



*Office of Inspector General*

# SRO Rule Filing Process

*March 31, 2008*

*Audit No. 438*



Office of Inspector  
General

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

To: Erik Sirri, Director, Division of Trading and Markets  
Nancy Morris, Director, Office of the Secretary  
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From: H. David Kotz, Inspector General

A handwritten signature in black ink, appearing to read "HDK", written over the printed name of the Inspector General.

Date: March 31, 2008

Re: Office of Inspector General Audit – SRO Rule Filing Process (No. 438)

Attached is our final audit report on the Division of Trading and Market's SRO Rule Filing Process. Your comments to the draft reports have been incorporated as appropriate.

Commission management agreed with all 19 of our recommendations. We appreciate the courtesy and cooperation that was extended to our staff during this audit.

Attachment

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# SRO RULE FILING PROCESS

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## EXECUTIVE SUMMARY

*The Office of Inspector General of the Securities and Exchange Commission conducts regular audits and inspections of Agency operations to promote the effectiveness, integrity and efficiency of the Commission.*

*We conducted an audit of the Commission's process for reviewing Self-Regulatory Organization (SRO) proposed rule changes. An SRO is a non-government organization that has the power to create and enforce industry regulations and standards. SROs include among others, national securities exchanges and securities associations registered with the Commission such as the New York Stock Exchange and the American Stock Exchange. The SROs are required to file proposed rule changes with the Commission in order for the rules to become effective. The Commission approves certain rules before they can take effect, while other rules are effective upon filing, without Commission approval.*

*We found that the Commission's overall timeliness in processing proposed rule changes needs improvement. The Commission did not approve proposed rule changes within the prescribed statutory timeframe in 8 of 15 instances that we judgmentally selected to review. Additionally, the Division of Trading and Markets (TM) does not have a policy that outlines criteria to follow-up with SROs on open proposed rule changes, request SROs to withdraw proposed rule changes, and disapprove or reject proposed rule changes. The establishment and adherence to such a policy would improve TM's timeliness in processing proposed rule changes. Timely processing assists the SROs to remain competitive with foreign and futures exchanges, electronic communications networks and alternative trading systems that can change their trading or trade new products with greater ease and without Commission review.*

*We also found that one SRO did not post two proposed rule changes to its website within two days of filing them with the Commission, as required by Rule 19b-4 of the Exchange Act. TM should remind the SROs of this requirement.*

*We identified several TM official SRO rule files that were incomplete and found that TM did not have a written policy identifying all of the documents to be included in such a file. Additionally, public comment letters were not always available on the Commission's website, in TM's official rule files or listed in the SRO Rule Tracking System (SRTS).*

*We found that a sample of data from the SRTS system was accurate and entered timely overall, but staff did not consistently record whether the electronic information received included a valid digital signature. A digital signature provides assurance that the information received has not been altered. We further identified enhancements that should be made to SRTS.*

*Management concurred with all 19 of our recommendations. Their formal written response is included as Appendix E.*

## **OBJECTIVES, SCOPE AND METHODOLOGY**

**Objectives.** Our audit objectives were to:

1. Verify Commission compliance with the requirements described in the Securities Exchange Act of 1934 (Exchange Act) and with the Division of Trading and Market's (TM) policies and procedures;
2. Evaluate TM's Self-Regulatory Organization (SRO) Rule Tracking System (SRTS) to determine:
  - a. The accuracy and timeliness of a sample of SRTS data;
  - b. The appropriateness of employee and contractor access to SRTS;
  - c. Whether SRTS has been subject to appropriate security reviews; and
  - d. If any enhancements should be made to SRTS.
3. Follow-up on recommendations made in the prior OIG audit of TM's SRO Rule Filing process (*Commission Review of SRO Rules*, Audit No. 272, July 14, 1998) and;
4. Identify improvements to the Commission's SRO Rule Filing process.

**Scope.** The scope of the audit covers 1,014 proposed rule changes the Commission processed in 2006 and 1,143 in 2007 as well as all open proposed rule changes as of November 7, 2007. We conducted our fieldwork from September 2007 to February 2008.

**Methodology.** The audit included reviewing a judgmental sample of 56 SRO rules that the Commission processed or finalized<sup>1</sup> in 2007. See Appendix B. To select this sample we chose rules from 14 SROs, ensuring that rules with and without amendments were selected as well as rules filed pursuant to Sections 19(b)(2) and 19(b)(3)(A) of the Exchange Act. We selected 4.9 percent (56 of 1,143) of the rules processed in 2007. We also judgmentally selected 20 rules processed in 2006 that contained comment letters and 10 rules that were open (*i.e.*, not finalized) for more than one year. (See discussion of sampling methodology in Appendix D).

We interviewed Commission staff in TM, the Office of the Secretary (OS) and one Commissioner. We reviewed and relied upon relevant information in the Exchange Act, the Code of Federal Regulations, TM's policies and procedures, TM's official rule files, and Commission management reports on SRO proposed rule changes. We reviewed the accuracy of SRTS data, employee access to SRTS and the process for

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<sup>1</sup> The report uses the terms "processed", "finalized", or "final action" to refer to proposed rule changes that the Commission approved or were effective immediately upon filing, without Commission approval. The Commission approves proposed rule changes filed pursuant to Section 19(b)(2) of the Exchange Act. Proposed rule changes filed pursuant to Section 19(b)(3)(A) of the Exchange Act are not approved by the Commission, as explained on page 4 of this report.

granting SRTS access to employees. We also surveyed SRO staff to obtain their views on the Commission's SRO rule filing process.

We surveyed SRO officials who file proposed rule changes with the Commission to obtain their views on the Commission's processing of SRO proposed rule changes.

**Use of Computer-Processed Data.** We relied on computer-processed data from the SRTS system. While we did not extensively test the system's internal controls, we found that a sample of data from the system was accurate overall and we believe the information generated by this system and used by us was sufficiently reliable for our audit objectives.

**Prior Audit Coverage.** *Commission Review of SRO Rules*, Audit No. 272, issued July 14, 1998.

**Management Controls.** Management controls were not a part of our objectives and were not reviewed.

We conducted this performance audit in accordance with generally accepted government auditing standards, except that we did not extensively test the SRTS system controls because this was not a part of our objectives. The standards require that we plan and perform the audit to obtain sufficient, appropriate evidence that provides a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

## **BACKGROUND**

SROs include among others, national securities exchanges and securities associations registered with the Commission, such as the New York Stock Exchange and the American Stock Exchange. Congress adopted self-regulation, as opposed to direct Federal regulation of the securities markets, to prevent excessive government involvement in market operations, which could hinder their competition and market innovation. Also, Congress concluded that self-regulation with federal oversight would be more efficient and less costly to taxpayers.<sup>2</sup>

SROs maintain an established set of rules which govern the activity of their members and their organization. TM began receiving SRO proposed rule changes in 1976, after an amendment to the Exchange Act was implemented. An SRO generally must file a proposed rule change<sup>3</sup> with the Commission prior to the rule's

<sup>2</sup> General Accountability Office Report No. 08-33, page 1.

<sup>3</sup> Under Section 19(b)(1) of the Exchange Act, the term "proposed rule change" encompasses "any proposed rule, or any proposed change in, addition to, or deletion from the rules of" an SRO. 15 U.S.C. § 78s(b)(1). Section 3(a)(27) of the Exchange Act defines "rules of an exchange", "rules of an association", or "rules of a clearing agency" as "the constitution, articles of incorporation, bylaws, and rules, or instruments corresponding to the foregoing, of an exchange, association of brokers and dealers, or clearing agency, respectively and such of the stated policies, practices, and interpretations of such exchange, association, or clearing agency as the Commission, by rule, may determine to be necessary or appropriate in the public interest or for the protection of investors to be deemed to be rules of such exchange, association, or clearing agency." 15 U.S.C. § 78c(a)(27).

implementation. The Commission will then publish the proposed rule in the *Federal Register (Notice)* to allow for public comment, review any comments received, and take action to finalize the proposed rule. This filing requirement helps ensure, through Commission review and the public comment process that the SROs carry-out the purposes of the Exchange Act. Rule 19b-4 of the Exchange Act governs the requirements for the SRO rule filing process.

Proposed rule changes range from routine to complex. The Commission approves most rules by authority delegated to TM.<sup>4</sup> Any proposed rule change that has been approved by delegated authority can be challenged after the Commission issues the approval order.<sup>5</sup> If the Commission has expressed an interest in a particular proposed rule change or the subject matter addressed by the proposal, or if the TM staff are aware that a particular proposal is controversial, the staff will send the proposal to the Commission for its review either by seriatim or for joint consideration by the Commission at a public meeting.

The Commission processed 1,014 proposed rule changes in 2006 and 1,143 in 2007.<sup>6</sup> Approximately eighty-five percent of the proposed rule changes were reviewed by TM staff in the Office of Market Supervision and the remainder was reviewed by personnel in other offices within TM. Several TM managers specialize in and routinely review proposed rule changes pertaining to specific subject areas.

