



March 8, 2005

Mr. Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth St., N.W.  
Washington, D.C. 20549-0609

Re: File No. S7-39-04 – Notice of Proposed Rulemaking Concerning Governance,  
Administration, Transparency, and Ownership of Self-Regulatory Organizations

Dear Mr. Katz:

The NASD staff appreciates the opportunity to express its views on the rules proposed (“Proposed Rules”) by the Securities and Exchange Commission (“SEC” or “Commission”) relating to the governance, administration, transparency, and ownership of securities self-regulatory organizations (“SROs”).<sup>1</sup> NASD commends the Commission’s significant efforts to assure that SROs have appropriate governance systems to carry out their regulatory responsibilities and that the Commission has the information needed to effectively oversee SROs. NASD also supports the Commission’s efforts to assist the public and market participants in better understanding significant aspects of SROs.

NASD agrees with the Commission that there are serious questions regarding how successfully SROs have managed the conflicts inherent in a self-regulatory structure, particularly those that can arise when an SRO also operates a trading market. Acknowledging such conflicts, NASD began some time ago, to separate its regulatory operations from any interest in a trading market and further is in the process of divesting its ownership interest in any such market.

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<sup>1</sup> Securities Exchange Act Release No. 50699 (Nov. 18, 2004); 69 Fed. Reg. 71126 (Dec. 8, 2004) (File No. S7-39-04) (“Proposing Release”). The comments provided in this letter are solely those of the NASD staff; the NASD Board of Governors has not considered or endorsed them. For ease of reference, this letter may use “we,” “NASD,” and “NASD staff” interchangeably, but with the exception of references to NASD systems, these terms refer only to the NASD staff.

As a companion to the Proposing Release, the Commission published a concept release discussing a range of issues related to the self-regulatory system of the securities industry. Securities Exchange Act Release No. 50700 (Nov. 18, 2004); 69 Fed. Reg. 71256 (Dec. 8, 2004) (File No. S7-40-04) (“Concept Release”). The NASD staff is submitting a separate comment letter to the Commission expressing its views on the issues raised in the Concept Release.

NASD expects to divest itself of any meaningful trading market ownership once The NASDAQ Stock Market, Inc. (“Nasdaq”) receives exchange status. Moreover, NASD has implemented numerous safeguards to manage the potential conflicts that exist in any SRO structure.<sup>2</sup>

NASD strongly supports the Commission’s expressed goals to enhance the SRO model and supports most aspects of the Proposed Rules. However, we believe that NASD’s focus on regulatory programs, coupled with its anticipated structure (i.e., not operating a trading market and having only a temporary, residual ownership interest in such a market) makes certain of the proposals inapposite, most particularly the proposal to require the designation of a Chief Regulatory Officer (“CRO”) and its attendant regulatory framework, including the establishment of an independent Regulatory Oversight Committee (“ROC”). NASD believes that the Commission should not impose the CRO/ROC requirements on SROs that do not operate a trading market or face related commercial competitive pressures.<sup>3</sup>

NASD also recommends, as discussed in more detail below, certain modifications to the Commission’s proposals regarding the SROs’ Board and committee structures. These suggested modifications are intended to ensure continued meaningful industry involvement in the regulatory process, which enables much-needed operational and business expertise to inform securities regulation. For example, while NASD agrees that the Commission should require an SRO’s Compensation Committee to be wholly independent, we believe that the composition of the other mandatory Board committees (Nominating, Governance, and Audit) should mirror the

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<sup>2</sup> This comment letter reflects NASD’s expectation that it will be divested of any meaningful ownership interest in Nasdaq prior to the effective date of any rules the Commission may adopt in this area. In this regard, while it is likely that NASD will have a temporary, residual ownership interest in Nasdaq immediately following Nasdaq’s registration as an exchange, NASD will diligently pursue full and prompt divestiture of such residual interest. Moreover, as further discussed herein, NASD believes that any such residual interest would not give rise to the types of conflicts of concern to the Commission, particularly given that NASD would not control or operate Nasdaq, as well as the existence of many other safeguards.

NASD completed its divestiture of the American Stock Exchange, Inc. (“Amex”) to members of Amex as of December 31, 2004. See also Securities Exchange Act Release No. 50926 (Dec. 23, 2004); 70 Fed. Reg. 131 (Jan. 3, 2005) (Order granting approval to amendments to NASD By-Laws and rules relating to the divestiture of NASD’s interest in Amex).

<sup>3</sup> See, e.g., Joel Seligman, Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation During the First Seventy Years of the Securities and Exchange Commission, 59 Bus. Law. 1347, 1380 (2004) (hereinafter cited as Seligman). In analyzing the New York Stock Exchange’s (“NYSE”) recent governance changes, Dean Seligman offers his view that:

Perhaps most significant, a full separation of the NASD from the Nasdaq would unequivocally change the mission of the NASD. Its role now would solely be regulation, subject to SEC oversight. Its board and leadership would not have to balance the type of business concerns that the owner of a stock market center inevitably must take into account.

(NASD notes that Dean Seligman has served on the NASD Board of Governors since January 2004.)

proposed majority independent composition of the Board, with the further limitation that management directors not be permitted to serve on such Committees.<sup>4</sup> NASD further believes the Proposed Rules should be revised to ensure that the definition of “independent director” does not preclude the participation of individuals who have relevant experience and expertise, yet may have recently served as outside directors of member firms. We have set forth other recommended changes that we believe are consistent with a strong, balanced, and well-informed Board.

In addition, in several instances, we request that the Commission clarify certain requirements set forth in the Proposed Rules to foster compliance and assure a common understanding of the rules. While NASD endorses the Proposed Rules, we note that the burden of compliance will be substantial and could escalate markedly depending on the Commission’s intended meaning or interpretation of several issues. To that end, this letter highlights certain provisions, particularly with respect to SRO disclosures and reporting requirements, where we were not able to assess the burden due to questions regarding the scope of the proposed requirement. NASD strongly encourages the Commission to work closely with the SROs to reduce burdens wherever possible, consistent with the Commission’s intended goals.

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## I. NASD's Unique Status

Self-regulation is a key component in the effective regulation, growth, and vitality of the U.S. securities markets. When the federal securities laws were enacted more than 70 years ago, the drafters of the Securities Exchange Act of 1934 ("Exchange Act") envisioned a layer of regulatory oversight in addition to the SEC that would work as a partner in regulating the securities industry. In the intervening decades, from the time NASD registered as the first and only national securities association in 1939 to today, the regulatory structure for the securities industry has been characterized by a unique partnership of private-sector and government responsibility.<sup>5</sup>

Self-regulation offers a range of benefits that governmental regulation standing alone simply cannot replicate. Perhaps most importantly, self-regulation can and does extend beyond enforcing legal standards to adopting and enforcing ethical standards. In identifying regulatory problems and developing necessary and appropriate measures and standards, self-regulators benefit from current insight into the workings of the industry. This coupling of ethical strictures with extensive knowledge of the workings of the industry is critical to assuring that regulatory solutions can be structured in a practical fashion and implemented, even when the ultimate resolution of a regulatory issue may not be popular with the industry. Also, industry participants often are in the best position to identify potential problems, thus buttressing the critical ability of regulators to stay ahead of the curve.<sup>6</sup>

At the same time, there are potential conflicts present in the self-regulatory model, and the Commission is correct to seek necessary enhancements to the system. Notably, virtually all the weaknesses in the effectiveness of SRO regulatory programs identified in both the Proposing Release and Concept Release have resulted from conflicts between an SRO's regulatory functions and its market operation functions and other related commercial interests, due in large part to the need to compete for order flow.<sup>7</sup> In this regard, NASD has divested itself of Amex

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<sup>5</sup> NASD notes that it has consistently been held by the courts to be a private, not a state (governmental), actor. See, e.g., D.L. Cromwell v. NASD, 279 F.3d 155 (2d Cir.), cert. denied, 537 U.S. 1028 (2002); Desiderio v. NASD, 191 F.3d 198, 206 (2d Cir. 1999), cert. denied, 531 U.S. 1069 (2001); Marchiano v. NASD, 134 F. Supp. 2d 90, 95 (D.D.C. 2001).

<sup>6</sup> For instance, industry's intimate knowledge of operational capabilities has been key in many major industry-wide initiatives, including enhancing trading processing and disclosure relating to mutual fund breakpoints, addressing the Y2K problem, and moving to decimals. Input from the industry often helps SROs to structure regulatory solutions in a manner that facilitates, rather than impedes, their implementation; a good example is NASD's taping rule, Rule 3010(b)(2), where the industry unsuccessfully opposed adoption but also made suggestions that were critical to smooth implementation.

<sup>7</sup> See generally Proposing Release 69 Fed. Reg. at 71151, where the Commission discusses its overarching concerns with conflicts faced by SROs that operate trading markets and their need to compete vigorously for order flow. In short, the economic health of an SRO that operates a trading market is tied to the economic health of its largest order flow providers, which can give rise to the conflicts cited by the Commission. Among other things, the loss of fees and prestige that would accompany the loss of a

and is in the process of spinning off its Nasdaq subsidiary as an independent company. Once Nasdaq receives exchange status, NASD will have, at most, only a temporary, residual interest in Nasdaq and no longer will face the types of market conflicts that the Proposed Rules are designed to address.<sup>8</sup>

Following divestiture of its trading market, NASD will continue to operate the Alternative Display Facility (“ADF”) and the Transaction Reporting and Compliance Engine (“TRACE”); however, each of these is a transparency and regulatory facility, not a competitive trading market that gives rise to the types of conflicts of concern to the Commission. Importantly, these facilities are not designed to attract or compete for order flow, nor do they have any type of dependency on order flow providers.

With respect to ADF, NASD created the facility solely to meet the requirements established by the SEC in connection with its approval of SuperMontage. ADF is a “display only facility” that simply handles quotation and trade collection, trade comparison, and information dissemination; it does not provide listing or order execution services.<sup>9</sup> Similarly, TRACE is a “display only facility” for corporate bonds that was created for regulatory and transparency purposes; it does not provide listing or order execution services. Moreover, TRACE does not compete with any other facility, and therefore does not face the competitive concerns that can contribute to abuses and conflicts of interest. It was designed solely to create a regulatory data repository and offer market participants, particularly individual investors, access to critical information.

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significant order flow provider could quickly have a material impact on an SRO that operates a trading market. Certain developments related to the allocation of market data fees have exacerbated this relationship as SROs that operate trading markets share fee rebates with order flow providers. See also Concept Release, 69 Fed. Reg. at 71261-62 (SRO regulatory staff may come under pressure to permit questionable market activity that attracts order flow to a market operated by an SRO).

<sup>8</sup> See supra note 2. NASD will continue to provide regulatory services to Nasdaq pursuant to a regulatory services agreement (“RSA”) executed by the parties in June 2000; it will not, however, control or operate Nasdaq, nor will NASD participate in Nasdaq’s business-related decisions. NASD also provides regulatory services to other entities through RSAs, including Amex, Chicago Climate Exchange, International Securities Exchange (“ISE”), and the Public Company Accounting Oversight Board. We also conduct, pursuant to a Rule 17d-2 agreement, options sales practice exams on behalf of Amex, ISE, the Chicago Board Options Exchange, the Boston Options Exchange, the Pacific Exchange, and the Philadelphia Stock Exchange.

<sup>9</sup> Notably, in discussing proposed Regulation AL, the Commission states that the ADF would not be an “SRO trading facility” because it does not execute orders. See Proposing Release, 69 Fed. Reg. at 71220. See also proposed Rule 15Aa-3(b)(21), which defines “SRO trading facility” to mean “any facility of an association that executes orders in securities.”

As the Commission is aware, NASD also will continue to operate a system for all residual equity securities, including the OTC Bulletin Board (“OTCBB”).<sup>10</sup> Like TRACE, this is a “display only facility” that serves as a regulatory database and a transparency facility. It does not compete with other providers and runs as a “utility.” In addition, it does not have listing or order execution functions, and NASD’s focus will be on integrity of information for investors.

With respect to fees for such facilities, the fee structures for ADF and TRACE currently are established to defray the cost of operating, maintaining, and improving the facilities and their associated functions, including market regulation. ADF fees generate revenue far less than the cost to support the facility. TRACE fees are set to cover the costs of operation, upgrades to the environment, and market regulation; it is not anticipated that these fees will cover the full cost of TRACE operations in the future. The fee structure and cost for the residual equity facility, including the OTCBB, will be set on a basis similar to TRACE once NASD assumes direct responsibility for the facilities. Moreover, the fee structures for all of these transparency facilities are (or, in the case of the residual equity market, will be) set without competitive interests in mind.

In short, none of these transparency facilities creates competitive concerns. And NASD is not faced with the types of issues that the Commission identifies in discussing the need to separate regulatory functions from market operations and other commercial interests – such as increased market competition, decreased trading volumes, pressures to retain primary liquidity providers and/or issuer listings, etc. Moreover, the Commission would have to approve any material changes to the operation of these facilities, including to their basic functionality, and any changes to the current cost recovery pricing models, thereby mitigating concerns relating to their potential evolution into trading markets. As such, the Commission can monitor and, if necessary impose conditions on, the future course and any potential evolution of these facilities.

