January 14, 2005
Princeton University
Woodrow Wilson School
Princeton, NJ 08544

Jonathan G. Katz
Secretary, Securities and Exchange Commission
450 Fifth Street, NW.,Washington, DC
20459-0609

Re: File No. S7-39-04, Release No. 34-50699 (November 18, 2004)
Fair Administration and Governance of Self-Regulatory Organizations

Dear Secretary Katz,

This fall a Princeton University undergraduate task force in the Woodrow Wilson School of Public Policy examined the regulation of publicly traded securities. The task force consisted of eight third-year policy students who were led by two fourth-year policy students and were advised by Harvard Law School Professor and Visiting Princeton Professor Hal S. Scott. Each of the eight students investigated a different area of securities regulation, and arrived at their own individual conclusions. The task force discussed each of the topics and eventually arrived at a collective set of recommendations summarized in the attached task force report. The comments and the recommendations the students have produced are the result of objective and extensive independent work and their opinions are entirely their own. The recommendations in this report are not necessarily the views of the senior commissioners or Professor Scott.

The students investigated many of the issues within proposed Regulation NMS and its Reproposal: in addition, there were additional aspects of market structure the task force felt needed to be addressed. One of these was the governance of exchanges and other market centers. This filing includes the overall Task Force Report as well as well as an appendix with the paper on governance. We are filing the entire report because our approach to governance must be understood in the context of the entire task force report. The collective judgment of the task force on governance is expressed in the report. Our comment consists only of the task force recommendations on governance. The individual paper is included only for background.

The eight Princeton students discussed these issues amongst themselves and with distinguished industry professionals over twelve weeks.[1] The students' lack of bias regarding the securities industry combined with the depth of knowledge they have about each topic makes their work unique and invaluable. We are looking forward to having an impact on improving the efficiency of American financial markets. Thank you for your consideration of this comment.

Best Regards,

Jayda Dagdelen
Senior Task Force Commissioner

Mara Tchalakov
Senior Task Force Commissioner

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Annette Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation

[1] Over the course of the semester, the task force met with Annette Nazareth, Director, Division of Market Regulation, Securities and Exchange Commission; John Thain, Chief Executive Officer, NYSE; Robert Britz, President and Chief Operating Officer, NYSE; Richard Ketchum, Chief Regulatory Officer, NYSE; David Shuler, Chief of Staff, NYSE; Richard Bernard, General Counsel, NYSE; Robert McCooey, Member of the Board of Executives, NYSE; Cameron Smith, General Counsel, The Island ECN; Peter Wallison, American Enterprise Institute; Douglas Shulman, President, Markets, Services and Information, NASD; Benn Steil, Council on Foreign Relations; Eric Roiter, General Counsel, Fidelity Investments.

PRINCETON UNIVERSITY

Woodrow Wilson School of

Public and International Affairs

POLICY TASK FORCE REPORT*

THE REGULATION OF PUBLICLY TRADED SECURITIES

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January 2005

*** This report represents the views of the Task Force Members but not necessarily those of Professor Scott or the senior commissioners.**

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I. INTRODUCTION

A Brief Overview of the Task Force

The monumental task facing the Securities and Exchange Commission (SEC) and United States policymakers today is how to administer rules and reforms that facilitate a more globally efficient and competitive marketplace, while maintaining the nation's commitment to a high level of individual investor protection. This Woodrow Wilson School report sets forth a set of policy recommendations on the aspects of securities regulation relevant to the SEC's recent Regulation National Market System Proposal (Reg NMS),[2] its proposal on Self-Regulatory Organizations, especially regarding Fair Administration and Governance of Self-Regulatory Organizations, [3] its Concept Release Concerning Self-Regulation,[4] and other securities regulation issues: the topics addressed are the trade-through rule, data distribution fees and market access fees, payment for order flow, corporate governance of the exchanges, regulation of the NYSE, Nasdaq and electronic communication networks (ECNs), the role of the federal government in securities market regulation, the regulation of short sales (Reg SHO), and the integration of international securities markets with a focus on transatlantic trading.

Advised by Harvard Law Professor and Visiting Princeton Professor Hal Scott, the task force brought together eight third-year public policy students and two fourth-year students known as "senior commissioners" for a semester of intense study of the policies regulating publicly traded securities under rapidly changing market conditions. The report is comprised of an introduction and background context, a summary of the task force recommendations and findings, a conclusion and an appendix on governance of the stock exchanges, written by one of the task force members. Before presenting the task force's recommendations, a brief exploration of the context of the regulation of publicly traded securities follows. This context is intended to provide the background for a larger discussion of the task force recommendations and arguments for why the SEC's approach to market regulation may no longer be appropriate.

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[2] Securities and Exchange Commission, *Regulation NMS*, File No. S7-10-04, December 16, 2004, http://www.sec.gov/rules/proposed/34-50870.pdf

[3] Securities and Exchange Commission, *Self-Regulatory Organizations-Various Amendments*, *Proposed Rule*, File No. S7-39-04, November 18, 2004 http://www.sec.gov/rules/proposed/34-50699.pdf

[4] Securities and Exchange Commission, *Concept Release Concerning Self-Regulation*, File No. S7-40-04, November 18, 2004, http://www.sec.gov/rules/concept/34-50700.pdf

The Evolving Context of Domestic Securities Regulation and Reg NMS

On February 26, 2004 the Securities and Exchange Commission (hereafter denoted SEC) proposed Regulation National Market System (Reg NMS). The proposal's intention to modernize existing and possibly outdated regulations concerning domestic equity markets represents the culmination of a long tradition of attempts by the SEC to integrate securities markets. The National Market System concept was originally enacted in the 1970s (through the congressionally mandated 1975 Exchange Act amendments) under Section 11A of the Securities Exchange Act (1934) in an attempt to ensure equal regulation of all markets for NMS securities.[5]

In the more than thirty years that have since passed, market conditions have changed rapidly in response to higher trading volume, lower trading costs and the evolving technology that has facilitated both trends. The National Market System now comprises the stocks of over 5000 listed companies that collectively represent more than $14 trillion in U.S. market capitalization.[6] Intense competition now exists between very different market centers (including automated electronic communication networks as well as traditional exchanges, regional exchanges, and other market-making securities dealers) resulting in a greater fragmentation of the marketplace. Computerized trading systems now handle close to forty-five percent of the orders in securities listed on the Nasdaq and almost seven percent of the orders in all exchange-listed securities.[7] The SEC's proposals stem in large part from a growing discrepancy between "fast" and "slow" markets—prompted by innovative trading technologies (ECNs, smart-order routers, direct access technology) and new market centers.

Reg NMS is an attempt by the SEC to update the existing National Market System through four proposals. Respectively, these include a uniform trade-through rule for exchange and Nasdaq-listed securities (the Reproposal eliminates any opt-out exemption for institutional investors and applies only to automated quotes under Rule 611), a uniform market access rule (barring lock and cross quotations and establishing prohibitions on ECN access fees),

[5] Freeman, David, Zambrowicz, Kevin and Eunice Yang. "The SEC's Proposed Regulation NMS." *Banking and Financial Services Policy Report*, Volume 23, No. 6, June 2004.
[6] Securities and Exchange Commission, *Regulation NMS*, File No. S7-10-04, February 26, 2004, <http://www.sec.gov/rules/proposed/34-49325.htm>
[7] Oesterle, Dale A. *Congress's 1975 Directions to the SEC for the Creation of a National Market System: Is the SEC Operating Outside the Mandate?* Public Law and Legal Theory Working Paper Series, No. 11, May 2004.

prohibitions on displaying sub-penny quotes, and a modified method of allocating and pricing market data. After the February 26th, 2004 initial proposal of Reg NMS, on May 20, 2004, the SEC extended its comment period[8] so as to reflect the results of the hearing on Reg NMS held on April 21, 2004. On December 16, 2004, after having received comments, the SEC amended and reproposed the Reg NMS.[9] The December Reproposal contains two alternatives for the scope of quotations protected, one protecting the NBBOs of the nine SROs and Nasdaq whose members trade NMS stocks, and the other protecting NBBOs of these same organizations but would secure additional protection for a market's depth-of-book quotations. The Reproposal additionally attempts to simplify the formulas in Reg NMS for allocating revenues generated by market data fees and authorizes markets to distribute their own data independently. The Reproposal intended to perfect the NMS, and promote equal regulation of different markets and stocks and greater order interaction and displayed depth. However, this task force views Reg NMS as one more step down a path towards an anti-competitive and inefficient trading market.

The birth of the national market system in 1975 consisted of a proposal for an electronic communication linkage of existing markets[10] (referring primarily to listed stocks on the registered exchanges of NYSE and AMEX) to which Congress referred to as a "public utility" that "should be regulated accordingly." This initiative developed into the set of semi-centralized order routing procedures for listed securities known as the Intermarket Trading System (ITS). Once almost exclusively the domain of the NYSE, ECNs have rapidly been encroaching on the market for trading exchange-listed stocks (the ITS most recently admitted a computerized electronic facility Archipelago).[11] Currently the SEC mandates order routing links through the ITS for listed securities and through the NASD system or Alternative Display Facility (ADF) for NMS securities. The SEC now appears to be in favor of moving towards an over-arching national computerized market trading system.

A Tale of Two Markets

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[8] Securities and Exchange Commission, *Proposed Regulation NMS: Request for Additional Comment*, May 26, 2004, http://www.sec.gov/rules/proposed/34-49749.htm

[9] Securities and Exchange Commission, *Regulation NMS*, File No. S7-10-04, December 16, 2004, http://www.sec.gov/rules/proposed/34-50870.pdf

[10] Oesterle, Dale A. *Congress's 1975 Directions to the SEC for the Creation of a National Market System: Is the SEC Operating Outside the Mandate?* Public Law and Legal Theory Working Paper Series, No. 11, May 2004. .

[11] Ibid Oesterle.

The essential policy debate that faces securities regulators today is a clash between the forces of centralization and competition. Contemporary U.S. securities markets in the new millennium are characterized by two entirely different trading structures—floor-based auction markets in the form of NYSE and AMEX, registered exchanges where a predominantly centralized venue accounts for the majority of trading in NYSE and AMEX securities, and electronic trading venues vying for a dominant share of Nasdaq securities.[12] The fragmentation in trading of Nasdaq securities among different venues appears to offer a more competitive, and less centralized market in these securities. Both the nature of the NYSE's auction exchange and its restrictions on competition (most prominently the trade-through rule) have contributed to the centralization in trading of NYSE-listed stocks (on the NYSE) versus Nasdaq stocks. Despite these restrictions, over the last five years increased competition from ECNs has diminished the NYSE's market share in the trading of its own stock (as of 2004 the NYSE only had 80% of the market in its own stock). In 2004 Nasdaq began to cross-list shares that are listed on the NYSE which resulted in direct competition for the trading of NYSE stocks. Intense speculation has emerged as to which system provides a better market structure for investors (in terms of execution, spread, speed, and total costs), and the SEC has been criticized for not taking a strong public stance. As Peter Wallison of the American Enterprise Institute notes, "What is unusual in the heavily regulated securities market is that government regulation seems to be preventing competition, perpetuating support for two different market structures so that competition between them cannot resolve the question of which is best for investors and public companies. It is as though the Federal Communications Commission were fostering two different and incompatible telephone systems, so that users of one system could not place calls to users of the other."[13] This incompatibility poses significant challenges: Are centralized markets better for investors in the long-term? Could ECNs out-compete the NYSE if competitive markets became the dominant strategy? This task force report attempts to address some of these significant policy issues.

