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SEC Proposes the Enhancement of the Regulation of Exchanges and the NASD, While Weighing the Risks and Benefits of the Self-Regulatory System as a Whole

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I. Introduction

For seven decades now, the U.S. has relied on the principle of self-regulation for the oversight of its securities markets and market participants. Throughout this period, Congress, the Securities and Exchange Commission ("SEC" or "Commission") and market participants have periodically weighed the risks and benefits of having an industry regulating itself and considered possible changes and enhancements to the system. Yet, to date, Congress has refrained from altering the underlying principle of self-regulation. Recent developments, including allegations of governance failures on the part of self-regulatory organizations ("SROs"), enforcement actions and examinations involving SROs and their members, increasing competitive pressures faced by SROs, and the growing trend of SROs to reorganize from mutual organizations to shareholder-owned entities, however, have prompted the Commission to undertake a detailed review of its regulation and oversight of SROs and to consider whether changes to the self-regulatory system are necessary.

As a first and, perhaps preliminary, step for addressing the various SRO-related issues that have arisen recently, the SEC is proposing new rules to strengthen SRO governance and the SEC's oversight and regulation of SROs (the "SRO Governance and Transparency Rulemaking").[1] The proposals relate to the governance, administration, transparency, ownership and listing rules of SROs that are national securities exchanges or registered securities associations, and the periodic reporting of information by these SROs with respect to their regulatory programs. The SEC has requested comment on this proposal on or before January 24, 2005.

Although the SEC believes that this rule proposal will help to manage a variety of the traditional limitations of the self-regulatory model, it does not believe it will fully address all such limitations. As a result, the Commission also has published a companion concept release to solicit broader comment on the role and operation of SROs in today's market ("SRO Concept Release").[2] The SRO Concept Release examines a number of issues concerning self-regulation, including the inherent conflicts of interest, inefficiencies and funding concerns. In light of the concerns about self-regulation in its existing form, the SRO Concept Release examines and seeks comment on possible enhancements, or other more fundamental changes, to the current SRO model. Comments on this proposal must be submitted on or before March 8, 2005.

II. Issues Raised by the Current Self-Regulatory System

The SEC examines a number of issues concerning self-regulation, including: (1) the inherent conflicts of interest between an SRO's regulatory obligations and the interests of its members, its market operations, its

1. *Securities Exchange Act Release No. 50699 (Nov. 18, 2004), 69 Fed. Reg. 71126 (Dec. 8, 2004) ("SRO Governance and Transparency Rulemaking").*

2. *Securities Exchange Act Release No. 50700 (Nov. 18, 2004), 69 Fed. Reg. 71256 (Dec. 8, 2004) ("SRO Concept Release").*

listed issuers, and in the case of demutualized SROs, its shareholders; (2) the costs and inefficiencies of the multiple SRO model; (3) the challenges of surveillance across markets by multiple SROs; and (4) the manner in which SROs generate revenue and how SROs fund regulatory operations. We discuss each of these in more detail below.

A. Inherent Conflicts Embedded in the Self-Regulatory System

Among the most controversial features of the existing self-regulatory system are the inherent conflicts between the SRO's regulatory function and its business function. The following discussion considers these conflicts in more detail.

1. Conflicts with Members

The SROs are responsible for promulgating and enforcing rules that govern all aspects of their members' securities business. Therefore, one inherent conflict in the self-regulatory system is the one between the SRO and its members. Unchecked conflicts in the dual role of regulating and servicing members can result in poorly targeted or less extensive rulemaking and/or under zealous or indifferent enforcement of SRO rules against members. Traditional 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. The SEC is concerned, however, that these traditional conflicts have been further exacerbated by recent developments in the securities markets. For example, consolidation within the securities industry may have enhanced the dependence of SROs on a relatively small number of firms for the bulk of their funding. Similarly, the conflicts issues may be heightened where an SRO, its facility or its affiliate owns or operates a member broker-dealer, as is the case with Archipelago Exchange's ("Arca-Ex") Wave broker-dealer.

2. Conflicts with Market Operations

In addition to conflicts with members, an SRO's regulatory obligations may conflict with the interests of its own or its affiliate's market operations. The SEC believes this conflict has been exacerbated by increased market competition. Because of the business pressure to attract and keep order flow, SRO's may attempt to use lax regulation as a means to attract business and use aggressive regulation as a weapon against competitors.

3. Conflicts with Issuers

Another potential SRO conflict involves issuers. The SROs are required to promulgate and administer listing standards that govern the securities that may be traded in their markets. The SEC, however, is concerned that the increased competition among SRO markets for listings may cause an SRO to fail to discharge its self-regulatory responsibilities properly. This can take the form of admitting issuers that fail to satisfy initial listing standards, delaying the delisting of issuers that no longer satisfy maintenance standards; failing to enforce listing standards; and reducing listing fees. In addition, the sponsorship of popular proprietary products by member firms, such as Exchange Traded Funds ("ETFs"), may compound the inherent conflicts because SROs may be disinclined to regulate vigorously either the trading activity of popular proprietary products or the activity of member firms that are the sponsors of such products.

4. Conflicts with Shareholders

Another significant conflict of interest is with SRO shareholders. SRO demutualization raises the concern that the profit motive of a shareholder-owned SRO, especially in today's highly competitive environment, could detract from proper self-regulation. For instance, shareholder-owned SROs may commit insufficient funds to regulatory operations or use their disciplinary function as a revenue generator with respect to member firms that operate competing trading systems or whose trading activity is otherwise perceived as undesirable.

B. Inefficiencies of Multiple SROs

Self-regulation, in its current form, carries with it an inherent inefficiency in that it can cause duplicative and potentially conflicting regulation. Specifically, the existence of multiple SROs can result in duplicative and conflicting SRO rules, rule interpretations, and inspection regimes. The system can also result in redundant SRO regulatory staff and infrastructure across SROs. Such inefficiencies may be aggravated by the greater market fragmentation of order flow among SROs today.

C. Gaps in Intermarket Surveillance

As trading has become less concentrated in the primary markets and more dispersed across a greater number of markets, SRO and Commission supervision of intermarket trading has been placed under increasing strain. Concern has been expressed about

gaps in intermarket trading surveillance because the order audit trail of individual markets does not provide information across markets and the Intermarket Surveillance Group may or may not serve effectively as a facilitator of regulatory data sharing and surveillance coordination among SROs. Correspondingly, the SEC raises the issue of whether crossover surveillance between the equities and options markets is necessary.