Proposed rule changes may cover organizational and administrative issues, fees, rebates, membership and listing requirements, trading rules, financial products traded, derivatives, new trading systems, business conduct, disciplinary procedures, and record retention plans. The primary types of proposed rule changes are described below:

**Section 19(b)(2).** The SRO submits a proposed rule change for notice, comment and approval. The Commission must allow for public comment by publishing the proposed rule change in the *Federal Register* and either:

- Approve the proposed rule change within 35 days following its publication for comment, absent certain circumstances<sup>7</sup> or
- Institute proceedings to determine whether the proposed rule change should be disapproved within 180 days following publication for comment, absent certain circumstances.<sup>8</sup>

The SRO may ask the Commission to accelerate its review and approval of a proposed rule change filed pursuant to section 19(b)(2) of the Exchange Act. The Commission may grant accelerated approval if it finds good cause for doing so and publishes its reasons in the *Federal Register*. In general, the Commission accelerates approval of a proposed rule change simultaneous with publishing it for

<sup>4</sup> 17 C.F.R. § 200.30-3(a)(12).

<sup>5</sup> Rule 430 of the Commission's Rules of Practice sets forth the timeframes within which a notice of intention to petition for review must be filed.

<sup>6</sup> Of the 1,014 rules processed in 2006, 479 were 19(b)(2) rules and 535 were 19(b)(3)(A) rules. Of the 1,143 rules processed in 2007, 511 were 19(b)(2) rules and 632 were 19(b)(3)(A) rules.

<sup>7</sup> The Commission may designate up to 90 days to take action on a proposed rule change if it finds it necessary and publishes its reasons; or the SRO may consent to a time extension. Exchange Act §19(b)(2).

<sup>8</sup> The Commission may extend the time for conclusions of such proceedings up to 60 days if it finds good cause and published its reasons; or the SRO may consent to a time extension. Exchange Act §19(b)(2)(B).



comment. Thus, the comment period follows approval and any changes to the rule in response to the comments must be done by the SRO on its own initiative or by the Commission using its authority under Section 19(c) of the Exchange Act.

**Section 19(b)(3)(A).** The proposed rule change is effective immediately upon the SRO filing.<sup>9</sup> The proposed rule change must:

- Constitute a stated policy, practice, or interpretation with respect to the meaning, administration or enforcement of an existing SRO rule;
- Establish or change a due, fee or other charge imposed by an SRO; or
- Concern solely SRO administration or other matters that the Commission, by rule, may specify, consistent with the public interest and the purposes of section 19(b) of the Exchange Act.

The Commission does not approve these proposed rule changes, but does have 60 days from the date the changes are filed to abrogate the rule change and require the proposal be re-filed and reviewed under Section 19(b)(2) of the Exchange Act, if necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the statute.

### SRTS and EFFS

TM worked closely with the Office of Information Technology (OIT) to develop SRTS and the Commission's Electronic Form 19b-4 Filing System (EFFS). See Appendix C. These systems allow for the electronic submission and tracking of proposed rule changes. TM began using SRTS in 2002 and the SROs began using EFFS in 2004. Prior to EFFS, the SROs submitted proposed rule changes in paper form to the Commission.

The SROs electronically submit proposed rule changes into the EFFS system. EFFS interfaces with SRTS and populates SRTS with key information about an SRO's proposed rule change such as the SRO filing date, the date any related amendments were received, the type of proposed rule change, and SRO contact information. SRTS calculates the comment period expiration date and the final action due date. SRTS also contains an inbox where TM staff receive assigned proposed rule changes and a docket, allowing TM staff to record important developments about the status of a proposed rule change. TM staff and staffers in other divisions have varying levels of access to SRTS ranging from read-only access to full access, which enables staff to assign proposed rule changes to other staff, change information and develop management reports.

### Commission Review Process

All the SRO proposed rule changes are received in the *Gatekeepers* inbox in SRTS. TM has a primary and backup gatekeeper per SRO. The gatekeeper reviews the proposed rule change and should ensure that an SRO's digital signature<sup>10</sup> is valid.

<sup>9</sup> A Section 19(b)(3)(A) filing normally becomes operative upon filing with the Commission, except for a proposal submitted pursuant to Rule 19b-4(f)(6), which becomes operative 30 days after the date of filing with the Commission or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest and certain other requirements are met. 17 C.F.R. § 240.19b-4(f)(6)(iii).

<sup>10</sup> A digital signature is an electronic signature that can be used to authenticate the identity of the sender of a message or the signer of a document, and help ensure that the original content of the message or document that has been sent is unchanged.

The gatekeeper then assigns the proposed rule change to senior manager in TM. The senior manager subsequently assigns the proposed rule change to an Associate Director, a principal attorney and possibly a staff attorney in TM. Assigned proposed rule changes are displayed in the SRTS inboxes of the assigned staff members.

TM staff review the proposed rule change to determine if it is properly filed, and in compliance with the Exchange Act as required in the instructions to the Commission's Electronic Form 19b-4. Generally, this involves ensuring the SRO has included required exhibits and that the proposed rule change is clear, complete, and written with sufficient clarity to elicit meaningful public comments. The documentation from the SRO must also allow the Commission to determine whether the proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to the SRO.

If TM's preliminary review concludes that the proposed rule change is properly filed, the Commission will generally *Notice* the proposal to solicit public comments. There is no statutory timeframe stating when the Commission must *Notice* a proposed rule change. However, TM attempts to *Notice* Section 19(b)(3)(A) proposed rule change within two to three weeks of receipt. A proposed rule change filed pursuant to Section 19(b)(2) requires slightly more review time than one filed pursuant to Section 19(b)(3)(A) because it is usually more complex in substance than one that is effective upon filing. If the proposed rule change is poorly drafted, requires changes or amendments, or raises policy issues under the Exchange Act, it can take longer to be *Noticed*. Regardless of the type of proposed rule change, Commission attorneys consult with SRO attorneys about pending proposed rule changes on a regular basis.

The Commission solicits comments on all proposed rule changes. Generally, the comment period is 21 days, commencing on the date the proposed rule change appears in the *Federal Register*. On rare occasions, the Commission, after consulting with the SRO, will provide an abbreviated comment period for as little as 15 days. As a general rule, the Commission will consider any comment letter it receives, even if the letter arrives after the expiration of the comment period, provided that it arrives before the date that the Commission takes final action on a proposed rule change. Most rule changes do not elicit public comments.

Ultimately, the Commission issues an order that provides a detailed summary of the procedural history of the proposed rule change, the substance of the commenters' concerns and any response to the comments provided by the SRO if applicable, the Commission's findings, and final action.

After final action has been taken on the proposed rule change, TM completes the preparation of the rule's official file, which should consist of the rule filing, any amendments and related information. TM retains rule files on-site for approximately five years and then stores the files at an off-site storage facility.

#### *Withdrawals, Rejections and Disapprovals*

A proposed rule change can be withdrawn, rejected or disapproved. TM may ask an SRO to withdraw a proposed rule change when concerns come to light after it has been published for comment or when an SRO fails to timely amend a proposed rule change. An SRO may also withdraw a proposed rule change on its own initiative.

According to TM, in 2006 and 2007, 96 and 46 proposed rule changes were withdrawn by the SROs, respectively.

The Commission may reject a proposed rule change that is incomplete, unclear, or otherwise fails to comply with Rule 19b-4. According to TM, in 2006 and 2007, 127 and 138 proposed rule changes were rejected by the SROs, respectively.

The Commission may disapprove a proposed rule change if it is inconsistent with the Exchange Act. The disapproval process is lengthy and complex. To disapprove a proposed rule change, the Commission must first institute proceedings to determine whether the proposed rule change should be disapproved. Such proceedings must include notice of the grounds for disapproval under consideration, and an opportunity for a hearing, and must be concluded within 180 days of the date of publication of notice of the filing of the proposed rule change. At the conclusion of such proceedings the Commission, by order, may disapprove a proposed rule change if it finds that that the proposal is not consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to the SRO.<sup>11</sup> The Commission rarely disapproves a proposed rule change and did not disapprove any in 2006 or 2007.

#### Comment Letter Log

OS manages the comment letter process by logging the comment letters received into a Microsoft Access database, which interfaces with and populates SRTS with information about the comment letters received. OS also posts comment letters to the Commission's website at [www.sec.gov](http://www.sec.gov).

#### Changes to the Rule Filing Process

In 1994, the Commission amended Rule 19b-4 to allow for additional proposed rule changes to become immediately effective upon filing and without Commission approval. In 1998, the Commission again amended Rule 19b-4 to streamline the listing and trading of certain derivative securities to enable exchanges to remain competitive with foreign and over-the-counter derivatives markets.

In 2001, the Commission proposed to allow most exchange trading rules to become effective immediately upon filing with the Commission. This proposed rule also would have imposed several new obligations on the SROs. The Commission received several negative comments on the proposal and did not act on the proposed changes.

During the audit, TM was considering ways to further streamline the SRO rule filing process.

## **AUDIT RESULTS**

Overall, the SRO rule filing process was well-organized and SRO officials were complimentary of Commission staff. We found, however, that the Commission did not consistently finalize proposed rule changes within the statutory timeframe set forth in the Exchange Act. The Commission should improve its overall timeliness in processing proposed rule changes. One SRO did not post two proposed rule changes

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<sup>11</sup> See footnote 8.

to its website within two days of filing them with the Commission, as required by Rule 19b-4, which governs the requirements for the SRO rule filing process. TM should periodically remind all of the SROs of this requirement.