At the same time, NASD recognizes that there remain potential conflicts of interest between any SRO and the interests of its members. In its Concept Release, the Commission states that “unchecked conflicts in the dual role of regulating and servicing members can result in poorly targeted and less extensive SRO rulemaking, and under zealous enforcement of SRO rules.”<sup>11</sup> Yet these are precisely the conflicts that NASD and the Commission have already

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<sup>10</sup> NASD has not yet assumed direct responsibility for OTCBB unlisted equity securities, although it has agreed to the transfer from Nasdaq. In addition, Nasdaq’s exchange registration is prompting NASD to consider its potential role in regulating a residual facility that would process all trades in exchange-listed securities executed otherwise than on an exchange. Similar to ADF and the OTCBB, this residual facility would be created to satisfy regulatory transparency concerns. See Securities Exchange Act Release No. 44396, Nasdaq Stock Market, Inc. Files Application For Notice as a National Securities Exchange, at 2 (June 7, 2001) (Commission states that before Nasdaq can register as a national securities exchange, Nasdaq must satisfy its obligations under Section 11A of the Exchange Act).

<sup>11</sup> See Concept Release, 69 Fed. Reg. at 71259. The Commission further states that “to be effective, an SRO must be structured in such a way that regulatory staff is unencumbered by inappropriate business pressure.” Such pressures may include “member domination of SRO funding, member control of SRO governance, and member influence over regulatory and enforcement staff.” Id.

confronted and addressed successfully and comprehensively in the context of a 1996 settlement.<sup>12</sup> As part of the 1996 Settlement, NASD entered into undertakings that are now embedded in the manner in which NASD operates and cannot be changed without Commission approval. These undertakings reflect both procedural and structural changes to many of the core aspects of NASD operations and address the very conflicts of concern to the Commission.<sup>13</sup> For example, as part of the undertakings, NASD has provided for the autonomy and independence of its regulatory staff, subject only to the supervision of the NASD and NASD Regulation Boards.<sup>14</sup> In addition, NASD maintains a majority Public and Non-Industry membership on its Board of Governors.<sup>15</sup>

Furthermore, since 1996, NASD has continued to enhance the independence of its regulatory programs and governance. For example, to ensure that the Board is not overly influenced by industry representation, as further discussed in Section III below, NASD has adopted By-Laws that contain special quorum requirements for key committees. These quorum requirements are designed to ensure that industry representatives on the Audit, Finance, Executive, and National Nominating Committees cannot have undue influence when the committees are called upon to conduct business. When the special quorum requirements are not satisfied, the only action these committees can take is to adjourn.

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<sup>12</sup> In the Matter of National Association of Securities Dealers, Inc. Administrative Proceeding File No. 3-9056, Securities Exchange Act Release No. 37538 (Aug. 8, 1996) (“1996 Settlement”). See also Report pursuant to Section 21(a) of the Exchange Act Regarding NASD and Nasdaq, Securities Exchange Act Release No. 37542 (Aug. 8, 1996) (“21(a) Report”).

<sup>13</sup> In the 21(a) Report, the Commission indicated that NASD “has taken and will take significant remedial steps relating to its governance and regulatory structure” which, when combined with the undertakings, were “intended to address many of the issues and concerns discussed in this Report ... [and] represent significant changes in the NASD’s self-regulatory process.” 21(a) Report at 10-11.

<sup>14</sup> As part of the undertakings, NASD also has taken the following actions:

- NASD regulatory staff (1) has sole discretion as to what matters to investigate and prosecute; (2) has sole discretion to handle regulatory matters such as membership applications and the conditions/limitations that may be imposed thereon; (3) prepares rule proposals, interpretations, and other policy matters with any consultations with interested NASD constituencies made in a fair and even-handed manner; and (4) is generally insulated from the commercial interests of its members.
- NASD promulgates and applies on a consistent basis uniform standards for regulatory and other access issues, such as admission to NASD membership.
- Professional hearing officers now preside over disciplinary proceedings.
- NASD maintains a substantial internal audit staff that reports directly to the NASD Audit Committee; the NASD Audit Committee includes a majority of Public and Non-Industry Governors and is chaired by a Public Governor.

<sup>15</sup> See infra notes 33 and 35 for definitions of the terms “Public Governor” and “Non-Industry Governor” for purposes of NASD By-Laws and rules.



Also, we have adopted numerous Code of Conduct provisions aimed at ensuring staff independence from the commercial interests of NASD members, such as prohibitions against investing in members or participating in initial public offerings, as well as strict limits on accepting gifts from members. NASD also has already adopted a requirement that there be no industry members on the Compensation Committee. In addition, NASD has amended its corporate documents to clearly delineate the neutral and ministerial role that NASD staff may perform in connection with the election of NASD Governors and members of the National Adjudicatory Council (“NAC”).<sup>16</sup> Further, NASD has empowered its staff to prevent committees from overriding staff determinations as to proposed rule changes.<sup>17</sup>

The effectiveness of this enhanced independence is most readily seen in the results of NASD’s comprehensive regulatory program. For example, in 2004 alone, we filed 1,360 enforcement actions, barred or suspended 830 individuals from the securities industry, and collected more than \$102 million in disciplinary fines. We also initiated 2,351 routine firm examinations and 10,545 “for cause” firm examinations.<sup>18</sup> In the area of rulemaking, we adopted a number of important investor-focused rules that touch on nearly every aspect of the securities industry, including new requirements for firms to establish emergency preparedness plans, new supervision and supervisory control requirements, and a required annual certification by CEOs of securities firms that the firm has processes to establish, maintain, review, test, and modify written compliance policies and supervisory procedures.

Accordingly, we believe that NASD’s organizational structure, independent regulatory operations, and anticipated divestiture of its ownership interest in a trading market already provide effective protections against the types of conflicts concerns that have been raised by the Commission.<sup>19</sup>

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<sup>16</sup> See Article VII, Section 12 of NASD By-Laws (limiting administrative support that staff may provide in contested elections); Article VI, Section 6.18 of NASD Regulation By-Laws (prohibiting staff from providing administrative support beyond that specified in the By-Laws of NASD and NASD Regulation).

<sup>17</sup> NASD has modified its internal procedures to ensure greater staff leadership. Among other things, recommendations for changes to NASD rules emanate from NASD staff, with the Board being advised of the reasons for any difference in view of the relevant advisory committee(s). In addition, NASD prosecutorial staff is empowered to appeal decisions rendered by disciplinary hearing panels. See NASD Rule 9311(a) (authorizing appeals to the NAC to be filed by a respondent, the Department of Enforcement, or the Department of Market Regulation). Further, non-prosecutorial staff routinely advises the NASD Board of its views regarding proposed NAC disciplinary decisions, including whether a proposed decision should be called for discretionary review.

<sup>18</sup> See NASD: 2004 in Review, available at [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&ssDocName=NASDW\\_012858&ssSourceNodeId=553](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_012858&ssSourceNodeId=553).

<sup>19</sup> In the Concept Release, the Commission also expresses concern with the potential conflicts between an SRO and its shareholders, as well as with listed issuers. See Concept Release, 69 Fed. Reg. at 71259-64.

## **II. CRO/ROC Framework is Unworkable for NASD**

### **A. Designation of a CRO and Establishment of an ROC**

Proposed Rules 15Aa-3(n) (for associations) and 6a-5(n) (for exchanges) would require each SRO to separate its regulatory function from its market operations and other commercial interests, whether through functional or organizational separation. In the SEC's view, such changes "would help insulate the regulatory activities of an exchange or association from the conflicts of interest that otherwise may arise by virtue of its market operations."<sup>20</sup> Proposed Rule 15Aa-3(n)(3) would require an association's Board to appoint a CRO to administer the regulatory program; the CRO would report directly to the proposed independent ROC, a standing committee mandated by the Proposed Rules. The ROC, among other things, would serve to assure the adequacy and effectiveness of the SRO's regulatory program; assess the SRO's regulatory performance; determine the regulatory plan, programs, budget, and staffing for the regulatory functions of the SRO; assess the performance of, and recommend compensation and personnel actions involving, the CRO and other senior regulatory personnel to the Compensation Committee; and monitor and review regularly with the CRO matters relating to the SRO's surveillance, examination, and enforcement units.

As discussed in Section I above, unlike all registered exchanges, which have operating a trading market as a primary objective, NASD is single-mindedly focused on regulation. NASD is not exposed to the conflicts to which other SROs that operate trading markets are exposed and for which the CRO/ROC structure is intended to be prophylactic. Therefore, it would be inapposite for NASD to designate a CRO, apart from its CEO, to administer its regulatory program. Rather, NASD's CEO is the individual who is first and foremost responsible for assuring the adequacy and effectiveness of the SRO's regulatory program; this individual is not involved in the operation of a trading market or in any way responsible for the viability or profitability of such a market. Accordingly, it would not only be illogical but would in fact markedly weaken NASD's regulatory structure to assign responsibility for NASD's regulatory program to an individual other than the CEO and prohibit that person (who essentially would be the de facto CEO) from participating on the Board of what is a regulatory organization.

For these same reasons, NASD should not be required to establish an ROC. Again, the NASD Board's core mission and focus is regulation, and it does not face or decide the types of matters that confront an SRO that operates a trading market; nor does it have to balance the same types of business concerns. As stated earlier, the NASD Board simply does not consider the types of issues that the Commission cites in proposing to separate regulatory functions from

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NASD is not subject to either category of conflict insofar as it does not have, or expect to have, any shareholders, and will not own or administer any listing venue or own any publicly traded entity.

<sup>20</sup> Proposing Release, 69 Fed. Reg. at 71133.

market operations and other commercial interests, such as heightened competition among marketplaces and the need to pursue strategies to increase market share. Rather, its focus is on operating a vigorous, effective regulatory program for the securities markets, including such things as assuring that disciplinary proceedings are conducted in accordance with the federal securities laws and NASD rules and that persons are not denied fair access to membership. And it would be illogical, duplicative, and costly to sever certain regulatory activities, such as examination and enforcement, from the operation of regulatory transparency systems that are not operated as competitive trading markets. Unlike the securities exchanges that do operate trading markets, these regulatory functions are appropriately related and should inform each other.

Accordingly, NASD requests that the Commission amend proposed Rule 15Aa-3(n)(2) and (3) to exclude those associations that do not operate an “SRO trading facility,” as that term is defined in proposed Rule 15Aa-3(b)(21).<sup>21</sup> As discussed in Section I, the Commission would be able to monitor the course of evolution of any particular facility owned by an association, such as ADF or TRACE, through its oversight of all SROs, including the SRO rulemaking process. Moreover, we note that proposed Rule 15Aa-3(n)(1) would require an association to establish policies and procedures to assure the independence of its regulatory program from its market operations or other commercial interests. In this regard, NASD could develop policies and procedures to further assure the Commission that it does not operate a trading market or maintain commercial interests that give rise to the conflicts of concern. For instance, NASD staff could present to the Audit Committee a periodic report on the operations and status of NASD’s transparency facilities, including their compliance with applicable rules, with such reports being included with the annual Committee performance evaluations to be submitted to the Commission under proposed Rule 17a-26(b)(3)(v), as certified by the CEO.<sup>22</sup>

## **B. Funding of Regulatory Functions**

Proposed Rule 15Aa-3(n)(4)(i) provides that “[a]ny funds received by the association from regulatory fees, fines, or penalties must be applied only to fund programs and operations directly related to such association’s regulatory responsibilities.” The Commission, in discussing this provision, states that it is intended to preclude an SRO from using its authority to raise regulatory funds for the purpose of benefiting its shareholders, or for other non-regulatory purposes, such as to fund executive compensation.<sup>23</sup> The Commission also states that this proposed requirement would help to ensure that an SRO’s regulatory activities are properly

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<sup>21</sup> See *supra* note 9 for text of proposed Rule 15Aa-3(b)(21).

<sup>22</sup> Similarly, NASD would need to address the independence of the regulatory program from market operations and other commercial interests in both Exhibit H of new Form 2 and in the annual report contemplated by proposed Rule 17a-26(b)(3)(iii). Any such discussions could include commentary on the continued status of ADF, TRACE, and the residual market for equities as non-competitive, transparency facilities. Of course, the Commission also would be aware of the status of Nasdaq’s exchange registration application prior to the effective date of any final rules in this area.

<sup>23</sup> Proposing Release, 69 Fed. Reg. at 71142.

funded, that the SRO is not abusing its regulatory authority, and that regulatory operations are separated from market operations or other commercial interests.

In proposing this requirement, the Commission cited perceived abuses relating to how SROs compensate senior non-regulatory employees<sup>24</sup> as well as concerns regarding SROs devoting an appropriate level of resources to their regulatory activities.<sup>25</sup> NASD shares the Commission's concerns.<sup>26</sup> That said, NASD does not believe that the Proposed Rules would limit NASD's use of funds, because NASD's job is regulation, and all of its fees, including revenue from regulatory operations, are "regulatory fees" for purposes of proposed Rule 15Aa-3(n)(4)(i).<sup>27</sup> In addition, NASD believes that applying such fees to fund all of NASD's business and operational expenses is consistent with proposed Rule 15Aa-3(n)(4)(i)'s requirement to fund only those "programs and operations directly related to [NASD's] regulatory responsibilities."

