

proposed changes to NSCC's rules facilitate the prompt and accurate clearance and settlement of securities transactions and are therefore consistent with the requirements of the Act and the rules and regulations thereunder.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NSCC does not believe the proposed rule change will impose a burden on competition.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

NSCC has not solicited nor received written comments on the proposed rule change. NSCC has worked closely with the industry to enhance the availability of mutual fund services to a wider range of mutual fund industry participants. NSCC will notify the Commission of any written comments it receives.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing rule change has become effective pursuant to section 19(b)(3)(A)(iii) of the Act⁵ and Rule 19b-4(f)(4)⁶ promulgated thereunder because the proposal effects a change in an existing service of NSCC that (i) does not adversely affect the safeguarding of securities or funds in the custody or control of NSCC or for which it is responsible and (ii) does not significantly affect the respective rights or obligations of NSCC or persons using the service. At any time within sixty days of the filing of the proposed rule change, the Commission could have summarily abrogated such rule change if it appeared to the Commission that such action was necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549-0609. Comments may also be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No.

SR-NSCC-2003-16. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street NW., Washington, DC 20549. Copies of such filing will also be available for inspection and copying at the principal office of NSCC and on NSCC's Web site at <http://www.nsc.com/legal/>. All submissions should refer to the File No. SR-NSCC-2003-16 and should be submitted by January 14, 2004.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.⁷

Margaret H. McFarland,
Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-48946; File No. SR-NYSE-2003-34]

Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Approving Proposed Rule Change Relating to the Amendment and Restatement of the Constitution of the Exchange To Reform the Governance and Management Architecture of the Exchange

December 17, 2003.

I. Introduction

On November 7, 2003, the New York Stock Exchange, Inc. ("NYSE" or "Exchange") filed with the Securities and Exchange Commission ("Commission" or "SEC"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to amend and restate the Exchange's Constitution to reform the

governance and management architecture of the Exchange. The proposed rule change was published for public comment in the **Federal Register** on November 13, 2003.³ In addition to the proposed amendments to the NYSE Constitution, which are the subject of this Order, the Notice of the proposed rule change included as exhibits the texts of the Proxy Statement sent to NYSE members detailing the proposed changes to the Constitution and a letter, dated November 4, 2003, from the Exchange's Interim Chairman and CEO to NYSE members supplementing the Proxy Statement (the "Supplemental Letter").⁴ On November 19, 2003, the Exchange filed Amendment No. 1 to the proposed rule change.⁵ The Commission received 18 comment letters regarding the proposed rule change.⁶ This Order approves the Exchange's rule change as proposed.

II. Description of the Proposed Rule Change

The NYSE proposes to amend and restate its Constitution to significantly change and enhance its governance

³ Securities Exchange Act Release No. 48764 (November 7, 2003), 68 FR 64380 ("Notice").

⁴ In the Supplemental Letter, the NYSE's Interim Chairman and CEO indicated, among other things, his intention to bring before the NYSE Board several further amendments to the Constitution to further clarify and underscore the separation and independence of the regulatory function from the Exchange's marketplace function and from inappropriate influence by members and member organizations. The Commission notes that on November 24, 2003, the reconstituted Board voted to approve these amendments, as well as several others, to the NYSE Constitution. See Special Membership Bulletin regarding Additional Amendments to the Constitution, dated November 26, 2003. See also Letter from Darla C. Stuckey, Corporate Secretary, NYSE, to Annette L. Nazareth, Director, Division of Market Regulation ("Division"), Commission, dated December 4, 2003 ("Additional Amendments Letter"). The NYSE intends to file a proposed rule change with the Commission pursuant to section 19(b)(1) of the Act to incorporate these additional Constitutional changes. See *infra* notes 14, 22, 23, 35, 36, 39, 40, and 88.

⁵ See Letter from Darla C. Stuckey, Corporate Secretary, NYSE, to Nancy J. Sanow, Assistant Director, Division, Commission, dated November 19, 2003. In Amendment No. 1, the Exchange advised that the proposed rule change was approved by unanimous written consent of the Exchange's Board of Directors effective November 13, 2003, and by vote of the members of the Exchange on November 18, 2003. The Exchange noted that, as a result, its internal procedures with respect to the proposed rule change were complete. Amendment No. 1 is simply a technical amendment and thus it is not necessary for the Commission to seek public comment on it.

⁶ A list of commenters on the rule proposal, whose comments were received as of December 12, 2003, is attached as Exhibit A to this Order. The public file for the NYSE's proposal, which includes all comment letters received on the proposal, is located at the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549-0102.

⁵ 15 U.S.C. 78s(b)(3)(A)(iii).

⁶ 17 CFR 240.19b-4(f)(4).

⁷ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

structure. In short, the Exchange proposes to restructure its governance architecture so that it will have a Board of Directors ("Board") that is independent of members, member organizations, and listed issuers, and whose membership includes only one officer of the Exchange. The Exchange also proposes to create a Board of Executives that is representative of securities firms, listed issuers, and institutional investors. In addition, the NYSE proposes that its regulatory unit report directly to a fully independent committee of the Board, and not to NYSE management. The Exchange represents that the proposed rule change would guarantee the independence of its regulatory function both from members and member organizations and from inappropriate linkage with its marketplace function, yet would retain sufficient proximity to the marketplace to assure the market sensitivity that, in the Exchange's view, is fundamental to effective regulation.

A description of the most significant changes to the NYSE Constitution follows.

A. Board of Directors

The NYSE proposes to reduce the size of its Board, which previously had 24 members plus as many as three members of NYSE management, to between 6 and 12 members, plus the Chairman of the Board and the Chief Executive Officer (if different than the Chairman). The Board would be required to meet not less than four times per year, and directors would serve one-year terms.⁷

Board members (excluding the Chief Executive Officer) would be required to be independent of the management of the Exchange, the membership of the Exchange, and issuers of securities listed on the Exchange. Among other things, no director (other than the Chief Executive Officer) could be a member of the NYSE; an officer or employee of the NYSE; a person employed by or affiliated, directly or indirectly, with a member organization of the NYSE or with a broker or dealer that engages in a business involving substantial direct contact with securities customers; or an executive officer of a listed issuer. In addition, no director (excluding the Chief Executive Officer) would qualify as independent unless the Board affirmatively determined that the director had no material relationship with the Exchange. The Board would be required to adopt specific standards relating to such determination,

comparable to standards required of issuers listed on the Exchange.⁸

The selection process for Board members would be designed to enable the Exchange to comply with the "fair representation" requirements of section 6(b)(3) of the Act.⁹ Under the proposed amendments to the Constitution, the Nominating & Governance Committee (which, under the proposal, would be composed solely of independent directors) ultimately would be responsible for recommending to the Board candidates for Board membership. The amendments further would require, however, that the "Industry Members" of the Board of Executives, described below, recommend candidates constituting twenty percent of the number of directors to be elected by members of the Exchange, but in no event fewer than two directors.¹⁰

If a single individual serves as both the Chairman and Chief Executive Officer ("CEO"), the Board would be required to designate a director as a "lead director" to preside over executive sessions of the Board. The CEO would not be permitted to participate in executive sessions. The Board would be required to publicly disclose the lead director's name and the means by which interested parties could communicate with the lead director.¹¹

The Board would be required to compile and distribute an annual nominating report listing the nominees for positions to be elected by the members. The Board would also be required to appoint the members of the Board of Executives.¹²

B. Board of Executives

Pursuant to the proposed Constitutional amendments, the Board would be required to establish a Board

of Executives which, subject to the Board's ultimate authority, review, and oversight (and except with respect to the responsibilities delegated to the Standing Committees, discussed below), would advise the CEO in his or her management of the operations of the Exchange.¹³ The Board of Executives would consist of the Chairman of Board, who would be the Chairman of the Board of Executives; the CEO (if different than the Chairman); and at least 20 but no more than 25 additional members, who would serve for one-year terms. The Board of Executives would be required to meet not less than six times per year.

The members of the Board of Executives would be required to include at least six individuals who are either the chief executive or a principal executive officer of a member organization that engages in a business with direct contact with securities customers; at least two individuals who are either the chief executive or a principal executive officer of a specialist member organization; and at least two floor representatives other than specialists. The members of the Board of Executives from these categories would be known collectively as the "Industry Members" of the Board of Executives. The Board of Executives also would be required to include at least two lessor members who are not affiliated with a broker or dealer in securities; at least four individuals who are either the chief executive or a principal executive officer of an institution that is a significant investor in equity securities, at least one of whom is a fiduciary of a public pension fund; and at least four individuals who are either the chief executive or principal executive officer of a listed company.¹⁴

If the Board were to increase the size of the Board of Executives, it must strive to maintain approximately the same balance between Industry Members and other members of the Board of Executives as set forth above. If the Board were to increase the size of the Board of Executives, it would also be free to add members to the Board of

⁸ The Board would be required to adopt these standards by effecting a rule change within the meaning of section 19(b)(1) of the Act. The Commission recently approved revisions to the Exchange's corporate governance standards for its listed issuers that, among other things, set forth criteria for determining whether a director is "independent." See Securities Exchange Act Release No. 48745 (November 4, 2003), 68 FR 64154 (November 12, 2003) ("NYSE/Nasdaq Corporate Governance Listing Standards Approval Order").

