

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-78326; File No. SR-NYSE-2016-37)

July 14, 2016

Self-Regulatory Organizations; New York Stock Exchange LLC; Order Approving Proposed Rule Change Removing from Its Rules Certain Internal Procedures Regarding the Use of Fine Income

I. Introduction

On May 13, 2016, New York Stock Exchange LLC (“NYSE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1)¹ of the Securities Exchange Act of 1934 (“Act”),² and Rule 19b-4 thereunder,³ a proposed rule change to remove internal procedures regarding the use of fine income, as described below. The proposed rule change was published for comment in the Federal Register on May 31, 2016.⁴ The Commission received one comment letter on the proposed rule change⁵ and a response to the comment letter from the Exchange.⁶ This order approves the proposed rule change.

II. Description of the Proposal

NYSE proposes to remove as Exchange rules internal procedures regarding the use of fine income, which were approved by the Commission in 2007 (“Fine Income Procedures” or

¹ 15 U.S.C. 78s(b)(1).

² 15 U.S.C. 78a.

³ 17 CFR 240.19b-4.

⁴ See Securities Exchange Act Release No. 77899 (May 24, 2016), 81 FR 34393 (“Notice”).

⁵ See letter from Michael Walsh, Attorney, received by the Commission on June 7, 2016 (“Walsh Letter”).

⁶ See letter from Martha Redding, Associate General Counsel and Assistant Secretary, NYSE, to Brent J. Fields, Secretary, Commission, dated June 16, 2016 (“NYSE Response Letter”).

“Procedures”⁷ in connection with the 2006 merger between New York Stock Exchange, Inc. and Archipelago Holdings, Inc. (“Archipelago Merger”).⁸ The Exchange explains that, at that time, it had delegated certain of its regulatory functions to its then subsidiary, NYSE Regulation, Inc. (“NYSE Regulation”)⁹ pursuant to a delegation agreement (“Delegation Agreement”).¹⁰ As a result, as originally approved, the Fine Income Procedures referred to actions to be taken by NYSE Regulation and NYSE Regulation’s board of directors (“NYSE Regulation Board”). However, following termination of the Delegation Agreement, the Regulatory Oversight Committee (“ROC”) of the Exchange’s board of directors (“Board”) assumed responsibility for providing independent oversight of the regulatory function of the Exchange.¹¹ The Exchange explains that, in addition to the restrictions in the Fine Income Procedures, Section 4.05 of the Exchange’s Operating Agreement (“Section 4.05”) contains limitations on the use of regulatory

⁷ See Securities Exchange Act Release No. 55216 (January 31, 2007), 72 FR 5779 (February 7, 2007) (“Order Approving the Fine Income Procedures”).

⁸ The Exchange states that the Archipelago Merger had the effect of “demutualizing” New York Stock Exchange, Inc. by separating equity ownership from trading privileges, and converting it to a for-profit entity. See Notice, *supra* note 4, at 34394 n.5 (citing Securities Exchange Act Release No. 53382 (February 27, 2006), 71 FR 11251, 11254 (March 6, 2006) (“Merger Approval Order”).

⁹ See Notice, *supra* note 4, at 34394. The Exchange states that, as approved, the Fine Income Procedures provide that fines would play no role in the annual NYSE Regulation budget process and that the use of fine income by NYSE Regulation would be subject to specific review and approval by the NYSE Regulation Board. See *id.*; see also Securities Exchange Act Release No. 55003 (December 22, 2006), 71 FR 78497, 78498 (December 29, 2006) (“Fine Income Procedures Proposing Release”). The Exchange notes that, in approving the Fine Income Procedures, the Commission expressed that the Fine Income Procedures would “guard against the possibility that fines may be assessed to respond to budgetary needs rather than to serve a disciplinary purpose.” See Order Approving the Fine Income Procedures, *supra* note 7, at 5780.

¹⁰ The Delegation Agreement terminated as of February 16, 2016. See Notice, *supra* note 4, at 34394; see also Securities Exchange Act Release No. 75991 (September 28, 2015), 80 FR 59837, 59839 (October 2, 2015) (“NYSE Approval Order”).

