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A REVIEW OF SELF-REGULATORY ORGANIZATIONS IN THE SECURITIES MARKETS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

ON

THE EXAMINATION OF SELF-REGULATORY ORGANIZATIONS IN THE SECURITIES MARKETS, FOCUSING ON STRENGTHS AND WEAKNESSES OF THE CURRENT SYSTEM, CONFLICTS OF INTEREST, AND ELIMINATING EXCESSIVE MARKET DATA FEES

MARCH 9, 2006

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C O N T E N T S

THURSDAY, MARCH 9, 2006

WITNESSES

A REVIEW OF SELF-REGULATORY ORGANIZATIONS IN THE SECURITIES MARKETS

THURSDAY, MARCH 9, 2006

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

Self-regulatory organizations have been a part of the statutory scheme for the U.S. securities industry since the passage of the landmark Federal securities laws in the 1930's. At that time, Congress decided that investors would be better served by "cooperative regulation" of the markets and market participants. The SRO's, for reasons of proximity and technical expertise, were given responsibility for supervising market operations. The Securities and Exchange Commission would oversee the SRO's, "standing in the corner with the well-oiled shotgun," as they said, if necessary. Of course, the markets have grown dramatically in size and complexity since then, but the basic structure remains in place today.

The level of success achieved by self-regulatory organizations in protecting investors has been the subject of considerable debate. In recent years, that debate has only intensified, particularly in the aftermath of the governance and specialist trading scandals at the New York Stock Exchange, the largest SRO, and the NYSE's conversion from a not-for-profit, member-owned organization to a for-profit, shareholder-owned entity.

The performance of the self-regulatory unit at the New York Stock Exchange has been a source of controversy. Between 1999–2003, the regulatory program repeatedly failed to discipline New York Stock Exchange specialists who were constantly trading ahead of customer orders and pocketing a small profit on each trade. All that skimming off the top cost investors $155 million over the 3-year period alone. In one particular case, the senior specialist responsible for the trading of General Electric and other blue-chip companies made 40,000 illegal trades in three stocks over the 3-year period, according to the Department of Justice and the SEC.

According to a *Wall Street Journal* report, a comprehensive SEC investigation of the New York Stock Exchange regulation in 2003 revealed "serious deficiencies," including a habit of ignoring repeat violations by specialist firms. When the unit did respond, it was usually a slap on the wrist and "inadequate to deter future violations." In connection with this scandal, last April, Federal prosecutors indicted 15 New York Stock Exchange specialists for securities fraud. The criminal probe grew out of a civil case brought by the SEC against all seven New York Stock Exchange specialist firms. It was settled for $247 million in 2004.

The New York Stock Exchange's record is especially relevant now that it has become a for-profit entity. While there have been changes in the Exchange's governance structure, questions remain as to whether robust and vigorous self-regulation will be subordinated to profit-making activities. This issue has been one of concern to the SEC for some time. In 2004, the Commission called the obvious conflicts between an SRO's regulatory functions and its shareholders the most controversial aspect of the current self-regulatory system.

Regulatory duplication is another issue that has arisen in this debate. Almost 200 firms are members of both the New York Stock Exchange and the NASD. For these firms, that means two sets of rules, exams, interpretations and enforcement, and fees. This dual structure for broker-dealers raises questions relating to whether the high regulatory costs can be justified.

This morning we want to welcome a distinguished panel of witnesses as we learn more about this. From left to right, no stranger—a lot of you are not—to this Committee, Mr. John Thain, Chief Executive Officer of the New York Stock Exchange Group, Inc.; Mr. Robert Glauber, Chairman and Chief Executive Officer, NASD; Professor Henry Hu, Professor of Law, University of Texas Law School; Mr. Marc Lackritz, President, Securities Industry Association; Mr. Richard Ferlauto, Director of Pension and Benefit Policy, American Federation of State, County and Municipal Employees AFL–CIO; and Ms. Ann Yerger, Executive Director, Council of Institutional Investors.

Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Mr. Chairman, thank you very much, and thank you for holding today's oversight hearing on self-regulatory organizations in the securities markets.

It is, obviously, timely and appropriate that we are examining the structure of our securities industry self-regulatory apparatus, and examining thoroughly the issue of whether there are any conflicts of interest, real or apparent, which need to be addressed in a self-regulatory organization conducting both its business and regulatory functions under the same umbrella organization.

Yesterday, the New York Stock Exchange Group stock started trading on the New York Stock Exchange. Upon approving the merger, February 27, of the New York Stock Exchange and Archipelago Holdings, Chairman Cox of the Securities and Exchange Commission said "the Commission is continuing its review of our current regulatory structure for all self-regulatory organizations," and he went on to pledge to "enhance the independence and effectiveness of regulation for the benefit of investors, our economy, and our Nation."

I encourage the Commission to continue its review in light of the comments that we have been receiving. For example, today we will hear from Ann Yerger, representing the Council of Institutional Investors.

Sometimes we read your statements ahead of time. I just want to register that point.

[Laughter.]

That 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."

Earlier, in December of last year, the *Wall Street Journal* editorialized, "the NYSE could do a good turn by using its new for-profit status as an excuse to spin off its self-regulatory duties to an outside organization."

USA Today, also back in December, reported that Columbia Professor Jack Coffee, who has testified many times before this Committee, says, "that in a for-profit environment, it will be difficult for NYSE regulators to exercise their most powerful weapon—delisting a company—since it will deprive the parent company of revenue. 'If your principal sanction is delisting, you almost never use it,' he says."

And, yesterday, the Chairman and I received a letter from Charles Schwab stating, "one concern we have with the current regulatory structure is the potential conflict of interest inherent in a for-profit, self-regulatory organization . . . This conflict has the potential to compromise the integrity of our self-regulatory system. In our view, for-profit exchanges should divorce themselves from the ownership of self-regulatory organizations. The NASD is finalizing its complete separation from the Nasdaq market and we believe that a similar course would be best for the NYSE/Arca combination."

We have received a number of comments, actually, on this issue. A number of letters have come into the Committee, and, of course, we will be reviewing those and the testimony this morning very carefully.

I think this is an important issue, and I am pleased the Chairman is focusing attention on it.

Thank you very much, Mr. Chairman.

Chairman SHELBY. Thank you, Senator Sarbanes.

Senator Hagel.

STATEMENT OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, thank you. I have no opening statement. Look forward to our witnesses' testimony this morning, and appreciate them spending some time with us. This is a critically important issue, not only for the reasons that Senator Sarbanes outlined, but for other reasons, which will, to a great extent, shape and frame the future for these markets. So thank you.

Chairman SHELBY. Mr. Thain, we will start with you. All of your written testimony will be made part of the hearing record, as you recall. You are no stranger to these proceedings. Thank you, sir, glad to have you all here.

STATEMENT OF JOHN A. THAIN
CHIEF EXECUTIVE OFFICER, NYSE GROUP, INC.

Mr. THAIN. Chairman Shelby, Senator Sarbanes, Senator Hagel, thank you very much for inviting me to speak today on the issues of self-regulation. I appreciate the opportunity to address these issues and to respond to your questions from my vantage point as the CEO of NYSE Group, the new public company that, as you said, began trading yesterday. I do want to mention that Rick Ketchum, who is here sitting behind me is the CEO of NYSE Regulation, and so the regulatory piece of the NYSE Group reports to Rick.

Let me first begin by briefly describing our own SRO experience and lessons we have learned from that. Second, I would like to discuss the new structure of NYSE regulation, and finally, I would like to speak about the importance of reducing duplication and the initiatives to achieve that goal, which you also mentioned.

When I took this position 2 years ago as the Chief Executive Officer of the New York Stock Exchange, our marketplace was in a crisis for many of the reasons which you articulated, the problems that occurred prior to my coming. One of my first priorities was to restore investor confidence and public trust in the Exchange. Toward that end, we created an entirely new governance system based on three core principles.

The first was independence. We appointed a new Board of Directors. Our Board is completely new. And stipulated that except for me, because I am an employee, all of the members of our board had to be completely independent, which means they had to be independent of the member firms, they had to be independent of the big broker-dealers. They had to be independent of the listed company executive officers, the companies listed on our Exchange.

The second principle we adopted was the separation of duties. So we first separated the functions of the Chairman from the CEO, so Marsh Carter is currently our Chairman. We also separated—and this is the most important piece—the regulatory functions from the business of the Exchange, so that our regulatory functions, which are run by Rick Ketchum, never intersect with the business of the Exchange, which I run. Rick reported up to a subcommittee of the board. That subcommittee of the board was called the Regulatory Oversight Board. That board was made up of 100 percent independent directors, which means it did not include me.

The third principle that we adopted was one of transparency. We wanted to become fully transparent, so we now have an annual report that has full financials and full footnotes. We disclose the compensation of our top five executive officers, and we also disclose all of our charitable and political contributions.

Mr. Chairman, I believe that this new governance system that we adopted that was approved by the SEC in December 2003, has worked very well. It has worked well for our listed companies, and it has worked well for investors. I believe the principles of independence, the separation of the regulatory functions from the business of the Exchange, and the transparency, have made a major contribution toward restoring confidence and trust in the New York Stock Exchange. In changing our structure to become a public company, we have gone even further to ensure that regulation will be both independent and robust.

Under our new structure, which was approved earlier this month by the SEC, Rick Ketchum is now the CEO of a separate not-for-profit company inside the NYSE Group. This not-for-profit company has its own board, which is totally independent, except for Rick, who will be on the board and will be an employee, but that board does not include me. So, again, total separation from the business and the regulatory side.

Importantly, the new NYSE Regulation Board of Directors, is also made up of a majority of directors who do not sit on the board of the new public company, NYSE Group. So in addition to the total independence of the public company board, we also have a majority of unaffiliated directors on the Regulatory Board.

NYSE Regulation also has its own contractual funding agreement with the NYSE Marketplace, and the regulatory company cannot distribute any excess cash outside of NYSE Regulation, nor can it use fine income for anything other than regulatory purposes. I believe that no other exchange in the United States has this level of independence from the industry that it regulates. We believe that the SRO system not only ensures independence, but it is also better.

Why? Because of the proximity of the regulatory functions to the market. We live in a new financial era of high-speed, multiproduct, very rapid electronic trading. Regulators who are closer to the markets and who work in real time, can more readily stay ahead of the curve and anticipate changes that are going on in the marketplace.

I had the opportunity to observe firsthand, in my prior life at a very large investment bank, and in my experience there, the New York Stock Exchange Regulation had a better understanding of the business of the broker-dealers, and I believe in large part that is because they were closer to the marketplace. Regulators working in close proximity are also better positioned to design cost effective regulatory solutions. An example is the way that we have worked with Rick Ketchum and his team as we developed our hybrid market initiative. Having the regulatory functions involved in the design process from the outset has enabled us to build regulatory protections into the software platform as it is developed. We believe that proximity produces better, more nimble regulation, and we believe it is also better for the business of the Exchange.

Why is that? Because we compete by striving to offer the highest value package to investors and to our listed companies, and part of that value package is determined by the quality of our market. Companies list on our exchange because we offer the highest standards in the world, and a well-regulated market is an indispensable ingredient of market quality and the trust of investors. Therefore it is essential to the business of the Exchange to have good, well-functioning independent regulation.

Let me turn to the examination of our member firms and the importance of reducing regulatory overlap. Both Rick Ketchum and I have spoken on this issue, and have taken steps to address this; however, we still need to do more work. We need to rationalize rules. We need to avoid duplication, and we need to use our resources wisely to ensure that investors and issuers have confidence that they are protected by a strong regulatory structure. Ending regulatory duplication is a top priority.

We believe that this initiative should go forward through a joint venture with NASD. I invite our colleagues at the NASD to work with us to develop a common approach of joint governance and joint ownership of the responsibilities of regulating the member firms. We are supportive of adopting a single set of rules. We support a single-member firm examination process. We are committed to working with NASD, with the SEC, and with the Members of this Committee, to achieve the best solution for U.S. markets and investors.

Finally, let me close by noting that these regulatory issues should not be taken in isolation. U.S. financial markets operate today in an increasingly competitive international capital market. Regulation that is ineffective or unworkable will place U.S. financial markets at a disadvantage in the global competition for capital, and will discourage companies from coming here to list in our marketplace. Regulation that is sound and sensible will help U.S. financial markets to remain competitive, and to provide the optimal environment for economic growth, job creation, and prosperity.

In conclusion, Mr. Chairman, we are confident that the regulatory model established for the New York Stock Exchange will provide independent, robust, and efficient regulation that inspires confidence among investors and our listed companies in a time of rapidly changing and competitive markets.

I thank you for giving me this opportunity. I will be happy to answer questions.

Chairman SHELBY. Thank you.

Mr. Glauber.

STATEMENT OF ROBERT GLAUBER
CHAIRMAN AND CHIEF EXECUTIVE OFFICER,
NATIONAL ASSOCIATION OF SECURITIES DEALERS

Mr. GLAUBER. Chairman Shelby, Senator Sarbanes, Senator Hagel, good morning and thank you. I am Robert Glauber, Chairman and CEO of NASD, a private sector regulator of the U.S. securities industry. I am grateful to the Committee for inviting me to testify on the current and future state of the self-regulatory system. This is a terribly important subject. The Committee is to be commended for addressing it. As the Committee begins to examine the changing nature of securities regulation at a time when exchanges are demutualizing and becoming for-profit, publicly traded companies, I think it is important that the recent evolution of NASD be understood.

Mr. Chairman, we are at a watershed in our capital markets history. The U.S. capital markets are unique in that they are markets with huge retail investor participation. This involvement is based on trust. As market centers migrate from nonprofit facilities to for-profit enterprises, the best way of ensuring that that public trust is maintained is by clear separation of the regulation of securities firms, which are, of course, customers of the exchanges into an independent SRO.

As you know, NASD was the creator, owner, and regulator of Nasdaq. In the mid-1990's NASD faced a conflict that fundamentally altered its existence. The SEC found NASD to be negligent in how it regulated its member firms and their trading on Nasdaq. This finding called into question NASD's governance structure and whether it was appropriate for maintaining both the regulation of securities firms and the operation of a trillion dollar trading market.

As a result, NASD formed two subsidiaries: NASD Regulation and Nasdaq. And just importantly, we implemented a new governance structure that ensured a majority of NASD's Board of Governors would be from outside the securities industry. But when Nasdaq decided, in 2000, to become a for-profit, shareholder-owned, and publicly traded company, the conflicts confronting NASD as a regulator increased significantly. The challenge for NASD was to create a corporate structure that would assure the public that commercial, financial, and stock price considerations did not taint regulatory decisions. We chose complete structural separation between Nasdaq and Regulation, in a completely separate SRO, two separate managements, two separate nonoverlapping boards, two separate balance sheets. In January, this separation was completed when the SEC designated Nasdaq as an exchange. NASD still regulates trading on Nasdaq under contract.

Yesterday, as all of us know and have discussed, the NYSE began a new era as a for-profit, shareholder-owned exchange. Whether it should continue operating as a regulator, especially of firms that are also its customers and competitors, has been the subject of a great deal of healthy and needed debate in our industry, and, of course, discussion in this Committee. The concern is that for-profit, publicly traded exchanges will be faced with the conflicting goal of having to maximize profits while not compromising regulation.

Mr. Chairman, late last year, the SEC floated some alternatives to the present SRO system. The SEC recognized there were inherent conflicts and inefficiencies in the current regulatory environment. As we told the SEC in our response, one glaring inefficiency in today's regulatory scheme is the dual regulation of firms that are members of both the NYSE and NASD. Currently, these approximately 200 firms, the largest firms, are faced with dual rule books, dual examinations, interpretations and enforcement, and dual fees.

A solution that could deal with this is a partnership between the NYSE and NASD to handle the regulation of the firms that are members of both organizations. Under such a partnership, firms would be regulated according to one rule book instead of two. They would pay one regulator instead of two, and they would have only one examination and enforcement staff to contend with, significantly lowering their compliance costs.

NASD believes that one very effective approach to such a partnership would be some form of the hybrid models set forth by the SEC in its concept release. The hybrid model would pull the regulation of all securities firms, who do business with the public, away from the exchanges, and unify such regulation under a single SRO.

Meanwhile, market surveillance and listing standards would be left at the specific exchanges. This model would enhance efficiency by eliminating inconsistent rules, eliminating redundant infrastructure, strengthening intermarket surveillance, and meaningfully reducing the current conflicts in the self-regulatory system.

It is no secret that there have been discussions between NASD and the NYSE about how a partnership could work. While it is too soon to know where these discussions will lead, my hope is that our two organizations can find a way to create a structure that best serves investors and solves some of these vexing problems.

To best protect the interests of investors, any new structure will have to solve the conflict inherent in both regulating and managing a for-profit exchange. The regulator will have rule-writing and enforcement authority over firms trading on the exchanges for sales practices, financial operations, and transaction routing decisions. Thus, absent complete separation of a for-profit exchange and regulation of its member conduct, there is an unavoidable inherent conflict that regulation of member conduct may be influenced by the commercial, financial, and stock price impact of such regulation on the affiliated exchange.

That is the guiding principle for NASD as we move forward in any discussion about SRO consolidation. We cannot agree to any structure that would result in a loss of independence over rule-writing, as well as examination, investigation, and enforcement. It would be a case in any 50/50 joint venture, where each side holds a veto over the other.

As we stated earlier, NASD has worked diligently over the last 5 years to become an independent, unconflicted regulator that does not own or control markets. Any integrated structure with NYSE cannot cause us to give up that independence and the benefits it brings to investors.

Mr. Chairman, that concludes my statement. Again, thank you for inviting me, and I look forward to answering your questions.

Chairman SHELBY. Thank you.

Professor Hu.

STATEMENT OF HENRY T.C. HU
ALLAN SHIVERS CHAIR IN
THE LAW OF BANKING AND FINANCE,
UNIVERSITY OF TEXAS SCHOOL OF LAW

Mr. HU. Mr. Chairman, Senator Sarbanes, Senator Hagel, thank you for inviting me. My name is Henry Hu, and I hold the Allan Shivers Chair in the Law of Banking and Finance at the University of Texas Law School. My oral and written testimony today reflects my preliminary personal views, and does not represent the views of my employer or any other entity. In the interest of disclosure, I had served, without compensation, on the Legal Advisory Board of the NASD.

While the topic of today's hearing opens the door to a number of important issues, I would like to focus on the delicate questions raised by the relationship between NYSE Regulation and NYSE Group. I am concerned about the issue of togetherness, the structural and institutional bonds that link NYSE Regulation and NYSE Group. Ironically, the Exchange has long been the symbol of

American capitalism, notwithstanding its nonprofit status. Now, as the Exchange is itself joining the capitalist parade it holds a non-profit entity close to its heart.

This is a curious structure, one where ends and means do not quite seem to line up. From the standpoint of first principles, it is extremely difficult to ensure that an organization actually pursues the objectives the organization is supposed to pursue. As Members of Congress, you are well aware that bureaucracies often take on a life of their own, developing their own agendas, pursuing their own interest. Simply setting out the formal ends of an organization is not enough. Experience demonstrates that carefully conceived legal and other mechanisms are essential.

Even when relatively simple ends are involved, ensuring that an organization follows those ends is a difficult task. Elaborate legal and market-driven means are necessary, and they sometimes do not work. We need look no further than the publicly held corporation.

The theme of means and ends has dominated thinking about governance of publicly held corporations since the 1930's. Modern corporate governance has largely revolved around one question: What mechanisms will lead managers to act in the interest of shareholders, that is, to act in accordance with the formal ends of the corporation?

So in terms of legal means, we have State substantive law, as well as Federal disclosure requirements. In terms of market means we have institutional investor activism and the pervasive threat of corporate takeovers to discipline wayward managers.

This highly sophisticated system has evolved over many decades with the benefit of both hard experience and new learning. Yet, in the cases of Enron, WorldCom, and other corporate debacles still fresh in our minds, all of the legal and market mechanisms, all four engines on the jet plane, failed simultaneously. The scandals remind us of the difficulty of ensuring that corporate managers behave in a manner consistent with even “simple” ends. Today, our system for the governance of the publicly held corporation, although the best in the world, is still a work in progress.

