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REVIEWING U.S. CAPITAL MARKET STRUCTURE: THE NEW YORK STOCK EXCHANGE AND RELATED ISSUES

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTEREPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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REVIEWING U.S. CAPITAL MARKET STRUCTURE: THE NEW YORK STOCK EXCHANGE AND RELATED ISSUES

Thursday, October 16, 2003

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The Subcommittee met, pursuant to call, at 10:05 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [Chairman of the Subcommittee] presiding.

Present: Representatives Baker, Ose, Shays, Bachus, Castle, Royce, Oxley (ex officio), Kelly, Ney, Ryun, Biggert, Capito, Hart, Kennedy, Tiberi, Harris, Leach, Kanjorski, Sherman, Meeks, Moore, Gonzalez, Frank (ex officio), Hinojosa, Lucas of Kentucky, Crowley, Israel, McCarthy, Baca, Miller of North Carolina, and Maloney.

Chairman BAKER. [Presiding.] I would like to call this meeting of the Capital Market Subcommittee to order.

This morning, the Subcommittee meets to begin a review of the nation's capital marketplace structure and it is the first in what, I think, will be a series to examine the many complex challenges facing today's marketplace. From ensuring proper regulation for the protection of investors to facilitating enhanced competition, we must maximize opportunities and preclude misinformation and potential losses.

We must also think forward, beyond merely the next quarter of business performance, but what our capital markets should really look like within the decade to remain competitive and the dominant force in the international marketplace.

The focus of today's hearing will be on the corporate governance question relating to the New York Stock Exchange and the appropriate role of the proposed reforms. Is the SRO model one, as some suggest, too troubled to succeed?

I am sure each of our witnesses today will provide valuable insight into this question, and I am anxious to learn of their perspectives. It is my judgment, however, that the lessons of the Sarbanes-Oxley Reform should not be overlooked.

The committee looked at the issue of audit team independence, and for the first time statutorily required the audit team to report to the Audit Committee to establish, not Chinese, but firm concrete high walls between CEO/CFO conduct and the audit function to en-

sure that the financial statement is an accurate reflection of corporate value for the shareholder's assessment.

This model, I think, establishes a valuable point: that those charged with regulatory or compliance functions within the Exchange should not directly report to the CEO of the for-profit enterprise. How this can be achieved is left to those within the market to best determine, but I think assurances of the separation are essential.

Of recent note, the NYSE has been criticized for failing to recognize conflicts of interest and potential abuses in IPO allocation practices. Criticism has been levied at the Exchange for not enacting all essential corporate governance reforms. This criticism has increased in volume following the announcements of Mr. Grasso's compensation.

Mr. John Reed, who will testify later this morning, has been installed as the interim Chairman and would quickly note, in contrast to his predecessor, Mr. Reed has agreed to a single dollar of compensation for his tenure, which began earlier this month. And that he has begun implementing changes that will enhance the regulatory efficiency of the Exchange.

This committee will certainly look forward to Mr. Reed's leadership and do all that is necessary to facilitate that those stakeholders in the New York Stock Exchange understand appropriate governance and, more importantly, that those who extend their valuable dollars by investing in America's capital markets can be assured that it is not only a transparent functioning marketplace, but it is one that engages in fair and ethical practice that should instill confidence in the performance of our capital markets.

To restate, our capital markets function in the most efficient and helpful manner of any in the world, and no other market, other than the New York Stock Exchange, can be cited for its dynamic contributions over the history of economic growth of our country.

But change is on the horizon. And, not only should we concern ourselves with ethical and appropriate conduct, but we must assess the impact of technological changes in the broader marketplace and facilitate that trades occur in the most appropriate fashion at the best price for those who invest.

The investing landscape has changed. Now, over 50 percent of our households in America, through the workplace or through direct investment, are participants directly in our capital markets function. And, accordingly, the Congress has appropriately enhanced its sensitivity to these issues because it literally affects every congressional district and, potentially, the economic fabric of this country.

For these reasons, the committee has turned its attention to this important matter and we look forward to the insights of those who will appear here today.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

We meet today to review, generally, the structure of our nation's capital markets and examine specifically corporate governance issues of the New York Stock Exchange.

In recent years, a variety of securities industry participants have questioned one or more aspects of the regulatory structure of our

capital markets. Recent events at the New York Stock Exchange have also brought to light some of the potential conflicts that exist in a self-regulatory model. I, therefore, congratulate you for convening this well-timed hearing.

Debate on market structure focuses on such important issues as competition, the definition of an exchange, access to market data, information transparency and technological advances. Each of these issues have evolved considerably in recent years. As a result, we have come to a crossroads facing a number of decisions that could fundamentally alter the structure of our capital markets for many years to come.

As my colleagues well know, I have made investor protection one of my top priorities for my work on this Committee. I, consequently, share your concerns, Mr. Chairman, that our committee must conduct vigorous oversight to examine whether the regulatory system for the securities industry is working as intended and to determine how we could make it stronger.

In addition, I continue, by and large, to favor industry resolving its own problems through the use of self-regulation. Since the enactment of our Federal Securities Laws, U.S. Stock Exchanges have served both the marketplaces for securities trading and as regulators of their member companies. For the last 70 years, this system has worked remarkably well and balanced in protecting the integrity of our markets.

In order for self-regulation to endure, however, the system must maintain the confidence of investors. We developed the self-regulatory model under the stewardship of William O. Douglas, who, before he became a Supreme Court justice, determined that it was impractical, unwise and unworkable for the Federal government to try to regulate our decentralized securities markets directly.

In order for self-regulation to work, he also determined that the Securities and Exchange Commission needed to keep a shotgun, so to speak, behind the door loaded, well-oiled, cleaned, ready for use but with the hope it would never have to be used.

Despite my strong support for self-regulation, recent events at the New York Stock Exchange have revealed some of the conflicts that exist in self-regulatory models and the need for effective Federal oversight.

I, consequently, look forward to hearing from the interim head of the New York Stock Exchange about his recommendations for eliminating and abating these conflicts within his organization. In particular, I want to learn his thoughts as to how we should best separate the Exchange's regulatory and commercial functions.

Additionally, I look forward to hearing from our distinguished witnesses on the second panel, which includes representatives from some of the regional exchanges, noted securities industry experts, and other market participants.

Their observations will help us to understand how the New York Stock Exchange might restructure its internal governance system. They will also help us to understand more about how important market structure subjects.

As we begin this series of hearings on market structure issues in the 108th Congress, I must caution my colleagues on both sides of the aisle to move carefully and diligently in these matters.

In testimony before the Senate yesterday, SEC Chairman Donaldson indicated that the Commission would be focusing with increased intensity on the structure of our equities markets in the upcoming months. It is my hope that the Commission will move expeditiously in these deliberations.

It is also my hope that our securities market participants and their Federal regulator will resolve these issues without unnecessary congressional interference.

In closing, I want to assure each of our witnesses that I approach the market structure debate with an open mind. Their comments about these matters will help me to discern how we can maintain the efficiency, effectiveness and competitiveness of our nation's capital markets in the future.

I also look forward to continue to work closely with you, Mr. Chairman, and with others as we address these multi-faceted, complicated and important matters so that we can conduct effective oversight over our capital markets and ensure that we maintain an appropriate and sufficiently strong supervisory system for them.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 79 in the appendix.]

Chairman BAKER. I thank the gentleman for his statement and look forward to working with him as well.

Chairman Oxley?

Mr. OXLEY. Thank you, Mr. Chairman, and thank you for holding this timely hearing and your leadership on investor protection issues.

The New York Stock Exchange is an important symbol of capitalism here and throughout the world. It has a rich and storied history and has served investors well for over 200 years.

The past year, though, has been a difficult one for the Exchange. Highly publicized controversies have tarnished the image of the New York Stock Exchange and have led many to call for changes to the corporate governance of the Exchange, its role as a self-regulator, and also to its defining characteristic: the auction market system.

And these calls for reform have heightened the urgency of a thorough review and modernization of the regulatory and operational structure of our capital markets. As electronic trading and the growth in investor participation in the securities markets have transformed those markets, problems have arisen that were never envisioned when many of the significant rules affecting market structure were put into place.

Indeed, the notion of a securities market as its own regulator is now in question. Several years ago, in response to a scandal on the over-the-counter market, the governance of the NASDAQ market was reformed considerably leading to a separation of its regulator from the market. Today, some are calling for a similar change to regulation of all exchanges.

The corporate governance of exchanges is now receiving the kind of close scrutiny that corporate America underwent leading up to, and since the passage of, Sarbanes-Oxley. It is vitally important to investor confidence that the management of the Exchanges that are at the heart of our capital markets be held to the highest possible standards of integrity and transparency.

Increasingly, institutional investors are calling for reforms of the New York Stock Exchange specialist system. Some view the specialist as an unnecessary middleman who impedes the efficiency of the marketplace. Even if the New York Stock Exchange is correct about its ability to achieve price improvement, large investors say they place a higher value on speed of execution and anonymity.

If we wanted to build a stock market from scratch, would it be run by humans or computers? Why does the New York Stock Exchange control 80 percent of the trading volume of its listed companies when NASDAQ controls only about 20 percent of the volume of its member companies? Have current rules and regulations contributed to these results? How does the current structure benefit or harm investors?

These are important questions, and, fortunately, we will hear from an esteemed group of witnesses this morning that can provide answers. And, the first one, of course, Mr. John Reed, who has come out of a well-deserved retirement to accept this challenging position and is off to an impressive start.

We are pleased to have you here, Mr. Reed, and we look forward to your testimony, and I please yield back.

[The prepared statement of Hon. Michael G. Oxley can be found on page 72 in the appendix.]

Chairman BAKER. I thank the Chairman.

Ranking Member Frank?

Mr. FRANK. Thank you, Mr. Chairman.

I appreciate Mr. Reed's being here, and I appreciate even more Mr. Reed's being where he is in New York because it would seem, to the naked eye, to be a degree of aggravation which he did not need. And I am very appreciative of his stepping up here.

It is a very great service to have someone who is literally disinterested, not bored, but in the literal sense of disinterested, someone who has no axe to grind, no interest other than trying to improve a very important institution.

Now, I will not be making any great number of substantive comments here because I will confess that the governance of the New York Stock Exchange is not one of the subjects which has, heretofore, fascinated me. It was not within the jurisdiction of this Committee for most of my service on the committee, and we tend to be in a situation where, if things have not reached a crisis stage, we often aren't able to get there.

I now understand that we have some serious questions to be resolved. The question of a conflict between regulation and promotion, the question of—we are all for self-regulatory organizations—but the question is whether we have, in this instance, allowed self-regulation to be carried too far. And I appreciate Mr. Reed's willingness to address this.

I understand that the compensation issue, of course, called our attention to it, but that, as I look at it, does not seem to be at the core of what we need to do here. We need to talk about what is the appropriate governance for a very important part of the American economic system.

So, I think this hearing is an entirely appropriate one. I look forward to learning from it. I won't be able to stay for the whole hearing, but when we have a Congress that meets a day and a half a

week, it tends to clutter up your day with other things to do. I regret that, but I have no control over it yet.

But I will be taking the testimony with me, and I appreciate the chance for Mr. Reed to come and share with us his thinking.

And I can say, finally, I am also struck by the way in which Mr. Reed has approached these issues, Mr. Chairman, namely, that he is prepared to listen, that he has outlined what the questions are, and I have hopes that we will come out of this with a very useful set of decisions.

Thank you.

Chairman BAKER. Thank the gentleman.

Mr. Bachus, you had an opening statement?

Mr. BACHUS. Thank you, Mr. Chairman.

Mr. Chairman, and Chairman Reed, I have read your testimony today, and I appreciate your testimony.

I do want to say that I think the issue that we are not discussing today, which is far more important, is the way that stocks are traded on the New York Stock Exchange. The fact that specialists are member firms which have an exclusive right to trade in each of the New York Stock Exchange listed stocks, and if a broker wants to trade in that stock he has to go to that specialist, and that specialist alone has the right to execute that sale or buy that stock.

And what, to me, is amazing about what I see as a monopoly is that the specialists make the bulk of their money by buying and selling stock for their own account. And, to me, that seems like a monopoly situation in which the specialist, who has monopoly, has an inherent right to make a lot of money at others' expenses.