The SRTS data, according to our sample tested, was accurate overall and timely entered. We identified areas where SRTS could be enhanced.

While all of our recommendations identified in the prior OIG audit report on the SRO Rule Filing process were closed out, the report identified timeliness issues in *Noticing* and finalizing proposed rule changes (*Commission Review of SRO Rules*, Audit No. 272, issued July 14, 1998).

We identified several improvements to the Commission's SRO Rule Filing Process, as described in this report.

During the audit, OIT worked with TM staff to address some of the issues that we brought to their attention by ensuring that SRTS is subject to an annual security review, fixing technical problems with SRTS and removing SRTS access from persons who should not have had access. We appreciate OIT and TM's prompt response in resolving these issues.

Our detailed findings and recommendations are described below.

## **TIMELINESS**

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It is important for the Commission to timely process proposed rule changes. Timely processing assists the SROs to remain competitive with foreign and futures exchanges, electronic communications networks and alternative trading systems that can change their trading or trade new products with greater ease and without Commission review.

While TM does not have a set timeframe to issue a *Notice* release for a proposed rule change, nor is there a statutory timeframe, we believe that doing this within 30 days is generally reasonable, based on our discussions with TM and SRO staff and our additional audit work. The statutory timeframe to finalize a proposed rule change is generally 35 days from the *Notice* release date for proposed rule changes filed pursuant to Section 19(b)(2) of the Exchange Act.<sup>12</sup>

### *Timeliness According to Commission Management Reports*

TM produces various reports that provide information about how long it took the Commission to process proposed rule changes. According to one of these reports, the Commission processed 300 proposed rule changes from October 1, 2007 to December 31, 2007. From the receipt date of each SRO's proposed rule change or the latest amendment (if applicable), the rules were processed as follows (see Table 1):

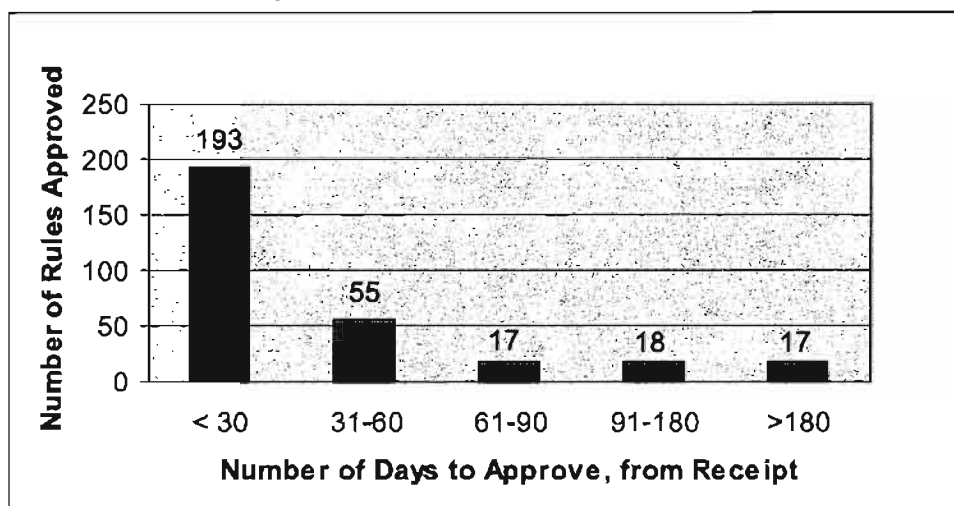
- Sixty-four percent (193 of 300) were processed in 30 days or less from the receipt date;
- Eighteen percent (55 of 300) were processed 31- 60 days from the receipt date;

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<sup>12</sup> See footnote 7.

- Six percent (17 of 300) were processed 61- 90 days from the receipt date;
- Six percent (18 of 300) were processed 91- 180 days from the receipt date; and
- Six percent (17 of 300) were processed more than 180 days from the receipt date.

**Table 1.** Proposed Rules Changes Processed from October 1, 2007 to December 31, 2007



#### Timeliness According to Audit Sample Data

Based on the 56 proposed rules we reviewed, we found that 28 were filed pursuant to Section 19(b)(2) of the Exchange Act and the remaining rules were filed pursuant to Section 19(b)(3)(A), and thus were effective immediately upon filing.

Only the 28 rules filed pursuant to Section 19(b)(2) were subject to the *Notice* and approval process. Fifty-four percent (15 of 28) of these rules were *Noticed* and had a separate approval order and forty-six percent (13 of 28) were granted accelerated approval. The 13 rules that were granted accelerated approval were *Noticed* and approved on the same date with a single Commission approval order.

The average time it took to issue a *notice* release for these 28 rules, from the date they were received by the Commission was 57 days, broken out as follows:

- Sixty-seven days for the 15 rules that were *not* granted accelerated approval; and
- Forty-four days for the 13 rules that were granted accelerated approval.

In addition, it took over 30 days to issue a *Notice* release for 54 percent (15 of 28) of the proposed rules.

#### **Recommendation A**

TM should establish a division-wide goal for issuing a *Notice* release for proposed rule changes within a certain period of time (*e.g.*, generally 30 days from receipt). TM should track its progress in meeting this goal.

Twenty-seven percent (15 of 56) of the rules we reviewed were subject to a 35-day statutory timeframe to finalize, from the Federal Register *Notice* date. Fifty-three percent (8 of 15) rules took more than the 35-day statutory timeframe to finalize, from the Federal Register *Notice* date. See Table 2. According to SRTS, there were two instances where TM waited for an amendment, or other information from the SROs, but extensions were not granted.

**Table 2.** Rules That Took Longer than 35 Days from the *Notice* Date to Finalize, In Violation of the Statutory Requirement

Rule	SEC Received Date	Last Amendment Received Date	Federal Register Notice Date	SEC Approval Date	Days to Notice *	Days to Finalize, from Notice Date **
AMEX 2007-35	4/5/2007	8/20/2007	9/6/2007	10/12/2007	154	36
AMEX 2007-08	1/19/2007	-----	2/2/2007	3/13/2007	14	39
ISE 2006-78	12/13/2006	-----	2/12/2007	3/29/2007	61	45
FINRA 2007-1	7/31/2007	-----	8/9/2007	9/28/2007	9	50
DTC 2007-04	4/19/2007	-----	6/28/2007	8/17/2007	70	50
OCC 2007-06	4/20/2007	6/14/2007	6/27/2007	8/20/2007	68	54
DTC 2006-07	3/28/2006	9/29/2006	12/20/2006	2/27/2007	267	69
ISE 2006-62	10/11/2006	1/5/2007	10/20/2006	1/24/2007	9	96

\* The number of days between the SEC received date and the *Federal Register Notice* date.

\*\* The number of days between the *Federal Register Notice* date and the SEC approval date.

### **Recommendation B**

TM should establish a policy to ensure that it meets the statutory timeframe for finalizing proposed rule changes that have been *Noticed* in the Federal Register. TM should track its progress in adhering to this policy.

#### Open Proposed Rule Changes According to Commission Management Reports

TM produces various reports that provide information about how long proposed rule changes have been open and why they are still open. According to one of these reports, as of December 31, 2007, the Commission had 226 open proposed rule changes, as follows:

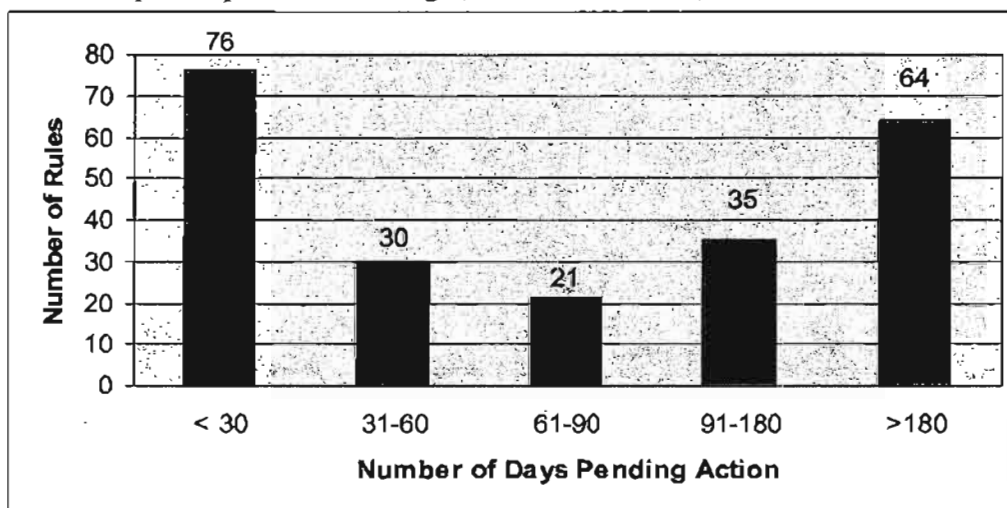
- Two hundred two proposed rule changes were filed under 19(b)(2) and twenty-four were filed under 19(b)(3)(A);