¹¹ See Notice, *supra* note 4, at 34394.

assets and income, including fine income.¹² Specifically, Section 4.05 prohibits the Exchange from: (i) using any regulatory assets or any regulatory fees, fines or penalties collected by its regulatory staff for commercial purposes; or (ii) distributing such assets, fees, fines or penalties to NYSE Group, Inc. (“NYSE Group”), i.e., the member of New York Stock Exchange LLC, or any other entity.¹³

The Exchange proposes to delete the Fine Income Procedures, noting that the Exchange would continue to remain subject to the restrictions of Section 4.05, which, coupled with the Operating Agreement provisions governing the ROC,¹⁴ the Exchange believes are sufficient to address concerns about its power to fine member organizations and the proper use of such funds.¹⁵ The Exchange also believes that limitations on the use of such funds are not the most effective way to assure the proper exercise by Exchange regulatory staff of the Exchange’s power to fine member organizations; in fact, the Exchange states that “usage limitations on fine income do not provide oversight of regulatory performance.”¹⁶ Rather, the Exchange believes that the responsibility to assure proper exercise by its regulatory staff of the Exchange’s power to fine member organizations more properly lies with the ROC, which is responsible for overseeing the Exchange’s regulatory and self-regulatory organization responsibilities and assessing its

¹² See id.; see also Ninth Amended and Restated Operating Agreement of New York Stock Exchange LLC (“Operating Agreement”), Art. IV, Sec. 4.05; NYSE Approval Order, supra note 10, at 59839.

¹³ See Operating Agreement, Art. IV, Sec. 4.05; see also NYSE Approval Order, supra note 10, at 59839.

¹⁴ The Exchange explains that “the ROC is specifically charged with reviewing the regulatory budget of the Exchange and inquiring into the adequacy of resources available in the budget for regulatory activities.” See Notice, supra note 4, at 34395 (citing Operating Agreement, Art. II, Sec. 2.03(h)(ii)).

¹⁵ See Notice, supra note 4, at 34395.

¹⁶ Id.

regulatory performance.¹⁷

Moreover, the Exchange believes that its disciplinary procedures, and specifically the appellate process contained therein, serve as “a powerful check on the improper exercise by Exchange regulatory staff of the power to fine members and member organizations.”¹⁸ The Exchange notes that in the event of an adverse hearing panel determination, members first have the opportunity to appeal the decision to a Board committee comprised of independent directors and individuals associated with member organizations of the Exchange (“Committee for Review” or “CFR”), which recommends a disposition to the Board, and then can appeal the decision to the Commission, whose decision in turn can be challenged in federal court.¹⁹

In support of its position that the protections in Section 4.05 are sufficient to ensure the proper use by the Exchange of fine income, the Exchange states that Section 4.05 is in fact “wider in scope than the Fine Income Procedures,” explaining that “because Section 4.05 encompasses all regulatory assets and income, not just fines, it ensures the proper use by the Exchange of a broader range of regulatory funds, by prohibiting their use for commercial purposes or distributions.”²⁰ The Exchange adds that Section 4.05 also guards against the possibility that other regulatory income, such as examination, access, registration, qualification, arbitration, dispute resolution and regulatory fees, or regulatory assets could be used or assessed to respond to the Exchange’s budgetary needs.²¹

The Exchange also believes that the circumstances that led to the creation of the Fine

¹⁷ Id. (citing the Operating Agreement, Art. II, Sec. 2.03(h)(ii)).

¹⁸ See id. at 34395.

¹⁹ Id.

²⁰ Id.

²¹ Id.

Income Procedures no longer exist.²² The Exchange states that when the Fine Income Procedures were adopted, a predecessor to Section 4.05 was in effect that directly bound the Exchange but not the entity—NYSE Regulation—actually performing the Exchange’s regulatory functions at the time.²³ Following NYSE’s reintegration of its regulatory functions and the corresponding termination of the Delegation Agreement, the Exchange itself is the entity that fines member organizations and is directly subject to the limits of Section 4.05.²⁴ Accordingly, the Exchange believes that removing the Fine Income Procedures and relying on Section 4.05, as well as the provisions governing the ROC,²⁵ would provide adequate protections against the use of regulatory assets, or assessment of regulatory income, to respond to budgetary needs.²⁶

Furthermore, NYSE explains that the proposed change would have the benefit of bringing the Exchange’s restrictions on the use of regulatory assets and income into greater conformity with those of its affiliates, NYSE MKT LLC and NYSE Arca, Inc., and would be consistent with limitations on the use of regulatory assets and income of other self-regulatory organizations (“SROs”).²⁷ The Exchange surveyed the rules of other SROs and found that no other SRO limits the use of fine income to extra-budgetary use or subjects the use of fine income

²² Id.