And I would hope that, as we go forward, we discuss this, the fact that this appears to be a monopoly at the expense of the public and that these specialists, the bulk of their money is buying and selling stock for their own account.

So, I appreciate your attendance here.

Chairman BAKER. Does the gentleman yield back?

Mr. BACHUS. Yes.

Chairman BAKER. The gentleman yields back his time.

Mr. Israel, did you have an opening statement?

Mr. ISRAEL. Thank you, Mr. Chairman. I will just be very brief.

Mr. Reed, I represent a district in New York that is about 40 miles away from the Stock Exchange. And I want to welcome you and thank you for the important undertaking that you are engaged in and look forward to continuing to work with you for the betterment of the Stock Exchange, for investors and for all of our financial institutions.

And I yield back, Mr. Chairman.

Chairman BAKER. Thank the gentleman.

Mr. Royce, did you have a statement?

Mr. ROYCE. I do, Mr. Chairman.

I want to thank you for holding this hearing on recent developments of the New York Stock Exchange. I also want to thank Mr. Reed, and I think you are to be commended for your current role at a particularly difficult time for the New York Stock Exchange.

And I have had the opportunity to review your prepared remarks today and I was very pleased to see that you are addressing a number of corporate governance issues, Mr. Reed, that are before the

Exchange. I think the New York Stock Exchange Board is too large; it needs reform. I think the Exchange also needs to alter the make-up of those that serve on the board.

It seems odd to me that regulatees are represented on the board and have a say in the compensation of the regulator. It would be as if bank CEOs decided the compensation of the comptroller of the currency.

I believe the New York Stock Exchange's largest constituencies should be represented on the board. As a holder of some $6.7 trillion of assets, the mutual fund industry should have at least one board seat, it would seem to me.

And the New York Stock Exchange should consider separating the dual roles of its CEO. There are clearly times when the role of regulator conflicts with the role of business leader.

Finally, it is my view that the Exchange should not limit itself to examining corporate governance issues. I have felt, for some time, that the New York Stock Exchange needs to do a better job of explaining the benefits of the specialist system to the marketplace. I was very troubled to learn of this morning's news that five separate firms had engaged in improper trading activity.

Mr. Chairman, I want to thank you, again, for your leadership on this issue and thank you for this timely hearing. And I look forward to the other testimony of the other panelists that are here today.

I yield back.

[The prepared statement of Hon. Edward R. Royce can be found on page 82 in the appendix.]

Chairman BAKER. I thank the gentleman for his statement.

If there are no other members desiring to give an opening statement, at this time I would like to welcome Mr. John Reed, Interim Chairman and Chief Executive Officer of the New York Stock Exchange.

Mr. Reed, as you can tell from the members' expectations, your reputation precedes you in a very advantageous way. I think we are all very excited to have you here to receive your comments, and we look forward to working with you, sir.

Please proceed at your leisure. We will make your official statement part of the record.

STATEMENT OF JOHN REED, INTERIM CHAIRMAN AND CHIEF EXECUTIVE OFFICER, NEW YORK STOCK EXCHANGE, INC.

Mr. REED. Chairman Baker, thank you very much.

If I could also say, Ranking Member Kanjorski and Chairman Oxley and Ranking Member Frank, I greatly appreciate the comments and the welcome that you have extended. And to all of the members of the Subcommittee, I am delighted to be here.

I appreciate that you invited me, and I hope that I can, at least, share with you what it is that we are doing.

I did, in fact, submit a written statement, and I appreciate that it will become part of the record, but what I will do is just summarize, very quickly, what it is that I am trying to do, where we stand. And I will touch on some of the issues that have been raised.

The New York Stock Exchange, as everybody has said, is an extremely important institution, not only in terms of its function and

role within the capital markets, but, indeed, I think it is a symbol of much that is important to this country in terms of its market system in general. And it is a symbol, not only within the United States, but, I believe, globally.

And, so when I was asked if I would step in during a period of difficulty, I did so because I do recognize the importance of the Stock Exchange, and I felt that it was extremely important that we restore the credibility that the investing public, the American public and, in fact, the world at large, wants to have in this institution.

And my job, in fact, is to try to see if we can restore that credibility as quickly as possible. My job is pretty clear: I have three things to do.

The first is I must understand what happened recently at the board that caused it to arrive at its current situation. I do this, not because I have any interest in pointing fingers or anything else, but because, obviously, you must understand what happened if you are going to try to correct for the failures that we clearly suffered.

The second thing I have to do is draft a proposal for a new governance structure, processes at the board level. And, indeed, architecture at the board and managerial level that not only prevents a reoccurrence of the kind of problems that we have had but, more importantly, would be appropriate to serve the interests of the Stock Exchange and the investing public in the years ahead, because as many members of this Committee have said, clearly we are at a period of change and a period of transition.

And it is extremely important that the board and the senior management structure of the Stock Exchange be appropriate to deal with the many issues that are coming down the pike. And, so, when I am looking at this architecture, I am doing so, not only from the point of view of trying to correct for whatever mistakes we did make, but, indeed, to try to make sure that the Stock Exchange has in place the kind of corporate governance and structure that can serve it going forward.

The third thing I have to do is find a permanent leader for the Stock Exchange. As much as I may be able to help in the short term, having interim leadership is not in the interests of the Exchange nor the markets. You need a permanent leader who is there and can be expected to be there for a period of time.

Whether we should end up with a Chairman separate from the CEO or a single person, I think, depends very much on the structure that we embrace. We first must have a structure then fill the slots, and the success of the structure depends, on the people. I think either structure could work. There are clearly benefits for having a separation.

There are advantages sometimes to having it together, but I think that we should allow for either and when the new governance structure is in place, we will then be in a position to deal with that issue. I am hopeful that we will be able to go to the members of the Exchange with a proposal for a new structure by the end of this month; that means in the next 10 days, approximately.

As you know, the bylaws of the constitution of the Exchange require that the members vote for any changes to that structure. Of course, the Securities and Exchange Commission must approve such changes as well. The SEC takes the position, I think correctly,

that any change to the constitution is a change of rules which they also have to approve.

And so, there is a process here that involves first making recommendations, then getting a vote from the membership and approval from the Securities and Exchange Commission. I am hopeful, as I said before, that by the end of this month I will have that proposal in the public domain for discussion with the members.

I would be hopeful because the bylaws require that we give the members between 10 and 50 days to make any change; I am planning on approximately two weeks. I am hopeful that we could have a vote by the membership that would take place by the middle of the month of November, and that would allow us to have a new structure in place, a new board in place that would then permit us to go on with my final task, which would be the selection of a permanent Chairman and CEO or Chairman/CEO.

So this is my timetable. I have had nothing but cooperation from everybody surrounding the Exchange and, in the Exchange, we all feel that this task is extremely important. There is no question that our historic governance structure did not serve us well, and clearly the flaws that Mr. Frank made reference to happened to take the form of compensation, but there were fundamental flaws in the structure as it existed.

It is not my task to make decisions about the long-term architecture of markets. This deserves, frankly, the attention of a permanent management and a new board. It is, intellectually, extremely interesting. It is not something that I would shy away from working on, but it is not the task of an interim Chairman to make important decisions with regard to architecture. But, indeed, I think we need a permanent management to get into this.

And, frankly, as this Committee and others in the Congress, I am sure will ensure, whatever is done has to be done within a broader public debate that focuses, not on the role of the Exchange and the role and advantages and disadvantages of a given intermediary, but on what is good for the investing public, and, frankly, what is good for the issuers: those companies that come to these markets to raise the capital to strengthen their own business, and so forth.

I am sure that the public debate will focus on how these markets can best serve those who issue securities and those who might wish to buy securities. And the role of exchanges and the role of intermediaries are important but, I think, the well-being of the economy rests with the investors and with the issuers, and the mechanisms in between should serve their interests.

I do think that we should all take pride that the capital markets in the United States stand alone in terms of their competence and their efficiency and their effectiveness. So while there is reason to anticipate change going forward—and I certainly would welcome this change—there is no reason to look backwards and feel anything but pride, because I think the capital markets in their aggregate have served the country and the investors, as well as the issuers, extremely well.

I will make a few comments with regard to some of the items that have been mentioned. They are, obviously, comments of somebody who is new to this business. But, with regard to regulation,

I have had, in fact, in my business career, a fair amount of exposure to regulation, and I think I do have some understanding of it.

There is no reason to doubt that the current structure of self-regulation that exists can be made to work. We, in the New York Stock Exchange, are good regulators. We are not perfect regulators, there are things that will need to be corrected and it is a continual improvement kind of thing, but we are quite good at it.

And there is no reason to believe that there needs to be a change to correct that. It is true that the governance structure is probably unacceptable as a supervisory structure for a regulatory function, and it is my intention, in the proposals that we will be making public in the next couple weeks, that we would correct that.

In other words, I intend to propose a governance structure that would clearly get rid of the conflicts that exist and, I think, were pointed out by one of the Members of having people who are regulated also sitting on the board that oversees the regulatory function itself. I would hope to have a board that is, essentially, independent and can pursue its activities without any conflicts whatsoever.

But I do not think there is any reason to believe that you need change the regulatory structure because of its ability to operate. I think it can operate well in its current configuration, and the need is to correct the supervisory, or the governance structure that sits on top of it, and my proposal is intended to, in fact, do that.

There may be other reasons to look at regulation, but it shouldn't be because it cannot be made to be effective. I think it can.

All indications are that the auction market serves investors well. It, too, can be improved. I am sure it will be improved, and the desire of large fund managers for more automation can, undoubtedly, be accommodated. I think it is important that we distinguish between accessing pools of liquidity and providing pools of liquidity.

Automation will improve access, it won't improve the providing of liquidity to the markets. The auction system is intended to provide liquidity to the markets and that is an important function, but trade-offs can shift. Somebody said in their prepared comments that there are people who would trade price for speed. Those trade-offs can shift as people's interests shift.

But the role of the auction market, every time it has been studied, has always been seen to have positive benefits for both investors and issuers. That doesn't mean that there is any reason to stop any further changes; I think changes should be looked at from the point of view of what is good for the overall functioning of the markets. And the New York Stock Exchange has, historically, embraced change, and there is no reason to believe that we will not do so going forward.

The role of the Exchange in promulgating standards for corporate governance of listed companies is important. Obviously, we are not in any position to promulgate standards if our own behavior doesn't pass those standards themselves.

So, obviously, one of my objectives in my proposals will be to make sure that our corporate governance is at least as good as anything that one might expect to be demanded of listed companies.

But the role of the Exchange in promulgating standards, while being in contact with the leadership of listed companies to make

sure that those standards result in the improvement of governance but not in bureaucracies, I think is extremely important, and it is a role that the Exchange welcomes. And, I think, it will help the Exchange in its overall functioning.

I believe very strongly that the strength of this company is in its private sector. I think the recent weaknesses that we have seen, not only in the New York Stock Exchange, but within the business community, point to the need for better boards and better governance. Obviously, the Congress has come to this opinion as well, because you have passed legislation that emphasizes that.

But I would simply say that the Exchange welcomes its role in that and I think that it is important that we improve the functioning of boards and corporate governance, not only in the New York Stock Exchange, but throughout our private sector economy.

So, I thank you, Mr. Chairman, for the opportunity to testify, and I welcome the opportunity to answer any questions that anybody might have.

[The prepared statement of John Reed can be found on page 192 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Reed, for your appearance and your testimony.

I, for one, am not yet ready to say the SRO model is fatally flawed and we need to go to the NASD, NASDAQ or some other model that has successfully operated. But I do believe the responsibility in this interim period is a very significant responsibility to demonstrate that the regulatory and/or compliance functions be clearly separate and above question as to their relationship to the CEO of the for-profit entity.

To that end, I think the Sarbanes-Oxley legislation is very instructive in that the importance of that audit function be maintained as in independent, beyond reach, activity from the corporate leadership side.

In looking at what post-Gramm-Leach-Bliley, post-Sarbanes-Oxley and what the Exchange has done—and I will note, again, prior to your arrival in facilitating certain ethical changes in conduct, for example, investment banking analyst relationships—it is clear to me that the Exchange has demanded of its listed companies conduct which, at the same time, is not applicable to itself. I find that troubling.

Not that all those rules are applicable or appropriate for the Exchange's operations but, in spirit and context, if we don't move away from the SRO model, we must establish a very clear high bar over which the Exchange must pass in order to, I think, obtain investor confidence that is so essential for all of us.