D. Ensuring Adequate Funding of Regulatory Operations

Another important issue for the self-regulatory system is the adequate funding of regulatory operations. The Securities Exchange Act of 1934 ("Exchange Act") contemplates that regulatory funding be sufficient to permit SROs to fulfill their statutory responsibilities, and that such funding would be achieved through equitable assessments on the members, issuers and other users of an SRO's facilities. Indeed, one of the key historical benefits of the SRO system is its self-funding structure, which has the advantage of leveraging the limited resources of the SEC. Traditionally, SROs have had five primary sources of SRO funding: (1) regulatory fees; (2) transaction fees; (3) listing fees; (4) market data fees[3]; and (5) other miscellaneous fees (e.g., product licensing, investment gains and fees for administering joint industry plans). The SEC requests comment on how best to assure whether regulatory funding through these sources and the subsequent expenditures by the SROs on regulatory operations is adequate.

The SEC believes that determining whether any particular SRO is spending sufficient funds on its regulatory operations is difficult, especially given the lack of comparability between the various SROs (i.e., the SROs and their markets have diverse characteristics, membership and roles). As a result, to date, the SEC has not issued any detailed rules specifying proper funding levels for SRO regulatory programs, or how costs should be allocated among the SRO constituencies. Rather, the SEC has examined the SROs to determine whether they are complying with their statutory responsibilities. To supplement this examination method, the SEC has proposed rules requiring enhanced transparency of SRO funding, as discussed below. The SEC requests comment on whether enhanced transparency will promote adequate regulatory funding levels or whether other steps would be more effective.

III. SRO Governance and Transparency Rulemaking

The SEC has decided to take action to address certain specific concerns related to SRO governance, regulatory programs, competition and new ownership structures through the proposal of new rules for exchanges and association. This SRO Governance and Transparency Rulemaking is described in detail below.

A. Administration and Governance Standards: Proposed Rules 6a-5 and 15Aa-3

The Commission is proposing new Rules 6a-5 and 15Aa-3 under the Exchange Act that would set forth minimum standards of governance to be adopted and implemented by national securities exchanges and registered securities associations, respectively.[4] The SEC's approach combines public disclosure of important governance information with guidelines for independent board representation and reliance on totally independent board committees for oversight of critical SRO functions and responsibilities. The proposed governance rules are intended to strengthen the governance of exchanges and associations, promote a greater degree of objectivity and impartiality in important SRO processes, foster a greater degree of independence of the regulatory programs of exchanges and associations, and address the conflicts that can arise when a mutual organization converts to another form of ownership.

To further strengthen the governance of exchanges and associations, the proposed rules also would apply to any person that, directly or indirectly, is controlled by the exchange or association and that provides, whether pursuant to contract, agreement or rule, regulatory services to or on behalf of the exchange or association (i.e., a regulatory subsidiary),[5] because they are an integral part of the SRO structure and carry out certain regulatory duties on behalf of the exchange or association.[6] Thus, the Commission proposes to require these regulatory subsidiaries to be subject to the same governance standards applicable to the SRO itself.

3. Market data fees, a significant source of SRO funding, have been the most controversial source of SRO funding to date. Because of the continued disagreement among market participants regarding the fairness and reasonableness of the existing fees for market data, as most recently expressed in response to the request for comment on proposed Regulation NMS, the SEC again is requesting comment on the level of market data fees and the necessity of market data fees to support the regulatory operations of the SROs.

4. Rules 6a-5 and 15Aa-3 would not apply to a national securities exchange registered pursuant to Section 6(g)(1) of the Exchange Act or a limited purpose national securities association registered pursuant to Section 15A(k)(1) of the Exchange Act because the SEC does not have primary responsibility for regulation of such exchanges and associations.

5. See proposed Rules 6a-5(b)(18) and 15Aa-3(b)(19).

6. See proposed Rules 6a-5(a) and 15Aa-3(a).

To implement this governance provision, each exchange and association would be required to submit to the Commission proposed rule changes reflecting new rules or rule amendments no later than four months following the date of publication in the Federal Register, and those rules or rule amendments would have to be approved by the SEC no later than ten months following the final rules' publication date and operative no later than one year following the final rules' publication date.[7]

I. Board Composition and Responsibilities

a. Independent Directors

Proposed Rules 6a-5 and 15Aa-3 would require an exchange or association's governing board to be composed of a majority of independent directors,[8] although an SRO may elect to impose a more rigorous requirement. For a director to be considered independent, the board of the exchange or association would be required to affirmatively determine that the director has no material relationship with the exchange or association or 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 association, or a facility of the exchange or association.[9] 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.[10] In addition to the general criteria of no material relationship, the proposed rules would identify certain specific circumstances under which a director would not be considered independent (e.g., if a director, or an immediate family member has, within the past three years had a material relationship with the exchange or association).[11] These proposed circumstances are similar to criteria that are contained in SRO listing standards which were recently approved by the SEC.

The board would be required to make the independence determination upon the director's nomination or appointment to the board and thereafter no less frequently than annually and as often as necessary in light of the director's circumstances.[12] Further, the exchange or association would be required to establish policies and procedures to require each director, on his or her own initiative and upon request of the exchange or association, to inform the exchange or association of the existence of any relationship or interest that may reasonably be considered to bear on whether such director is an independent director.[13] Any failure to comply with the independence requirement because of a vacancy or a change in a director's independent status must be remedied by the earlier of the next annual meeting or one year from the date of the occurrence of the event that caused the non-compliance.[14]

The SEC believes that independent directors must be provided with the opportunity to discuss any important matters regarding the exchange or association in a frank and open manner, free from the presence of management. Therefore, the SEC proposes that the independent directors of the exchange or association's board meet regularly in executive sessions.[15] 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.[16] Accordingly, the proposed governance rules would require that the exchange or association 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.[17]

The Commission is not proposing to require that an exchange or association's Chairman of the board be an independent director in all circumstances. However, if the exchange or association's CEO is not also the Chairman, the SEC is proposing that the Chairman must be an independent director.[18] If the CEO and the Chairman are the same individual, then the proposed governance rules would prohibit that person -- who, as the CEO, would not be "independent" -- from participating in any executive sessions of the board and from serving on the Standing Committees.[19] In addition, if the CEO and the Chairman are 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, and the board would be required to publicly disclose the lead director's