Accordingly, NASD requests that the Commission recognize in the release adopting any requirement in this area that it considers regulatory "programs and operations" to include, but not be limited to, such functions as enforcement, examinations, rulemaking, regulatory services, regulatory operations, transparency services and facilities, compensation of regulatory staff at all

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<sup>24</sup> Proposing Release, 69 Fed. Reg. at 71129 (discussing letter sent by SEC Chairman Donaldson to NYSE requesting information regarding the compensation of NYSE's Chairman and CEO).

<sup>25</sup> Proposing Release, 69 Fed. Reg. at 71159; see also Concept Release, 69 Fed. Reg. at 71268 ("When the Commission examines the underlying reasons for regulatory failings, it is often clear that an SRO has not allocated sufficient resources to its regulatory function.").

<sup>26</sup> See, e.g., Concept Release, 69 Fed. Reg. at 71265 (Commission cites to NASD comment letter on the SEC's concept release resulting from Nasdaq's petition for rulemaking concerning the regulation of intermarket trading of Nasdaq securities; in that letter, NASD notes that the disparities in certain rules between SROs serves to degrade the quality of regulation).

<sup>27</sup> For instance, NASD would consider the following to be regulatory fees for purposes of proposed Rule 15Aa-3(n)(4)(i): member dues and assessments and similar fees (the Gross Income Assessment, Personnel Assessment, and Trading Activity Fee); revenue generated from RSAs; revenue generated from such operations as Dispute Resolution, Education and Training, Transparency Services (including ADF and TRACE), Operations and Administration; registration fees, Corporate Financing fees; and Advertising Review fees.

In this regard, we note that Exhibit I of new Form 2 distinguishes between "Regulatory fees" [Item 1.c.i.A] and other fees that we also would consider to be "regulatory fees" for purposes of proposed Rule 15Aa-3(n); accordingly, we ask the SEC to modify proposed Exhibit I to indicate that, notwithstanding the heading of Item 1.c.i.A, other enumerated fees may constitute regulatory fees for purposes of SEC rules. See also Concept Release, 69 Fed. Reg. at 71269 (Question 19), where the Commission asks whether it should require that SRO funding for regulatory operations be derived only from regulatory fees, rather than allowing the cost of regulatory operations to be subsidized by other revenue sources. NASD firmly believes that the Commission should continue to permit the cost of regulatory operations to be subsidized by other revenue sources, provided that those revenue sources do not raise the conflict of interest concerns identified by the Commission. In this regard, NASD notes that certain of its regulatory operations, such as ADF, are funded in part from NASD's balance sheet.

levels, regulatory staff training, and investor and member education, as well as other aspects of the organization that support regulation (e.g., human resources), and that the SROs are permitted to fund all such regulatory functions by means of regulatory fees.

### **C. Confidentiality of Regulatory and Trading Information**

NASD seeks clarification regarding proposed Rule 15Aa-3(n)(5)(i)'s limitations on the dissemination of regulatory and trading information. In this regard, proposed Rule 15Aa-3(n)(5)(i)(A) would require an association to establish policies and procedures reasonably designed to prevent the dissemination of regulatory information<sup>28</sup> to any person other than those officers, directors, employees, and agents of the association directly involved in carrying out the association's regulatory obligations under the Exchange Act. Proposed Rule 15Aa-3(n)(5)(i)(C), in turn, would require an association to have policies and procedures to maintain the confidentiality of information submitted to the association to "effectuate a transaction on or through" the association or a facility; the proposed rule would, however, allow an association to make available such information in an aggregated form or upon consent.

NASD urges the Commission to tailor these provisions (as well as the equivalent provisions applicable to exchanges) to better target the specific information dissemination practices of concern to the Commission. For instance, we ask that the Commission modify proposed Rule 15Aa-3(n)(5)(i) to permit NASD and other SROs to continue the practice of sharing regulatory information with certain authorized recipients, such as certain federal, state, and international financial regulators, as well as enforcement agencies, subject to appropriate assurances of confidentiality.

We also recommend that the text of any final rule in this area be adjusted to take into account the existence of Rule 17d-2 agreements. While proposed Rule 15Aa-3(n)(5)(i)(A) would permit an SRO to disseminate regulatory information to an "agent" of the SRO, it is not clear whether such language would encompass Rule 17d-2 agreements insofar as any SRO that is a party to a Rule 17d-2 plan is relieved of responsibility as to any person for whom such responsibility is allocated under the plan to another SRO to the extent of such allocation.<sup>29</sup> Similarly, we request that the Commission modify the text of any final rule to reflect NASD's (and any other SRO's) role as a private-sector provider of regulatory services to other entities, including other SROs, outside of Rule 17d-2. Again, such arrangements require NASD (and any

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<sup>28</sup> Proposed Rule 15Aa-3(b)(18) defines "regulatory information" to mean "any information collected by an association in the course of performing its regulatory obligations under the Act." The Proposing Release includes as examples information relating to an on-going disciplinary investigation or action against a member, the amount of a fine imposed on a member, financial information, or information regarding proprietary trading systems gained in the course of examining a member. See Proposing Release, 69 Fed. Reg. at 71142.

<sup>29</sup> See Rule 17d-2(d).

SRO-recipient of such services) to be able to exchange regulatory information relating to the recipient of the regulatory services, subject to appropriate assurances of confidentiality.<sup>30</sup>

In addition, it is unclear how proposed Rule 15Aa-3(n)(5)(i)(A) would affect the disclosure of a regulated firm's regulatory information to that firm. For instance, as the Commission is aware, NASD has long issued report cards to its regulated firms that provide information concerning their compliance with various regulatory requirements; certain of these report cards also disclose the recipient's rank within a peer group of firms subject to the requirement. Accordingly, we ask that the proposed rule be modified to permit disclosure of a regulated firm's information to that firm and its authorized agents, as well as the aggregated information necessary to provide the related ranking disclosures. We further recommend that the rule exclude regulatory information that is otherwise publicly available.

Lastly, we believe that the Commission should clarify the rule to assure that it permits the disclosure of fines and other sanctions resulting from disciplinary actions or settlements, as well as all other regulatory information, where such information meets the SEC-approved publicity standards set forth in NASD or other SRO rules. In this regard, public disclosure of such information is of great value to, among others, the investing public and other market participants and bolsters confidence in the self-regulatory system.<sup>31</sup>

With respect to proposed Rules 15Aa-3(n)(5)(i)(C)'s conditions on the dissemination of transaction-related information, we do not view persons reporting information to our facilities as "effectuating a transaction on or through" such facilities; accordingly, we ask that the Commission amend subparagraph (C) to more clearly extend the provision to information necessary to report a transaction to, or post quotes on, an NASD facility, thereby enabling NASD to disseminate such information in aggregated form or upon consent consistent with the proposed rule.

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<sup>30</sup> NASD recognizes that any such arrangements may be a form of agency relationship, and would not be subject to, e.g., Rule 17d-2(d)'s provisions re: relief of responsibility; nonetheless, NASD requests clarification of the proposed rule to enable both SRO parties to exchange such regulatory information as needed to carry out the terms of regulatory services agreements.

<sup>31</sup> The Commission not only has approved SRO publicity standards, but has encouraged SROs to increase the amount of information that is provided to the public regarding disciplinary sanctions. In this connection, the Commission has noted that "the absence of adequate publicity concerning disciplinary proceedings conducted by [SROs] tended to diminish public and investor confidence in the efficacy of self-regulation and lessen the value of these proceedings as a means of establishing guidelines for members' conduct." Securities Exchange Act Release No. 10152, reprinted in [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79373 at 83089 (May 17, 1973) (referencing the Wells Committee Report).

### **III. Certain Aspects of the Proposed Rules Should Be Modified to Provide for More Meaningful Participation of Industry Representatives and to Avoid Imposing Executive Responsibilities on Directors**

NASD is concerned that the Proposed Rules could work to preclude persons who have experience and expertise in the securities business from informing the regulatory process, particularly given the diminished role contemplated for the non-independent directors. In this regard, the Proposing Release states that the proposed definition of “independent director” is based on the existing SRO definition of a “public” director.<sup>32</sup> While this is true, it is important to note that all NASD Governors, whether classified as Public,<sup>33</sup> Industry,<sup>34</sup> or Non-Industry,<sup>35</sup> are meaningful participants in NASD governance: Industry Governors are prevented from dominating the Board, but they are not relegated to a marginal role.

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<sup>32</sup> Proposing Release, 69 Fed. Reg. at 71135.

<sup>33</sup> Article I(ff) of the NASD By-Laws defines a “Public Governor” as: [A] Governor or committee member who has no material business relationship with a broker or dealer or the NASD, NASD Regulation, NASD Dispute Resolution, or a market for which NASD provides regulation.

<sup>34</sup> Article I(o) of the NASD By-Laws defines an “Industry Governor” as: [A] Governor (excluding the Chief Executive Officer of the NASD and the President of NASD Regulation) or committee member who: (1) is or has served in the prior three years as an officer, director or employee of a broker or dealer, excluding an outside director or a director not engaged in the day-to-day management of a broker or dealer; (2) is an officer, director (excluding an outside director), or employee of an entity that owns more than ten percent of the equity of a broker or dealer, and the broker or dealer accounts for more than five percent of the gross revenues received by the consolidated entity; (3) owns more than five percent of the equity securities of any broker or dealer, whose investments in brokers or dealers exceed ten percent of his or her net worth, or whose ownership interest otherwise permits him or her to be engaged in the day-to-day management of a broker or dealer; (4) provides professional services to brokers or dealers, and such services constitute 20 percent or more of the professional revenues received by the Governor or committee member or 20 percent or more of the gross revenues received by the Governor's or committee member's firm or partnership; (5) provides professional services to a director, officer, or employee of a broker, dealer, or corporation that owns 50 percent or more of the voting stock of a broker or dealer, and such services relate to the director's, officer's, or employee's professional capacity and constitute 20 percent or more of the professional revenues received by the Governor or committee member or 20 percent or more of the gross revenues received by the Governor's or committee member's firm or partnership; or (6) has a consulting or employment relationship with or provides professional services to the NASD, NASD Regulation, NASD Dispute Resolution, or a market for which NASD provides regulation, or has had any such relationship or provided any such services at any time within the prior three years.

<sup>35</sup> Article I(cc) of the NASD By-Laws defines a “Non-Industry Governor” as: [A] Governor (excluding the Chief Executive Officer and any other officer of the NASD, or the President of NASD Regulation) or committee member who is: (1) a Public Governor or committee member; (2) an officer or employee of an issuer of securities listed on a market for which NASD provides regulation; (3) an officer or employee of an issuer of unlisted securities that are traded in the over-the-counter market; or (4) any other individual who would not be an Industry Governor or committee member.

We fear that under the Proposed Rules, NASD would lose the voice of Industry Governors and that the effectiveness of the NASD Board would suffer by this loss of Board level expertise. Having access to meaningful industry input when large scale regulatory initiatives are being contemplated is invaluable. Board membership also better maintains the confidence of industry in such initiatives in that it ensures meaningful and timely input during the crucial give and take that occurs during any Board's deliberations. As a minority, the Industry Governors would inform but not dominate board deliberations. Accordingly, NASD recommends that certain changes be made to the Proposed Rules to ensure that the self-regulatory process retains the industry input and meaningful involvement that is critical to its success while maintaining the checks and balances provided by a Board consisting of a majority of independent directors.<sup>36</sup>

We also are concerned with the level of executive responsibilities that the Proposed Rules contemplate for independent directors. For instance, as further discussed below, proposed Rules 15Aa-3(d)(2) and (e)(2) would require that independent directors (in the context of executive sessions) and each Standing Committee have the authority to "direct and supervise" inquiries into any matter brought to their attention within the scope of their duties; proposed Rule 15Aa-3(c)(9), in turn, would require that there be procedures for interested persons to communicate concerns directly to the independent directors of each Standing Committee. In addition, as discussed below, the SRO's Nominating Committees would be required to "administer" contested elections. As written, these provisions can be read to expect or support an unusual level of direct involvement by SRO Board members – independent or otherwise – in day-to-day corporate management. And, in the case of independent directors, we believe that such blurring of the boundaries between their role as directors and that of executive management only serves to undermine their independence in their oversight responsibilities. We therefore recommend that aspects of the Proposed Rules be modified to refrain from imposing on the independent (or industry) directors what are essentially executive responsibilities.

## **A. Standing Committees of the Board**

### **1. General**

NASD supports the Commission's proposal that SRO Boards should include a majority of independent directors.<sup>37</sup> The Commission, however, also proposes to require that SRO Boards

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<sup>36</sup> The Commission has acknowledged the importance of industry expertise even as it has detailed conflicts that may arise in self-regulation. See 21(a) Report at 17 ("Industry participants bring to bear expertise and intimate knowledge of the complexities of the securities industry and thereby should be able to respond quickly to regulatory problems.").