Turning to the new corporate structure of the New York Stock Exchange, our previous example of the typical corporation with a relatively one-dimensional objective, serving shareholder objectives, becomes far more complex. Here, the ends diverge along different paths: Shareholder wealth maximization at the level of the holding company, but the fulfillment of regulatory responsibilities at the level of a wholly owned subsidiary. The governance question this Committee must consider revolves around this question: Are the legal and other mechanisms equal to the task of ensuring adherence to these complex ends?

The written testimony has the analysis of some of the structural features, so I want to focus on, in a sense, my preliminary conclusions instead here in this oral testimony, that is, that the legal protections created by the Exchange to avoid conflicts and to protect the integrity of its dual functions appear robust, but let us take a closer look.

With respect to the legal framework, a fundamental assumption of the new governance structure is the notion the NYSE regulations, independence will be preserved by limiting the participation of NYSE Group's directors on NYSE Regulation's board. The basic argument is that because only a minority of directors on NYSE Regulation's Board and various committees, will come from NYSE Group, that truly independent NYSE directors are in full control and completely directed to proper regulatory ends.

I am not fully persuaded by this minority of directors argument. A minority position does not automatically equate to minority influence or minor influence. For example, let us just say that the Chairman of the NYSE Group happens to be one of the members of NYSE Regulation's Board. He would be the 800-pound gorilla in the room.

Moreover, board meetings generally operate through consensus, not by actual contested voting. Thus, the fact that NYSE Group directors constitute a minority of NYSE Regulation's Board does not render them powerless over important regulatory decisions. And the reality is, many corporate boards operate with a certain element of structural bias, a "go along to get along" mentality.

Another structural concern that warrants the Committee's attention is the relationship between NYSE LLC and NYSE Regulation. NYSE LLC is a wholly owned subsidiary of the NYSE Group, and a vital element in the NYSE Group's efforts as shareholder wealth maximization. Although NYSE LLC lacks authority over NYSE Regulation's individual disciplinary actions—and there is SEC oversight—NYSE LLC does have authority over other actions undertaken by the regulatory arm. Indeed, NYSE LLC has explicitly retained a right to, among other things, resolves any disputes between NYSE Regulation and NYSE Market.

The foregoing focuses on formalisms, on these boxes that are created. As we all know, in the area of executive compensation, actual incentive structures matter. In the case of NYSE Regulation, compensation will be set by its board. But as discussed above, the board remains susceptible to NYSE Group's influence. In addition, because of likely differences between NYSE Group and NYSE Regulation compensation, the prospect of an alternative career path at the for-profit parent level may be attractive to those at NYSE Regulation.

In conclusion, SEC Chairman Christopher Cox has stated that he intends to closely monitor the NYSE's performance under the new structure. This is commendable. It is also vital. The not-for-profit NYSE Regulation, within the for-profit NYSE Group structure is an experimental structure. It is one that is far more complicated than that of the usual publicly held corporation. Yet, ironically, the legal and market mechanisms in place seem far more primitive than those operating in the publicly held context.

When the playwright, Henrik Ibsen was ill, a nurse came to take a look. The nurse said to Ibsen that he "seemed to be a little better." Ibsen said, "[o]n the contrary"—and died.

[Laughter.]

It is important to go beyond a quick look. It is important to go beyond stated goals and to try to assess whether the legal and market mechanisms in place will in fact nurture and sustain those goals. I say "maybe."

Thank you.

Chairman SHELBY. Thank you, Professor.
Mr. LACKRITZ.

STATEMENT OF MARC E. LACKRITZ
PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. LACKRITZ. Thank you, Mr. Chairman, Senator Sarbanes, and Senator Hagel. Thank you very much, Mr. Chairman, for holding this hearing, and thank you very much for the opportunity to testify on this very, very important issue.

Mr. Chairman, as we have often testified, our Nation's securities markets are the most transparent, liquid, and dynamic in the world, and self-regulation has really been a critical ingredient to our success. Self-regulators or SRO's, are on the front line and have an intimate knowledge of the operations, trading and practices. As a result, they can develop rules quickly, and set standards that exceed statutory or even common law legal minimums.

Despite these compelling benefits, Mr. Chairman, self-regulation has two drawbacks. First is conflicts of interest between SROs' roles as both market operators and regulators, and second, regulatory inefficiencies resulting from duplication among SRO's.

To address these deficiencies, we have supported a consolidated hybrid for broker-dealer regulatory functions for firms that are regulated by both the New York Stock Exchange and the NASD. This consolidated self-regulatory structure would eliminate conflicts of interest and regulatory duplication. In addition, a single principles-based rule book would strengthen investor protection and improve the global competitiveness of our markets.

Mr. Chairman, our primary concern revolves around conflicts of interest as for-profit SRO's attempt to wear two hats, as both market operators and regulators. The recent merger of New York and Archipelago fell short of the separation that is necessary to insulate regulation from the business interest of its for-profit parent. However, we have no interest in disturbing that restructuring. Rather, we hope that the SEC, with the support of this Committee, will ensure that the New York and NASD move the primary source of the conflict, regulation by the New York Stock Exchange of its competitors, into an entity that consolidates their overlapping regulatory programs.

Other major concerns include duplicative regulation and redundant infrastructure. Both the New York Stock Exchange and the NASD frequently adopt separate rules on similar or identical topics, leaving many firms to cope with two different recordkeeping, procedural and audit trail requirements for the exact same product or service. It is a little bit like trying to play basketball, following both the college rules and the pro rules at the same time. The resulting unnecessary compliance costs obviously impact our firms and their customers, the investors, by either increasing costs or reducing choices.

Now, consolidation of New York and NASD rules make sense to ensure global competitiveness. But in light of the variations in institutional culture, history, and constituency between the New York and the NASD, just reconciling existing rules will be inferior to what could be produced by a single regulator.

Think if—and I apologize to my colleagues—if Hemingway and Faulkner—see, I thought by citing Hemingway and Faulkner I would be reaching for the stars, but I did not realize Professor would going to cite Henrik Ibsen, so I am obviously way behind here.

But think about if we urged Hemingway and Faulkner to harmonize their work. Right now, actually, is an ideal time for a new risk-based rule book, and consolidated interpretations, examinations, and enforcement can follow.

Mr. Chairman, in brief, what we are looking for is a single set of rules, a single set of interpretations, a single set of examinations, and a single organization. The SRO's have broad agreement that consolidation is needed, but differences on details remain. As you have heard earlier, the New York favors a true joint venture controlled by both SRO's, while the NASD wants to move the New York regulatory functions into itself, or to create an entirely new regulatory entity.

Any of these approaches, Mr. Chairman, could eliminate the conflicts of interest and regulatory inefficiency that would create a single entity that is responsive, accountable, transparent, and well-funded.

We strongly urge this Committee, Mr. Chairman, and the Securities and Exchange Commission, to take the lead on capitalizing on this present opportunity. The differences between New York and the NASD are much less significant than their agreement that consolidation should occur. As long as the SEC and this Committee stay engaged, these differences should be bridged in short order.

In summary, Mr. Chairman, we ask for one set of rules, one set of interpretations, one set of examinations, and one organization. We must remove these conflicts of interest and regulatory inefficiencies if we are to maintain the preeminence of our securities markets and our securities industry. We are here to work with all the parties that are interested in this to achieve the result.

Thank you very much.

Chairman SHELBY. Thank you.

Mr. Ferlauto.

STATEMENT OF RICHARD FERLAUTO
DIRECTOR OF PENSION AND INVESTMENT POLICY,
AMERICAN FEDERATION OF STATE, COUNTY, AND
MUNICIPAL EMPLOYEES, AFL–CIO

Mr. FERLAUTO. Good morning, Chairman Shelby, Senator Sarbanes, Senator Hagel, and Senator Schumer. My name is Richard Ferlauto. I am the Director of Pension and Investment Policy at the American Federation of State, County, and Municipal Employees. Our union represents 1.4 million State government health care and child care workers.

I appreciate the opportunity to appear before the Committee on behalf of AFSCME. I am also representing the views of the 9 million member AFL–CIO to discuss regulation of the New York Stock Exchange.

The appropriate level of regulation and oversight of capital markets is a key concern to us because it impacts on the financial condition and retirement security of every working family in this new ownership society. As a matter of fact, AFSCME members, through the public pension systems, have assets totalling well over one trillion dollars in the public markets. These public systems lost more than $300 billion in assets due to the loss of market confidence in the 2 years following the scandals of Enron and WorldCom. That totaled about 15 percent of the net assets, and one reason our defined benefit plans are now underwater, if you will, in many places, is because of the impact of those scandals.

All told, union members participate in benefit plans with well over $5 trillion in assets, not including the individual dollars that our members invest as individuals, which is about that same number.

Institutional investment funds are highly indexed, and are long-term owners as patient investors. Confidence in the markets, transparency, and appropriate regulation are the foundation of their success as investors.

As a matter of fact, for our retial, our individual investors who are our members, information and regulatory support is absolutely key to their success in managing their personal savings.

The AFL–CIO and AFSCME are convinced that the NYSE and other self-regulatory organizations play an absolutely vital role in the marketplace. We have been supportive of NYSE's unique strengths as an in-person market maker. As a matter of fact, we have well over 200,000 members who rely on the economic dynamisms of the NYSE in the metro region and are strong supporters of that organization.

But, very importantly, the recent conversion to for-profit status and its unwise determination to retain and finance its regulatory unit within the NYSE Group creates a clear conflict of interest, which we believe poses a significant danger to investors.

We urge Congress to call on the SEC to directly regulate, or in an alternative, to support the creation of a genuinely independent organization to regulate the NYSE. Whether regulation is a hybrid model between NASD and the NYSE, or an individual regulation model, or the partnership described by Mr. Glauber earlier in his testimony, we believe that independence is vital.

As Mr. Glauber has said before, there was a conflict in an enterprise operating as a regulator.

As a matter of fact, there are many new statistics we could cite and examples we could talk about. A recent report by Glass, Lewis, a proxy advisory firm, shows that the amount of company restatements has doubled in 2005, and as a matter of fact, in the NYSE, 12 percent of their listed companies had to restate last year. We are very concerned that the lack of significant and aggressive regulation has led to some of those restatements.

There are a number of examples that I would like to cite that further indicate the problems that we see. One is the case of Qwest. It is a company that has had a troubled financial history, and it took investors and the NYSE an extended period of time before we were able to get reliable reports out of that company.

Most recently, we have had Sovereign Bank that was able to proceed with a restructured sale of stock in which they were able to sell Treasury shares in order to skirt NYSE listing standards on technical grounds.

Following that we had a similar problem with Fannie Mae. Fannie Mae was also able to skirt rules around delisting requirements. It is also interesting to note that Fannie Mae pays an annual listing fee of half a million dollars to the NYSE. So that there is a direct conflict of interest that we see.

As a matter of fact, as Professor Hu talked about earlier, even though a majority of directors are so called independent, in fact, a significant number of the board of the NYSE Regulatory Group will overlap, and we believe that any overlapping at all causes a conflict of interest.

We urge Congress to work with the SEC with the goal of eliminating self-regulation by the exchanges. The Commission should set timelines for pursuing reform goals, and open up the process through public roundtables and other forums allowing for investor participation and public engagement.

The oversight role of the SEC might be enhanced during this review of the powers of SRO's. While the Commission has the power under the Exchange Act to improve changes in SRO rules, the full extent of its authority remains unclear and has caused concerns for investors for many years. For example, as investors focused on corporate governance, which many of our public funds are, we believe that the Commission should have the ability to regulate listing standards, contrary to the limitations imposed by the SEC on the business roundtable versus the SEC.

Despite these concerns, we are also afraid that the SEC does not have or will not have the administrative capacity to guard against the NYSE's historic lack of oversight. We are very concerned that the annual budget for 2005 reflects actual program costs, which is a cut back from prior years. As a matter of fact, the 2005 annual report for the SEC notes that staff turnover is up 7.5 percent, the highest turnover rate since 2001.

So we support a regulatory structure for the NYSE that fosters investor confidence, ensures fairness for all market participants, and encourages competition to promote efficiency in today's markets. This system should ensure that all exchanges meet or exceed established standards for investor protection, and should prohibit a race to the bottom.

Equally important, this system should guarantee regulatory oversight functions that are adequately and securely funded. Simply, we believe that there should be no conflict of interests between the regulator and the owner, and this calls for complete separation between the two.

And I might add, given Mr. Lackritz's testimony before mine, I think this is one occasion where we agree completely in terms of a regulatory approach. It is a very odd occasion.

Thank you very much, Mr. Chairman.

Senator SARBANES. Another first has been accomplished here this morning.

[Laughter.]

Ms. YERGER. Miracles can happen.

Chairman SHELBY. Ms. Yerger.

STATEMENT OF ANN YERGER
EXECUTIVE DIRECTOR,
COUNCIL OF INSTITUTIONAL INVESTORS

Ms. YERGER. Good morning. I appreciate the opportunity to share the Council's views on SRO's and the securities markets.

The Council shares the prior panelists' concerns over the potential conflicts facing an exchange, particularly in a for-profit context, when it is responsible, not only for running a marketplace, but also for regulating its customers, its competitors, and protecting investors.

The Council believes separating the regulatory and exchange functions is the best way to protect the 84 million Americans and others investing their hard-earned savings in our U.S. equity markets.

Council members number more than 130 public, corporate, and union pension funds with more than 3 trillion in assets. They are long-term investors in our markets. They have a very significant stake in the success of the markets. As a result, they are keenly interested in keeping the U.S. markets the best in the world. They strongly support the Exchange's work to provide the highest quality, most efficient, and cost effective marketplaces.

However, a critical component of market effectiveness and success is investor confidence. Part of that confidence comes from knowing that rules and 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 standards have harmed investors and shown that the SRO model is in need of reform.

The Council has three recommendations. First, we believe regulatory arms should be independent of the exchanges, and they should be securely and fully funded. Such structures are currently in place at the NASD. They are not at the NYSE. We believe the structure of NYSE regulation would be greatly improved if it were independent of the NYSE Group, and it shared no directors with the public company. We believe the need for independence also applies to any merger of Exchange regulatory operations. While such a combination certainly could improve efficiencies, it would be deeply flawed if it failed to be independent of the exchanges.

Second, listing standards should be a regulatory responsibility, and processes should be in place to keep these standards current. In the Council's experience, the exchanges have been hesitant to update their listing standards, perhaps for fear of upsetting listed companies and driving business to competing exchanges. As a result, too often it has taken major corporate scandals, along with suggestions from the SEC to prod the exchanges into action. The Council's written testimony details a few examples of challenges in this area. It took nearly 8 years to strengthen the rights of owners to vote on equity compensation plans. More than 10 years of discussion has not yet changed the NYSE's 70-year-old rule allowing broker votes, a process which the Council believes amounts to ballot box stuffing for management.

Third, SEC oversight of the SRO's, particularly of listing standards, should be strengthened. The SEC's oversight role is an important safety net to ensure that SRO's continue to protect investors and the integrity of the marketplace. However, the SEC's power over listing standards has been unclear, particularly since a 1990 court ruling invalidating the SEC's imposition of a one-share one-vote listing standard. Since then, the Commission seems reluctant to do more than use a bully pulpit to encourage reforms at the exchanges. The Council believes Congress can and should clarify the SEC's authority to amend or impose listing standards when doing so would protect investors and serve the public interest. Such a reform would help curtail the challenges currently faced by investors interested in modernizing listing requirements.

In conclusion, this is a transformative time for our capital markets, and we believe it is an opportunity to put in place not only the best structures for the marketplace, but also the best structures for the regulatory arms.

Thank you for considering this important issue.

Chairman SHELBY. Thank you, Ms. Yerger.

Professor Hu, I will direct this question to you. When other stock exchanges across the globe demutualized and became for-profit entities over the past 10 years or more, I understand that they all took steps to ensure structural separation between the supervisory authority and the management of the exchange. I am referring to the London Stock Exchange—correct me if I am wrong—Euronext, the Hong Kong Exchange, the Exchange in Stockholm, the Australian Stock Exchange, the Singapore Stock Exchange—these are busy exchanges—and others. So is it your understanding as well, Professor, and if so, what is your view about the New York Stock Exchange going forward employing a different structure? Do you feel this structure could have implications for investor protection?

Mr. HU. The bottom line is, I think that this structure represents the triumph of hope over experience. In terms of the various exchanges that have demutualized, they vary all over, they go all over the map in terms of how they achieve this separation. As you know, this trend basically accelerated only in the past few years. So it is still an ongoing experiment, but people have recognized throughout the world the need for this separation.

In terms of the London Stock Exchange, the one that probably is the one we want to look to most carefully simply because, well, you know, it is the Anglo-American system of corporate governance, and the London Stock Exchange, preeminent for a long period of time, and in terms of the London Stock Exchange and its relationship to the FSA, I think it is particularly instructive.

The London Stock Exchange, basically in terms of its power overreach, in a sense, the regulatory power, essentially focuses only on trading, only in trading. In terms of, for instance, the listing and delisting powers, it is up at the financial services supervisory authority, at the FSA, the super regulator that controls fairness, transparency, and order of conduct in the financial markets, overseeing basically all U.K. financial banking markets, basically takes over delisting-listing powers, and retains general oversight of the LLC. The LLC is focused on trading.

In terms of some other examples, the Toronto Stock Exchange, basically keeps the listing-delisting powers, but the Market Regulation Services Authority is this national authority, basically has everything else.

So you see, patterns differ, but there is this expressed concern in terms of how you adjust for these conflicts.

Perhaps the most extreme example of not trusting the markets, may be in Germany, in terms of Deutsche Börse. the regulation of Deutsche Börse is basically controlled by the Hessian Ministry of Finance, the government. So it is all over the map.

It is too early to figure out what the lessons are in terms of these experiences. We have not really seen what happens in terms of market stress, or fraud, or those other things, but I would like to think about the fact that these issues really coming to a head for instance, those NYSE Group directors who also happen to serve on the board of NYSE Regulation. They have a divided allegiance, as at the parent company level, they are supposed to do everything they can to maximize the wealth of shareholders. But when they have their hat on as members of the NYSE Regulation Board, they have responsibilities to fulfill the regulatory ends of NYSE Regulation. They are put in a real spot in terms of normal corporate governance, this kind of thing comes up when say a controlling shareholder has directors on the board of its subsidiary.

Corporate law goes all over the map in terms of how you control these conflicts, but it is a very difficult, precarious situation.

Chairman SHELBY. Mr. Thain, you want to answer that?

Mr. THAIN. Sure. I think there are two pieces here. When we talk about regulation, the regulatory functions really oversee three distinct groups. First, they surveil the market itself. And if you look at what other exchanges around the world do, many of those exchanges have maintained their surveillance of the trading activities inside the exchange functions. They have not separated that out. There are lots of example, actually, both in the United States as well as internationally, the Boston Exchange, the Philly Exchange, all the futures exchanges, as well, actually, London Stock Exchange, a significant part of the markets, the trading itself, is actually maintained inside the exchange.

The second major piece is the listed companies. Here, what is particularly interesting is we took our listed company compliance and moved that to the regulatory side. In the case of Nasdaq, the regulatory compliance of listed companies with the listing standards is actually directly reporting to the business of Nasdaq. So here we have a circumstance where best practice would say the listed company compliance should be separated and put inside the regulatory function. In the case of Nasdaq, it continues to report directly to the businesses exchange.

The third piece which you have heard the most about is the member firm examination, and there are different models, and as a matter of fact, what is interesting is the model that the futures markets have taken, where they have actually combined and they have created an association, a group, a partnership, to create one set of rules and one examination process. And, again, I actually think that there is pretty broad agreement here that we do want to have one set of rules and that we do want to have one examination process, and the real question is how we get there.

The second thing I want to talk about just for a moment is this governance question, because Professor Hu made a very interesting point about minority positions on board and having a minority of the directors of the regulatory board coming from the parent company board. This goes to the point that there is no perfect model here. NASD's board has a very significant number of its board members directly affiliated with the members who it regulates. So if you believe, as Professor Hu said, or actually as Mr. Ferlauto said as well, that a minority position on the board can represent something beyond minority influence, then NASD should not allow any of its board members to have affiliations with its members that it directly regulates.