And, sort of the last piece of this—because under our business we get five minutes and then you can talk for as long as you like—I am very impressed by your aggressive outline of the schedule.

And it would also lead me to the observation that in that same time period, during which you are pursuing such extraordinary changes, how do we feel comfortable that a selection process for your successor can concurrently be engaged? And how would you suggest that that selection process be obtained?

Mr. REED. Mr. Chairman, if I could respond to a few of these, I share this feeling that there is no way that the New York Stock

Exchange could ask that listed companies have standards of governance which we ourselves don't meet.

I fully expect that we will embrace a set of standards that go perhaps even beyond that which we are expecting of listed companies. And I share your sense of wonder that it took a problem of this sort to cause us to get there. Clearly that had to be done.

I think it is imperative to us that we have governance of our regulatory functions that is visibly good, solid, without conflict and without problem with regard to our role as an exchange and as a regulator of both participants in the Exchange and the activity of the exchange itself.

I would point out that governance and regulatory structures like this abound. Most banks have internal controls for both audit and risk taking, and the national banking examiners and the Federal banking examiners from the Federal Reserve System, sit on top of that and make sure that those systems do, in fact, work and work adequately.

And it is true that the SEC does sit on top of our own self-regulatory function and I must say, they do so quite effectively. And so, while we are self-regulated, we are self-regulated within a construct that does have checks and balances which, I think, are needed, and I do think they serve the investor public. But to your point, I will be proposing a governance structure for the Exchange that speaks directly to that issue and I believe would satisfy your concerns and those of the general public.

The final issue is, of course, important. We had a board meeting two days after I took this job, or three, and we are not scheduled to have another board meeting until December. And so, just to expedite things, I asked that the existing search group that had been put in place by the board would be reactivated so we could begin to look at potential candidates to fill my job on a permanent basis.

I don't, frankly, believe we want to get into it very seriously until we have revised the corporate governance because it is a little hard to figure out what kind of person you want if you don't know what the structure of the institution is going to be. But I didn't also want to wait until December to start, which would have been my next opportunity to have a meeting.

What I am actually planning to do, I am hopeful, I can't guarantee this because it is difficult to do, but I am hopeful that when I go to the members for a vote to change corporate governance, I will also go to them with a slate of potential board members, which will be an essentially new board for the Exchange.

Assuming that I am able to do that, the problem, of course, as you might appreciate, is that it is not easy to get people to be willing to stand in a public election of quite that sort. But I am hopeful that I will, in fact, be able to have a proposed board of directors slate for the members to vote on at the same time that they vote for the various changes.

I would then propose to go to that board, which will be a newly-constituted board and a board that has had the expression of support from the membership, and use them as the body to make the decision about my replacement. Because I think they would, by virtue of the election and by virtue of the new governance proposals, be seen by everybody to be a legitimate body to make that selec-

tion, as opposed to the situation we have today, where I have to rely on the old board.

And so that was my answer to your final question, Mr. Chairman.

Chairman BAKER. Thank you, sir.

Just by way of clarification, it is my understanding that Mr. Grasso's compensation issue, which started all of this, he forewent in excess of $40 million, but he is legally entitled to and will receive, as far as I understand, $140 million package, which was the subject of controversy, or is that not the case?

And secondly, in your new construct for the committee that would do the selection process for the follow-on CEO, would they also have similar authorities with regard to compensation? And would that disclosure be made public?

Mr. REED. Yes. The answer with regard to your second question is, "Yes." With regard to Mr. Grasso's compensation, as I said, the first thing I am doing is to try to find out what happened. The facts are: Mr. Grasso did receive a check and cashed it for $139.5 million prior to my election. The first question I asked was, "Has the money, in fact, been paid out?" The answer is yes.

He has, under the contract that I guess was approved at the board meeting, other claims on the Exchange. I have taken the position that I don't want to deal with those until I feel comfortable that I know how all this transpired, because I have to feel that I am on solid ground as to what transpired and what is the nature of his claims to us.

And I just felt that it wasn't prudent for me to speak to Mr. Grasso, whom I have never met, nor ever spoken with, until such a time that I was on, sort of, solid ground. I would expect to be there by early November. Subsequent to that time, when I have a firmer understanding of what happened and the basis on which decisions were made, I then would expect to call Mr. Grasso. Hopefully he will be able to sit down and resolve any continuing claims or any problems that I might have with regard to what he has already received.

Chairman BAKER. Thank you, gentleman. I am way over my time.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Reed, it is interesting that we come at a time when a conflict of interest internally on payment should have been made, but it seems that you may have some ability to look out over so many areas of our society that tests the same question: conflict of interest, greed, misstatement, lack of transparency, lack of accountability.

And when I listened to your testimony I just thought of so many of the institutions across the board, whether it is the church, whether it is political institutions, whether it is the New York Stock Exchange, or some companies: Enron, WorldCom, we go on and on.

It seems to me that it has always been our proposition that we presume an honest, participating society and whatever institutions they are in. Do you see any reason why we should start questioning that basic presumption? And that we have to develop processes and

methodologies that anticipate that where opportunity of conflicts could be taken advantage of, they will be?

And as a result, are we required now to go to some cellophane society to see what the product is before we buy it?

Mr. REED. If I could say, I think that the great majority of practitioners in all of these institutions, be it the church, be it private sector, be it government, are honest, hard-working people that we have every reason to believe will do the right thing, serve the right interest and so forth.

I do think we have all learned over the years that transparency is valuable. We embodied it in the Constitution of the United States in the form of free press and so forth, and I think most of us have felt that having a society in which you have a free press has been an appropriate thing.

And I think transparency with regard to corporate governance and how decisions are made and who is making them and whether or not there is the potential for conflict; these transparencies which have been enacted, I think, are appropriate. And checks and balances work.

I think it is true that what we have seen recently was written about by the Greeks thousands of years ago; power does corrupt, greed is alive and well. But I repeat, I think our system works extremely well and the people who are not in the headlines, the companies that have had no problems far outnumber the ones that are in the headlines and that have had problems.

But I think that it is appropriate that we have checks and balances; we have a board of directors that sits on top of the operating management of companies, with clear responsibilities. And I think transparency with regard to compensation, transparency with regard to accounting standards and performance, and so forth, is an appropriate safeguard.

So, while I am fundamentally an optimist and fundamentally believe that most people in this world are pretty good and work pretty hard and do pretty well, I do support the idea that we need checks and balances and that transparency is useful.

Had we, in the Stock Exchange, for example, had the same transparency with regard to compensation, I think some of the issues with regard to Mr. Grasso's pay would have come up years earlier when the first large compensation decisions were made, which, at that time, were not disclosed and therefore were not subject to any kind of conversation or reaction.

Mr. KANJORSKI. I think I will just consume my time, Mr. Chairman. I yield back.

Chairman BAKER. Thank the gentleman.

Chairman Oxley?

Mr. OXLEY. Thank you, Mr. Chairman.

And again, Mr. Reed, it is comforting to know that you are at the helm and I know that, based on your testimony and your answer to the questions, that you are setting up a governing structure, changing the board, doing some of the architectural things that are absolutely necessary and it is good to know that you are working yourself out of a job. And based on your compensation, I can understand why you would want to do that.

But it is also true that, I think, the members of the committee would agree that you understand what your position is as an interim leader at the big board and are making the changes necessary. But the long-term market structure implications, obviously, will be after your departure, which, I think, is entirely understandable and laudatory in my estimation.

It gives you a certain amount of leeway and autonomy to deal with some of those difficult issues that we struggle with, frankly, when we passed the legislation dealing with corporate governance, and your response has been extraordinary.

Let me first begin on the SRO question, and I know that you have expressed a strong support for the idea of having an SRO. It has been my belief all along that without an SRO the SEC really is in a position where they are almost certainly overwhelmed in the real world trying to deal with regulatory matters.

And for a long time, the concept of a self-regulatory organization working hand in glove with the SEC has been a pretty effective model, in my estimation. Do you agree with that?

Mr. REED. Yes, Mr. Chairman, I definitely do. And I think that the facts would suggest that that is true. In other words, we are not here discussing a regulatory failure.

Mr. OXLEY. Exactly. And I would think, when we have Chairman Donaldson here, I think next week, or soon anyway, I would ask him the same question. I think, perhaps, we would get the same answer, particularly given the fact that he once sat where you do. And that does make a difference, I think, in where we are headed.

Obviously you can make some changes and nothing is perfect, but at the end of the day, without an effective SRO, it really does burden the SEC rather dramatically and diffuses their ability to deal with the real big issues.

On the auction system and specialists—this goes back to when I chaired a Subcommittee that had jurisdiction over securities and exchanges—and we had always, I think, most of the members of the committee, at that time, and we were told and learned that the special system and the auction system was to provide liquidity; that specialists were there to make a market.

And to some extent, well it was before the advent of the ECNs, the changes in technology, the demands for more speed. To what extent has the creation and the birth of these ECNs, and even with the ability of the New York Stock Exchange to make—I think one of the great untold stories is the fact that the New York Stock Exchange, during this time—made significant improvements on their electronic capabilities?

And the last time I was at the Exchange I was, frankly, amazed at how successful that the Exchange had been in adapting to the new world. Does it appear to you that the Exchange needs to continue to move in that direction? And what is the future of the auction market as you see it?

Mr. REED. Well, Mr. Chairman, my impression is: number one, that the auction market has served us well. Every time we take a look and study it, it turns out that the process of searching for an appropriate price is greatly facilitated by the fact that you do have a specialist who is part of that system. And to the question that was asked before about the role of the specialists, it is true that

specialists intervene in transactions, but there are distinct rules as to how they can intervene so as to ensure that they are not just snipping little profits. And indeed, the report in this morning's newspaper about some disciplinary and disgorgement actions that are underway, are because specialists did misbehave and broke the rules and they will be forced to disgorge those profits.

But the system works well. Every time we look at it, the benefit of having an auction system seems to rest on solid ground. But as you say, Mr. Chairman, I have been shocked myself. I, obviously now, have spent some time on the floor, and having been away for a while, the degree to which there is automation on the floor is amazing.

Clearly the New York Stock Exchange is making use of the latest computer technology, a tremendous number of transactions never have to get to a specialist. If you have two people wanting to buy and sell a commodity at the same price, the computer can do that rather well.

The problem is when the prices at which somebody wants to buy and sell are not the same, and then the question is, "How do you move them toward a common price?" And that is where the auction system is thought by those who look at it to provide better results.

I think the challenge here—and by the way, the investors have changed in their desires, there was a time when price was everything. Some of the large mutual funds, and others, put a premium on time as opposed to price, and so maybe there is reason to look at this again.

But, I think—to answer your question—the position of the Stock Exchange is that we should continually want to modernize. If there ever were to come a time when the specialist system didn't serve us well, we would have to acknowledge that. At this point, we don't believe we are there. And we think examination would support our position, but I am sure an examination will take place.

The one thing that I would urge us to all do, is focus on the investor. I don't think we are trying to move profits from one intermediary to another. We are trying to ensure the investor's interests are served. Are the issuer's interests served? Can you go list on a market, get people to buy your stock reasonably? If you want to buy stock, can you go to the market and find things in a reasonable way to buy?

Everything I have seen, says, number one, the current system works pretty well. It has been substantially automated and it is not the position of the New York Stock Exchange that we are just trying to defend history and we are unwilling to make modifications and changes; quite to the contrary.

And I must say, Mr. Chairman, in my own thinking, with regard to the kind of board and management that I would hope we will be able to put in place over this next five-or six-week period, I am looking for the kind of board that would be knowledgeable and be willing to accept change and the kind of management that would be willing to engage deeply with the investing community, including the State treasurers and the large mutual funds and all of what we refer to as the "buy side" of the market, as well as the traditional broker dealers and the "sell side."

So when I am looking at the kind of governance structure, the kind of board and the kind of management that we want to have, I am looking at it from the point of view of people who are going to have to intermediate these different desires that exist and have to deal with them. I am not looking for the kind of board, or the kind of governance structure, that could simply "tough it out" as the saying goes.

I don't think that would serve the American public and I don't think that it would serve the members of the Exchange. And so, my view is we have done a very good job to date.

We have certainly embraced automation; There is always room for improvement and clearly, this is the time when there are many people asking for change and we have to accept that and deal with it. But we should deal with it from the point of view of what serves the American public, as opposed to what serves a special interest.