<sup>37</sup> As discussed in Section I above, since 1996, the NASD By-Laws have required that a majority of NASD Governors be Non-Industry. The By-Laws also have required that, of these Non-Industry Governors, a specified number (which varies depending on the overall size of the Board at a given time) must meet the stringent definition of a Public Governor. NASD was the first SRO to implement a majority Non-Industry Board, and believes that its current compositional requirements ensure that representatives of the securities industry do not dominate the NASD Board. At the same time, however, the By-Laws ensure that industry representatives are not shut out from meaningful participation in NASD governance.



have at least the following standing committees (or their equivalents), each of which must be composed solely of independent directors: Nominating Committee, Governance Committee, Compensation Committee, Audit Committee, and ROC. Each of these committees would be required to have a written charter,<sup>38</sup> sufficient funding and resources to obtain assistance of independent counsel and other advisors, and, with the exception of the Governance Committee, to conduct an annual performance self-evaluation. The Governance Committee would be required to prepare an annual self-evaluation of the SRO's governance, including the effectiveness of the SRO Board and its committees.<sup>39</sup>

NASD believes that the Commission should modify this provision and require only the Compensation Committee to be composed exclusively of independent directors;<sup>40</sup> the composition of all other mandatory Standing Committees should be required to mirror the proposed majority independent composition of the SRO Board, with the further limitation that management directors not be permitted to serve on these mandatory Standing Committees.<sup>41</sup>

Mandating that the Compensation Committee be wholly independent would address the conflict issues raised by the Commission. There is no need to preclude industry service on the remaining committees and permitting such service would leave open opportunities for meaningful committee participation by industry representatives, which also will help to attract talented industry candidates for the Board and ensure that the committees have the benefit of members with differing perspectives, varied professional experiences, and a range of skills.<sup>42</sup> In addition, committees (or a Board) made up entirely of directors without industry expertise could be more easily dominated by an SRO's CEO and professional staff as these persons will be

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<sup>38</sup> The committee charters are to be filed with Exhibit E to Form 1 and the new Form 2, and thus would be publicly available.

<sup>39</sup> Proposed Rule 17a-26 would require the committees' evaluation forms to be filed with the Commission. Proposing Release, 69 Fed. Reg. at 71177. An SRO that wished to keep the evaluations non-public would be required to request confidential treatment. See Proposing Release, 69 Fed. Reg. at 71180.

<sup>40</sup> As noted in Section I above, there are no industry members on the NASD Compensation Committee; rather, the Committee includes only Public and Non-Industry members.

<sup>41</sup> Because NASD does not believe it should be required to have a ROC, it expresses no opinion on whether such a Committee should be wholly independent.

<sup>42</sup> NASD notes that its Audit Committee, which is (and is required to be) chaired by a Public Governor, consists of four or five Governors, none of whom may be officers or employees of NASD. A majority of the Audit Committee must be Non-Industry Governors, and at least two of these Non-Industry Governors must be classified as Public.

The charter of the NASD Corporate Governance Committee calls for the number of Non-Industry Governors to equal or exceed the number of Industry Governors. The committee currently consists of six members (two Public, one Non-Industry, and two Industry). The committee's charter does not mandate the classification of the committee's chair. Although an Industry Governor currently chairs the committee, both Industry and Non-Industry Governors have served in this capacity.

perceived as the sole source of industry expertise.<sup>43</sup> Alternatively, such committees and Boards may become overly reliant on outside advisers. This risk of such over-reliance is especially significant for non-industry directors who also lack a business background. Such over-reliance concerns are particularly relevant to the work of the NASD Board, which addresses the myriad technical issues surrounding products available in the OTC market.

## 2. Nominating Committee – Special Considerations

With respect to the Commission's proposed requirements for Nominating Committees, NASD notes that, since 1996, the NASD By-Laws have included provisions that ensure that its National Nominating Committee ("NNC") cannot be dominated by Industry representatives and is structured so as to preclude a self-perpetuating NASD Board. Unlike most public companies (and the governance model contemplated by the Proposed Rules), the NNC is not composed exclusively of sitting Governors. Indeed, current Governors are precluded from sitting on the NNC unless they are in their final year of service on the NASD Board.<sup>44</sup> NASD believes this separation of the NNC from the NASD Board fosters a high degree of independence, and thereby ensures that the NASD Board is not a self-perpetuating entity.

The number of Non-Industry NNC members must equal or exceed the number of Industry members. This balance ensures that industry expertise is brought to bear in identifying qualified candidates for inclusion on the NASD Board but industry influence does not dominate. Requiring that the NNC be replaced with a committee composed entirely of current Governors would represent a step backward from the perspective of promoting the independence of the NASD nomination process. Moreover, limiting membership on the NNC to current Governors who meet the proposed definition of independence would deprive the NNC of valuable expertise, specifically because the Nominating Committee must nominate Industry as well as Independent Governors. Accordingly, NASD recommends that an SRO's Nominating Committee be majority, rather than wholly independent (without any management directors), and that it not be limited to sitting Governors.

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<sup>43</sup> See, e.g., Seligman, *supra* note 3, at 1378-79. In analyzing the NYSE's recent governance changes, Dean Seligman observes that:

There is little basis for confidence that with a part-time Board of Directors either the Chair or the Chief Executive Officer will not emerge as a new dominant figure at the NYSE. Her or his expertise inevitably is likely to dominate a Board largely made up of non-securities Directors. . . . A real concern is that over time the Board of Directors will become increasingly quiescent to the full-time professionals on the Board of Executives or the full-time professionals working for the Exchange who are more likely to be viewed as possessing the wisdom and experience to guide the Exchange on pivotal policy issues.

<sup>44</sup> Historically, it has been extremely rare for even sitting Governors in their final year of NASD Board service to serve as NNC members. At present, the NNC has no sitting Governors as members.

## B. Determination of Director Independence

In addition to believing that all key corporate committees should not be limited to independent directors, we believe that certain aspects of the proposed “independence” definition are unnecessarily narrow. Read together, these aspects of the Commission’s proposal effectively would exclude all individuals with recent and current industry affiliations from leadership roles on the Boards of those SROs with broad-based membership.

The Proposed Rules define the term “independent director,” with respect to all SROs, as a director who has no material relationship with the exchange or association or any affiliate of the exchange or association, any member of the exchange or association or any affiliate of such member, or any issuer of securities that are listed or traded on the exchange or a facility of the exchange or association.<sup>45</sup> No director may qualify as an independent director unless the Board affirmatively determines that the director has no material relationship with the exchange or association.<sup>46</sup> The term “material relationship” is defined as a relationship, whether compensatory or otherwise, that reasonably could affect the independent judgment or decision-making of the director.<sup>47</sup> In addition to the general criteria of no material relationship, the Proposed Rules identify certain specific circumstances when a director would not be considered independent.<sup>48</sup>

As currently proposed, the “independent director” definition captures not only material relationships *with management* – historically the focus of the “independence” inquiry<sup>49</sup> – but also material relationships with a number of entities that could “affect the independent judgment or decision-making of the director.”<sup>50</sup> Significantly, specific circumstances where a director would not be considered independent include if the director is, or within the past three years was, a member or employed by or affiliated with a member of the SRO or any affiliate of a member, or

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<sup>45</sup> See proposed Rules 15Aa-3(b)(13) and 6a-5(b)(12).

<sup>46</sup> See proposed Rules 15Aa-3(c)(2) and 6a-5(c)(2). The Proposed Rules require the Board to make this independence determination upon the director’s nomination and thereafter no less frequently than annually and as often as necessary in light of the director’s circumstances. See *id.*

<sup>47</sup> See proposed Rules 15Aa-3(b)(14) and 6a-5(b)(13).

<sup>48</sup> See proposed Rules 15Aa-3(b)(13) and 6a-5(b)(12).

<sup>49</sup> For example, independence from management is the focus of the independence standards contained in market listing standards. See, e.g., NYSE Commentary on Section 303A (Corporate Governance Rules) (“[m]aterial relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable, and familial relationships, among other. *However, the concern is independence from management . . .*”) (emphasis added).

<sup>50</sup> See Proposing Release, 69 Fed. Reg. at 71135.

the director has an immediate family member that is, or within the past three years was, an executive officer of a member of the SRO or any affiliate of a member.<sup>51</sup>

With respect to the Commission's proposal to classify all directors with current or recent affiliations with SRO members or their affiliates as non-independent, we request that the Commission permit individuals who served within the past three years as outside directors of SRO members or their affiliates to be eligible to serve as independent directors. While such relationships could possibly affect the director's independence as to matters involving that particular broker-dealer, recusal from such matters would offer an appropriate means to address conflicts concerns. Such a relationship, however, is not likely to impair a director's ability to exercise independent judgment as to all members of NASD, particularly since the individual served an independent role at the broker-dealer or its affiliate.

In addition, as noted earlier, a director would not be considered independent if the director has a material relationship with any issuer of securities that are listed or traded on a facility of the association.<sup>52</sup> We request confirmation that such a provision would not encompass those issuers whose securities trade based on information on NASD's transparency facilities and ask the Commission to clarify the provision (and similar limitations) by, e.g., referencing a director's relationship with any issuer of securities that are listed or traded on an "SRO trading facility" as defined in proposed Rule 15Aa-3(b)(21).<sup>53</sup>

### **C. Limitations on Non-Independent Directors' Voting**

The Proposed Rules require that when an SRO's Board considers any matter that has been recommended by, or otherwise is within the authority of, a Standing Committee, a majority of the directors who vote on the matter must be independent.<sup>54</sup> As an example, the Commission

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<sup>51</sup> The Commission notes that the Proposed Rules do not expressly preclude an individual associated with a non-member broker-dealer or affiliate from being classified as independent, unless such non-member broker-dealer or affiliate has a material relationship with the association or exchange, and asks whether such preclusion is appropriate. See Proposing Release, 69 Fed. Reg. at 71147 (Question 6). Because virtually all broker-dealers are required to be NASD members, the current version of the proposed definition has the practical effect of precluding any individual with a current or recent broker-dealer affiliation (i.e., within three years) from being classified as independent. Therefore, the modification on which the Commission seeks comment would have little effect on NASD, other than by leveling the playing field vis-à-vis NASD and less broadly based SROs.

<sup>52</sup> Specific circumstances where the director would not be considered independent include where the director, or an immediate family member, is, or within the past three years was, an executive officer of an issuer of securities listed or primarily traded on a facility of the association. See proposed Rule 15Aa-3(b)(13)(v).

<sup>53</sup> On a similar note, proposed Rule 15Aa-3(p)(2) would prohibit NASD officers and employees from being a member of the Board of any "listed issuer" or member firm. We request that the Commission confirm our understanding that this restriction would not include issuers whose securities trade based on information on our transparency facilities.

<sup>54</sup> See proposed Rules 15Aa-3(c)(6) and 6a-5(c)(6).

posits a Board composed of nine independent directors and eight non-independent directors: “If two independent directors do not participate in a Board meeting but all the non-independent directors participate in such meeting, the matter could be voted upon only by the seven independent directors present and six of the eight non-independent directors present.”<sup>55</sup> The Commission explains that “[e]ach SRO with non-independent directors would have to establish procedures for determining which non-independent directors would vote under such circumstances, consistent with the ‘fair representation’ requirements . . . .”<sup>56</sup> The Commission states that this proposal is intended to preserve and bolster the requirement that the majority of the Board be independent, and is designed to assure that matters before the Board that are within the authority or jurisdiction of the fully independent Standing Committees are considered by and voted on by a majority of independent directors.<sup>57</sup>

NASD, which is incorporated in Delaware, has been advised that such a limitation would be invalid under Delaware law, which requires that all directors have equal voting powers unless a corporation has established classes of directors.<sup>58</sup> In light of this and other concerns, NASD recommends an alternative approach that would achieve the Commission’s objectives. Specifically, as noted in Section I, NASD’s existing By-Laws include special quorum provisions that are intended to address similar concerns regarding “balanced” NASD committees (i.e., those committees that are required to be balanced between Industry, Non-Industry, and Public members). For example, the NASD Executive Committee is required to include percentages of Non-Industry and Public members that are at least as great as those classifications represented on the NASD Board as a whole. The NASD By-Laws further specify that a quorum for the transaction of business “shall consist of a majority of the Executive Committee, including not less than 50 percent of the Non-Industry committee members. In the absence of a quorum, a majority of the committee members may adjourn the meeting until a quorum is present.”<sup>59</sup> Such quorum provisions achieve the objective that the Commission seeks to accomplish without raising state law concerns or disenfranchising a group of directors.

#### **D. Executive Sessions of the Board**

The Proposed Rules define the term “executive session” as a meeting of the independent directors of the Board, without the presence of either SRO management or the non-independent

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<sup>55</sup> Proposing Release, 69 Fed. Reg. at 71137.

<sup>56</sup> Id. at n.141.