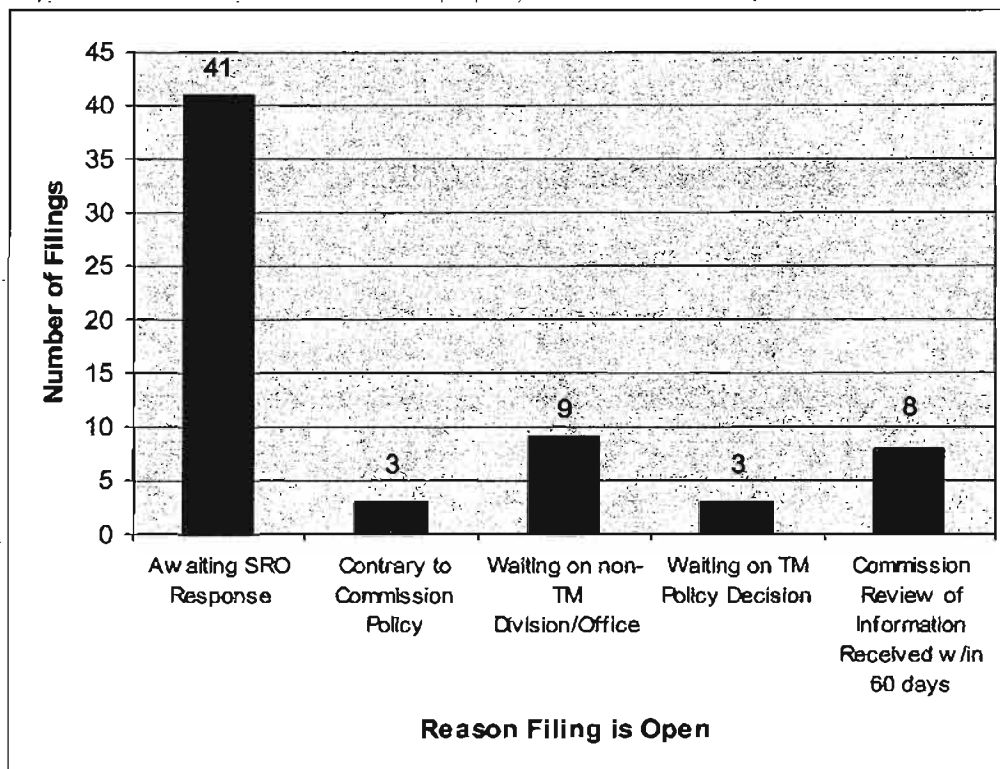
- The oldest proposed rule change was open for more than four years;
- The proposed rule changes were open on average for 229 days; and
- The proposed rule changes were open for 115 median days.

From the latter of the receipt date for each SRO's proposed rule change or the latest amendment received date (if applicable), these 226 open proposed rule changes were pending as follows (See Table 3):

- Thirty-four percent (76 of 226) were pending action for 30 days or less from the receipt date;
- Thirteen percent (30 of 226) were pending action for 31-60 days from the receipt date;
- Nine percent (21 of 226) were pending action for 61-90 days from the receipt date;
- Fifteen percent (35 of 226) were pending action for 91-180 days from the receipt date; and
- Twenty-eight percent (64 of 226) were pending action for more than 180 days from the receipt date, for the following stated reasons (see Table 4):
  - Forty-one, awaiting an SRO response.
  - Three, contrary to Commission policy.
  - Nine, waiting on non-TM division or office.
  - Three, waiting on TM policy decision.
  - Eight, reviewing information received within 60 days.

**Table 3.** Open Proposed Rule Changes, as of December 31, 2007



**Table 4.** Proposed Rule Changes Open More than 180 Days, as of December 31, 2007

As illustrated in Tables 3 and 4 above, as of December 31, 2007, the Commission had 226 open proposed rule changes, 64 of which were pending action for more than 180 days from the receipt date.

*Open Proposed Rule Changes According to Audit Sample Data*

Table 5 shows our judgmental sample of 10 open proposed rule changes, which were open for at least one year, as of November 7, 2007.



**Table 5. Sample of Ten Proposed Rule Changes Open More than One Year,  
As of November 7, 2007**

<b>Proposed Rule Change</b>	<b>Commission Received Dated</b>	<b>Number of Days Open as of 11/7/07</b>	<b>Noticed in Federal Register</b>	<b>Awaiting Action from</b>	<b>Action After 11/7/07</b>
AMEX 2006-31	4/7/2006	579	Yes: 12/20/07	SRO	Approved
CBOE 2005-11	1/25/2005	1,016	No	Commission	Second amendment filed on 3/7/08. Noticed on 3/11/08.
CHX 2005-39	12/22/2005	685	No	SRO	Withdrawn
CSE 2003-04	3/27/2003	1,686	No	SRO	Withdrawn
ISE 2006-01	1/5/2006	671	Yes: 1/19/06	Commission	-----
NSCC 2006-04	3/15/2006	602	Yes: 5/8/06	Commission	-----
NYSE 2004-60	10/26/2004	1,107	No	TM	Withdrawn
NYSE 2006-50	6/30/2006	495	No	SRO	-----
NYSEArca 2006-53	9/1/2006	432	No	SRO	Withdrawn
PHLX 2004-63	9/28/2004	1,135	No	SRO	Withdrawn
<b>Total number days open: 8,408</b>					
<b>Average days open: 841</b>					
<b>Median days open: 678</b>					

As of November 7, 2007, these 10 proposed rule changes had been open from 432 to 1,686 days and a median of 678 days. Only three of these proposed rule changes had been *Noticed*. As of this date:

The Commission was waiting for SRO action on six proposed rule changes.

- In these instances, TM management informed us that it had material concerns with these proposed rule changes and/or the proposals failed to adequately articulate their purpose or include pertinent details. Therefore, TM requested and was waiting for additional information from the SROs or TM requested the SROs to withdraw these proposed rule changes.

Commission action was required in three instances. According to TM:

- In one instance, another Federal agency believed that it had jurisdiction over the product in question. In order to address the concerns of the other agency, the Commission delayed acting upon the proposal.
- In another instance, while TM recommended approval, the Commission had not approved the proposed rule change.
- In another instance, the proposed rule, if approved, would change the way trades are processed. This proposal involves several complex issues and the Commission received 12 comment letters, 10 of which opposed the proposed rule change. Commenters met with Commissioners in 2006 and 2007 to discuss their comments. TM drafted a memo discussing the issues and making recommendations and circulated the memo to the Commissioners in April 2007. Since that date, TM staff have met with Commissioners, commenters, and the SRO to flesh out further issues and to gather information to address additional questions and comments raised with respect to the proposed rule change.

TM action was required in one instance.

- TM had not *Noticed* this proposed rule change because TM believed that the proposal was not in the best interest of investors. The SRO withdrew this proposal, per TM's request. TM management told us that if the SRO had not withdrawn this proposed rule change, the Commission would have initiated disapproval proceedings.<sup>13</sup>

These 10 proposed rule changes were complex and/or controversial, lending themselves to a longer review period. In these cases, additional amendments and frequent communication between the Commission, SROs and third parties occurred. In at least two instances, the SROs had to obtain approval from their Boards of Directors before making changes to the proposed rules that TM requested. Accordingly, some factors that may affect TM's timeliness are not in TM's control.

However, while TM managers generally encourage their staff to follow-up with SRO staff on open proposed rule changes and recommend that the SROs withdraw certain proposals, there is no division-wide policy to this effect. Some TM staff suggested that TM should be firmer in requesting SROs to withdraw pending proposed rule changes that have been overcome by events or that the Commission refuses to *Notice* because they are not in the best interest of investors. TM staff also told us that an SRO may not timely withdraw a proposed rule change, even after requested by TM, because the SRO fails to prioritize this action. On other occasions, the SRO refuses to withdraw a proposed rule change. If the SRO does not withdraw a proposed rule change, the Commission may institute proceedings to determine whether the proposed rule change should be disapproved. The disapproval process is lengthy and complex.

TM also does not routinely reject proposed rule changes that are incomplete, unclear, or otherwise fail to comply with Rule 19b-4. Instead, TM staff delay

<sup>13</sup> The disapproval proceedings process is described on page 7 and in footnote 8 of this report.

*Noticing* or approving such proposed rule changes until an agreement is reached with the SRO on making appropriate changes. This adversely affects TM's timeliness in processing proposed rule changes. TM staff told us that it would be more efficient if TM rejected insufficient proposed rule changes, while continuing to work with the SROs to improve such proposals "off the clock."

### **Recommendation C**

TM should establish a written policy containing:

- Procedures for following up with SRO staff when TM is waiting for information from the SROs;
- Criteria for requesting an SRO to withdraw a proposed rule change;
- Criteria for instituting a disapproval proceeding; and
- Criteria for rejecting a proposed rule change.

TM should share this information with the SROs and train its staff to utilize this policy.

Our prior OIG audit report also identified timeliness issues regarding proposed rule changes open for a significant period of time and recommended similar action (*Commission Review of SRO Rules*, No. 272, issued July, 14, 1998).

## **REVIEW OF SRO RULES**

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From our judgmental sample of 56 finalized SRO rules, we determined whether TM's official rule files were complete and the related SRTS data was accurate. The sample included 19(b)(2) and 19(b)(3)(A) rules, which were finalized in 2007, from 14 different SROs (see Appendix B).

### Completeness of TM's Official SRO Rule Files

We reviewed 51 of TM's official SRO rule files that corresponded to our judgmental sample of 56 rules to determine whether the files were complete. TM could not locate the remaining five files during the audit but provided them to us after we issued this report in draft form.