[12] Wallison, Peter J. "The SEC and Market Structure Reform: No Data, No Analysis, No Vision (July 2004)." American Enterprise Institute for Public Policy Research.
[13] Ibid Wallison.

Task Force Policy Recommendations: An Overview

Balancing Deregulation with Investor Protection

The task force has determined that most of the SEC's recent proposals to modernize the regulatory structure of the U.S. equities environment (Reg NMS and recently its December 15th 2004 Reproposal) unnecessarily interfere with competitive, market-based efficiency to the detriment of investors. After examining the effects of existing trading rules, the task force has concluded that the SEC continues to over-complicate and micro-manage market trading structure, creating burdensome and potentially harmful trading rules, and fixing prices (particularly in the arena of access fees and market data distribution where the SEC, in effect, sets price ceilings) that are better left determined by market forces. The task force focuses the majority of its recommendations on a deregulatory approach to the securities industry, keeping in mind the paramount importance of investor protection. Thus, in arenas such as corporate governance the task force decided to opt for a greater degree of federal oversight. In many other areas like trade-through and market data distribution however, the task force suggests the SEC significantly scale back its intervention in the market.

The Role of the SEC and the Future of US Capital Market Structure

The United States continues to compete among the world's exchanges for listings and liquidity. In examining the future of U.S. capital market structure, this task force has promoted a set of recommendations in tune with an increasingly global securities marketplace. To that end, this report recommends the SEC adopt a more European-styled approach to securities regulation. On a conceptual level, the European Union has demonstrated a much greater commitment than the United States to harmonization of worldwide accounting standards. It has also managed to maintain an optimal level of investor protection without sacrificing the liberalization of markets necessary for a healthy, competitive marketplace. The EU has fostered both electronic trading and competition among trading venues to a much greater degree than has the United States. The European Union currently has no Intermarket Trading System (ITS), and no such restrictions on competition as a trade-through rule or price-fixing of data fees. The EU's Directive on Financial Instruments Markets adopts a "best-execution" rule that allows for the consideration of factors such as time and size of the order in addition to price. The SEC's position on these issues in the name of investor protection and “best price” priority will significantly impede progress towards an internationally integrated market. The SEC should reconsider its position by overhauling its restrictive trading regulations that stifle competition among markets, and refrain from protecting the NYSE’s near-monopoly on trading in NYSE-listed stocks.

The task force reevaluates the proper boundaries of the SEC’s regulatory jurisdiction. The criticism of Reg NMS suggests the possible need for a new non-SEC review of these issues. To that end, the task force has recommended the formation of a Presidential Commission to evaluate current trading rules and regulations. Based on the findings of the Commission, it may even be appropriate for a congressional reevaluation of the National Market System a generation after its inception in 1975. Free markets and a competitive environment between market centers should determine the structure of US capital markets.

II. Summary of Task Force Recommendations

The Trade-Through Rule

The task force examined the trade-through rule for securities listed on the NYSE or the AMEX and considered options for reforming it. The rule prohibits trading at a price other than the best one posted on any market in a security. A number of market centers and institutional investors have called for the rule to be repealed or for there to be exceptions. The New York Stock Exchange has called for the rule to be extended to Nasdaq securities. In proposed Regulation NMS, the Securities and Exchange Commission seeks to expand the regulation to all securities (thereby making the trading rules consistent for all securities) but to apply the rule only to automated quotes. This is a change from the original SEC proposal that extended the trade-through rule to all quotes for NMS securities but permitted trade-throughs of manual markets and permitted institutional investors to opt-out of the rule. The Commission believes the trade-through rule protects consumers and encourages the posting of aggressive limit orders.

The SEC's December Reproposal on the trade-through rule considers whether the rule should be extended to each market's depth-of-book or whether it should apply only to the market's best bid or offer. The proposed depth-of-book trade-through rule is intended by the Commission to provide investors with an incentive to display additional limit orders and to improve the execution quality of larger limit orders. Considering the task force's position generally on the trade-through rule, it does not recommend extending the rule in this manner—the Reproposal represents another step down a regulatory path towards an artificial centralization of the market in NYSE-listed stocks and restricts the fierce competition and technological innovation that characterizes trading in the Nasdaq markets which up until now have functioned successfully without it.

Neither does the SEC address the issue of internalization with respect to this reproposed new rule, particularly since the rule only requires that orders entered into the market be routed to the best-priced quotations. Internalization is allowed to continue as long as internalizers match the best prices displayed in the market.[14] To address this problem, the SEC may, in the future, be tempted to prevent "free-riding" of such internalizers off the prices established by the displayed

[14] SEC remarks. http://www.sec.gov/news/speech/spch121504psa.htm

limit orders, rather than relying on market forces. This could provide the foundation for the creation of a future nationalized central limit order book. As Commissioner Paul Atkins remarks, “Market participants' order routing decisions that are now based upon fiduciary duties and competitive pressures would be replaced with a government mandate to route orders based on its own rigid definition of what constitutes the best price.”[15]

The debate about the trade-through rule is closely tied to the question of what constitutes the best execution for investors. If the best posted-price is the sole factor in determining execution quality, then the trade-through rule is an effective way of protecting investors. But if other factors such as speed, certainty of execution and minimal market impact are important to execution quality, then the trade-through rule is unduly simplistic and makes it harder for some investors to obtain best execution. If the number of trade-throughs that currently occur in domestic securities markets is any indication of how reliant investors are on the rule to protect best price execution quality, the rule is unnecessary. The number of trade-throughs that occur in both the NYSE and Nasdaq amounts to only 2-3% of the total number of trades.[16] In its concept release, the SEC estimated that the absence of a stronger trade-through rule cost American investors roughly $326 million in 2003. This amounts to only .002% of the $17 trillion in total dollar share volume that traded in both the NYSE and Nasdaq markets in that same year.

The specific question this task force considers also involves the larger issue of market structure. What types of markets are best for investors? The NYSE presently dominates the market in securities listed there, whereas the market for OTC volume is much more competitive. This competition has led to innovation in market technology and increased responsiveness to investors’ demands. As primarily a floor-based auction market, the NYSE operates slowly compared to Nasdaq and ECNs such as INET. The prices posted on the NYSE are sometimes superior to prices posted elsewhere, but they are also prices at which there is little depth and at which execution is far from certain. The difference between a posted price and a price at which one can execute a trade immediately is critical. For many investors, particularly institutions trading in large blocks, it can be difficult to complete an order and the overall price for the order may move against the institution as it is filled. This experience suggests that there is more to best execution than price alone.

[15] SEC remarks December 15, 2004.
[16] Ibid. SEC remarks December 15, 2004.

Applying the trade-through rule only to automated quotes is problematic. It raises questions about how to define an automated quote. The SEC has tried to provide this definition, but the proposed definition is complicated and requires several exceptions. It may also adversely affect the incentives for further innovation once the minimal requirements for being “automated” have been satisfied. Furthermore, it is unclear why a fast quote at which someone could execute immediately would ever be traded through, making a rule superfluous.

Therefore, this task force recommends that the Commission repeal the trade-through rule for NYSE securities and take no action with respect to non-listed securities. Experience with non-listed securities suggests that liquidity has been adequate and trade-throughs have not affected the confidence of investors nor discouraged them from posting limit orders. There is no compelling empirical data that shows otherwise. The trade-through rule has restricted competition for trading volume in listed securities and stalled innovation in those markets. It has also harmed investors whose overall execution quality has been negatively impacted by delays and market impact. Repeal of the trade-through rule would eliminate the regulatory protection the NYSE has enjoyed for decades. Though a venerable institution and powerful franchise, the NYSE should not enjoy special status compared to other securities markets. Competition based on execution quality should be encouraged. The NYSE has already shown itself to be capable of reform by developing and proposing to expand the NYSE Direct+ system and turn itself into a hybrid market. Volume and liquidity will flow to the market center that most effectively serves the needs of all investors.

Without a trade-through rule to define best execution simply on the basis of one factor, price, the best execution obligation under which brokers operate will be increasingly important. It must be enforced either by the SEC or alternatively the courts. This standard is a sounder basis for regulating the execution of trades and affords investors important protection.

Payment for Order Flow

At the core of the payment for order flow controversy is the principal-agent problem that arises between investors and their brokers. Solving the principal agent problem requires either aligning broker-investor incentives with those of their customers or obtaining complete price transparency in the market. Due to the difficulty of obtaining the latter, this task force recommends regulatory measures that compel agents to act in the best interest of their customers. The task force concludes that a deregulatory approach will most effectively solve the principal-agent problem. Specifically, it recommends the removal of the brokers' requirement to credit their clients' accounts based on the price at which the trade was ultimately executed and instead allow brokers to promise to give their customer the national best bid or offer, even if the broker were to obtain a better price. The benefits the brokers receive from getting a better price would be passed on in whole or in part to customers in the form of lower brokerage commissions. The commission-only pricing option would eliminate the principal-agent problem by creating incentives for brokers to minimize costs – a goal that matches the desires of investors. Retail customers would have the choice to either have the broker credit their account with the NBBO or at the price at which the trade was executed.

The rule would allow investors to cheaply audit the quality of their brokers' services by looking to commission fees, thereby eliminating the incentive to remain rationally ignorant. Brokers would likely find the commission-only pricing option attractive because it would enable them to reduce their commissions – the variable to which customers are most attune – while not necessarily decreasing their profit per trade. Institutional investors however would not take this option because of their ability to monitor and their desire to capture all price improvement. Taken together, these factors would standardize fee structures while retaining the benefits of a competitively fragmented marketplace.

Regulation of the NYSE, Nasdaq and ECNs

A registration system that categorizes and regulates trading venues by operational differences and ownership obligations is preferable to one that relies on arbitrary definitions. Nasdaq's application to be an exchange has been pending before the SEC since 2000 and the SEC has granted itself an indefinite period to act on the application. The major stumbling block to approval is an asserted barrier regarding the central limit order book (CLOB). Until now, the SEC has required that every exchange possess a CLOB, which Nasdaq officially does not possess. The SEC has required exchanges to operate a CLOB honoring time/price priority. Rule 3b-16 of the Regulation ATS act release specifies that a CLOB brings together orders of multiple buyers and sellers and displays this information on screens.[17] Furthermore, a CLOB allows the orders to interact in the system before execution.

Nasdaq's Supermontage, implemented in 1997, has features pursuant to a CLOB, but the SEC is concerned with Nasdaq's internalized trades.[18] Supermontage collects quotes posted by market makers and ECNs. It displays bid and ask prices five levels deep on the Level II screens (which are viewed by institutional investors).[19] However, financial intermediaries off the primary market execute Nasdaq's internalized trades when Nasdaq dealers route orders.[20] Nasdaq's system allows orders to be executed without interaction with out other Nasdaq market makers on the condition that trades are reported within 90 seconds.[21] Furthermore, orders do not necessarily follow the time/price priority by allowing preferenced customers while neglecting price displays on Supermontage. The SEC is concerned about these internalized trades which do not go through Supermontage. The task force does not believe exchange status, as described below, should depend on having a CLOB.