⁹ 15 U.S.C. 78f(b)(3). Section 6(b)(3) of the Act requires the rules of a national securities exchange to provide for the fair representation of its members in the selection of directors and the administration of its affairs, and 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. See *infra* notes 15-21 and accompanying text for a discussion of fair representation.

¹⁰ See *infra* note 17 and accompanying text.

¹¹ NYSE Constitution, Article IV, Section 2.

¹² NYSE Constitution, Article IV, Section 1.

¹³ NYSE Constitution, Article V, Section 1.

¹⁴ *Id.* The Commission notes that the reconstituted NYSE Board recently voted to further amend the provisions of the NYSE Constitution relating to the composition of the Board of Executives to: (1) Add a representative of individual investors who are retail clients of member organizations; and (2) remove the requirement that specialist representatives be chief executive or principal executive officers of specialist firms, but require that each such representative be registered as a specialist and spend substantial time on the floor of the Exchange. See Additional Amendments Letter, *supra* note 4.

⁷ NYSE Constitution, Article IV, Section 2.

Executives who represent other elements of the Exchange community.

C. Fair Representation Requirements

As a registered national securities exchange, the NYSE must adhere to section 6(b)(3) of the Act,¹⁵ which requires the NYSE to assure a fair representation of its members in the selection of its directors and the administration of its affairs, and provide that one or more directors be representative of issuers and investors.¹⁶ In order to satisfy this fair representation obligation, the NYSE proposes to provide in its amended Constitution that the Industry Members of the Board of Executives would recommend to the Board candidates constituting 20% of the directors to be elected by the members of the Exchange, but in no event fewer than two directors.¹⁷ The Constitution would state that the Industry Members are required to propose persons who, in their opinion, are committed to serving the interests of the public and strengthening the Exchange as a public market, and will allow the Exchange to meet the fair representation requirements set forth in the Act.¹⁸

The Constitution would provide that the directors elected by Exchange members must include directors who will enable the Exchange to comply with the requirements of section 6(b)(3) of the Act.¹⁹ To this end, the proposed amendments also would require the Nominating & Governance Committee, in meeting its responsibilities to recommend candidates for Board membership, to propose candidates who are, in its opinion, committed to serving the interests of the public and strengthening the NYSE as a public securities market, at least one of whom is intended to allow the Exchange to meet the requirements of section 6(b)(3) of the Act concerning issuers and at least one of whom is intended to allow the Exchange to meet the requirements of section 6(b)(3) of the Act concerning investors.²⁰

The NYSE also proposes an amendment to permit members of the Exchange to propose, by petition, nominees for positions that are to be filled at the elections prescribed in the Exchange's Constitution.²¹ Specifically, any such nominee would be required to be endorsed by not less than forty members. No member would be permitted to endorse more than one nominee. However, not less than one hundred members would be permitted to propose, by petition, an entire ticket or any portion of a ticket. If the Board finds that an individual proposed by petition is eligible for election, then the individual would be deemed a nominee for the relevant office or position.

D. Committees

1. Committees Consisting Solely of Directors

The proposed amendments to the NYSE Constitution would provide for the appointment of two types of Standing Committees of the Exchange: (a) Standing Committees composed entirely of directors other than the CEO; and (b) Standing Committees that are joint committees composed of both directors other than the CEO and members of the Board of Executives. The Board would appoint the Standing Committees and their respective chairpersons at its annual organizational meeting, and the Board would be required to adopt a charter for each Standing Committee consistent with the duties of that committee as prescribed in the NYSE Constitution.²²

The amendments would provide for the appointment of four Standing Committees that would consist solely of directors other than the CEO and would report to the Board: (a) The Nominating & Governance Committee; (b) the Human Resources & Compensation Committee; (c) the Audit Committee; and (d) the Regulatory Oversight & Regulatory Budget Committee. Each of these Standing Committees could be combined with any other Standing Committee in this group, or be

subdivided into one or more Standing Committees.²³

The Nominating & Governance Committee would be responsible for: (a) Recommending to the Board candidates for Board membership; (b) recommending to the Board candidates for membership on the Board of Executives; (c) conducting the Board's annual governance review; (d) reviewing and recommending the Exchange's corporate governance guidelines; (e) establishing an appropriate process for, and overseeing the implementation of, the Board's self-assessments (including Board self-assessment, committee self-assessments and director assessments) and the Board of Executives' self-assessments; (f) recommending director compensation; and (g) succession planning for the Chairman and the CEO.

In addition to the criteria that the Nominating & Governance Committee would be required to follow in recommending candidates for the Board, discussed above,²⁴ the Committee also would be required to establish procedures to solicit the input of investors in equity securities and members of the Exchange regarding Board candidates.

The Nominating & Governance Committee also would be required to solicit input from the various Exchange communities regarding candidates for appointment by the Board to the Board of Executives. Consensus recommendations for candidates for the Board of Executives representing specialists, floor representatives, and lessor members²⁵ that are put forward by the respective representatives of these groups would be required to be forwarded to the Board as the recommendations of the Nominating & Governance Committee, unless and to the extent the committee determines that a candidate does not qualify for the position.

The Human Resources & Compensation Committee would be responsible for: (a) Reviewing and approving corporate goals and objectives relevant to the compensation

¹⁵ 15 U.S.C. 78f(b)(3).

¹⁶ See *supra* note 9.

¹⁷ NYSE Constitution, Article IV, Section 2. The Exchange has confirmed that the slate of candidates approved by the Board would constitute a full slate of candidates and 20% of that slate (but in no event fewer than two candidates) would be candidates proposed by the Industry Members. Telephone conversation between James F. Duffy, Senior Vice President and Associate General Counsel, NYSE, and Nancy J. Sanow, Assistant Director, Division, Commission, on December 10, 2003.

¹⁸ NYSE Constitution, Article V, Section 1.

¹⁹ NYSE Constitution, Article IV, Section 2.

²⁰ NYSE Constitution, Article IV, Section 12. The Nominating & Governance Committee also would be required to establish procedures to solicit the input of investors in equity securities and members

of the Exchange regarding Board candidates. See *infra* at note 24 and accompanying text.

²¹ NYSE Constitution, Article III, Section 1.

²² NYSE Constitution, Article IV, Section 12. The Commission notes that the reconstituted NYSE Board recently voted to further amend the Constitution to grant Standing Committees the authority to engage independent legal counsel and other advisors, but the committees may not use counsel or advisors who advise Exchange officers or employees. See Additional Amendments Letter, *supra* note . The Exchange confirms that the reconstituted Board also has the authority to engage independent legal counsel and other advisors. Telephone conversation between Darla C. Stuckey, Corporate Secretary, NYSE, and Nancy J. Sanow, Assistant Director, Division, Commission, on December 15, 2003.

²³ The Board could also constitute itself as a committee of the whole in respect of a Standing Committee consisting solely of directors. However, if the Board does so with respect to the activities of the four Standing Committees enumerated above, the CEO would be recused from such Board deliberations. The Commission notes that the reconstituted NYSE Board recently voted to further amend the Constitution to provide that the CEO would be recused from deliberations of the Board with respect to the four Standing Committees whether it is acting as the Board or as a committee of the whole. See Additional Amendments Letter, *supra* note 4.

²⁴ See *supra* note and accompanying text.

²⁵ See *supra* Section II.B.

of the CEO, evaluating the CEO's performance in light of these goals and objectives, and, together with the other directors elected by the members, determining and approving such compensation; (b) reviewing and approving recommendations regarding compensation and personnel actions involving senior Exchange personnel, including recommendations received from the Regulatory Oversight & Regulatory Budget Committee regarding senior regulatory personnel; and (c) reporting annually to the members of the Exchange and the public on the compensation of the five most highly compensated officers of the Exchange, as well as director compensation, and on the compensation philosophy and methodology used to award the compensation, including information relating to appropriate comparisons, benchmarks, performance measures and evaluation processes consistent with the mission of the Exchange.

