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14 March 2005

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W., Stop 6-9
Washington, D.C. 20459

Re: Fair Administration and Governance of Self-Regulatory Organizations; Disclosure and Regulatory Reporting by Self-Regulatory Organizations; Recordkeeping Requirements for Self-Regulatory Organizations; Ownership and Voting Limitations for Members of Self-Regulatory Organizations; Ownership Reporting Requirements for Members of Self-Regulatory Organizations; Listing and Trading of Affiliated Securities by a Self-Regulatory Organization (File No. S7-39-04)

Dear Mr. Katz:

The CFA Centre for Financial Market Integrity (CFA Centre) [1] appreciates the opportunity to comment on the SEC's proposal relating to various aspects and functions of self-regulatory organizations that are national securities exchanges or registered securities associations (collectively referred to as SROs).

Summary Position

We support the efforts of the SEC, through this proposal, to address the current system of governance and reporting by SROs in light of the challenges they face in today's market environment. In particular, market forces and the resulting competition have introduced conflicts that were not contemplated when the SRO system was first established. While we appreciate the objectives and anticipated efficiencies underlying the creation of the SRO system, we also are mindful of the compromises that threaten to undermine its integrity.

Thus, we greatly support and urge the SEC to implement many aspects of this proposal, including, in particular, requirements that

[1] The CFA Centre for Financial Market Integrity is a part of CFA Institute. With headquarters in Charlottesville, VA and regional offices in Hong Kong and London, CFA Institute, formerly, the Association for Investment Management and Research®, is a global, non-profit professional association of more than 71,000 financial analysts, portfolio managers, and other investment professionals in 119 countries and territories of which more than 57,900 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 131 Member Societies and Chapters in 52 countries and territories.

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- A majority of the SRO's board be composed of independent directors;
- Key board committees be solely made up of independent directors;
- Regulatory and market interests be separate, with regulatory fines, fees, and penalties only used to fund SRO regulatory efforts;
- Ownership and voting interests be subject to a 20% limitation;
- The SRO provide the SEC with relevant information on aspects of its operations, including governance and regulatory programs; and
- Any SRO that lists or trades its own security, or that of any trading facility, or of their affiliates be subject to most provisions of proposed Regulation AL.

Discussion

As a general principle, we support self-regulation by market participants in lieu of government-imposed regulation. Thus, it is with an appreciation that we review the role that the various SROs have served throughout the decades in promoting a member-oriented regulatory system for the U.S. domestic markets. In many respects, this system has endeavored to eliminate the need for direct government intervention through voluntary compliance by SRO members.

We strongly believe that maintaining the trust and confidence of the investing public is essential to the efficient and effective functioning of our financial markets. This trust can only be maintained through an SRO system that is credible, strong, and fully transparent. We also believe that changing market conditions, including a highly competitive environment (both domestically and abroad) and demutualization have undermined certain of the safeguards originally observed by SROs. In addition, there are numerous inefficiencies in the current system of SROs that need addressing.

We intend to address these areas in more depth in response to the SEC's Concept Release on self-regulation, including a discussion of whether the current SRO structure should continue. However, for purposes of this letter, we are intending to provide comments in the context of the existing structures and regulatory systems, and in response to the specific issues raised by the SEC in this Release.

I. New Governance Standards

We generally support the range of corporate governance requirements that are being proposed. The focus on independent directors and the separation of SRO functions that fuel conflicts of interest are positive steps to restore an appropriate balance within SROs.

As a general rule, we oppose a system of two-tiered regulation. Absent compelling reasons to the contrary, we believe that regulations should be uniform, uniformly applied, and serve to create a level playing field among market participants. Thus, we appreciate the staff's intent in

this proposal to harmonize requirements being proposed for SROs with those already in place for listed corporate issuers. However, we question in certain instances the types and degree of corporate governance reforms that are being proposed. For example, after a discussion of the severity of conflicts of interest evident in the current SRO system, the Release proposes requirements that fall below those required by the SEC of other industry groups, often accompanied by a discussion of how the SEC wants to afford the SROs maximum flexibility with respect to how to structure their operations.

The Exchange Act requires SROs to have rules in place that protect investors and the public interest and that are designed to perfect the mechanism of a free and open market and national market system. It also recognizes the role that SROs serve as front-line regulators of securities firms.

Given the regulatory issues that have been uncovered involving various aspects of some SROs, we question whether maintaining flexibility should be a primary goal; instead, implementing measures to restore functional integrity to a system that appears to have wandered from its initial intent should be of paramount importance. We urge the SEC to consider whether certain enhancements to current listing standards may be appropriate, given the different nature and role of SROs.

It is against this background that we provide our comments below.