7. See proposed Rules 6a-5(r) and 15Aa-3(r).

8. See proposed Rules 6a-5(c)(1) and 15Aa-3(c)(1).

9. See proposed Rules 6a-5(b)(12) and (c)(2); and 15Aa-3(b)(13) and (c)(2).

10. See proposed Rules 6a-5(b)(13) and 15Aa-3(b)(14).

11. See proposed Rules 6a-5(b)(12) and 15Aa-3(b)(13).

12. See proposed Rules 6a-5(c)(2) and 15Aa-3(c)(2).

13. See proposed Rules 6a-5(c)(3) and 15Aa-3(c)(3).

14. See proposed Rules 6a-5(c)(8) and 15Aa-3(c)(8).

15. See proposed Rules 6a-5(d)(1) and 15Aa-3(d)(1). The SEC is not mandating a minimum frequency for such meetings.

16. See proposed Rules 6a-5(d)(2) and 15Aa-3(d)(2).

17. See proposed Rules 6a-5(d)(3) and 15Aa-3(d)(3).

18. See proposed Rules 6a-5(m)(1) and 15Aa-3(m)(1).

19. See proposed Rules 6a-5(m)(2) and 15Aa-3(m)(2).

name and a means by which interested parties may communicate with the lead director.[20]

b. Member, Issuer and Investor Representation on Board

Sections 6(b)(3) and 15A(b)(4) of the Exchange Act require that the rules of an exchange and association, respectively, assure a fair representation of its members in the selection of its directors and administration of its affairs, and must provide that one or more directors be representative of issuers and investors and not be associated with a member of the exchange, broker or dealer. To implement the fair representation requirement, the SEC would require that the Nominating Committee of an exchange or association administer a fair process that provides members with the opportunity to select at least 20% of the total number of directors.[21] This 20% standard comports with previously-approved SRO rule changes that raised the issue of fair representation. The exchange or association would have some leeway in implementing the fair process for members to select board candidates.

Correspondingly, exchanges and associations would be required to adopt rules to establish a fair process for the nomination of alternative candidates by members through a petition process. The percentage of members that is necessary to put forth such alternative member candidate or candidates would be required to be specified in the exchange or association's rules, and could not exceed 10% of the total number of members.[22] The Nominating Committee would be required to administer the petition process established by the exchange or association's rules.[23]

In addition, to implement the issuer and investor representation requirement, 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 director must not be associated with a member or broker or dealer.[24]

c. General Requirements for Board Members

The proposed rules would require exchanges and associations to explicitly mandate that each director, in discharging his or her responsibilities as a member of the board, reasonably consider all requirements applicable to the exchange or association under the Exchange Act,[25] in addition to any fiduciary obligations under state law. In addition, the proposed governance rules would require that the rules of the exchange or association prohibit a person subject to any statutory disqualification, within the meaning of Section 3(a)(39) of the Exchange Act, from being a director or officer of the exchange or association.[26]

2. Board Committees

a. Standing Committees

As the SEC notes, recent developments have highlighted the critical role that board committees play in the governance of exchanges and associations and the importance of having key committees function independently of the pressures that otherwise could be exerted on them by management, members or other interested parties. As a result, the SEC is proposing that each exchange and association, at a minimum, have the following Standing Committees (or their equivalent) and that each such committee be composed solely of independent directors:[27] Nominating Committee, Governance Committee, Compensation Committee, Audit Committee and Regulatory Oversight Committee.[28]

Each Standing Committee would be required to conduct an annual self-evaluation of its performance,[29] except that the Governance Committee would be required to conduct an annual evaluation of the governance of the exchange or association as a whole.[30] Exchanges and associations would be required to provide sufficient funding and other resources to each Standing Committee, as determined by each Standing Committee, to permit it to fulfill its responsibilities, and retain independent counsel and advisors.[31] When the board considers any matter that is recommended by or otherwise is within the authority or jurisdiction of any Standing Committee, a majority of the directors who vote on the matter would be required to be independent.[32] Finally, exchanges and associations also would be required to establish procedures for interested persons to communicate their concerns relating to any matter within the authority or jurisdiction of a Standing Committee directly to the independent directors.[33]

The proposed rules also would delineate the responsibilities of each Standing Committee. The Nominating Committee would identify

20. See proposed Rules 6a-5(m)(3) and 15Aa-3(m)(3).

21. See proposed Rules 6a-5(f)(3) and 15Aa-3(f)(3). This requirement is not intended to prohibit exchanges and associations from having boards composed solely of independent directors. If an exchange or association's board is composed solely of independent directors, the candidate(s) selected by members would have to be independent.

22. See proposed Rules 6a-5(c)(7) and 15Aa-3(c)(7).

23. See proposed Rules 6a-5(f)(3) and 15Aa-3(f)(3).

24. See proposed Rules 6a-5(c)(5) and 15Aa-3(c)(5).

25. See proposed Rules 6a-5(l)(2) and 15Aa-3(l)(2).

26. See proposed Rules 6a-5(l)(1) and 15Aa-3(l)(1).

27. See proposed Rules 6a-5(f)(1), (g)(1), (h)(1), (i)(1) and (j)(1); and 15Aa-3(f)(1), (g)(1), (h)(1), (i)(1) and (j)(1).

28. See proposed Rules 6a-5(b)(21) and (e)(1); and 15Aa-3(b)(22) and (e)(1). A single committee may carry out the functions of two Standing Committee as long as the committee consists solely of independent directors.

29. See proposed Rules 6a-5(f)(5), (h)(3), (i)(3) and (j)(6) and 15Aa-3(f)(5), (h)(3), (i)(3) and (j)(6).

30. See proposed Rules 6a-5(g)(3) and 15Aa-3(g)(3).

31. See proposed Rules 6a-5(e)(3) and 15Aa-3(e)(3).

32. See proposed Rules 6a-5(c)(6) and 15Aa-3(c)(6).

33. See proposed Rules 6a-5(c)(9) and 15Aa-3(c)(9).

individuals qualified to become board members, consistent with criteria approved by the board, and administer a process for the nomination of individuals to the board.[34] The Governance Committee would develop and recommend to the board a set of governance principles applicable to the exchange or association and to oversee the evaluation of the board and management.[35] The Compensation Committee would have direct responsibility to review and approve corporate goals and objectives relevant to the compensation of the executive officers of the exchange or association; evaluate the performance of the executive officers in light of those goals and objectives; and consider and approve recommendations with respect to the compensation level of the executive officers, based on this evaluation.[36]

The Audit Committee would assist the board in oversight of the integrity of the exchange or association's financial statements; the exchange or association's compliance with related legal and regulatory requirements; the qualifications and independence of the exchange or association's auditor, including direct responsibility for the hiring, firing, and compensation of the auditor, overseeing the auditor's engagement, meeting regularly in executive session with the auditor, reviewing the auditor's reports with respect to the exchange or association's internal controls, and pre-approving all audit and non-audit services performed by the auditor; determining the budget and staffing of the exchange's or association's internal audit department; and establishing procedures for the receipt of complaints regarding accounting, internal accounting controls, or auditing matters of the exchange or association and the confidential submission by employees of the exchange or association of concerns regarding questionable accounting or auditing matters.[37]