²³ Id. The Exchange notes that the Commission, when approving the Archipelago Merger, stated in the approval order that while “NYSE Regulation had the obligation under the Delegation Agreement to assure compliance with the rules of the Exchange, . . . the Fine Income Procedures provided a more direct commitment by NYSE Regulation to ensure the proper exercise of NYSE Regulation’s power to fine member organizations and the proper use by NYSE Regulation of fines collected.” Id. (citing the Merger Approval Order).

²⁴ See Notice, supra note 4, at 34394; see also NYSE Approval Order, supra note 10.

²⁵ See Operating Agreement, Art. II, Sec. 2.03(h)(ii).

²⁶ See Notice, supra note 4, at 34395.

²⁷ See id. at 34395–96.

to specific review and approval by a regulatory oversight committee or any other body.²⁸

Rather, the Exchange found that other SROs' limitations on the use of regulatory funds are largely similar to Section 4.05, by generally limiting the use of regulatory funds to the funding of an SRO's legal, regulatory and (in some cases) surveillance operations, and prohibiting the SRO from making a distribution to its member or stockholder, as applicable.²⁹ In support of its position, the Exchange references the limitations on the use of regulatory funds by NYSE MKT LLC; NYSE Arca, Inc.; BOX Options Exchange LLC; International Securities Exchange, LLC; ISE Gemini, LLC; ISE Mercury, LLC; BATS BZX Exchange, Inc.; BATS BYX Exchange, Inc.; BATS EDGX Exchange, Inc.; EDGA Exchange, Inc.; Miami International Securities Exchange, LLC; National Stock Exchange, Inc.; NASDAQ Stock Market LLC; and Boston Stock Exchange, Inc. (n/k/a NASDAQ BX, Inc.).³⁰

As noted above, the Commission received one comment letter on the proposed rule change.³¹ The commenter objects to the proposed rule change, citing both substantive and procedural bases.³² The commenter enumerates the following specific concerns with the proposal: (1) the Exchange's proposal is deficient because it does not include a "redline" of the rule text to allow interested persons to review the proposed changes;³³ (2) the Exchange's argument that the proposed rule change would bring it closer in line with other SROs' rules is objectionable because NYSE, as an industry leader, should be held to a higher standard and

²⁸ See id. at 34396.

²⁹ See id.

³⁰ See id. at 34395–96 nn.18–26 and accompanying text.

³¹ See Walsh Letter, supra note 5.

³² See id. at 1.

³³ See id.

“leading the way for other exchanges;”³⁴ (3) the Exchange, as an SRO, is both a market participant and a regulator, and the Fine Income Procedures “are important because they provide an objectively justifiable arms-length limitation to separate business from regulation;”³⁵ (4) the Exchange’s argument that its disciplinary process, including, in particular, the appellate process, provides safeguards is insufficient and does not provide the same “checks and balances” as the Fine Income Procedures do;³⁶ (5) the rule of statutory construction that the “specific provision prevails over the general” makes “the Fine Income Procedures superior to Section 4.05;”³⁷ and (6) the Exchange’s argument that the circumstances that led to the Fine Income Procedures no longer exist fails to explain what circumstances changed and what prevents their reoccurrence.³⁸

The Exchange submitted a letter responding to the issues raised by the commenter.³⁹

With respect to the commenter’s assertion that the proposal was insufficient because the Exchange’s proposal omitted a redline of the rule text, the Exchange explains that the Fine Income Procedures are internal rules that are not included in its published rulebook or governing documents, but the content of the rules are set forth in its proposal.⁴⁰

With respect to the commenter’s claim that the Exchange should be held to a higher standard than other SROs and should not be permitted to delete the Fine Income Procedures simply because it would bring NYSE closer in line with the limitations of other SROs, the

³⁴ See id. at 1–2.

³⁵ See id. at 2–4.

³⁶ See id. at 4–5.

³⁷ See id. at 5.

³⁸ See id.

³⁹ See NYSE Response Letter, supra note 6.

⁴⁰ See id. at 3–4. The Commission notes that the Fine Income Procedures were reproduced in the Notice. See Notice, supra note 4, at 34394.