TM did not have a complete list identifying which documents should be contained in each file, but did have a document that discussed its rule filing close-out procedures and a written checklist, both of which indicated some, but not all of the documents that should be included in each official SRO rule file. Based on our review of these documents and discussions with TM staff, an official SRO rule file should contain the following:

- Rule filing from the SRO;
- SEC *Notice* and/or order containing a raised SEC seal, which is signed by the Secretary's office;
- TM Close-out sheet;
- SRTS snapshot report; and
- Relevant page(s) of the *Federal Register*.<sup>14</sup>

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<sup>14</sup> TM includes the close-out sheet, SRTS snapshot report and relevant page(s) of the *Federal Register* in its SRO

If applicable, the following additional documents should also be included in an official SRO rule file:

- Amendments from the SRO;
- Comment letters;
- SEC release containing a raised SEC seal and signed by the Secretary's office;
- Information related to partial approvals and extensions; and
- Substantive e-mails, memoranda or notes, or other information related to the rule filing.

Table 6 shows the results of our review of the 51 of 56 official SRO rule files:

**Table 6. Completeness of Official SRO Rule Files**

Document Reviewed	Exceptions
SRO Rule Filing	None.
Signed SEC Notice or Order with raised Seal	Six files contained a Notice or Order that did not have an SEC raised seal. One file did not contain the Notice Release and Order Release.
Close-out Sheet	Missing in 31 instances.
Snapshot Report	Missing in 33 instances.
<i>Federal Register</i> page(s)	Missing in 3 instances.
Amendment(s)	Missing in 1 of 24 applicable instances.

A TM manager believed that the close-out sheet and SRTS snapshot report were unnecessary and therefore, were not included in 12 files that we reviewed. Both of these documents were listed as required items in TM's written documentation.

During the audit, we provided TM management with a list of exceptions that identified which official rule files were missing and the additional documentation that was needed for the incomplete files.

### ***Recommendation D***

TM should ensure that the incomplete files are supplemented with the missing documents and work with OS to ensure that all Commission *Notices* and orders contain an SEC raised seal.

### ***Recommendation E***

TM should establish a complete written list of all documents that should be contained in each SRO official rule file. The list should identify which documents are required in all instances as well as the documents that should be included if applicable (*e.g.*, amendments; comment letters; extensions). TM should enforce compliance with this documentation requirement by periodically reminding its staff of this requirement and spot-checking the files for completeness.

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official rule file for reasons of administrative convenience. However, if the Commission were required to produce the official file for a proposed rule change, it would not include these items.

*SRTS Data Accuracy*

For our sample of 56 rules, we reviewed the completeness and accuracy of SRTS data by comparing the SRTS data to source documents. Overall, the SRTS data pertaining to our sample was 94 percent accurate, as illustrated in Table 7.

Inaccuracies included erroneous data and missing data because it had not been timely entered into SRTS.

**Table 7. SRTS Data Accuracy**

<b>Information Reviewed</b>	<b>Accuracy Rate</b>	<b>Yes</b>	<b>No</b>	<b>N/A</b>	<b>Total</b>
Digital Signature Verification noted in SRTS	73%	41	15	0	56
SRO Contact Information in SRTS	100%	56	0	0	56
Accelerated Approval Properly Indicated in SRTS	85%	11	2	43	56
Notice Release:					
Correct SEC Release Number	100%	28	0	28	56
Correct SEC Release Date	96%	27	1	28	56
Correct <i>Federal Register</i> Citation	96%	27	1	28	56
Correct <i>Federal Register</i> Date	93%	26	2	28	56
Final Action Release:					
Correct SEC Release Number	100%	56	0	0	56
Correct SEC Release Date	95%	53	3	0	56
Correct <i>Federal Register</i> Citation	96%	54	2	0	56
Correct <i>Federal Register</i> Date	96%	54	2	0	56
<b>Overall SRTS Data Accuracy Rate</b>	<b>94%</b>				

During the audit, we provided TM management with a list of exceptions, identifying the incorrect SRTS data. Specifically, the digital signature was noted in SRTS as being verified in only 73 percent (41 of 56) of the cases sampled. A digital signature is important because it provides assurance that the information the SRO sends to the Commission has not been altered. TM staff did not consistently note in SRTS whether the digital signature was valid.

***Recommendation F***

For each SRO submission received by SRTS, TM should ensure that the SRO's digital signature is valid and note this fact in SRTS.

***Recommendation G***

TM should correct all of the data in SRTS that the OIG identified as incorrect and periodically compare samples of SRTS data to source documents to ensure that the data is accurate.

## SRO RULES CONTAINING COMMENT LETTERS

### *Review of Rules Containing Comment Letters*

As shown in Table 8, we reviewed a sample of 20 finalized rules where comment letters were received. Between one and five comment letters were received for each rule. We compared the comment letters in TM's official rule files to the comment letters posted on the Commission's website at [www.sec.gov](http://www.sec.gov) and to those listed in SRTS.<sup>15</sup>

**Table 8.** Rules Containing Comment Letters, as of December 17, 2007

<b>Rule</b>	<b>Comparison of Comments in TM's Official Rule File, <a href="http://www.sec.gov">www.sec.gov</a>, and SRTS</b>	<b>Difference</b>
AMEX 2006-72	Same	None
AMEX 2006-78	Same	None
AMEX 2006-98	Same	None
NASDAQ 2006-6	Different	Comment letter not listed in SRTS.
NASDAQ 2006-11	Same	None
NYSE 2006-30	Different	Comment letter not listed in SRTS.
NYSE 2006-69	Different	Comment letter not listed in SRTS. Comment letters field not checked in SRTS.
NYSE 2006-106	Different	Comment letter not listed in SRTS. Comment letters field not checked in SRTS.
CBOE 2006-70	Same	None
CBOE 2006-98	Unable to Determine	SRTS indicates that comment letters were received but does not provide information about the comment letters.
CHX 2006-5	Same	None
DTC 2006-8	Unable to Determine	SRTS indicates that comment letters were received but does not display information about the comment letters.
NSX 2006-3	Same	None
NSX 2006-8	Same	None
NYSEArca 2006-13	Different	Comment letter not in TM official rule file.
NYSEArca 2006-31	Same	None
PHLX 2006-52	Different	Comment letter not in TM official rule file.
PHLX 2006-53	Different	Comment letter not in TM official rule file.
BSE 2006-10	Different	Comment letter not in TM official rule file.
BSE 2006-30	Same	None

In only 10 of 20 instances, the comment letters in each of the three sources matched. In eight instances, comment letters were missing from one or more source. In two

<sup>15</sup> SRTS identifies the commenter and the date of a comment letter, but does not contain a copy of the comment letter.

instances, the comment letters in TM's files matched those on the Commission's website but we could not determine whether SRTS listed the comment letters. This is because the underlying rules were filed under Section 19(b)(3)(A) of the Exchange Act. Because the Commission does not receive many comment letters for 19(b)(3)(A) filings, SRTS was not designed to capture information about comments associated with these proposed rule changes. SRTS was designed in this manner to avoid inadvertent data entry errors. (See SRTS Enhancements, p.21).

### ***Recommendation H***

TM should work with OS to ensure that each comment letter associated with an SRO rule is contained in TM's official file, available on the Commission's website at [www.sec.gov](http://www.sec.gov) and listed in SRTS.

#### ***Comment Letter Logging Process***

OS logs all comment letters received into a Microsoft Access database. This database interfaces with SRTS and automatically populates SRTS with information about any comment letters received. If a comment letter is received, a checkmark automatically appears in SRTS next to the "comment letters" field and information about the comment letters is displayed in the *Notice* tab in SRTS.

As shown in Table 8, in two instances, the "Comment Letters" field did not contain a checkmark and SRTS did not contain any information about the comment letters. OS's comment letter log accurately listed the comment letters.

OS and TM management told us that in one instance, a technical problem resulted in the failure of a comment letter to upload into SRTS. In the other instance, the comment letter was received after the proposed rule change was finalized. When this happens, SRTS considers the filing to be "closed" and does not extract comment letter information from the OS comment letter log after a filing has been closed.

### ***Recommendation I***

TM should coordinate with OIT and OS to ensure that, where practicable, all comment letters in OS's comment letter log accurately and completely upload into SRTS.<sup>16</sup>

After logging the comment letters into its database, OS then forwards an electronic and hard copy version of each comment letter to the appropriate TM staff. The only difference between the hard copy and electronic version is that OS writes the sequence number on the hard copy version. OS stated that it could include the sequence number in the electronic version, if needed.

It is not necessary for OS to forward a hard copy of the comment letter to TM because, if needed, TM could print out the comment letter on its own. Additionally, TM staff often receives a copy of the comment letter directly from the commenter. Sending only an electronic version of a comment letter is more efficient and would

<sup>16</sup> See also "SRTS Enhancements" section on page 21.

save paper resources.

OS management agreed with this recommendation but stated that sometimes TM staff specifically request a hard copy of the comment letters.

### ***Recommendation J***

OS should discontinue sending a hard copy of the comment letters to TM, unless specifically requested by TM staff. OS should only send an electronic version of the comment letters to TM and ensure that the sequence number is included with the transmittal of each electronic comment letter.