Finally, the Regulatory Oversight Committee would assure the adequacy and effectiveness of the exchange or association's regulatory program; assess the exchange or association's regulatory performance; determine the regulatory plan, programs, budget and staffing for the regulatory functions of the exchange or association; assess the performance of, and recommend compensation and personnel actions involving, the Chief Regulatory Officer and other senior regulatory personnel to the Compensation Committee; monitor and review regularly with the Chief Regulatory Officer matters relating to the exchange or association's surveillance, examination, and enforcement units; assure that the exchange's or association's disciplinary and arbitration proceedings are conducted in accordance with the exchange or association's rules and policies and any other applicable laws or rules, including those of the Commission; prior to the exchange or association's approval of an affiliated security for listing, certify that such security meets the exchange or association's rules for listing; and approve any reports filed with the SEC as required by Regulation AL (as discussed below).[38] The Regulatory Oversight Committee also would be required to oversee the preparation of the exchange or association's annual regulatory report, as required by proposed Rule 17a-26 of the Exchange Act (also discussed below).[39]

In addition, any committee, subcommittee, or 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.[40] Although the Regulatory Oversight Committee would be required to be composed solely of independent directors, the SEC believes that, to satisfy the fair representation requirement, the exchange or association must provide for member participation on any committee, subcommittee, or panel that is responsible for conducting hearings, rendering decisions, and imposing sanctions with respect to disciplinary matters.[41] In order to satisfy this requirement, the proposal would require that at least 20% of the members of any such committee, subcommittee or panel be members of the exchange or association.[42] The SEC notes that this 20% standard is consistent with prior SRO proposals that were approved by the SEC.

b. Other Board Committees

The proposed governance rules would permit an exchange or association to establish such other committees of the board as it determines to be appropriate; however, if such 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.[43] 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 exchange or association could not delegate to any committee not consisting

34. See proposed Rules 6a-5(f)(2) and 15Aa-3(f)(2).

35. See proposed Rules 6a-5(g)(2) and 15Aa-3(g)(2).

36. See proposed Rules 6a-5(h)(2) and 15Aa-3(h)(2).

37. See proposed Rules 6a-5(i)(2) and 15Aa-3(i)(2).

38. See proposed Rules 6a-5(j)(2) and 15Aa-3(j)(2).

39. See proposed Rules 6a-5(j)(5) and 15Aa-3(j)(5).

40. See proposed Rules 6a-5(j)(4) and 15Aa-3(j)(4).

41. See proposed Rules 6a-5(j)(3) and 15Aa-3(j)(3).

42. Id.

43. See proposed Rules 6a-5(j)(5) and 15Aa-3(j)(5).

solely of independent directors the authority to act on matters that otherwise are within the jurisdiction of a Standing Committee.[44]

In addition, the SEC is proposing that at least 20% of the persons serving on any committee that is not a Standing Committee or any committee, subcommittee, or panel that is subject to the jurisdiction of a Standing Committee, and that is responsible for providing advice with respect to trading rules or disciplinary rules, be members of the exchange or association.[45]

3. Separation of Regulatory and Market Operations

a. Independence of Regulatory Program

To better manage the conflicts of interest inherent in any self-regulatory structure, under proposed Rules 6a-5 and 15Aa-3, each exchange and association would be required to separate its regulatory function from its market operations and other commercial interests, whether through functional or structural separation.[46] In either case, the proposed governance rules would require the board to appoint a Chief Regulatory Officer to administer the regulatory program and the Chief Regulatory Officer to report directly to the proposed independent Regulatory Oversight Committee.[47]

b. Use of Regulatory Fees, Fines and Penalties

Exchanges and associations would be required to direct monies collected from regulatory fees, fines and penalties ("regulatory funds") exclusively to fund the regulatory operations and other programs of the exchange or association related to its regulatory responsibilities, and to keep such books and records as are necessary to evidence compliance with this requirement.[48] An exchange or association could not use such regulatory funds to pay dividends or make distributions to its shareholders. This proposed restriction is intended to preclude an SRO from using its authority to raise regulatory funds for the purpose of benefiting its shareholders or for other non-regulatory purposes, such as to fund executive compensation.

c. Confidentiality of Regulatory and Trading Information

Exchanges and associations also would be required to establish policies and procedures 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 exchange or association's regulatory obligations.[49] The proposed rules also would require that an exchange or association's policies and procedures be reasonably designed to prevent the use of regulatory information for any purpose other than for carrying out the exchange or association's regulatory obligations.[50]

In addition, exchanges and associations would be required to have policies and procedures reasonably designed to maintain the confidentiality of information that must be submitted to the exchange or association to effect a transaction on or through the exchange, association or a facility.[51] The proposed rules, however, would allow an exchange or association to make available such information in an aggregated form, if the information is aggregated to such an extent that the recipient is unable to identify (such as by reverse engineering) any person whose data is included in the aggregate information, or if the person consents.[52]

The SEC is also proposing that an exchange or association's policies and procedures require that its officers, directors, employees and agents agree to comply with these requirements.[53]

4. Member Voting and Ownership Limitations

The proposed governance rules would require exchanges and associations to limit the ability of their members that are brokers or dealers to own or vote a significant interest in the exchange, association or any separate facility.[54] Given the substantive governance and other standards proposed to strengthen the independence of SROs and their regulatory function, the SEC is not proposing at this time ownership and voting restrictions on persons other than members. Therefore, the SEC is proposing a less restrictive approach than the rules previously adopted by the Philadelphia Stock Exchange and the Pacific Exchange with regard to its facility, Arca-Ex.

Specifically, a member that is a broker or dealer would not be able to, alone or together with its related persons, own more than 20% of the exchange or association of which it is a member or a facility through which the member is permitted to effect transactions. A member that is a broker or dealer, and its

44. See proposed Rules 6a-5(k)(1) and 15Aa-3(k)(1).

45. See proposed Rules 6a-5(k)(2) and 15Aa-3(k)(2).

46. See proposed Rules 6a-5(n)(1) and (2); and 15Aa-3(n)(1) and (2).

47. See proposed Rules 6a-5(n)(3) and 15Aa-3(n)(3).

48. See proposed Rules 6a-5(n)(4) and 15Aa-3(n)(4). The scope of categories of regulatory funds included in this requirement is intended to be broad.