Mr. OXLEY. If I could just use the Chairman's prerogative for one more question, Mr. Chairman, I would appreciate your indulgence.

There is a lot of skepticism out there, as you well know, about the specialist system, "market makers are profit makers." I was stunned by the specialist firms' free tax margins are between 35-60 percent compared to 9.7 percent for the rest of the comparable industry.

Even during the bear market, I am told, that none of these firms even lost money in a bear market, which if you are making a market and the market is going south, I guess that is pretty good. But I am not quite sure that that wasn't because of their particular position. I guess that skepticism will continue to be out there; it is obviously being fed now by advertising by some of the ECNs as a result.

Can the specialist systems survive given all of that skepticism out there? It was a statement that your predecessor made a few years ago with the advent of the ECNs when he said he didn't want to preside over the New York Stock Exchange becoming the largest museum in Lower Manhattan.

And it struck me because we had visited several of the bourses in Europe and not one of the, not one, had an auction exchange. As a matter of fact, we had a meeting on the floor of the Swedish Stock Exchange in Stockholm, where there was nobody there except the participants in this meeting.

So, there is, I think, a lot of skepticism out there fed by, what appears to be, some rather interesting facts regarding the auction/specialist system.

Mr. REED. Mr. Chairman, we, the New York Stock Exchange, and others who make use of an auction system have the responsibility for making the case as to why this serves the public interest and the investors. And we accept the challenge.

There is, as you correctly say, a lot of skepticism. It is up to us, to answer that skepticism and I believe that we will be able to do it.

There is nothing that I have seen on the Exchange during the very, very short time that I have been there that suggests to me that the specialists are unusually profitable. I would guess that they are profitable; from what I hear, they struggle hard to be profitable.

As you probably well know, many of the specialist firms, if not the majority, are owned by broker dealers themselves, in part because private individuals simply didn't have the capital and the capacity to perform this kind of function and they exited and sold their businesses because they were under such pressure and such need to invest capital in order to perform the function.

And so it may be that, at one time or another, specialists have reported high margins. I don't get the impression from talking to these people—and I have asked about profitability—that they are particularly profitable, nor particularly confident about the continuing profitability.

And I think the price of the one specialist firm that is publicly quoted probably reflects some investor skepticism as to the long-term attractiveness of this. So, I am not worried that money is being creamed away from the American people, if you will, by the specialist system, but it certainly is worthy of discussion.

I think you want to look at all of the intermediaries. I would say that from the point in time that somebody decides to make some investments to provide for their retirement until they feel comfortable that they have done so, there are lots of intermediaries in that chain, each of which tends to be relatively profitable.

But in any event, I think the specialist system is subject to question. I think it is up to us to defend it. I believe the facts I have read, some of the studies that were made; I have looked at times of dislocation.

I have also looked, with regard to Europe, at some of the exchanges that did give up the auction system and moved to computers, and one of the things that strikes you is that the number of listed companies on those exchanges has dropped, which suggests that at least, from a listed company point of view, they didn't find that to be the best place to attract the type of investors they wanted.

And it seems to me that the volume of transactions that take place in some of these highly automated exchanges reflects the fact that they aren't great pools of liquidity. And it is important for us not to fracture the pools of liquidity around the system. I think it is important to point out to the American public that we in the New York Stock Exchange, and others, have an obligation to take the best price.

So, if there is a price on the New York Stock Exchange, that at the moment, that second, that it is going to be taken, there is a better price available through an ECN, the obligation is to take the best price so that the person engaged in the transaction is not disadvantaged by us, vis-a-vis some other particular pool of liquidity.

But if you look at some of the European Stock Exchanges that have gone into automation, while they function well and it is true that you could have a cocktail party on the floor without worrying about the number of people, it is not clear that it has served the listing companies, i.e., you have seen listings fall on those exchanges, nor does it appear that they have attracted great pools of liquidity.

So, I think, as this Committee, and others, examine this there will undoubtedly be witnesses a bit more confident than I am who will be able to put these issues in full context.

My whole career has been a career of trying to bring technology into the banking business, so I am not somebody who is up here trying to push back appropriate technology. I just think that we want to bring it into a system that serves the investors and the listers in an appropriate way.

Mr. OXLEY. Thank you, Mr. Chairman.

Mr. Chairman, let me just say that the turnout for members of this Subcommittee is quite extraordinary. It indicates how interested the members are on this critical issue, and again, thank you for your leadership.

Chairman BAKER. Thank you, Mr. Chairman.

Ranking Member Frank?

Mr. FRANK. Mr. Chairman, we have been taking a lot of time so far and I worry about all of the members not getting a chance to question, so I am going to waive. Would you go on to the next Democrat?

Chairman BAKER. Mr. Chairman?

Thank you.

Mr. SHERMAN. I want to thank the Ranking Member.

Mr. Reed you have made headlines by saying you would accept only $1 in compensation. Can you assure the committee—and I know it is not legally binding—that you will not accept any additional compensation, fixed or contingent, current or deferred?

Mr. REED. I can indeed. I would like to state, just for the record—since you seem concerned—I have no contract. When I was called and asked if I would take this job and the representative of the Exchange talked to me about compensation, I said, "Why don't we simply agree on $1?" I have no contract, it is not in writing, I am not sure that I could make good that claim that I have on the Exchange, if it came to that.

My understanding is it is $1 to get the job done, not $1 per year, so if I can get it done in three months I would like to take the dollar, not only a quarter.

Mr. SHERMAN. I understand your point. I understand your point.

Mr. REED. But I would like——

Mr. SHERMAN. Yes. But the reason I have to bring this up is that you serve under a board of directors that, in dealing with your predecessor, was either grossly negligent or is suffering from a strange new disease that I would identify as kleptophilia: a strange love and affection for those who would want to rip off institutions.

How you have a board—and I will point out—that includes very prominent Democrats, as well as prominent Republicans, who would embrace the contractual relationship with your predecessor is just amazing. And it is this kleptophilia that seems to afflict a number of boards of directors around the country.

But it is particularly bad when you have, in effect, a public utility, a quasi-monopoly, a regulated industry, and even more so when that board's representative's here in Washington came to our committee and said, "You have got to serve the American people by reducing the transactions cost on selling stock on the New York Stock Exchange. Cut that SEC tax."

So we cut the tax, reduced the Treasury; we thought that was going to inure to the benefit of investors. We didn't know the money was going to Grasso.

The board of directors you work for has made some very strange decisions. It is also often argued that our exchanges are somehow the best in the world—God it feels good to say that—I have no reason to think that it is anything other than a reflection of the incredible hard work of American working families that have built this incredible economy.

Yes, we have to assume that WorldCom and Enron are the exceptions, but we have no assurance that they are as limited exceptions as we thought. I am going to be working, hopefully with others would join me, in putting together legislation designed to regulate the compensation of those who work for the Exchanges and design to set standards for those who serve on the boards of directors, so that we don't have kleptophiliacs continuing to serve on these boards.

I don't know how people missed what was going on, or whether they just thought, "$180 million"; sounds good to them. But one way or another, this system has got to be checked and you may be gone—and if your wishes are complied with in just a few months—and this strange, new disease could rear its head again.

Can you tell me, is there any reason why your successor should—well we couldn't find a person to do a good job for $5 million in current dollars?

Mr. REED. I would certainly expect that you could find a person who would do the job for that, or less.

Mr. SHERMAN. So, we would not be preventing the Exchange from finding a competent replacement in allowing you to go off into the sunset, as you so wishly desire, if we limited your successor's total compensation to $5 million?

Mr. REED. Well, I wouldn't want to be thought to agree that you should legislate this, because, by and large, I would prefer that you have transparency and accountability and allow that work to——

Mr. SHERMAN. We had transparency, accountability, and——

Mr. REED. Well, we certainly did not in this case, Congressman, but to the point of what I believe will be necessary to have appropriate leadership of the Exchange, I don't think that we want people to take the job because of what it pays.

And there are many jobs, such as the President of the New York Fed, which is certainly a job of immense responsibility and with operating responsibility and markets and so forth, and you don't have any lack of people willing to take that job. And none of them: Mr. Volcker, Mr. Corrigan, Bill McDonough, none of these people were paid exceptional amounts.

I believe that we can find appropriate leadership for the Exchange at a quite reasonable price. But I would not encourage you to legislate it.

Mr. SHERMAN. Well, the system we had last year didn't work very well.

And I yield back.

Chairman BAKER. I thank the gentleman.

Mr. Bachus?

Mr. BACHUS. Thank you, Mr. Chairman.

Chairman Reed—is it on?

Chairman Reed—is it working now?

Chairman BAKER. No.

Mr. BACHUS. Sorry. I hope my time starts right now, right?

Chairman Reed, as a self-regulatory body, of course, you have rules, and then when people violate the rules they are fined or other actions taken against them. The GAO recently did a study and they found that the NASD levied $211 million worth of fines between 1997 and 2002 in about 4,700 cases.

The New York Stock Exchange during that same period of time, as opposed to 4,700 cases, brought 256 cases, and as opposed to $211 million in fines there were only $19 million in fines. While I recognize that the NASD has more entities under its regulatory jurisdiction, this wide disparity does seem to, at least, send the wrong message, and that message is about how rigorous the NYSE's enforcement is.

Does it trouble you that you have such a wide discrepancy between at least the fines levied?

Mr. REED. Congressman, it doesn't, to be honest. I, obviously, don't know what the circumstance at the NASD is or was. I would like to have no actions and no fines, in other words, I would love to run an exchange where people knew what the rules were and followed them.

And I don't think the level of fines or the number of actions is necessarily a measure of the regulatory function, it might be a measure of the quality of the market.

Mr. BACHUS. Well, it would either show that people are not violating the rules or the rules aren't being enforced. I think it would——

Mr. REED. It could be either, obviously. In other words, you could have a situation where the rules were being violated and we weren't paying attention. But I wouldn't take that one indicator as a negative. I have——

Mr. BACHUS. You wouldn't take it as a negative or, at all as a negative, or at least——

Mr. REED. Frankly, it would make me look at what is going on in the NASD, if you wanted an honest answer, not necessarily the politically correct answer. Because it seems to me——

Mr. BACHUS. Do you believe that by the high level of fines there, that that is——

Mr. REED. You would worry about it, because—when I was running Citi, which was a pretty big company strewn around the world, and we had a very disciplined audit process and regulatory process and so forth—when we started seeing a lot of audit comments and problems that typically to us was an indication that we had bad management and sloppy activities, not that we had a particularly diligent audit group.

Mr. BACHUS. I would think that when actions are being brought and fines are being levied, it is certainly an indication that enforcement is going forward.

Mr. REED. That certainly is true.

Mr. BACHUS. And the absence of that would, to me——

Mr. REED. You could at least ask the question.

Mr. BACHUS. It could either indicate that nothing bad was going on or the rules weren't being enforced.

Mr. REED. That is certainly true.

Mr. BACHUS. All right.

You referred to this, and others have, as an auction system or an auction market. But I think when the public thinks about an auction, they think about an auctioneer who does it by himself for his own profit, so that is a distinction, is it not?

Mr. REED. Certainly it is.

Mr. BACHUS. Does it bother you that the specialists, who really have a monopoly in a certain listed stock, that the bulk of their money is made buying and selling stock for their own account? Is that troubling?

Mr. REED. It is disturbing. If you look over the last five years there has been a shift from Commission to trading income on the part of the specialist. This reflects, frankly, that the Commissions have been squeezed to almost nothing. Whether that is good for the functioning of the market, you could debate.

Mr. BACHUS. To me, at a time when the market is falling and people are losing money, and as you mentioned earlier, they have to hang back or they have to step in, so if anything, it ought to be harder for them to make a profit, than——

Mr. REED. And I think it is. In other words, from what I could gather talking to only one with public data—we obviously have other data—I don't think there is anybody who believes that the specialists have been doing particularly well over the last year or so.

Mr. BACHUS. Let me just, and I will say this.

Mr. Glassman is going to testify, I read his testimony, and he actually says, as opposed to not being particularly well over this period of time, that their pre-tax—and I think the Chairman mentioned this, it is on page six of his testimony—their pre-tax margins are between 35 and 60 percent, compared to a little less than 10 percent for the industry.