<sup>57</sup> Proposing Release, 69 Fed. Reg. at 71137.

<sup>58</sup> See DGCL Section 141(d) (corporate actions taken in contravention of the one-director, one-vote requirement are invalid).

<sup>59</sup> Article IX, Section 4(d), NASD By-Laws. Similar quorum provisions are contained in Article VII, Section 9(f) (NNC), Article VIII, Section 5(e) (Audit Committee), and Article VIII, Section 6(c) (Finance Committee).

directors.<sup>60</sup> The Proposed Rules prohibit the SRO's CEO from participating in executive sessions, and require that, when a single individual serves as both CEO and Chairman of the Board, the SRO Board designate an independent director as a lead director to preside over executive sessions.

In its Proposing Release, the Commission notes that executive sessions are intended to foster candid discussion by excluding management directors.<sup>61</sup> This is a typical feature of executive sessions; indeed, the NASD Board annually elects a lead director and holds executive sessions that exclude all management Governors and NASD staff. NASD, therefore, has no objection to the proposed exclusion of the SRO's CEO from executive sessions or to designating an independent director to preside over executive sessions.

However, the Proposed Rules not only exclude management directors and staff, but also exclude all non-independent directors. The proposed mandatory exclusion of non-independent directors from executive sessions again raises concerns under Delaware (and possibly other state) laws, which provide that all directors are entitled to be present at Board meetings, although some directors may choose not to attend.<sup>62</sup> While it is permissible for the directors of a Delaware corporation to agree that the non-management directors should meet in executive session – as noted, the NASD Board already has implemented this practice – non-independent and/or non-management directors cannot be prohibited from attending the sessions.

As a practical matter, NASD believes that it could establish a committee of the Board consisting only of independent directors that could meet apart from all non-independent directors, consistent with applicable state law. Nonetheless, NASD does not believe that non-independent directors who are not part of management should be excluded from executive sessions of the Board (or equivalent Committee meetings). Among other things, the non-management, non-independent directors have valuable industry expertise that only serves to inform such meetings.

#### **E. Independent Directors' Use of Outside Advisers and Authority to Direct and Supervise Inquiries**

The Proposed Rules require SROs to provide sufficient funding and other resources, as determined by the independent directors, to permit the independent directors to fulfill their responsibilities and to retain independent legal counsel and other advisors.<sup>63</sup> While NASD does

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<sup>60</sup> See proposed Rules 15Aa-3(b)(10) and 6a-5(b)(9).

<sup>61</sup> See Proposing Release, 69 Fed. Reg. at 71140 (text accompanying note 187).

<sup>62</sup> See, e.g., DGCL Section 141(a).

<sup>63</sup> See proposed Rules 15Aa-3(d)(3) and 6a-5(d)(3) (in the context of executive sessions) and Rules 15Aa-3(e)(3) and 6a-5(e)(3) (in the context of the Standing Committees).

not object to the Commission's proposal that the availability of independent advisors be made explicit (and is aware of similar requirements under the Sarbanes-Oxley Act of 2002 and market listing standards),<sup>64</sup> liability concerns may cause committee members to believe it necessary or prudent to avail themselves of outside expertise on a regular basis. The routine use of such advisors by independent directors can actually undermine a Board's ability to function effectively.<sup>65</sup> Therefore, NASD requests that the Commission clarify in any release adopting such a requirement that use of independent advisors is within the discretion of the particular committee (or those directors meeting in executive session) and should not be viewed as necessary for the proper operation of the committee (or executive session).<sup>66</sup>

The Proposed Rules also require that the independent directors have the authority to "direct and supervise" inquiries into any matter brought to their attention within the scope of their duties.<sup>67</sup> As noted earlier, this language can be read as contemplating an unusual level of direct involvement by members of an SRO's Board, particularly with respect to the independent directors, in day-to-day corporate management.<sup>68</sup> To avoid possible confusion on this point, NASD encourages the Commission to note in its adopting release that it does not contemplate any change in the normal role that any directors play with regard to day-to-day corporate management.

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<sup>64</sup> In fact, the charter for the NASD Compensation Committee already provides that the Committee may retain its own advisers, and NASD supports the use of such advisers by any of its Board committees.

<sup>65</sup> As an ABA Task Force has noted in addressing the routine use of outside advisers:

[S]uch a practice generally would not be desirable. Apart from the added cost of additional counsel, the division of management and the board of directors into two separately counseled factions may result in less open communication, less constructive collaboration between directors and senior executive officers, and, ultimately, less effective oversight by the board of directors. The Task Force recognizes, however, that there are situations in which separate counsel, for the board or one or more of its committees, may be necessary or desirable.

Report of the American Bar Association Task Force on Corporate Responsibility, 59 Bus. Law. 145, 157 n.54 (2003) (hereafter cited as "ABA Report").

<sup>66</sup> NASD further notes that, as written, the Proposed Rules could result in directors individually retaining lawyers and advisers, a result we believe is not intended by the Commission.

<sup>67</sup> See proposed Rules 15Aa-3(d)(2) and 6a-5(d)(2) (in the context of executive sessions) and Rules 15Aa-3(e)(2) and 6a-5(e)(2) (in the context of the Standing Committees).

<sup>68</sup> See generally ABA Task Force, *supra* note 65, at 158 (undesirable for directors to try to manage corporation directly and comprehensively); B. Manning, The Business Judgment Rule and the Director's Duty of Attention: Time for Reality, 39 Bus. Law. 1477, 1494 (1984) (Board's role does not consist of taking affirmative action on individual matters; it is instead a "continuing flow of supervisory process, punctuated only occasionally by a discrete transactional decision.").

## **F. Fair Representation**

### **1. Minimum Percentage of Member-Elected Governors for SROs Without Non-Member Shareholders**

The Proposed Rules would require the Nominating Committee to administer a fair process that provides SRO members with an opportunity to select at least 20% of the total number of directors.<sup>69</sup> The Commission explains that this 20% requirement strikes an appropriate balance “by giving members a practical voice in the governance of the exchange or association and the administration of its affairs, without jeopardizing the overall independence of the board.”<sup>70</sup> The Proposing Release notes that this requirement is not intended to prohibit SROs from having Boards composed solely of independent directors: if an SRO required an all-independent Board, the 20% elected by the SRO members would have to be independent directors.

NASD understands this provision to be relevant to SROs that have non-member shareholders. In this circumstance, the SRO members must be guaranteed the right to elect at least 20% of the directors, even if more than 80% of the SRO shares are controlled by non-members. It is NASD’s understanding that proposed Rule 15Aa-3(f)(3) would not require NASD to change its existing election procedures, which call for the NASD membership to elect all members of the Board of Governors. However, the Proposing Release can be read as suggesting that it would be permissible for an SRO situated as NASD is (i.e., a non-stock corporation with members but no non-member shareholders) to reduce the percentage of member-elected Governors to a minimum of 20%.<sup>71</sup> To prevent ambiguity on the intended scope of the proposed rule, NASD encourages the Commission to clarify in any release adopting a final rule in this area that the provision’s applicability is limited to SROs that have non-member shareholders.

### **2. Contested Elections**

The Proposed Rules would require the Nominating Committee to “administer” contested elections,<sup>72</sup> which would represent a major departure from the NASD NNC’s current role. In response to criticism of NASD’s handling of a contested election in 1994, NASD changed its By-Laws. Among other things, the By-Laws limit the nature and amount of administrative

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<sup>69</sup> See proposed Rules 15Aa-3(f)(3) and 6a-5(f)(3). See also proposed Rules 15Aa-3(c)(4) and 6a-5(c)(4) (requiring at least 20% of the total number of directors to be selected by members).

<sup>70</sup> Proposing Release, 69 Fed. Reg. at 71137.

<sup>71</sup> Such a reduction would be impermissible under Delaware law, which requires that all directors be elected by the corporation’s equity holders. DGCL Section 215.

<sup>72</sup> See proposed Rules 15Aa-3(f)(3) and 6a-5(f)(3).



support that NASD staff is allowed to provide, and require that any such staff support be provided on an even-handed basis to both petition candidates and candidates of the NNC. This support is provided through the NASD Office of Corporate Secretary. These provisions, among other things, serve to ensure that the NNC generally remains “above the fray” when a contested election arises.<sup>73</sup>

NASD believes that the administration of contested elections is appropriately left to the Office of Corporate Secretary, which is well suited to handle such administrative functions. Burdening the NNC (or any other similarly situated SRO Nominating Committee) with administrative functions far removed from its core mission would, NASD believes, undermine objectivity of the NNC’s current role, which is detached from both the NASD Board and the mechanics of the election process.<sup>74</sup>

### **3. Issuer Representation**

The Proposed Rules would require the Nominating Committee to 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.<sup>75</sup> We recognize that Section 15(b)(4) of the Exchange Act requires that the rules of an association provide that one or more directors be representative of issuers and investors and not be associated with a member; however, in those cases where an association does not operate a trading market or have other related commercial interests, we believe that the association should be exempted from any requirement to have separate and distinct issuer representation on its Board.

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<sup>73</sup> Indeed, prior to 2001, the NNC was not allowed to provide any support for its nominee. In 2001, however, the By-Laws were amended to permit the NNC to provide up to two responsive mailings in support of the NNC candidate. This change was made because NASD had found that precluding the NNC from supporting NNC candidates when they were in a contested election deterred qualified individuals from accepting NNC nominations.

<sup>74</sup> We note that, under proposed Rules 15Aa-3(c)(7) and 6a-5(c)(7), the percentage of members that is necessary to put forth an alternative candidate(s) may not exceed 10% of the total numbers of members. This proposed requirement is consistent with Article VII, Section 10 of the NASD By-Laws, which currently requires the signatures of 3% of the members in support of a single petition candidate, and 10% in support of a slate of petition candidates.

<sup>75</sup> See proposed Rules 15Aa-3(f)(4) and 6a-5(f)(4). See also proposed Rules 15Aa-3(c)(5) and 6a-5(c)(5) (requiring Boards to have at least one director representative of issuers and at least one director representative of investors).

#### **IV. Certain Aspects of the Proposed Rules Should Be Modified to Provide the Board with Greater Flexibility in Developing Procedures to Meet Obligations**

##### **A. Code of Conduct and Ethics; Disclosure of Personal Information**

The Proposed Rules require SROs to establish a code of conduct and ethics for directors, officers, and employees.<sup>76</sup> At a minimum, these documents must establish policies and procedures regarding conflicts of interest, corporate opportunities, confidentiality, fair dealing, protection and proper use of the association's assets, compliance with laws, rules, and regulations, and the reporting of illegal or unethical behavior. NASD's existing Code of Conduct ("NASD Code") already satisfies most of the mandatory areas identified by the Proposed Rules, and thus only minor changes would be necessary to implement the Commission's proposals as to an employee code of conduct. At present, the NASD Code applies only to NASD employees. Therefore, implementation of the Proposed Rules would require NASD either to establish separate business conduct standards for NASD Governors, or to apply a single set of conduct standards to both employees and Governors.

While NASD supports the proposed requirement that SROs establish conduct codes for employees, officers, and directors, NASD is concerned with the proposed requirement that the SRO Board approve every waiver of a code of conduct provision. Given its experience administering the NASD Code, NASD believes that requiring the Board to approve each waiver request would impose a time-consuming burden on directors, and this burden is unwarranted given the nature of many NASD waiver requests.<sup>77</sup>

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<sup>76</sup> See proposed Rules 15Aa-3(p)(1) and 6a-5(p)(1).

<sup>77</sup> It has been long-standing NASD practice to empower only its most senior officers to grant or deny waivers of the NASD Code. Section III of the NASD Code provides:

If an employee believes that compliance with a specific provision of the Code of Conduct will result in an undue hardship in his circumstances, the employee may seek a waiver from his Executive Vice President.

All waiver requests must be in writing and approved in writing by an Executive Vice President (or the General Counsel of NASD if the waiver request is made by an employee who is an Executive Vice President or higher). Waivers may be granted only if the application of a specific provision of the Code of Conduct will, in fact, result in an undue hardship to the employee seeking the waiver. In determining whether an undue hardship exists, the Executive Vice President will consider whether: 1) compliance with the Code of Conduct is contrary to the best business interests of NASD; and/or 2) the burden on the employee and NASD of complying with the Code of Conduct outweighs the business needs of NASD. A written response to the waiver request must be provided and must clearly state whether the waiver is denied, granted as requested, or granted with modifications or restrictions. If a waiver is granted, the response must detail the nature of the undue hardship present and reference specific sections of the Code of Conduct, as applicable. If the waiver is granted subject to any restrictions or conditions, the response must detail the restrictions or conditions. If an Executive Vice President determines that

[Footnote continued on next page]

The NASD Board has delegated to the Audit Committee responsibility for overseeing the administration of the NASD Code, and that committee already receives periodic reports from NASD's Office of General Counsel regarding its administration of the Code.<sup>78</sup> These reports include discussions of trends, including trends in waiver requests, and could easily be expanded to include more complete waiver summaries.<sup>79</sup> NASD believes that, rather than mandating that the NASD Board (or its delegee, the Audit Committee) take action on each waiver requested, the Commission should allow SRO Boards to grant executive staff (in NASD's case, at the Executive Vice President and higher level) with authority to grant waivers to all other staff, subject to oversight by the Board (or Audit Committee) to ensure that waivers are granted infrequently and only when truly warranted by an individual employee's circumstances.<sup>80</sup> This is particularly warranted in light of the broad-based codes of conduct maintained by many, if not all, SROs. NASD believes, however, it would be appropriate to require the NASD Audit Committee, rather than its General Counsel, to approve any waiver of the code of conduct sought by directors or officers at the Executive Vice President or higher level.