49. See proposed Rules 6a-5(n)(5)(i)(A) and 15Aa-3(n)(5)(i)(A).

50. See proposed Rules 6a-5(n)(5)(i)(B) and 15Aa-3(n)(5)(i)(B).

51. See proposed Rules 6a-5(n)(5)(i)(C) and 15Aa-3(n)(5)(i)(C).

52. Id.

53. See proposed Rules 6a-5(n)(5)(ii) and 15Aa-3(n)(5)(ii).

54. See proposed Rules 6a-5(o) and 15Aa-3(o).

related person, also would not be able to vote or cause the voting of more than 20%.[55]

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." "Related persons" would be defined to mean, with respect to a member that is a broker or dealer: (1) an affiliate of the member; (2) a person associated with the member; (3) any immediate family member of the member, or any immediate family member of the member's spouse, who, in each case, has the same house as the member or who is a director or officer of the exchange, association or facility of any of its parents or subsidiaries; and (4) any immediate family member of a person associated with the member or any immediate family member of such person's spouse, who, in each case, has the same home as the person associated with the member or who is a director or officer of the exchange, association or facility of any of its parents or subsidiaries.[56]

The proposed rules would require an exchange or association 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.[57] To be an effective mechanism, the rule must require the exchange or association to take action to reduce the member's and its related person's ownership interest that exceeded the proposed ownership limit. In addition, the proposed rules would require that the rules of the exchange or association 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.[58] The SEC is providing exchanges and associations with the flexibility to determine the best approach under relevant state law. Finally, the proposed rules would require an exchange or association's rules to provide a mechanism for obtaining information relating to ownership and voting interests in the exchange, association or separate facility from any owner of any interest.[59]

As a complement to the ownership and voting limitations, the SEC is proposing Rule 17a-27, which would require any member of an exchange or association that is a broker or dealer to provide a report to the Commission and the exchange or association of which it is a member when it, alone or together with its related persons, acquires, directly or indirectly, more than 5% of any class of securities or other ownership interest of such exchange, association or of a facility of such exchange or association through which it is permitted to effect transactions.[60]

5. Code of Conduct and Ethics and Governance Guidelines

Finally, the proposed governance rules would require that exchanges and associations adopt both a code of conduct and ethics for directors, officers and employees and governance guidelines, and provide that any waiver of such code of conduct and ethics must be approved by the board, or the appropriate board committee. The code of conduct and ethics, at a minimum, must establish policies and procedures regarding: conflicts of interest; corporate opportunities; confidentiality; fair dealing; protection and proper use of the exchange or association's assets; compliance with laws, rules and regulations by directors, officers and employees; and the reporting of illegal or unethical behavior.[61]

Correspondingly, the governance guidelines, at a minimum, should 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.[62] The proposed rules also would require that the exchange or association prohibit any of its employees or officers from being a member of the board of directors of a listed issuer or member firm.[63]

B. Listing Affiliated Securities: Regulation AL

The listing of securities issued by an SRO, the facility of an SRO, or an affiliate of either on the SRO raises questions as to the SRO's ability to independently and effectively enforce its rules against itself. For instance, the SRO might be reluctant to vigorously monitor for compliance with its initial and continued listing rules by the securities of an affiliated issuer of its own securities. The trading of securities of an SRO or the securities of an affiliated issuer on the SRO also raises similar potential conflict concerns, in that the SRO might choose to selectively enforce (or not enforce) its trading rules with respect to trading in its own stock or that of an affiliate so as to benefit itself. Indeed, with the owner of a facility of an SRO already having completed an initial public offering ("IPO"), and another SRO having filed a registration statement under the

55. The 20% voting limitation would not apply to any solicitation or receipt of revocable proxies by a member, if conducted pursuant to Regulation 14A under the Exchange Act. See proposed Rules 6a-5(o)(2) and 15Aa-3(o)(2).

56. See proposed Rules 6a-5(b)(19) and 15Aa-3(b)(20).

57. See proposed Rules 6a-5(o)(3) and 15Aa-3(o)(3).

58. See proposed Rules 6a-5(o)(4) and 15Aa-3(o)(4).

59. See proposed Rules 6a-5(o)(5) and 15Aa-3(o)(5).

60. Proposed Rule 17a-27 is also intended to complement proposed Exhibit Q to revised Form 1and new Form 2, which would require an exchange or association to provide to the Commission information on all persons that own more than 5% of the exchange, association or facility of the exchange or association. See Section C below.

61. See proposed Rules 6a-5(p)(1)(i) and 15Aa-3(p)(1)(i).

62. See proposed Rules 6a-5(q) and 15Aa-3(q).

63. See proposed Rules 6a-5(p)(2) and 15Aa-3(p)(2).

Securities Act for its IPO, the conflicts related to self-listing are no longer an academic issue.

To address these concerns, proposed Regulation AL would prohibit an exchange or association from approving for listing an affiliated security unless such exchange or association's Regulatory Oversight Committee (composed of independent directors) certified that such security satisfies the exchange or association's rules for listing.[64] The term "affiliated security" means any security issued by an affiliated issuer, except any option exempt from the Securities Act pursuant to Rule 238 under the Securities Act and any security futures product exempt from the Securities Act under Section 3(a)(14) of the Securities Act.[65] The term "affiliated issuer" would be defined to mean a national securities exchange or registered securities association, an affiliate thereof, an SRO trading facility thereof or an affiliate of the SRO trading facility thereof.[66] An "SRO trading facility" would mean a facility of an exchange or association that executes orders in securities.[67] It would capture Nasdaq's SuperMontage, Arca-Ex and the New York Stock Exchange ("NYSE") floor, but, it would not capture the NASD's Alternative Display Facility ("ADF") because the ADF does not execute orders.

Proposed Regulation AL also would impose reporting and notice requirements on an exchange or association with respect to an affiliated security. Specifically, an exchange or association would have to file quarterly reports with the Commission regarding its monitoring of the listing and trading of an affiliated security on its market and its surveillance of the trading of affiliated securities by its members.[68] In addition, on an annual basis, exchanges and associations must provide the Commission a copy of a report prepared by a third party analyzing compliance by the affiliated security with the exchange or association's listing rules.[69] The SRO must promptly notify an affiliated issuer of any alleged non-compliance with a listing rule, provide the Commission with a report detailing such alleged non-compliance, and provide the Commission and Regulatory Oversight Committee with a copy of any response from the affiliated issuer.[70] The exchange or association's Regulatory Oversight Committee would have to approve the quarterly reports and the report detailing non-compliance.[71]

Proposed Regulation AL also would require that, except as otherwise required by proposed Regulation AL, (1) 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 exchange or association; and (2) the exchange or association must not apply the same listing and trading rules to affiliated securities in a manner materially different than the treatment afforded to other securities listed on the exchange or association.[72]

C. Proposed Amendments to Registration Forms for Exchanges and Associations: Revised Form 1 and New Form 2

The Commission proposes to amend the procedures for application as a national securities exchange (or exchange exempt from registration based on limited volume) or registered securities association (or affiliated securities association), and for the submission of amendments to such applications. The proposals are intended to bring greater transparency to the governance structure of SROs and to their regulatory programs and processes, and to provide the mechanism for more timely disclosure of the specified information. The proposals also are intended to assist the SEC in its oversight of exchanges and associations. The SEC also intends to harmonize the disclosure requirements for exchanges and associations.