Chairman SHELBY. Thank you.

Do you have any response to that?

Mr. HU. I agree totally with Mr. Thain that no model is perfect. Indeed, in my written testimony, I acknowledge that even with a traditional SRO, there are conflicts and it is far from a perfect model.

My point relates in part to the experimental structure of the setup here, the complexity and ends in terms of shareholder wealth maximization, at the parent level for regulatory purposes at the subsidiary level. It is tough to get things right as far as getting organizations to actually behave. With a traditional SRO, we basically have more experience. We have learned some things, and that we are constantly tweaking with the structure. And in terms of a traditional SRO the ends are a little bit simpler. There is no profit end that we have to contend with.

So, I agree totally with Mr. Thain. Every system has flaws, and the issue is—and we also have to take into account what——

Chairman SHELBY. What is the best system, that is what we are getting to, is it not? What would be the best system?

Mr. HU. This, obviously, calls for a major research grant.

[Laughter.]

Chairman SHELBY. Thank you.

Senator Sarbanes, I have to share my time.

Senator SARBANES. Thank you very much, Mr. Chairman.

First of all, I want to thank each of the panelists for the care and thought that obviously has been put into your prepared statement, and your oral presentations, but the prepared statements are all quite lengthy, and they have obviously reflected a very careful consideration of the issue, and we appreciate that very much. It is enormously helpful to us to have that material.

Mr. Thain, I want to address this issue to you first, because a lot of the focus, of course, is on what the exchange is going to do, or not do, as we move ahead. I quoted *The Wall Street Journal* earlier. There was another article they ran that said a key concern for consumer advocates and regulators is the Exchange's self-regulatory responsibilities. Some consumer advocates say the NYSE, which the SEC has criticized in the past for lax oversight, should shed its self-regulation unit if it goes public. The Consumer Federation of America says the for-profit environment adds to the pressures, potential conflicts of interest. Arthur Levitt said that an independent regulator would no longer care about offending the principal clients of the Exchange.

And in that *Journal* editorial I reference earlier, they went on to say, "A split from the regulators would minimize any conflicts of interest, whether real or perceived. Even if the NYSE were to run the most hard-nosed enforcement outfit in the world, it can always be accused of playing both sides."

What is your response to all of that, and particularly, to what extent are you concerned that, as the *Journal* says, even if you run a very hard-nosed enforcement outfit, if something goes wrong, it is going to be laid at the doorstep of the model that you are using, so that it seems to me you have quite an exposure here in pursuing this path, as you look out into the future?

Mr. THAIN. I go back to my fundamental view that good, strong, robust, independent regulation is key to the confidence of investors and the confidence in participating, either as an investor or a listed company on our exchange. Our structure does that. It is not the only structure that can be used, but as we heard before, there is no perfect answer, and there are always conflicts in whatever structure you come up with. You know, you have heard the comment about WorldCom and Enron. WorldCom was a Nasdaq company. Enron was a New York Stock Exchange company. Neither system is foolproof. It is up to us to make sure that our regulatory functions are sufficiently independent, sufficiently well-funded, and in fact, work well, because ultimately that is what reinforces confidence on the part of investors.

Senator SARBANES. How do you get away from being accused of playing both sides the way you are structuring it?

Mr. THAIN. Again, I think that those types of conflicts exist in the NASD model as well. There is no model that is void of conflicts. In addition to the board conflicts that NASD has, NASD also has multimillion dollar contracts with Nasdaq, with the AMEX and with ISE, which is the options exchange. NASD also supports a trade reporting facility in which broker-dealers, who internalizing trades, not exposing them to the market, print the trades on NASD's trade reporting facility, and then they rebate that money that they get from the market data from those trades to Nasdaq. So there is a direct conflict there between supporting that trade reporting facility, as well as supporting the internalization of trades, which is not generally good for the marketplace itself.

Then finally, the point about the listed company compliance, there is no reason why Nasdaq, the business, should be responsible for the compliance of its listed company with its own standards, as opposed to NASD.

So, no model here is perfect, and I think it really is up to the regulatory side of the New York Stock Exchange to demonstrate that it can in fact maintain its independence, that it can in fact maintain its proximity to the marketplace, and that it can in fact maintain investor confidence.

Senator SARBANES. Mr. Glauber, what would you say with respect to those critiques of the NASD model?

Mr. GLAUBER. Senator Sarbanes, let me try and take them piece by piece if I can. As Mr. Thain has said, clearly, conflicts abound all over. What we have focused on in our testimony, and indeed what Mr. Thain and I are focusing on in our discussions, is a particular set of conflicts that occur when a now for-profit, shareholder-owned exchange regulate the financial institutions, the securities firms that are its customers, fundamentally, and as I said in my testimony, we believe structural separation is the way to deal with it, the way we have dealt with it at Nasdaq when it became a for-profit exchange back in 2000.

On the specific issues, we do indeed regulate under contract market activities of certain exchanges, the ISE, the AMEX, Nasdaq. In each one of those cases, none of those revenues in any way support our regulation of firms, our primary activity under the statute, of regulating the activities or securities firms. And indeed, none of those in aggregate are very important. The Nasdaq contract accounts for 5 or 6 percent of our revenue in total. So if we did not do that, if they decided to take that activity somewhere else, do as the New York Stock Exchange does, and internalize that and do it themselves, we would survive in fine shape, and it does not in any way affect our primary responsibility of regulating what we call member firms.

On the trade reporting facility, it is indeed a facility that we operate to permit trades to be reported. It is a facility that we made available to any exchange, and we are in fact in discussions with other exchanges, and offer that facility on the same terms that it is proposed to be used by Nasdaq.

Senator SARBANES. What about the independence of the directors?

Mr. GLAUBER. Well, that particular conflict was raised initially in the legislation that was passed by Congress in 1934, and the conflict centered on securities firms being part of SRO's, and indeed, that is an inherent conflict. We have chosen to deal with that by assuring that those security firms are a minority of the board. The majority of the board are nonindustry, nonsecurities industry people. It was the view of Congress when it passed that legislation that there was a value to having the input of the securities industry in this regulatory process, obviously, a conflict as well, but that that could be managed by this kind of board structure.

Senator SARBANES. My time is up, Mr. Chairman.

Chairman SHELBY. Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman, for holding this hearing.

I want to welcome everyone here, but particularly the New Yorkers. I guess there must be a few, given that this is financial services. Just a few brief points. I understand the need to have strong regulation. I like to describe my views on these issues as both probusiness and proregulation, and I think if you are probusiness, you will be proregulation. Those who say regulation hinders business, have not looked at history. Sure, outliers do not like regulation, but good, mainstream businesses do.

Now, we have two issues here. One issue I am sympathetic with and one I am not. I think it is tough to have duplicatory regulators with different rules. When New York firms come to me and say it is crazy to jump through two different hoops, then they are right, and we know this in many walks of life. So to try to come up with one set of rules makes a great deal of sense.

The second issue is what set of rules should those be? And I do not see any reason inherently to say we should pick NASD's set of rules over the NYSE set of rules. It is clear from Senator Sarbanes' questions, conflicts are there all along. As Professor Hu said, no model is perfect. And I think some kind of hybrid that combines both and comes up with one set of rules, but allows for the differences in the structures of the two organizations makes the most sense. I do not think it is a good idea, frankly, to just say let's impose NASD's rules on the NYSE or its firms. It just does not fit, just does not work. I would work hard against that kind of situation.

Let me ask some questions here. As for self-regulation, all of it is in one degree or another, self-regulation with the SEC overseeing it. That is not a model I am adverse to. Day to day you cannot ask the SEC—you cannot have a cop on every street corner. You are not going to have an SEC personnel person looking over every single trade. It would be expensive, and it probably would not be as efficient, and particularly now that we have two competitive models, the merger of NYSE with Archipelago, the merger of Nasdaq with Instanet—I forget which of the other ones you bought—make two very strong competitors, and to me that is a great model. I always worry about fragmentation of the markets, Mr. Chairman, seven or eight places. But to have two strong competitors, each doing it a slightly different way, that is probably the best of all worlds for the moment. So that is my basic view.

I have some questions here. I think it is clear there are as many conflicts, more conflicts, on the regulatory board of NASD than there are on NYSE, and Senator Sarbanes brought that out. I understand, Mr. Thain, that you have worked with the SEC on your structure closely because you obviously have to win approval from them. And even though places like my good friend Mr. Lackritz, and the SIA, have asked that they have their member firms on your board, you have said no.

Mr. THAIN. Correct.

Senator SCHUMER. Which may be one of the reasons they are not as happy with your structure. I love the SIA.

Mr. LACKRITZ. Thank you, Senator.

Senator SCHUMER. But, Mr. Glauber, you criticized the NYSE's Group structure because of conflicts, but are there not as many conflicts in your situation, if not more, in terms of the board members, than there is with the NYSE structure? I mean that seems pretty clear to me. You may say they do not matter in your type of organization, but the conflicts are there.

Mr. GLAUBER. Senator Schumer, I would not say they do not matter. Conflicts are there. What I will say is that we think the inherent structure of having a for-profit, shareholder-owned exchange, responsible for regulating the activities of the financial firms that are its customers, is a conflict at the heart of the issue.

Senator SCHUMER. Will you explain to me why, if someone is a bad person, and is conflicted, why they could do any less damage on your board than the NYSE's board? It seems to me, just because there is a different structure, if you have someone with a conflict who wants to exercise that conflict, they will find a way with your setup and with New York Stock Exchange's setup, and to me, the best thing to do is to say your board should not have those conflicts, which they have done and you have not.

Mr. GLAUBER. Senator Schumer, I think the fundamental difference is that at the end of the day what we regulate in financial firms, securities firms, are members who have to be members of our institution or they cannot do business with the public, they are out of business. What New York is put in the position of, now that it is for-profit and shareholder-owned, it is regulating financial firms that are its customers and can take that business elsewhere.

Let me, if I might, just make one point.

Senator SCHUMER. But could the people you regulate, the American and the others, not take their business elsewhere and their customers?

Mr. GLAUBER. No. Senator Schumer, we are talking about our regulation of firms as firms, not of exchanges, and——

Senator SCHUMER. But that argument would apply to your contractual arrangements with the other people you regulate.

Mr. GLAUBER. And as I answered earlier——

Senator SCHUMER. You have been frank and forthright, which we appreciate.

Mr. GLAUBER. No. As I answered earlier, were those contracts to go somewhere else, that is fine. They are a small part of what we do. The fundamental thing we do is regulate the activities of financial firms, of securities firms, and they have to be members of the NASD.

My point was, when exchanges become for-profit entities, they now are regulating customers who can in fact go somewhere else. That I think is the fundamental difference.

Senator SCHUMER. So if you want to set a rule no one should regulate their customers, then you should not be allowed to have contracts with all these other exchanges. It is the same conflict. You are saying it is one context or another, but it is the exact same conflict open to the exact same problems. What is good for the goose is good for the gander, or not good for the goose, not good for the gander.

Mr. GLAUBER. Senator Schumer, when we regulate the ISE under a contract, I do not think they are our customers. We have a contract, and they can take their contract anywhere they want.

Senator SCHUMER. And they are paying you money to do it.

Mr. GLAUBER. Of course, but they can take it anywhere they want. I think that is fundamentally different from what is the focus of Mr. Thain's and my discussions, which is the regulation of the securities firms that are members of NASD by law, and are customers of the exchanges.

If I could just ask your indulgence.

Senator SCHUMER. Sure.

Mr. GLAUBER. The point I want to make is what we are talking over and over again here is about problems of structure, not of people. I have known Rick Ketchum for 20 years, and——

Senator SCHUMER. Right. But every structure is fraught with conflict, and to me, the best way to deal with that is to eliminate the conflicts at the outset. And I think this structure that NYSE has proposed would do that very well, because their board, their regulatory—now, obviously, if the NYSE leans on the regulatory board, there is a problem, but your board can be leaned on by a whole variety of people too, including, the broker-dealers who pay their fees to the—anyone can lean on anybody, and one structure does not make that different.

Let me ask you this. Would you be adverse to coming up with a hybrid system that would take the account of the different structures—which are great structures. I am glad you are both here. I am glad you are both in New York. I am glad you are both competing. I think it is good for each of you, and most of all, good for the customers. But would you be adverse to sitting down and trying to come up with a hybrid that recognizes the differences in the way you people trade, but at the same time would create the kind of single regulatory standard that the people you serve are justifiably seeking? Would you be willing to do that?

Mr. GLAUBER. Senator Schumer, I am happy to answer that. Could I just intervene as required by a part of your question. We do not compete with the New York Stock Exchange. We are just a regulator. We are not in business. We do not compete with these firms that are our members and have trading licenses at the New York Stock Exchange. So we do not think of ourselves as competing with the New York Stock Exchange. Let me just clarify that.

Senator SCHUMER. No, I am talking about——

Mr. GLAUBER. And again, we are separate from Nasdaq.

Senator SCHUMER. I know, I know.

Mr. GLAUBER. Over a 5-year period have achieved that.

Senator SCHUMER. Five years is not—I know Professor Hu said experience. Five years is not that long, and there have been some problems with your structure, as well as with the NYSE's, right?

Mr. GLAUBER. Absolutely, correct. Let me answer the question you posed to me.

Senator SCHUMER. Yes.

Mr. GLAUBER. The answer is, of course, we are prepared to work on some kind of partnership, as I said, and we have some discussions. I am sure we will have some more. We seek to do something to eliminate this duplication and deal with these inherent structural conflicts.

Senator SCHUMER. That is a very good place for me to end.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you, Senator Schumer.

Conflicts do abound, all of you know, and they are relative at times. I want to ask Mr. Lackritz, is there any larger potential conflict, a more fundamental one, than one between SRO's regulatory function and its shareholders?

Mr. LACKRITZ. Senator, conflicts abound throughout this process, and I think at the core of self-regulation is in fact the conflict that we have member involvement with regulating themselves at some level, and it is something that Senator Schumer just addressed with Mr. Thain and Mr. Glauber. We believe that self-regulation has actually worked very effectively. It has involved members in regulation, it has provided expertise, experience, knowledge, to help regulation in a way that is going to be very effective and efficient. So that has actually worked.

When you in fact take members out of that picture completely, we can call it self-regulation, but really, the self is out of self-regulation when that happens.

Chairman SHELBY. It changes.

Mr. LACKRITZ. That is right. It is changed. It is a different system.

Chairman SHELBY. Ms. Yerger, you have a comment on that?

Ms. YERGER. I think that this really is an issue that the SEC needs to address and consider because it has been a concern for us, frankly, and I think the question of whether——

Chairman SHELBY. The SEC has the power to do this.

Ms. YERGER. Absolutely.

Chairman SHELBY. I think they do.

Ms. YERGER. And it would be a logical follow-up to the concept release issued last year.

Chairman SHELBY. Mr. Thain, you have already touched on this some. I would like to explore some of the concerns about conflicts of interest between the regulatory side and the profit-making side of the New York Stock Exchange. I understand the argument that NYSE should maintain responsibility, your argument, for policing its own marketplace, subject oversight by the SEC. But now that you are a for-profit company, what is the argument for allowing it to continue to regulate how other for-profit companies, namely broker-dealers, interact with their customers? Do you see a conflict, given that these brokers are in direct competition with the New York Stock Exchange?

Mr. THAIN. I do not believe that these broker-dealers are in direct competition with the New York Stock Exchange. They are our customers, yes. They are not our competitors, and these broker-dealers provide the vast majority of all of our order flow to the floor of the exchange. The importance of having the New York Stock Exchange regulatory functions involved with those member firms is they drive a lot of the behavior that is going on on the floor of the exchange. They are the participants on the floor of the exchange for the most part, and so it is actually quite important that the regulatory functions be involved with the oversight of those member firms.

Chairman SHELBY. Professor Hu, you have any comment on that?

Mr. HU. We have to take into account, in a sense, some of the benefits of proximity, togetherness. I think in a sense that has to be weighed together with these issues of conflict. With self-regulatory organizations, we do not want the SEC to regulate all this stuff. There is a place for SRO's. I think that even the SEC really concedes that.

Chairman SHELBY. Would you need a single nonprofit self-regulator?

Mr. HU. You may.

Chairman SHELBY. Would that work?

Mr. HU. That may be one model you need. That may be one model. There may be this hybrid model in terms of trading, plus this joint—you know, each responsible for trading, plus this joint venture. These are the kinds of issues that we have to explore, but I do want to emphasize that in a sense, I have been as guilty about this as anybody. I have only, in a sense, focused on the negatives. But in designing——

Chairman SHELBY. But there is a positive side to self-regulation.

Mr. HU. Yes, there is a positive side, and in terms of the positive side, how you structure the hybrid or these alternative models makes a huge difference in terms of trying to figure out the best way of maximizing those proximity or togetherness benefits with the inevitable cost of conflicts of interest.

Getting rid of conflicts of interest is not the goal. That is not the goal. It is really the balancing——

Chairman SHELBY. But you want to minimize it, do you not?

Mr. HU. Oh, on the whole, but you have to weigh that against all the——

Chairman SHELBY. Nobody is pure, I understand that, not totally, but we try to work at that goal.

Mr. HU. Absolutely.

Chairman SHELBY. Mr. Thain, what, if it is determined that the New York Stock Exchange Regulation needs more resources, and that fees need to be raised, who would make that final decision on that?

Mr. THAIN. The resource needs of regulation are dictated ultimately by Rick Ketchum who runs it, and ultimately, by the board of the regulatory entity.

Chairman SHELBY. Mr. Glauber, you want to comment on any of that? I did not mean to ignore you.

Mr. GLAUBER. Indeed, that would be, I think, where it would be done. The structure inherent there I think leads to an obvious tension. Raising fees could get some of these customers to give up their trading licenses and do business somewhere else. So the structure is at the heart of the problem. It is not Mr. Ketchum. It is not Mr. Thain, who clearly are going to run this operation in the public interest. But the structure provides these kinds of conflicts, which we think in the case of firm regulation, really are so great that they should be the subject of structural separation.

Chairman SHELBY. Mr. Hu.

Mr. HU. I think the funding issue is an important one, and because there is this—according to the February 27 SEC order, there is this agreement to provide for, “adequate funding of NYSE Regulation,” and I understand NYSE Regulation, of course, collects fees, and cannot distribute to fees to the for-profit side and so forth. But there is this element of what adequate funding means. Unless, in a sense, the actual agreement is much more specific than that, there is the issue of what is adequate? On what basis is adequacy determined? How often is this determination reviewed and revised? Will NYSE Regulation’s actions be influenced by a possible leverage or refunding that NYSE LLC, NYSE Market, may have. So, I am concerned about this funding issue because this relates to the incentive structure.

Chairman SHELBY. It could be a real problem, could it not?

Mr. HU. Yes.

Chairman SHELBY. Mr. Glauber, in your written testimony, you described a process of separating NASD from Nasdaq. How does NASD’s current structure compare with the current structure of the New York Stock Exchange? And do you believe it better ensures that Regulation will be free from conflicts of interest? Compare and contrast those, if you can, as objective as you can be.

[Laughter.]

Mr. GLAUBER. As you correctly point out, Mr. Chairman, NASD faced the same issue 5 years ago when Nasdaq decided to become a for-profit, shareholder-owned institution. So we took some steps to deal with that new conflict the way we thought was right. What we ended up with is an institution that is completely separate of all exchanges, that has no alliance now with any exchanges, that is a member organization, who, as I said earlier, has members that have to be members to us, or they cannot do business with the public.

The difference is that NYSE, as of yesterday now, is a for-profit, shareholder-owned institution like Nasdaq, and——

Chairman SHELBY. You think there is enough separation there?

Mr. GLAUBER. The point is, they now are going to regulate these firms——

Chairman SHELBY. Because the professor says conflict is going to be there, it is a question of how much, right? Those are my words.

Mr. GLAUBER. Well, and whether the structure can handle it. And in their case, what they are going to regulate, these firms, financial institutions, securities firms, are going to be customers, as Mr. Thain just said, not members that have to stay there, they are customers that can leave and go somewhere else. We think that that is a conflict that needs to be handled by full structural separation, completely separate boards, no overlap of the boards, separate balance sheets, no overlap of the finances.