So it would appear as if, if Mr. Glassman and, I think a Mr. Becker—he quotes him—if their figures are right, it has been a very profitable enterprise in a time of falling market. And you would think a period of time, if they were ever going to lose money, they would lose money over that period of time.

But I would ask——

Mr. REED. I would suggest you ask them directly and they will be in a better position than I am to answer. My overall impression is it is not a great business, certainly not a business I would invest in.

Mr. BACHUS. Not that profitable?

Mr. REED. First of all, you have to commit capital, so I don't know if this margin you are making reference to is the return on revenue or a return on capital. I would be astounded if it were a return on capital.

And it is hard work. It is hard work and it is a difficult business. And I don't believe that you have seen the consolidation of specialists that we have all witnessed and the buying of specialists by institutions——

Mr. BACHUS. Let me——

Mr. REED.—because it is a great business.

Mr. BACHUS. Let me say this. I will end with this.

Actually, I think four specialists account for 80 percent of activity on the floor, so you had a consolidation. And all of those either sit

on the board or the company that owns them sits on the board. Is that a possible area to be addressed, whether those two specialists or the two representatives of those companies that own them sit on the board?

Mr. REED. Absolutely.

Mr. BACHUS. Thank you.

Chairman BAKER. I thank the gentleman, his time has expired.

Mr. Gonzalez?

Mr. GONZALEZ. Thank you very much, Mr. Chairman, and good morning, Mr. Reed and thank you for your testimony.

I want to clarify something at the outset and then go into the questions. And I think in response to Chairman Oxley's inquiry you indicated, "We are not discussing a regulatory failure." Is that correct?

Mr. REED. That is correct.

Mr. GONZALEZ. Okay. All right.

And I want to kind of put the world on notice that Congress doesn't require a regulatory failure in order to revamp, modify and alternate any regulatory scheme. And the legislation we have pending now in GSEs would be a real good example of that. And I don't think anyone has ever said that regulatory scheme that was in place, in any way, failed to detect anything that would affect safety and soundness, which is really the cornerstone of what the regulatory apparatus is supposed to protect.

Nevertheless, we will move forward with that. So, anyone that comes before this Committee or Congress needs to be placed on notice that it doesn't have to be broken in order for us to try to fix it. Now do I agree with that? Not necessarily.

And there are those that will say, "You don't have to be sick to feel better." And in Texas—I will end this with another little Texas axiom—and it all depends whose ox is being gored at any given time in this Congress.

What is curious about what you have stated, and I do wish you well, because I like the concept of self-regulation. The strength of self-regulation is its weakness, and I think your written testimony points that out, and somehow you are trying to find this balance.

You still want individuals in a self-regulatory scheme that have the familiarity and the knowledge of the Stock Exchange and what goes on, but maybe not have as great a stake in what is going on, directly. How do you accomplish that when you keep talking about this independence?

You are talking about independence in the context of a SRO. So I guess what I am trying to get at is how do you keep all the strength and the familiarity and the knowledge and all that, and still somehow insulate those individuals from some self-interest and conflict of interests?

Mr. REED. If I could, first of all, I fully accept and do understand that you may well have very good reason to change regulation with no visible failure. So I cede to you the point.

My hope here is that we will create a board that is independent. In other words, a board that is not made up of people who are regulated or who have interests in the industry. But I want to, at the same time, create an industry group that can get deeply engaged in the substance of what we are concerned about here, with regard

to regulation and with regard to the evolutionary pathway, if you will, of these markets.

In order to keep the regulatory function clean you clearly need professionalism at the level of the people who do the regulation itself, just as within a firm you need an audit department that is professional as auditors, even though they may rest within the structure of the firm.

And you need to make sure that, with regard to compensation, with regard to budgets, with regard to manpower, and things of this sort, that the regulatory process is quite free of any constraints that might stem from the operational side of the business.

In most private sector companies, the audit department tends to report to the Chairman of the audit committee and not to the CEO of the company, even though they work within the company. And usually budgets for audit functions, and so forth, are approved by the audit committee and not within the overall budget process for the rest of the company.

And so, I think, you could set up mechanisms that give you some reason to be comfortable that self-regulatory activities can live in a particularly good environment without any kind of conflict. And frankly, you don't want a board that is engaged in compensation decisions and other things that is made up of people who are regulated because there is no question but that there is a chilling effect on their willingness to operate as fiduciaries if they also are in a position where they are being regulated.

And so I think we need to come up with a governance structure that cleans up some of these things. On the other hand, at the working level, you want a regulatory function that is tightly coupled with the activities.

And when you get into situations, for example, such as the one reported in today's newspaper where we are going to pursue some of the specialists firms for possible misbehavior, those conversations will have to be where the people know exactly how the specialist system works and what the rules are. Because, obviously, in order to decide whether something improper has happened or not happened, you have to be a hands on practitioner.

And you will see that in the existing structure of the Exchange, which I am told has worked well, the court of last appeal, if you will, of a member who is being fined by the Exchange is a committee of the board with a majority of outside directors, but with two representatives from the Stock Exchange floor itself, who bring to that deliberation some understanding. Obviously, not people representing the particular firm being disciplined.

But you do need the coming together with expertise and independence at that level. And by the way, the overview of the SEC is extremely important. The fact that the SEC gets engaged in these disciplinary matters, the matters that were reported this morning in the press, the SEC was deeply engaged. We happened to find the first problems and we obviously shared that with the SEC.

But they came back to us with subsequent demands for further information, that frankly, broadened the investigation and made it a better one, I think.

And so, this interaction between an SRO, as we are calling it, and the overall regulatory function is a delicate one. It does, I think, work pretty well. And what I am trying to do is to clean up the board and its supervision of the regulatory function so there is no conflict there.

But I am also going to try to clean up the board with regard to its other functions, including compensation, so that we don't have people who are being regulated by the Exchange making decisions, with regard to the compensation of the management of the Exchange. I don't believe that people are incapable of dealing with those conflicts, but I think most people would say it has a chilling effect.

If you are being investigated by the regulatory side of the Exchange, and you happen to sit on the compensation committee of the board, it is probably quite likely that you are going to be a quiet participant in those discussions, because anything you say is going to be taken out of context. They are either going to think you are trying to affect the regulatory process or you are trying to behave improperly on the other side.

So my proposal, with regard to corporate governance, is designed to eliminate those potential problems on both sides; to provide an appropriate governance structure, budget and manpower structure for the regulatory function that is independent of other considerations. And also make sure that those on the board who have fiduciary responsibilities and include the compensation and selection of management, and so forth, aren't people who also are subject to the regulation.

Mr. GONZALEZ. Thank you very much and good luck.

Mr. REED. Thank you.

Chairman BAKER. Ms. Hart?

Ms. HART. Thank you, Mr. Chairman.

I also wanted to welcome you, Mr. Reed. And ask my colleagues to have confidence in you because of your pedigree, as a fellow Washington and Jefferson alum. And also, knowing of your reputation in your prior business, I am pleased that you have decided to take this on, as well.

One of the things that you discuss in your testimony was that you believe that the board must be independent, and I think all of us in this room agree with that. And having read the last several weeks' worth of articles, numerous newspapers about the whole situation and the resignations that followed and all those interesting drama, I would agree.

Does that also mean that you believe the Chairman's position and the CEO position should be separate?

Mr. REED. Not necessarily. In other words, I certainly believe that there are places where a Chairman and a CEO being the same person can work. I suffer, of course, I was Chairman and CEO for 16 years, and we didn't have that separation, and so I am sure I have biases resulting from that.

I think the jobs are quite different. In other words, I think as Chairman your responsibility is to make sure that the board functions effectively; that it is sort of like the Chairman of the Subcommittee, his responsibility is to make sure that the right subjects

are talked about with the right kind of witnesses in the right kind of environment allowing the right discussion, and so forth.

A Chairman of a board has to make sure that the board thinks about the right things, has the right information when they do, the meetings are arranged so that, in fact, you could have substantive discussions, et cetera, et cetera, et cetera. The CEO is responsible for running the company.

You can do the two as one person. There are some distinct advantages in having two people, because, obviously, you have two human beings sharing a responsibility and it gives you twice the manpower, if nothing else, or womanpower. And in the case of the Stock Exchange, you could argue that our public responsibilities as a leader of the community almost require a Chairman who has a public role and maybe being hands on running the place everyday makes that somewhat harder.

So, I am quite open as to which is the better configuration. Frankly, I am just getting engaged in the process of looking at who might be potential candidates to take my job. Clearly you have more people to look at if you separate it. You have a broader potential arena if you separate it.

There are, however, at least two people I have thought of that I would be quite happy to see in a joint role. So, I could be persuaded either way.

Ms. HART. What, when you say, you have already found several people that you believe may fit the role, what kind of qualities and background are you looking for someone who may be able to take on those roles, or separate roles?

Mr. REED. Well, I could read you the job description if you would like.

You need somebody who is capable of acting as a spokesman for the industry and who can be fully engaged with the industry and bring all these disparate views about regulation, about the role of computers and automated exchanges and so forth to fruitful discussions. You need somebody who is credible in that, capable and can play a public, as well as a private role in that.

Obviously, whoever is there has to have the capability to run the board, which, if one could criticize Mr. Grasso, you would have to say he didn't run the board very effectively. And——

Ms. HART. Or, if you are a banker, he did.

Mr. REED. Clearly the board did not function well.

Ms. HART. Not enough.

Mr. REED. He may have been the best CEO the Exchange ever had, I have no opinion, but I think there is enough evidence on the table that the board didn't do its job very well. And so running the board is an important capability. I wouldn't want a person on the job who hadn't had some experience at running boards and doing so properly, and so forth. Integrity is everything.

When you get down to operational characteristics, you need somebody who can be an engaged leader of the diverse communities who are in the Stock Exchange. You go down to that Stock Exchange floor and it is a bunch of very small businesses that all come together and interact; you have broker dealers, you have independent brokers, you have specialists.

And each of those communities, and many of the members of the Exchange, rent their seats from owners who are retired. They have a very different point of view on things than some of the owners, who are retired. And so whoever comes in has to be an engaged and effective leader of all those various communities.

And the most difficult problem we are going to be facing going forward is what I call this "evolutionary pathway." Today, the New York Stock Exchange, I believe, functions exceedingly well. We have 80-plus percent of the volume, we have the best of the companies listed on the Exchange. The real challenge for the new leadership is, "Will that be true seven years from now?"

And if so, it has got to be because we continue to occupy that position where people want to list on our exchange and where people want to come to the Exchange to transact business. And if anything we do over the next seven years loses either of those constituencies: those who would list and those would bring business to us, then the Exchange is going to get fragmented.

And so the principal requirement of the new leadership, including the board, is how you manage yourself through that evolutionary pathway.

Chairman BAKER. Gentlelady's time has expired.

Ms. HART. Unfortunately. Thank you.

Chairman BAKER. Thank you, Ms. Hart.

Mr. Hinojosa?

Mr. HINOJOSA. Thank you, Mr. Chairman.

In light of recent developments in the capital markets, particularly the reported New York Stock Exchange actions against the five largest specialist firms, I appreciate hearing the testimony of Interim Chairman Reed and learning what initial changes you believe must be made to corporate governance at the New York Stock Exchange.

I further understand that the Senate Banking Securities Subcommittee held another hearing on market structure yesterday, at which SEC Chairman William Donaldson testified. It is clear to me that Chairman Donaldson expressed certain concerns about the current corporate governance at the various exchanges.

And after the hearing, he reportedly stated that SEC approval for the New York listing standards proposed by the New York Stock Exchange and NASDAQ is imminent. Having said that, do you believe that there are directors who would be willing to accept directorships on the New York Stock Exchange after you have finished with your remodeling of such corporate governance?

Mr. REED. Congressman, that is a very good question. I believe so, obviously, because I couldn't put in place a proposal that would fail simply by being unable to get a board together. But there is no question that sitting on a public board nowadays is an undertaking of greater gravity, if you will, and accountability than maybe it was 20, 25 years ago.

And there is no question that there are any number of people who would be very good directors, but who when approached, simply are unwilling to accept those extra responsibilities. I am hoping that the same thing that causes me to be here with you this morning will cause directors to serve on the Exchange; that is, an appreciation of the importance and the role of the Exchange.