Under the proposals, an applicant for registration as an exchange or an association would be required to submit a registration statement and provide disclosure to the Commission on revised Form 1 (for exchanges) and new Form 2 (for associations).[73] Any exchange or association that is registered with the Commission as of the publication date of the adoption of any proposed amendments to the forms would be required to file a complete registration statement on revised Form 1 or new Form 2, as applicable, within six months following such publication data. Exchanges and associations also would use revised Form 1 and new Form 2, respectively, to submit amendments. An exchange or association further would be required to comply with proposed amendments to Rule 6a-2 and

64. See proposed Rule 800(b)(1).

65. See proposed Rule 800(a)(4).

66. See proposed Rule 800(a)(3).

67. See proposed Rule 800(a)(6).

68. See proposed Rule 800(b)(2)(i).

69. See proposed Rule 800(b)(2)(ii).

70. See proposed Rules 800(b)(2)(iii)-(v) and (c)(ii).

71. See proposed Rule 800(c)(i).

72. See proposed Rule 800(d)(i)-(iii).

73. Because new Form 2 would serve as the form for both initial registration of associations and for all amendments, the SEC proposes to repeal current Forms X-15AJ-1 and X-15AJ-2. .

revised Form 1, and proposed Rule 15Aa-2 and new Form 2, on behalf of any facility that is a separate legal entity or any regulatory subsidiary of the exchange or association with respect to the filing of specified Exhibits.[74]

The Commission's proposals would require the disclosure of more information about exchanges and associations than previously required, particularly with respect to their governance and organizational structure, their regulatory programs, and significant ownership of the exchange or association or facility of the exchange or association. Under the Commission's proposals, certain Exhibits to the current Form 1 (exchanges) would be revised to require more detailed disclosures; comparable disclosures would be required pursuant to Form 2 (associations). These revised Exhibits would pertain to information about (1) the officers of the exchanges and associations (Exhibit D); (2) a description of the structure, composition and responsibilities of any executive board and each committee (Exhibit E); (3) financial information, including an itemization of revenues and expenses (Exhibit I); (4) the ownership interest of any exchange, association, or facility of an exchange or association, and information on persons owning more than 5% of such ownership interest (Exhibit Q); and (5) information about securities listed or traded on the SRO or on any SRO trading facility (Exhibit T).

In addition, the Commission is proposing to add several new Exhibits to current Form 1 and to incorporate those Exhibits in new Form 2. These Exhibits would pertain to: (1) the composition, structure and responsibilities of the board (Exhibit C); (2) the governance guidelines, code of conduct and ethics (and waivers thereof) (Exhibit F); (3) the method established by the exchange or association for interested parties to communicate their concerns regarding any matter within the authority or jurisdiction of a Standing Committee directly to independent directors (Exhibit C); (4) the organizational structure of the exchange or association (Exhibit G); (5) the regulatory program of the exchange or association (Exhibit H); (6) the relationship between and among the exchange (or association), any facility of an exchange (or association), and any affiliate of the exchange (or association) or facility of the exchange (or association) (Exhibit P); and (7) the location of the exchange's or association's books and records (Exhibit U).[75]

One of the most significant proposed features is the requirement that exchanges and associations provide more in-depth disclosures about their regulatory programs. Exchanges and associations would need to provide a description of their regulatory programs (and those of any regulatory subsidiary). The description would include information concerning member firm regulation, market surveillance, enforcement, listing qualifications, arbitrations, rulemaking and interpretation, and the process for the assessment and development of regulatory policy. Exchanges and associations would be required to provide a copy of any delegation plan or other contract or agreement relating to regulatory services that are provided or will be provided to the exchange or association by another SRO, a regulatory subsidiary, or a regulatory subsidiary of another SRO.

Further, revised Form 1 and new Form 2 would require the exchange and association to provide a description of the structural or functional independence of the regulatory program from the market operations and other commercial interests of the exchange or association, and to discuss fully any significant regulatory issues that have arisen or any significant events that have taken place in the past year and the effect of these significant issues or events may have on the mission, strategy and future operations of the exchange or association's regulatory program.[76]

In addition, the proposals would require exchanges and associations to disclose their regulatory expenses as a proportion of their total budget, and separately as a proportion of their total annual revenues. Pursuant to this provision, exchanges and associations would be required to disclose the aggregate amounts that they expend on regulatory activities, as well as the amounts that they expend on certain subcategories of regulatory activities, including supervisory activities (e.g., routine examinations and oversight of member activity conducted in the regular course of business), surveillance activities (e.g., manual and automated surveillance to ensure compliance with rules, such as trading rules and financial responsibility rules), and disciplinary activities (e.g., enforcement activities). Revised Form 1

74. The proposed Exhibits to revised Form 1 and new Form 2 for which an exchange or association would need to include information with respect to a facility or regulatory subsidiary are Exhibits A (governance documents and rules), B (written rulings, interpretations), C (composition, structure and responsibilities of the board), D (list of officers), E (information about executive board and committees), F (governance guidelines, code of conduct and ethics, and waivers thereof), G (internal organization charts), H (regulatory program), and I (financial information).

75. The SEC proposes to change Rule 17a-1 to require national securities exchanges, national securities associations, registered clearing agencies and the Municipal Securities Rulemaking Board to keep in the United States at least one copy of all documents required to be kept by Section 17(a) of the Exchange Act and Rule 17a-1 thereunder.