Chairman SHELBY. It is your judgment that the SEC can do this?

Mr. GLAUBER. The SEC certainly has the right to order that——

Chairman SHELBY. Do you agree with that, Professor? You are a law professor.

Mr. HU. Absolutely. The SEC has to take a strong stand on this issue.

Chairman SHELBY. Mr. Thain, what about the global competitiveness of U.S. capital markets? They are the biggest in the world. I have visited the London Stock Exchange, the German Stock Exchange, the French Stock Exchange, even Italian in Milan. They all seem to be functioning, but they are not as big yet as ours. Why are some of the biggest foreign companies, IPO's, some of them, increasingly decided not to trade their shares in this country? Some of them have gone to London and elsewhere.

Mr. THAIN. Mr. Chairman, that is a very real concern, certainly for us, as it should be for everyone concerned about the competitiveness of the American marketplace. As you said, we are much bigger. The market value of the companies that trade on the New York Stock Exchange is over 21 trillion U.S. dollars, which is more than five times bigger than the next biggest marketplace. But we have seen a very concerning trend.

In 2000, $9 out of every $10 raised in the IPO market was raised in this country. Last year, in 2005, none of the 10 largest IPO's in the world——

Chairman SHELBY. Say this again. I want you to say it for the record.

Mr. THAIN. None of the 10 largest IPO's in the world were registered in the United States. Only 2 of the 25 largest IPO's in the world were registered in the United States.

Chairman SHELBY. That is not good news, is it?

Mr. THAIN. No, it is not. Why is that? There are probably five reasons why that is. The first reason is not one that we can really do anything about, which is, the euro has been successful, and companies can raise very large amounts of money in the euro. They can also raise very large amounts of money outside the United States, so they do not have to come here any more.

Chairman SHELBY. But the British do not have the euro.

Mr. THAIN. No, no, but they are accessing the European marketplace, and, of course, the British are raising it in sterling.

The concerns, the reasons why companies do not list here is, first, some of the concerns about how Section 404 of Sarbanes-Oxley is being implemented. Section 404, and having good internal controls is a very important thing. The way it was implemented really resulted in a substantial cost and duplication of effort in a way that international companies find the benefits are dramatically outweighed by the cost.

Second concern is the litigation environment in this country, and the lack of tort reform is a very significant problem for international companies. Now, frankly, it is a problem for U.S. companies as well. However, they cannot do anything about it other than lobby to get tort reform. International companies have a choice.

The third is, and this is particularly true for European companies, is there is a concern about the lack of accounting convergence. We are making progress, and the SEC and the FASB are working toward accounting convergence, but there is no question that European companies, who are just adopting the new international accounting standards, are much less willing to have duplicative U.S. GAAP financials. Particularly, as they get closer together, there is seemingly less difference.

Chairman SHELBY. If they get closer together, will that hopefully work out some of our problem, or are they deeper than that?

Mr. THAIN. No, no, it will solve one of the four problems, of which I have gotten to three.

The fourth problem is the competition between the various different enforcement bodies at the moment, between the enforcement agencies at the SEC, the enforcement agencies at various different States, particularly New York, and that competition for who can be the toughest cop is also a concern on the part of international companies.

Chairman SHELBY. Thank you.

Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

How important is the perception that our capital markets are honest, efficient, transparent, have integrity in the overall success of the workings of the system, as contrasted with a market that is very lax, and someone says, "We can go into that market. There are hardly any limitations on us, hardly any restrictions. Standards are low. No one inspects. There is no enforcement. We can have a free and easy ride in that market."

That is one model at one end. Then you come and people start raising all these problems. They say, "Your standards are too tough. You inspect, you really mean it," and so forth and so on. How important is the reputation for the integrity as far as the investor is concerned in the success of these markets? Mr. Glauber, anyone who wants to address that?

Mr. GLAUBER. I will start, but I am sure others have views. I think it is of absolutely crucial importance, and it is particularly true in our markets in the United States that depend much more heavily on retail investors than markets in other countries. Investors simply are not going to go to markets where they do not believe they are going to be taken care of properly and protected properly. As I say, I think that is even more important, retail investors.

As Mr. Thain now competes in a global marketplace, he has said, and he fully appreciates, having good, effective regulation is going to be at the heart of one of his competitive weapons. So, I think the answer is of utmost importance, and particularly, when retail investors are as important to a marketplace as they are in the United States.

Mr. HU. I completely agree with it. It is critically important, and it is particularly important for retail investors, but the integrity of the market, the trust in the market are core to what we offer to the world.

Chairman SHELBY. Mr. Lackritz.

Mr. LACKRITZ. Senator, I completely share those views, but I would just add that I think the entire success and global preeminence of our industry really rests on a bedrock of the public's trust and confidence in the marketplace and in the industry and in the integrity of what is going on. So it is absolutely critical. It is an asset without which we could not be successful.

Senator SARBANES. Ms. Yerger, you represent——

Ms. YERGER. I would just comment that the integrity of the market is not just a real concern for retail clients, but also institutional clients, and our members simply will not invest in markets where they do not feel they are adequately protected.

Chairman SHELBY. That would go to pensions too, would it not, Mr. Ferlauto?

Mr. FERLAUTO. Absolutely. But again, I want to emphasize the retail investment that has been done by our members is that they remain frightened. And they look at their 401(k) statements and others, and there still has not been a return of confidence in the markets. So that if you are concerned about the American investor, my members, and other average folk, confidence in regulation is key.

Senator SARBANES. Sorry, I had to leave the room, but Senator Schumer was making the point, you can have people who misbehave whatever the structure is, and I think that is a reasonable point. But the question becomes, what is the structure most likely to preclude the misbehavior, and in particular, you can have one structure, and if something goes wrong, then immediately people say, "It was not the right structure. That structure had in it an essential conflict of interest." Or you can have a structure that seems to address that question if something goes wrong, and then the focus is on the misbehavior of the individual, and the response is, "Well, no system is perfect, so if you have somebody who really wants to cheat and maneuver, you are going to face that, and that is what happened in the latter instance."

There is a difference between a situation in which the structure is open to the criticism as something goes wrong, and where the structure, to the extent you can do it, seems to take into account all of that, and then if something goes wrong, they say, “Well, we had errant behavior here, and this person is going to be punished,” and all the rest of it. I think that is one of the things we are trying to search for here.

As I understand it, listening to the testimony, I think, Mr. Thain, you are the only one at the panel who feels that the regulator of an exchange ought not to be separate from the business side. Is that correct? Let me ask the others. You feel there should be the separation, is that right?

Ms. YERGER. Correct.

Mr. FERLAUTO. Complete separation.

Mr. THAIN. With all due respect, I do not believe that is correct, because the panel has talked about the regulation of different pieces, and so I do not think this panel is recommending that the regulation of the marketplace itself be separated. I think that most of the conversation has been around the member firm examination, and we really have not talked much about the listed company surveillance.

Mr. GLAUBER. Senator Sarbanes, let me just add to what Mr. Thain has said. The focus of our discussions have been on what we call firm regulation, the regulation of the firms that use the exchange. Mr. Thain has made, on a number of occasions, arguments that this particular benefit in the surveillance of the activities on an exchange, to have that close to the exchange. It is a different set of issues, and I think the argument is stronger there for surveillance.

Senator SARBANES. Professor Hu.

Mr. HU. I want to point out that I have an open mind in terms of this separation, or the togetherness issue. I do want to mention one thing in connection with your perception point. I did not comment earlier. The New York Stock Exchange really is the crown jewel of capitalism. Because of that, we have to hold it to, in a sense, especially high standards because the new New York Stock Exchange I really do think is emblematic of basically our whole approach to how the economy should be run. In this particular instance, it is important to be purer than Caesar’s wife in this context, so that we have to take a special care in terms of watching out for conflicts and so forth because of this symbolic iconic role of the new New York Stock Exchange.

Mr. LACKRITZ. Senator, I guess I want to go back to the point Mr. Thain raised. Part of the reason that we came out with our support of a hybrid self-regulatory organization was the effort to separate member regulation from market surveillance and regulation, and we strongly believe that market surveillance and enforcement should be with the market themselves. They are close to the problem as was described before. They have proximity. They have experience. They have understanding, and it is much more effective to have that kind of hybrid, as we called it, organization, where you then remove member regulation into a separate body where you have one single set of rules, one set of interpretations, one set of examinations, and one organization.

Senator SARBANES. So on member regulation, other than Mr. Thain, everyone so far has taken the position that it should be independent, correct?

Mr. Ferlauto.

Mr. FERLAUTO. Just so long as there is a relationship in which a regulator's action can impact the profitability, we believe that there is a conflict, so there should be a separation there, obviously. I think we also may go a step beyond other members of this panel, is that we believe there have been inherent problems in modernizing the listing standards, and the structural problems there are such that we would recommend separation on those matters also.

Senator SARBANES. Ms. Yerger.

Ms. YERGER. I agree that there is benefits for proximity in the market surveillance issues, but in terms of regulating the member firms and listed companies, we believe that should be handled by a separate independent entity.

Senator SARBANES. Thank you very much, Mr. Chairman.

Chairman SHELBY. I have a few observations just from the meeting. We appreciate this. This is, I know a lot of preparation, as Senator Sarbanes said. And you have really prepared for this. You all know this subject. And we have tried to put together a cross-section. We have security industry representatives. We have labor representatives. We have academics. We have the SRO's and we have the pension funds, and we appreciate this very much.

We know it is complicated, and we know no model is perfect, as Professor Hu points out, among others.

We have also seen that there are conflicts and real potential conflicts in the SRO model. Some of these conflicts can be managed. They have to be. They are managed every day. Others are, I believe, fundamental, and perhaps they cannot be managed. I am not sure.

Because of such conflicts, it calls into question the basic integrity of our markets. Senator Sarbanes asked the question, what is the most important thing of the markets? It is integrity, trust, not just for retailers like me, but the pension people. People have to have trust above everything.

And so I think it is our responsibility to closely monitor this. These issues will be going forward, and we plan to work on this. We know the SEC is listening to this today, make no mistake about it. They will be up here, Chairman Cox, soon, and I am sure these questions will probably be asked, among others.

For all of you today, we appreciate your involvement. We appreciate your candid testimony, and we thank you very much.

The hearing is adjourned.

[Whereupon, at 11:52 a.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF JOHN A. THAIN

CHIEF EXECUTIVE OFFICER, NYSE GROUP, INC.

MARCH 9, 2006

Introduction

Chairman Shelby, Senator Sarbanes, and distinguished Members of the Committee, I am John Thain, Chief Executive Officer of the NYSE Group. I thank you for the opportunity to address issues raised regarding the current structure of securities industry self-regulation. Given the sweeping changes affecting our Nation's securities markets today, your examination of these issues could not be more timely. As many of the matters the Committee is examining are within the purview of NYSE Regulation, I want to state from the beginning that my comments reflect my perspective as the CEO of the NYSE Group, where I oversee the business of the Exchange, as opposed to the functioning of NYSE Regulation. That separate subsidiary is led by its own Chief Executive Officer, Rick Ketchum, who reports directly to the NYSE Regulation Board.

The U.S. Needs to Remain the Global Leader in Financial Services

We find ourselves at the center of sweeping changes: March 7, 2006 was a milestone in the 213-year history of the New York Stock Exchange. On that date, the Exchange became a publicly owned, for-profit company, the NYSE Group, and we began trading yesterday under the symbol NYX. In the days ahead, we will introduce new products, platforms, and strategies to modernize our business, increase our listings, serve our shareholders, and gain market share against formidable, global competitors.

The competition from other exchanges in Europe, Asia, and the United States, and our desire to keep not just the NYSE, but the United States markets ahead, is one of the primary drivers of the transformation we have undertaken at the NYSE. In an increasingly globalized world, foreign companies are avoiding the U.S. markets when they raise capital. A recent *Wall Street Journal* article provided some troubling statistics: In 2000, $9 out of every $10 raised by foreign companies through new stock offerings were done in the United States. But last year, the top 10 IPO's measured by global market capitalization were not registered in the U.S. markets. Indeed, 23 out of 25 of the largest IPO's in the world did not register in the United States. That is a major concern for U.S. markets.

A number of well-capitalized, Europe-based global exchanges are competing for the listing and trading of securities. The Deutsche Börse, Euronext, and London Stock Exchange are all well-capitalized, public, for-profit markets that offer broader product mixes, and they are positioned to compete aggressively to capture U.S. and global market share.

Our new structure will help us to compete with these markets and, we believe, help keep the capital formation and resulting job creation that is the lifeblood of the U.S. economy here in our own country, rather than fleeing to foreign markets.

As technology links domestic and international exchanges through instantaneous, electronic trading, transaction costs decline and investors are empowered. Investors today can send their orders to virtually any market to invest in a plethora of products at very low costs. This has raised the bar of competition for U.S. exchanges.

The New York Stock Exchange is responding comprehensively, by transforming our structure, modernizing our market, and adapting our strategy. Becoming a public company will enhance our ability to invest in technology and to offer new products that investors from around the world want to trade. We will also have a currency for acquisition, allowing us to play an active role globally in the next stages of consolidation in the exchange space.

We will modernize our market and provide customers more choices by expanding our portfolio of product offerings and categories. With the Archipelago merger, we have begun trading options. We are planning to expand significantly trading in the bonds of our listed companies, driving down spreads and enhancing investment opportunities for retail investors. We will expand our listings business through a second listings platform that will provide growing companies that today cannot meet the high financial listing standards of the NYSE with a new choice: To list with Archipelago and begin on a track toward an NYSE listing.

As we champion innovation and choices for customers, we will redouble efforts to provide investors the most reliable, cost-efficient, and competitive venue for trading our listed stocks. Specialists and floor brokers will continue to provide the best execution prices, best-quoted spreads among U.S. markets along with the deepest liquidity of any capital market in the world. These metrics of market quality translate into real savings. On February 9, 2006, we released the findings of a NYSE study that compared the market quality of 67 companies that transferred to the NYSE from Nasdaq from 2002 to 2005. The study showed that intraday volatility declined by 48 percent, average quoted spreads tightened by 46 percent, and execution costs to investors decreased by 38 percent on average for these companies after moving to the NYSE.

Capital is the lifeblood of American dynamism, innovation, productivity, and prosperity. The global competition for capital is a contest of paramount importance for our country's future. Nothing is written in stone that decrees American capital will stay here or that global capital will continue to come here. The competition we face to keep America at the center of global financial markets is becoming tougher by the day. We must succeed in the future through superior, competitive performance in our financial markets, and through sound, forward-looking public policies. And those are the driving forces behind the transaction that has led us to create the new NYSE Group.

SRO Regulation

As our markets are evolving, it is entirely appropriate, and, we think, necessary to examine the self-regulatory structure governing our financial markets.

In 2003, the NYSE faced a crisis like few it had ever known. The NYSE's governance structure was perceived to have broken down, its specialist firms were accused of self-dealing at the expense of customers, and public confidence in the NYSE reached historic lows. The NYSE, critics argued, could not effectively manage the conflicts of interest inherent in its structure. In swift reaction, however, the NYSE implemented—with SEC approval—sweeping changes to its governance structure. Among other things, the NYSE created a structure in which members of the Board of Directors were independent of the interests of the NYSE members whom they regulated. The new structure functionally separated market operations from regulation, assured the independence of regulatory decisionmaking, and installed a Chief Regulatory Officer (CRO)—Rick Ketchum, who reported directly to the Board of Directors through the Board's Regulatory Oversight Committee (ROC). The NYSE also separated the functions of Chief Executive Officer (CEO) and Chairman of the Board, installed new board members, including a new chairman, and hired a new CEO—me.

Based on over 2 years of experience, this structure has proven effective. The ROC played an active role in overseeing Rick's activities at NYSE Regulation ensuring that Regulation received both staff and technology resource increases, and in assuring its independence. Rick has been aggressive in the oversight of market and member firm activities and has been proactive by embracing a risk-based approach to regulation.

Under the new structure that was just approved by the SEC, we have sought to establish the NYSE Group as a model corporation guided by integrity and strict standards for transparency and accountability to our shareholders and the public. The new structure adheres to the principles that made our initial reforms 2 years ago effective—proximity with independence. Under our new structure, the independence of NYSE Regulation will be strengthened. While the market is now a for-profit entity, NYSE Regulation has become a separate, not-for-profit corporation. Members of the Board of NYSE Regulation will meet the independence standards of NYSE Group Board members, which precludes ties to member organizations and listed companies.

Most important, the NYSE Regulation Board will have a majority of directors who are unaffiliated with the NYSE Group. Their fiduciary obligation as directors will be to NYSE Regulation, undiluted by service on any other board within the NYSE Group.

Maintaining NYSE Regulation within the NYSE Group will Improve Regulatory Performance

A More Knowledgeable Regulator

While, as I mentioned earlier, NYSE Regulation is not part of my executive responsibilities, I am pleased to offer my views on the benefits of having a regulator that is proximate to the markets that I do run.

The rationale underlying self-regulation is straightforward: Regulators are in the best position to regulate when they are intimately knowledgeable about the activities they are regulating. Market regulators who are integrally tied to the regulated market know the conduct and activities that they should be examining when they engage in compliance reviews and surveillance. This knowledge also allows regulators to know when rule changes are needed to address systemic concerns.

Based on my experience here at the Exchange, as well as in my previous position with a large broker-dealer, I believe a regulator with a real-time understanding of how the marketplace is evolving in the face of competitive forces has a better chance of keeping ahead of the curve and being integrally involved in shaping marketplace evolution to ameliorate any regulatory concerns. That real-time understanding can be obtained most effectively when the regulator functions on a day-to-day basis alongside the market it is regulating.

Similarly, a regulator who is proximate to the market is more likely to devise the optimal solution to a regulatory challenge or problem—one that is cost-effective and minimizes regulatory interference with sensitive market mechanisms. Proximity also reduces the risk of misaligning the performance incentives of regulatory personnel, avoiding the "small town speed trap" syndrome of police officers writing speeding tickets to fund municipal services rather than deterring reckless driving.

Cooperative Regulatory Risk Assessment and Sensible Regulation

The coordination and communication that arises from affiliation also reduces the "us versus them" mentality that prevents cooperative regulatory risk assessment and management. Affiliation also creates a regulator with market sensitivity and a businessperson who understands regulation. Finally, the affiliation of a regulator with an exchange focuses accountability for the direct and indirect costs that regulatory activities impose on the market. Neither the effectiveness nor the efficiency of regulation becomes "someone else's problem."

Preventive Regulation to Deter Issues from Arising in the First Place

I also believe that proximity benefits the market participants being regulated. By taking early advice and input from the regulator, those being regulated can create a more effectively regulated environment by designing compliance and surveillance systems into their products and services.

A recent example of this is the NYSE's development of the NYSE Hybrid Market^{SM}. The NYSE designed the hybrid market to improve its competitiveness, achieve the efficiencies demanded by its customers and comply with Regulation NMS. We on the business side of the NYSE have benefited greatly by having Rick Ketchum and his team at the table. While we were designing our systems and building order types to meet the demands of the market, Rick was in a position to tell us whether NYSE Regulation would have the tools to properly regulate that platform. A "distant" regulator also could have vigorously regulated the hybrid market, but, by having NYSE Regulation involved in the development of the hybrid market from the outset, regulatory protections were designed into the platform.

NYSE Group's Structure will Protect the Independence of the Regulator

There is a Strong Market Incentive for NYSE to Maintain a Robust Regulator

We have heard the concern that self-regulation within a for-profit holding company structure that includes an affiliated market is problematic because the for-profit goals of a marketplace are in direct conflict with the regulatory duties of that marketplace. The premise underlying this argument is false. In order to attract listing and trading on their platforms, stock exchanges must run a fair, well-regulated marketplace, or risk losing business. Companies list on a trading venue in part to associate themselves with the branding that comes from meeting high standards in a regulated environment. In addition, broker-dealers send their order flow to a trading venue to seek access to liquidity in a fair and orderly marketplace. A trading scandal or a poorly regulated market undermines investor confidence and erodes business at a stock exchange. The reorganization of the NYSE in 2003 to separate the regulatory function from the marketplace and strengthen our regulator is a perfect example of the strong business incentives that are created by a perceived weakness in regulation. Accordingly, those of us running the business side of the Exchange have every incentive to ensure that the regulatory oversight of our listed companies, member organizations, and trading platforms is robust.