The Audit Committee would be responsible for assisting the Board in its oversight of the integrity of the Exchange's financial statements, the Exchange's compliance with legal and regulatory requirements, and the independent auditor's qualifications and independence. The Audit Committee would have direct responsibility for: (a) The hiring, firing and compensation of the independent auditor; (b) overseeing the independent auditor's engagement; (c) meeting regularly in executive session with the auditor; (d) reviewing the auditor's reports with respect to the Exchange's internal controls; (e) pre-approving all audit and non-audit services performed by the auditor; and (f) determining the budget and staffing for the Internal Audit Unit. The amended Constitution would state that the Audit Committee charter must contain additional duties and responsibilities comparable to those required of issuers listed on the Exchange.²⁶

The Regulatory Oversight & Regulatory Budget Committee would be responsible for: (a) Assuring the effectiveness, vigor and professionalism of the Exchange's regulatory program; (b) determining the budget for the Exchange's Regulatory Group, Listings and Compliance Unit, Hearing Board, Arbitration Unit, and Regulatory Quality Review Unit; and (c) oversight of the Exchange's Regulation, Enforcement & Listing Standards Committee and Regulatory Quality Review Unit. The Regulatory Oversight & Regulatory Budget Committee also would determine annually the Exchange's

regulatory plan, budget, and staffing proposals, and would be responsible for assessing the Exchange's regulatory performance and recommending compensation and personnel actions involving senior regulatory personnel to the Board's Human Resources & Compensation Committee for action.

2. Joint Committees

The amended Constitution would provide for a Regulation, Enforcement & Listing Standards Committee, which would be a Joint Committee composed of both directors (other than the CEO) and members of the Board of Executives, including at least one Industry Member, as selected by the Board. A majority of the members of the committee voting on a matter subject to its vote, however, would be required to be Board directors.²⁷

The Regulation, Enforcement & Listing Standards Committee would report to the Regulatory Oversight & Regulatory Budget Committee, and would: (a) review and provide general advice with respect to the Exchange's programs for market surveillance, member and member organization regulation and enforcement, and the listing and de-listing of securities; and (b) hear appeals of disciplinary determinations and determinations to de-list a listed company.²⁸

Under the proposed changes to the Constitution, the Board could appoint additional Joint Committees from time to time, provided that each Joint Committee would consist of at least one director other than the CEO.²⁹

3. Committees With Directors From the Board and the Board of Executives

The Proxy Statement noted that the Market Structure & Strategy, Quality of Markets/Public Policy and Finance Committees would be comprised of members of both the Board of Directors and Board of Executives, but there must be at least one independent director on such committees and all such committees would report to the Board.³⁰

E. Special Committees, Advisory Committees, and Other Bodies

The amended Constitution would provide for the appointment of special committees, subcommittees, advisory committees, boards, or councils from time to time in the Board's discretion, and could be comprised of individuals who are not Board directors or members of the Board of Executives.³¹

²⁷ NYSE Constitution, Article IV, section 12(b)(1).

²⁸ *Id.*

²⁹ NYSE Constitution, Article IV, section 12(b)(2).

³⁰ See Proxy Statement.

³¹ NYSE Constitution, Article IV, section 13.

F. Officers

The officers of the Exchange would include the Chairman of the Board; the CEO; the President, if there be one; the Chief Regulatory Officer; one or more Vice Presidents; a Secretary; a Treasurer; a Controller; and such other officers as the CEO may propose, subject to the approval of the Board.³² The proposed amendments would permit any of these offices to be occupied by more than one individual.

The Board would appoint the Chairman, the CEO, and the Chief Regulatory Officer. If the Chairman is neither the CEO nor chosen from among the directors elected by the members, he or she must satisfy the independence criteria set forth in Article IV, Section 2 of the Constitution. The CEO would be authorized to appoint the President and the other officers of the Exchange, subject to the approval of the Board.³³

No officer of the Exchange would have any authority to recommend candidates for the Board or for appointment by the Board to any committee. However, the Board or the Nominating & Governance Committee would be permitted to solicit the input of any Exchange officer at its own initiative and discretion.

G. The Chairman

The Chairman of the Board would preside at all meetings of the Board and the Board of Executives. If the Chairman is also the CEO, however, he or she would not participate in executive sessions of the Board. The Chairman would also be required to make an Annual Report on the Exchange's activities to a Plenary Session.³⁴

H. The CEO

The CEO, subject to the authority of the Board, would be responsible for the management and administration of the affairs of the Exchange.³⁵

³² NYSE Constitution, Article VI, section 1. The amendments would remove the positions of Executive Vice Chairman and Vice Chairmen and add the positions of CEO and Chief Regulatory Officer to the list of the Exchange's officers.

³³ *Id.*

³⁴ NYSE Constitution, Article VI, section 2. The Board and Board of Executives must meet jointly in a Plenary Session at least twice a year. The Chairman would chair all Plenary Sessions. NYSE Constitution Article V, section 11.

³⁵ NYSE Constitution, Article VI, section 3. As noted above, the CEO would not appoint the Chief Regulatory Officer, and could not participate in executive sessions of the Board. In addition, as described in the Additional Amendments Letter, the reconstituted NYSE Board voted to further amend the Constitution, subject to Commission approval, to clarify that the CEO's responsibilities are subject to the specific provisions in the Constitution regarding the segregation of the

I. The Chief Regulatory Officer

The Chief Regulatory Officer would be responsible for the management and administration of the regulatory functions of the Exchange. The Chief Regulatory Officer would be subject to the authority of the Board and the Regulatory Oversight & Regulatory Budget Committee, and to the administrative standards and policies established by the CEO made applicable to the Chief Regulatory Officer by the Regulatory Oversight & Regulatory Budget Committee.³⁶

J. Other Officers

The President and other officers would have such functions and responsibilities as the CEO assigns, subject to the approval of the Board, and, in the case of senior regulatory personnel, subject to the specific oversight and control of the Regulatory Oversight & Regulatory Budget Committee.³⁷

K. Delegation Authority

The amended NYSE Constitution would provide that the Board may delegate such of its powers as it may determine to the Board of Executives, to such officers of and employees of the Exchange, and to such committees, composed either of directors or otherwise, as the Board may authorize.³⁸ Notwithstanding the foregoing, however, the Board would not be permitted to delegate, and no committee would be permitted to re-delegate, to the Board of Executives or to any committee not consisting solely of directors, authority to adopt rules under Section 1 of Article VIII (dealing with rulemaking), or Section 1 of Article IX (dealing with disciplinary rules). Moreover, the Board would not be permitted to delegate, and no committee would be permitted to re-delegate, to the Board of Executives or to any committee not consisting solely of directors, authority to act on any subject matter described in the Constitutional

regulatory functions of the Exchange. See Additional Amendments Letter, *supra* note 4.

³⁶ NYSE Constitution, Article VI, section 4(a). As described in the Additional Amendments Letter, the reconstituted NYSE Board voted to further amend the Constitution to clarify that the President could not appoint any regulatory officers. See Additional Amendments Letter, *supra* note 4.

³⁷ NYSE Constitution, Article VI, section 4(b).

³⁸ NYSE Constitution, Article IV, section 14. The amended Constitution would also provide that any committee of directors to which authority is delegated to adopt rules under Article VIII, section 1 (dealing with the operation and administration of the Exchange) and Article IX, section 1 (dealing with the discipline of members, member organizations and others) must include at least one director nominated by the Industry Members of the Board of Executives.

provisions concerning the responsibilities of the Nominating & Governance Committee; the Human Resources & Compensation Committee; the Audit Committee; the Regulatory Oversight & Budget Committee; and the Regulation, Enforcement & Listing Standards Committee.³⁹ Any exception to these delegation provisions would require a rule change filed with the Commission within the meaning of section 19(b)(1) of the Act.⁴⁰

The proposed amendments also would provide that the Board could continue to exercise any and all powers that it has delegated notwithstanding such delegation, and that the Board could exercise such review and oversight over the exercise of (or omission to exercise) any delegated authority as it might at any time determine.⁴¹

L. Amendments to the Constitution

Under the proposed amendments, the Board would be permitted to amend or repeal specified provisions of the Constitution, or adopt new provisions, by the affirmative vote of a majority of the entire Board in favor of the amendment or repeal, or by the members of the Exchange who are entitled to vote thereon.⁴² The specified provisions include Articles of the Constitution relating to: the Board of Directors (excluding the provision relating to the limitation on the delegation of authority); the Board of Executives (excluding that provision which requires the Board of Executives to be a reasonably balanced representation of Exchange communities); the officers of the Exchange; and the indemnification of

³⁹ The Commission notes that the reconstituted NYSE Board recently voted to amend this proposed provision to allow the Board to delegate rulemaking authority on the subjects normally confined to the Board or Standing Committees consisting solely of directors to an Exchange officer in between Board meetings, as necessary, subject to informing the Board at its next meeting and, in the case of regulatory matters, subject to the approval of the Chief Regulatory Officer. See Additional Amendments Letter, *supra* note 4.