76. See proposed Exhibit H to revised Form 1 and new Form 2.

and Form 2 also would require exchanges and associations to disclose the dollar amount of their revenues and expenses of their regulatory programs, with detailed itemization within the following broad categories: revenues, direct expenses; and allocated expenses. Exchanges and associations would provide this information for each area of their regulatory programs, such as surveillance, supervision and discipline, and provide aggregate data for all program areas.[77]

Further, the proposals would require exchanges and associations to amend Form 1 and Form 2 closer in time to the occurrence of an event that requires amendment.[78] The Commission also is proposing to require that each exchange and association prepare annually an updated Form 1 and Form 2, as applicable,[79] and continuously post its most recent form and any subsequent amendments on a publicly accessible Internet website controlled by the exchange or association.[80] The proposed amendments would give exchanges and associations the option of complying with the annual filing requirements for specified Exhibits by posting the required information on an Internet website and certifying that the posted information is accurate.[81]

D. Periodic Reporting Obligations of Exchanges and Associations: Proposed Rule 17a-26

The SEC believes that its ability to identify system-wide issues at SROs, given the periodic nature of SEC inspections of SROs, could be enhanced by its receiving regulatory program information from the SROs on a regular basis. Accordingly, the Commission proposes to adopt new Rule 17a-26 under the Exchange Act to establish a system of quarterly and annual reporting by national securities exchanges and registered securities associations with respect to key aspects of their regulatory programs. The reports would be submitted electronically. Proposed Rule 17a-26 would require exchanges and associations to establish procedures for the preparation of the required reports in a uniform, readily accessible, and usable electronic format.[82]

The quarterly reports would include information with respect to an exchange or association's surveillance program; complaints received; investigations, examinations and enforcement cases; and listing programs; as well as copies of final agenda from any board or board committee meeting that took place during the quarter.[83] The annual report would contain: (1) an aggregated year-end cumulative summary of specified categories of information regarding the SRO's regulatory program in the quarterly reports;[84] (2) additional updated information on all items that are required to be part of the annual report, including a discussion of regulatory program procedures, the effectiveness of the regulatory program, internal controls addressing conflicts of interest, employment arrangements with senior regulatory personnel, efforts to comply with undertakings made to the Commission, and copies of the proposed Standing Committee self-evaluations and the annual governance performance evaluation prepared by the Governance Committee;[85] and (3) the annual report of an independent third party designed to assess whether the operations of any electronic SRO trading facility of the exchange or association (if any) comply with the rules governing such facility.[86] Finally, exchanges and associations would be required to file a supplement under certain circumstances in order to provide information concerning material changes or material events that affect the SRO's regulatory program.[87]

All quarterly and annual reports filed with the SEC pursuant to proposed Rule 17a-26 would be required to be accompanied by a signed certification executed on behalf of the exchange or association by the CEO or an equivalent officer, representing that the information is current, true and complete.[88] An exchange or association may request confidential treatment of any report provided to the SEC pursuant to proposed Rule 17a-26.[89] The SEC would be permitted to grant time extensions and exemptions from the rule's requirements under appropriate circumstances.[90]

The first quarterly report would be due for the first full quarterly reporting period commencing six months after publication of the final rules in the Federal Register.[91]

IV. SRO Concept Release: Alternative Regulatory Approaches

In light of the concerns about the existing self-regulatory structure discussed above, the

77. See proposed Exhibit 1 to revised Form 1 and new Form 2.
78. See proposed Rules 6a-2(a) and 15Aa-2(a).
79. See proposed Rules 6a-2(b) and 15Aa-2(b).
80. See proposed Rules 6a-2(c) and 15Aa-2(c).
81. See proposed Rules 6a-2(d) and 15Aa-2(d).
82. See proposed Rule 17a-26(b)(1)(ii).
83. See proposed Rules 17a-26(b)(2)(i)-(viii).
84. See proposed Rule 17a-26(b)(3).
85. See proposed Rule 17a-26(b)(3)(i)-(vi).
86. See proposed Rule 17a-26(a)(2).
87. See proposed Rule 17a-26(d)(1).
88. See proposed Rule 17a-26(c).
89. See proposed Rule 17a-26(e).
90. See proposed Rule 17a-26(g) and (h).
91. See proposed Rule 17a-26(f).

SEC is evaluating, and seeking comment on, the advantages and disadvantages of a variety of possible alternatives to self-regulation as it is structured today. The SEC queries whether the SRO Governance and Transparency Rulemaking will adequately address the most pressing issues with self-regulation or whether additional, and perhaps, more radical steps may be necessary. Indeed, the SEC's potential alternatives range from merely enhancing intermarket surveillance to eliminating self-regulation entirely in favor of direct SEC regulation. The SEC, however, does not consider its list of potential alternatives to be exhaustive and requests comment on any other alternatives that may better address concerns about self-regulation.

A. Proposed Enhancements to the Current SRO System

Given that the current SRO system has provided essential regulation of markets and members for over seven decades, the SEC suggests that one approach would be to merely improve the identified limitations of self-regulation, specifically SRO governance and intermarket surveillance. The SRO Governance and Transparency Rulemaking would address many of the regulatory conflicts. To complement this effort, the SEC could also enhance the SEC and SRO's ability to regulate intermarket trading activity. Full implementation of a more robust intermarket order audit trail for both the options and equity markets could enhance surveillance of intermarket order flow. These incremental improvements, however, would fail to address other inherent SRO limitations, such as the inefficiencies of multiple SROs.

B. Independent Regulatory and Market Corporate Subsidiaries

Another approach would be to increase SRO regulatory independence through mandated SRO internal restructuring. One such option would be to require that all SROs create independent subsidiaries for regulatory and market operations, as the NASD did. Under this model, regulatory staff of each SRO would be placed within an independent regulatory subsidiary, which would report directly to the corporate parent's board. By providing a clearer organizational separation than most SROs currently exhibit, this model would help strengthen an independent attitude in the regulatory subsidiary, which could address conflicts with members, market operations, issuers and shareholders.

This incremental change, however, would not alleviate all SRO limitations. The independent regulatory subsidiary would still be a component of a larger competitive enterprise and subject to business pressure on some level. With respect to regulatory funding, the influence of major members, issuers and shareholders and increased intermarket competitive pressure could still have a detrimental impact on the regulatory budgeting process. Also, with this proposal, unequal funding and regulation across markets, conflicting and redundant SRO activities and intermarket surveillance issues would persist. This approach also could reduce market specific knowledge on the part of the regulatory staff by removing it on a corporate level from market operations.

C. Hybrid Model

Another option, which would require significant system restructuring, would be the SEC's designation of a market neutral single self-regulatory organization ("Single Member SRO") to regulate all SRO members with respect to membership rules, including rules governing members' financial condition, margin practice, handling of customer accounts, registered representative registration, branch office supervision and sales practices. The Single Member SRO would be solely responsible for promulgating membership rules, inspecting members for compliance with "member" rules, and taking enforcement action against those members that fail to comply. Each SRO that operates a market ("Market SRO") would be solely responsible for its own market operations and market regulation.