Conflicts are Inherent in Self-Regulation: The Corporate and Functional Separation of NYSE Regulation from the Market Guards Against Conflicts

No matter what model one chooses, self-regulation has inherent conflicts of interest. While we believe that our model sufficiently accounts for and addresses these conflicts, we acknowledge their existence and work to mitigate its potential for harm to the investor. Likewise, NASD and Nasdaq have inherent conflicts of interest because of their financial interrelationships and the fact that NASD has board members who would not meet standards of independence we have established for NYSE Regulation Board members. With the SEC's approval of Nasdaq's exchange application and the impending separation of NASD and Nasdaq, the NASD is moving closer to true independence, but there remain financial interrelationships that create conflicts regardless of corporate structure. These include large dollar contracts for the NASD to conduct regulatory activities for Nasdaq, the American Stock Exchange, and the International Stock Exchange as well as the proposed NASD Trade Reporting Facility, through which the NASD will provide a market it regulates, Nasdaq, with considerable revenues. Further, a key regulatory function, listing compliance, remains within Nasdaq as opposed to the NASD. We, however, moved this function to NYSE Regulation in July 2004 to ensure independent decisionmaking and remove potential conflicts of interest.

The question is not whether conflicts exist but rather how they are accounted for and controlled.

(Appendix A contains a more detailed description of the ways in which the NYSE Structure complies with the principles and proposed rules of Regulation SRO.) *

Independent Directors Represent a Majority of the NYSE Regulation Board of Directors

As noted above, the board governing NYSE Regulation is structured to ensure the independence of the regulator from the marketplace. Every director of NYSE Regulation, except for Rick, will be independent of broker-dealers, New York Stock Exchange-listed companies and management of NYSE Group. A majority of the directors of NYSE Regulation must be persons who are not directors of NYSE Group. These requirements insulate NYSE Regulation from the for-profit interests of NYSE Group and from the interests of the other entities and persons that NYSE Regulation regulates. The final form of this structure evolved out of the careful review conducted by the SEC before approving our merger rule filing.

NYSE Regulation has a separate compensation committee that will be appointed by the NYSE Regulation board of directors. A majority of the members of this compensation committee must be persons who are not directors of NYSE Group. NYSE Regulation will also have a separate nominating and governance committee. As with the compensation committee, a majority of the members of this nominating and governance committee must be persons who are not directors of NYSE Group.

Any disciplinary decision of the NYSE Regulation board of directors will be deemed to be final and is not subject to review or approval except by the SEC. In addition, with respect to the promulgation of rules and regulations, any proposed changes to them must be published in the *Federal Register* and will be subject to public comment and the SEC approval process. Moreover, the SEC oversees all of NYSE Regulation's regulatory responsibilities.

Finally, the Chief Executive Officer of NYSE Regulation will report solely to the NYSE Regulation board of directors and will not be an officer or director of NYSE Group. In addition, neither he nor any other NYSE Regulation employee will be permitted to own NYSE Group stock or options.

NYSE Regulation Board Members should not be Affiliated with Industry, in Order to Protect against Conflicts of Interest

Some have made arguments that broker-dealer members should be members of the Board of NYSE Regulation.

We disagree. The presence of member organization executives on the board of an entity charged with regulating those member organizations raises potential conflicts of interest that can interfere with effective regulation. The NYSE learned this lesson and, in 2003, restructured its board from a constituent assembly into a corporate-type board comprised of directors wholly independent from those that it regulates. Significantly, we work closely with key legal and compliance officials at our member firms to identify unnecessarily burdensome regulatory requirements. We believe that industry access without industry control appropriately manages the inherent conflicts of self-regulation.

Direct involvement of constituents in the selection of our independent directors is another matter. Through our Director Candidate Recommendation Committees, member organizations of New York Stock Exchange LLC select at least 20 percent, and no less than two, of the directors of the boards of the New York Stock Exchange LLC, NYSE Market, and NYSE Regulation. In addition, there is a formal director nomination petition process incorporated into our rules, as well as many informal ways in which our constituents can suggest director candidates.

This structure not only carries forward the NYSE's former governance structure, which required that each director of the NYSE be independent from constituents, but also complies with the SEC's proposed rules regarding fair representation of members in the governance of a registered exchange.

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* Held in Committee files.

No Particular NYSE Member Organization will have Undue Influence on NYSE Group or its Subsidiaries

Under the NYSE Group certificate of incorporation, there are limitations on the concentration of voting power and ownership of NYSE Group stock to ensure that no member organization or other stockholder will exert undue influence on the NYSE Group or its subsidiaries, including NYSE Regulation. Specifically, the certificate of incorporation requires that no person (either alone or together with its related persons) will be entitled to (1) vote more than 10 percent of the total number of votes entitled to be cast on any matter or (2) beneficially own shares of stock of NYSE Group representing in the aggregate more than 20 percent of the then outstanding votes entitled to be cast on any matter.

NYSE Regulation will be Independently and Fully Funded

New York Stock Exchange LLC and NYSE Market have entered into a contractual agreement with NYSE Regulation to provide funding to NYSE Regulation. The Pacific Exchange, now known as NYSE Arca, has entered into a similar services agreement with NYSE Regulation. NYSE Regulation will also collect regulatory fees from the members it regulates, and will collect fines from persons who are disciplined by NYSE Regulation for rule violations. Under the operating agreement of New York Stock Exchange LLC, New York Stock Exchange LLC will be prohibited from using any of these regulatory fees, fines or penalties for commercial purposes. Moreover, because NYSE Regulation is a New York not-for-profit corporation, NYSE Regulation may not distribute these fees and fines in the form of a distribution or dividend to New York Stock Exchange LLC.

NYSE Regulation is Working to Reduce Regulatory Duplication

Separate and apart from the issue of the independence of NYSE Regulation is the issue of regulatory duplication. NYSE Regulation has committed to take steps to address the issue of duplication and has taken numerous steps over the past 12 months to do so. These include: Developing a coordinated plan for examinations of firms with the NASD that divides responsibilities for each firm visited by regulators in a given year; coordinating with industry committees and organizations in response to major initiatives to harmonize interpretations and rulemaking; participating with other exchanges and markets in the Intermarket Financial Surveillance Group to share audit trail and coordinate financial monitoring; and coordinating on Enforcement actions to lessen duplicative efforts. That being said, while we recognize that these initiatives are a step in the right direction, we agree that there is more to be done.

In that regard, NYSE Regulation has pledged to the SEC that it will work to eliminate inconsistent rules, and to use its best efforts, in cooperation with the NASD, to submit to the Commission within 1 year, proposed rule changes, reconciling inconsistent rules and a report setting forth those rules that have not been reconciled. In addition, as Rick and I have both said publicly, we are committed to finding other ways to reduce regulatory duplication, including exploring the possibility of forming a joint venture with the NASD. This joint venture would leverage the talent, expertise and experience of two seasoned regulators giving both organizations substantially authority and control over the regulation of the broker/dealers in securities industry. We believe the efforts taken to date, as well as our willingness to work with the NASD in a joint venture, demonstrate our substantial commitment to working through this issue.

Conclusion

The corporate governance and trading scandals that led up to and followed Sarbanes-Oxley and other governance reforms hurt the reputation of the NYSE and other U.S. markets and hindered us in the competition for capital. We cannot afford to have ineffective governance or regulation going forward. Companies and investors need to trust U.S. governance standards and market regulation. We believe that our structure embodies the principles necessary to deliver on that goal.

We also need market regulation that is efficient. In order for the NYSE and other markets to compete globally, we need knowledgeable regulatory staff that is proximate to the market. They are in a better position to regulate in an efficient manner that does not unduly interrupt the workings of the market. We believe that our model accomplishes this goal as well.

Ultimately, the industry, markets and policy leaders all play a role in how competitive the United States remains. We believe that the new NYSE Group with its new governance structure is properly positioned to do its part alongside all of you to fight to preserve the preeminence of the U.S. markets in this global race.

I thank the Chairman and the Committee for the opportunity to testify.

PREPARED STATEMENT OF ROBERT GLAUBER

CHAIRMAN AND CEO, NATIONAL ASSOCIATION OF SECURITIES DEALERS

MARCH 9, 2006

Mr. Chairman and Members of the Committee: NASD is grateful for the invitation to testify regarding self-regulation in the securities industry. NASD commends the Committee's efforts in reviewing the self-regulatory system. As a regulatory organization devoted to investor protection and market integrity, NASD welcomes the Committee's focus on possible enhancements to the current regulatory system that could strengthen its operation and efficacy. As Congress considers the self-regulatory structure, we hope that insights derived from NASD's recent experiences may provide some helpful background.

NASD Experience

Founded in 1936, NASD is the world's preeminent private-sector securities regulator. In 1939, the Securities and Exchange Commission (SEC) approved NASD's registration as a national securities association under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934. We regulate every broker-dealer in the United States that conducts a securities business with the public—about 5,100 securities firms that operate more than 108,000 branch offices and employ about 664,000 registered representatives. We are the only private-sector regulator with industry-wide scope.

Our rules regulate every aspect of the brokerage business. Our market integrity and investor protection responsibilities include rule writing, compliance examinations, enforcement, professional training, licensing and registration, dispute resolution, and investor education. NASD examines broker-dealers for compliance with NASD rules, MSRB rules, and the Federal securities laws, and we discipline those who fail to comply. Last year, NASD filed 1,399 new enforcement actions and barred or suspended 740 individuals from the securities industry. NASD has a nationwide staff of more than 2,400 with an operating budget of more than $530 million and is overseen by a Board of Governors, more than half of whom are not in the securities industry.

During the last 5 years, NASD has been in the process of separating from the Nasdaq Stock Market, which in January of this year won SEC approval to become a national securities exchange. Nasdaq is now on an independent course under its own management and Board of Governors. NASD still monitors all trading on Nasdaq pursuant to a regulatory services agreement.

NASD also divested itself of the American Stock Exchange 15 months ago by selling it back to the AMEX membership. As with Nasdaq, NASD continues to monitor all activity on the AMEX pursuant to a regulatory services agreement.

When Nasdaq decided to become for-profit, shareholder-owned, and publicly traded, the conflicts confronting NASD as a regulator increased significantly. The challenge for NASD was to create a corporate structure that would assure the public that commercial, financial, and stock price considerations did not taint regulatory decisions. We chose complete structural separation between the Nasdaq Exchange and regulation—regulation in a completely separate self-regulatory organization (SRO), two separate managements, two separate, nonoverlapping boards, two separate balance sheets. This structural separation has allowed NASD to realign as a private-sector regulator with an exclusive focus on regulating the broker-dealer industry and, by contract, exchanges and markets.

Today, the New York Stock Exchange (NYSE) finds itself in a similar position with its merger with Archipelago and its conversion to a public company. To deal with these new conflicts, the NYSE has chosen to place regulation inside the shareholder-owned, for-profit holding company and to wall it off as a separate subsidiary with a different governance structure. Whether this approach provides the requisite assurance to the public that regulation will always be performed to protect them, not the shareholders, has been the subject of a great deal of healthy and needed debate in our industry. Interestingly, among competing for-profit exchanges in this country the NYSE proposes to be the only one that will have comprehensive regulatory authority over the firms that are or would be its customers.

Last year, the SEC published a concept release examining the current SRO system and sought public comment on a range of issues, including: (1) the inherent conflicts of interest between an SRO's regulatory obligations and the interests of its members, its market operations, its listed issuers and, in the case of a demutualized SRO, its shareholders; (2) the costs and inefficiencies of the multiple SRO model; (3) the challenges of surveillance across markets by multiple SRO's; and (4) how SRO's generate revenue and fund regulatory operations. The SEC also is examining and seeking comment on certain enhancements to the current SRO system and a number of regulatory approaches and legislative initiatives.

The SEC stated that the most controversial aspect of the current SRO system is the inherent conflicts of interest between an SRO's regulatory functions and its members, market operations, listed issuers and shareholders. Conflicts can result in poorly targeted and less extensive SRO rulemaking, and weak enforcement of SRO rules.

As we told the SEC in our response, one glaring inefficiency in today's regulatory scheme is the dual regulation of firms that are members of both the NYSE and NASD. Currently, these approximately 200 firms are faced with dual rulebooks; dual examinations, interpretations and enforcement; and dual fees. And, following the NYSE's current restructuring, the number of dually regulated firms may increase substantially, because NYSE has chosen to require that each firm that desires a trading license must submit not only to market, but also full member, regulation by the NYSE.

A solution that makes sense is a partnership between the NYSE and NASD to jointly handle the regulation of the firms that are members of both organizations. Under such a partnership, firms would be regulated according to one rulebook instead of two. They would pay one regulator instead of two, and they would have only one examination and enforcement staff to deal with, lowering their compliance costs. These savings could then be passed on to investors, while the regulation of these firms would be more coherent, effective, and efficient.

This structure is very much in line with the hybrid SRO proposal that the SIA put forward a few years ago and has recently reiterated.

It is no secret that John Thain and I have had discussions about how a partnership between our two organizations could work. While it is too soon to know where these discussions will lead, my hope is that our two organizations can find a way to create a structure that best serves investors and solves some of these vexing problems.

To best protect the interest of investors, any new structure would have to solve the conflict inherent in both regulating and managing a for-profit exchange. The regulator will have rule writing and enforcement authority for sales practices, financial operations, and transaction routing decisions. Thus, absent complete separation of a for-profit exchange and regulation of member conduct, there is the unavoidable inherent conflict that regulation of member conduct may be influenced by the commercial, financial, and stock price impact of such regulation on the affiliated exchange.

That is the guiding principle for NASD as we move forward in any discussion about SRO consolidation. NASD has put forth to the NYSE several proposals concerning a possible partnership, but we cannot agree to any structure that would result in a loss of independence over rule writing, as well as examination, investigation, and enforcement. As stated earlier, NASD has worked diligently for the last 5 years to become an independent, unconflicted regulator that does not own or control markets. Any integrated structure with the NYSE must not cause us to give up that independence. That means NASD cannot give the NYSE control over our rulemaking, interpretation function and examination decisions through a veto or any other mechanism.

A little history is important at this point. At the inception of the securities laws, Congress was deliberate in its design of a statutory scheme of self-regulation. It was recognized that it was impractical for government to provide the necessary resources to effectively regulate the securities industry and there was a legislative preference that the industry, as opposed to greater taxpayer-funded appropriations, pay for the task of necessary and increasingly extensive regulation. Congress understood that conflicts could arise in such a system of regulation, but, as the SEC's 1963 Special Study of Securities Markets noted in reflecting the intent of Congress in words and scheme, "regulation in the area of securities should, in short, be a cooperative effort, with the Government fostering maximum self-regulatory responsibility, overseeing its exercise, and standing ready to regulate directly where and as the circumstances require."

But the views of Congress were fashioned at a time when all self-regulatory bodies were not-for-profit, member-owned institutions, with a manageable degree of conflicts. The relatively recent advent of demutualized, shareholder-owned markets has significantly increased the degree of conflict by potentially putting at odds the interests of shareholders in maximizing profits with the interests of market participants in operating fair and orderly markets. This significantly increased conflict arising from the marriage of regulation and for-profit markets is unavoidable; it is a matter of corporate structure even if it is not fueled by intent. In short, the commercial for-profit mandates of these SRO's threaten to belie that "cooperative effort" between government and self-regulation, noted in the SEC's 1963 Special Study, when it comes to regulating member conduct. It is the recognition of this conflict that has led all major European exchanges, which have lead the way in converting to for-profit, shareholder-owned structures, to give up the regulation of the financial institutions that trade on their exchanges. Similarly, it is both the recognition of conflict and an effective response that are critical to ensuring the long-term integrity of the U.S. capital markets in international finance.

NASD is in a unique position among U.S. securities SRO's. NASD has separated its regulatory operations from any interest in an exchange. NASD has fully divested itself of the American Stock Exchange, Inc., and with the SEC's recent approval of Nasdaq's application to become a registered national securities exchange, will complete the process of selling its remaining financial interest in Nasdaq before the end of the year.

We also have taken effective actions to address member conflict issues, implementing rigorous corporate structure changes to prevent undue influence of regulated firms over boards, key committees and staff. These actions reflect both structural and procedural changes to many of the core aspects of NASD operations and address the very conflicts of concern identified by the SEC in its review of self-regulation. With respect to funding, as noted earlier, virtually all broker-dealers are required to be NASD members. We have the authority to assess our members, as necessary, to fund our regulatory operations, and they cannot resign membership unless they give up doing securities business with the public. We do not face the same types of competitive pressures as other SRO's to retain their members. NASD has members subject to regulation, not customers.

For these reasons, any partnership with the NYSE, and any resulting SRO structure, must preserve these attributes of independence in the SRO exercise of the regulatory mandate.

Rule Harmonization

In its February 7, 2006, response to comments filed with the SEC regarding its Archipelago merger, the NYSE suggests that rule harmonization with NASD will effectively address the conflicts between its for-profit exchange and its member regulatory function. But NASD believes harmonized rules amount to a topical treatment of some—but not all—symptoms of a more serious problem.

There are several reasons why harmonization of rules is a less-than-ideal substitute for the hybrid model of self-regulation. First, harmonization does not resolve the inescapable conflict where an SRO both operates a trading market and regulates that market's participants, which in some instances may be competitors of that market. Under the hybrid model of self-regulation, the SRO responsible for member regulation would have no incentive to promulgate rules that either drive business to a particular market center or otherwise protect the SRO's commercial interests; the NYSE model is unavoidably embedded with these conflicts because of its shareholder-owned, publicly held, for-profit structure, and the answer does not lie in making the rulebooks of a conflicted SRO and a nonconflicted SRO look alike.

Second, while harmonization would result in substantially similar rulebooks, it would not eliminate all duplicative costs and efforts associated with having two organizations, rather than one, write, administer, and enforce those rules. Third, harmonization at the level of the SRO rulebook will inevitably not be sustainable as divergence will necessarily occur at the level of interpretation, examination, and enforcement. Common sense dictates that more effective, efficient, and evenhanded rules would result from a single rulemaking entity than from an arranged marriage of two distinct entities with differing institutional histories.

Benefits of Self-Regulation

Clearly, in light of developments at the SRO's, it is appropriate to consider the future of the self-regulatory model. The evolving model of securities regulation has proven effective through nearly 70 years of regulatory experience. Both Congress and the SEC have periodically examined the role of self-regulation in the securities industry, and while each has taken steps when needed to remedy shortcomings, the concept of self-regulation has been repeatedly reaffirmed and strengthened.

The self-regulatory model has many important benefits to investors and the markets. Self-regulation can and does extend past enforcing just legal standards to adopting and enforcing ethical standards (that is, just and equitable principles of trade). Government regulation is well-suited for policing civil or criminal offenses, but less so for ethical lapses, which, while not necessarily illegal, may be unfair or hinder the functioning of a free and open market. Self-regulation is uniquely capable of protecting investors from those sorts of transgressions.

Private funding is another critical advantage to the self-regulatory model. Millions of dollars can be spent by SRO's on examination, enforcement, surveillance, and technology at no cost to the U.S. Treasury. In a self-regulatory system, the industry—not the taxpayers—pays for regulation by NASD. Regulators operating in the private sector are also better positioned to move quickly to address regulatory issues because, among other things, they are not subject to spending restrictions of the Federal Government, and are better able to develop large-scale systems for regulatory matters like market surveillance, broker registration, and trade reporting.

Moreover, private-sector regulators are able to tap industry expertise in ways not readily available to the government and to use this expertise to better protect investors and ensure market integrity. Among other things, this expertise helps to make certain that rules are practical, workable, and effective. Also, industry participants often are in the best position to identify potential problems, thus enabling regulators to stay ahead of the curve.

Need for Separation of Market and Regulator

This is not to say that self-regulation is free from conflicts. NASD's evolution into its current corporate structure and separation from Nasdaq illustrates the conflicts that exist when an entity both owns and regulates a market, and how NASD resolved those conflicts.