## **POSTING PROPOSED RULE CHANGES ON THE INTERNET**

Rule 19b-4 requires SROs to post proposed rule changes and amendments to their website within two business days after filing the proposal or amendment with the Commission.<sup>17</sup>

We printed a list of all open proposed rule changes as of January 31, 2008. This list identified 14 proposed rule changes from 6 SROs that were received by the Commission during the two-week period starting on January 14, 2008, and ending on January 25, 2008.

As of January 31, 2008, 12 of the 14 proposals were listed on the SROs' websites. Two proposals, both from the same SRO, were not on the SRO's website.

We notified TM management of these exceptions. TM management contacted the SRO and the SRO subsequently posted the proposed rule changes to its website.

### ***Recommendation K***

TM should issue a reminder to the SROs of the requirement to post proposed rule changes and amendments to their websites within two business days of filing them with the Commission. TM should periodically check the SROs' websites to determine if the SROs comply with this requirement in a timely manner.

## **SRTS**

### ***SRTS Access to Commission Staff and Contractors***

During the audit, 131 current and former Commission employees and contractors were initially listed on OIT's SRTS access report as having varying levels of access to the SRTS system. Access levels ranged from read-only to full access, which enables users to make changes to SRTS data.

We found that some of the users listed on the access report should not have had access to SRTS and we questioned the level of access granted to other users. After

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<sup>17</sup> 17 C.F.R. § 240.19b-4(f)



bringing this to TM's attention, TM requested and OIT subsequently deleted two users' access to SRTS and made ten user accounts inactive. TM management informed us that many of its 170 staff require some level of access to SRTS and that OIT contractors sometimes require full access to SRTS in order to assist staff with technical problems.

In order to comply with its own operating procedure, OIT stated that, on a quarterly basis, it would begin sending a SRTS access report to the SRTS system owner in TM, for review.<sup>18</sup> TM management informed us that they would review the access report each quarter and request OIT to change or update users' access to SRTS, as necessary.

### ***Recommendation L***

Each quarter, OIT should send a SRTS access report to TM and work with TM to ensure that each user's access and level of access to SRTS is appropriate. OIT and TM should also coordinate to ensure that Commission employees' and contractors' access to SRTS is removed immediately upon their permanent departure from the Commission.

#### *OS Access*

While the OS staff compiles the comment letter log and has SRTS access, the Secretary and Deputy Secretary stated that it would be useful if they had read-only access to SRTS. According to these OS officials, SRTS access would enable them to more easily ensure that the comment letters listed in SRTS matched the comment letters in OS's comment log. It would also enable these staff to quickly determine who in TM has been assigned to a particular proposed rule change, which would help them to respond more quickly to related questions from Commission staff and people outside of the Commission.

TM staff stated that the OS Secretary and Deputy Secretary do not require SRTS access and previously denied their requests for access.

### ***Recommendation M***

TM should reconsider granting SRTS access to the Commission's Secretary and Deputy Secretary.

#### *SRTS Enhancements*

During the audit we identified or TM staff brought to our attention the following enhancements to improve SRTS, as listed in Recommendation N below.

### ***Recommendation N***

TM should implement the following SRTS enhancements:

- 1) We identified two 19(b)(3)(A) rules where comment letters were received according to SRTS, but SRTS was unable to display a list of the comment letters.<sup>19</sup> SRTS should identify comment letters received for 19(b)(3)(A)

<sup>18</sup> OIT Operating Procedure OP 24-04.06.01.04 (01.0) May 30, 2006.

<sup>19</sup> See report section "SRO Rules Containing Comment Letters", pages 18-20.

- proposed rule changes.
- 2) Sometimes it takes more than one minute to advance from one SRTS screen to the next and several minutes to gain initial access to SRTS. The speed of gaining access to and navigating within SRTS should be improved.
  - 3) Currently, a 19(b)(3)(A) proposed rule change is automatically removed from a user's inbox as soon as the rule is published for comment in the *Federal Register*. A 19(b)(3)(A) proposed rule change should remain in a SRTS user's inbox for the duration of the 60-day abrogation period, as a reminder to TM staff.
  - 4) Once the *Notice* for a 19(b)(3)(A) proposed rule change has been issued, SRTS considers the filing to be "closed" and no longer extracts comment letter information from the OS comment letter log. If practicable, SRTS should be enhanced to ensure that it uploads all comment letters from the OS comment letter log, regardless of when the comment letters were received.

## **FISMA**

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The Federal Information Security Management Act (FISMA)<sup>20</sup> requires Federal agencies to develop agency-wide programs to provide security for their information systems. Agencies are required to categorize their information systems as low-, medium- or high-impact and commensurate security reviews are required based on the assigned risk level.

We found that the SRTS system was not included in the Commission's FISMA inventory and therefore, had not been subject to any FISMA security reviews.

In response to our finding, OIT characterized SRTS as a medium-impact system, conducted a commensurate risk analysis and coordinated with TM to complete additional FISMA requirements.

As a result of TM and OIT's action on this matter during the audit, we are not making a related recommendation.

## **DOCUMENT IMAGING OF SRO OFFICIAL RULE FILES**

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TM worked with OIT and an outside contractor to image the contents of many of its 2002 official SRO rule files. Some earlier rule files, going as far back as 1985 were imaged by a different contractor. While the 2002 imaged files are useful to TM staff, many of the older files were imaged in a manner that made them very difficult to review, search or use in an effective manner because the contractor imaged each page of information as a separate document.

TM staff said that imaging is useful because if the files are imaged correctly, they could quickly search them, if needed. TM also began imaging its rule files for

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<sup>20</sup> 44 U.S.C. § 3541 *et seq.*

disaster recovery purposes.

TM has not established a timeline for imaging the remaining rule files; nor has TM decided how far back to image the rule files. TM management told us this is due to staffing and budgetary reasons.

### ***Recommendation O***

TM should determine which additional SRO official rule files should be imaged and coordinate with OIT to establish a timeline for imaging additional rule files. TM should also work with OIT to ensure that imaging is conducted in a manner that makes it easy for TM staff to search and review the files.

## **DOCUMENT RETENTION**

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TM told us that it retains its hard-copy official SRO rule files on-site for approximately five years and stores older files at an off-site records management center. TM began receiving SRO proposed rule changes in 1976, after the Exchange Act was amended. TM told us that it has retained all of its documentation pertaining to SRO proposed rule changes.

The Commission's document retention policy for SRO rule documentation was implemented in 1982 and has never been updated. The policy states that the Commission should destroy SRO rule records six years after the SRO is no longer registered. The policy does not address retention requirements for rule documentation that is stored electronically, nor does it contain provisions for destroying additional rule filings.

OS informed us that Commission offices need instruction on proper maintenance of SEC records under National Archives and Records Administration guidelines and SEC document retention schedules. In 2007, OS hired an archivist to develop a Commission-wide document retention program and provide guidance to individual offices on document retention. This program is expected to take 3 to 5 years to implement.

During the audit, TM began coordinating with the Commission's archivist to update the records retention policy for SRO rule documentation and ensure compliance with this policy.

### ***Recommendation P***

The OS archivist, in consultation with TM, should update the Commission's document retention policy pertaining to SRO rule filing information in both paper and electronic form. TM should develop a procedure to ensure compliance with the updated retention policy.

## COMMISSION WEBSITE

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The [www.sec.gov](http://www.sec.gov) website lists the *Noticed* and finalized rules from each SRO. While overall we found the website useful and well-organized, it was sometimes difficult to find a rule filing, especially if it was *Noticed* in one year and finalized in a different year. For example, if a proposed rule change was *Noticed* in 2004 (e.g., AMEX 2004-1) but not finalized until 2007, it would be listed under rules finalized in 2007. If the rule filings were listed in chronological order by rule number, they could be easier to locate.

The OS web unit is responsible for the presentation of the SRO rule information on the Commission's website. In response to this issue, OS management informed us that it is taking steps to reorganize SRO notices of proposed rule changes and Commission orders approving SRO rules so that each proposed rule change that is noticed will be listed in chronological order by rule number (with any associated approval order), in addition to being listed chronologically by date of issuance.

### **Recommendation Q**

The OS web unit, in consultation with TM, should list the SRO rule filings in chronological order by rule number or undertake other appropriate measures to ensure that all SRO proposed rule changes are easy to locate.

## SRO FILE ROOM

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TM stores its official SRO rule files in individual folders in a file room. We found it difficult to locate several files because the labels on the shelves were often incorrect.

### **Recommendation R**

TM should ensure that the labels on the shelves inside its file room correctly identify the SRO rule files contained on each shelf.

## SRO SURVEY

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We surveyed SRO officials who file proposed rule changes with the Commission to obtain their views on the Commission's processing of SRO proposed rule changes. Overall, the staff we interviewed were pleased with the responsiveness of TM staff, EFFS and the Commission's website's organization and listing of SRO proposed rule changes.

While SRO staff believed that the Commission had improved its processing turnaround times over the past few years, they believed that timeliness should be improved further. SRO staff said that the Commission delayed *Noticing* proposed rule changes for policy or political reasons unrelated to whether the proposed rule changes violated the Exchange Act. SRO staff believed that TM should *Notice* proposed rule changes more quickly.