This Hybrid model could improve upon the current system in a variety of respects. For instance, because the Single Member SRO would not be affiliated with a particular market, inherent conflicts that exist between the regulatory function and market operation of an SRO would be reduced. It would also eliminate duplicative regulation with respect to membership rules. This approach could result in beneficial synergies through the centralization of membership regulation, while maintaining the value of having market regulatory staff embedded within the Market SROs. The Single Member SRO would also potentially

serve as a more effective liaison with the SEC, Congress, and international entities on behalf of the industry because it would be a single, market neutral voice. Depending on the extent to which the Single Member SRO was delegated responsibility under this approach for intermarket surveillance, cross-market surveillance could be simplified and enhanced.

Yet, this model has it limitations. This approach could reduce self-regulatory knowledge of business practices by removing the Single Member SRO from market operations. In addition, this model would raise a "boundary issue" between member and market rules, in that every SRO rule would have to be characterized as either a "member" or "market" rule. While this Single Member SRO approach could reduce certain conflicts, it would not resolve the conflicts arising from member funding, and control, and from reliance on industry members for business experience. Furthermore, funding issues could arise. Either the Single Member SRO would be required to depend solely on regulatory fees for funding or the Market SROs would have to contribute to the Single Member SRO from listing, market data and market operation revenues. Finally, the present concerns regarding conflicts of interest and the inefficiencies of multiple SROs would persist in Market SROs.

D. Competing Hybrid Model

Another approach involving a significant departure from the current system would be a derivative of the Hybrid approach. 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, however, this approach would permit the existence of multiple competing member SROs ("Competing Member SROs"), which would be required to be registered with the SEC and, thereby, authorized to provide member regulatory services. Under this approach, each Market SRO member would also have to be a member of one of the Competing Member SROs.

This model has many of the same benefits as the pure Hybrid Model, with two particular differences: (1) it would not require the elimination of one of the existing primary member regulators in favor of another; and (2) it may foster competitive discipline by allowing Competing Member SROs to compete with each other and, thereby discourage them from becoming unresponsive to the industry.

This model, however, has significant drawbacks. In addition to the disadvantages discussed with regard to the Hybrid approach, competition could result in an effort by the Competing Member SROs to reduce their fees to attract and keep members and the Commission would ultimately continue to be responsible for determining whether funding remained adequate. Also, this model would only eliminate conflicting rules if the Competing Member SROs adopted a uniform set of member rules.

E. Universal Industry Self-Regulator

Another model, which would require significant restructuring, would be the establishment of a universal industry self-regulator ("Universal Industry Self-Regulator"). Under this model, the current SROs' self-regulatory authority for all market and member rules would be transferred to one industry SRO, the Universal Industry Self-Regulator. Under this approach, all member firms would be registered directly with the Universal Industry Self-Regulator and all markets would be ATS-like non-SROs registered with the Universal Industry Self-Regulator. This approach likely would require legislation or significant restructuring of the current SROs.

This model could resolve weaknesses of prior alternatives in a variety of ways. For instance, it would erase the "boundary" issues associated with the Hybrid models; it would establish a level playing field among competing markets in that they would all be subject to the same uniform standards of a single SRO; it would eliminate conflicts with market operations, issuers, and shareholders as well as regulatory redundancies; it would address the inefficiencies of multiple SROs; and it would facilitate the development of a consolidated order audit trail for intermarket trading.

As with other models discussed, this approach has limitations. The regulator would lack market-specific expertise. The possibility for the regulator to become unresponsive to industry developments would greatly increase because of its size, scope, and lack of competition. Finally, implementing this model would effectively result in the elimination of the existing SROs' role and, thus, could be met with significant resistance.

F. Universal Non-Industry Regulator

Another approach, which would also require significant industry reshaping, would be the establishment of a universal, independent non-industry regulator ("Universal Non-Industry Regulator"). Under this approach, one non-industry entity that is independent, non-profit and non-governmental, would be designated to be responsible for all markets and member regulation for all members and all markets.

While not exactly analogous, this model could resemble the regulatory regime recently adopted for audits of public companies. Specifically, the Public Company Accounting Oversight Board ("PCAOB") was established as an independent, non-profit corporation, to oversee the audits of public companies that are subject to the securities laws, and related matters, in light of significant failings in the self-regulatory oversight of the accounting profession. The board of the Universal Non-Industry Regulator would consist of full-time members appointed by the Commission, and would be tasked with overseeing all member and market rules for all members and all markets. The SEC would have ongoing oversight responsibility for supervising the universal regulator, including appointing and removing members, approving its budget, and approving its rules.

This model would have several advantages over other approaches. For instance, this approach would substantially eliminate conflicts with members, market operations, issuers and shareholder, eliminate "boundary" concerns, reduce redundancies and other issues associated with multiple SROs, and facilitate cross market surveillance.

This model also has serious drawbacks. For example, it could result in a lower degree of market specific expertise in the regulator and more limited direct industry involvement. It could be inefficient, inflexible, and unresponsive to evolutionary market practices. Finally, this model would likely require legislation and could be met with resistance from the existing SROs, whose SRO role would be largely eliminated.

G. SEC Regulation

Another alternative would be the termination of the SRO system in favor of direct Commission regulation of the industry. Under this approach, the SEC would be solely responsible for the market and member regulation of all members and all markets. The SEC would assume the current responsibilities of the SROs, including the promulgation of detailed member and market rules, the surveillance of members and markets, and the enforcement of member and market rules.

Benefits could be gained from this approach. Direct SEC regulation would eliminate substantially all of the conflicts that exist between SRO regulation and members, market operations, issuers, and shareholders. The inefficiencies of multiple regulators would be eliminated. Cross market surveillance would likely be facilitated by this approach because the relevant regulatory data would be collected and examined by the Commission, rather than by disparate SROs. In addition, this model could potentially align the U.S. regulatory scheme more closely with those of a variety of other countries.

An SEC-only approach, however, would also have numerous problems. Indeed, the Commission attempted to undertake direct SRO level regulatory duties in the past and found the program to be a failure. The SEC would be responsible for detailed regulation and interpretation of complex areas previously the province of SROs, without the aid of direct industry involvement. Direct Commission regulation would be governed by the limitations and rules addressing federal rulemaking and would be undertaken in a political environment. Finally, the cost of carrying out all of the duties of the SROs would be potentially prohibitive.

If you would like a copy of the SRO Governance and Transparency Rulemaking or the SRO Concept Release, or if you require further assistance, please contact:

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