⁴⁰ NYSE Constitution, Article IV, section 14. The Commission notes that the reconstituted Board recently voted to further amend the Constitution to add officers and employees of the Exchange to the provision prohibiting the Board to delegate, and a committee to redelegate, authority to adopt rules under Article VIII, section 1 or Article IX, section 1 of the Constitution, or to act on any subject matter described in Article IV, section 12(a) or (b)(1), except by effecting a proposed rule change within the meaning of section 19(b) of the Act. See Additional Amendments Letter, *supra* note 4.

⁴¹ NYSE Constitution, Article IV, section 14(b).

⁴² NYSE Constitution, Article XIV, section 1. The Commission notes that any further changes to the NYSE Constitution would be required to be filed with the Commission pursuant to section 19(b) of the Act.

Exchange directors, officers or employees. The remaining provisions of the Constitution may be amended or repealed, and new provisions may be adopted, only by the members of the Exchange who are entitled to vote thereon.

However, no Constitutional amendment approved by the majority of the entire Board would be permitted to take effect without the vote of members until the expiration of two weeks from the date the proposed Constitutional amendment was first furnished to members.⁴³

M. Transition

The proposed amendments also would add a new Article XVI to the Constitution, to provide for a "Transition Period" that commences on the date that the amended and restated Constitution is approved by members and ending on the date of the next annual meeting of the Exchange and that is intended to allow for continuity of the Exchange's governance during the interim period.⁴⁴ Upon expiration of the Transition Period, Article XVI would have no further force and effect. Article XVI further would note that the extraordinary circumstances under which the restated and amended Constitution was proposed and the initial Board of Directors was constituted caused the Exchange to dispense with certain requirements, including: (a) Use of the Nominating Committee to nominate directors; (b) the opportunity for members to petition to nominate additional director candidates; and (c) approval of the proposed amendments by the Board in accordance with the prescribed time frames. The amended Constitution would state that all such requirements are waived and the actions taken in contravention of all such requirements are ratified.⁴⁵

N. Other Governance Changes Proposed by the NYSE

The NYSE has directly implemented other governance changes that are in

⁴³ The NYSE also proposes that the Board may make such changes to a proposed amendment approved by the affirmative vote of a majority of the entire Board as it may deem necessary or appropriate to carry out the intention of such proposed amendment without the need for a further waiting period. As noted above, changes to the NYSE Constitution would be required to be filed with the Commission pursuant to section 19(b) of the Act.

⁴⁴ The amended and restated Constitution was approved by NYSE members on November 18, 2003. See Amendment No. 1, *supra* note 5.

⁴⁵ The Commission notes that the revisions to the NYSE Constitution set forth in the proposed rule change are effective upon Commission approval of the proposed rule change.

addition to the revisions to the NYSE Constitution approved in this Order. Those other changes include, among other things, commitments to increase the transparency of the Board and Board Committees by requiring the disclosure of Committee charters and bases for certain Board and Committee action; to provide a means by which members and investors may communicate with the NYSE's non-management directors; and to provide annual reports regarding certain activities of the Board and several key committees, including an annual report detailing the charitable activities of or on behalf of the Exchange.

III. Summary of Comments on NYSE Proposal

The Commission received a total of 18 comment letters on the NYSE proposal.⁴⁶ A number of commenters broadly supported the NYSE's proposed governance changes, at least to the extent that the changes are considered a positive initial step toward reform.⁴⁷ Many of the commenters, however, stated that the proposals did not go far enough. For example, they expressed concerns about the adequacy and effectiveness of the NYSE's revisions to its governance, particularly with respect to the composition of the Board of Directors, the establishment of the Board of Executives, and the structure of the regulatory function.⁴⁸ Several commenters also urged the Commission not to approve the proposal until the NYSE had made further changes to it,

⁴⁶ Exhibit A to this Order contains a list of comment letters received by the Commission on the NYSE proposal as of December 12, 2003, including the citations to the comment letters referenced in this Order. The public file for the proposed rule change includes a letter to Chairman Donaldson from NYSE Interim Chairman & CEO John S. Reed regarding the NYSE proposal. The Reed Letter stated that the SRO model can properly fit within the governance structure of the Exchange and pointed to five design elements that support this view. For example, the Reed Letter pointed to a pure "outside" "independent" Board as a core requirement, and a special Oversight Committee of the Board with its specific functions and a charter that will be made public, as design elements. The Reed Letter also pointed out that the fact that the Exchange hosts the trading environment for members but does not directly participate in members' results helps create a distance between business issues and management. Another design element noted in the Reed Letter is that the success of the Exchange requires a tough but fair regulatory regime that is publicly visible. The Reed Letter noted the existence of "tight" SEC oversight as the final design element. The Second Reed Letter, *infra* Section IV, is also contained in the public file for the proposed rule change.

⁴⁷ See Saul Letter, ICI Letter, First CII Letter, and SIA Letter.

⁴⁸ See Saul Letter, Peake Letter, CalPERS Letter, CALSTRS Letter, ICI Letter, First CII Letter, PIABA Letter, SIA Letter, State Treasurers' Letter, Knotter Letter, and Ohio Retirement Systems Letter.

arguing that the proposal did not go far enough to restore investor confidence.⁴⁹ The commenters generally addressed issues falling into one or more of the categories discussed below.

A. The Board of Directors

A number of commenters criticized the proposed composition of the Board of Directors for failing to include investor representatives on the Board.⁵⁰ Two commenters referred to investors as being the "ultimate constituency" of the Exchange and consequently there should be several investor representatives on the Board.⁵¹ Another commenter advocated that the Board should have "significant representation" from the public institutional investor community, and yet another commenter stated that approximately one-third of Board seats should be reserved for investor representatives.⁵² In contrast, one commenter criticized the proposed Board composition for excluding industry representatives from serving as directors.⁵³ This commenter argued that industry professionals bring valuable experience and insight to the Board in addressing regulatory and other issues, particularly in hectic times.

Four commenters questioned the independence of the directors.⁵⁴ In particular, these commenters suggested that director independence is compromised by the fact that directors are elected by the Exchange members or by their ties to corporate America. One commenter proposed having the Commission and the North American Securities Administrators Association each annually appoint individuals having a background in securities regulation to one seat on the Board in order to ensure some independent and qualified representation.⁵⁵

Several commenters questioned the ability of the reconstituted Board to operate effectively.⁵⁶ One of these commenters raised concerns regarding the directors' availability (noting in particular one candidate who serves on eight Boards for listed companies in addition to other long term commitments, and two other candidates who live in the United Kingdom). This

⁴⁹ See CalPERS Letter, CALSTRS Letter, and ICI Letter.

⁵⁰ See CalPERS Letter, CALSTRS Letter, ICI Letter, PIABA Letter, State Treasurers' Letter, and Ohio Retirement Systems Letter.

⁵¹ See ICI Letter and State Treasurers' Letter.

⁵² See CALSTRS Letter and CalPERS Letter, respectively.

⁵³ See Saul Letter.

⁵⁴ See Anderson Letter, CALSTRS Letter, PIABA Letter, Knotter Letter and Second CII Letter.

⁵⁵ See PIABA Letter.

⁵⁶ See Saul Letter, Peake Letter, and PIABA Letter.

commenter expressed doubts that the Board would be able to handle the responsibilities of regular Board meetings, meetings with the Board of Executives, and overseeing and serving on the various key standing committees.⁵⁷ Another commenter questioned the ability of a small body of public directors, meeting only four times a year, to function without help from securities professionals.⁵⁸ One commenter also expressed concern about the proposed directors' lack of securities industry experience, as well as their ties to corporate America and/or the financial services industry.⁵⁹

B. Board of Executives

Several commenters disputed the efficacy of having the proposed Board of Executives. One commenter argued that the creation of a Board of Executives is an inadequate substitute for direct industry participation in exchange governance.⁶⁰ Two commenters characterized the existence of the Board of Executives, in addition to the Board of Directors, as an unnecessarily complex structure, having no advantages over the traditional Board structure with independent key committees, and as setting a poor example for listed companies.⁶¹ One of the commenters also expressed a concern that the dual Board structure would obfuscate rather than enhance accountability.⁶²

Another commenter criticized the composition of the Board of Executives for not having adequate "buy-side" representation, arguing that the Board of Executives as proposed would be composed primarily of "sell-side" representation.⁶³ This commenter advocated increasing the number of members representing individual and institutional investors.

C. Regulatory Function

A majority of commenters called for greater independence of the regulatory function from the business operation of the NYSE.⁶⁴ Most of these commenters advocated a complete separation of the regulatory function from the Exchange.⁶⁵ Several commenters

⁵⁷ See Peake Letter.

