission.[32]

Finally, the SEC proposes the equivalent of the 8-K requirement, providing that an SRO must file with the SEC "any material changes to or material developments" that affect the SRO's regulatory program. The SRO would need to make a supplemental filing within 10 days of the triggering event.[33]

Ownership Restrictions

Proposed Rule 17a-27 would require a member of a SRO that is a broker or dealer to provide notice to the Commission and the SRO of which it is a member when it acquires more than a 5% ownership interest in such SRO or in a facility of such SRO through which it is permitted to effect transactions. A member would be required to make its initial filing of a statement under Rule 17a-27 within 10 calendar days of when it, together with its related persons, beneficially owns more than 5% of any class of securities or other ownership interest. The broker-dealer would need to file a copy with the SEC and with the SRO. The SRO would be required to post a copy of the statement on its publicly-accessible web site within 10 calendar days of receipt. The broker-dealer would need to file an amendment to the statement within ten days of any change, unless the change is less than 1% of the interest previously reported.

Concept Release

As noted, accompanying the Fair Representation Release is a concept release on SRO issues. The Commission is soliciting comment on a range of issues related to the SRO system. The release reviews the history of self-regulation and discusses development such as demutualization and the creation of ECNs. The release discusses advantages and disadvantages of the SRO system. The Commission notes that the proposed changes in Fair Administration Release would improve SRO governance and transparency. But the Commission states that although these changes "could help manage a variety of the traditional limitations, it would not eliminate them."[34]

The Commission then posits a number of alternatives to the current SRO structure[35]:

- Independent Regulatory and Market Structure – This proposal would require internal restructuring. For example, the Commission could require that all SROs create independent regulatory and market operations. This model would be similar to the original restructuring of the NASD, separating Nasdaq and NASD-R.
- Hybrid Model – Under this proposal, the SEC would designate a market neutral single SRO to regulate all SRO members with respect to financial condition, margin, handling of customer accounts, registered representative registration, branch office supervision, and sale practices. Each SRO that operates a market would be solely responsible for its own market operations and market regulation.[36]
- Competing Hybrid – Under this approach, Market SROs would exist as in the pure Hybrid approach and market regulation would be conducted separately from member regulation. Rather than one single member SRO, multiple competing member SROs ("Competing Member SROs"), would provide member regulatory services. Each Market SRO member would also have to be a member of one of the Competing Member SROs.

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32 *Cf.* Dechert Update, *SEC Approves NASD CEO Compliance Certification Rule, Oct. 2004*.

33 69 FR at 71177.

34 69 FR 712276.

35 69 FR at 71276 – 71282.

36 The Securities Industry Association endorsed one version of the hybrid model to eliminate duplication and cost. http://www.sia.com/market_structure/html/siawhitepaperfinal.htm. See also Section 17(k) of the Exchange Act.

- Universal Industry Self-Regulator – This model posits the creation of a single SRO that would be responsible for all market and member rules.
- Universal Non-Industry Regulator – Under this proposal, one non-industry regulator would be responsible for all market and member regulation. The Concept Release suggest it would be analogous to the Public Company Accounting Oversight Board that the Sarbanes-Oxley Act created.
- SEC Regulation – Finally, the Commission could be the sole regulator, replacing self-regulation entirely.[37]

[37] Rule 15b9-2 provides that:

> an OTC derivatives dealer, as defined in Exchange Act Rule 3b-12, shall be exempt from any requirement under Section 15(b)(8) of the Exchange Act to become a member of a registered securities association.

The Commission solicits comments on all of these models and attendant issues.

Conclusion

The Fair Administration Release contemplates some of the most significant and extensive changes to self-regulation and to SRO practices since Congress passed the 1975 Acts Amendments. To some extent, the Commission is proposing to exercise much of the rulemaking power that Congress gave it a generation ago. The Concept Release contains policy alternatives that could fundamentally alter the shape of securities regulation, if the Commission chooses to pursue them. Both releases have important implications not only for the SROs, but also for their members and for investors. They warrant careful attention and comment from the public.

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