SRO staff also wanted more guidance from TM regarding which types of proposed rule changes qualify for accelerated approval, especially for copycat proposed rule changes.<sup>21</sup> Some SRO staff wanted a better idea of how TM develops policies that affect SRO proposed rule changes and the filing process. An SRO employee stated that the duplicative information required in Commission Form 19b-4 should be eliminated.

Some SRO personnel further stated that TM staff are inconsistent in rejecting proposed rule changes, based on non-technical issues such as punctuation errors, or incorrectly numbered pages. They claimed that some TM staff, such as new attorneys, are too particular about non-material issues. SRO staff also informed us that these inconsistencies and particularities resulted in unnecessary delays to the Commission's *Notice* and approval of proposed rule changes.

TM management stated they maintain a consistent dialogue with the SROs.

### ***Recommendation S***

TM should take into account all of the suggestions described above regarding ways to improve their review process, and in particular, should:

- Articulate what criteria qualifies for accelerated approval and provide this information to the SROs; and
- Provide guidance to its staff on when it is appropriate to request an amendment to a proposed rule change for non-substantive issues (*e.g.*, formatting issues, spelling and grammar errors, page number errors).

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<sup>21</sup> A proposed rule change is considered a copycat filing when the proposed rule change submitted by one SRO is the exact proposal that was previously submitted by another SRO and approved by the Commission.

## ***Discussion of Management's Comments***

TM, OS and OIT concurred with all of the report's recommendations. TM provided a formal written response, which is included as Appendix E.

In its written response, TM noted: "The report also showed that our timely approval of noticed rule filings was substantially higher (21 of 28 versus 8 of 15) when the accelerated rule filings in the sample were included." From our judgmental sample of 56 rules that we reviewed, only 15 rules were subject to the 35-day statutory approval timeframe. Of these 15 rules, 53 percent (8 of 15) were *not* processed within the 35-day statutory timeframe.

There were 13 rules from our sample that could have been subject to the 35-day statutory timeframe, but instead, TM honored the SROs' requests to process these rules in an accelerated manner. As a result, these 13 rules were *Noticed* and approved using the same Commission order. Had these rules been approved using both a *Notice* order and Approval order, they would have been subject to the 35-day statutory approval timeframe for approval. Because they were not subject to the 35-day statutory approval timeframe, it would be inaccurate to conclude that 21 of 28 rules were approved within the 35-day statutory timeframe.

**Appendix A****Abbreviations**

AMEX	American Stock Exchange
BSE	Boston Stock Exchange
CBOE	Chicago Board Options Exchange
CHX	Chicago Stock Exchange
DTC	Depository Trust Company
EFFS	Electronic Form 19b-4 Filing System
FICC	Fixed Income Clearing Corporation
FINRA	Financial Industry Regulatory Authority
FISMA	Federal Information Security Management Act
ISE	International Stock Exchange
NSX	National Stock Exchange
NYSE	New York Stock Exchange
NYSEArca	NYSE Arca, Inc.
OCC	Options Clearing Corporation
OIG	Office of Inspector General
OIT	Office of Information Technology
OS	Office of the Secretary
PHLX	Philadelphia Stock Exchange
SEC	Securities and Exchange Commission
SRO	Self-Regulatory Organization
SRTS	SRO Rule Tracking System
TM	Division of Trading and Markets

## Appendix B

## Rules Selected for Review

Rule	Type of Rule	Amendments Received by the Commission
AMEX 2007-08	19(b)(2)	No
AMEX 2007-11	19(b)(3)(A)	Yes
AMEX 2007-35	19(b)(2)	Yes
AMEX 2007-67	19(b)(3)(A)	No
BSE 2007-33	19(b)(2)	Yes
BSE 2007-36	19(b)(3)(A)	No
BSE 2007-43	19(b)(3)(A)	Yes
BSE 2007-45	19(b)(2)	No
CBOE 2006-110	19(b)(2)	Yes
CBOE 2007-121	19(b)(2)	No
CBOE 2007-14	19(b)(3)(A)	Yes
CBOE 2007-66	19(b)(3)(A)	No
CHX 2006-42	19(b)(2)	Yes
CHX 2007-08	19(b)(2)	No
CHX 2007-20	19(b)(3)(A)	No
CHX 2007-25	19(b)(3)(A)	Yes
DTC 2006-07	19(b)(2)	Yes
DTC 2006-17	19(b)(3)(A)	Yes
DTC 2007-04	19(b)(2)	No
DTC 2007-08	19(b)(3)(A)	No
FICC 2006-16	19(b)(2)	Yes
FICC 2007-2	19(b)(3)(A)	No
FICC 2007-3	19(b)(2)	No
FICC 2007-7	19(b)(3)(A)	No
FINRA 2007-1	19(b)(2)	No
FINRA 2007-15	19(b)(3)(A)	No
FINRA 2007-2	19(b)(3)(A)	No
FINRA 2007-7	19(b)(2)	No
ISE 2006-62	19(b)(2)	Yes
ISE 2006-78	19(b)(2)	No
ISE 2007-62	19(b)(3)(A)	No
ISE 2007-72	19(b)(3)(A)	Yes
Nasdaq 2007-27	19(b)(2)	Yes
Nasdaq 2007-30	19(b)(2)	No
Nasdaq 2007-82	19(b)(3)(A)	Yes
Nasdaq 2007-83	19(b)(3)(A)	No
NSX 2007-05	19(b)(2)	No
NSX 2007-07	19(b)(2)	Yes
NSX 2007-10	19(b)(3)(A)	No
NSX 2007-2	19(b)(3)(A)	Yes
NYSE 2007-11	19(b)(3)(A)	No
NYSE 2007-29	19(b)(3)(A)	Yes




## Appendix B

<b>Rule</b>	<b>Type of Rule</b>	<b>Amendments Received by the Commission</b>
NYSE 2007-37	19(b)(2)	Yes
NYSE 2007-74	19(b)(2)	No
NYSEArca 2006-38	19(b)(2)	No
NYSEArca 2006-62	19(b)(2)	Yes
NYSEArca 2007-07	19(b)(3)(A)	Yes
NYSEArca 2007-67	19(b)(3)(A)	No
OCC 2007-04	19(b)(2)	No
OCC 2007-06	19(b)(2)	Yes
OCC 2007-10	19(b)(3)(A)	No
OCC 2007-5	19(b)(3)(A)	No
PHLX 2007-28	19(b)(3)(A)	No
PHLX 2007-37	19(b)(2)	Yes
PHLX 2007-52	19(b)(2)	No
PHLX 2007-53	19(b)(3)(A)	Yes

Appendix C






















Commission Form 19b-4

OMB APPROVAL	
OMB Number:	3235-0045
Expires:	
Estimated average burden hours per response.....	34

Page 1 of <input style="width:40px;" type="text"/>	SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549 Form 19b-4	File No. SR - <input style="width:40px;" type="text"/> - <input style="width:40px;" type="text"/> Amendment No. <input style="width:40px;" type="text"/>			
Proposed Rule Change by <input style="width:400px;" type="text"/> Select SRO					
Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934					
Initial <input type="checkbox"/>	Amendment <input type="checkbox"/>	Withdrawal <input type="checkbox"/>	Section 19(b)(2) <input type="checkbox"/>	Section 19(b)(3)(A) <input type="checkbox"/>	Section 19(b)(3)(B) <input type="checkbox"/>
Pilot <input type="checkbox"/> Extension of Time Period for Commission Action <input type="checkbox"/> Date Expires <input style="width:60px;" type="text"/>			Rule		
			<input type="checkbox"/> 19b-4(f)(1) <input type="checkbox"/> 19b-4(f)(4) <input type="checkbox"/> 19b-4(f)(2) <input type="checkbox"/> 19b-4(f)(5) <input type="checkbox"/> 19b-4(f)(3) <input type="checkbox"/> 19b-4(f)(6)		
Exhibit 2 Sent As Paper Document <input type="checkbox"/>		Exhibit 3 Sent As Paper Document <input type="checkbox"/>			
<b>Description</b>					
Provide a brief description of the proposed rule change (limit 250 characters).					
<b>Contact Information</b>					
Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.					
First Name	<input style="width:200px;" type="text"/>	Last Name	<input style="width:200px;" type="text"/>		
Title	<input style="width:500px;" type="text"/>				
E-mail	<input style="width:500px;" type="text"/>				
Telephone	<input style="width:100px;" type="text"/>	Fax	<input style="width:100px;" type="text"/>		
<b>Signature</b>					
Pursuant to the requirements of the Securities Exchange Act of 1934,					
has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.					
Date	<input style="width:150px;" type="text"/>				
By	<input style="width:200px;" type="text"/>		<input style="width:250px;" type="text"/>		
	(Name)		(Title)		
NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.					
					