⁵⁸ See Saul Letter.

⁵⁹ See PIABA Letter.

⁶⁰ See Saul Letter.

⁶¹ See CalPERS Letter and CALSTRS Letter.

⁶² See CALSTRS Letter.

⁶³ See ICI Letter.

⁶⁴ See Peake Letter, CalPERS Letter, Merrill Letter, CALSTRS Letter, First CII Letter, SIA Letter, State Treasurers' Letter, Second CII Letter, Ohio Retirement Systems Letter, and Sonoma Letter.

⁶⁵ See Peake Letter, CalPERS Letter, Merrill Letter, First CII Letter, SIA Letter, Second CII Letter,

suggested that the Commission consider alternative regulatory models, including merging the Exchange's regulatory function with that of the NASDR, adopting a "hybrid SRO," or having the Commission take a more direct regulatory role.⁶⁶

Several commenters questioned the effectiveness of the regulatory oversight of a Board whose members are directly elected by the persons they are regulating.⁶⁷ One commenter proposed that a nomination model similar to that in place for the Public Company Accounting Oversight Board be adopted for nominating the directors charged with overseeing the regulatory arm of the Exchange, with the SEC having sole responsibility of appointing the directors of the oversight bodies.⁶⁸

In contrast, another commenter argued that member participation in regulation was necessary, and that a Board of Directors consisting solely of public directors would find itself "severely handicapped" in dealing with regulatory issues, despite the presence of an advisory Board of Executives.⁶⁹ This commenter also expressed concern that the proposal represents a major change in regulation and that it was proposed without a full discussion of the consequences. This commenter argued that one of the possible consequences of excluding member representatives from the Board is that Exchange members might turn away from the Exchange and the auction system, resulting in internalized order flow and a fragmented market. This commenter also stated that member participation makes regulation more "palatable" and generates awareness of regulatory issues.

D. Committee Structure

One commenter expressed concern that, with respect to the Market Structure Committee, a mixed committee of members of the Board of Directors and the Board of Executives, the proposal did not explicitly require a majority of directors to be members of this committee.⁷⁰ This commenter criticized this omission, stating that the most crucial part of the regulatory structure is market structure, particularly in light of recent controversies. This commenter also criticized the fact that the Nominating &

Ohio Retirement Systems Letter, and Sonoma Letter.

⁶⁶ See Peake Letter, Second CII Letter, SIA Letter, and Sonoma Letter.

⁶⁷ See Anderson Letter, CALSTRS Letter, PIABA Letter, and Knottner Letter.

⁶⁸ See Second CII Letter.

⁶⁹ See Saul Letter.

⁷⁰ See Peake Letter.

Governance Committee is composed solely of existing directors, and has no outside members, and argued that this creates a self-perpetuating Board.

E. Chairman and CEO

Two commenters expressed concern that allowing the CEO and Chairman to be the same person would result in a concentration of too much power, particularly in light of the fact that, under this proposal, the Chairman also would act as the sole liaison between the Board of Directors and the Board of Executives.⁷¹ Another commenter also urged separation of the Chairman and CEO functions to enhance the independence of the Board of Directors.⁷²

F. Transparency

Several commenters proposed that the Exchange take additional steps to improve its transparency,⁷³ advocating that the Exchange should set the "gold standard" for disclosure.⁷⁴ One commenter stated that the Exchange should be under the same disclosure requirements as listed companies.⁷⁵ In addition, this commenter asserted that the Exchange should disclose all ties between Board members, that the Exchange should be banned from making any charitable or political contributions, and that the Exchange should post all documents relating to Board and committee reports and compensation disclosures on its Web site.⁷⁶ Another commenter proposed that all key Exchange committees be required to publish annual reports on how they functioned and executed their duties.⁷⁷

In addition, a few commenters urged that final details on the compensation package of the Exchange's former Chairman be made public.⁷⁸

IV. NYSE's Response to the Comment Letters

The Exchange, through its Interim Chairman and CEO, submitted a letter dated December 11, 2003, which responds to issues raised by the commenters.⁷⁹ The Exchange noted that the proposed rule change was "intended to solve an immediate board-level governance problem faced by the

Exchange" and was "not intended to address all structural issues that the Exchange, and indeed our industry, now face."

The Exchange took issue with the view of several commenters that the Board should include one or more individuals to represent the interest of the public investor. The Exchange stated that "the single most important feature of the proposed rule change is that, with the exception of the CEO, the [Board] is completely independent." In that regard, the Exchange noted that "[a]s the Exchange's fiduciaries, our directors will not have the agenda of a customer, an owner or user, and will not represent any single constituent group." Therefore, the Exchange concluded that "it would be inappropriate to seek to specifically include [Board] members that are representative of the buy-side or of any particular constituent group."

The Exchange acknowledged that individual investors are the Exchange's "ultimate constituency." However, the Exchange stated that "individual investors trading on the Exchange through broker-dealers in small volumes have interests that conflict with other individual investors who participate in the market through public or private funds trading in larger volumes." Thus, the Exchange stated that the "hard-won lesson is that the only way to sort out these issues without bias or conflicts is through an independent board whose primary goal is to 'do the right thing' for the individual investor as such."

Finally, in response to commenters who believed that there should be an individual investor representative on the Board of Executives, the Exchange noted that it intends to amend its Constitution to provide for an individual investor representative on the Board of Executives.

In response to comments regarding regulation and the merits of separating the regulatory and market functions of the Exchange, the NYSE reiterated its position as set forth in the proposed rule change that the filing "does not ask the Commission to approve either the continuation of self-regulation in the United States or at the Exchange." The Exchange noted that "[i]f the Commission decides that broker-dealers should continue to regulate themselves through national securities exchanges, [the] Exchange's new governance architecture provides the best model for resolving and managing conflicts of interest inherent in self-regulation while maintaining the marketplace proximity requisite for optimizing regulatory intervention in delicate market mechanisms." The Exchange added that it expects to implement its model

⁷¹ See CalPERS Letter and CALSTRS Letter.

⁷² See Ohio Retirement Systems Letter.

⁷³ See CALSTRS, First CII Letter, State Treasurers' Letter, and Second CII Letter.

⁷⁴ See CALSTRS and Second CII Letter.

⁷⁵ See First CII Letter.

⁷⁶ See also Second CII Letter.

⁷⁷ See CALSTRS Letter.

⁷⁸ See CALSTRS Letter and State Treasurers' Letter.

⁷⁹ See Second Reed Letter.

through an independent Board and through a division of regulatory and marketplace functions within the Exchange, including by having a Chief Regulatory Officer reporting directly to the Board of Directors.

In conclusion, the Exchange noted that its proposal seeks to address a "very immediate board-level governance problem" and urged that "the Commission approve the proposed rule change as soon as possible so that the Exchange can continue to function effectively as a marketplace while revitalizing its regulatory function and addressing other important issues from a much improved governance platform."

V. Discussion

The Commission has considered the Exchange's proposed rule change and finds that, in the context in which they were submitted, the proposed amendments to the NYSE Constitution are consistent with the Act and the rules and regulations promulgated thereunder that are applicable to a national securities exchange and, in particular, with the requirements of section 6(b) of the Act.⁸⁰ Specifically, the Commission finds that, in this context, the amended and restated Constitution is consistent with section 6(b)(1) of the Act⁸¹ which requires that the exchange be "so organized and [have] the capacity to carry out the purposes of [the Act]" and to "enforce compliance by its members and persons associated with its members with the provisions of [the Act]." The Commission also finds that, in this context, the amended and restated Constitution is consistent with section 6(b)(3) of the Act,⁸² which requires that the rules of a national securities exchange assure the 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. In addition, the Commission finds that, in this context, the amended and restated Constitution is consistent with section 6(b)(5) of the Act⁸³ in that it is designed, among other things, to facilitate transactions in securities; to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to remove impediments to and perfect the

mechanism of a free and open market and a national market system; and in general, to protect investors and the public interest, and does not permit unfair discrimination among issuers. Further, the Commission finds that, in this context, the amended and restated Constitution is consistent with section 6(b)(7) of the Act,⁸⁴ which, among other things, requires that the rules of a national securities exchange provide a fair procedure for the disciplining of members and persons associated with members.

Recent events at the Exchange have called into question whether its Board of Directors and key Board committees have been sufficiently independent from NYSE management to assure that these governing bodies exercise their judgment in an objective and autonomous manner. The Exchange quickly confronted its governance issues by appointing an Interim Chairman, without any ties to the Exchange, and by proposing amendments to its Constitution that would significantly alter its governance structure. Moreover, the Exchange has proposed changes to its Constitution that are designed to assure the independence of its regulatory unit from NYSE management and from the entities that it regulates. At the same time, the NYSE has created a mechanism of nomination to the Board of Directors designed to fulfill the "fair representation" requirements applicable to national securities exchanges, as set forth in section 6(b)(3) of the Act.⁸⁵

The Commission discusses below significant aspects of the amendments to the NYSE Constitution.