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a waiver should be denied, the response must provide the reason(s) and refer to the specific Code sections, as applicable.

An example of a recent waiver request involves several NASD employees that participated in a foreign regulatory program who were given a set of coins from the foreign regulatory authority sponsoring the program in appreciation of their participation. Because NASD employees may not accept cash business gifts or business gifts with an aggregate value of over \$100 in a single year from a single source, the employees were required to obtain waivers or return the coins. We note that the General Provisions of the NASD Code prohibit employees from accepting any business gifts or courtesies if the employee will appear to be improperly influenced.

<sup>78</sup> Since 1999, NASD OGC has been responsible for the day-to-day administration of the NASD Code. Effective January 2005, NASD established a new Office of Corporate Ethics, which has assumed this function. The Office of Corporate Ethics reports to NASD's General Counsel.

<sup>79</sup> In addition to receiving close scrutiny from the Audit Committee, NASD OGC's administration of the NASD Code is subject to regular oversight from both the NASD Internal Audit Department and the Commission's Office of Compliance Inspections and Examinations ("OCIE"). In sum, if waivers of the NASD Code were to become routine, it is unlikely that this development would escape detection and correction. Requiring the NASD Board to become directly involved in the waiver process, NASD believes, is likely to offer little additional protection against routine waiver grants.

<sup>80</sup> NASD recognizes that the Sarbanes-Oxley Act and market listing standards require Board approval of waivers granted to directors and certain of the most senior officers of public companies. However, mechanically extending this requirement to all employees and directors of an SRO makes no sense from either a cost-benefit or public policy standpoint. Indeed, the proposed requirement appears to represent the very type of "check the box approach" to corporate governance that Commission officials have criticized. See, e.g., William H. Donaldson, Remarks at the 2003 Washington Economic Policy Conference (Mar. 24, 2003), available at <http://www.sec.gov/news/speech/spch032403whd.htm>.

In addition, NASD is concerned that the Commission proposes to require SROs to disclose in Form 1 and new Form 2 (Exhibit F) any waivers of the code of conduct granted to directors, officers, or employees of the SRO. Neither Section 406 of the Sarbanes-Oxley Act nor the rules implementing that statutory provision require public companies to disclose all waivers granted. Rather, they merely require disclosure of waivers granted to a small number of specified senior officers.<sup>81</sup> Significantly, when it adopted rules implementing Section 406 of the Sarbanes-Oxley Act, the Commission added only one corporate officer – the CEO – to the senior financial officers as to whom the Sarbanes-Oxley Act required waiver disclosure. This being the case, it is unclear why the Commission believes it necessary to dramatically expand the mandatory scope of waiver disclosure required of SROs to all directors, officers, and employees.<sup>82</sup>

NASD notes that the Commission has not specified the level of disclosure that would be required regarding waivers. The instructions for Exhibit F simply call for the SRO to provide “[a] disclosure of any waivers of the code of conduct and ethics for directors, officers, or employees of the applicant.” To the extent that the Commission anticipates that Exhibit F would contain personally identifiable (including financial) information regarding waivers granted to SRO directors and staff, NASD believes such disclosure would be an unnecessary invasion of privacy.

NASD therefore urges the Commission to reconsider the need for the sweeping disclosure it has proposed. The policy arguments that support the limited waiver disclosure that the Sarbanes-Oxley Act contemplates for a small number of senior executives of public companies simply cannot be made in support of requiring the same level of disclosure regarding all SRO directors and staff. This is particularly so given that SROs already provide waiver information to OCIE whenever requested to do so. Given that the same information currently is available upon request to Commission staff, NASD urges the Commission to carefully weigh both the need for, and the respective advantages and disadvantages of, requiring routine public filing of SRO directors’ and employees’ personal and financial information.

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<sup>81</sup> See Securities Exchange Act Release No. 47235 (Jan. 24, 2003), 68 Fed. Reg. 5110, 5118 (Jan. 31, 2003); see also NASD Rule 4350(n) (requiring Nasdaq issuers to obtain Board approval of waivers granted to directors or executive officers and to disclose such waivers on Form 8-K within five business days); NYSE Rule 303A (requiring NYSE issuers to promptly disclose any waivers granted to directors or executive officers).

<sup>82</sup> The Commission’s release states “disclosure of waivers of the code of conduct and ethics should give market participants, investors, the public, as well as regulators, the opportunity to evaluate the board’s performance with respect to adherence to the code of conduct and ethics and the circumstances under which it has determined to grant waivers.” Proposing Release, 69 Fed. Reg. at 71158. The release does not explain why the Commission believes that waiver disclosure for SRO staff and directors should be dramatically broader than that required in the context of public companies under either the Sarbanes-Oxley Act or market listing standards.

## **B. Communications with Standing Committees**

The Proposed Rules would require SROs to establish procedures for interested persons to communicate their concerns regarding any matter within the authority or jurisdiction of a Standing Committee directly to the independent directors.<sup>83</sup> NASD notes that implementing the proposed direct communication could require SROs to establish multiple hotlines and/or e-mail boxes. Further, it is unclear how SRO directors would react to being required to review and respond to unfiltered (and possibly irrelevant or/or misdirected) communications. NASD believes that, rather than mandating implementation details, it would be preferable for the Commission to allow SRO Boards to determine how they should be kept informed regarding concerns, inquiries, reports, etc. relevant to the mandates of the Standing Committees. Among other things, NASD believes that it should be left to the SRO Board whether establishing means of direct communication is necessary, or whether an existing (albeit non-direct) communication vehicle can serve the same purpose.<sup>84</sup>

For example, in 1996, NASD established its Office of the Ombudsman, which is staffed with personnel who specialize in receiving complaints and concerns of NASD employees, investors, registered representatives, and member firms. The Ombudsman offers a neutral and confidential listener to whom an individual can bring concerns or complaints when he or she cannot determine the proper channel for addressing the concern, or fears that the concern will not be addressed through normal channels. The Ombudsman's office is equipped with a toll-free number and a separate e-mail box that permit persons to contact the office anonymously.

The Ombudsman reports quarterly to the NASD Audit Committee and executive management on trends, issues, and/or concerns. NASD believes that the Commission should allow SROs discretion to use such existing mechanisms to ensure that directors who serve on Standing Committees are made aware of contacts/concerns relevant to the committees' areas of jurisdiction. Under this alternative to the Commission's proposal, SROs would be free to modify existing mechanisms to ensure that Standing Committees were regularly made aware of communications relevant to their mandates.

## **V. Implementation of Proposed Rule 15Aa-3**

Proposed Rule 15Aa-3(r)(1) provides that the rules each association promulgates to implement the requirements of Rule 15Aa-3 (to the extent adopted) "must be . . . operative no

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<sup>83</sup> See proposed Rules 15Aa-3(c)(9) and 6a-5(c)(9).

<sup>84</sup> NASD notes that, in adopting rules relating to the "whistle-blower" requirement contained in Section 301 of the Sarbanes-Oxley Act, the Commission eschewed a "one-size-fits-all" approach and allowed each company's audit committee to develop procedures appropriate to the company's circumstances. See Securities Exchange Act Release No. 47654, 68 Fed. Reg. 18788, 18798 (April 16, 2003). SROs should be allowed parallel flexibility in implementing a means of ensuring that members of SRO Standing Committees are regularly informed of communications relevant to their areas of responsibility.

later than one year following the date of publication of final rules in the Federal Register"; subparagraph (r)(2) provides that "each association must submit to the Commission a proposed rule change that complies with this section no later than four months following the date of publication of final rules in the Federal Register"; and subparagraph (r)(3) states that "each association must have final rules that comply with this section approved by the Commission no later than ten months following the date of publication of final rules in the Federal Register."

We assume that "final rules" refers to a final published version of proposed Rule 15Aa-3 (assuming the Commission adopts such a rule). If so, this means that NASD and other SROs would have four months to file with the SEC all rules required to comply with proposed Rule 15Aa-3 (and the equivalent rule proposed for the exchanges). NASD urges the Commission to grant the SROs a minimum of nine months to meet the proposed rule filing requirements, particularly in light of the need to develop the necessary rule provisions, present such proposals to their Boards for approval, and in NASD's case, obtain member vote on the necessary By-Law changes. In addition, with respect to the proposed implementation date of one year following SEC approval of proposed Rule 15Aa-3, we request that the Commission revise the provision to take into account SRO election cycles. For example, assuming the Commission were to grant each SRO nine months in which to file its related rule changes, the implementation date could be 16 months following the date of publication of the final rule in the Federal Register, provided that an SRO would have until the next regularly scheduled election to "cure" its failure to comply with any requirement under the rule relating to Board or Committee structure or composition.<sup>85</sup>

## **VI. Compliance Burden Resulting from Disclosure and Reporting Requirements will be Substantial**

### **A. Disclosure by SROs (Form 1 and new Form 2)**

The Commission has proposed extensive revisions to the forms that SROs use to register with the SEC. Exchanges would continue to register on Form 1, as proposed to be amended, while NASD would be required to register on new Form 2. In essence, Form 1, Form 2, and their exhibits would be used as the primary vehicle by which SROs would make public information about their operations, administration, governance, and finances. Such disclosures would include information on the composition, structure, and responsibilities of the SROs' Boards and committees, as well as copies of the SROs' governance guidelines and codes of conduct and ethics. SROs also would be required to describe their regulatory programs, including the independence of such programs from market operations and other commercial interests. In addition, SROs would be required to submit a table detailing the compensation

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<sup>85</sup> Cf. proposed Rules 15Aa-3(c)(8) and 6a-5(c)(8) (proposing that if an SRO fails to comply with the requirement that the Board be composed of a majority of independent directors because there is a vacancy on the Board or a director ceases to be independent, it must comply with the requirement by the earlier of its next annual meeting or one year from the date of occurrence of the event that caused the failure to comply with the requirement).

(including perquisites) of their five most highly compensated executives, as well as a description of the material terms of these individuals' employment agreements. SROs further would have to provide compensation schedules for the CRO and all other senior regulatory personnel.

NASD generally supports the expansion of the Forms and the scope of information provided to the public regarding SROs' structures and regulatory programs; however, we request certain modifications to and/or clarifications of the Forms. First, we have concerns with certain aspects of proposed Exhibit I (Audited Financial Statements and Other Financial Information) which would require an SRO to include audited financial statements for the SRO's last fiscal year, prepared by a registered public accounting firm in accordance with U.S. generally accepted accounting principles.<sup>86</sup> An SRO also would be required to file audited financial statements for any facility that is a separate legal entity and for any regulatory subsidiary. In addition, an SRO would have to provide certain additional categories of financial information for the current fiscal year, as compared to the same figures for the prior fiscal year and estimated figures for the next fiscal year.

Given that NASD currently prepares its financial statements on a consolidated basis, which includes both NASD Regulation and NASD Dispute Resolution, we request clarification that the Commission would not require NASD to prepare separate audited financial statements for either NASD Regulation or NASD Dispute Resolution. NASD's consolidated statements already capture the affiliate financial information sought by the Commission pursuant to the proposed requirement. Moreover, given the regulatory character of all three entities, there is no need for separate information.<sup>87</sup> In addition, if the Commission requires the SROs to disclose the other categories of financial information in Exhibit I, we request that the Commission, in the first year of implementation, not require an SRO to compare the financial information for the current fiscal year to the prior fiscal year. We base this request on the fact that NASD (and presumably other SROs) does not currently track the requisite information in the manner and format contemplated by Exhibit I.

Second, we have concerns with the proposed detailed disclosure requirements relating to an SRO's regulatory services agreements ("RSAs"). Exhibit I would require an SRO to provide information regarding the costs associated with any contract or other agreement with a regulatory subsidiary or another SRO that provides regulatory services to or on behalf of the applicant, disclosed separately. In addition, proposed Exhibit H (Regulatory Program) would require,

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<sup>86</sup> NASD currently posts its annual financial statements on its public Web site. These statements provide comprehensive information regarding NASD's revenue sources and expenditures. In addition, as a tax-exempt organization, NASD is required to file an IRS Form 990, which contains detailed information regarding staff compensation. The Form 990 is available to the public upon request.