Furthermore, an inherent conflict of interest lies in Nasdaq's affiliation with NASD, so it is undesirable for the SEC to, in effect, require Nasdaq to continue to be affiliated with NASD because it is unwilling to grant Nasdaq separate exchange status. Therefore, the task force believes the SEC should approve Nasdaq's application to be an exchange to minimize conflicts of interest and avoid anti-competitiveness.

The task force would adopt a two-tier system of regulation—under which an exchange would be defined as, "a venue that provides a facility through which, or sets material conditions under which, participants entering such orders may agree to terms of a trade" (modified from SEC Concept Release). "Facility" in this instance does not have to be a physical place. This new definition of an exchange will include traditional exchanges and ECNs. Tier 1 is any exchange (under the new definition) without members. Tier 2 is any exchange (under the new definition) with members (persons having the right to trade in the venue). Tier 1 exchanges would be regulated by NASD and Tier 2 exchanges would be regulated by themselves.

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[17] Securities and Exchange Commission, Rule Release No. 34-40760
[18] Interview with Stephanie Dumont, December 13, 2004.
[19] Biais, B., Davydoff, D. "Internalization, Investor Protection and Market Quality." 2002. Retrieved on December 14, 2004 from http://www.oee.fr/pdf/oeefree_pdf/361_10.pdf
[20] Ibid.
[21] Brown, J. Cincinnati Stock Exchange's Comments to SEC on Nasdaq's application to be an exchange. 2001. Retrieved on December 14, 2004 from http://www.sec.gov/rules/other/10-131/brown1.htm

The main differentiation between the trading venues is the presence or absence of members. Members entail significantly more regulatory and enforcement responsibilities. Therefore exchanges with members should be recognized as functionally different from venues without members. As set forth later in this summary, the task force recommends that all trading venues should be able to sell their own data. Thus the ability to charge data fees will no longer determine the status of exchanges. Similarly the charging of listing fees should not be used to determine whether an entity is an exchange. Under this system, ECN's are formally acknowledged as exchanges. ECNs meeting the definition of an exchange should not have the option of registering as broker-dealers since ECNs should be held to a higher degree of responsibility for enforcing anti-fraud practices and anti-manipulation practices. Likewise, ECNs should be responsible for efficient operating systems, such as adequate software.

Governance of the Stock Exchanges

The SEC (as opposed to states or the Congress) is the appropriate body to oversee the regulation of the corporate governance of stock exchanges. First, the SEC currently is the authority that exchanges must report to when they change their rules. The SEC approves the rules submitted by self-regulatory organizations (SROs) and maintains its authority through its enforcement of the SRO rules. Because governance of exchanges can effect how they discharge their SRO function, the SEC should oversee exchange governance standards. Second, the SEC as a federal agency can oversee all exchanges, wherever they might be incorporated, and is thus able to ensure that investors in all states receive adequate protection. Given the highly technical nature of exchange regulation and the consequent transaction costs of individual investors examining various state regulatory regimes and then deciding to do business with exchanges in states with investor-friendly regulation, state control of exchange governance does not make sense. Third, the SEC is capable of being flexible in its examination of SRO governance proposals. By setting baseline standards and allowing individual exchange variation, the SEC can ensure that regulation of governance is fair and appropriate for each institution.

The task force also recommends certain requirements for exchange corporate governance. The task force recommends that terms for Board of Director members last for two years and be staggered in terms of expiration. This will allow the more experienced members of the board to communicate to the newer members the history and rationale of various exchange rules and procedures. In this way, the public directors shall not have to rely exclusively upon the non-public directors for information; rather, they can gain information from both independent and non-independent sources. Second, the task force recommends mandated separation of the positions of CEO and chairman of the board; this will prevent the chief executive officer from exerting too much authority during board meetings. This prevents his or her perspective from automatically being the "accepted" one, and places him or her as an equal among the other board members. Third, the task force also recommends limited board size (a maximum of 13 voting members). Smaller boards prevent board members from not being fully engaged and relying on others to do the work in committee meetings. Fourth, an 8-consecutive-year term limit prevents individuals who have sat on the board for too long from becoming stale and failing to be as active. Fifth, required quarterly executive sessions without the presence of non-independent directors will allow these independent directors time to think critically about the suggestions of the board members that may have conflicts of interest.

Currently the SEC's proposed governance rule requires structural separation of the regulatory and business functions of the exchange. Complete independence of the regulatory function is necessary to prevent the business-side board members from influencing the decisions of the regulatory oversight committee. This would guard the SRO function from conflicts of interest and guarantee objective regulatory oversight. Complete independence could be codified either as a fully separate board of regulators or a standing committee on regulatory oversight that does not report to any non-independent directors – essentially it could only report to the executive sessions of the boards of directors. The task force also recommends mandated inclusion of the public, members, and listed companies in the nomination process as a way to safeguard that various constituencies are represented on the board of directors. While independent directors can represent the public in their nomination of directors, it is vital that members and listed companies be guaranteed a procedure by which they can nominate members to represent their interests as well.

The Integration of International Securities Markets

This task force recommends that the SEC permit foreign companies listing on US exchanges to organize their financial statements in accordance with either International

Accounting Standards (IAS) or US Generally Accepted Accounting Principles (US GAAP) – that is, foreign firms would no longer be required to reconcile IAS with US GAAP. This would significantly reduce the costs of cross-listing, allowing more companies to afford to cross-list and thus facilitating more globally integrated, liquid and efficient equity markets. Several in depth studies over the past decade have indicated that the differences between IAS and US GAAP are minor in impact and that the information they provide are valued almost identically by investors when all other factors are held constant. Permitting foreign companies to comply with IAS would contribute to an improved marketplace at no expense to investor protection. In addition, the International Accounting Standards Board (IASB) and FASB are already working to eliminate some of the key remaining differences between IAS and US GAAP. Mutual recognition of IAS and US GAAP is preferential to immediate, complete harmonization because allowing the two standards to compete should lead to a more efficient and informative uniform standard. Accounting standards sometimes reflect nuances in different countries' regulatory frameworks, and a harmonized standard may be less compatible with certain countries than existing standards, particularly if a new standard is formed to resemble US GAAP more closely than IAS.

The task force also recommends that the SEC permit qualified institutional buyers (QIB or professional investors) to access foreign screens within the US. Professional investors already trade on foreign markets, and have sufficient expertise to accurately assess the risks of trading on foreign exchanges with different disclosure requirements. For this reason, solicitation of institutional investors in unregistered stocks located on foreign screens should be allowed. Permitting foreign screens in the US would give investment companies the ability to solicit foreign stocks that are *already* being traded by these institutional investors, and thus inform their clients of a wider variety of investment options and opportunities without risk to investor protection. The task force does not recommend that retail investors be solicited with respect to trading in unregistered foreign stock, regardless of the existence of foreign screens in the United States. Retail investors in general do not have the sufficient expertise, capacity and depth of experience to accurately assess the risks of trading in unregistered foreign stock.

While permitting compliance with IAS in lieu of US GAAP will allow more access to foreign stocks through cross-listing on US exchanges, permitting foreign screens will provide another avenue for US investors to trade foreign stocks. Having both options will allow foreign companies to decide whether listing on US exchanges or simply having their stock traded by institutional investors via foreign screens within the US is most efficient.

Further, as noted in the introduction, we believe the EU approach to market structure is a preferable model for the United States and the SEC to look to as it reforms the US domestic market.

A Presidential Commission to Examine Trading Rules

In the current system, the SEC plays the dominant regulatory role, with no clear supervision from the Congress or other branches of the government. The dominance of one federal agency creates efficiency, since it consolidates in one institution expertise and experience. However the trade-off is the entrenchment of SEC philosophy into market regulation, through price-fixing and standard-setting, to serve as the "official market referee."[22]

Many existing regulations that may or may not be appropriate for current market conditions are still in place (what is sometimes referred to as "institutional memory-loss"), and this plethora of regulations hampers the functioning of a more efficient marketplace. We propose that a Presidential Commission be formed to review the various market regulations that currently exist. The Presidential Commission will consist of four members: one chosen representative each from the U.S. Treasury, the Federal Reserve, the Commodities Futures Trading Commission (CFTC), and from the SEC. This Commission would be an outgrowth of a pre-existing organization known as the President's Working Group on Financial Markets (formed in the wake of the 1998 Long-term Capital Management debacle)[23] which meets regularly to discuss issues relevant to all financial services regulators and consists of the Treasury Secretary, the Chairman of the SEC, and members from the CFTC and Board of Governors of the Federal Reserve system.

This Commission will have a lifetime of two years, and the members will present their analysis to the president at the end of that time. During its tenure, the Commission will review all the regulations that affect the operation of domestic securities markets and it will recommend to the president which regulations may be outdated and therefore unnecessary or in need of reform.

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[22] Speech by SEC Commissioner Paul Atkins: Remarks before the Open Meeting to Consider the Reproposal of Regulation NMS December 15, 2004.
[23] President's Keynote Address http://www.ici.org/issues/dir/01_mfimc_fink_spch.html

At the discretion of the Commission, input may be brought from relevant constituencies. This Commission is the most efficient way of reviewing the current regulatory system as a whole, and the most effective way of involving the executive branch of the government in the review of market regulation without disrupting an existing system that relies primarily on the input of the SEC and the Congress.

Regulation of Short Sales

This task force believes that short selling is a necessary and beneficial aspect of an efficient market. Short sellers stabilize prices by providing liquidity and creating demand-by covering their shorts-in a falling market. The practice of margin trades and shorts are simply the inverse of one another: the margin trader borrows cash to buy stock; the short seller borrows stock to raise cash. The margin trader closes his position by repaying the cash loan through the sale of the stock; the short seller closes his position by purchasing the stock and returning it to the lender. In the opinion of this report, it is no less legitimate to borrow a stock in anticipation of a decline, than to borrow money and purchase in anticipation of a rise. Furthermore, the price that can be diminished by short selling is an inflated value, and the accurate pricing of securities is the aim of an efficient market.

The SEC made adjustments to short sale governance through Regulation SHO. The new regulations are a progressive measure. In Regulation SHO, the SEC has shown a willingness to consider the benefits of deregulation by constructing a pilot program to examine the behavior of stocks without a price test. After the pilot provides sufficient data to the SEC, this report urges a decision that moves toward a greater deregulation of short selling through removal of price tests altogether. Since the pilot has yet to be implemented and its results await a more distant time frame (nor has the SEC constructed a pilot program to determine how a uniform bid test might be preferable to current rules), this task force recommends the need for more research although the removal of price tests appears preferable to the current tick test.