A. Board of Directors

The amended Constitution provides for a smaller board, composed of independent directors (other than the CEO). Board members (excluding the CEO) must be independent from the management of the Exchange, from the members of the Exchange, and from the issuers listed on the Exchange. In addition, the Exchange must make an affirmative determination of a director's independence. The NYSE also commits to adopting specific standards requiring that the independence determination be comparable to the standards required of listed issuers. Generally, the Board will supervise the regulatory function; monitor the Exchange's performance; approve the Exchange's strategy; hire, fire and determine the compensation of senior management; create a succession plan; and ensure appropriate behavior

by Exchange employees, officers and directors.

The Commission believes that the proposal to completely replace the previously large, mixed-composition NYSE Board with a smaller board composed of independent directors (other than the CEO) should increase the likelihood that the directors will be free of any relationship that might impair, or appear to impair, the directors' ability to make judgments in the best interest of the Exchange and investors. The changes to the Constitution explicitly prohibit a director from being a member or lessor member, an officer or employee of the Exchange (except for the CEO), a person employed by or affiliated with a member organization or with a broker-dealer that has substantial direct contact with securities customers, or an executive officer of a listed issuer. Not only must the Board make an affirmative determination that the director (other than the CEO) has no material relationship with the Exchange, it also must assess the director's eligibility according to specific standards relating to independence that are comparable to the standards the NYSE now requires of its listed companies.⁸⁶ Indeed, the Commission notes that the NYSE proposal goes one step further than the new requirements for NYSE listed companies because the NYSE will have a board composed of independent directors (except for the CEO), whereas NYSE listed companies must have only a majority of independent directors on their boards.⁸⁷ Several commenters raised doubts about the independence of the NYSE directors because of the ties that directors may have to corporate American and/or the financial industry. Also, a few commenters advocated a greater role by the Commission in appointing NYSE directors in order to further assure the directors' independence. The Commission believes that this "independence" standard for the NYSE Board should benefit the Exchange by assuring that key decisions are made by persons free from material relationships

⁸⁶ See NYSE Constitution Article IV, Section 2, which states that the Exchange "shall adopt specific standards relating to such determination, comparable to the standards required of issuers listed on the Exchange, by effecting a rule change within the meaning of section 19(b)(1) of the Act." 15 U.S.C. 78s(b)(1). See also NYSE/Nasdaq Corporate Governance Listing Standards Approval Order. The Commission expects the NYSE to file shortly after issuance of this Order a proposed rule change pursuant to section 19(b) of the Act that contains independence standards for NYSE directors comparable to those recently adopted for its listed issuers.

⁸⁷ The Commission notes that the NYSE's CEO would be the only director that would not meet the definition of "independence."

⁸⁰ In approving the proposed rule change, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c (f).

⁸¹ 15 U.S.C. 78f(b)(1).

⁸² 15 U.S.C. 78f(b)(3).

⁸³ 15 U.S.C. 78f(b)(5).

⁸⁴ 15 U.S.C. 78f(b)(7).

⁸⁵ 15 U.S.C. 78f(b)(3).

with—and thus from potentially improper influence by—the Exchange or the entities it regulates.

Several commenters expressed concerns about the composition of the Board, including the lack of investor or industry representation, and issues regarding the ability of the directors to operate effectively, given each director's time constraints and the relatively small number of times the Board is required to meet. The Commission believes that, at this point, the NYSE has taken steps designed to assure that the concerns of investors are adequately represented on the NYSE Board. The NYSE has proposed that its new board be independent of specific constituencies, most notably broker-dealer members of the Exchange. In this manner, the NYSE intends the Board to be able to consider the needs of the entire exchange community, including large and small investors, issuers, and securities firms. The Commission notes that the Nominating & Governance Committee will establish procedures to solicit the input of investors regarding Board candidates, and that the committee is explicitly required to nominate a director that represents investors, as discussed in more detail below.

In addition, some commenters expressed concern that permitting the Chairman and CEO to be the same person would result in too great a concentration of power, and some commenters advocated a formal separation of the two positions. The Commission notes that the NYSE has established constraints on the ability of a combined Chairman-CEO to influence decisions that should be made by persons independent of Exchange management. For example, the NYSE's proposal prohibits the CEO from participating in executive sessions of the Board so that, if there is a combined Chairman-CEO, a "lead director" must be designated to preside over executive sessions.⁸⁸ In the Commission's view, these structural changes are designed to help assure the independence of the Board from undue management pressures and, in the context of the amendments to the Constitution before the Commission, should be approved.

B. Board of Executives

The NYSE proposes to create a Board of Executives composed of from 20 to 25

⁸⁸ The Commission notes that, under an amendment to the Constitution recently approved by the reconstituted NYSE Board, the CEO would be recused from deliberations of the Board, whether it is acting as the Board or as a committee of the whole with respect to the activities of the four Standing Committees. See Additional Amendments Letter, *supra* note .

individuals who are drawn from clearly defined segments of the NYSE constituencies, including representatives from the retail broker-dealer, specialist, floor broker, lessor member, institutional investor, and listed company communities. The Board of Executives' main role is to advise the CEO in his or her management of the Exchange's operations. The Industry Members of the Board of Executives, representing member organizations, specialist organizations and floor representatives, are to recommend candidates constituting 20% of the members to be elected, but no fewer than two directors.

A number of commenters questioned the efficacy of the Board of Executives and the composition of the Board of Executives, and several stated that a dual board structure is unnecessarily complex and offers few advantages.

The Commission believes that the NYSE's creation of a Board of Executives, composed of individuals from the various Exchange constituencies, is reasonable in the context of an independent Board of Directors. The Board of Executives provides a useful mechanism designed to assure that various Exchange stakeholders continue to have a voice in the decisions of the Exchange; yet the Board of Directors, the body charged with governance of the Exchange and regulation of its members, is independent. The Commission notes that the concept of self-regulation is based on the principle that regulation is most effective when it is done as close as possible to the regulated activity. That principle becomes strained, however, if those in charge of regulation are dependent or aligned with those engaged in the regulated activity. The NYSE has taken steps to address this concern by providing for a self-regulatory function reporting to an independent Board. The Commission believes that the Board of Executives is designed to strike an appropriate balance by allowing representatives of those groups that have a day-to-day stake in the affairs of the Exchange to continue to have a voice, but not the leading role, in the Exchange's governance.

C. Fair Representation

Section 6(b)(3) of the Act⁸⁹ imposes specific obligations on the NYSE as a registered national securities exchange to ensure that members are fairly represented in the selection of its directors and the administration of its affairs. The Commission believes that,

⁸⁹ 15 U.S.C. 78f(b)(3).

in this context, the NYSE's proposal is consistent with this mandate.

Under the amended Constitution, NYSE members would continue to elect the Board of Directors, other than the Chairman and the CEO. The ability to cast a vote for Board candidates ensures that members are involved in the selection of the NYSE directors, in compliance with section 6(b)(3).⁹⁰ Additionally, the amended Constitution would provide that the Industry Members of the Board of Executives, who represent different segments of the NYSE membership, including member organizations, specialist organizations, and floor representatives, have the right to designate 20% of the nominees elected by members to the Board (and in no event fewer than two directors).⁹¹ Accordingly, NYSE members not only elect all of the members of the Exchange Board, (excluding the Chairman and CEO), but they also have the ability to nominate no less than 20% of them. These nominations must satisfy the independence standards for the Board. In addition, the amended NYSE Constitution maintains a petition process that permits members to put forward nominees for elected positions, so long as the nominee or nominees receive a sufficient number of endorsements.⁹²

Furthermore, Industry Members are assured a role in the administration of the Exchange through their participation on the Board of Executives, which is empowered to advise the CEO in the management of the Exchange's operations. As members of the Board of Executives, Industry Members also will have the opportunity to participate on Joint Committees, including the Regulation, Enforcement & Listing Standards Committee, which is required to have at least one Industry Member. The amended NYSE Constitution also requires the Chairman to call a special meeting of the members upon written request of no less than one hundred members.⁹³

Finally, section 6(b)(3) of the Act requires the NYSE to have rules that ensure that one or more directors represent issuers and investors, and not be associated with a member of the exchange, broker, or dealer. The Commission believes that the NYSE proposal explicitly fulfills this mandate

⁹⁰ 15 U.S.C. 78b(b)(3).

⁹¹ The Commission notes that the amended Constitution also would explicitly require the Industry Members to propose persons who, in their opinion, would allow the Exchange to meet the fair representation requirements set forth under section 6(b)(3).