## Appendix C

## Commission Form 19b-4

SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549	
For complete Form 19b-4 instructions please refer to the SRS Online Filing website.	
<b>Form 19b-4 Information</b>   	<p>The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.</p>
<b>Exhibit 1 - Notice of Proposed Rule Change</b>   	<p>The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1995 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3).</p>
<b>Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications</b>    Exhibit Sent As Paper Document <input type="checkbox"/>	<p>Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.</p>
<b>Exhibit 3 - Form, Report, or Questionnaire</b>    Exhibit Sent As Paper Document <input type="checkbox"/>	<p>Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.</p>
<b>Exhibit 4 - Marked Copies</b>   	<p>The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.</p>
<b>Exhibit 5 - Proposed Rule Text</b>   	<p>The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item 1 and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.</p>
<b>Partial Amendment</b>   	<p>If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.</p>

## Appendix D

### Sampling Methodology

#### Rules Finalized in 2007

We selected a judgmental sample of 56 SRO rules finalized in 2007. In selecting this sample, we selected rules from 14 different SROs, ensuring that rules with and without amendments were selected as well as rules filed pursuant to sections 19(b)(2) and 19(b)(3)(A) of the Exchange Act. These 14 SROs filed several proposed rule changes with the Commission. We did not select rules from SROs that filed a small number of rules with the Commission in 2007, nor did we select rules from SROs that were not very prominent. We believed that selecting 4.9 percent (56 of 1,143) of the rules processed in 2007 was sufficient.

In each instance, we compared our sample data to source documents to determine whether TM's official SRO rule files were complete and information was accurately captured in SRTS at [www.sec.gov](http://www.sec.gov)

#### Rules Finalized in 2006 That Contained Comment Letters

We selected a judgmental sample of 20 rules finalized in 2006 that contained comment letters. In selecting this sample, we chose 10 prominent SROs that had filed many proposed rule changes with the Commission. While there was no efficient way to determine how many of the rules finalized in 2006 contained comment letters, TM staff estimated that only about five to ten percent of SRO rules contain comment letters. Based on this, 51 to 101 of the 1,014 rules finalized in 2006 contained comment letters. As a result, we believe that selecting 20 rules (20 to 39 percent) was sufficient.

In each instance we determined whether the comment letters were in TM's official rule file at [www.sec.gov](http://www.sec.gov) and listed in SRTS.

#### Rules Open for More Than One Year, as of November 7, 2007

We selected 10 rules that were open for more than one year, as of November 7, 2007. As of this date, according to SRTS data there were 257 open proposed rule changes, 47 of which had been open for at least one year. We believe that selecting 21 percent (10 of 47) of the proposed rule changes was sufficient.

In each instance we determined why the proposed rule changes were still open and the Commission's action to finalize these rules.

#### Sample Data Selected on a Judgmental Basis

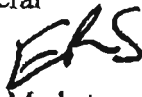
Our sample data was selected on a judgmental basis, as opposed to using statistical sampling methods. We believe that the results of our sample data are generally representative of the SRO rule filing process.

## Appendix E

## Management's Comments

## MEMORANDUM

TO: H. David Kotz, Inspector General  
Office of Inspector General

FROM: Erik Sirri, Director   
Division of Trading and Markets

RE: Draft Audit Report Dated March 10, 2008

DATE: March 24, 2008

On behalf of the Division of Trading and Markets ("TM" or "Division"), thank you for the opportunity to assist the Office of Inspector General in its examination of the Self-Regulatory Organizations ("SRO") rule filing process. The Division recognizes the inherent value in taking a critical look at the SRO rule filing process, with the hope of addressing any deficiencies in a timely and efficient manner. With that in mind, we have reviewed the Draft Audit Report, and provide the following comments.

I. Formal Concurrence or Non-Concurrence with Recommendations

The Division concurs with all of the Recommendations of the Draft Audit Report.

We offer one observation with regard to recommended changes to the SRTS system as detailed in Recommendation N. The SRTS was developed by OIT at the request of the Division. Thus, rather than directly making the 4 changes as suggested in the report, we would like to first consult with OIT to see if these changes would be feasible and cost effective. Provided they are, we would be happy to see these changes made by the OIT staff.

II. Additional Comment

We feel it is important for an interested reader not to rely solely on the Executive Summary of the audit report in coming to his or her own conclusions about the SRO rule filing process as the body of the report contains additional details that place the report's findings in context. For example, paragraph three of the Executive Summary speaks of the Commission's need for improvement in processing proposed rule changes within the prescribed statutory timeframe. However, the audit report found that, in many instances, the reasons for delay in approving proposed rule changes are beyond the Division's control (see pages 12 and 13 of the draft report). The report also showed that our timely approval of noticed rule filings was substantially higher (21 of 28 versus 8 of 15) when the accelerated rule filings in the sample were included (page 9).

**Appendix F****List of Recommendations****Recommendation A:**

TM should establish a division-wide goal for issuing a *Notice* release for proposed rule changes within a certain period of time (*e.g.*, generally 30 days from receipt). TM should track its progress in meeting this goal.

**Recommendation B:**

TM should establish a policy to ensure that it meets the statutory timeframe for finalizing proposed rule changes that have been *Noticed* in the Federal Register. TM should track its progress in adhering to this policy.

**Recommendation C:**

TM should establish a written policy containing:

- Procedures for following up with SRO staff when TM is waiting for information from the SROs;
- Criteria for requesting an SRO to withdraw a proposed rule change;
- Criteria for instituting a disapproval proceeding; and
- Criteria for rejecting a proposed rule change.

TM should share this information with the SROs and train its staff to utilize this policy.

**Recommendation D:**

TM should ensure that the incomplete files are supplemented with the missing documents and work with OS to ensure that all Commission *Notices* and orders contain an SEC raised seal.

**Recommendation E:**

TM should establish a complete written list of all documents that should be contained in each SRO official rule file. The list should identify which documents are required in all instances as well as the documents that should be included if applicable (*e.g.*, amendments; comment letters; extensions). TM should enforce compliance with this documentation requirement by periodically reminding its staff of this requirement and spot-checking the files for completeness.

**Recommendation F:**

For each SRO submission received by SRTS, TM should ensure that the SRO's digital signature is valid and note this fact in SRTS.

**Appendix F*****Recommendation G:***

TM should correct all of the data in SRTS that the OIG identified as incorrect and periodically compare samples of SRTS data to source documents to ensure that the data is accurate.

***Recommendation H:***

TM should work with OS to ensure that each comment letter associated with an SRO rule is contained in TM's official file, available on the Commission's website at [www.sec.gov](http://www.sec.gov) and listed in SRTS.

***Recommendation I:***

TM should coordinate with OIT and OS to ensure that, where practicable, all comment letters in OS' comment letter log accurately and completely upload into SRTS.

***Recommendation J:***

OS should discontinue sending a hard copy of the comment letters to TM, unless specifically requested by TM staff. OS should only send an electronic version of the comment letters to TM and ensure that the sequence number is included with the transmittal of each electronic comment letter.

***Recommendation K:***

TM should issue a reminder to the SROs of the requirement to post proposed rule changes and amendments to their websites within two business days of filing them with the Commission. TM should periodically check the SROs' websites to determine if the SROs comply with this requirement in a timely manner.

***Recommendation L:***

Each quarter, OIT should send a SRTS access report to TM and work with TM to ensure that each user's access and level of access to SRTS is appropriate. OIT and TM should also coordinate to ensure that Commission employees' and contractors' access to SRTS is removed immediately upon their permanent departure from the Commission.

***Recommendation M:***

TM should reconsider granting SRTS access to the Commission's Secretary and Deputy Secretary.

## Appendix F

### **Recommendation N:**

TM should implement the following SRTS enhancements:

- 1) We identified two 19(b)(3)(A) rules where comment letters were received according to SRTS, but SRTS was unable to display a list of the comment letters. SRTS should identify comment letters received for 19(b)(3)(A) proposed rule changes.
- 2) Sometimes it takes more than one minute to advance from one SRTS screen to the next and several minutes to gain initial access to SRTS. The speed of gaining access to and navigating within SRTS should be improved.
- 3) Currently, a 19(b)(3)(A) proposed rule change is automatically removed from a user's inbox as soon as the rule is published for comment in the *Federal Register*. A 19(b)(3)(A) proposed rule change should remain in a SRTS user's inbox for the duration of the 60-day abrogation period, as a reminder to TM staff.
- 4) Once the *Notice* for a 19(b)(3)(A) proposed rule change has been issued, SRTS considers the filing to be "closed" and no longer extracts comment letter information from the OS comment letter log. If practicable, SRTS should be enhanced to ensure that it uploads all comment letters from the OS comment letter log, regardless of when the comment letters were received.

### **Recommendation O:**

TM should determine which additional SRO official rule files should be imaged and coordinate with OIT to establish a timeline for imaging additional rule files. TM should also work with OIT to ensure that imaging is conducted in a manner that makes it easy for TM staff to search and review the files.

### **Recommendation P:**

The OS archivist, in consultation with TM, should update the Commission's document retention policy pertaining to SRO rule filing information in both paper and electronic form. TM should develop a procedure to ensure compliance with the updated retention policy.

### **Recommendation Q:**

The OS web unit, in consultation with TM, should list the SRO rule filings in chronological order by rule number or undertake other appropriate measures to ensure that all SRO proposed rule changes are easy to locate.

### **Recommendation R:**

TM should ensure that the labels on the shelves inside its file room correctly identify the SRO rule files contained on each shelf.



## Appendix F

### ***Recommendation S:***

TM should take into account all of the suggestions described above regarding ways to improve their review process, and in particular, should:

- Articulate what criteria qualifies for accelerated approval and provide this information to the SROs; and
- Provide guidance to its staff on when it is appropriate to request an amendment to a proposed rule change for non-substantive issues (*e.g.*, formatting issues, spelling and grammar errors, page number errors).