Market Access Fees and Data Distribution

The task force recommends a market-based approach to the charging of fees for data and the means by which data is distributed. The SEC should eliminate its reporting and consolidation requirements and allow private entities to process, consolidate, and distribute data according to investor demand. Market centers should be allowed to sell their own data and investors should be allowed to buy the data that they desire. Market forces will determine the price of securities data and the revenues of market centers. If a market center attempts to keep its data private or charge too much for it, then investors will move their trading volume to market centers that sell their data at affordable prices and the withholding market center will lose market share. In the new system, the SEC must only ensure the integrity of market data in order to protect investors. In addition under this reformed structure, ECNs (like exchanges) would be able to sell their own data and this would eliminate payments necessary for print flow.

The current system of fee disclosure in price quotations requires market centers to include few of the fees that investors incur for trading. In particular, under current SEC regulations quotations do not have to include access fees, which are charged by market centers to fund liquidity rebates and business costs. The rise of ECNs, which often rely on access fees as an integral part of their business model, creates a situation in which an ECN quote and a market maker quote posted at the same price are not equivalent. Brokers trying to find the best price for their customers often cannot execute against best overall price, including access fees. Access fees also create incentives for market participants to lock and cross the markets in order to reap liquidity rebates without incurring access fee charges.

The task force further recommends a disclosure-based approach to trading fees. All market centers, including ECNs, exchanges, and Nasdaq should be able to charge any access, transaction, or communications fee they deem necessary, but must display all fees paid by all traders in the posted prices. Prices should continue to omit trader-specific fees such as brokerage commissions. The disclosure of all universal fees will most likely result in sub-penny pricing. In order to prevent the front-running associated with sub-penny quotes, market maker quotes should be subject to a minimum tick size. The SEC should reduce its control over the data distribution system and allow market forces to efficiently price the data of each market center according to investor demand. By allowing ECNs to participate in this market-based approach, this would eliminate the need for payment-for-print flow. At the same time the SEC should increase its disclosure regulation of trading fees in order to ensure the accuracy of market information. The technological ability of modern markets to provide market data according to investor demand and the rise of ECN access fees requires an adjustment in SEC policy.

III. CONCLUSION

In conclusion, the task force recommendations are to eliminate the trade-through rule, establish a Presidential Commission to review all trading rules and regulations, allow brokers to credit their client's accounts with the NBBO, allow compliance with IAS standards for foreign companies that cross-list on US exchanges, permit institutional buyers to access foreign screens, approve Nasdaq's application to be an exchange, adopt a two-tiered system of exchange regulation, provide for exchange corporate governance rules of one-year term limits for Board of Directors, mandated separation of the positions of CEO and Chairman and limited board size, mandated inclusion of the public in the nomination process for directors, the removal of price tests altogether for short sales trading, and a market-based approach to data distribution and access fees.

APPENDIX:

INDIVIDUAL

TASK FORCE REPORT

ON

GOVERNANCE OF THE STOCK EXCHANGES

Governance of the Stock Exchanges

Karis Anne Gong

Table of Contents

Common Abbreviations

Amex: American Stock Exchange
NASD: National Association of Securities Dealers
NYSE: New York Stock Exchange
PCX: Pacific Stock Exchange
SEC: Securities and Exchange Commission
SRO: Self-Regulatory Organization

I. EXECUTIVE SUMMARY

Despite the exorbitant amount of money that the “not-for-profit” New York Stock Exchange elected to pay its CEO and chair, Dick Grasso, in September 2003, the heart of the corporate governance quagmire was not simply that executives were being paid too much by the corporate boards. The real problem is that there were conflicts of interest in the organization of board structure and the CEO’s power did not have a sufficient check. Therefore, the objectives in reform of corporate governance are to reduce conflicts of interest and to limit the authority of the CEO in board meetings. This report argues that the Securities and Exchange Commission add the following to its exchange governance rule proposal: a board composed of a majority of independent directors, a more focused definition of “independence,” staggered terms that last two years, an 8-consecutive-year term limit, full separation of the regulatory and business functions of the exchange, limited board size, mandated separation of the CEO and chair of the board, clearer requirements for the holding of executive sessions, clearer standards for inclusivity in the nomination process, performance-based compensation for both managers and board directors, and public disclosure of top executive pay by the compensation committee.

The SEC (as opposed to decentralized state governments or Congress) is the appropriate body to oversee the regulation of corporate governance for a few reasons. First, the SEC is the authority that trading associations must report to when they change any rules of exchange operation. The SEC approves the rules submitted by self-regulatory organizations (SROs) and maintains federal authority in filing suit against SROs that fail to uphold their regulatory standards. Because the Board of Directors is responsible for the SRO function, the SEC should oversee governance standards as well. Second, the SEC as a national institution would oversee all exchanges and thus be able to ensure that investors in all states received adequate protection.

Given the highly technical nature of exchange regulation, the transaction costs of individual investors examining various state regulatory regimes and then organizing to support states with investor-friendly regulation would be too high; thus the public check on regulatory structures would fail. Third, the SEC is capable of being flexible in its examination of SRO governance proposals. By setting baseline standards and approving individual applications, the SEC can oversee that regulation of governance is fair and appropriate for each institution.

Three main constituencies are affected by the decisions of the exchange directors: the investing public, members or shareholders of the exchanges, and corporations that are listed on the exchanges. Sound governance strategy must consider the effects on all three.

The reasoning behind a majority of independent directors is simple: if the directors have interests other than what is best for the exchange, their judgment will be less objective. Independent directors offer the perspective of the public, prevent the opinions of some members from being unfairly represented over other members, and are not susceptible to exchange regulation in the way that representatives of listed firms are. The biggest problem with independent directors is their lack of knowledge – directors who have no experience overseeing the running of an exchange are less familiar with the rules and operations of the management. This is not a reason to not prefer independent directors – rather, steps can be taken to aid directors in climbing the knowledge curve so that they may be effective and objective participants on the board of directors.

First, mixing a minority of non-independent directors into the Board may provide independent directors with a historical context. Second, terms that last longer than one year and are staggered in classes allow the more experienced members of the board to communicate to the newer members the history of various exchange rules and procedures. In this way, the public directors shall not have to be reliant upon the non-public directors for information; rather, they can gain information from both independent and non-independent sources. Third, an 8-consecutive-year term limit provides a consistent influx of fresh perspectives and prevents stale directors from hindering board performance. Fourth, limited board size prevents board members from being passive and relying on others to do the work in committee meetings. Fifth, mandated separation of the CEO and chairman of the board will prevent the chief executive officer from exerting too much authority during board meetings. This prevents his or her perspective from automatically being the "accepted" one, and places him or her as an equal among the other board members. Sixth, required quarterly executive sessions without the presence of non-independent directors will allow the independent directors time to think critically about the suggestions of the board members that may have conflicts of interest. This last suggestion is more specific than "regular sessions" and thus prevents "regular sessions" from meaning once each year or even less often. Given these steps, the presence of independent directors should be constructive and useful, as well as beneficial in representing the interests various non-industry constituencies.

Currently the SEC's proposed rule requires structural separation of the regulatory and business functions of the exchange associations. Taking this one step further – complete independence of the regulatory function – is necessary to prevent the business-side board members from influencing the decisions of the regulatory oversight committee. This would guard the SRO function from conflicts of interest and guarantee objective regulation oversight. Complete independence could be codified either as a fully separate board of regulators or a standing committee on regulatory oversight that does not report to any non-independent directors – essentially it could only report to the executive sessions of the boards of directors.

Clearer inclusivity requirements in the nomination process are another way to guarantee that the various constituencies – the public, members, and listed companies – are represented on the board of directors. While the independent directors could represent the public in their nomination of directors, it is vital that members and listed companies be guaranteed a procedure by which they can nominate members to represent their interests as well.

Finally, we go full circle back to compensation with the final recommendations: performance-based pay, disclosure of top executive pay and director to shareholders by the compensation committee, and disclosure to association members of board of director percentage changes in pay and methodology of pay calculation by the compensation committee. These measures are to provide transparency in the operation of the compensation committee, and a public check that the executives are being paid according to their performance. Removal of the conflicts of interest through the use of independent directors should rectify the compensation problem, but these final measures provide additional public checks.

These regulations may seem stringent, but the objective in corporate governance standards is not simply to remove conflicts of interest and leave the boards of directors high and dry when it comes to understanding the way the exchanges operate. These standards will improve the effectiveness of the SEC's general strategy for improving exchange governance and will guarantee that the perspective of the board of directors takes into account all the constituencies that are affected by its decisions.

II. INTRODUCTION

THE PROBLEM

On September 17th, 2003, Richard Grasso amidst a storm of criticism from political pundits, individual investors, and the media, resigned as chief executive officer (CEO) and chairman of the New York Stock Exchange (NYSE) Board of Directors. The main reason for his resignation was the furor that arose upon the disclosure of pay package – which amounted to approximately $188 million. His resignation and pay marked the beginning of intense scrutiny of the NYSE's board and "reflected a 'paradigm for misbehaviour' by a board and a 'fundamental breakdown' of corporate governance."[24] Around the country and even across the Atlantic, the compensation of executives who sit on corporate boards has been the primary subject of criticism, even "the litmus test for corporate reform."[25]

Despite the exorbitant amount of money that the "not-for-profit" New York Stock Exchange elected to pay its CEO and chair, Richard Grasso, in September 2003, the heart of the corporate governance quagmire is not simply that executives were being paid too much by the corporate boards. The real problems were conflicts of interest in the organization of previous board structures and the lack of checks upon the CEO's power to prevent abuses of authority.

In the case of the NYSE board, many members of the compensation committee were also representatives of firms regulated by the NYSE's board of directors. This gave Grasso unfair control over some directors. "One unnamed board member from Wall Street told investigators that Mr. Grasso 'confronted' him after he expressed concern about his proposed 2000 pay to a staffer... The member voted in favor of that year's package and later recalled thinking, 'Thank God I escaped that one. This man was also our regulator [so] you have to be careful."[26] Other members of the industry also "perceived potential advantages" to those who served on the Board – James Cayne, CEO of Bear Stearns, was urged to join because an executive at Bear Stearns

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[24] Eliot Spitzer, Attorney General of the State of New York, cited in "Greed is Bad: Richard Grasso, self-professed "CEO of capitalism," is sued for being too greedy" The Economist. 27 May 2004.

[25] Bill Patterson, head of corporate governance at AFL-CIO, cited in "Have fat cats had their day?: British and American shareholders have begun what looks increasingly like a sustained revolt against excessive executive pay" The Economist. 22 May 2004

[26] Kelly, Kate, and Susanne Craig. "Spitzer Files Suit Seeking Millions of Grasso Money; Action Targets Ex-Chief of NYSE and Exchange over $200 Million Package." Wall Street Journal (Eastern Edition) 25 May 2004, p. A1

thought the specialist division might get better treatment from the NYSE if Cayne joined.[27] The regulatory sway possessed by Mr. Grasso may have contributed to the passivity of the Board – according to the civil suit filed by the State of New York against Mr. Grasso and others, the Board of Directors opted to approve Grasso's compensation proposal even though not all Directors had been "adequately prepared or briefed on the Grasso [compensation] Proposal."[28] Additionally, board members were misled as to the final sum of the compensation package. Kenneth Langone, chair of the compensation committee and Grasso's longtime friend and colleague,[29] failed to disclose approximately $8.05 million as part of the compensation package.[30]

These failures in corporate governance undermined the integrity of the NYSE in the eyes of the public and represented a breach of the members' confidence. After briefly discussing the recent history of governance reforms, this paper will make recommendations to address the remaining conflicted and corrupt governance practices.