⁹² NYSE Constitution, Article III, Section 1(c).

⁹³ NYSE Constitution, Article III, Section 4.

by specifying that the directors elected by Exchange members shall include directors who will enable the Exchange to comply with the requirements of section 6(b)(3) of the Act⁹⁴ and also by requiring that the Nominating Committee recommend to the Board one candidate that represents issuers and one candidate that represents investors.⁹⁵

D. Independence of the Regulatory Function

The Act requires registered exchanges to be so organized that they act as self-regulatory organizations in overseeing their markets and the conduct of their affairs. The Commission believes that any proposed revisions to the Exchange's governance must assure that the NYSE's regulatory function is strong, vigorous, and sufficiently independent and insulated from improper influence from management or any regulated entity. In the Commission's view, the proposed amendments to the NYSE's governance and management architecture are designed to advance this goal.

The NYSE has proposed to create a Chief Regulatory Officer who reports directly to the Board's Regulatory Oversight & Regulatory Budget Committee. As noted above, this Committee determines the Exchange's regulatory plan, programs, budget and staffing proposals and, significantly, is composed of independent directors (other than the CEO), *i.e.*, persons certifiably independent of management or any regulated entity. Inappropriate influence by management that might compromise regulatory integrity also is checked by the fact that the Regulatory Oversight & Regulatory Budget Committee recommends compensation and personnel actions involving senior regulatory personnel to the Board's Compensation Committee—another independent Board committee—rather than to the CEO or any other representative of management. In addition, the Chief Regulatory Officer

has no formal reporting relationship with the CEO, except for limited administrative purposes.

Some commenters expressed concern regarding the regulatory function of the NYSE and supported a complete structural separation of the Exchange's regulatory and market functions. As noted above, the exchange self-regulatory structure set forth in the Act is based on the principle that regulation is best informed and most able to reflect ethical standards when that regulation takes place close to the activity to be regulated. Nonetheless, there must be sufficient independence in the regulatory process to prevail against undue interference or influence from the persons or entities being regulated. This independence could be achieved in a variety of ways, including separating entirely the regulatory and market functions of an SRO through, for example, the creation of separate subsidiaries, one of which contains the market function and the other the regulatory function.⁹⁶

The Commission believes that the proposed amendments to the NYSE's governance structure, and in particular the creation of a Chief Regulatory Officer reporting directly to an independent Regulatory Oversight & Regulatory Budget Committee, add a significant degree of independence that should insulate regulatory activity from economic pressures and potential conflicts of interest. The Commission believes that, in this context, the NYSE's proposal is consistent with the statutory requirements. As the Commission continues to review issues relating to self-regulation, it may determine that further separation of the self-regulatory process from market operations would better assure the integrity of the securities markets and the protection of investors.

E. Committees

The proposed amendments to the NYSE Constitution codify the composition and operations of several key committees that have been delegated responsibility over critical Exchange operations. The Commission notes that information about the functions of nearly all NYSE committees was previously not widely available; indeed, only the Nominating Committee had been explicitly mentioned in the NYSE Constitution. The proposed amendments increase the transparency of several key committees and, as a

result, their accountability, to the benefit of the Exchange and the investing public.

The Commission believes that the duties, responsibilities, and guidelines assigned to each Standing Committee should help foster strong and independent committees. For example, the Nominating & Governance Committee is subject to an explicit mandate to propose candidates for the Board who are committed to serving the interests of the public and strengthening the Exchange as a public securities market, and that meet the fair representation requirements of the Act. That Committee also has the obligation to conduct the Board's annual governance review, and establish an appropriate process for Board and Board of Executive self-assessments. In the Commission's view, an annual governance review and self-assessments are promising means of assuring that the NYSE remains vigilant and active in its pursuit of improved governance processes.

Similarly, the Commission believes that the new responsibilities of the Human Resources & Compensation Committee are appropriate. This Committee, and not management, must now set forth explicit corporate goals and objectives related to the compensation of the CEO, and evaluate the CEO's performance in light of these goals. These changes comport with the newly-adopted standards for NYSE listed issuers, which require that compensation matters be considered by a committee of the board composed exclusively of independent directors.⁹⁷ The new provision is in marked contrast to the way the NYSE Human Resources & Compensation Committee previously appeared to operate. In addition, the Commission believes that the requirement that the Committee report annually to members and the public on the compensation of the five most highly compensated officers of the Exchange, as well as on director compensation, should increase the transparency of this Committee's actions.

The Commission believes that the responsibilities assigned to the NYSE's Audit Committee also are appropriate, particularly with respect to the Audit Committee's direct responsibility for assuring that the NYSE retain a suitable independent auditor. The Commission notes that the NYSE has committed that the Audit Committee's charter would contain additional duties and responsibilities comparable to those

⁹⁴ NYSE Constitution, Article IV, Section 2.

⁹⁵ NYSE Constitution, Article IV, Section 12(a)(1). In this regard, the Commission notes that, in the Second Reed Letter, the Exchange disagreed with the suggestion of some commenters that the Board should include specific directors who represent "public investors," the "buy-side" or "any other particular constituent group." For the sake of clarity, the Commission would like to point out that, while the Act does not require the Board to include any directors who represent a discrete group within the universe of investors, in order to give effect to section 6(b)(3) of the Act, at least one director should represent the interests of investors generally, including when those interests may differ from the interests of Exchange members and broker-dealers. A proper reading of the proposed Constitution requires this result.

⁹⁶ For example, NASD, Inc. has one subsidiary, The Nasdaq Stock Market, Inc., to carry out NASD's market function and another subsidiary, NASD Regulation, to carry out the NASD's regulatory function.

⁹⁷ See NYSE/Nasdaq Corporate Governance Listing Standards Approval Order, *supra* note 86.

required of issuers listed on the Exchange.⁹⁸ Thus, the NYSE's own Audit Committee will be held to the same degree of independence and appropriate conduct that the NYSE requires of its listed companies.

The Commission also believes that the responsibilities assigned to the Regulatory Oversight & Regulatory Budget Committee should support and enhance the independence of the NYSE's regulatory regime. As noted above, this Committee is responsible for overseeing the Exchange's regulatory program. It is the Commission's view that this Committee should play a particularly important role in making certain that the Exchange possesses a strong and independent regulatory program.

Finally, the Commission also believes that the composition and operation of the Regulation, Enforcement & Listing Standards Committee which, among other things, is charged with hearing appeals of disciplinary determinations, complies with the Act's requirement to provide for a fair procedure for the disciplining of member and persons associated with members. This Joint Committee will be composed of both directors (other than the CEO) and members of the Board of Executives, including at least one Industry Member; moreover, a majority of the members voting on a matter subject to a vote of this Committee must be directors. Committee action on appeals of disciplinary determinations will require that a majority of members voting on the action must be independent directors, but the Committee must include at least one Industry Member, which means that there will be representation and input by at least one NYSE member.⁹⁹

One commenter expressed concern about the composition of certain NYSE committees, while another commenter called for greater disclosure of information by key committees. In addition, several commenters advocated that the NYSE increase the transparency of its own operations. The Commission believes that the amendments regarding NYSE Committees should improve the governance of the NYSE and the transparency of its processes. The amended Constitution explicitly outlines the responsibilities and duties of several key committees. This increased disclosure of the decision-making processes and the bases for

Committee actions should benefit the Exchange, its constituencies, and investors. The Commission recognizes that for the most part SROs in the past were not required to adhere to high standards of transparency. The Commission plans to continue to work with the NYSE and other SROs to improve their level of transparency.

F. Amendments to the Constitution

The Commission believes that the ability of directors to amend certain specified provisions of the Constitution without member approval should help streamline the Exchange's governance processes. Through this revision, the Board should be able to respond quickly and decisively if a revision to the specified provisions of the Constitution is considered appropriate and the majority of directors votes in favor of such change. The Commission believes that this kind of flexibility for directors is an appropriate tool to address potential governance weaknesses.

VI. Conclusion

In light of the serious governance issues recently confronted by the Exchange and the need for immediate reform measures, the NYSE's proposal is designed to address concerns about the independence of the Board of Directors and to assure the independence of the NYSE's regulatory function from the market function. The Commission believes that the proposed changes to the NYSE Constitution strengthen and improve the Exchange's governance structure. Among other things, under the amended Constitution, the independent Board will be responsible for monitoring the Exchange's governance processes, assessing whether further changes are warranted, and recommending appropriate action.