Exchange explains that it cited to other SROs’ provisions relating to use of fine income to demonstrate that there are mechanisms other than the Fine Income Procedures that the Commission has found appropriate for ensuring that an SRO uses its regulatory funds properly.⁴¹ The Exchange contends that “[j]ust as the Commission found that the provisions in these other SROs’ governing documents were consistent with the Act, the Exchange believes that the Commission should conclude that Section 4.05, as an alternative to the Fine Income Procedures, is consistent with the Act.”⁴² The Exchange further states that it would be inappropriate to hold NYSE to a higher standard than other SROs (as the commenter has urged) because “[a]s a national securities exchange, the Exchange is subject to the same obligations and requirements under the Act as other national securities exchanges.”⁴³ Moreover, the Exchange maintains that to “hold individual exchanges to different standards based on their size, economic worth, leadership or any of the other factors that the comment letter cites would be contrary to just and equitable principles of trade, would create impediments to a free and open market and national market system, and would impede the protection of investors and the public interest.”⁴⁴

Regarding the commenter’s statement that the Fine Income Procedures are a means to ensure the separation of the Exchange’s business from its regulation, the Exchange states that it does not rely on the Fine Income Procedures to ensure the independence of its self-regulatory responsibilities and regulatory performance from its business interests, and instead notes how its corporate structure, including the required compositions of the Board, ROC, and CFR help to

⁴¹ See id. at 5.

⁴² Id.

⁴³ Id.

⁴⁴ Id.

ensure the independence of its regulatory obligations.⁴⁵ The Exchange also notes that the Fine Income Procedures are in fact limited in scope and thus the ROC and Section 4.05 in combination are more effective means in providing adequate protections against the use of regulatory assets, or the assessment of regulatory income, to respond to the budgetary needs of the Exchange.⁴⁶

With respect to the commenter's statement that the disciplinary process, and the appellate process in particular, alone does not provide sufficient safeguards against potential conflicts of interest, the Exchange disagrees with the commenter's assertion that the Fine Income Procedures provide a greater check on regulatory misbehavior than the appellate process.⁴⁷ The Exchange reiterates its view that the Fine Income Procedures do not provide oversight of regulatory performance and simply monitor how the resulting fine income is spent.⁴⁸ In addition, the Exchange describes how its appellate process provides an independent check on the disciplinary process and the possibility of improper exercise by Exchange regulatory staff of the power to fine members and member organizations in light of the CFR's composition, which requires the inclusion of both independent directors as well as representatives of Exchange members.⁴⁹

The Exchange also addresses the commenter's statutory construction argument that deletion of the "more specific provision" (i.e., Fine Income Procedures) could imply that the conduct prohibited by the Fine Income Procedures is no longer prohibited. In response, the Exchange notes that both the Fine Income Procedures and Section 4.05 apply to the use of fine

⁴⁵ See id. at 6.

⁴⁶ See id. at 6–7.

⁴⁷ See id. at 7–8.

⁴⁸ See id.

⁴⁹ See id. at 8.

income. The Exchange notes that, if the Fine Income Procedures are deleted, Section 4.05 would still apply to the use of the Exchange’s fine income and other regulatory assets.⁵⁰

Finally, the Exchange takes issue with the commenter’s assertion that it did not address “what circumstances occurred that will not occur again.” The Exchange states that the Fine Income Procedures provided a more direct commitment by NYSE Regulation to ensure the proper exercise of NYSE Regulation’s power to fine member organizations and the proper use by NYSE Regulation of fines collected.⁵¹ The Exchange notes that because the Delegation Agreement is no longer in effect, it is the Exchange itself that fines member organizations, and the Exchange is subject to the limitations of Section 4.05.

III. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange.⁵² In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(1) of the Act, which requires an exchange to be so organized and have the capacity to carry out the purposes of the Act and to comply, and to enforce compliance by its members and persons associated with its members, with the Act, the rules and regulations thereunder, and the rules of the exchange.⁵³ In addition, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act, which requires that the rules of the exchange be designed, among other things, to prevent fraudulent and manipulative acts and practices, to promote just and

⁵⁰ See id.

⁵¹ See id. at 8–9.

