March 8, 2005

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street NW
Washington, DC 20549-0609

Re: File Nos. S7-39-04 and File No. S7-40-04

Dear Mr. Katz:

The Council of Institutional Investors, an association of more than 140 corporate, public and union pension funds responsible for more than $3 trillion in pension assets, appreciates the opportunity to comment on the SEC's proposals to amend rules on the governance of self-regulatory organizations (SROs). This letter provides comments on the Commission's rulemaking proposal (File S7-39-04) and concept release (File s7-40-04).

With more than 70 percent of their assets invested in the U.S. stocks and bonds, Council members believe is vitally important for the U.S. capital markets—the model for the rest of the world—to be as fair, competitive, efficient and effective as possible. The Council applauds the efforts of the NYSE, the Nasdaq stock market and other exchanges to ensure they provide high quality and cost effective marketplaces.

The integrity of the U.S. markets is also of paramount importance. As the Commission is aware, the Council has long questioned the propriety of businesses such as the stock exchanges also acting as regulators. These concerns are magnified by the SROs' histories of maintaining stale listing standard requirements and by press reports suggesting that some exchanges have failed in their duty to oversee member firms.

The Council believes these oversight failures provide powerful evidence of the need to reform the SRO models. Regarding the proposed rulemaking release (S7-39-04):

1. The Council supports requiring SRO boards to be composed of a majority of independent directors and audit, compensation, nominating and regulatory committees to be all-independent. The Council also agrees that the definition should apply to relationships between SRO directors and immediate family members and SROs, SRO affiliates, member firms and listed companies.

   However, we encourage the SEC to toughen the definition of independent director to be more in line with definitions used by institutional investors. A copy of the Council's definition is attached as Appendix I. The Council also believes SROs should be banned from making campaign or charitable contributions to entities affiliated with SRO directors or family members, because these contributions may diminish the effectiveness of the government's oversight of the exchanges.

As an added safeguard, the Council requests that the SEC require public disclosure of all links between a director/immediate family member and the SRO, any SRO affiliates, listed companies, member firms and governmental agencies responsible for the oversight of the SRO. Such disclosure would give investors the opportunity to make their own assessments of a director's independence.

2. The "fair representation" requirement is problematic to the Council if an SRO board has regulatory powers. The Council does not believe that broker-dealers and specialists should nominate and select directors responsible for their oversight. The Council agrees that SRO boards should include directors representing issuers and investors. However, we believe such representation should be meaningful, and we question whether the "at least one" standard ensures meaningful representation. The Council also believes the SROs should be required to follow a formal, publicly disclosed process to solicit nominations from the investing public and issuer communities.

3. The Council encourages the SEC to adopt a tougher approach to the independent chair issue by incorporating the Council's policy, which endorses the separation of the chair and CEO roles except in very limited situations. If the roles are combined, the Council's policy calls on boards to provide a written statement discussing why the combined role is in the best interests of shareholders and to name a lead independent director.

4. The Council supports requiring SROs to follow the same disclosure and governance standards required of listed companies; these reforms have long been recommended by the Council. In some cases, the Council believes that SROs should be held to higher standards.

5. The Council believes that in some cases SRO reports regarding SRO regulatory programs should be available to the public. Without such disclosure, it is impossible for investors to assess the performance of SROs and to offer recommendations for change.

6. Regarding separating the commercial and regulatory functions of the SROs, the Council continues to be concerned about structures similar to the one in place at the New York Stock Exchange, where broker dealers and specialists have the authority to select the individuals responsible for their oversight. The Council understands that the NYSE considers its current model to be "transitional," and we urge the NYSE and SEC to press forward with considerations of alternative models. Another concern for the Council is the funding of regulatory operations. We note that the proposed rules would prohibit SROs from using revenues derived from regulatory activities for any purpose other than regulation. This prohibition, however, would not by itself guarantee that sufficient funds would be available to carry out regulatory functions. It is imperative that a mechanism be put in place for independent funding of regulatory programs.

7. Several issues of importance to the Council are not addressed by the proposed rule. First, the Council continues to believe that a 21-day comment period for most SRO releases is inadequate. We urge the SEC to take the necessary steps to ensure that the minimum comment period be extended beyond 21 days to ensure full participation by all interested parties. Second, the Council urges the SEC to clarify that SRO proposals regarding SRO governance or listing standards do not qualify for consideration as non-controversial and immediately effective. The NYSE's attempt in 2004 to circumvent public comment on its proposal to weaken the definition of independent used by listed companies is proof that SROs may abuse their "immediately effective" privileges. Third, we urge the SEC to ensure that all SROs have processes in place to ensure that listing standards are kept up-to-date with the input of investors and listed companies and not shelved for years until the next series of corporate scandals.

The Council is pleased that the concept release recognizes some of the problems with self-regulation and offers some innovative solutions. The Council does not at this time endorse one particular model, though the Council clearly does not favor the status quo, particularly at the NYSE. The Council urges the SEC to continue on the path laid out by the concept paper, with the goal being to eliminate self-regulation by the exchanges. The Commission should set timelines for pursuing reform goals and open the process through public roundtables and other open forums allowing investor participation and public engagement.

The end result must be a regulatory structure that fosters investor confidence, ensures fairness to all market participants and encourages competition to promote efficiency in today's markets and in the future. The system should ensure that all exchanges meet or exceed established standards of investor protection and should prohibit "races to the bottom" by ongoing lowering of regulatory standards and listing requirements. In addition, the system should guarantee that regulatory oversight functions are adequately and securely funded.

Please contact me with any questions.