In the mid-1990's, NASD faced a conflict that fundamentally altered its existence. The SEC found NASD to be negligent in how it regulated its member firms and their trading on Nasdaq. This finding called into question NASD's corporate structure and whether it was appropriate for managing both the regulation of more than 5,000 firms and their half-million securities professionals, and the operation of a trillion-dollar securities market with its own myriad purposes.

In November 1994, the NASD Board of Governors appointed an independent committee to review NASD's corporate governance structure and recommend changes that would enable NASD to better meet its regulatory and business obligations, including oversight of the Nasdaq Stock Market. In September 1995, the committee recommended the establishment of two distinct subsidiaries: One to perform NASD's regulatory functions and the other to run Nasdaq. The committee recommended that each subsidiary have a separate Board of Directors and that NASD remain as the nonprofit parent corporation overseeing the operations of both subsidiaries.

Based on those recommendations, NASD formed two subsidiaries—NASD Regulation and Nasdaq. And, just as importantly, NASD implemented a new corporate governance structure that ensured a majority of NASD's Board of Governors would be from outside the securities industry. In 2000, NASD created another subsidiary for its mediation and arbitration functions, NASD Dispute Resolution.

In 2000, when Nasdaq decided to become a shareholder-owned, publicly traded exchange, NASD determined that the existing structure that placed regulatory activities in a subsidiary no longer afforded sufficient protection for investors. Operating an exchange to maximize profits for shareholders and simultaneously managing regulatory activities to fully protect investors could not be conducted under the same corporate structure without unmanageable conflicts, in our view. We therefore restructured Nasdaq and NASD as two wholly separate companies with separate managements, separate funding sources and separate, nonoverlapping boards. The governance separation is complete; economic separation is near completion with the recent action by the SEC to designate Nasdaq an exchange and the sale of NASD's remaining minority share ownership in Nasdaq, which we are committed to doing by the end of this year.

Conclusion

Thank you for giving us the opportunity to testify on this important topic and for your timely review of the securities industry's self-regulatory structure. NASD looks forward to working with Congress as it continues to review the changing regulatory landscape.

PREPARED STATEMENT OF HENRY T.C. HU

ALLAN SHIVERS CHAIR IN THE LAW OF BANKING AND FINANCE
UNIVERSITY OF TEXAS SCHOOL OF LAW

MARCH 9, 2006

Introduction

Mr. Chairman, Senator Sarbanes, and Members of the Committee, thank you for inviting me. My name is Henry Hu and I hold the Allan Shivers Chair in the Law of Banking and Finance at the University of Texas Law School. My testimony today reflects preliminary personal views and does not represent the views of my employer or any other entity. In the interests of disclosure, I had served without compensation on the Legal Advisory Board of the National Association of Securities Dealers.[1]

While the topic of today's hearing opens the door to a number of important issues, I would like to focus on the delicate questions raised by the relationship between NYSE Regulation and NYSE Group. In the new environment in which the New York Stock Exchange (the Exchange) operates on a for-profit basis, I am especially concerned by the issue of "togetherness"—the structural and institutional bonds that link NYSE Regulation and NYSE Group—and the potentially troubling implications for regulation.[2] Ironically, the Exchange has long been the symbol of American capitalism, notwithstanding its nonprofit status. Now, as the Exchange is itself joining the capitalist parade, it holds a nonprofit entity close to its heart.

This is a curious structure, one where ends and means do not quite seem to line up. From the standpoint of first principles, it is extremely difficult to ensure that an organization actually pursues the objectives the organization is supposed to pursue. As Members of Congress, you are well aware that bureaucracies often take on a life of their own—developing their own agendas and pursuing their own interests. Simply setting out the formal ends of an organization is not enough. Experience demonstrates that carefully conceived legal and other mechanisms are essential. An expectation that the newly configured Exchange can both fully pursue its regulatory ends at the same time as it fully pursues its shareholder wealth-maximization ends may represent the triumph of hope over experience.

I would like to emphasize that my concerns pertain to issues inherent in structural design and do not reflect on the capabilities of particular individuals. John Thain and Rick Ketchum are exceptional managers who have risen to extraordinary challenges. But, unfortunately, structures cannot be designed on the assumption that exceptional individuals will always be in place.

"Simple" Ends and Sophisticated Legal and Market-Driven Means: The Publicly Held Corporation

Even when relatively "simple" ends are involved, ensuring that an organization follows those ends is a difficult task. Elaborate legal and market-driven means are necessary, and they sometimes do not work. We need look no further than the publicly held corporation.

The theme of means and ends has dominated thinking about governance of publicly held corporations since the 1930's. In the classic Berle-Means framework, managers hold few shares but exercise substantial control over their firms. Although shareholders own the company, they face collective action problems in effectively overseeing corporate managers. Modern corporate governance has largely revolved around one question: What mechanisms will lead managers to act in the interest of shareholders, that is, to act in accordance with the formal ends of the corporation?

So, in terms of legal means, we have state substantive law (for example, fiduciary duties such as the duty of loyalty owed by managers to shareholders) as well as Federal disclosure requirements (for example, proxy statements and annual reports). In

[1] I am on NASD's e-Brokerage Committee and anticipate being on NASD's Market Regulation Committee.

[2] I largely leave aside the related issue of regulatory duplication caused by the overlapping jurisdictions of the NYSE and the NASD. Among other things, the NYSE has represented to the SEC that it has undertaken to work with the NASD and industry representatives to eliminate inconsistent rules and duplicative examinations and to submit proposed rule changes within 1 year. *See* Securities and Exchange Commission, *Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Granting Approval of Proposed Rule Change and Amendment Nos. 1, 3, and 5 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 6 and 8 Relating to the NY Business Combination with Archipelago Holdings, Inc.,* Release No. 34–53382, 2006 SEC LEXIS 457, at 11–12 (Feb. 27, 2006) [hereinafter *February 27 SEC Order*].

terms of market means, we have institutional investor activism and the pervasive threat of corporate takeovers to discipline wayward managers.

This highly sophisticated system has evolved over many decades, with the benefit of both hard experience and new learning. Yet, in the cases of Enron, WorldCom, and other corporate debacles still fresh in our minds, all of the legal and market mechanisms—all four engines on the airplane—failed simultaneously. The scandals remind us of the difficulty of ensuring that corporate managers behave in a manner consistent with even "simple" ends. Today, our system for the governance of the publicly held corporation, although the best in the world, is still a work in progress.

"Complex" Ends and Simple Means: NYSE Regulation-NYSE Group

Turning to the new corporate structure of the New York Stock Exchange, our previous example of the typical corporation with a relatively one-dimensional objective—serving shareholder interests—becomes far more complex. Here, the ends diverge along different paths: Shareholder wealth maximization at the level of the holding company, but the fulfillment of regulatory responsibilities at the level of a wholly owned subsidiary. The governance question Congress and the Securities and Exchange Commission must consider revolves around this question: Are the legal and other mechanisms equal to the task of ensuring adherence to these complex ends?

The New NYSE Structure: The Ends

With this week's anticipated merger,[3] the businesses of the Exchange and Archipelago Holdings are now held under a single, publicly traded holding company: The NYSE Group. The Exchange's current businesses and assets are held in three separate entities: New York Stock Exchange LLC (NYSE LLC), NYSE Market, and NYSE Regulation. NYSE LLC will be a direct, wholly owned subsidiary of NYSE Group and is expected to hold all of the equity interests of NYSE Market and NYSE Regulation. The essential trading and regulatory activities which we had associated with the traditional Exchange will be operated, under the new system, by these latter two subsidiaries pursuant to two contracts. NYSE LLC is delegating the exchange business to NYSE Market under one contract. And, more importantly for our purposes, NYSE LLC is delegating certain of the regulatory functions to NYSE Regulation. NYSE Regulation is organized as a nonprofit corporation under New York law and, as noted, is a wholly owned subsidiary of NYSE LLC, which in turn, is a wholly owned subsidiary of the NYSE Group.

The ends with respect to the new structure are more complex than with the usual publicly held corporation. The proper ends of the NYSE Regulation are to further most of the traditional regulatory functions of the Exchange: To engage in market surveillance, to regulate market firms, and to ensure that listed companies comply with Exchange rules.[4] The proper ends of NYSE Group center on maximizing the wealth of its shareholders. In certain circumstances, conflicts will arise between NYSE Regulation's regulatory goals and NYSE Group's shareholder wealth-maximization goals. In such circumstances, in theory, NYSE Regulation's regulatory mission is to trump the interests of the parent company's shareholders.

NYSE Regulation: The Means

A variety of means are used to try to ensure that NYSE Regulation adheres to its regulatory mission. Some of the key steps are:

(1) NYSE Regulation CEO and Board[5]

(a) The CEO of NYSE Regulation will report solely to NYSE Regulation's board. The CEO will be a member of this board and may not be an officer or employee of any unit of NYSE Group other than NYSE Regulation.

(b) NYSE LLC will choose NYSE Regulation directors, subject to the following constraints:

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[3] I am assuming the system as approved in the February 27 SEC Order and leave aside transitional provisions. Exhibits 5A through 5K of Amendment No. 8 to the proposed rule change relating to NYSE's business combination with Archipelago Holdings setting forth the text of the NYSE rules and the governing documents, as proposed to be amended, are available at *http://www.sec.gov/rules/sro.shtml* [hereinafter *SEC-Approved NYSE Documents*].

[4] *See* Certificate of Incorporation of NYSE Regulation, Inc., reproduced at *SEC-Approved NYSE Documents, supra* note 3, at Article II (specifying the formal purposes of NYSE Regulation) [hereinafter *NYSE Regulation Certificate of Incorporation*].

[5] *See* Amended and Restated Bylaws of NYSE Regulation, Inc., reproduced at *SEC-Approved NYSE Documents, supra* note 3, at Article III (specifying directors and board committees) [hereinafter *NYSE Regulation Bylaws*]; *February 27 SEC Order, supra* note 2; Securities and Exchange Commission, *Approval of SRO Rule Changes Necessary to Effectuate Merger of NYSE and Archipelago Holdings,* Feb. 27, 2006 (press release: 2006–29).

(i) All directors on the board of NYSE Regulation (other than its CEO) are required to be "independent" as to NYSE Group under NYSE Group guidelines (that is, independent from management, listed companies, and member organizations). Thus certain NYSE Group directors can serve as directors of NYSE Regulation.
(ii) A majority of the directors of NYSE Regulation will be persons who are not NYSE Group directors. These "Non-Affiliated Regulation Directors" are nominated by the "Nominating and Governance Committee," a committee consisting solely of NYSE Regulation directors.
(iii) 20 percent, and not less than two of the NYSE Regulation directors will be chosen by members of NYSE LLC. These "Regulation Fair Representation Directors" are recommended by the "Director Candidate Recommendation Committee" (DCRC), a committee that is appointed by the NYSE Regulation board but does not consist of NYSE Regulation directors.
(iv) The Nominating and Governance Committee will nominate at least one director candidate to represent issuers and one director candidate to represent investors, according to a representation by the Exchange to the SEC.

(2) Committees of the Board and Committees Appointed by the Board
(a) The NYSE Regulation board's "Compensation Committee" shall be responsible for setting the compensation for NYSE Regulation employees. Directors of the NYSE Group shall constitute a minority of the committee.
(b) Directors of the NYSE Group shall constitute a minority of the NYSE Regulation board's Nominating and Governance Committee. Members of the DCRC appointed by the NYSE Regulation board do not have to meet any independence requirements. Indeed, this latter committee must include specified numbers of individuals drawn from various NYSE Market members.
(c) The NYSE Regulation board will appoint a "Committee for Review" that will be comprised of any NYSE Regulation board member other than the CEO as well as persons who are not directors. A majority of the members voting on a matter must be NYSE Regulation directors. The other members will include representatives of members of NYSE LLC, specialists, and floor brokers. This committee will, among other things, review disciplinary decisions on behalf of the NYSE Regulation board.
(d) The Exchange has represented that it is expected that the audit committee of the NYSE Group board will perform the NYSE Regulation board's audit committee functions.

(3) NYSE Regulation Finances [6]
(a) NYSE LLC has delegated to NYSE Regulation the authority to assess NYSE LLC members in order to cover the costs of regulation. Subject to SEC approval, NYSE Regulation will determine, assess, collect, and retain examination, registration, arbitration, and other regulatory fees.
(b) NYSE Regulation will also receive funding independently from the markets for which it will provide regulatory services. For instance, the Exchange has represented that there will be an explicit agreement among NYSE Group, NYSE LLC, NYSE Market, and NYSE Regulation to provide "adequate funding" to NYSE Regulation.
(c) NYSE Regulation establishes and assesses fees and other charges on NYSE LLC members and others using the services or facilities of NYSE Regulation.
(d) NYSE LLC will not be permitted to use any assets of or regulatory fees, fines, or penalties collected by NYSE Regulation for commercial purposes or distribute them to any other NYSE Group-related entity.
(e) NYSE Regulation determines its annual budget and the allocation of its resources.

(4) Promises of Non-Interference [7] and Delegation of Responsibility [8]
(a) A variety of provisions in the NYSE Group's certificate of incorporation and bylaws seek to preclude the NYSE Group from interfering with the

[6] *See February 27 SEC Order, supra* note 2, at 128–32; Delegation Agreement (among NYSE LLC, NYSE Regulation, and NYSE Market), reproduced at *SEC-Approved NYSE Documents, supra* note 3, at II(A)(14)–(17) [hereinafter *NYSE LLC Delegation Agreement*].
[7] *See, for example,* Amended and Restated Certificate of Incorporation of NYSE Group, Inc., reproduced at *SEC-Approved NYSE Documents, supra* note 3, at Articles VI (Section 8), XI, XII, and XIII [hereinafter *NYSE Group Certificate of Incorporation*].
[8] *See NYSE LLC Delegation Agreement, supra* note 6.

self-regulatory obligations of NYSE LLC, NYSE Market, and NYSE Regulation. By way of example, NYSE Group board members must "to the fullest extent permitted by applicable law" take into consideration the effect that the NYSE Group's actions would have on the ability of such regulated subsidiaries to carry out their responsibilities under the Securities Exchange Act of 1934.

(b) Certain regulatory responsibilities are delegated to NYSE Regulation. With exceptions, NYSE LLC delegates to NYSE Regulation the responsibility to establish and administer rules relating to the business of exchange members and enforce rules relating to trading on the NYSE Market and in NYSE-listed securities by member firms. A decision upon appeal to the NYSE Regulation board of disciplinary matters shall be the final action of NYSE LLC.

(c) The exceptions just referred to are not insignificant. Apart from NYSE Regulation disciplinary decisions, the NYSE LLC board can review, approve, or reject the actions of NYSE Regulation. In addition, NYSE LLC has the right to, among other things, resolve any disputes between NYSE Regulation and NYSE Market and coordinate actions of NYSE Regulation and NYSE Market "as necessary."

A Preliminary Evaluation

On the surface, the legal protections created by the Exchange to avoid conflicts and to protect the integrity of its dual functions appear robust. But a closer examination suggests that the legal means and market-based incentives in place may prove inadequate.

Legal Means: The "Minority of Directors" Theme

With regard to the legal framework, a fundamental assumption of the new governance structure is the notion that NYSE Regulation's independence will be preserved by limiting the participation of NYSE Group's insiders and directors on NYSE Regulation's board. The basic argument is that because "only a minority of directors" on NYSE Regulation's board and various committees will come from NYSE Group, the truly independent NYSE Regulation directors are in full control and completely directed to proper regulatory ends.

I am not fully persuaded by this "minority of directors" argument. A minority position does not automatically equate to minor influence. For example, let us say that the Chairman of the NYSE Group happens to be one of the members of NYSE Regulation's board. He would be the 800 pound gorilla in the room. His influence will inevitably far exceed his voting power as an individual board member.

Moreover, board meetings generally operate through consensus, not by actual contested voting. Thus, the fact that NYSE Group directors constitute a minority of NYSE Regulation's board does not render them powerless over important regulatory decisions. And the reality is that many corporate boards operate with a certain element of structural bias—a "go along to get along" mentality. Such bias, inherent in the governance of almost all publicly held corporations, may reduce the incentive for NYSE Regulation's independent directors to aggressively pursue regulatory matters that threaten the financial interests of their corporate parent.

Finally, apart from a possible fixed fee for attendance at each meeting, NYSE Regulation's bylaws prevent board members from being paid for their directorial services. This fact further reduces the likelihood that NYSE Regulation's independent directors will be willing to fully engage with those directors with the luster and prestige of being on the parent company's board.

Legal Means: The Relationship between NYSE LLC and NYSE Regulation

Another structural concern that warrants the Committee's attention is the relationship between NYSE LLC and NYSE Regulation. NYSE LLC is a wholly owned subsidiary of the NYSE Group and a vital element in the NYSE Group's efforts at shareholder wealth maximization. Although NYSE LLC lacks authority over NYSE Regulation's individual disciplinary actions and there is SEC oversight, NYSE LLC does have authority over general rules and other actions undertaken by the regulatory arm. These general rules will guide future activity by NYSE Regulation—including future disciplinary actions. NYSE LLC has explicitly retained the right to, among other things, resolve any disputes between NYSE Regulation and NYSE Market. The bottom line is that, other than as to individual disciplinary matters, NYSE LLC has extensive authority with respect to the behavior of NYSE Regulation.

Market Incentives

The above discussion has focused on "legalisms" and formal governance issues. As important is another question which is often overlooked—to what extent will reform of the New York Stock Exchange alter incentives and other market mechanisms that play a crucial role in our system of self-regulation. In the American model of corporate governance, incentives and related mechanisms are terribly important.

When properly designed, executive compensation packages can help to properly align the interests of managers with those of shareholders. Too often, we have seen compensation packages that instead create perverse incentives for managers, the detriment of shareholders as well as the public alike.

In the case of NYSE Regulation, compensation will be set by its board. But as discussed above, the board remains susceptible to NYSE Group's influence. In addition, because of likely differences in NYSE Group and NYSE Regulation compensation, the prospect of an alternative career path at the for-profit parent level may be attractive to those at NYSE Regulation. This may reduce incentives on the part of those at NYSE Regulation to take actions inconsistent with the goals of the NYSE Group.

Another matter of concern is the agreement that provides for "adequate funding" of NYSE Regulation. Who determines what is adequate? On what basis is "adequate" determined? How often is this determination reviewed and revised? Will NYSE Regulation's actions be influenced by the possible leverage over funding that NYSE LLC and NYSE Market may have?

Furthermore, NYSE Regulation provides regulatory services pursuant to contract with a limited term. There are no answers as of yet as to what happens when this contract terminates—and how this knowledge of an impending change would influence NYSE Regulation decisions. Has the Exchange fully considered what happens in the inevitable "end-game"? This is the Hong Kong-in-1999 issue.

NYSE Group Directors on the NYSE Regulation Board

The possible conflict between NYSE Group shareholder wealth-maximization goals and NYSE Regulation regulatory goals is brought into sharpest relief when looking at the duties of the NYSE Group directors who serve on the NYSE Regulation board. As a matter of corporate law, each such director has a divided allegiance. As an NYSE Group director, he owes a duty of loyalty to NYSE Group shareholders; thus, he must generally undertake decisions that would further the interests of the shareholders. As an NYSE Regulation director, he owes a duty to further the regulatory goals of NYSE Regulation. Can he serve two masters, especially when the two masters' goals differ in their very nature?

In the normal corporate law context, one situation in which corporations with common directors transact business with each other is where one corporation is the controlling shareholder of another corporation. To what extent will common directors participate in intercorporate dealings when there are real or apparent conflicts? If they do participate, to what extent should the dealings be voidable or subject to special scrutiny? Given that the case law with respect to common directors and the obligations of controlling shareholders do not provide clear guidance, the actual behavior of such NYSE Group directors may be especially difficult to predict. Moreover, because of the special public responsibilities of the Exchange and the importance of public confidence, the mere appearance of self-interested behavior is troublesome.

Conclusion

In conclusion, SEC Chairman Christopher Cox has stated that he intends to closely monitor the NYSE's performance under the new structure. This is commendable. It is also vital.