The Commission believes that the revised NYSE governance structure is one, but not the only, model for SRO governance consistent with the Act that would provide independence between the business side of the Exchange and its regulatory operations. Other self-regulatory structures or allocations of regulatory duties among SROs may offer advantages and disadvantages in terms of expertise, effectiveness, responsiveness, costs and, ultimately, investor protection. In considering the NYSE proposal, some commenters have advocated the complete separation of market and SRO functions. In the Commission's view, the complete structural separation of the NYSE's—or any other SRO's—regulatory function cannot be accomplished by an individual SRO, but would require

Commission or Congressional action on a market-wide basis.

The Commission is considering a regulatory initiative to assess possible steps to strengthen the framework for the governance of SROs. In addition, the Commission will continue to consider ways to improve the transparency of the governance procedures of all SROs. In this context, some of the transparency topics the Commission may examine include increasing the disclosure of information relating to compensation of SRO directors, officers and employees; regulatory performance (e.g., number of enforcement actions); types and amounts of fines levied; financial information and financial results; and the operation of key committees.

Finally, the Commission believes that the NYSE Board should continue to monitor and evaluate the Exchange's governance structure and processes on an ongoing basis, and propose further changes as appropriate, including whether the positions of Chairman and CEO should be separated permanently.

For the foregoing reasons, the Commission finds that the proposed rule change, File No. SR-NYSE-2003-34, is consistent with the Act and rules and regulations thereunder, applicable to a national securities exchange, and in particular with sections 6(b)(1), 6(b)(3), 6(b)(5) and 6(b)(7) of the Act.¹⁰⁰

It is therefore ordered, pursuant to section 19(b)(2) of the Act that the proposed rule change, File No. SR-NYSE-2003-34, be, and hereby is, approved.

By the Commission.

Margaret H. McFarland,
Deputy Secretary.

Exhibit A—List of Comments Letters as of December 12, 2003 NYSE Amended and Restated Constitution and Corporate Governance Proposal (NYSE-2003-34)

1. Letter from Ralph S. Saul to Jonathan G. Katz, Secretary, Commission, dated November 12, 2003 ("Saul Letter").
2. Letter from Junius W. Peake, Monfort Distinguished Professor of Finance, Kenneth W. Monfort College of Business, University of North Colorado, to Jonathan G. Katz, Secretary, Commission, dated November 22, 2003 ("Peake Letter").
3. Letter from Sean Harrigan, President, Board of Administration, California Employees' Retirement System ("CalPERS"), to William H. Donaldson, Chairman, Commission, dated November 6, 2003 ("CalPERS Letter").
4. Letter from Gary Andersen to Commission, dated November 6, 2003 ("Andersen Letter").
5. Letter from Robert G. Merrill to William H. Donaldson, Chairman, Commission, dated November 7, 2003 ("Merrill Letter").

¹⁰⁰ 15 U.S.C. 78f(b)(1), (b)(3), (b)(5), and (b)(7).

⁹⁸ NYSE Constitution, Article IV, Section 12(a)(3).

⁹⁹ The Commission further notes that members of the Board of Executives have been added to the list of persons or entities that can call for a review by the Board of a determination by an Exchange hearing panel regarding a disciplinary proceeding. NYSE Constitution, Article IX, Section 6.

6. Letter from Jack Ehnes, CEO, California State Teachers' Retirement System ("CALSTRS"), to Jonathan G. Katz, Secretary, Commission, dated November 20, 2003 ("CALSTRS Letter").

7. Letter from John Reed, Interim Chairman and CEO, NYSE, to William H. Donaldson, Chairman, Commission, dated November 25, 2003 ("Reed Letter").

8. Letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Commission, dated December 2, 2003 ("ICI Letter").

9. Letter from Sarah A.B. Teslik, Executive Director, Council of Institutional Investors, to William H. Donaldson, Chairman, Commission, dated November 3, 2003 ("First CII Letter").

10. Letter from Charles W. Austin, President, Public Investors Arbitration Bar Association, to Jonathan G. Katz, Secretary, Commission, dated December 2, 2003 ("PIABA Letter").

11. Letter from Marc E. Lackritz, President, Securities Industry Association, to Jonathan G. Katz, Secretary, Commission, dated December 5, 2003 ("SIA Letter").

12. Letter from Alan Hevesi, Comptroller, State of New York; Phil Angelides, Treasurer, State of California; Richard H. Moore, Treasurer, State of North Carolina; Sean Harrigan, President, CalPERS; Jack Ehnes, CEO, CALSTRS; Dale McCormick, Treasurer, State of Maine; Randall Edwards, Treasurer, State of Oregon; Michael Fitzgerald, Treasurer, State of Iowa; Jonathan Miller, Treasurer, State of Kentucky; Denise Nappier, Treasurer, State of Connecticut; and Brian K. Krolicki, Treasurer, State of Nevada; to Chairman Donaldson, Commission, dated November 20, 2003 ("State Treasurers' Letter").

13. Letter from James D. Knotter to William H. Donaldson, Chairman, Commission, dated November 10, 2003 ("Knotter Letter").

14. Letter from Hans R. Reinisch to William H. Donaldson, Chairman, Commission, dated November 11, 2003 ("Reinisch Letter").

15. Letter from Sarah A.B. Teslik, Executive Director, Council of Institutional Investors, to Jonathan G. Katz, Secretary, Commission, dated November 24, 2003 ("Second CII Letter").

16. Letter from John S. Reed, Interim Chairman & CEO, NYSE, to Jonathan G. Katz, Secretary, Commission, dated December 11, 2003 ("Second Reed Letter").

17. Letter from J.P. Allen, Chair, Highway Patrol Retirement System; Robert M. Beck, Chair, Ohio Police and Fire Pension Fund; Charlie Adkins, Chair, Public Employees Retirement System of Ohio; Eugene E. Norris, Chair, State Teachers Retirement System of Ohio; and Barbara J. Miller, Chair, School Employees Retirement System of Ohio, to William H. Donaldson, Chairman, Commission, dated November 24, 2003 ("Ohio Retirement Systems Letter").

18. Letter from John B. Licata, CEO, Sonoma Securities Corporation, to William H. Donaldson, Chairman, Commission, dated November 22, 2003 ("Sonoma Letter").

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-48908; File No. SR-OCC-2003-05]

Self-Regulatory Organizations; the Options Clearing Corporation; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to the Assignment of S&P 100 Index Options

December 11, 2003.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on July 21, 2003, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in items I, II, and III below, which items have been prepared primarily by OCC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The proposed rule change changes the assignment methodology for S&P 100 ("OEX") index options from random to *pro rata*.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, OCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in item IV below. OCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of such statements.²

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

At present, OCC uses a random assignment procedure for most classes of options.³ *Pro rata* assignment was approved by the Commission for flexibly structured foreign currency

options⁴ and at present is used only for those options.

The Chicago Board Options Exchange ("CBOE") has asked OCC to change to a *pro rata* assignment methodology for exercises of OEX options. CBOE believes that assigning OEX option exercises on a *pro rata* basis will permit more effective hedging by market participants. When exercises are assigned on a random basis, a holder of a short position in a series in which less than 100% of the open interest is exercised cannot accurately predict whether and to what extent his position will be assigned even after he knows the percentage of open interest exercised. Under the *pro rata* assignment methodology, OCC assigns exercises in a series of options to each clearing member account in approximately the same proportion that the number of short positions of that series carried in the account bears to the total number of short options of that series. As a result, once the percentage of open interest exercised is known, clearing members and market makers can predict whether and to what extent their positions will be assigned and take appropriate market action if desired.⁵

OCC's procedures for assigning exercise notices are not set out in OCC's rules but are treated as a stated policy, practice, or interpretation with respect to OCC Rule 803, which generally addresses assignments to clearing members.⁶ This proposed rule change will not effect a substantive change in either of the assignment procedures. It would merely change the assignment procedure for OEX exercises from random to *pro rata*.

OCC believes that the proposed rule change is consistent with section 17A of the Act because it promotes the prompt and accurate clearance and settlement of securities transactions and fosters cooperation and coordination with persons engaged in the clearing and settlement of securities transactions.

(B) Self-Regulatory Organization's Statement on Burden on Competition

OCC does not believe that the proposed rule change would impose any burden on competition.

⁴ Securities Exchange Act Release No. 38165 (January 14, 1997), 62 FR 3070 (January 21, 1997) (File No. SR-OCC-96-19).

⁵ OCC assigns exercises directly to clearing members and market makers. Positions carried in combined market maker accounts are carried net and identified by acronyms that make it possible for OCC to assign exercises to short positions of individual market makers on a *pro rata* basis.

⁶ Upon request to OCC, investors may obtain a description of OCC's assignment procedures and the options classes to which they apply.

¹ 15 U.S.C. 78s(b)(1).

² The Commission has modified parts of these statements.

³ This process was discussed in detail in Securities Exchange Act Release No. 46735 (October 28, 2002), 67 FR 67434 (November 5, 2002) (File No. SR-OCC-2002-19).