⁵² In approving this proposed rule change, the Commission notes that it has considered the proposed rule’s impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

⁵³ 15 U.S.C. 78f(b)(1).

equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.⁵⁴

As the Exchange notes, it implemented the Fine Income Procedures in connection with the Archipelago Merger, which had the effect of demutualizing New York Stock Exchange, Inc. (the predecessor to New York Stock Exchange LLC) by separating NYSE's equity ownership from trading privileges and converting it to a for-profit entity.⁵⁵ According to the Exchange, at that time it had delegated certain of its regulatory functions to its then subsidiary, NYSE Regulation, pursuant to the Delegation Agreement. In September 2015, the Commission approved the Exchange's proposal to revise its regulatory structure by amending various Exchange rules and the Operating Agreement, including to establish as a committee of the Board a ROC, to be composed of at least three members who satisfy the Exchange's independence requirements.⁵⁶ The Delegation Agreement recently was terminated in connection with the Exchange's reorganization of its regulatory structure that had resulted in the creation of the ROC. Because the Fine Income Procedures were instituted in connection with the delegation of certain of the Exchange's regulatory functions to NYSE Regulation, the Commission believes that it is appropriate for the Exchange to remove the Procedures because NYSE Regulation no longer performs any regulatory services on behalf of the Exchange. Further, given that the Exchange has reintegrated its regulatory functions under the oversight of the ROC, the Commission believes that Section 4.05 should continue to help ensure that the Exchange does

⁵⁴ 15 U.S.C. 78f(b)(5).

⁵⁵ See supra note 8.

⁵⁶ See NYSE Approval Order, supra note 10.

not inappropriately use its regulatory assets, fees, fines or penalties for commercial purposes or to distribute such assets, fees, fines or penalties to its direct parent, NYSE Group, Inc., or to any other entity. Finally, the Commission believes that creation of the ROC, along with its responsibilities under Section 2.03(h)(ii) of the Operating Agreement, should help to ensure the proper oversight of the Exchange's regulatory program, including the exercise by the Exchange's regulatory staff of its power to fine member organizations, and the use of regulatory assets, fees, fines and penalties collected by the Exchange's regulatory staff.

As noted above, the commenter raises several concerns regarding the Exchange's proposal, including by asserting that the proposal was insufficient because it did not include rule text indicating the deletion of the Procedures. The Exchange responds that the Procedures are available in the Exchange's filing and on the Exchange's website. The Commission believes that, because the Fine Income Procedures were internal procedures of the Exchange and were not part of the Exchange's rulebook or governing documents, it was appropriate for the Exchange to include the Procedures in its Form 19b-4 describing the proposed rule change, which were published by the Commission as part of the Notice.⁵⁷

The commenter remarks that the NYSE should be "held to a higher standard" than other exchanges. In response, the Exchange states that, as a national securities exchange, treating it differently than any other national securities exchange based on its size, prominence or any of the other factors noted in the comment letter, among other things, would be contrary to just and equitable principles of trade.⁵⁸ The Commission previously found that Section 4.05 is consistent

⁵⁷ See Notice, supra note 4, at 34394.

⁵⁸ See NYSE Response Letter, supra note 6, at 5.

with the Act⁵⁹ and continues to believe that it is consistent with the Act, and that it is substantially similar to requirements relating to the use of regulatory assets, fees, fines and penalties that were approved by the Commission with respect to other exchanges, including the Exchange’s affiliates—NYSE MKT LLC and NYSE Arca, Inc.⁶⁰

The commenter also expresses the view that deleting the Fine Income Procedures would remove rules that serve to separate the Exchange’s business function from its regulatory obligations, and that the Exchange’s disciplinary process did not provide an adequate safeguard against “regulator misbehavior.” The Commission believes that the Exchange has adopted several measures to ensure the independence of its regulatory functions including, among other things, creating a ROC, which is composed entirely of directors of the Exchange who satisfy the Exchange’s independence requirements, and the CFR, which is composed of Exchange members and directors who satisfy the Exchange’s independence requirements.⁶¹

The commenter further expresses concern that deleting the Fine Income Procedures may imply that the conduct banned by the Procedures no longer is prohibited. The Commission believes, however, that even with the deletion of the Fine Income Procedures, given the scope of Section 4.05, the Exchange would continue to be prohibited from using regulatory assets, fees, fines or penalties for other than regulatory purposes.

Finally, the commenter states that Exchange did not adequately describe why the circumstances that existed at the time the Fine Income Procedures were adopted no longer exist.

⁵⁹ See NYSE Approval Order, supra note 10, at 59842–43.

⁶⁰ See Notice, supra note 4, at 34395–96 nn.18–26 and accompanying text.

⁶¹ See NYSE Approval Order, supra note 10, at 59838–41.

The Commission notes that the Exchange's proposal states that NYSE Regulation no longer performs regulatory services on behalf of the Exchange.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (SR-NYSE-2016-37) is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁶²

Jill M. Peterson
Assistant Secretary

⁶² 17 CFR 200.30-3(a)(12).