<sup>87</sup> Proposed Exhibit J (Financial Statements of Affiliates) further would require separate financial statements for the latest fiscal year for each affiliate of the SRO, unless otherwise provided in Exhibit I. Again, because NASD prepares its financial statements on a consolidated basis, we would not anticipate having any disclosure under Exhibit J.

among other things, an SRO to provide copies of any contract or agreement relating to regulatory services that are provided or will be provided to the SRO by another SRO, a regulatory subsidiary of the SRO, or a regulatory subsidiary of another SRO. As the Commission is aware, NASD provides regulatory services to other SROs pursuant to Rule 17d-2 agreements or other RSAs.<sup>88</sup> We do not believe the Commission should require SROs to disclose RSAs in their entirety or to disclose the associated costs for each RSA on a separate basis. In fact, given the proprietary nature of such agreements, NASD typically includes confidentiality provisions in them. We believe it would be sufficient for an SRO to provide a summary of the material, non-financial terms of such agreements in Exhibit H and to disclose the related costs in Exhibit I on an aggregated basis; of course, the Commission and its staff would continue to have access to the entire agreements, and any related financial information, under Section 17 of the Exchange Act.

Third, proposed Exhibit E (Composition, Structure, and Responsibilities of Committees and Executive Boards) would require an SRO to disclose, among other things, any affiliations or relationships that reasonably could affect a director's or committee member's independent judgment or decision-making. This requirement would include members of any executive Board or committee (including Board, non-Board, and mixed Board/non-Board committees and executive Board committees). NASD agrees that disclosure of information that may affect a director's independent judgment or decision-making would be valuable to the Commission, the public, and market participants in understanding the significant aspects of an SRO. However, we believe that the scope of Exhibit E should be limited to Board members (which includes committees composed of Board members that are authorized to act on behalf of the Board), as well as those non-Board committees that have "balancing requirements" due to the nature of their functions.<sup>89</sup> While NASD maintains approximately 25 other committees that provide subject matter advice to the staff on various rule proposals,<sup>90</sup> overall, we do not believe that the role of individuals on these non-Board advisory Committees merit public disclosure of all such person's potential conflicts. Among other things, such disclosure would almost certainly result in a smaller pool of individuals willing to serve on such Committees.

Fourth, proposed Exhibit O (Listing Applications) would require an SRO to disclose documents relating to its listing applications. If the SRO does not list securities, it would be required to provide a brief description of the criteria used to determine what securities may be traded on the SRO, or in the case of an association, on any facility of the association. Similarly, proposed Exhibit T (Securities Listed and Traded) would require, in the case of an association, a schedule of such items as "securities listed on the applicant or any facility of the applicant," as

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<sup>88</sup> See *supra* note 8.

<sup>89</sup> In NASD's case, this would include the NAC, the Market Regulation Committee, the National Arbitration and Mediation Committee, and the Uniform Practice Code Committee. These Committees have compositional requirements in large part because of their ability to issue decisions that are binding on members.

<sup>90</sup> While these Committees consist of both Industry and Non-Industry persons, they currently are not subject to any compositional requirements.



well as “other securities traded on the applicant or any facility of the applicant, including for each the name of the issuer and a description of the security.” NASD asks whether we would be required to provide the information contemplated by these Exhibits with respect to issuers whose securities trade based on information on our transparency facilities; if not, we suggest that the Commission clarify the provision by referring to “SRO trading facilities” as defined in proposed Rule 15Aa-3(b)(21).

Fifth, while we do not object to the proposed requirement, we note that proposed Exhibit D (Officers) would require disclosure of the officers who currently hold their offices or positions, or have held them during the previous year, with certain identifying information, including “type of business in which each is primarily engaged (e.g., floor broker, specialist, odd lot dealer, etc.).” This disclosure currently is contained in Form 1 (applicable to exchanges). We believe that, in the case of an association that does not operate a trading market, the disclosure of the type of business in which each officer is primarily engaged would not be applicable.

Finally, under proposed Rules 15Aa-2 and 6a-2, each SRO would have to update either Form 2 (NASD) or Form 1 (exchanges) within 60 days of the end of each fiscal year, as well as within 10 days of any material change to the information reflected in the Forms or any of their exhibits. Such updates would have to be posted simultaneously on the SROs’ Web sites. In response to specific questions raised by the Commission,<sup>91</sup> we believe that the Commission should permit the SROs to file the annual amendment to the Forms within 90 calendar days of the end of the fiscal year, given the breadth of the information.<sup>92</sup> We further believe that the SROs should have 30 business days in which to provide the periodic updates for any material changes to the Forms. In this regard, in proposing a 10-day filing requirement for any material changes, the Commission chose to retain the deadline from the current Form 1 used by exchanges;<sup>93</sup> however, allowing the SROs additional time in which to file such updates is appropriate in light of the additional, extensive disclosure requirements that are proposed.<sup>94</sup> Moreover, we believe that the Commission should not require paper filing, relying instead on the posting of such information on the SRO’s individual Web sites. In the event the Commission determines to require paper filing at this time, we strongly support the development of an electronic filing system, in lieu of paper filing, similar to the SEC’s recently established Electronic Form 19b-4 Filing System, pursuant to which SROs electronically file proposed rule changes with the Commission.

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<sup>91</sup> See Proposing Release, 69 Fed. Reg. at 71171 (Questions 120, 121, 122, and 124).

<sup>92</sup> With respect to the proposed financial-related disclosures under Exhibit I, we note that even a 90-day deadline would require significant acceleration of NASD’s audit schedule. In this regard, we ask the Commission to consider a phase-in of the disclosure required pursuant to Exhibit I, such as permitting an SRO to make its first filing of Exhibit I within 120 calendar days of the end of the fiscal year, to be reduced to 90 calendar days for subsequent years.

<sup>93</sup> See Proposing Release, 69 Fed. Reg. at 71168.

<sup>94</sup> As NASD is not a public company, it is not addressing any possible obligation to update the Form 2 or other public disclosure apart from the Proposed Rules.

## **B. Regulatory Reports Required by Proposed Rule 17a-26**

Under Proposed Rule 17a-26, SROs would be required to disclose to the Commission, on a quarterly basis, extensive information about their regulatory operations, including results of market surveillance, member examinations and inspections, enforcement investigations, enforcement actions, all complaints, actions related to listing or delisting issuers, and agendas for meetings of an SRO's board and board committees. An SRO would be required to disclose, on an annual basis, among other things, extensive and detailed information relating to the administration of its regulatory programs. An SRO also would be required to evaluate annually the effectiveness of its regulatory programs and its internal controls designed to prevent certain conflicts of interest. An SRO's CEO would be required to certify that the information provided in the new quarterly and annual reports is current, true, and complete.

While proposed Rule 17a-26 would place significant additional burdens on NASD, we are prepared to comply with the new requirements.<sup>95</sup> As the Commission is aware, NASD currently collects and retains electronically much of the information that would be required to be reported to the Commission under proposed Rule 17a-26. In this regard, earlier this year, NASD introduced a new tracking application, the System for Tracking Activity for Regulatory Policy and Oversight ("STAR"). STAR consolidates the legacy tracking applications for NASD's Market Regulation and Enforcement departments, as well as the "cause" portion of the Member Regulation department's examination program.<sup>96</sup> As part of this consolidation, these three departments have adopted uniform terminology in many areas to improve NASD's ability to track various regulatory issues. As further discussed below, having the flexibility to use this same terminology when complying with certain of the proposed reporting requirements would enhance NASD's ability to efficiently comply with the Proposed Rules.

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<sup>95</sup> The Commission estimates that each SRO would spend approximately 35 hours during the initial year of proposed Rule 17a-26's effectiveness to establish procedures for the preparation of all required reports, and thereafter would incur an average burden of 40 hours to prepare each quarterly report, 35 hours to prepare each annual report, and four hours to prepare each interim report. Proposing Release, 69 Fed. Reg. at 71192. We believe that the Commission has significantly underestimated the costs and burdens associated with implementation of proposed Rule 17a-26, as well as the other proposed requirements, including in terms of staffing needs and systems modifications and costs.

<sup>96</sup> Because it consolidates data internally and enhances its uniformity, STAR delivers a capability to more efficiently report and track regulatory data, which benefits both internal and external constituencies, such as the Commission, Congress, and regulated firms. STAR Version 1.1, scheduled to be deployed in the next few months, will add tracking of all formal disciplinary actions and the "cycle" portion of the Member Regulation examination program.

## **1. General**

### **a. Timing of Reports**

Proposed Rule 17a-26(a)(1) provides that the quarterly reports would have to be filed within 20 business days after the end of each calendar quarter and the annual report would have to be filed within 60 calendar days after the calendar year end. In response to the Commission's specific request,<sup>97</sup> NASD believes that the Commission should provide the SROs with additional time in which to file both the quarterly and annual reports, given the comprehensive scope of these reports, coupled with the additional proposed disclosure requirements for Form 1 and Form 2. Specifically, we recommend that the SROs be permitted to file the quarterly reports within 30 business days after the end of each calendar quarter and within 90 calendar days after the calendar year, consistent with our recommended timeframes for filing of Form 1 and Form 2 annual and periodic updates.<sup>98</sup> We also urge the Commission to provide substantial lead-time between finalizing the Proposed Rules and having the first reporting take effect. Moreover, in the event the Commission declines to provide additional time for filing of the quarterly and annual reports, we ask the Commission to consider a phase-in of the due dates for the reports (e.g., quarterly reports could be filed 30 business days after quarter-end for the first year, and then reduced to 20 business days after the first year).

We also believe, in response to the Commission's specific request,<sup>99</sup> that the Commission should not require a fourth quarter report to be filed 20 business days after the calendar year end, given the proposed requirement to file an annual report 60 days after the year end and the fact that the annual report would contain, in an aggregated form, information from the fourth quarter.

### **b. Format of Reports**

Proposed Rule 17a-26 would require that the quarterly and annual reports, as well as audits of electronic SRO trading facilities, be submitted electronically in a uniform, readily accessible and useable format. The Commission notes that the term "uniform" in this context means that there should be uniformity in presentation of the data. The Commission indicates that the Proposed Rules would not mandate a technology-specific format or a particular template for presenting the data, but does contemplate that an SRO would select a commonly acceptable standard that would emphasize presentation of the data in a simple layout with the ability to access and manipulate the data provided. The Commission also cites a recent concept release addressing "data tagging" for supplemental information using eXtensible Business Reporting

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<sup>97</sup> See Proposing Release, 69 Fed. Reg. at 71178-79 (Question 127).

<sup>98</sup> NASD's fiscal year is the calendar year; therefore, our suggested deadlines for filing of the annual update to the new Form 2 and the annual report to the Commission would coincide.

<sup>99</sup> See Proposing Release, 69 Fed. Reg. at 71179 (Question 129).

Language (XBRL), a derivative of eXtensible Mark-Up Language (XML), and seeks comment on whether to adopt a technological standard.<sup>100</sup>

NASD asks the Commission to confirm that, while each SRO would be encouraged to provide data in an internally consistent uniform format, that different types of data reported by an SRO could be provided in different formats rather than the same electronic format. For instance, certain provisions would require us to report information that is not data generated directly from an NASD system (e.g., proposed Rule 17a-26(b)(3)(ii) would require an SRO to evaluate the effectiveness of its regulatory programs). In this regard, NASD requests confirmation that such information would not have to be reported in the same format as data-generated information (e.g., the number of open investigations during a particular quarter).

In addition, with respect to the filing method, in the past, NASD has made certain reports and files available to the Commission by using a secure NASD Web-based system (i.e., the NASD Report Center). NASD believes that both NASD and SEC staff have found this to be a cost-effective, efficient, and reliable method of providing information to the Commission. NASD urges the Commission to leverage the use of this secure Web-based system for purposes of the proposed reporting requirements; absent such an approach, NASD would incur significant additional costs/burdens. In this regard, we further note that while the Commission is not proposing to mandate XML or a variant now, if it decides to do so in the future, NASD would incur significant additional costs/burdens to meet the future directional change.

### **c. Unique Identifiers For Firms**

In several provisions of proposed Rule 17a-26, the Commission directs SROs to use a “unique identifier” when reporting information relating to regulated firms and their associated persons. The Commission states that, although the SROs would not be required to include the identity of the regulated firm or its associated persons in the regularly filed reports, a “unique identifier” would need to be used in a consistent manner in each quarterly and annual report to allow the Commission to spot trends involving a particular firm or individual. The Commission further states that the protection afforded by a system of “unique identifiers” is intended to maintain the anonymity, with respect to the Commission, in information filed regularly with the Commission of the regulated firms or individuals subject to an investigation or regulatory action by an SRO. We urge the Commission to permit NASD (and other SROs) to use CRD<sup>®</sup> numbers as “unique identifiers” to avoid unnecessary additional costs/burdens, recognizing, however, that the use of CRD numbers may not maintain firms’ and associated persons’ anonymity vis-à-vis the Commission.

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<sup>100</sup> See Proposing Release, 69 Fed. Reg. at 71179 (Question 132).