And it is a semi-public both honor and responsibility. This is not the same as sitting on the board of a purely for-profit quoted company. We have a greater public role and public responsibility and I am hoping that we will find very good directors who respond to the public responsibility associated with being on the board and are willing to serve, in part because it is a challenging technical, intellectual business activity, but more because they sense the importance of this particular entity and the imperative that it have appropriate governance.

Mr. HINOJOSA. Knowing that you will be stepping down after you get this job done, would you personally accept such a directorship?

Mr. REED. That is an interesting question, Congressman. From a personal point of view, I would rather not, because I am happily retired and you never quite appreciate retirement as much as when you give it up.

But on the one hand, and there is a second concern, I wouldn't want to bring in a new Chairman who, in any way, found it difficult to have the prior Chairman, sitting there on the board. Obviously, the new Chairman should not, in any way, worry that somebody before him was sitting on the board.

On the other hand, I will be honest, when I have talked to some people about the possibility of joining the board, they inevitably ask me, "Hey John, are you going to be willing to stay on the board?" And it is hard for me to say, "I am not, but you should." And so I get a little bit of a problem there, and I don't have a strong point of view.

My personal preference would be to not stay on. But if it seemed to me that in order to help getting the board to gel and so forth, that my continuing presence for a short period of time—a year, two years, whatever, would be useful, I certainly think that I have some obligation to take that seriously.

Mr. HINOJOSA. Well, I think you would make a great director, and I will respect whatever decision you make.

But let me ask you for some clarification. In today's New York Times' article entitled "Big Board Plans Fines for Specialists," dated October 16th, it States that, "The New York Stock Exchange has decided to fine its five largest floor-trading firms about $150 million for trading in ways that deprived investors of the best price they could have received."

Has that amount already been set, or is it plus or minus that $150 million? And the second part to that question, is it a $150 million per-trading firm?

Chairman BAKER. And that will have to be the gentleman's last question as his time expired. But please respond, sir.

Mr. REED. The answer is that—first of all, I don't know where that number came from because the press release that the Exchange issued did not have any numbers in it—what happened is very simple.

We detected, some time ago—I say we, I was not there—but the Exchange detected that there seemed to be some strange behavior in the price of a stock and they investigated and they discovered that there had been some inappropriate behavior on the part of the specialist. They expanded the investigation and said, "Hey, if one specialist did this, maybe other specialists have done this."

And it is amazing—you might not be aware of this—but they actually could cut down to every five seconds, so that they could look in five second slices at all the information that was displayed on all of the screens that are available to the specialist and then they could see what the specialist did every five seconds.

And therefore, if you know what the specialist should have done, given the information that was available to him, and compare it to what they did do, you can decide whether or not they behaved properly or not. Needless to say, you could fill a fairly large room with the data accounting for transactions.

We went back and looked over a three-year period across all the specialists. At the end of that analysis, it was decided, not by me but by the people in our enforcement division, that indeed, there had been, amongst these firms, improper behavior. That doesn't mean all transactions, all specialists, but within each of these firms, there had been improper behavior, i.e., they didn't do what the facts, circumstances would have dictated they do.

You can calculate the difference between the price that was agreed to and the price that should have been agreed to and, therefore, you could sum it up and come up with a number, and the number you have is in the ballpark.

Each of the firms will be called up, and we will be talking to them both about disgorging the profits back to the people whose transactions were involved as well as paying a fine. In other words, it is not sufficient simply to disgorge, but also these firms—our proposal is going to be—that these firms will be fined.

There is an appeals process within the Exchange where the firms can contest, they could argue with the data, they could suggest that our calculations are incorrect, et cetera, et cetera.

And so, what you are seeing here is simply the first notification that we have given to these firms of our intention to pursue it. And my guess is what you are seeing here will be pretty close to what, in fact, will actually happen. But there is a process and it is subject to disagreement and that process has to be allowed to take place.

Chairman BAKER. That gentleman's time has expired.

Mr. HINOJOSA. Thank you, Mr. Chairman. I look forward to learning more about it and working with you and our Ranking Member.

Chairman BAKER. I thank the gentleman.

Ms. Kelly?

Mrs. KELLY. Thank you, Mr. Chairman.

Welcome, Mr. Reed. We are glad to have you here.

Yesterday, Chairman Donaldson testified, and he was talking about the market system being fair and efficient and so forth. And he raised an issue that I would like you to address, if possible.

He was talking about some questions regarding the fragmentation of the markets and whether or not that is reducing the effectiveness of the regulatory process. I wonder if you would give us some of your thoughts on that issue.

Mr. REED. Well, I think it is a very important issue. It is not in anybody's interest to see these markets fragment. The reason being, of course, if you don't have all of the potential buyers and sellers in contact with each other, the danger of getting a bad price goes up, for obvious reasons.

This is the reason why in buying and selling houses, brokers tend to list with all the brokers in a community so that you are sure that all of the people who might be interested in buying your house, not just the ones who happen to deal with the broker that you selected to sell it, get a chance to come and look at the home and maybe buy it.

And, so, it is in everybody's interest that the liquidities be pulled together, now they can be pulled together by rules that require, as I mentioned before, that you be aware of prices and alternative locations and, if they are better from the customer's point of view, you must take advantage of them.

From a regulatory point of view, the fragmentation is even worse because you have more things to regulate, but you also have to regulate the interaction among them. And, so not only do you have to regulate each individual exchange, but you must make sure that the interactions among them are as they should be so as to produce the best possible result.

And, so from a regulatory point of view, the fragmentation is also a problem and it makes it more difficult to be assured that the total marketplace is working the way you want it to. And, as you well know, some of these markets exist only in software. I mean, it isn't that there is something there you could watch.

All of a sudden the regulatory function becomes one actually of looking at the software and seeing whether that software would respond to potential different scenarios in ways that you would deem to be appropriate.

And, so, you are beginning to have to regulate the underlying logic under each exchange. I think Mr. Donaldson, who has the ultimate responsibility, is quite correct to point out that this fragmentation is a danger not only to the well functioning of the markets, but it is also a danger to the regulatory process itself.

And the likelihood of having an aberrant something off in a corner someplace, that you maybe didn't fully understand that could lead to some problems for you, becomes quite important. So, I am happy that I am not the regulator who would have to overview all of this.

Mrs. KELLY. Since we are talking about regulation, in your testimony you say, "Self-regulation is one of the two legs of a larger regulatory regime that includes government regulations by the SEC and Congress."

I am curious as to where you see State legislators and State security regulators fitting into the framework since you didn't talk about them. I think we would all agree that it is better to have a lot of cops on the beat, but it would be good to, anything we can do, to ensure against fraud. But do you see any benefit to having States participating in setting securities regulation?

Do you think this could create fragmentation?

Mr. REED. Yes, I would prefer that the regulation—this is a personal preference—be at least tightly coupled together, if not that we simply have national regulation. But you would have to honestly say that the States have played a role in bringing some discipline to some recent misbehaviors.

It is certainly true that there have been States attorneys general who have felt that there have been inappropriate behaviors and

have made a constructive contribution to reform. So, I do believe that the diversity of State vs. Federal interests are there.

I would hate to have States begin to enact legislation that started to conflict with the legislation that this body might enact because then you really do put the working entities in a situation where you can conceivably have conflicting regulation and it makes it almost impossible to operate.

But certainly the activism on the part of some of the State Attorneys general, I think, has to be seen as positive. I would like to hope that the framework, whether it be the State or the Federal government, be approximately the same.

Mrs. KELLY. But you are not worried that this would add to fragmentation and impact the market structure?

Mr. REED. It clearly would.

If you started getting significant differences in regulation it would, in fact, fragment the market. And that should be avoided to the extent that it can be.

My own sense is the Federal government stepped in in the 1930s after our problems with the big crash and created an over-arching framework for the capital markets that looks pretty good across time.

If you look at it, it seems to me, that as compared to other regulatory regimes, the securities acts and the creation of the SEC have served the American public rather well. I would hate to see lots of independent States creating their own regulation even though, as I say, their attorneys general probably helped this process a little bit, if we look at recent history.

Mrs. KELLY. Thank you.

Chairman BAKER. I thank the gentlelady.

Mr. Tiberi?

Mr. TIBERI. Thank you, Mr. Chairman. Thank you, Mr. Reed, for coming here today.

I am concerned—you touched on this throughout the hearing today but let me get more specific—I am concerned about the apparent conflict at the Exchange between the one hat you wear as a regulator, the other hat you wear as a marketplace competitor.

The former Chairman once said he viewed his job as one-third regulator, two-thirds businessman. The NASD solved that conflict by separating its marketplace competition function from its regulatory function.

Two questions. One: do you believe, specifically, there is a conflict? And two: would you support what the NASD did at the Exchange by separating those two functions clearly?

Mr. REED. I don't believe there is a conflict. I said this in a press conference once, "I believe that regulation in the New York Stock Exchange is analogous to quality control in Toyota." People come to the New York Stock Exchange because they believe it is a well-regulated market.

I have personally—when I was in my prior incarnation—listed the stock of Citi at other exchanges and the New York Stock Exchange and delisted from most of these other exchanges. And I have sat over the years on any number of investment committees, and I would tell you that in a couple of instances, I have insisted

that we simply make no investments in certain markets because I didn't have confidence in the functioning of those markets.

And, if you don't have confidence in how they function, you are really at risk if you buy and sell in them.

And, so, this question of the quality of the market—I think one reason that the United States attracts something in the area of $200 billion to $300 billion a year of excess investment, by excess I mean more than our current account might suggest that we would have—is because if you were to be given a large sum of money and you were to live any place in the world and you say, "Gee, where do I want to invest?" You would inevitably come here.

And you would come here, in part, because the underlying companies are attractive investments, but you would also come here, in part, because you could invest in the American capital markets knowing that they are honest, that they are straight, that they are well-regulated and that you will be fairly treated.

So my view is, were I to be the permanent leader of the Stock Exchange, I would want to keep regulation only because I think the better regulated that we are, and the better our reputation is for being toughly regulated, the more people who would want to list on us and the more people who would want to do business with us.

So I view the promise that you make to your customers that you are going to do things properly, which can only be enforced through supervision and regulation, is part of the business and shouldn't be separated as if it were on the side.

And I don't think there is a conflict because anybody who would want to run the business poorly—I mean, it is good for a week, it is good for a month—but you will lose business over time.

The particular path that NASDAQ took, I don't have an informed view. It may have served their interests quite well given where they were and what they were trying to do. I am going to hope to propose, to you and to the American public, a governance structure that permits the regulation to work side by side with the Exchange in a positive way and that would appear to everybody to be an appropriate governance structure. And that is my objective.

Mr. TIBERI. Second question, briefly. The exchange, in the past—talking about corporate governance—has resisted representation on its board from the mutual fund industry. There are 95 million mutual fund investors out there—I am one of them—what do you propose doing to allow mutual fund industry?

Mr. REED. Absolutely. I am going to come up with a complicated structure—but within the structure we are going to have representation from the big, state pension fund leadership, the big, private pension fund leadership, the large——

Mr. TIBERI. The board representatives?

Mr. REED. We are going to try to get senior representatives from each of these constituencies to sit with us on a board that will have the broker dealer community, the floor community, and so forth; the professionals who surround this industry. I think that we all believe we need the buy side, which are these people, as well as the sellers.

Mr. TIBERI. Thank you. Thank you, Mr. Chairman.

Chairman BAKER. We have a vote pending and at least one, perhaps two more votes. I am going to recognize Ms. Biggert. I would then go to Mr. Castle, and then to Mr. Shays, if time permits.

Ms. Biggert?

Mrs. BIGGERT. Mr. Chairman, I would thank Mr. Reed for coming, but I think that he has answered, several times, all the questions that I had. So I would just yield back.

Chairman BAKER. I thank the gentle lady.

Mr. Castle?

Mr. CASTLE. Thank you, Mr. Chairman. I will also be brief. Let me just, first of all, thank you and Mr. Kanjorski. I think these hearings are necessary.

I will say, Mr. Reed, I just become increasingly concerned with all the corporate scandals that we have had with the mutual fund issues and they seem to always be holier than thou, if you will, and some of the securities exchange issues which have arisen in a variety of ways.

And, in addition, we are trying to deal with some of the housing entities here, and some questions have been raised about some of their practices.

