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The propriety of stock exchanges exercising regulatory authority over their members and market participants has been discussed for many years. This debate takes on greater significance now that the nation's largest stock exchange, the New York Stock Exchange, is set to become a publicly owned, for-profit corporation.

The Council of Institutional Investors, an organization of more than 300 investment professionals, including more than 130 public, corporate and union pension funds with more than $3 trillion in investments, has long advocated the separation of the exchanges' regulatory and business functions. The Council believes such an approach is in the best interests of the investing public. In the Council's opinion, an exchange faces an inherent and untenable conflict of interest when it is responsible not only for running an efficient and effective marketplace but also for regulating its customers and protecting the investing public.

Council members have a significant commitment to the U.S. capital markets, particularly the public equity markets. The average Council fund invests about 45 percent of its total

portfolio in publicly traded U.S. stocks and another 30 percent in domestic bonds. Council members are long-term owners. As fiduciaries of employee benefit plans, they have long-term investment horizons; and they are indexers, with an average of about 45 percent of their U.S. stock portfolios and around 15 percent of their bond portfolios passively managed.

By virtue of their significant stake in U.S. publicly traded companies, Council members are keenly interested in ensuring that the U.S. capital markets continue to be the best in the world. As a result, our members are very supportive of the efforts by the NYSE, the Nasdaq stock market and other exchanges to provide the highest quality, most efficient and cost-effective marketplaces.

However, the integrity of the U.S. equities markets and the protections provided to investors are also of paramount importance. A critical component of market effectiveness and success is investor confidence. Part of that confidence comes from knowing that adequate rules and other safeguards are in place to protect investors. Unfortunately, lapses in self regulation over the years—including failures to adequately oversee specialists, enforce rules and maintain up-to-date listing requirements—have harmed investors and shown that the self-regulatory model is in need of reform.

The Council recognizes that the exchanges have adopted proactively many reforms in recent years aimed at upgrading their corporate governance structures, improving their transparency to the marketplace at large and toughening their regulatory oversight.

While laudable, these changes cannot resolve the conflicts faced by a business also charged with regulating its owners and its customers. These potential conflicts only deepen when an exchange is a for-profit entity.

To address these potential conflicts, the Council recommends:

- Any regulatory operation should be independent of the exchange(s) and adequately funded.

- Listing standard requirements should be a regulatory, rather than an exchange, responsibility.

- Congress should consider clarifying the SEC's oversight authorities over the exchanges.

Regulatory arms should be independent and adequately funded

Combining exchange and regulatory functions puts the regulatory arm in the difficult position of overseeing the primary customers of the exchange. Such combinations have not worked in the past. For example, a Nov. 3, 2003, *Wall Street Journal* article reported that a confidential SEC report of the NYSE "paints a picture of a floor-trading system riddled with abuses, with firms routinely placing their own trades ahead of those by customers—and an in-house regulator either ill-equipped or too worried about increasing its workload to care."

The Council believes that for regulatory arms to be functional and effective they must be independent of the exchanges and have mechanisms in place to ensure secure and full funding.

Such structures are currently in place at the NASD, which today is an independent, not-for-profit organization responsible for overseeing NASD members and regulating the Nasdaq stock market.

The NYSE has taken a different approach, with NYSE Regulation structured as a wholly owned subsidiary of a soon-to-be-publicly-traded company, the NYSE Group. While the final structure approved Feb. 27, 2006, by the SEC included some refinements designed to enhance the independence of NYSE Regulation and secure adequate funding for the NYSE's regulatory program, the structure could be improved.

First, the Council believes NYSE Regulation should be an independent entity separate from the publicly traded company. Second, we believe the NYSE Regulation and NYSE Group boards should not have interlocking directors. "Shared" directors, regardless of their skills or backgrounds, face an impossible-to-resolve conflict of interest between maximizing the long-term value of the for-profit exchange business while ensuring the regulation side is adequately resourced.

Additional changes to the regulatory models may be underway. In recent weeks, officials of the NASD and the NYSE have expressed interest in merging their regulatory arms. Certainly a combination could improve regulatory efficiencies. However, the Council believes a combined regulatory operation would be deeply flawed if it failed to be independent from the exchanges.

Listing standards should be a regulatory responsibility

The exchanges' listing rules are an important element in the total system of legal protections on which investors rely. Given their importance, the Council believes listing standards should be the responsibility of the regulatory arms, and processes should be in place to ensure that listing standards are kept up-to-date. Housing the listing standard requirements with the business side of the exchanges may harm the investing public by promoting: (1) a race to the bottom, with exchanges competing for listings by watering down their standards; (2) standoffs when it comes to updating outdated requirements; and (3) a reluctance to enforce standards when pressured by listed companies.

