

Client Alert

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SEC Proposes New Governance Provisions for Self-Regulatory Organizations

The Securities and Exchange Commission ("SEC") has proposed new rules and the amendment of existing rules and forms under the Securities Exchange Act of 1934 (the "Proposal") pertaining to the governance, administration, transparency and ownership of self-regulatory organizations ("SROs") that are national securities exchanges or registered securities associations.¹ The Proposal also would require periodic reporting by these SROs on their regulatory programs and set certain requirements relating to the listing and trading of their own and affiliates' securities.

Under the new governance standards, a majority of the members of an exchange's or securities association's board of directors would have to be independent. Key committees (such as corporate governance, auditing, director nominations and compensation) would have to be comprised solely of independent directors. Under the Proposal, no director would qualify as an independent director unless the board affirmatively determined that the director had no material relationship with the exchange or association. The term "material relationship" would be defined as a relationship, whether compensatory or otherwise, that reasonably could affect the independent judgment or decision-making of the director. The Proposal would require the board to make this independence determination upon the director's nomination and, thereafter, no less frequently than annually and as often as necessary in light of the director's circumstances (e.g., a job change or marriage that would disqualify the director from being considered independent).

The Proposal also would require these SROs to establish policies and procedures to separate their regulatory functions from their market operations and other commercial interests. All money collected by these SROs from regulatory fees, fines or penalties would have to be used exclusively for regulatory purposes.

As to ownership, the Proposal would prohibit any SRO member that is a broker or dealer from owning and voting more than a 20% ownership interest in the exchange or securities association, or any of its facilities, of which it is a member. Each SRO member that is a broker or dealer also would have to file a report with the SEC if it acquired ownership of more than 5% of any interest in the exchange or securities association, or any of its facilities, of which it is a member. In addition, the Proposal would require these SROs to maintain their books and records in the United States.

In order to provide greater transparency as to the governance, ownership structure and regulatory operations of exchanges and securities associations, the Proposal would amend the forms for SRO registration with the SEC to require enhanced reporting and more frequent updates. SROs also would need to post this information on their websites.

The Proposal also would require these exchanges and securities associations to file electronically quarterly and annual reports with the SEC on their regulatory programs. These reports would provide the SEC with better oversight and surveillance capabilities over the SROs' regulatory programs and enhance the Commission's ability to identify issues and trends as they arise.

Another significant aspect of the Proposal pertains to the conflicts which may arise when a national securities exchange or a national securities association list its own securities, the securities of any of its trading facilities, or the securities of any affiliate or any affiliate's trading facility. The Proposal would impose

¹ SEC Release No. 34-50699, November 18, 2004.

obligations to ensure these SROs' ongoing compliance with their own listing standards and to supervise trading in their securities, including by filing with the SEC quarterly and annual reports on their monitoring of the trading of such securities and their ongoing compliance with the applicable listing standards.

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