## **2. Quarterly Reporting of Regulatory Information**

### **a. Information on General Surveillance Programs**

Proposed Rule 17a-26(b)(2)(i) would require each SRO to provide the results of surveillance programs, both manual and automated, during the reporting period, including the number of exception reports and alerts generated, sorted by applicable rule or category, the number of exception reports and alerts that were reviewed, and the number of exception reports and alerts closed or referred for further investigation or for enforcement proceedings. We note that the required information would have to be collected from multiple source systems, not just from NASD's STAR system, and would impose considerable burdens on NASD. In addition, the burdens associated with maintaining and reporting data gathered in ad hoc sweeps would be exceptionally high because NASD would need to develop systems to capture and prepare for reporting relevant data generated in each ad hoc sweep.

### **b. Information on Surveillance Programs Relating to Financial and Operational Requirements**

Proposed Rule 17a-26(b)(2)(ii) would require each SRO to provide, among other things, a list of member firms with net capital computational errors exceeding ten percent of excess net capital, and a factual description of any action taken by the SRO in response. NASD seeks clarification of this requirement and requests that the Commission staff further discuss this provision with the SROs to foster compliance. Among other things, we are uncertain as to what would serve as the source of the specified list of firms with computational errors (e.g., amendments to earlier filed FOCUS reports and/or calculations made by staff at the time of an examination), the response to which would have a significant impact on costs/burdens. NASD assumes that the Commission does not contemplate that SROs would recalculate each regulated firm's net capital quarterly, without regard to examination schedules, as this would be extremely time-consuming and costly. In addition, from a risk assessment perspective, we ask whether the Commission would seek such information in cases where, e.g., a firm would still have significant amounts of excess net capital.

In addition, Proposed Rule 17a-26(b)(2)(ii) would require each SRO to provide the SEC with a list of member firms that filed late or amended FOCUS reports, and a factual description of any action taken by the SRO. We seek clarification generally on the Commission's expectations regarding the requirements to provide "factual descriptions" of any actions taken in response to those events that fall within the scope of the proposed rule, particularly in light of the related systems changes that would be required.<sup>101</sup>

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<sup>101</sup> In this regard, as the Commission is aware, NASD receives approximately 35,000 FOCUS filings and 6,000 amended FOCUS filings per year.

**c. Information on Complaints Received**

Proposed Rule 17a-26(b)(2)(iii) would require each SRO to provide a summary of all complaints relating to their regulatory programs received during the reporting period from any source, grouped by subject matter and using a “unique identifier” specific to the member and any associated persons involved. The summary also would need to include the date the complaint was received, the type of source from which the complaint originated (e.g., “regulated firm” or “public”), and a factual description of any response or action taken by NASD in response to the complaint, including any disposition of the matter and the date of any such response. NASD requests clarification on the scope of this requirement. In particular, NASD assumes that this requirement is not applicable to complaints against NASD and/or its staff, but only to complaints involving members and their associated persons. NASD also urges the Commission to clarify that this requirement extends only to written complaints received by an SRO (either by mail, facsimile, e-mail, or, in our case, through an on-line complaint center form) involving members or their associated persons.<sup>102</sup> NASD further seeks clarification regarding whether the proposed requirement would extend to the complaint information we receive from members and associated persons pursuant to NASD Rule 3070(c) or the Uniform Registration Forms (e.g., Form U4).

**d. Information on Investigations, Examinations, and Enforcement Cases**

Proposed Rule 17a-26(b)(2)(iv)-(vi) would require each SRO to report specific information on all investigations, examinations, and enforcement cases opened, closed, and pending during the reporting period. NASD assumes that an SRO would be permitted to use existing designations regarding the status of investigations, examinations, and enforcement cases. For example, NASD assumes that the intended scope of the term “enforcement cases” is limited to formal actions initiated by an SRO. Further, with respect to information on examinations, NASD assumes that, notwithstanding the text of proposed Rule 17a-26(b)(2)(v), it would be acceptable to capture the NASD membership date rather than the date the regulated firm was registered under the Exchange Act. Also, with respect to the scope of the requirement that NASD provide a “factual description of the scope and subject matter” of the examination, NASD assumes that it would be permissible to provide the allegation (e.g., suitability, misrepresentation) and product(s) relevant to an NASD cause examination.

If the Commission’s interpretation of the scope of certain terms (e.g., “open” enforcement case) differs from NASD’s, the costs/burdens associated with this requirement would significantly increase. In addition, the costs/burdens would escalate if the Commission were to require NASD to capture the date the member was registered under the Exchange Act as part of the required examination information, or if the Commission were to require NASD to

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<sup>102</sup> In this regard, we note that when an individual calls NASD’s Gateway Call Center with a complaint, we provide instructions to the caller on how to submit his or her complaint through NASD’s on-line complaint center; if the caller does not have Internet access, we mail a complaint packet to the caller, which includes instructions on how to file a written complaint with NASD.

provide more than the allegation and product(s) relevant to a cause examination for the field requiring a “factual description of the scope and subject matter” of the examination.

**e. Copies of Board and Committee Meeting Agendas**

Proposed Rule 17-26(b)(2)(viii) would require each SRO to provide the final agenda from any meeting of the Board of directors or executive committee of the SRO, or any meeting of any committee of the Board of directors or executive committee, that occurs during the reporting period. In response to the Commission’s specific request on this provision,<sup>103</sup> we do not believe the Commission should require the filing of Board and/or Committee minutes; moreover, we do not believe the provision should extend to subject matter committees that are not composed of directors and are not a part of the official Board committee structure, due to the advisory-only function of such committees and the increased burden that would be placed on the SROs to routinely file such documents. Again, the Commission and its staff would continue to have access to all such information under Section 17 of the Exchange Act.

**3. Annual Reporting of Regulatory Information**

**a. Internal Policies and Procedures**

Proposed Rule 17a-26(b)(3)(i) would require each SRO to provide a “complete discussion of the internal policies and procedures for carrying out the regulatory responsibilities of the [SRO], including a discussion of the overall program of surveillance and enforcement . . .” The Proposing Release states that “the Commission proposes to require each [SRO] to describe in detail its overall program of surveillance for member compliance with all applicable rules, laws, and regulations. The purpose of this requirement, among other things, is for the SRO to report on its designated examining authority responsibilities, as well as on its manual and automated surveillance programs, including the processes for ensuring compliance by its members with the SRO’s rules, as well as the federal securities laws and regulations.”<sup>104</sup> NASD requests clarification on the intended scope of this requirement. While we anticipate that we would expend considerable time in gathering and reporting this information, depending upon the scope, NASD easily could expend thousands of staff hours annually in complying with this one new requirement alone.

**b. Evaluation of Effectiveness of SRO Programs**

Proposed Rule 17a-26(b)(3)(ii) would require each SRO to evaluate the “effectiveness” of its regulatory programs. The Proposing Release notes that this discussion would “complement” information that would be required to be disclosed on proposed Form 2, which implies that some additional discussion or analysis would be required. Again, clarification of the

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<sup>103</sup> See Proposing Release, 69 Fed. Reg. at 71179 (Question 138).

<sup>104</sup> See Proposing Release, 69 Fed. Reg. at 71176.

intended scope of such additional analysis and discussion is critical to assist NASD in determining the costs/burdens associated with this requirement. Like the discussion of SRO internal policies and procedures, preparation of this information could take thousands of hours of staff time.

**c. Discussion of Internal Controls**

Proposed Rule 17a-26(b)(3)(iii) would require each SRO to provide a complete discussion of internal controls implemented by the SRO that are designed to “detect, prevent, and control for any conflicts of interest between the market operations and other commercial interests” of the SRO and its self-regulatory responsibilities. NASD anticipates that such discussion would address the status of its efforts to divest of any remaining residual interest in Nasdaq as well as its procedures for monitoring any potential evolution of its transparency facilities.<sup>105</sup>

**d. Discussion of Employment Arrangements**

Proposed Rule 17a-26(b)(3)(iv) would require each SRO to provide a complete discussion of “all aspects” of its employment arrangements with its CRO and other senior regulatory personnel, including salary and bonus levels and benefits and other cash and non-cash compensation. While “senior regulatory personnel” is not explicitly defined, the Proposing Release indicates that this term means, “those individuals, including the proposed Chief Regulatory Officer, who are the senior managers of the SRO’s regulatory program.”<sup>106</sup> Also, as noted earlier, NASD would be required to disclose compensation of all “senior regulatory personnel” on proposed Form 2. NASD assumes that this disclosure would apply only to persons who are at the Executive Vice President or higher level.

**e. Compliance with SEC Staff Recommendations**

Proposed Rule 17a-26(b)(3)(vi) would require a complete discussion of an SRO’s “efforts to comply with any recommendations or plan resulting from any inspection or examination conducted by the Commission’s staff.” It is unclear at what point an SRO would no longer need to report on the status of any particular matter. We believe that the Commission should allow an SRO to satisfy any requirement it may adopt in this area by providing an explanation of planned and actual actions taken in response to SEC recommendations made in the current year and that SROs should not be required to discuss, each year, efforts to comply with all SEC recommendations made to the SRO at any time for which the SRO already has indicated it has taken corrective action. For example, if an SRO is continuing its efforts related

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<sup>105</sup> See supra note 22.

<sup>106</sup> See Proposing Release, 69 Fed. Reg. at 71139.



to a recommendation made several years ago, it should not be required to address those compliance efforts on an annual basis.

#### **4. Interim Reporting of Regulatory Information**

Proposed Rule 17a-26, in addition to requiring quarterly and annual reports, would require that any material change to an SRO's regulatory program, or any material developments that affect such program, must be reported to the SEC in a supplemental, or "interim," filing within 10 business days after the occurrence of such change, along with a discussion of the reasons for such change. Examples include any changes to the parameters used in surveilling for and enforcing compliance with the federal securities laws and SRO rules, including any new, revised or discontinued surveillance or enforcement programs. In addition, any material change to the organization or staffing of any regulatory or supervisory department or unit must be reported to the SEC within 10 business days of such change, along with a discussion of the reasons.

NASD urges the Commission to reconsider the necessity of the interim filings in light of the proposed requirement to file comprehensive reports on a quarterly basis. NASD currently operates three major market regulation automated surveillance systems. These systems run alert detection programs using 107 different regulatory scenarios that produce alerts on a daily, weekly, monthly, and quarterly basis. These scenarios generate nearly four million alerts annually. In addition, there are at any time additional ad hoc and special purpose alert reports in development or operation. All systems, programs, and discrete alert reports are in a constant state of analysis, validation, and modification. An obligation to create a report to the SEC for each such change, in addition to quarterly reporting, would create a burden on both the SEC and NASD staff, and, without business context, would not provide the useful information that would be contained in a quarterly report.

#### **5. Confidentiality of Submitted Information**

The Commission indicates that, under its current rules, if an SRO wanted to request confidential treatment for information filed pursuant to proposed Rule 17a-26, the SRO would need to submit a request for confidential treatment pursuant to Rule 24b-2 and follow that Rule's procedures. The Commission seeks specific comment on whether it should adopt a confidential treatment request procedure like Rule 83, and if so, whether the Rule should be tailored in the context of proposed Rule 17a-26.<sup>107</sup> Given the volume and regularity of the information that an SRO would have to submit, NASD believes that requiring compliance with either Rule 24b-2 or a rule like Rule 83 would be extremely burdensome. NASD urges the Commission to provide a streamlined process regarding confidential treatment of information filed pursuant to any final rule in this area, including developing procedures specifically covering such information.<sup>108</sup>

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<sup>107</sup> See Proposing Release, 69 Fed. Reg. at 71180 (Question 147).

<sup>108</sup> NASD recommends that any such procedures, among other things, not require SROs to (1) submit specific written confidential treatment requests or written applications making objection to the disclosure of

[Footnote continued on next page]

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NASD appreciates the opportunity to express its views to the Commission on these important issues and looks forward to working with the Commission and its staff to address the serious concerns that have been identified. If you have any questions regarding the foregoing, please call T. Grant Callery, Executive Vice President and General Counsel, at 202-728-8285, Elisse Walter, Executive Vice President, Regulatory Policy and Programs, at 202-728-8230, or Patrice Gliniecki, Senior Vice President and Deputy General Counsel, at 202-728-8014.

Very truly yours,



Robert R. Glauber  
Chairman and CEO

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

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confidential information; (2) mark confidential information submitted to the Commission with a specified legend (such as "Confidential Treatment"); or (3) renew confidential treatment requests after a specified period. We also suggest that the Commission consider entering into confidentiality agreements with each SRO (see, e.g., Rule 83(k), which allows the Commission and its General Counsel, in their discretion, to use alternative procedures for considering requests for confidential treatment) and/or specifically addressing confidentiality of the information in proposed Rule 17a-26.

The Commission also notes in the Proposing Release that FOIA Exemptions 4 (trade secrets and commercial or financial information obtained from a person and privileged or confidential) and 8 (contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions) are two exemptions that likely would be relevant to a Commission determination whether to grant confidential treatment for information filed with the Commission under proposed Rule 17a-26. NASD believes that other FOIA exemptions (such as Exemption 6, pertaining to personnel and similar files the disclosure of which would constitute a clearly unwarranted invasion of personal privacy, and Exemption 7, pertaining to records or information compiled for law enforcement purposes) also might be relevant in certain circumstances.