Board of Directors

(a) Independence Requirements

The current SRO structure operates on the principle that SROs will monitor and enforce their members' compliance with SRO rules and regulations. Yet, this system requires the disciplining of the very entities that form the SRO's membership. Particularly as membership numbers dwindle and remaining members wield greater power, the need to discipline those who provide the foundation of the membership and business base poses obvious conflicts and tensions. We therefore strongly endorse the approach taken by the SEC through this proposal to strengthen governance practices by SROs as a way to foster independent decision-making and mitigate potential conflicts of interest.

The maxim that the board of directors serves as a watch dog for investor interests remains relevant in the context of SROs. To be effective, the board must be structured in a way that allows it to address business issues in an environment free from undue influence from management or other interested parties, and to mitigate other potential conflicts of interest. The Release notes that this approach reflects accepted corporate governance best practices, and reflects current company listing standards.

While this is so, we find it noteworthy that when directed to review its own corporate governance standards, the New York Stock Exchange departed from what it required of listed companies in deciding to require of itself an entirely independent board of directors. The Release notes that "SROs, of course, can elect to implement a greater proportion of independent directors" than the simple majority that is being proposed. As we understand it, the set of

reforms proposed through this Release are intended to put in place regulations that are best able to restore the integrity of a system that has suffered for its lack of transparency, clear lines of delineation between business and regulatory functions, and fulfillment of the purposes for which Congress created it. Accordingly, should the SEC determine to require only a majority of independent directors in its final rules, we suggest that is may also want to encourage SROs to adopt the current NYSE approach as a means of taking the extra step in shoring up a system that has suffered from lapses in oversight.

We agree with the proposed definitions of "independence" and "material relationship" and believe that they will help maintain a truly independent board and ensure that it is not controlled by individuals who are subject to potential conflicts of interest. We appreciate the examples that are provided in the Release on how the independence definition would be applied as providing needed clarification in this area.

(b) Selection Requirements

We urge adoption of the proposed requirements that members of the SRO would have to select at least 20% of the total number of directors, and that at least one director would have to be representative of issuers and another of investors. Consistent with our prior positions for corporate issuers, we believe that the role of directors is to act in the best interests of shareowners/investors. It is important for investors to know that at least one member of the board is committed to serve as their representative. However, given the size of the board, one investor representative may be insufficient. We therefore recommend that the final rule either require a certain number of directors that must be investor representatives for certain sizes of boards, or simply set a percentage of directors that must be so dedicated.

(c) Separation of Chairman and CEO Positions

We appreciate aspects of the proposal that would not require the chairman of the board to be independent except where there is a separate CEO. Where the positions are combined, the SRO would have to appoint a lead director who would conduct executive sessions of the board.

As discussed below, we believe that an inherent problem in the current SRO structure is the lack of separation between areas that should be addressing different, and sometimes, conflicting issues. While recognizing that the governance documents of neither the NYSE nor the Boston Stock Exchange require separation of these positions, we also find it significant that both entities currently observe that arrangement. This approach not only represents a corporate governance best practice, but is designed to mitigate the conflicts of interest that arise when one individual is presiding over areas that may present tensions, both commercially and politically, to each other. We encourage wide acceptance of this approach and encourage the SEC to consider separation as another means of addressing relevant conflicts underlying the current SRO system. Where no separation is required, we strongly support a requirement to appoint a lead director.

Standing Committees

Under the proposal, key board committees—including the Nominating, Governance, Compensation, Audit, and Regulatory Oversight Committees—would be composed entirely of independent directors and would report directly to the board. We believe that requiring that these integral committees be free of management's influence provides added safeguards that those directors will be acting in the best interests of members, listed companies, and the investing public, and not in direct response to pressure by the SRO's governing body.

Similarly, we support the proposed requirement that independent directors conduct regular executive sessions without the participation of management and that they be authorized to fund independent legal counsel to help in the fulfillment of their duties. We also support a requirement that the standing committees (other than the Governance Committee) would conduct annual self-assessments as a means of defining areas that were effective or that needed more focus or change. We encourage the final rule to clarify whether the evaluations should assess individual performance of committee members, or address the work of the committee as a whole.

In particular, we applaud the proposed creation of the Regulatory Oversight Committee. Charged with ensuring the effectiveness of the SRO's regulatory program, overseeing its arbitration and disciplinary proceedings, and evaluating applications by affiliated issuers to list securities on it, among other duties, this one entity is imbued with the authority and responsibility for reestablishing the integrity of the SRO regulatory function. We support the requirement that it report to the Chief Regulatory Officer matters relating to the SRO's surveillance, examination and enforcement units, as well as recommend the compensation for the Chief Regulatory Officer and other senior regulatory personnel to the Compensation Committee. We also support the requirement that the Regulatory Oversight Committee would have jurisdiction over other committees, subcommittees or panels that are responsible for conducting hearings, rendering decisions and imposing sanctions relating to disciplinary matters.