Sincerely,

Ann Yerger
Executive Director

Appendix I
Independent Director Definition
Council of Institutional Investors

Members of the Council of Institutional Investors believe that the promulgation of a narrowly drawn definition of an independent director (coupled with a policy specifying that at least two-thirds of board members and all members of the audit, compensation and nominating committees should meet this standard) is in the corporation's and all shareholders' ongoing financial interest because:

- independence is critical to a properly functioning board,
- certain clearly definable relationships pose a threat to a director's unqualified independence in a sufficient number of cases that they warrant advance identification,
- the effect of a conflict of interest on an individual director is likely to be almost impossible to detect, either by shareholders or other board members, and,
- while an across-the-board application of any definition to a large number of people will inevitably miscategorize a few of them, this risk is sufficiently small that it is far outweighed by the significant benefits.

Thus, the members of the Council approved the following basic definition of an independent director:

an independent director is someone whose only nontrivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer is his or her directorship.

Stated most simply, an independent director is a person whose directorship constitutes his or her only connection to the corporation.

The members of the Council recognize that independent directors do not invariably share a single set of qualities that are not shared by non-independent directors. Consequently no clear rule can unerringly describe and distinguish independent directors. However, the independence of the director depends on all relationships the director has, including relationships between directors, that may compromise the director’s objectivity and loyalty to shareholders. It is the obligation of the directors to consider all relevant facts and circumstances, to determine whether a director is to be considered independent.

The notes that follow are supplied to give added clarity and guidance in interpreting the specified relationships.

A director will not be considered independent if he or she:

(a) is, or in the past 5 years has been, or whose relative is, or in the past 5 years has been, employed by the corporation or employed by or a director of an affiliate;

An "affiliate" relationship is established if one entity either alone or pursuant to an arrangement with one or more other persons, owns or has the power to vote more than 20 percent of the equity interest in another, unless some other person, either alone or pursuant to an arrangement with one or more other persons, owns or has the power to vote a greater percentage of the equity interest. For these purposes, joint venture partners and general partners meet the definition of an affiliate, and officers and employees of joint venture enterprises and general partners are considered affiliated. A subsidiary is an affiliate if it is at least 20 percent owned by the corporation.

Affiliates include predecessor companies. A "predecessor" is an entity that within the last 5 years was party to a “merger of equals” with the corporation or represented more than 50 percent of the corporation's sales or assets when such predecessor became part of the corporation.

“Relatives” include spouses, parents, children, step-children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, aunts, uncles, nieces, nephews and first cousins, and anyone sharing the director’s home.

(b) is, or in the past 5 years has been, or whose relative is, or in the past 5 years has been, an employee, director or greater- than-20-percent owner of a firm that is one of the corporation's or its affiliate's paid advisers or consultants or that receives revenue of at least $50,000 for being a paid adviser or consultant to an executive officer of the corporation;

NOTES: Advisers or consultants include, but are not limited to, law firms, auditors, accountants, insurance companies and commercial/investment banks. For purposes of this definition, an individual serving “of counsel” to a firm will be considered an employee of that firm.

The term "executive officer" includes the chief executive, operating, financial, legal and accounting officers of a company. This includes the president, treasurer, secretary, controller and any vice-president who is in charge of a principal business unit, division or function (such as sales, administration or finance) or performs a major policymaking function for the corporation.

(c) is, or in the past 5 years has been, or whose relative is, or in the past 5 years has been, employed by or has had a 5 percent or greater ownership interest in a third-party that provides payments to or receives payments from the corporation and either (i) such payments account for 1 percent of the third-party’s or 1 percent of the corporation’s consolidated gross revenues in any single fiscal year, or (ii) if the third-party is a debtor or creditor of the corporation and the amount owed exceeds 1 percent of the corporation’s or third party’s assets. Ownership means beneficial or record ownership, not custodial ownership.

(d) has, or in the past 5 years has had, or whose relative has paid or received more than $50,000 in the past 5 years under, a personal contract with the corporation, an executive officer or any affiliate of the corporation;

NOTES: Council members believe that even small personal contracts, no matter how formulated, can threaten a director's complete independence. This includes any arrangement under which the director borrows or lends money to the corporation at rates better (for the director) than those available to normal customers -- even if no other services from the director are specified in connection with this relationship.

(e) is, or in the past 5 years has been, or whose relative is, or in the past 5 years has been, an employee or director of a foundation, university or other non-profit organization that receives significant grants or endowments from the corporation, one of its affiliates or its executive officers or has been a direct beneficiary of any donations to such an organization;

NOTES: A “significant grant or endowment” is the lesser of $100,000 or 1 percent of total annual donations received by the organization.

(f) is, or in the past 5 years has been, or whose relative is, or in the past 5 years has been, part of an interlocking directorate in which the CEO or other employee of the corporation serves on the board of a third-party entity (for-profit or not-for-profit) employing the director or such relative;

(g) has a relative who is, or in the past 5 years has been, an employee, a director or a 5 percent or greater owner of a third-party entity that is a significant competitor of the corporation
or

(h) is a party to a voting trust, agreement or proxy giving his/her decision making power as a director to management except to the extent there is a fully disclosed and narrow voting arrangement such as those which are customary between venture capitalists and management regarding the venture capitalists' board seats.

The foregoing describes relationships between directors and the corporation. The Council also believes that it is important to discuss relationships between directors on the same board which may threaten either director's independence. A director's objectivity as to the best interests of the shareholders is of utmost importance and connections between directors outside the corporation may threaten such objectivity and promote inappropriate voting blocks. As a result, directors must evaluate all of their relationships with each other to determine whether the director is deemed independent. The board of directors shall investigate and evaluate such relationships using the care, skill, prudence, and diligence that a prudent person acting in a like capacity would use.