THE HISTORY

Governance shortcomings are nothing new – the boards of directors of public companies have been scrutinized for their failures to represent the interests of shareholders for more than a decade. Underlying the failures of Enron, MCI Worldcom, and RJR Nabisco were conflicted

[27] Complaint vs. Richard Grasso, Kenneth Langone, and the NYSE by Eliot Spitzer, Attorney General of New York State, on behalf of the State of New York.. Filed 24 May 2004. Statement no. 27, p. 8. Citing Frank Ashen. Hereafter "Complaint vs. Grasso et al."
[28] Complaint vs. Grasso et al, Statement no. 151, p. 41. Citing Frank Ashen.
[29] Ho, David. "Langone: 'Truth on our side'; Grasso ally to fight suit over NYSE pay." The Atlanta Journal-Constitution. p.1Q
[30] Complaint vs. Grasso et al, Statement no. 75, p. 22.

directors under the control of the CEO. The boards of the major securities markets[31] – the NYSE, American Stock Exchange and Nasdaq – have also had their share of problems.[32]

Over the past couple of decades, the problems of poor corporate governance have risen to the forefront in the eyes of the investing public. Now, individual and institutional investors are concerned not only with the governance of the companies in which they invest, but also the institutions that organize their investment – Wall Street as a whole.[33]

In 2002, following the collapses of Enron and MCI Worldcom, the NYSE and NASD acted quickly to establish tougher standards on corporate governance.[34] They focused on the establishment of a majority of independent directors on boards of directors and rigorous auditing and audit committee standards.[35] Ironically, these standards were not followed by the NYSE (or other exchanges for that matter). Explanations for why the exchanges did not reform their own corporate governance requirements include their "quite simply not [keeping] pace with either best practices in corporate governance or the tremendous changes in the nature of [the]

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[31] The term "exchange" in this paper shall represent any SRO. Although Nasdaq is officially a "registered securities association," for the sake of governance recommendations it shall be treated like the exchanges. This report finds there is no relevant distinction that would affect recommendations in terms of corporate governance.

[32] (a) In 1994-5, following the scandal over "odd-eighths" quotes, U.S. Senator Warren Rudman chaired an investigation to review NASD governance. The committee found that "It is not the board of directors of the National Association of Securities Dealers, which owns the market, nor the board of Nasdaq itself, but a powerful committee of traders that has largely usurped the authority of both boards." Knight, Jerry. "Nasdaq Board Powers Eroded, Report Says; Traders' Committee Said to Control Market" The Washington Post. 22 September 1995 p C01. Also, Ingebretsen, Mark. NASDAQ: A History of the Market that Changed the World. Roseville, California: Prima Printing, 2002. pp 129-132.

(b) Recently, the regulatory function and the compensation committee of the American Stock Exchange has also been criticized: "The proposed payments [of $22 million to NASD Vice-Chair Salvatore Sodano and $1.5 million to Amex President Peter Quick] have drawn criticism, especially because the Amex has been losing money. "The stock exchanges should be in the forefront of good governance," said Arthur Levitt, a former SEC chairman [and] Amex's chairman and CEO from 1978 to 1989. "This reported compensation package does not appear to be justified in light of recent performance."" Harrigan, Susan. "Insecurities Swirl at Amex" Newsday. 6 December 2004

[33] "The Value of Trust" The Economist. 6 June 2002

[34] ibid.

[35] "Corporate Governance Rule Filing No. SR-NYSE-2002-33" http://www.nyse.com/pdfs/corp_gov_pro_b.pdf, 16 August 2002. Filed along with NASD; full order approving rule changes available at http://www.sec.gov/rules/sro/34-48745.htm, 4 November 2004

constituents,"[36] a previous lack of "necessity,"[37] and the distraction of other corporate mishaps. It was not until late 2003 that the NYSE submitted new Securities and Exchange Commission (SEC) filings to alter its corporate governance structures; shortly thereafter other exchanges followed suit.[38]

The SEC filed its own governance rule proposal on November 18, 2004.[39] The rule proposal "would require SROs to adopt specified baseline governance standards, including a majority independent board and fully independent nominating, governance, audit, compensation, and regulatory oversight committees. It also would require each SRO to take steps to separate its regulatory function from its business operations."[40] This paper will argue that these models of restructuring are a step in the right direction, but are not sufficient to achieve a regulatory system that minimizes conflicts of interests.

Continuing reforms in corporate governance of the exchanges and Nasdaq is necessary in order to provide trade environments that are both stable and capable of adapting to changes in the

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[36] U.S. Senate, Committee on Banking, Housing, and Urban Affairs. "Improving the Corporate Governance of the New York Stock Exchange." Testimony of NYSE Interim Chairman and CEO John Reed. November 20, 2003: Available online http://www.nyse.com/Frameset.html?displayPage=/about/viewpoints.html

[37] "In John Reed's Hands" The Economist. 6 November 2003

[38] (a) NYSE filed in November 2003, SEC approved in December 2003. SEC Release No. 34-48764; File No. SR-NYSE-2003-34. "Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc. Relating to the Amendment and Restatement of the Constitution of the Exchange to Reform the Governance and Management Architecture of the Exchange," 7 November 2004. http://www.sec.gov/rules/sro/34-48764.pdf
[less extensive governance reforms were instituted in June 2003 before the major SEC filing in November. "NYSE Implements Governance Committee's Recommendations" NYSE Newsletter June 2003, Vol 10, No. 7, p. 4]
(b)Amex submitted its proposal in June/July 2003, pending approval by the SEC. SEC Release No. 34-50057; File No. SR-Amex-2004-50. "Notice of Filing of Proposed Rule Change by the American Stock Exchange LLC Relating to the NASD's Sale of its Interest in the American Stock Exchange LLC to The Amex Membership Corporation" 22 July 2004. http://www.sec.gov/rules/sro/amex/34-50057.pdf,
(c) PCX submitted its proposal in February 2004, SEC approved in May 2004. SEC Release No. 34-49718; File No. SR-PCX-2004-08. "Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1 Thereto Relating to the Demutualization of the Pacific Exchange, Inc." 17 May 2004 http://www.sec.gov/rules/sro/pcx/34-49718.pdf,
(d) Incidentally, Amex and PCX only submitted governance proposals as part of their plans for demutualization.

[39] SEC Release No. 34-50699; File No. S7-39-04. "Securities and Exchange Commission 17 CFR Parts 240, 242, and 249: Self-Regulatory Organizations—Various Amendments," Proposed Rule, 69 Fed. Reg. 71126-71254 (Filed 18 Nov 2004; published in the Federal Register December 8, 2004) http://www.sec.gov/rules/proposed/34-50699.pdf. Page numbers refer to the Federal Register.
Also at http://www.sec.gov/rules/proposed/34-50699.htm.

[40] SEC Press Release No. 2004-154, 9 November 2004. http://www.sec.gov/news/press/2004-154.htm

market. Because the governance structure is ultimately responsible for the self-regulatory aspect of the organizations, development of a framework that ensures objective assessment of the corporations that individual and institutional investors place their faith in is essential to maintaining the public trust in these institutions.

This report recommends that the SEC proceed with its proposed ruling to provide oversight of corporate governance standards, with some amendments. The first part of this paper briefly outlines why the SEC is the appropriate institution to regulate the governance of the exchanges. The second part of the paper recommends that the exchange governance boards be composed of a majority of independent directors. Because independent directors cannot be a panacea for the recent problems that have arisen in corporate governance – consider for instance, the lack of knowledge of the industry that often comes with their status as "independents"[41] – this report also recommends structural measures to provide information to newer independent members and incentives for active participation on the part of all directors. The third part of the paper argues for a more concrete, perhaps stricter, implementation of the "independent" regulatory function. The fourth part of the paper discusses the role of the CEO and argues for mandatory separation of the CEO and chairman of the Board of Directors. The fifth part of the paper argues for the following specific recommendations relevant to particular board committees: inclusivity in the nominating process, annual performance reviews, and compensation disclosure. In the final section of the paper, we return to compensation and argue for more universal transparency on part of the compensation committees in their disclosure of executive and director salaries.

[41] Lorsch, Jay. Cited in "Non-Executive Directors" The Economist. 18 March 2004

III. THE CONSTITUENTS

Before delving into the specific recommendations, it is necessary to discuss the major constituencies affected by any proposal for exchange governance reform. Three major constituencies exist: the public, listed corporations on the exchange (or traded corporations), and members (or shareholders in the case of demutualized exchanges[42]).

The public, although not formally tied to the exchanges, is inevitably affected by the decisions of exchange directors, especially given the volume and value of the securities traded each day on each market. The value of the companies traded on the NYSE alone is nearly $18 trillion;[43] 1.5 billion shares are traded each day[44] on the NYSE and 1.78 billion shares are traded each day[45] on the Nasdaq. Even if the volume of shares and the value of securities traded were much smaller, the self-regulatory responsibilities of the exchanges have placed the exchanges in a position of securing the public trust. They are responsible for ensuring that they fulfill specific regulatory requirements that ensure fair trade.

Listed corporations and affiliates of the exchange are another important constituency – they are directly regulated by the exchanges and thus they are directly affected by any rule changes adopted by the exchange. Listed corporations provide the business of the exchange: without them, no trades would take place. At the same time, listed corporations must not be treated as the only group with an interest in the outcome of exchange governance structure. The power of the listed corporations must be tempered by concerns for other stakeholders.

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[42] A demutualized stock exchange has undergone the process of transforming from a non-profit member-owned mutual organization into a for-profit shareholder corporation. Its fiduciary responsibility is to its shareholders in the same way that a mutual exchange's fiduciary responsibility is to its members. Demutualization of Stock Exchanges: Problems, Solutions, and Case Studies. Ed, Shamshad Akhtar. Asian Development Bank, 2002. p xiii
[43] The New York Stock Exchange Homepage. www.nyse.com
[44] "About the NYSE" http://www.nyse.com/about/1088808971270.html, 2005
[45] "Nasdaq 2004 Factsheet": http://www.nasdaq.com/about/CorporateFactSheet2004.pdf

The final and most obvious constituency is the owners of the exchange, whether they are members (such as in the case of the NYSE, where a seat sells for more than one million dollars)[46], or shareholders (as in the case of PCX). The owners have a clear fiduciary interest in an effective board of directors; thus it makes sense that their interests be represented in some form.

Balancing all three constituencies is necessary for effective governance to represent all stakeholders in the business of the exchanges. The interests of each will be considered in the analysis of this report's recommendations.

