

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.