The not-for-profit NYSE Regulation within the for-profit NYSE Group structure is an experimental structure. It is one that is far more complicated than that of the usual publicly held corporation. The ends involved here cannot, as with the usual publicly held corporation, be essentially reduced to the single end of shareholder wealth maximization. Yet, ironically, the legal and market mechanisms in place here seem far more primitive than those operating in the publicly held corporation context. I worry whether, in fact, the mechanisms here are sufficient to ensure adherence to the stated goals.

But just because there are possible problems with this NYSE approach does not mean necessarily mean that some full or partial alternative is better overall—whether that alternative is a spun-off NYSE Regulation, a joint venture with the NASD, or something else. An apples for apples comparison is necessary. After all, even traditional not-for-profit self-regulatory organizations are hardly free from conflicts of interest. Far from it. But one advantage to a more traditional SRO is that we have experience. Moreover, the goals of such an SRO are simpler and do not get so intertwined with the goal of shareholder wealth maximization. Coming up with tolerably good organizational structures may be easier as a result. On the other hand, there are many benefits to the togetherness advocated by the NYSE. But the benefits of such togetherness do need to be weighed against the costs. And among the soft, hard-to-quantify, costs are the many uncertainties associated with a complicated experimental structure.

When the playwright Henrik Ibsen was ill, a nurse came to take a look. The nurse said to Ibsen that he "seemed to be a little better." Ibsen said *"[o]n the contrary"*—and died. It is important to go beyond a quick look. It is important to go beyond stated goals and to try to assess whether the legal and market mechanisms in place will in fact nurture and sustain those goals. I say *"maybe."*

PREPARED STATEMENT OF MARC E. LACKRITZ

PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

MARCH 9, 2006

Introduction

Mr. Chairman and Members of the Committee, I am Marc E. Lackritz, President of the Securities Industry Association.[1] We commend you for holding this hearing and appreciate the opportunity to testify on reforming the securities industry's self-regulatory system.

Our Nation's securities markets are the most transparent, liquid, and dynamic in the world. New forms of competition, technological advances, globalization, and broader investor participation have driven phenomenal changes in the capital markets and the securities industry over the past decade. Our industry has embraced these changes, further strengthening the preeminent status of the U.S. capital markets across the globe. The mergers between the New York Stock Exchange (NYSE) and Archipelago Holdings, Inc., as well as the Nasdaq Stock Market (Nasdaq) merging with Instinet, LLC, are a natural and healthy outgrowth of these trends.

Our markets' advantages are also grounded in their structural framework. Self-regulation—and the historical level of member cooperation in particular—has been a key ingredient to our success. For example, the extensive expertise of members and their involvement in the rulemaking process has undoubtedly led to more effective, less costly self-regulatory rules. As the SEC has noted, self-regulation "has been viewed as having certain advantages over direct governmental regulation" because "[i]ndustry participants bring to bear expertise and intimate knowledge of the complexities of the securities industry."[2] Self-regulatory organizations (SRO's) also "supplement the resources of the government and reduce the need for large government bureaucracies" and "can adopt and enforce compliance with ethical standards beyond those required by law."[3]

Despite these compelling benefits, self-regulation has two significant drawbacks: (1) conflicts of interest between SROs' roles as both market operators and regulators, and (2) regulatory inefficiencies resulting from duplication among multiple SRO's. In addition, the regulatory environment in which the securities industry operates has undergone a profound transformation in recent years, resulting in dramatically higher compliance costs.[4] One industry observer noted the confluence of these issues, saying, "Tighter regulation and more disclosure and compliance give

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[1] The Securities Industry Association brings together the shared interests of approximately 600 securities firms to accomplish common goals. Our primary mission is to build and maintain public trust and confidence in the securities markets. Our members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated $236.7 billion in domestic revenue and an estimated $340 billion in global revenues. (More information about SIA is available at: *www.sia.com.*)

[2] Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Stock Market (Aug. 8, 1996), available at *http://www.sec.gov/litigation/investreports.shtml.*

[3] *Id.*

[4] We recently issued a report demonstrating that the cost of compliance for the securities industry has nearly doubled over the past 3 years. The Costs of Compliance in the U.S. Securities Industry, SIA Research Reports, Volume VII, No. 2 (Feb. 22, 2006), available at *http://www.sia.com/research/pdf/RsrchRprtVol7–2.pdf.*

investors the feeling that they are better off and safer, but that's only true when each level of compliance adds to the others, rather than overlapping significantly."[5]

The Committee's interest today in these developments is timely, as the mergers present the perfect opportunity to undertake structural reform and address the aforementioned drawbacks. However, if no action is taken these deficiencies will redouble as conflicts of interest and regulatory duplication extract an ever-increasing cost on industry and investors.

To address these concerns, we support consolidation of the broker-dealer regulatory functions for firms that are dually regulated by both the NYSE and the NASD in accordance with the following objectives:

- There should be one principles-based rulebook for broker-dealer activities, and one source of interpretations, examinations, and investigations for compliance with that rulebook;
- Broker-dealers should have fair representation in the governance of the SRO that oversees their affairs;
- Broker-dealers should pay fees for regulation of broker-dealer activities through a transparent fee-setting process, and fees for specific services or products should be designed to recover costs, but not to subsidize the general cost of regulation or to cross-subsidize other products or business lines;
- The SRO's costs should be contained in a budget that is subject to independent review; and
- Examination programs and queries for trade information should be structured to eliminate duplication.

These objectives should be embodied in a single organization for those broker-dealers currently subject to duplicative regulation by the NYSE and the NASD. By eliminating unnecessary regulatory duplication and inherent conflicts of interest, a revamped self-regulatory structure can strengthen investor protection and increase the competitiveness of the U.S. capital markets. A principles-based rulebook would strengthen the competitiveness of our markets by capturing the benefits of risk-based regulation now increasingly practiced in other major markets around the world. Except for regulation of trading on an exchange, all activities of broker-dealers that are currently regulated by both the NYSE and the NASD—encompassing licensing of individuals, sales practices, supervision, communications with the public, net capital and margin requirements, account statements and securities distributions—would be handled by one body. This consolidation would not apply to each exchange's trading rules, market surveillance, or listing standards, which should remain separately administered by their respective marketplace SRO's, so as to draw on specialized knowledge of their own market.

Strengths and Weaknesses of the Current SRO System

The success of today's self-regulatory governance is directly related to member involvement in the process.[6] Self-policing by professionals who have the requisite working knowledge and expertise about both marketplace intricacies and the technical aspects of regulation creates a self-regulatory system with valuable checks and balances. Supplemented by government oversight, this tiered regulatory system can provide a greater level of investor protection than the government alone might be able to achieve.

Because self-regulators are on the frontline of marketplace developments, they have an intimate knowledge of industry operations, trading, and sales practices. As a result, they can develop and revise rules—which are typically forward-looking and up-to-date with market realities—more quickly and frequently than traditional government regulators. In addition, SRO rules often set standards that exceed statutory or common law legal minimums. For example, the NASD requires that its member firms adhere to "just and equitable principles of trade," a standard that generally exceeds the antifraud requirements of securities statutes and SEC rules.

Conflicts of Interest

In spite of how well self-regulation has worked, market participants, governmental bodies, scholars and investor advocates have recognized in recent years a

[5] Jaffe, *Commentary: Added Regulation Bringing Few Benefits,* MarketWatch.com, (March 1, 2005), available at *http://www.marketwatch.com/News/Story/Story.aspx?guid=%7B46193141%2D1FB2%2D4506%2D852C%2D984A40692178%7D&siteid=google.*

[6] *See generally* S. Rep. No. 94–75, at 22 (1975) (*accompanying* S. 249, 94th Cong., 1st Sess. (1975)) (In enacting the Exchange Act, Congress balanced the limitation and dangers of permitting the securities industry to regulate itself against "the sheer ineffectiveness of attempting to assure [regulation] directly through the government on a wide scale."); SEC Report of Special Study of Securities Markets, H.R. Doc. No. 88–95, Part 4 (1963) (Special Study).

growing need for structural reform of self-regulation. The main concern revolves around the potential conflicts of interest due to the SROs' roles as both market operators and regulators.[7] The profit motive of a shareholder-owned SRO further heightens the concern that self-regulation could be impaired.[8] Moreover, the current lack of transparency and competition in setting market data fees is heightened with just two consolidated for-profit market centers.

This conflict between operating and regulating a market has been publicly discussed since the NYSE first raised the idea of demutualizing in the late 1990's. For example, NYSE Group (the for-profit parent) would have an interest in promoting trading products offered by it, and discouraging broker-dealers from offering competing products. Similarly, NYSE Group would have a strong interest in promoting trading on its exchange, and could discourage broker-dealers or their affiliates from offering, or routing trades to, competing platforms. These types of conflicts have long been an issue between exchanges and their members, even predating for-profit exchanges. Conflicts have grown as exchange members have become increasingly competitive with the NYSE. For example, NYSE members have been internalizing order flow and offering alternative trading venues that compete with the NYSE for third party order flow.[9] Once an exchange or its parent gains for-profit status, this conflict of interest becomes much more acute.[10] In addition, as the NYSE Group or its subsidiaries enter into a broader array of businesses, or add to their trading products (as they have stated they plan to do)[11] the opportunities for conflicts will multiply.

The SEC recently approved a restructuring of the NYSE regulatory function in connection with the Archipelago merger.[12] We think that the proposal approved by the SEC falls short of the degree of separation that is necessary to insulate regulation from the business interests of a for-profit parent.[13] However, we do not wish to disturb the finality of the SEC's decision, on which the NYSE's legitimate and urgent business plans rest. Rather, we hope that the Commission, with the support of this Committee, will continue to address this issue by ensuring that the NYSE and NASD finalize their stated intentions to move the regulatory functions that are

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[7] "Securities Markets: Competition and Multiple Regulators Heighten Concerns about Self-Regulation," General Accounting Office, May 2002, GAO–02–362, available at *http://www.gao.gov/new.items/d02362.pdf,* at 1–2 (GAO SRO Report). The GAO also noted, "Heightened competitive pressures have generated concern that an SRO might abuse its regulatory authority—for example, by imposing rules or disciplinary actions that are unfair to the competitors it regulates." The SEC shares this concern. "As intermarket competition increases, regulatory staff may come under pressure to permit market activity that attracts order flow to their market . . . . Also, SRO's may have a tendency to abuse their SRO status by over-regulating members that operate markets that compete with the SRO's own market for order flow." Concept Release Concerning Self-Regulation, 69 *Fed. Register* 71256, 71262 (Dec. 8, 2004) (SEC SRO Concept Release).

[8] The SEC has stated that:

"SRO demutualization raises the concern that the profit motive of a shareholder-owned SRO could detract from self-regulation. For instance, shareholder-owned SRO's may commit insufficient funds to regulatory operations or use their disciplinary function as a revenue generator with respect to member firms that operate competing trading systems or whose trading activity is otherwise perceived as undesirable."

SEC SRO Concept Release, at 71263.

[9] "[S]elf-regulation now poses massive agency-cost problems because exchanges are seeking to regulate members who are, in fact, competing firms rather than firms with whom the exchanges' interests are aligned with respect to most regulatory issues." Jonathan R. Macey & Maureen O'Hara, *From Markets to Venues: Securities Regulation in an Evolving World,* 58 Stan. L. Rev. 563, 578 (Macey & O'Hara). For an illustration of the long history of competitive issues between the NYSE and its members *see, e.g, The Structure of the Securities Market—Past and Future,* Thomas A. Russo and William K.S. Wang, 61 Fordham L. Rev. 1, 42 (1972) (The New York Stock Exchange has taken every opportunity to fight competition . . . ." (citing then-current illustrations)).

[10] Macey & O'Hara at 581.

[11] Interview by CNBC News with NYSE Chairman Marshall N. Carter and NYSE CEO John A. Thain (April 8, 2005)(quoting Mr. Thain as stating "Well, as I've said before, I think we would like to see some derivative trading, some options trading, and certainly some fixed income trading.), available at *http://www.nyse.com/Frameset.html?displayPage=/about/1113302992920.html.*

[12] Exchange Act Rel. No. 34–53382 (Feb. 27, 2005), available at *http://www.sec.gov/rules/sro/nyse/34–53382.pdf* (SEC Approval Order).

[13] Letter to Nancy M. Morris, Secretary, Securities and Exchange Commission, from Marc E. Lackritz and Micah S. Green, (Feb. 2, 2006), available at *http://www.sec.gov/rules/sro/nyse/nyse200577/melackritz020206.pdf.* (SIA–TBMA comment letter). The SEC Approval Order, while noting our main concerns, took few steps to address the concerns raised by many commenters on the lack of sufficient separation between NYSE Group and its regulatory affiliates.

the primary source of the conflict—regulation by the NYSE of its competitors[14]—out of the sole control of the NYSE and into an entity that consolidates the overlapping regulatory programs of the NASD and NYSE.

Duplicative and Inconsistent Regulation

Another major concern is duplicative and inconsistent regulation among multiple SRO's, as well as redundant SRO regulatory staff and infrastructure.[15] Regulatory duplication can, and does, occur with rulemaking, data reporting, examinations, and enforcement actions. On the rulemaking front alone, both the NYSE and the NASD frequently adopt separate rules on similar or identical topics, leaving many firms to cope with two different standards, including different recordkeeping, procedural and audit trail requirements for the same product or service. Similarly, on the examination front firms have expressed concern about a lack of coordination among the SRO's, and between the SRO's and the SEC's Office of Compliance Inspections and Examinations (OCIE). Another area of significant and rising redundancy concerns trade reporting. Currently, the trade information requested and the formats may be different for each SRO. Since the information requested could go back many years, firms must maintain access to all the old historical data while allowing the flexibility to augment the data with today's newly requested and created fields of information resulting from new regulation. This process is extremely difficult and costly to manage. A consolidated SRO would more easily be able to work with the industry to develop a system that would submit all order and execution data in a standardized format to an industry data warehouse. This will eliminate a key unnecessary redundancy in the current SRO system.

Solutions

In addition to the waste of regulatory resources, the impact on investors from unnecessary compliance costs, in terms of either increased costs or reduction in choices of products and services, should not be minimized. Fortunately, the senior staffs of both the NYSE and the NASD are signaling a clear intention to address these issues. We are greatly heartened, for example, by recent remarks by senior officials of both organizations indicating a commitment to combine their regulatory functions (albeit with different points of view on how that should occur).[16]

It is important to emphasize that some form of regulatory consolidation of NYSE and NASD rules into one risk-based rulebook, rather than merely seeking to "harmonize" two separate rulebooks, is the only approach that makes sense in the long-term. We have worked with both SRO's on specific discrepancies between their rulebooks and interpretations, and many of these issues have been resolved through great effort.[17] A recent regulatory effort on business entertainment is a good illustration of why this approach is only a stopgap solution that is far less desirable than one consolidated rulebook. In the past year, both the NYSE and the NASD have considered new rules on gifts and entertainment given by broker-dealers or their employees to employees of customers. Initially, the two SRO's considered vastly different approaches. After we raised concerns about the inconsistent approaches, the two SRO's worked with each other and with our industry to devise a single, principles-based approach that is now in the process of being adopted. Even now, however, there are small but substantive differences in the key proposed definitions of "business entertainment" and "customer."[18]

[14] Similar concerns relating to Nasdaq becoming a for-profit company are less substantial due to the gradual shedding of the NASD's equity interest in Nasdaq. However, the NASD still has a stake in Nasdaq that it is trying to sell.

[15] "Multiple SRO's can result in duplicative and conflicting SRO rules, rule interpretations, and inspection regimes, as well as redundant SRO regulatory staff and infrastructure across SRO's." SEC SRO Concept Release at 71264. The GAO has noted similar "inefficiencies associated with SRO rules and examinations." GAO Report at 2.

[16] *NYSE Seeks a Regulatory Alliance, Wall Street Journal*, C–3 (Feb. 23, 2006).

[17] We have also had productive discussions with the NYSE and NASD, as well as OCIE, on improving coordination among these three regulators' examination programs. An overview of the results to date of those discussions is available at *http://www.sia.com/RegulatoryCoordination/index.html.*

[18] For example, the NASD definition requires that to be considered as "business entertainment" rather than under its different limitations for "gifts," it is necessary that a person associated with the broker-dealer "accompanies and participates" with the customer's employee in the event, "irrespective of whether any business is conducted." The NYSE definition requires that an employee of the broker-dealer "accompanies" the customer's employee, without the added nuance of "participation." Unlike the NASD, the NYSE waives the accompaniment requirement if "exigent circumstances make it impracticable" for the broker-dealer's employee to attend. See Proposed NASD IM–3060, NASD Notice to Members 06–06, January 2006 (available at *http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/asdw_015876.pdf);*

In its recent regulatory filing, the NYSE committed itself to continuing to work with the NASD to address inconsistent rules and duplicative examinations, and "to use its best efforts, in cooperation with the NASD, to submit to the Commission within 1 year proposed rule changes reconciling inconsistent rules and a report setting forth those rules that have not been reconciled."[19] Although this determination to address inconsistencies and duplication as they arise is praiseworthy, it is not a satisfactory long-term solution. First, as the business entertainment example illustrates, it requires continual senior-level effort to reconcile new discrepancies as they arise, and even then the resulting rules may have some discrepancies in nuance or interpretation. Second, harmonization does not resolve the concern about conflicts when a for-profit exchange has regulatory power over its competitors. Third, no matter how capable the regulators or how valiant their efforts to reconcile their rules, in light of the variations in institutional culture, history, and constituency among the NYSE and NASD, just synthesizing their rules will be inferior to what could be produced by a single regulator. Think of the result if Hemingway and Faulkner sought to "harmonize" their work. This is particularly true given that rule interpretation is as important to the outcome as the literal wording.

Rather than trying to pick and choose between existing SRO rules, or splitting the difference between two separate rules addressing the same conduct, investors, issuers, and the industry would benefit greatly from the more "prudential" regulatory approach followed by other financial service regulators. A principles-based rulebook—one that abjures the temptations to write highly proscriptive and inflexible rules, then use examination and enforcement programs to set unwritten policies that the rules fail to articulate—will benefit investors and the U.S. capital markets alike. It will foster an atmosphere in which broker-dealers will be more likely to take the initiative and approach regulators with issues they have self-identified in order to seek a rational solution, rather than simply self-police for compliance with highly technical, and possibly outdated, rules.

In short, duplication and inefficiency will continue to occur as long as two separate entities regulate the same conduct of the same firms. The only effective long-term answer is to combine the best elements of the existing SRO broker-dealer regulatory programs in one centrally managed entity that is responsive, accountable, transparent and well-funded.

Significance of the NYSE-Archipelago Merger

The proposed NYSE-Archipelago merger represents an important opportunity to address the valid concerns raised by critics of self-regulation. The following are some observations about the implications of the merger.

(1) There is strong economic justification for the NYSE's transition to for-profit status, and none of our comments today should be taken as opposition to the merger with Archipelago. The merger both illustrates and accelerates the trend toward increased consolidation of, and competition between, market centers around the globe. This competition is, on balance, a very healthy development.

(2) This global competition applies not just to market centers, but to all types of financial intermediaries. Unnecessary regulatory duplication and failure to embrace risk-based regulation are weights around the ankles of financial intermediaries in the United States that has a real cost in terms of the future competitiveness of our capital markets. The merger represents an opportunity to address these disparities.

(3) The merger raises the exact issues that both the SEC and SIA have identified previously concerning conflicts between shareholders' interests and regulatory authority. In general, to the extent that self-regulatory conflicts are seen to have contributed to lapses in oversight in recent years, the incorporation of the regulatory function in a for-profit exchange structure can only heighten those concerns. A number of stock exchanges around the world have become for-profit over the past decade, and all of them have taken steps to ensure "structural separation between the supervisory authority and the management of the exchange or market."[20]

In fairness, the NYSE proposes some steps to address this conflict. Each of its regulatory divisions (Listed Company Compliance, Member Firm Regulation, Market Surveillance, Enforcement and Dispute Resolution/Arbitration) and its 700 employees will be moved into a separate affiliated nonprofit entity, which will regulate all

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Proposed NYSE Rule 350A, File No. SR-NYSE–2006–06, Feb. 15, 2006 (available at SEC Public Information Office).