We think it is important for the Regulatory Oversight Committee to operate as independently as possible from the Board in making its assessments and overseeing the various aspects of the regulatory process. We also believe it is important for the Committee to make periodic reports to the Board on its activities, especially with respect to any recommended or implemented changes that directly affect the SRO's business operations. We also suggest that the Committee adopt procedures for disclosing and dealing with potential conflicts of interests of any of its committee members stemming from existing or past relationships with the SRO's commercial interests, as well as with SRO members or their affiliates.

We agree with the scope of responsibilities detailed for the Audit Committee under proposed Rule 15Aa-3. However, we encourage adding a requirement that the Audit Committee have someone deemed to be a financial expert. Not only is such a requirement a good idea for a committee charged with assisting the Board "in oversight of the integrity of the association's financial statements" and its "compliance with related legal and regulatory requirements", it is consistent with the rule passed by the SEC just last year relating to the mutual fund industry.

Separation of Marketing and Oversight Functions

One of the most important aspects of this proposal addresses ways to separate an SRO's business functions from its regulatory oversight responsibilities. One of the peculiarities of the SRO system is the dual role that the SRO must assume in regulating the very members that form the basis of its business or of its membership. Commingling both functions raises obvious conflicts of interest. We agree with the discussion in the Release that the increased market competition and the shrinking numbers of SRO members that account for an ever-increasing percentage of the SRO's business raise the risk that important regulatory safeguards will not be as stringent as needed, or consistently applied to all members.

Demutualization of SROs has raised similar concerns. We agree that the creation of a shareholder class that is separate from the membership class interposes issues and end-goals that may be at odds with each other. Thus, we believe that a clear separation of regulatory functions from business operations is one of the pivotal issues in deciding whether the current structure can provide the appropriate degree of regulatory oversight of its members.

We believe that the creation of the proposed independent Regulatory Oversight Committee and a Chief Regulatory Officer who would function independently of commercial influence is an important step in establishing a mechanism for addressing conflicts of interest and reestablishing an independent regulatory system. Given the evidence of recent weaknesses in the SRO system, it is important to remove any direct influence by the SRO business concerns on the SRO's regulatory and enforcement arms, and to establish boundaries that achieve that goal.

The creation of an entirely independent Committee, with an independent Regulatory Oversight Officer that reports to an independent Board, appears to establish the needed mechanisms that will effectively mitigate conflicts of interest. In addition, we believe that requiring the Committee to oversee the preparation of the SRO's annual regulatory report builds in additional accountability. Short of creating a second board for the regulatory arm of an SRO, we believe that this approach is a laudable attempt to impose mechanisms for ensuring an independent regulatory and enforcement system. Any circumvention of these safeguards, however, will seriously threaten the integrity of the system.

Generally, we agree with the accompanying aspects of the proposal dealing with keeping separate the SRO's role as a regulator from its roles as a commercial operator and as a membership organization, including using monies from regulatory fees, fines and penalties to fund regulatory operations and other programs related to its regulatory responsibilities. We believe that prohibiting the use of such monies to pay dividends or to make shareholder distributions, along with the proposed recordkeeping requirements, will establish needed boundaries in this area.

We agree with the proposed rules that would require SROs to safeguard information related to the regulatory process, by prohibiting its dissemination to those persons directly involved in that process. Similarly, we support the protection of information that must be submitted to the SRO to effect transactions. While both of these responsibilities may be implicit under the Exchange Act, we strongly support the SEC's intent to make them explicit through regulations.

Voting and Ownership Limitations

The demutualization of SROs has raised some obvious questions about the conflicts posed by overseeing and regulating members that are also shareholders. Thus, we support in principle proposed requirements that would limit the ability of SRO members that are broker-dealers to own or vote significant interests in the SRO or in any separate facility.

We question the validity, however, of imposing these limitations only on members who are broker-dealers, rather than maintaining the approach staff has taken when approving ownership and voting limitations on a case-by-case basis imposed on *any* person, including SRO members. We question whether a compelling reason exists to restrict application of these limitations only to members that are broker-dealers, rather than applying them to any person.

The Release notes that "there is also a potential for any person that controls an exchange or association or facility of an exchange or association to direct its operation so as to cause the SRO to neglect its regulatory obligations under the Exchange Act." Moreover, the Release also states that "For the time being…the Commission intends to maintain its current policies in this area while it considers whether to adopt ownership and voting restrictions that apply only to members." In light of the need to mitigate conflicts stemming from control positions in an SRO, we suggest that the SEC reconsider the reach of these limitations.

We support the overall requirement that the voting and ownership requirements will apply to all SROs, not just ones that have been demutualized. We agree that while the problem may be more pronounced in settings of demutualization, conflicts of interest exist in other settings. We also agree that the limitations should apply to indirect, as well as direct, ownership interests, and support the approach that is being proposed for defining "beneficial ownership." We think that this not only applies consistency across the securities laws, but recognizes a commonsense approach to addressing the problems at the heart of the matter.