IV. THE SEC AS IMPLEMENTER

The SEC (as opposed to decentralized state governments or the U.S. Congress) is the appropriate Board of Directorsy to oversee the regulation of corporate governance for a few reasons. First, the SEC is the authority that trading associations must report to when they change any rules of exchange operation. The SEC approves the rules submitted by self-regulatory organizations (SROs) and maintains federal authority in filing suit against SROs that fail to uphold their regulatory standards. Because the Board of Directors is responsible for this SRO function, the SEC should oversee governance standards as well. Second, the SEC as a national institution could oversee all exchanges and thus ensure that investors in all states received adequate protection. Given the highly technical nature of exchange regulation, the transaction costs of individual investors examining various state regulatory regimes and then organizing to support states with investor-friendly regulation would be too high; thus the public check on regulatory structures would fail. Third, the SEC is capable of being flexible in its examination of

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[46] "Seat Prices," The New York Stock Exchange Website.
http://www.nyse.com/Frameset.html?displayPage=/press/1022834145706.html

SRO governance proposals– a quality that congressional legislation could not achieve. By setting baseline standards and approving individual applications, the SEC can oversee that regulation of governance is fair and appropriate for each institution.

V. INDEPENDENT DIRECTORS

THE NECESSITY OF INDEPENDENT DIRECTORS

The actions of boards run by non-independent directors most clearly illustrate the need for nconflicted, independent directors. In the late eighties and early nineties, NASD officials overlooked misquoting and even-eights collusion scandals; not surprisingly, the governance of Nasdaq at the time was overrun by the market-making firms.[47] The benefit of decreased regulatory pressure conferred on non-independent NYSE Directors[48] is also representative of the problems that may arise when non-independent directors control boards. These sorts of obvious problems with conflicted directors provide the rationale for the SEC's proposal requiring that "independent directors" constitute a majority of exchange boards and setting forth more stringent requirements in defining "independence."[49]

Some research remains lukewarm in the supposition that independent directors are enough to solve the concerns that exchange owners, the public, and listed companies might hold. Randall Morck, using behavioral psychology studies, suggests that the dominance of the CEO might be too much for independent directors to overcome.[50,51] Studies of the performance of

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47 Ingebretsen, pp. 126, 129

48 See Complaint v. Grasso et al, Statements Nos. 28-31, pp 8-10. Grasso intervened on behalf of Langone when his investment bank was under investigation by NASD, and the NYSE held off investigation of firms that had allegedly committed fraud, and that also had executives represented on the NYSE Compensation Committee.

49 See SEC Release No. 34-50699

50 Morck, Randall. "Behavioral Finance in Corporate Governance – Independent Directors and Non-Executive Chairs" Working Paper 10644, NBER Working Paper Series. July 2004

51 See section entitled "The Role of the CEO" for further development.

firms with, versus without, a majority of independent directors, were inconclusive in proving superior performance.[52] At the same time, however, these studies note that conclusively determining the relationship between board composition and corporate performance is problematic for two reasons. First, the length of time that "majority independent boards" have existed is not long enough to determine any statistically significant trend.[53] Second, the definition of "independence" has been vague – so comparison among different corporations cannot be as cut-and-dry as the label of independence might appear.[54] Prior to the SEC's current proposal, no standardized definition of independence existed – the exchanges each had separate definitions of independence for listed corporations versus exchange officers, and different definitions even existed for various board functions, such as the audit committee.[55]

A more recent study of board composition and corporate fraud takes into account the distinction between "outside directors" and "independent directors." (Former studies might combine the two and treat them as the same class of directors).[56] Its findings were that an increased proportion of outside directors on the board correlated with a decreased incidence of

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[52] Bhagat, Sanjai, and Bernard Black. "The Uncertain Relationship between Board Composition and Firm Performance." Business Lawyer, Vol 54, May 1999. Cited also in "The fading appeal of the boardroom," The Economist. 8 February 2001.
[53] Bhagat and Black, p. 952-953
[54] ibid.
[55] NYSE, Nasdaq, Amex, and PCX require there be "no material business relationship" between independent directors and the exchange. Other than that, the various "independence" disqualifications vary with regard to, among other things, how the individual's immediate family affects his or her independence; the amount of money an individual may receive before being disqualified as independent; and "cooling off periods," the mandatory span of years between the end of an individual's formal business relationship with an exchange or exchange affiliate, and the time when the individual is eligible for qualification as "independent." See: NYSE -"NYSE Independence Policy" http://www.nyse.com/pdfs/DirectorIndependencePolicy.pdf; Nasdaq – "Nasdaq Bylaws" I(s), http://www.nasdaq.com/investorrelations/Bylaws.pdf; Amex – "Constitution" Art. II, Sect. 1 http://wallstreet.cch.com/AmericanStockExchangeAMEX/Constitution/ARTICLEIIGovernmentandAdministration/162600002C.asp 2005; PCX – SEC Release No. 34-49718, p 4;
[56] Bhagat and Black use "outside" and "independent" interchangeably. However, outside directors may not necessarily be "independent" – see Uzun, Hatice; Samuel Szewczyk; and Raj Varma, "Board Composition and Corporate Fraud," 60 Financial Analysts Journal. May/Jun 2004.

corporate fraud. [57] The presence of outside directors who were not independent due to "business or personal ties to the company" increased the likelihood of fraud.[58]

Critics of the utility of independent directors often have not evaluated their potential benefits in the context of other governance reforms. For example, although the exchanges have taken measures to improve their corporate governance, many of the new blueprints for governance resort to the use of independent directors *alone* to solve the majority of conflicts that once plagued the boards. Instead of this approach, it is more productive to consider mechanisms that both overcome the chief weakness of independent directors – their lack of knowledge – and preserve their chief strength – their objectivity.

This report contends that independent directors will play a productive monitoring role in corporate governance so long as knowledge barriers can be overcome.[59] Knowledge barriers can arise for a few reasons. First, an outsider with no historical context of the organization's decision-making history would not have as much of a basis for future decisions as someone who is more familiar with the particular historical quirks of the organization. In terms of the board's regulatory responsibility, because the rules of the exchanges are different for each, it would be tough for any independent person to know and understand all of them from the beginning. Finally, although some directors may have served on previous boards and may have an understanding of the business, it is possible that some independent directors will have no understanding of what constitutes good management practices in the context of an exchange; his or her performance of the management advisory function would be, at least at first, impaired. Without the background in exchange operations and regulations that comes with experience

[57] Uzun et al, p. 41
[58] ibid, p. 42.
[59] Even authors who disagree with "supermajority" independent boards acknowledge there is a specific place and need for independent directors. See Bhagat and Black, p. 953.

either working in exchange management, on the floor, or as a listed firm's liaison, it is extremely difficult for a director to understand the technicalities and context necessary for informed decisions.

But because independent directors are the only way to fully remove conflicts of interest, their presence on the board of directors is necessary. Independent directors serve the public by representing the perspective and interests of non-industry parties. They also serve the interests of the exchange ownership because their decisions are less likely to be conflicted and thus more likely to benefit the business rather than a particular faction of the exchange or industry. Even industry affiliates or listed companies may benefit from the perspective of outsider opinions in boardroom discussions. Structural solutions to the weaknesses of independent directors come in the next few sections.[60]

STANDARDIZED DEFINITION OF INDEPENDENCE

A standardized definition of independence is necessary to facilitate institutional and public oversight of selected "independent" directors and to create a consistent industry-wide regime of effective corporate governance. The SEC's proposed rule change to part 240 of the General Rules and Regulations under the Securities Exchange Act of 1934 adds §240.6a-5 to provide a standardized definition of an "independent director" as one who "has no material relationship with the national securities exchange or any affiliate of the national securities exchange, any member of the national securities exchange or any affiliate of such member, or any issuer of securities that are listed or traded on the national securities exchange or a facility of

[60] This report acknowledges that a variety of options are also available to help directors overcome the "knowledge barrier," including a shadow period before the director takes office during which he/she sits in on board meetings; training sessions; and the use of outside firms to provide confidential information to board members. These go beyond the scope of this paper's aim – improving governance structure, but the author encourages exchanges to pursue the options as means to better educate their independent directors.

the national securities exchange."[61] The SEC also lists a number of circumstances that disqualify an individual as independent, including a minimum 3-year period during which the individual cannot have been employed or engaged in a material relationship with any affiliate and a maximum sum of $60,000 that the director or immediate family member can have received from any affiliate within a 12 month period of the 3 year "cool-off" period.[62]

The SEC's definition of independence is fairly extensive, and therefore it gives the impression of thoroughness. Yet in the rhetoric of its definition of independence, the SEC fails to mention formal business relationships among "independents" or prior, non-exchange-related business relationships between the "independents" and management personnel as possible barriers. The definition cannot possibly account for all circumstances that will hinder an individual's independence. "Material relationship" is also defined vaguely: it "means a relationship, whether compensatory or *otherwise*, that *reasonably could affect* the independent judgment or decision-making of the director."[63] The flaw in language is not that the definition of "material relationship" is vague, but rather that such vague language is coupled with very concrete and specific other requirements that give the impression of providing a black and white definition of independence.

Instead of outlining eight disqualifications with minor subsections and exceptions as part of the definition of independence, the SEC would be clearer and more effective if the focus of its language were "no material relationship," accompanied by the clear-cut cooling off period and maximum of $60,000 in payments from any exchange or affiliate. This way, individuals would be scrutinized as meeting further board-specific standards of independence, not "failing the disqualifications to independence." In other words, the bar would be set higher – instead of

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[61] SEC Release No. 34-50699, p. 71214; [71219] is the corresponding reference for "securities associations"
[62] ibid, pp. 71214-71215; [71219-71220]
[63] ibid, p. 71214, emphasis mine; [71219]

searching for reasons why an individual is not "not independent," the nominating committee would need to show why an individual "is independent."

FULLY INDEPENDENT BOARDS VS. MAJORITY INDEPENDENT BOARDS

If independent directors are so integral to decreasing conflicts of interest, it could be argued that boards of directors should be fully independent so as to remove any potential conflict of interest. Doing so is undesirable for a couple of reasons. First, it would deprive the directors from having enough information to make informed decisions – "independent directors are independent, but often ignorant about what is happening inside the company."[64] A mixed composition of independent and non-independent directors helps to resolve the knowledge barrier because the non-independents can help provide a historical context to the independent directors. Second, for the sake of constituent representation, members and industry should have some voice on the board that makes the major decisions affecting their livelihoods.

A simple majority of independent directors will be enough prevent industry representatives from pursuing business and regulatory strategies that benefit their interests at the expense of other constituents. At the same time, boards with both independent and non-independent directors will have a stronger knowledge base and represent all of the constituencies affected by the exchanges. Thus, instead of fully independent boards, this paper recommends that boards be composed of a mix of majority of independent directors and minority of non-independent directors.[65]

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[64] Bhagat and Black, p. 950.

[65] Regarding "non-independent advisory boards," (boards composed of non-independent persons with the purpose of advising the board of directors; an example is the NYSE's Board of Executives): This paper contends that non-independent advisory boards serve the same purpose as non-independent directors on a mixed board of directors. Because this paper argues for a simple majority of independent directors rather than an entirely independent board, any advisory board would be unnecessary. However, should an exchange opt to have an entirely independent board of directors, it should never appoint more members to its advisory board than to the board of directors – doing so may overwhelm the opinions of the independent directors and hinder objectivity in decision-making. Representatives at the NYSE who have seen the Board of Executives at work note that (a) their opinions strongly

TERM LENGTHS AND LIMITS

Two additional structural measures to improve the performance of independent directors by providing them with additional information are lengthening terms and setting term limits. First, terms that last longer than one year and are staggered in classes allow the more experienced members of the board to communicate to the newer members the history of various exchange rules and procedures. The public directors shall not have to be reliant upon the non-public directors for information; rather, they can gain information from both independent and non-independent sources. Given the highly technical nature of the material that exchange boardrooms must analyze, this extra source of information will aid directors in making better-informed decisions.