In the past, the exchanges have been hesitant to update their requirements, perhaps for fear of upsetting listed companies and driving business to competing exchanges. As a result, historically it has taken major corporate scandals, usually coupled with strong suggestions from the Commission, to prod the exchanges into action.

Certainly the exchanges acted quickly in response to the 2002-2003 market scandals, proposing far-reaching upgrades to their listing standard requirements. However, some of these rules were decades-old and long in need of updating.

An example of the challenges facing investors interested in ensuring modern listing standard requirements can be seen in the lengthy fight to strengthen the rights of shareowners to vote on equity compensation plans. In 1998, at the same time stock-based incentive plans had exploded in popularity and potential cost, investors found their rights to review these programs diminished by changes proposed by the NYSE and approved by the SEC. What followed was a several-year odyssey, largely due to a stand-off between the NYSE and the Nasdaq, with the NYSE refusing to change its rules until the Nasdaq also made changes.

Another example is the Council's decade-plus effort to have the NYSE eliminate broker voting. This rule—now nearly 70 years old—allows brokers to vote on certain "routine" proposals, including the uncontested election of directors, if the beneficial owner has not provided voting instructions at least 10 days before a scheduled meeting. The Council believes broker votes amount to ballot-box stuffing, because these shares are always cast for management. Despite evidence that broker votes are not necessary for companies to ensure that a quorum is present for a meeting, the rule remains in place.

Most recently the Council was troubled by the NYSE's decision to allow Sovereign Bancorp to issue a block of stock greater than 20 percent to a third party without

obtaining prior shareowner approval. The Council believes the decision exemplifies the challenges facing a self regulatory organization when it faces opposing pressures from listed companies and investors.

SEC oversight of the SROs should be strengthened

The Council views the Commission's oversight role as an important safety net for ensuring that stock exchange regulators continue to adequately protect investors and the integrity of the marketplace. The Commission has long enjoyed significant authority over SRO rules, including the power to approve or disapprove SRO rule changes, and to amend SRO rules "as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization, to conform its rules to requirements of this chapter and the rules and regulations thereunder applicable to such organization, or otherwise in furtherance of the purposes of" the Exchange Act.

Although protection of investors is unquestionably a purpose of the Exchange Act, the extent to which that purpose gives the Commission power over listing standards has been unclear. In 1990, the Court of Appeals for the D.C. Circuit (*Business Roundtable v. SEC*) invalidated the Commission's imposition of a one-share/one-vote listing standard on the SROs, holding that Congress did not intend to delegate power to the Commission to regulate the internal corporate governance of listed companies through the Exchange Act.

Since that time, the Sarbanes-Oxley Act arguably has extended the Commission's jurisdiction over the corporate governance of listed companies, and has shown that

investor protection can extend to at least some substantive corporate governance matters. Concern also has grown regarding the potential harm to investors posed by competition among SROs based on listing standards. The one-share/one-vote controversy, which was sparked in the mid-1980s when the NYSE refused to enforce its own one-share/one-vote listing standard out of a desire to compete for listings, illustrates this dynamic. Demutualization and the emergence of SROs as for-profit entities have exacerbated these tensions.

These developments have not led, however, to any agreement about the proper scope of the Commission's authority to shape SRO listing standards. Because the Business Roundtable is the sole judicial pronouncement in this area, the Commission's reluctance to test the limits of its jurisdiction is perhaps understandable. The Council believes that Congress can and should clarify the Commission's authority to amend listing standards or impose them on the SROs when doing so would protect investors and serve the public interest.

In doing so, it may be desirable to distinguish between listing standards and other SRO rules. The advantages of self-regulation—industry expertise, efficiency and superior incentives—are not as acute in the context of listing standards as they are when an SRO is investigating or disciplining market participants, enforcing rules governing member firms, arbitrating disputes and regulating the treatment of customers. The logic of fostering competition among SROs, which was among the purposes of the Exchange Act

amendments in 1975, may not extend to competition based on listing standards even as it may continue to be relevant in other areas of SRO rulemaking.

Conclusion

The Council respects Congress' past affirmations of self-regulation as the best oversight model for the complex securities industry. However, times have changed. The Council believes a separation of regulatory and business functions is the best way to protect the 84 million Americans and others who invest their hard-earned savings in the U.S. equities markets. Such a change would not impede the capital raising process, impose burdensome costs on listed companies or impede the functioning of the markets. It may, however, strengthen investor confidence in the U.S. markets by ensuring robust oversight of market participants.

The Council commends the Committee for considering this very important issue. We appreciate the opportunity to appear before the Committee and look forward to working with you as you move forward.