It just seems, to me, when we get into large monetary circumstances people try to develop ways to, obviously, take advantage of whatever they can, not necessarily always in a criminal way, but in the sense of perhaps deprivation to the smaller owners of this. So, all those things concern me.

And I am delighted you are here, I am delighted you are there. If these notes are correct and you are being paid $1 for the rest of your tenure there, then maybe you should get a pay increase like some of the others we have had there in the past.

I guess I do have one very brief question and, that is—and you may have already answered this, I wasn't here—but I think the New York Stock Exchange is probably going to get away from the specialists and go to electronic at some point. I don't know when; that is what I gleaned from everything.

If that happened, can you opine as whether it would be easier or more difficult to regulate or is that just not something that is in your purview at this point?

Mr. REED. It will be more difficult to regulate if you get there. Electronic systems of whatever sort, are more difficult to deal with than human systems. There is no question, just ask Microsoft how many bugs are in some of their releases and how long it takes to get the bugs out. Even Intel has occasionally had to recall a chip because it turned out that there was a flaw in the architecture.

When we get into highly-automated systems, the regulation becomes much, much more difficult because, basically, you have to regulate the code, and that is inherently difficult.

Mr. CASTLE. Thank you. I yield back, Mr. Chairman. Thank you.

Chairman BAKER. I thank you, Mr. Castle.

Mr. Shays?

Mr. SHAYS. Thank you, Mr. Chairman. Just to thank you for holding these hearings; to apologize to Mr. Reed for my not being here, I was in the district.

And look forward to the next panel, and just, also, to thank him for, not just being here, but for the good work; the very important work that he needs to do.

Thank you.

Chairman BAKER. I thank the gentleman.

Mr. Reed, we certainly appreciate your patience and courtesies extended today. Your remarks and responses to questions have been most helpful. We look forward to working with you and the Administration of the Exchange to assure all investors that our markets are transparent and functioning fairly for all those who are involved.

And we appreciate your contributions.

To the participants in our second panel, it is unclear whether we have two or three votes. We are well into the first vote. We will just stand in recess for 20 minutes. Thank you.

Mr. REED. Chairman Baker, thank you for your courtesy.

Chairman BAKER. Oh, thank you, sir.

[Recess.]

Mrs. BIGGERT. [Presiding.] The committee will come to order.

We are happy to have our second panel. Sorry for the delay with the votes.

I would like to introduce the second panel and, as you know, give you five minutes, and then we will have questions. And I am sure there will be more members back by then.

First on our panel is Mr. Robert Greifeld, President and Chief Executive Officer of NASDAQ Stock Exchange; second, Mr. Mark Lackritz, President, Securities Industry Association; third, Mr. James Glassman, Resident Fellow, American Enterprise Institute; and then Mr. Gerald D. Putnam, Chairman and Chief Executive Officer, Archipelago Holdings.

Mr. Meyer "Sandy" Frucher—the names are very difficult here, for me, anyway—Chairman and Chief Executive Officer, Philadelphia Stock Exchange; Mr. David Colker, President and Chief Executive Officer of the Cincinnati Stock Exchange.

And a special welcome to Mr. Colker, who is a resident of Chicago, even though the name of the Stock Exchange at the current moment is Cincinnati, it does exist in Chicago, Illinois. Professor John C. Coffee, Jr., Columbia University School of Law.

You can correct my pronunciation when you give your testimony. And so we will start with Mr. Greifeld.

STATEMENT OF ROBERT GREIFELD, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE NASDAQ STOCK MARKET, INC.

Mr. GREIFELD. Thank you, Madam Chairman, and all the members of the Subcommittee.

I appreciate the invitation to testify before you today. As you may know, I became CEO and President of NASDAQ Stock Market some five months ago. I consider NASDAQ to be a unique asset of the U.S. economy and the growth of this economy. Our success is driven by how well we serve the individual investor.

My premise today is that the individual investor is best served by free choice, competition and fundamental fairness. Of course, every aspect of this country's capital markets is affected by the decision of the public policymakers. In this regard, we are fortunate

to be served by an institution, like the SEC, with its expertise and tradition of excellence.

I have learned that the SEC can say, "Yes," and can say, "No." And for a manager, such as myself, in a fiercely competitive market, when they don't say anything, this means "no" as well. So, as we examine the issue of capital market structure, I urge you to encourage the SEC to continue to be deliberative and cautious, but also expeditious.

With respect to the debate about securities market structure, the Securities and Exchange Commission is faced with critical decisions at a unique time in our economic history. Now is the time to face these decisions.

At the top of the list, I would put three issues. One: reform of the trade-through rule; two: the need to separate the securities regulator from the market center, and in this position, we are not advocating the abolition of the SRO function, but we are advocating that the SRO function needs to be separated from the market center. And third: the need to ensure uniform regulation of the marketplace by addressing the emergence of trading in sub-pennies.

NASDAQ is the listing market for over 3,500 companies. Corporations list their shares because of the good name of NASDAQ, our listing standards and our government practices. The corporation's decision to list on the NASDAQ stock market does not mandate trading on the NASDAQ stock market.

Currently, 55 percent of the trading of stocks on NASDAQ, occurs within our system. NASDAQ competes for every listing, every quote, every execution, and every trade report, and we feel other markets should do so as well.

Competition has always been good for NASDAQ. Our open architecture has facilitated competition. We have nearly 300 market makers who are willing to commit capital and we have numerous ECNs matching buyers and sellers, all helping with the execution process. Our market structure promotes efficiency and market quality stats mandated by the SEC bear this out.

Attached to my written testimony is an analysis of how stocks trade on the electronic NASDAQ market vs. the floor-based New York Stock Exchange. As an example, the trading of the S&P 500 stocks, NASDAQ has a spread that is 38 percent better than what you see on the floor-based market. Our order execution time is 3.3 times faster and our trading costs are 37 percent lower. At NASDAQ, the speed of execution is faster than ever and the spreads are tighter.

Many argue that a floor-based monopoly can produce short-term benefits. But history and economics show that monopoly power is corrupting and is bad for citizens, markets and investors. Competition forces market participants to focus on how to best serve the customer and the investor.

Rapid technological strides, as well as decimal pricing, has helped to promote the spread of electronic markets and should lead to a reappraisal of market structure. Electronic trading has revolutionized trading on NASDAQ, but the listed arena is frozen in time. When electronic orders try to move in the listed environment, they are held up for an eternity of seconds because of the trade-through

rule. Trading in New York Stock Exchange stocks is slowed to the pace of the slowest market.

The example I use to illustrate this point is a story I have. It happened two Saturdays ago. My son had a football game. And after the football game, we went to our local fast-food place. And we sat down to have, as us good Americans do, a burger and a Coke. My son was about to sip on his Coke, and I said, "You cannot have that."

And he said, "Dad, why not? I am thirsty. I just played a game."

I said, "That Coke is 99 cents in this fast-food place. But if you go across the six-lane highway, there's a place advertised at 98 cents."

And he said, "But I want the Coke now."

And I said, "Well, in this market that we have today, you do not have the right to drink that Coke."

The amazing thing is if he decided to cross that six-lane highway, when he got there, there is no obligation for that Coke to be available at 98 cents. In fact, it could be 99 cents. It could be a dollar. It could be $1.01.

We need to have choice for investors. My son wanted to drink that Coca-Cola then and there. He was willing to pay 99 cents. He did not want the possibility of going across the six-lane highway.

And when I talk to individual investors, which I do on a regular basis—I see it as a key part of my job—I ask them what do they value most in an execution. And they describe a situation where they are on an online Web site and they click on that button to buy or sell a stock. They care about two things.

One is speed. When they click on it, the sooner they get that execution message back, the happier they are. And two is certainty of price. They see 99 cents advertised, 98 cents. If they get it back at 98 cents in two seconds, they are happy.

This trade-through rule is a 20-year-old provision of a plan approved by the SEC. Clearly, now is the time for reform of the trade-through.

Much is being written these days about corporate governance within the Exchange itself. America's exchanges rely on the trust of investors. At the moment, NASDAQ is in the process of separating from its regulator, the NASD, based on the belief that separation is the only structure that works for all markets.

As CEO and President of the NASDAQ, I cannot imagine explaining to Congress that my regulator hat was on one day and off the next. This is why we contract with the NASD to provide our market with unsurpassed regulation. NASD regulations are on the case 24 hours a day, seven days a week. It is untenable to combine a market center with a regulator in one corporate parent. It would be as if the FDA had an ownership interest in Merck.

And as we were waiting for this meeting to restart, I came up with another analogy. It is this. If I was going to sit here and testify, be done with my testimony, take my hat off, walk up there, sit down and put my other hat on, it just does not work.

And what is important, again, in the eyes of the individual investor, you can come up with tortured descriptions of why it is tenable. But they don't buy it. We are in a post-Enron era where we have to be very concerned about our credibility.

I sit here and I say, "Really, I do like the position the Exchange takes and that they want to keep the things together." I think that is great for our business, my listing business. The listing companies, the corporate CEOs that I talk to understand that you have to be separated from a regulator. So in a real sense, I would have a competitive advantage if the New York Stock Exchange chose to keep the regulator combined with the market center.

What really would have to carry the day is the individual investor. You cannot have these investors walk away from this market because they believe the game is rigged. And I do tie back to John Reed's comment. And he came up with a couple of words that I think are very interesting.

He said, "You can become comfortable with having a regulator and the market center together." He said, "I am going to come up with a complicated structure." Clearly, there are ways to engineer it, but in that engineering process, you will lose the interest and the faith of the individual investor.

NASDAQ does not simply list public companies. It is itself part of the environment of public companies. No NASDAQ CEO has ever sat on the board of a listed company. NASDAQ is subject to Sarbanes-Oxley and it adheres to the same listing requirements that we impose upon our listed companies. This list includes standards such as Sarbanes-Oxley 404 and Regulation FD.

NASDAQ will not complete the task of separating from the——

Mrs. BIGGERT. If you could come up——

Mr. GREIFELD. I sure will. Okay.

Just a last point that we want to make is with respect to subpennies. We have a market today that really disadvantages retail investors. Professional investors trade in subpennies. Retailer investors that I talk to; every survey shows that they are not aware of this. I think it is harmful and would erode investor confidence. And we need to make sure that the investors believe Main Street and Wall Street play by the same rules.

If the SEC does not act quickly, we will be forced to accept no action as a policy decision endorsing subpennies.

I do thank you for your time.

[The prepared statement of Robert Greifeld can be found on page 128 in the appendix.]

Mrs. BIGGERT. Thank you very much.

Mr. Lackritz?

STATEMENT OF MARC LACKRITZ, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. LACKRITZ. Thank you, Madam Chair.

My name is Marc Lackritz, and I am the President of the Securities Industry Association. I appreciate the opportunity to testify on this very important topic of the structure of the U.S. capital markets, because our nation's securities markets have long been the most transparent, liquid and dynamic in the world.

This is a really important issue because the functioning of our secondary markets allows us to raise capital in the primary markets that finances economic growth and is the engine of entrepreneurs and jobs and success.

In the past 10 years, the securities industry has raised over $21 trillion of equity and debt to finance economic growth. So in a lot of ways, we are at the center of the engine of growth. And these secondary markets are critical to ensuring that that function continues.

The success of these markets depends on one word, trust. Investors and market participants must always have confidence that the markets operate fairly and with complete integrity. And they must also trust that the regulators will make fair and well-informed decisions about how to regulate these complex markets and that they will enforce the rules evenhandedly.

The dot.com meltdown, the economic recession, terrorist attacks, and accounting and corporate scandals have combined to form a perfect storm that has greatly shaken the public's trust in our industry.

But Congress and the regulators have taken decisive steps through enactment and implementation of the Sarbanes-Oxley Act and, more importantly, through tough enforcement actions to address corporate wrongdoings, bad faith behavior and outright criminal conduct.

Our industry has worked closely with Congress and the regulators on these legislative and regulatory initiatives, and we have undertaken efforts on our own to help restore the public's faith in our markets and our industry.

And new revelations at the New York Stock Exchange have raised concerns about the dual role of the Exchange as both marketplace and regulator of its own activities and those of its members. We believe that action should be taken to address these concerns, and we suggest that one near-term step should be to separate clearly the New York Stock Exchange's member regulatory function from its function as a marketplace.