Currently, Amex offers the only potential governance structure with term limits longer than one year and its approval is pending sale of the exchange by NASD. The proposed rule filing sets up two-year, staggered terms.[66] This policy report recommends a similar requirement for other exchanges – as a representative of the NYSE remarked, "you come up a learning curve and you don't want to lose somebody after a year."[67]

Second, an eight-consecutive-year term limit prevents individuals who sit on the board for too long from becoming comfortable, losing interest, and performing less actively. While the information possessed by individuals who serve longer than 8 years may be useful to the independent board members, the possibility of losing a number of such board members –even half – at one time could threaten the succeeding board's ability to think critically and make

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affect decisions ultimately made by the Directors and (b) that the Board of Executives is a "very vocal community" and will speak on behalf of their interests (not necessarily those that are best for the business of the Exchange). Thus, the NYSE's current Board of Executives should be cut in size. [Conversation with BoE member Robert McCooey 10/27/04 and Interview with NYSE Representative 10/28/04].

[66] SEC Release No. 34-50057, p. 9

[67] Interview with NYSE representative, 28 October 2004

sound decisions. A consistent flow of incoming and outgoing members is useful for board stability; term limits help maintain this consistency.

The main argument against both of these requirements is the loss of flexibility on the part of the board to determine its composition. Two-year terms do not significantly threaten the composition of the board – if an individual is really not working, the nominating committee may not re-nominate him or her for a second term. If two years seems too long, the committee can elect to add a member in the transition, provided that the board size is flexible. The eight-consecutive-year limit may force some good people to retire from service for a period of time before returning; at the same time, the board would always gain fresh perspectives and new insights. Thus, no major harm would be incurred by imposing these structural limitations. The worst-case scenario is that the board retains a nonproductive member for an extra year or relinquishes someone who has provided good service after eight years. The best-case scenario is that the board retains knowledgeable, effective independent directors and remains consistently active in its discussions and decision-making.

LIMITED BOARD SIZE

A final recommendation to maximize the performance of independent directors is setting limits on board size. Currently, the only market with a fully flexible board size is Nasdaq, which permits the Board of Directors to determine its size via board resolution.[68] There is no lower or upper limit to the number of Directors. Perhaps this is why Nasdaq has the largest Board of Directors out of all case studies – a total of 17 Directors. Eisenberg et al, in a study of U.S. and

[68] "Nasdaq Bylaws" Art.4, Sec.2; at http://cchwallstreet.com/nasd/nasdviewer.asp?SelectedNode=4&FileName=/nasd/organization/CorporateOrganization.xml

Finnish firms, look at the decrease in value that occurs as board size increases.[69] Reasons for this include "impaired communication and coordination."[70] Another problem with large boards is the coordination of opinions, which results in a "decreased ability of the board to control management, thereby leading to agency problems stemming from the separation of management and control."[71]

A more productive structure would set maximum and minimum numbers of directors, but leave the exact size to be determined either by a Governance Committee of the Board of Directors or the Board itself. Because the economic literature at this time is still limited in its determination of optimal board size, this report recommends that the SEC or exhanges conduct their own self-examination of minimum and maximum numbers. Current findings indicate that board sizes larger than 7-8 members tend to be less responsive to poor CEO performance, but these boards are for firms of different average size than the exchanges and probably require less technical expertise.[72] This report estimates that a board size between 7 and 15 is probably optimal, but further research either by the exchanges themselves or the SEC must be conducted to determine such limits. At this point, the best recommendation is that exchanges set some limitations regarding board size following research as to the optimal limits.

VI. THE REGULATORY FUNCTION

INDEPENDENCE OF THE REGULATORY FUNCTION

The potentially greatest problem with the lack of governance regulation is the potential

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[69] Eisenberg, Theodore, et al "Larger board size and decreasing firm value in small firms" Journal of Financial Economics 48 (1998)
[70] ibid, 37.
[71] Ibid.
[72] Beiner, Stefan, et al. "Is Board Size an Independent Corporate Governance Mechanism" Kyklos, Vol 57 No 3, 2004.

for abuse of the SRO function. New York Senator Charles Schumer states in a hearing of NYSE governance reform: "Now, we are all here today because of the circumstances that led to … Dick Grasso's resignation, and they are serious and they have to be addressed. It is now clear there was not enough hands-on oversight, that there was too much abuse of the regulatory function, there were too many conflicts of interests."[73] This abuse culminated in the manipulation of directors and exploitation of the Board's function as an SRO.[74]

Currently the SEC's proposed rule requires structural separation of the regulatory and business functions of the exchange associations. However, taking this one step further – complete independence of the regulatory function – is necessary to prevent the business-side board members from having the opportunity to influence the decisions of the regulatory oversight committee (ROC). This would guard the SRO function from conflicts of interest and guarantee objective regulation oversight.

STRUCTURAL PROPOSALS

Complete independence could be codified either as a fully separate board of regulators or an ROC that does not report to any non-independent directors – essentially it could only report to the executive sessions of the boards of directors. In this way, the ROC members would not have to report to potentially conflicted directors.

The SEC's proposal requires all standing committees of the Board, including the ROC, to report to the Board;[75] it also requires 20% of any subcommittee responsible for conducting hearings, rendering decisions, and imposing sanctions with respect to disciplinary matters, be

[73] U.S. Senate, Committee on Banking, Housing, and Urban Affairs. "Improving the Corporate Governance of the New York Stock Exchange." November 20, 2003
[74] See n.24 above for examples.
[75] SEC Release No. 34-50699, p. 71216; [71221]

composed of members of the exchange.[76] Requiring the ROC to report to the full Board of Directors undermines the committee's independent authority and also retains the potential conflicts of interest wherein the regulators must report to those that they are regulating. The requirement of 20% members in subcommittees related to regulation makes sense, but only so long as it is clear that recusal is required for any members who are materially related to parties involved in such hearings.

VII. THE ROLE OF THE CEO

Currently, the CEO may serve as chair of the Board of Directors on all exchanges. The NYSE and Nasdaq have recognized the undesirability of this apparent conflict of interest –i.e., the CEO chairing a board charged with evaluating him or her – and currently, their CEOs are non-chair members of the Board.

In addition, placing the CEO in the additional position of authority as Board Chairman, concentrates his or her power, yields a greater potential for abuse, and discourages other board members from serving actively.[77] Morck, citing Milgram's study of loyalty to authority figures,[78] explains, "Like the ordinary Americans who felt duty-bound to administer high voltage electric shocks to perfect strangers, directors often feel an allegiance to the CEO. Criticizing a CEO, even for palpably awful decisions, smacks of 'disloyalty.' Such a feeling is apparently to be avoided, even at considerable cost to one's conscious."[79]

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[76] ibid, p. 71217; [71221-71222]
[77] Higgs, Derek. "Review of the role and effectiveness of non-executive directors." UK Department of Trade and Industry. January 2003, p.23. Hereafter, "Higgs Report"
[78] In Milgram's original study, subjects were told that they were assisting an experimenter in determining "the effects of punishment on learning and memory." They were told by the experimenter, an authority figure, to administer volts of electricity when "learners" answered questions incorrectly. Although no actual learners were physically shocked, simulated responses occurred at different voltages. Over 60% of subjects were willing to shock their "learner" to death when commanded by a "legitimate authority figure." Morck, p. 3-5.
[79] Morck, p. 6.

Furthermore, regardless of whether or not the Board of Directors is independent, it is always true that the CEO and other Directors may have informal relationships that are pre-existing or develop over time. In the Grasso case, seven directors voted against his resignation; not surprisingly, one of them was Grasso's friend, Langone.[80] Other examples of boards where CEOs have wielded (and abused) such informal control include those such as CEO Ross Johnson's RJR Nabisco board[81] and CEO Michael Eisner's Disney board.[82]

Thus, the SEC should mandate separation of the CEO and chair of the board positions. The current rule proposal does not "require that an exchange's or an association's Chairman of the board be an independent director in all circumstances."[83] The only case in which the Chairman may be non-independent is when the CEO is also Chair. If CEO is not also Chair, the SEC proposes "that the Chairman must be an independent director."[84] The only reasoning behind not mandating a separation of the CEO and Chair positions is that "the Commission understands…some SROs may perceive efficiencies in having one person serve as Chairman and CEO."[85]

This reasoning is arbitrary, then, in requiring all non-CEO chairs be independent: obviously, SROs could also perceive efficiencies in having another non-independent director, such as a Chief Operating Officer, serve as chair of the board. The exception for the CEO also

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[80] "Grasso Vote: 13 to 7 for resignation" USA Today. 18 September 2003, http://www.usatoday.com/money/markets/us/2003-09-18-vote_x.htm

[81] Johnson would court his directors by inviting them to lavish events in which they could socialize with professional athletes; he would also permit them to use the company's fleet of over 13 planes and jets. His charm and awarding of consulting contracts and perks did not go unreciprocated. When he began making arrangements for the leveraged buy-out, the director he named as chair of the special committee essentially helped him "name his own judges." Bryan Burrough and John Helyar, Barbarians at the Gate. New York: Harper Collins, 2003. pp. 94, 97, and 174

[82] Despite "shareholder outrage," a history of questionable decisions including the awarding of a multimillion dollar severance package to Michael Ovitz for only 14 months of work, and declining earnings, Eisner remains in charge of Disney. See Bruce Orwall and Joann S. Lublin, "Fading Magic: For Disney's Eisner, Years of Corporate Sparring Catch Up," The Wall Street Journal (Eastern Edition) 1 March 2004, p. A1

[83] SEC Release No. 34-50699, p. 71141.

[84] ibid.

[85] ibid.

goes against the SEC's general desire to make boards more independent and less susceptible to management manipulation. Furthermore, allowing the SROs to use "efficiency" to justify poor governance structures that entrench management control is problematic: SROs may also "perceive efficiencies" in a variety of weaker regulations, but such efficiencies do not justify further ignoring governance abuses.

The SEC maintains that its proposal is "consistent with accepted corporate governance 'best practices' regarding board independence,"[86] yet the very reports that it cites – the Report of the American Bar Association Task Force on Corporate Responsibility[87] and the Derek Higgs Review of the Role and effectiveness of Non-Executive Directors[88] both argue for a consideration of separation of the CEO from the chair.[89]

Requiring a separation of the CEO and Chair roles would force board members to step up and make informed decisions without relying on the CEO for guidance. In addition, separation of the two roles would prevent the CEO from influencing the Board to make decisions that help him or her in the short term but hurt the exchange in the long run. This report recommends the that SEC mandate separation of the two roles even though it recognizes that separation of the two roles is not yet the norm in corporate governance practices. After all, the trend in governance reforms should be, and is, towards tighter standards that hold executives more accountable.[90]

EXECUTIVE SESSIONS

The current SEC proposal requires that independent directors meet regularly in executive

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86 ibid, 71134

87 n.91 at Ibid, 71134;

88 ibid.