Code of Conduct and Ethics and Governance Guidelines

We heartily endorse the requirement that SROs provide for a code of conduct and ethics for their directors, officers, and employees. We appreciate that the SROs would retain the flexibility to structure this code in accordance with a minimum range of proposed topics, but also agree that the code should at least contain a mandatory provision prohibiting SRO employees or officers from being a member of the board of directors of a listed issuer or of a member firm. Given the role of the SRO and the assets entrusted to it, we strongly believe that SROs must set and enforce high standards of conduct for both its members and its employees, even when not specifically required by law.

We also strongly endorse the proposed governance guidelines that SROs would be required to follow. It is not clear from the Release whether the suggested guidelines regarding "annual performance evaluations of the board" anticipate one review of the board's activities as a whole. If so, we also suggest that directors undertake individual annual self-assessments as an added incentive for evaluating the personal contributions of board members.

II. New Reporting Requirements

We strongly support efforts to ensure that the national securities exchanges and securities associations operate ethically. Thus, we support the underlying principles of proposed Regulation AL to expose and eliminate preferential treatment afforded by the SROs in the listing and trading of affiliated securities. The proposal would require a national securities exchange or registered securities association to gain their Regulatory Oversight Committee's certification that an affiliated security satisfied the respective listing rules before listing that security. After listing, the exchange or association would have to file quarterly reports with the SEC summarizing the issuer's compliance with the listing rules in an attempt to force a more active monitoring of an area that raises potential conflicts of interest. These reports would have to be approved by the Regulatory Oversight Committee before filing and would thus alert the Committee to any areas of concern relating to an affiliated security. We suggest that the final rule provide guidance on the types of information that should be contained in these reports.

We agree that the additional requirements associated with Regulation AL--including the filing of reports prepared by a third-party, the filing of notices and responses relating to non-compliance issues, and continued involvement by the Regulatory Oversight Committee—all serve to fulfill the underlying objectives of Regulation AL. However, it does inject a number of added oversight and administrative responsibilities into the system, including SEC review.

III. Additional Disclosure to the Public

We believe that the proposed amendments to the registration process for SROs will help add a new element of accountability and provide the marketplace with helpful information. In particular, we support the objective of making available the information required by securities exchanges and associations uniform, to allow more comparable review of information by both investors and regulators.

Specifically, we support the approach in the proposed rules that recognize the ultimate accountability of SROs for certain basic self-regulatory duties, even if they delegate them to a separate legal entity or subsidiary. Given the purpose of the SRO system, and in light of the potential shifting of responsibilities that delegation to other entities allows, we think a reinforcement of responsibilities is important.

Accordingly, we support the provision of more detailed information through Form 1 and Form 2 relating to the governance practices, regulatory functions, and ownership interests for securities exchanges and securities associations, respectively, as well as any of their facilities that are separate legal entities or any "regulatory subsidiary." We also strongly support requirements that would require the SROs to post amendments to these forms on their Web sites, as a responsive way to provide updated information in a timely manner.

We also support the new disclosure these forms would provide relating to some of the new requirements that are being proposed through this Release, particularly those relating to new corporate governance practices. We think discussion of how the independence of board members is determined, and discussion of the board's authority, including its ability to delegate it to others, are areas of interest to the investing public One of the most important new requirements, however, is that the SRO would have to state the method for interested persons to communicate directly to the independent directors concerns relating to any matter within the jurisdiction of a

standing committee. This gives investors a direct avenue for addressing issues and invites active participation in the process, all of which not only empowers the investor, but also strengthens the overall system of accountability.

We also strongly support the proposed disclosure relating to the composition, structure and responsibilities of the SRO boards and committees, including a chart showing the governance structure of the SRO and any of its facilities or regulatory subsidiaries. We believe that this information, along with copies of the governance guidelines, code of conduct and ethics, organizational charts, and description of regulatory program all provide needed information to the investor and to the SEC.

Conclusion

We appreciate the opportunity to comment on this proposal that seeks to address a myriad of issues intended to shore up the strength and integrity of the SRO system. We believe that it is a thoughtful approach to an area for which easy answers may not be obvious. As discussed above, in most respects we support the approaches taken with respect to requiring new governance standards and reporting requirements that will provide the SEC and investing public with important additional information on the inner workings of SROs. In certain other respects, we suggest that the SEC consider enhancements to the proposed requirements as an appropriate response to the range of conflicts of interest facing this system.

If we can provide additional information, please do not hesitate to contact me at 434.951.5333 or linda.rittenhouse@cfainstitute.org.

Sincerely,

/s/ Linda L. Rittenhouse

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