[19] Amendment No. 6 to SR–NYSE–2005–77, available at *http://www.sec.gov/rules/sro/nyse/34–53382amend6.pdf.*

[20] Macey & O'Hara, note 9, *supra,* at 581 (surveying the Australian Stock Exchange, Deutsche Börse, Euronext, Hong Kong Exchange, London Stock Exchange, OM (Stockholm), Singapore Stock Exchange, and Toronto Stock Exchange).

aspects of the NYSE parent's markets, as well as the activities of the Pacific Stock Exchange (which Archipelago now owns).

While moving regulation out of the parent organization is certainly necessary, it is not sufficient. We have expressed concern[21] that the new entity, titled "NYSE Regulation," will be under the control of a board of directors that will include a number of its members drawn from the NYSE parent's own board. Moreover, the NYSE itself, which will have plenary authority to review actions of NYSE Regulation, will be controlled by directors of the for-profit parent. Just as the NYSE has made solid efforts to foster more assertive and less conflicted boards for the companies that it lists, we had hoped that it would recognize the conflict that NYSE Group directors may bring to the boardroom when they serve as directors of the subsidiaries that regulate NYSE Group's competitors. While the SEC secured some modest adjustments to the NYSE's proposal to address these concerns, they stopped well short of what we thought was desirable.

The SEC's approval order illuminated another potential conflict between the NYSE for-profit parent and its regulatory affiliate: The potential for misuse of NYSE Regulation's ability to impose fines and penalties to benefit the parent's business. The NYSE's proposal states that such monies cannot be used for commercial purposes or distributed to any entity other than NYSE Regulation.[22] However, even if penalties or fines cannot be diverted to directly benefit the parent's bottom line, the possibility still remains that NYSE Group directors participating in the oversight of the regulatory function could encourage heavy reliance on fines and penalties, most or all of which would come from NYSE Group competitors, to sustain the regulatory budget. The SEC appears to have concerns in this area, since as part of the approval process it asked for and received from the NYSE a commitment to file a separate proposed rule on NYSE Regulation's use of regulatory fees, fines, and penalties.[23]

The most effective way of dealing with the conflict between the NYSE's regulatory authority and its business interests, as well as with duplicative regulation, is to combine the overlapping broker-dealer regulatory functions of the NYSE and NASD in a separate entity. Fortunately, senior NYSE officials in recent public statements have seemed to recognize this, and have suggested they are "open to the idea of a 'joint venture' with the NASD."[24]

This convergence of views suggests that this is an ideal moment for implementing significant structural reform to self-regulation. Unfortunately, the NYSE and NASD seem to be at an impasse on turning their shared views into reality. From recent public statements, the NYSE appears to favor a true "joint venture," controlled by both the NYSE and the NASD, to regulate the firms that are currently dually regulated, while the NASD seems to seek to move the NYSE regulatory functions into itself, or possibly to create an entirely new regulatory entity totally separate from either existing SRO. We think any of these approaches could achieve the five goals that we outlined.

For example, a joint venture by the two SRO's for dually regulated firms could be structured so that it alleviates the conflicts inherent in a for-profit parent regulating its competitors by providing (i) a single principles-based rulebook, (ii) a single examination staff (for example, by contracting the examination function out to one of the SRO's, or by seconding examination staff from the NASD or the NYSE) so that the purpose of a single rulebook is not undermined by duplicative or inconsistent examinations by two sets of regulators, (iii) the protections that we discuss below regarding public and industry involvement in its oversight, and (iv) restrictions on the use of market data fees or enforcement penalties to fund its operation. Since the NASD arguably does not face conflict of interest issues to the same degree as the NYSE,[25] a structure involving folding dual-registrant regulation into an arm

[21] SIA–TBMA comment letter, note 13, *supra,* at 9.
[22] SEC Approval Order, note 12, *supra,* at 46,
[23] *Id.* at n. 231. The SEC has previously warned that "shareholder-owned SRO's may . . . use their disciplinary function as a revenue generator with respect to member firms that operate competing trading systems or whose trading activity is otherwise perceived as undesirable." SEC SRO Concept Release, n. 7 *supra,* at 71263.
[24] *NYSE Seeks a Regulatory Alliance, Wall Street Journal*, C3 (Feb. 23, 2006). *Big Board and NASD Consider Merging Parts of Regulatory Units, Wall Street Journal*, C3 (November 11, 2005). Senior NASD officials have also signaled receptivity to a hybrid SRO. *See New Theorem for Merging Regulators: 1>2, Wall Street Journal*, C3 (November 14, 2005).
[25] The NASD does have a potential conflict due to its contract to provide regulatory services to Nasdaq, but this appears much less significant than the conflict faced by the NYSE's regulatory function, which is wholly owned by the for-profit parent and contains substantial representation of the for-profit parent's independent directors on its oversight boards.

of the NASD, or into a new entity entirely independent of either SRO, could be at least as effective a means to satisfy the conflict of interest concerns.

We strongly urge this Committee and the SEC to take the lead in capitalizing on the opportunities created by these developments. The differences between the NYSE and NASD are much less significant than their agreement with the principle that consolidation should occur, and as long as the SEC and this and other Congressional oversight committees stay engaged, these differences should be bridged in short order. With the help of this Committee and the involvement of the SEC, SRO's, market participants and investors working together, one of these forms of a "hybrid regulator" could be the vehicle for driving self-regulation into the 21st century.

Structural Reform of Self-Regulation

Consolidating broker-dealer regulation addresses the two primary areas of weakness in the current self-regulatory structure we identified previously—conflicts of interest and regulatory inefficiency. In addition, the proposal will likely provide better investor protection. Enhanced regulatory efficiency will allow both the SRO's and firms to use compliance resources more effectively. Regulatory accountability will be bolstered as the result of one entity being responsible for overseeing broker-dealer activity at the SRO level. Finally, the regulatory expertise of the SRO staff will expand as a single SRO gains the resources, power, and prestige to attract talented staff. At the same time, the existence of multiple-market SRO's, each with responsibility over those regulations applicable to its unique trading structures, will keep market expertise where it is most useful. Much of the innovation that makes the U.S. markets so strong occurs in market operations, so the maintenance of separate market SRO's will foster continued competition and innovation and preserve U.S. capital market dominance.

In general, the SEC has already begun moving toward more universal capital market rules. For instance, parts of Regulation SHO[26] and Regulation NMS[27] reflect a convergence of rules. Regulatory consolidation will build on this streamlining of regulations while eliminating redundancies and gaps in regulatory coverage.

Overseeing a Consolidated Regulator

We realize that SRO regulatory consolidation would concentrate regulatory power and authority in one entity. Therefore, this regulatory structure will function effectively only if the SEC provides attentive oversight that includes the vigilant review of the consolidated regulator's costs and fee structures. Similarly, the Commission should review the consolidated regulator's final disciplinary proceedings in order to counter any self-serving interest by the regulator in levying excessive enforcement fines that would be paid into its own coffers.

Additionally, strong public and member involvement will become even more important to prevent the consolidated regulator from becoming an unresponsive entity with prohibitive cost structures. While the consolidated regulator should have a majority of nonmember representatives on its board, it will need substantial member input—especially from smaller cost-sensitive members—to effectively oversee regulation across a diverse group of members with divergent needs and business models.[28] Member involvement and SEC oversight of the hybrid SRO also will be necessary to identify and harmonize any "boundary" issues between conduct rules subject to the consolidated regulator's oversight, and market rules subject to the continued oversight of the various market SRO's.

The SEC should develop increased transparency requirements for the consolidated regulator, particularly concerning funding and budgetary issues. Making the regulator's operations transparent to both members and the investing public will place appropriate checks on the consolidated regulator and will enhance accountability to its constituents.

Funding the Regulator

Another significant issue is how best to fund the consolidated regulator. The goal of the consolidated regulator is not to stint on regulation, but to make each regulatory dollar more effective. At the same time, fees for regulation should be apportioned to the industry on a fair and reasonable basis. Imposing regulatory fees that exceed the true costs of regulation acts as a tax on capital and imposes undue harm on the capital-raising system. We recommend that the consolidated regulator be re-

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[26] *See* Exchange Act Release No. 50103 (Jul. 28, 2004), 69 *Fed. Reg.* 48008 (Aug. 6, 2004) (Regulation SHO).

[27] *See* Regulation NMS.

[28] The needs of fixed-income markets differ from those of equities markets, for instance. The knowledge members have about the ramifications of these differences is essential to ensure that a self-regulatory system works well for all participants.

quired to define the costs necessary to meet its self-regulatory obligations, prepare and make public a budget to meet those obligations, and then fairly apportion those costs among members by making periodic filings with the Commission subject to public notice and comment.

Regulatory funding for the consolidated regulator should come from regulatory fees assessed on broker-dealers, as well as from the issuers and other constituents of the trading markets. Trading markets will benefit significantly from regulatory oversight of broker-dealers and the various examination and continuing education programs conducted by the consolidated regulator. Such regulation and education initiatives foster the market integrity and investor confidence that bring so much business to the U.S. capital markets. Markets would receive these benefits, and market SRO's should assume some of the associated regulatory and administrative costs.

Market data fees should only fund the collection and dissemination of market data—not regulatory costs.[29] Combining the broker-dealer regulatory functions of the NASD and NYSE should result in savings for the SRO's that may offset much of the loss of market data fees as a revenue source. If there is still a shortfall due to the elimination of market data fees, the industry is willing to pay higher regulatory fees to the consolidated regulator than it now pays to the NYSE and NASD. For member firms, higher fees would be offset by relief from the burdens of duplicative regulation and market data fees that vastly exceed their costs. Our only qualification is that any increase in regulatory fees on member firms should be, allocated with the SEC's assistance and in a manner that does not place an undue burden on smaller firms.[30]

Eliminating Excessive Market Data Fees

Regardless of the outcome of regulatory consolidation, it is vitally important that the SEC deal with longstanding concerns by market participants about the opaque and nonaccountable way in which market data fees are currently set.[31] The purpose of disseminating market data is to create transparency in the prices that investors receive for buying and selling securities and, where there are competing market centers, to increase investor choice and opportunity. For that reason, regulation should not depend on revenue from market data fees. The current approach to market data fees hurts the transparency of prices and imposes unjustifiable costs on market participants and, ultimately, investors.

The conflicts arise from the danger that that the current lack of transparency and competitiveness in setting market data fees will foster monopolistic behavior, with the ability to use the monopoly revenue to subsidize other activities. The proposed NYSE and Nasdaq mergers heighten this danger, by creating the prospect of an oligopoly over market data controlled by just two consolidated for-profit market centers. A cost-based approach will minimize many of the conflicts of interest related to market data fees that SRO's face now.

Market participants are legally required to provide certain specific market data to the SRO's. Market participants should not be required to relinquish any additional rights to market data as a condition of membership in an SRO. Indeed, an SRO should not be permitted to condition access to the exchange on the acceptance of terms that seem designed primarily to advance the commercial interests of the exchange.

We applaud the SEC's expressed intention to address many open issues concerning market data fees in the context of SRO reform.[32] We strongly believe the resolution of these issues—sooner than later—is of the utmost importance for the integrity of the markets.

Conclusion

America's securities markets are the envy of the world, but we must be vigilant about removing unnecessary regulatory inefficiencies if we are to maintain our

[29] The SEC estimates that in 2003 market data fees provided 18 percent of the funding of the NYSE and NASD. SEC Concept Release Concerning Self-Regulation, 69 *Fed. Reg.* 71256, 71270 (Dec. 8, 2004).

[30] For example, such fees might be based on any number of factors designed to approximate the degree of resources required of the Single Member SRO in overseeing a particular firm, such as the number of registered representatives of a firm, or the scope and nature of its customer base or operations.

[31] For a more detailed discussion of our concerns about market data fee practices that we believe the SEC should consider reforming, see letter to Jonathan G. Katz, Secretary, SEC, from Marc E. Lackritz, SIA, (Feb. 1, 2005) at 24 et seq., available at *http://www.sia.com/2005*_comment_letters/4601.pdf.

[32] *See* SEC Release Adopting Regulation NMS, 70 Fed. Reg. at 37560 (June 29, 2005).

international preeminence. We are eager to work with Congress, the SEC, the SRO's, and all other interested parties to ensure that our markets remain the most transparent, liquid, and dynamic, with unparalleled levels of investor protection.

PREPARED STATEMENT OF RICHARD FERLAUTO

DIRECTOR OF PENSION AND INVESTMENT POLICY,
AMERICAN FEDERATION OF STATE, COUNTY AND MUNICIPAL EMPLOYEES, AFL–CIO

MARCH 9, 2006

Good Morning Chairman Shelby, Senator Sarbanes, and Members of the Committee. My name is Richard Ferlauto, and I am the Director of Pension and Investment Policy at the American Federation of State, County and Municipal Employees (AFSCME), a union representing 1.4 million State and local government, healthcare, and childcare workers. I appreciate the opportunity to appear today on behalf of AFSCME and the 9 million member AFL–CIO to discuss regulation of the New York Stock Exchange.

The appropriate level of regulation of capital markets is a key concern to us because it impacts on the financial condition and retirement security of every working family in this new ownership society. AFSCME members have their retirement assets invested by pubic pension systems with combined assets totaling over $1 trillion dollars. These public systems have lost more than $300 billion in assets due to the loss of market confidence following the scandals of Enron and WorldCom. In addition to these public funds, union multi employer-sponsored pension plans hold approximately $400 billion in total assets and are beneficial shareholders of corporate issuers through banks, brokers, and other custodians. All together, union members participate in benefit plans with over $5 trillion in assets, not including the dollars they invest as individuals. The institutional investment funds are highly indexed and are long-term owners as patient investors. Confidence in the markets, transparency and appropriate regulation are the foundation of their success as investors.

AFSCME and the AFL–CIO are convinced that the New York Stock Exchange (NYSE) and other self-regulatory organizations play a valuable role in the marketplace. We have been supportive of the NYSE's unique strengths as an in-person market maker. However, the NYSE's recent conversion to "for-profit status" and its unwise determination to retain and finance its regulatory unit within the NYSE Group creates a clear conflict of interest that we believe poses a significant danger to investors.

We urge Congress to call on the Securities and Exchange Commission (SEC) to directly regulate, or in the alternative, to support the creation of a genuinely independent organization to regulate the NYSE. Recent press accounts of a possible consolidation of NYSE and National Association of Security Dealers (NASD) regulation make it clear that the SEC must act with haste to protect the public interest.

Speaking to regulators and leading Wall Street executives about the NYSE Group's new structure at the Securities Industry Association's November 11, 2005 meeting, NASD Chairman and CEO Robert Glauber said, "There is a conflict in an enterprise operating as regulator." In fact, according to a recent report by Glass, Lewis and Company, the number of company restatements have surged, due in part to a lack of adequate internal controls. Now that the auditors have determined what was actually in these accounts, we are finding many of the problem companies were on the NYSE. In its new structure as a corporation, the NYSE has even fewer legal and financial resources to protect investors. Indeed, its regulatory unit has a glaring conflict of interest. Since making a profit would become even more critical to its ability to sustain its stock price, it makes its in-house regulatory arm a bigger issue.

Conflicts of Interest

We are very concerned about the potential for conflicts of interest. For example, the NYSE/Archipelago Holdings, Inc. merger, expected to become effective this quarter after SEC approval last week, comes after 213 years in which the NYSE operated as a not-for-profit corporation. The Exchange Act gave the NYSE "front-line" authority to regulate itself. While this structure has resulted in significant enforcement lapses, the new entity raises conflict concerns to an entirely new level.

Importantly, the SEC has shown a willingness to criticize the NYSE for lax oversight. In response, the NYSE has retained its regulatory unit as a "not-for-profit" division of the corporation, with a board that has at least 20 percent of its directors from outside the NYSE Group board. What this means, of course, is that 80 percent of the directors of the NYSE's regulatory unit can also be members of the NYSE

Group board. These directors unfortunately do have an inherent conflict of interest since they have a duty to maximize returns for the shareholders of the NYSE Group. Consequently, the NYSE regulatory unit's actions may well have an adverse impact upon the revenues of the NYSE thereby putting conflicting directors who serve on both boards in a situation where the appearance of conflicts may be unavoidable.

Moreover, the NYSE regulatory unit's budget comes from the fines and fees that brokerage firms pay to it. If this does not create a conflict of interest for its Group board, any additional revenues for the regulatory unit must, according to the NYSE, come from the NYSE Group itself. Directors must then decide whether their duty to the NYSE Group overrides their duty to the NYSE regulatory unit. Either the directors agree to pay more for enforcement and potentially cut the revenues of the NYSE Group, or they maximize revenues for the NYSE Group and cut the necessary revenues for the regulatory unit.

Recent Examples of NYSE's Problematic Self-Regulation

Our public fund investors have come to rely on the considerable efforts by New York Attorney General Eliot Spitzer and the SEC to correct for lapses in the NYSE's self-regulation. In the area of financial reporting, the NYSE has been lax in its supervision and when problems were discovered at companies such as Qwest, it took extended periods of time, in some cases over a year, before investors were once again able to receive reliable reports.

In another case, the NYSE's decision last October to allow Sovereign Bancorp to proceed with a restructured stock sale was a striking example of a conflict and the need for an independent regulator. Instead of requiring a shareholder vote on the proposed sale of more than 20 percent of Sovereign shares to Banc Santander, the NYSE's self-regulatory body allowed Sovereign to skirt the NYSE rule on the technical grounds that Sovereign only sold "treasury shares." Sovereign, as an NYSE listed company, virtually avoided any shareholder accountability.

Less than a month after its decision in the Sovereign matter, the NYSE also permitted Fannie Mae to skirt its filing rules, granting an exemption from de-listing requirements when it failed to file its financial statements on time. This certainly appears to be a serious conflict of interest in light of the fact that Fannie Mae pays the NYSE the maximum annual listing fee of $500,000.

Role of the Securities and Exchange Commission

The SEC is well aware of these concerns and has already identified serious issues related to self regulation of a "for-profit" entity. Its concept papers (File No. S7–39–04 and File No. S7–40–04) have pointed out that demutualization raises the concern that the profit motive of a shareholder-owned Self-Regulatory Organization (SRO) could detract from proper self-regulation.

We urge Congress to work with the SEC with the goal of eliminating self-regulation by the exchanges. The Commission should set timelines for pursuing reform goals and open the process through public roundtables and other forums allowing investor participation and public engagement.

The oversight role of the SEC might also be enhanced during this review of the self-regulatory powers of SRO's. While the Commission has the power under the Exchange Act to approve changes in SRO rules, the full extent of its authority remains unclear and has caused concerns for investors for many years. For example, as investors focused on corporate governance, we believe that the Commission should have the ability to regulate listing standards contrary to the limitations posed on the SEC by *BusinessRound* v. *SEC*.

Despite these concerns, we are also afraid the SEC will not have the administrative capacity to guard against the NYSE's historically lax oversight. The SEC's annual report for 2005 reflects actual program costs of $917,650 million for the fiscal year 2007 budget which is a cut back. The 2005 annual report also notes that staff turnover is up to 7.5 percent, the highest since 2001.

While we raise these concerns, we stress that AFSCME and the AFL–CIO are strong supporters of the NYSE and its in-person market. Moreover, we support a regulatory structure for the NYSE that fosters investor confidence, ensures fairness to all market participants, and encourages competition to promote efficiency in today's markets. This system should ensure that all exchanges meet or exceed established standards of investor protection and should prohibit "races to the bottom" by the ongoing lowering of regulatory standards and listing requirements. Equally important, the system should guarantee that regulatory oversight functions are adequately and securely funded.

The NYSE cannot, in any reasonable person's mind, be both a "for-profit" entity whose critical success is tied to growing revenues, including from listing fees, and at the same time be expected to take actions that would result in a negative impact on those fees. As we saw with the auditors, one cannot carry the water buckets for two masters at the same time.

I appreciate your time and attention regarding this important issue and would be happy to answer any questions you might have.

PREPARED STATEMENT OF ANN YERGER

EXECUTIVE DIRECTOR, COUNCIL OF INSTITUTIONAL INVESTORS

MARCH 9, 2006

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 SRO's 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 ensure 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 SRO's, 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 SRO's based on listing standards. The one-share/one-vote controversy, which was sparked in the mid-1980's 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 SRO's 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 SRO's 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 SRO's, 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.