89 (a)The Higgs Report is firm in its proposal that the positions of CEO and Chair be separated. See Higgs Report, p. 23

(b) The ABA Task Force recommended that the board of directors consider whether to appoint a lead director as Chair or to preside over Executive Sessions. The ABA Task Force does not make any arguments for or conclude that the CEO and Chair positions remain vested in one person. See "Report of the American Bar Association Task Force on Corporate Responsibility," American Bar Association 31 March 2003, pp. 71-72.

90 "Who's In Charge: The Ins and Outs of Corporate Governance" The Economist. 23 October 2003

session.[91] This requirement is a step in the right direction, but the rule could be improved by a) allowing the independent chair of the board or a majority of the independent directors the authority to call executive session at their discretion and b) clearly defining "regularly" to mean at least as often as the Board of Directors meets. Granting a majority of independent directors the authority to call executive sessions prevents a deadweight chair from undermining the functionality of the board by not calling independent executive sessions. Defining "regularly" more clearly prevents executive sessions from occurring only once or twice per year, and gives independent directors more freedom and opportunity to be critical of information they receive during regular board meetings.

VII. BOARD COMMITTEE RECOMMENDATIONS

THE NOMINATING COMMITTEE: INCLUSIVITY IN THE NOMINATIONS PROCEDURE

The SEC's proposal states (1)"the Nominating Committee must administer a fair process that provides members with the opportunity to select at least 20% of the total number of directors;"[92] (2)"the national securities exchange must adopt rules establishing a fair process for members to nominate an alternative candidate or candidates to the Board by petition and the percentage of members that is necessary to put forth such an alternative candidate or candidates. The percentage of members that is necessary to put forth an alternative candidate or candidates must not exceed 10% of the total numbers of members;"[93] and (3) "the Nominating Committee must nominate at least one director who is representative of issuers and at least one director who

[91] SEC Filing No. 34-50699, p. 71141. Proposed Rules 6a-5(d)(1) and 15Aa-3(d)(2)
[92] SEC Filing No. 34-50699, p. 71216; [71221]
[93] ibid.

is representative of investors and who, in each case, is not associated with a member or broker or dealer."[94]

These three provisions intend to guarantee representation of the members, public, and industry constituents. However, the first requirement – that only 20% of directors be selected by the membership – is a step backward from the exchanges' current requirements for inclusivity. Right now, candidates are proposed by the Nominating Committee but fully elected by members or owners. What is more necessary is a procedural guarantee that members/owners can nominate candidates. The second requirement is the most salient – it fills the need for codified inclusion of the members and shareholders in the nomination process. The third requirement is nonsensical – instead, the SEC could require a procedure by which investors and issuers may petition for a limited number of candidates to the Board of Directors.

The most important step in improving the procedure of the nominating committee is guaranteeing the membership or owners an opportunity to nominate directors for whom they eventually vote. This report recommends that the SEC approve the second requirement be approved and drop the first and third requirements.

THE GOVERNANCE COMMITTEE: SYSTEMATIC ANNUAL REVIEW

Annual review is critical to evaluating and improving board performance. The SEC's proposal would mandate that the Governance Committee "conduct an annual performance evaluation of the governance of the national securities exchange, including the effectiveness of the Board and its committees."[95] This section of the rule proposal addresses concerns that the governance could become stagnant or ineffective; this report endorses such efforts.

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[94] ibid.
[95] ibid.

THE COMPENSATION COMMITTEE: PERFORMANCE-BASED PAY

One problem that potentially arises with independent directors is that their lack of affiliation with the exchange also means they have no stake in the company.[96] For profit-making firms, one way to align shareholder interest with the Board of Directors is to compensate directors in stock or stock options. A study of director performance found a positive correlation between independent directors who own stock in the firm and firm performance.[97] Another study found "evidence that director stock ownership correlates with the probability of a disciplinary change of CEO," indicating that directors who own stock are more likely to be more critical of CEO performance and active in penalizing poor performers.[98]

Demutualized exchanges may be able to incorporate this method of payment; however, mutual exchanges such as the NYSE cannot do this because they are not publicly traded. Compensation based on firm performance is an alternative way to align Director interests with those of the firm. This report recommends that compensation committees issue payment in the form of a base salary and either stock options or a performance-based bonus in order to incentivize active, engaged Director performance.

THE COMPENSATION COMMITTEE: TRANSPARENCY THROUGH DISCLOSURE

Current regulation requires that the compensation committee disclose the compensation of corporate management – this is required of all public companies. Disclosure is valuable because "Whatever scheme is adopted, the only way that shareholders can judge whether it is really working and executives are being rewarded only for a job well done is if pay and

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[96] Kaen, Fred. A Blueprint for Corporate Governance. New York: American Management Association, 2003, p. 175

[97] Bhagat and Black, p. 952

[98] ibid, citing Sanjai Bhagat, Dennis C. Carey, and Charles M. Elson. "Director Ownership, Corporate Performance, and Management Turnover," 54 Business Lawyer (1994) p. 885

performance figures are disclosed, transparently and in full."[99] Similarly, the only way members of private companies can determine whether or not Directors are receiving proper incentives is through disclosure of compensation practices.

Disclosure of management pay allows members and owners to monitor the performance of executives, and also provides incentives for executives to perform well. The same arguments can be made for disclosure of director pay.[100] Currently, the SEC does require public companies to disclose director compensation to shareholders.[101]

For private exchanges, the issue is more complex. After all, the firm is private and such disclosures are not required of other private firms. Directors are also providing a service, and they may be less likely to take the job if their compensation figures are released.

To address the concern for privacy, this report recommends that the annual report of the Board of Directors include at least (a) any percentage changes in director compensation and (b) the methodology behind compensation calculations. This way, members who possess significant financial stakes in the performance of the directors may monitor the performance of the corporate governance. Empirically, "weak boards and powerful executives" – characteristics of poor governance - have been linked to inefficient compensation packages.[102] Extravagantly large packages may indicate persistent management influence over compensation committees

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[99] "Running Out of Options" The Economist. 9 December 2004

[100] Two major authorities in the field of corporate governance endorse disclosure of director pay. See Higgs Report, p. 87 and "Recommendations from the National Association of Corporate Directors" The National Association of Corporate Directors, 3 May 2002. http://www.nacdonline.org/nacd/enron_recommendations.asp

[101] 17 C.F.R. § 229.402.(g)

[102] Ryan Jr., H.E. and R.A. Wiggins III. "Who is in whose pocket? Director compensation, board independence, and barriers to effective monitoring," 73 Journal of Financial Economics 18 Nov 2003, p. 499

that are designed to be independent and further “enhance management domination”[103] over such boards of directors, who would then be “eager not to bite the hand that feeds them”.[104]

The aforementioned disclosures would be indicators that investors could use to evaluate the performance of exchange governance and would not significantly threaten the privacy of directors. Greater transparency would also instill more trust on the part of the public and provide a quicker response to any problems that develop in governance.

The principal argument against mandatory disclosure of director pay is that disclosure might alter compensation practices without resulting in substantive improvements in governance. But these more efficient director compensations packages remove opportunities in which management can obligate, and then exert unhealthy control over, the Board of Directors, which is the aim of governance reforms. Thus this report reasserts the recommendation that compensation practices be disclosed to the members of private exchanges.

IX. NON-EXCHANGE MARKETS

The ECNs are not exchanges, and therefore do not have to comply with the same self-regulatory requirements that exchanges do. ECNs are also not price-setters; instead they serve more of a broker-dealer function. Therefore, it is not appropriate to apply the same corporate governance guidelines that should apply to SROs to the ECNs. However, any non-exchange market that receives SRO status should be required to follow the same standards as other SROs.

X. CONCLUSION

Now that confidence in Wall Street is low and corrupt practices are being uncovered with increasing frequency, it is time for the SEC to step in and demand that the exchanges behave

[103] Elson, Charles. “Director Compensation and the Management-Captured Board - The History of a Symptom and a Cure” 50 Southern Methodist University Law Review 127, p. 162
[104] ibid, p. 164

honestly. The setting of baseline governance standards is necessary to restore public trust in the exchanges and to ensure that boards are equipped with the proper resources to make informed decisions. Moving towards more independent and active boards would allow exchanges to expedite their responses and adaptations to changing technology and markets. The aforementioned recommendations, if adopted by the SEC, will enhance independent director participation in the boards. These recommendations will also reduce unhealthy management control of the board and conflicts of interest that might hurt the operation of the exchange. Furthermore, these recommendations will improve the ability of SROs to properly regulate their markets and protect the investing public.

This report recognizes that some of the proposed standards may not be popular with the exchanges. Some standards will require exchanges to invest more time and valuable resources into their Boards of Directors. But in the end, internal corporate efficiency is not worth remaining mired in governance structures that lend themselves to stagnation, corruption, and management domination. Moving towards improved governance is the key to ensuring that exchanges both fulfill their SRO responsibilities and answer to the demands of their investors and members.

XI. SUMMARY OF RECOMMENDATIONS

1. The SEC should pursue setting a standardized, industry-wide definition of independence
    a. The focus of the language should define independence as "no material relationship to an exchange or affiliate," which should be accompanied by the clear-cut cooling off period and maximum of $60,000 in payments from any exchange or affiliate
    b. Other disqualifiers should be dropped
2. Boards of Directors must include a majority of independent directors and should include a mix of industry constituents as well.
3. Director Term Lengths should be two years long and staggered in classes.
4. No director should serve more than eight consecutive years
5. The SEC or exchanges should conduct further research to determine appropriate board size limitations
6. The Regulatory Function should be completely separated from the business function of the exchanges
    a. Either the Regulatory Oversight Committee should report only to independent directors or a separate Board of Regulators should be required
    b. The ROC or Board of Regulators should never report to non-independent Directors
    c. Non-independent Directors involved in ROC subcommittees for purposes such as conducting disciplinary hearings should be expected to recuse themselves in the case of a conflict of interest
7. The roles of CEO and Chairman should be separated
8. Executive sessions should meet at least as frequently as the Board of Directors meets
9. A majority of independent directors and the lead director shall each have the authority to call additional meetings in Executive Session.
10. Of the following three proposed rules, (1) and (3) should be scrapped and the SEC should pursue approval of (2)

(1)“the Nominating Committee must administer a fair process that provides members with the opportunity to select at least 20% of the total number of directors;”[105]

(2)“the national securities exchange must adopt rules establishing a fair process for members to nominate an alternative candidate or candidates to the Board by petition and the percentage of members that is necessary to put forth such an alternative candidate or candidates. The percentage of members that is necessary to put forth an alternative candidate or candidates must not exceed 10% of the total numbers of members;”[106]

(3) “the Nominating Committee must nominate at least one director who is representative of issuers and at least one director who is representative of investors and who, in each case, is not associated with a member or broker or dealer.”[107]

11. The SEC should pursue its rule regarding Governance Committee performance of systematic annual review
12. The compensation committees of private exchanges should disclose executive compensation, percentage changes in director compensation, and the methodology of determining director compensation in annual reports to the members.
13. These recommendations shall apply to the governance of SRO markets only

[105] SEC Filing No. 34-50699, p. 71216; [71221]
[106] ibid.
[107] ibid.

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