For example, it might be appropriate to remove regulatory activities from the marketplace reporting lines and put them in a separate unit within the New York Stock Exchange. There are other models, too, that we have outlined in a white paper that we submitted to the committee along with my testimony. In the longer term, it is appropriate to address the broader issue of the structure of self-regulation, and we believe that this debate should be shaped by the following four considerations.

First and foremost, investor protection: Regulation should put investors' interests first and foremost. Effective, consistent and transparent regulation is essential to keeping investors' trust, the most essential element in the success of our markets. Secondly, competition: Regulation should promote competition, rather than favoring or protecting one market over another.

Three, uniform national standards: The regulatory system should ensure the primacy of the SEC as a strong, national regulator. The system also should include appropriate roles for, and coordination with, the self-regulatory organizations, the States, and broker-dealer firms, to achieve uniform national standards. And, fourth, expert regulation: Our system should be structured in such a way as to ensure that the regulatory staff overseeing day-to-day activities possesses the requisite expertise necessary to perform their duties.

We believe the current model of self-regulation has worked quite well for our nation, and that this model should be preserved and strengthened. Self-regulation contemplates self-policing by professionals who have the requisite working knowledge and expertise about the intricacies involved in the marketplace and the technical aspects of regulation.

The system of self-regulation is supplemented, of course, by government oversight. This tiered regulatory structure provides the checks and the balances that protect investors much better than might otherwise be achievable. Moreover, it can be more effective and less costly than regulation by government alone.

Before the recent controversy at the New York Stock Exchange, other events raised questions about the needs to alter the current regulatory system. We have long advocated making timely improvements to self-regulation when appropriate, and we strongly support the elimination of unnecessary inconsistencies among Federal regulators and self-regulators. Duplicative and inconsistent regulation diminishes investor protection and contributes to the cost of regulation.

Investor protection should not be subject to the happenstance or whim of whether a broker-dealer is a member of one SRO as opposed to another. Redundant regulation also hurts investors. They ultimately pay for costs of compliance through higher fees or costs. We owe it to investors to give them absolutely the best protection we can at the lowest cost.

We believe there are opportunities to improve the current self-regulatory structure, and we stand ready to contribute to that effort. In that vein, as I mentioned, we are attaching our White Paper that we prepared three years ago, evaluating the advantages and disadvantages of six different approaches to self-regulation.

Our securities markets remain the envy of the world. The United States continues to offer investors and companies the most liquid, innovative, and fair capital markets available with unparalleled levels of investor protection.

And it is this structure that really allows us to raise the capital that fuels the economic growth of the broad economy. But we hope that an improved regulatory structure can preserve these goals that we all share, effective, efficient regulation that maintains the trust of investors and all market participants.

We are confident that by working together we can seize this opportunity to enhance corporate governance and transparency within the SROs and further improve the securities industry's regulatory system.

Thank you very much.

[The prepared statement of Marc E. Lackritz can be found on page 135 in the appendix.]

Mrs. BIGGERT. Thank you very much, Mr. Lackritz.

Mr. Glassman?

STATEMENT OF JAMES GLASSMAN, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. GLASSMAN. Thank you, Madam Chair, members of the Subcommittee. My name is James K. Glassman. I am a fellow at the

American Enterprise Institute, host of the Web site Tech Central Station and a syndicated financial columnist.

One of my main concerns is the nexus between finance and public policy, especially as it affects small investors.

Madam Chair, may I first ask for permission to enter into the record the study of economist Brian Becker that was referred to earlier by Congressman Bachus. This shows the high level of profitability of specialists. This study was the subject of a conference just last week at the American Enterprise Institute.

Mrs. BIGGERT. Without objection.

[The following information can be found on page 203 in the appendix.]

Mr. GLASSMAN. Thank you.

The recent resignation of the CEO of the New York Stock Exchange in the wake of controversies over specialist activity, board composition and compensation has provided a once-in-a-lifetime opportunity to reform a management structure built on a massive conflict of interest. So far, this opportunity has been squandered.

This hearing coming at a crucial time must help reverse a course that will inevitably lead to more scandals like those involving specialists that we just learned of this morning and a further erosion of confidence among your constituents.

The remedy is to put an end to an unconscionable conflict through two steps: first, separating the regulatory and business functions of the Exchange and, second, making the NYSE a public company owned by thousands of outside shareholders just like the nearly 3,000 companies that the Exchange itself lists.

The regulatory function of the New York Stock Exchange and of every other exchange and market should be separated by contract and by structure from its commercial market function. As the best insurance against conflict, the NYSE and the NASDAQ should become public companies with the majority of their shares owned by outside shareholders who would choose directors.

A system of electing board members, whether there are 27 or 17 based on the constituencies that they represent, is doomed to failure. All directors must be rowing in the same direction toward the same goal.

Unfortunately, top officials of the New York Stock Exchange and the Securities and Exchange Commission have not supported separation. It happened again today in Mr. Reed's testimony. This is a shame, and it is inexplicable, especially today with the news that at long last five large NYSE specialist firms will face disciplinary action for trading violations that, according to reports, could cost investors $100 million.

And let me be clear: Such violations are inevitable given the current structure of the Exchange. Five specialist firms have been named. Four of them sit on the board of the NYSE.

The structure is behind not merely specialist trading violations but the very existence of the anachronistic floor trading system of the NYSE, the only exchange in the world—the only major exchange—that uses an auction system with specialists.

The alternative is to separate the regulated from the regulator and to take the Exchange public. And the Exchange would not be

a completely passive party. It would choose its regulator, either private or public, and be responsible for that choice.

The model exists today: the National Association of Securities Dealers. The NASD, a private entity with a staff of 2,000, already regulates the NASDAQ stock market and 5,330 securities firms. The NASD used to own NASDAQ outright and the structure was self-regulatory. The separation was part of an effort by the SEC to remedy serious trading proprieties of the NASDAQ that emerged in 1996.

It has worked well, but it is still unfinished. And to achieve complete separation, the SEC should move quickly to grant exchange status to NASDAQ. A similar complete separation should be effected for the NYSE. And both exchanges would then be free to launch initial public offerings.

Finally, the decline in scandals at the NYSE should not have been surprising. As Sarah Teslik, executive director of the Council of Institutional Investors put it, "The nicest thing you can say about the NYSE and their performance is that they are set up in such a way that you can't expect them to do a good job. And they have not disappointed us."

The Congress, the SEC and the Exchanges and markets themselves have the opportunity to end the conflict that brought about the current scandals by establishing a new regulatory regime when built on choice, competition, strict compliance and investor protection. Time is short.

Thank you.

[The prepared statement of James Glassman can be found on page 120 in the appendix.]

Mrs. BIGGERT. Thank you very much.

Mr. Putnam?

STATEMENT OF GERALD DEAN PUTNAM, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, ARCHIPELAGO HOLDINGS

Mr. PUTNAM. Thank you, Madam Chair, members of the Subcommittee. I am honored to have the chance to testify here today on behalf of Archipelago today, which I refer to as ArcaEx. Just one moment of branding opportunity here—we used to be a very large ECN—today, we are a U.S. national securities exchange.

We have heard a lot today about the virtues of an auction marketplace. We, in fact, operate an auction marketplace. The difference between ours and the New York Stock Exchange is that our auction marketplace involves no specialists and it is entirely electronic.

Today, we operate the largest electronic exchange in the world based on dollar volume and the second largest exchange in the United States behind the New York Stock Exchange. I guess, in the spirit of the season, one of my favorite quotes, it is deja vu all over again. We have been here before."

Why is the New York Stock Exchange in need of reform? Why does the New York Stock Exchange not innovate? And the simple answer is that the New York Stock Exchange does not have to compete.

Back in 1995, we were in a similar situation. NASDAQ was coming out of a massive scandal: price fixing, collusion by market makers.

One of the solutions, a new rule came from the SEC that lowered the barriers to entry and created a competitive environment, which actually is the reason why I started my firm, Archipelago.

The results are in. Seven years later—I think it was seven years later—we have a marketplace where NASDAQ, the trading of a NASDAQ stock like Microsoft went from horrific to where it as good or better than the trading of GE, the largest stock on the New York Stock Exchange.

I was asked for my opinion or my views, my expert views, on what we should do to fix the New York Stock Exchange; some of these things are actually in my best interest to stay broken. As a competitor, we like to differentiate ourselves from the New York Stock Exchange.

But one of the key areas, I think, in terms of creating more competition for New York, is that a large part of the problem is based on New York as a monopoly and New York as the regulator.

We read in the Wall Street Journal today about the specialists' scandal. How can a situation like this exist? This is not a recent event. This has been going on since that blasted goat came into Wrigley Field and cursed our team in 1945. It is not new.

How can that happen? And how can we have a CEO of a monopoly earn $185 million? When Mr. Bachus pointed this out to earlier, there are conflicts on that board and the thing that comes to my mind, are things like, "Why rock the boat?" I won't rock the boat if you don't rock the boat. One hand washes the other.

There are conflicts there. The business head is in charge of regulation. Those on the floor that do the things that are pointed out in the Wall Street Journal, sit on the board of the company and the compensation committee that rewards that individual.

As far as Archipelago is concerned or ArcaEx is concerned, we don't like the bullying that takes place. When the regulator shows up at our member's office and says, "We noticed you have been trading on ArcaEx. We understand that the floor of the New York Stock Exchange represents best execution. We are not sure about ArcaEx. So we think we are going to need to have, 12 of our police officers in your company for the foreseeable future just to make sure you are getting best X." It is a competitive weapon. It is used.

I think if you compare the New York's model to the ArcaEx model, we actually have this situation of having to be a regulator and a marketplace, although our model is very similar, is actually similar to the NASDAQ and NASD model.

I head up the business unit. The people that work for me run the business of operating an exchange. Phil DeFeo heads up the regulator. The people who are in the business of regulating report to him, there is no cross reporting. I have no say over their compensation. I have no say over their duties.

And for those of you—and we heard earlier today about how it is hard to regulate electronic marketplaces—for any of you that believe that, just one word, the movie "The Matrix." It is not a documentary, it is science fiction. It is not hard. The machines aren't taking over and thinking for themselves. Humans do.

A very important point to us, and this is something that has been raised at the Commission. I have raised it down there many times. And we have a window of opportunity to fix something here.

How do you get New York to compete? It is through ITS reform. ITS is governed in a way where if any one of the competitors of the New York Stock Exchange so much as eyeballed that moat around 11 Wall Street, they show up for the meeting with a blackball.

There is a current example. Three very unlikely competitors: NASDAQ with its market-makers; ArcaEx with its electronic model; and the Chicago Stock Exchange, joined together to bring a proposal to the ITS Committee; a major reform. The thing that you heard from Bob Greifeld earlier, this reform will allow us to compete.

We showed up with a very, very negotiated proposal. The New York Stock Exchange showed up with a black walnut in their front pocket. That proposal for change; reform was put on the table. The New York Stock Exchange used its single veto and vetoed it.

Fortunately today, we actually have a program that was put in place by the SEC, a pilot program about a year ago in three securities: these three securities, one of which is QQQ. It is the largest, most liquid stock in the world. We have a de minimus trade-through experiment going on there. You can trade through the better price by up to three cents when a customer chooses speed over absolute dollar best price.

Well, the results are in. We are the largest marketplace, ArcaEx is, for trading QQQs. New York has one-third the market share that we do in that security. Put them in a competitive environment with their system, and they don't do so well.

I am going to ask the question: Why don't we do as well in GE, the most liquid, largest stock that trades on the New York Stock Exchange? It is because of the competitive barriers. Those competitive barriers need to be removed.

Thank you.

[The prepared statement of Gerald D. Putnam can be found on page 182 in the appendix.]

Mrs. BIGGERT. Thank you very much.

Mr. Frucher?

STATEMENT OF MEYER "SANDY" FRUCHER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, PHILADELPHIA STOCK EXCHANGE

Mr. FRUCHER. Thank you very much. I would like to thank the committee for having me here today.

My name is Sandy Frucher. I am Chairman and Chief Executive Officer of the Philadelphia Stock Exchange. On behalf of the Philadelphia, I appreciate the opportunity to speak at this hearing. And I would like to express our views on market structure.

This is a complicated subject, but I think it is very simple in a lot of ways. It is all about competition.

Let me begin by saying a word about the Philadelphia and the role of the regional Stock Exchanges. The Philadelphia is the oldest securities exchange in the United States. We trade over 2,000

stocks listed on the New York and American Stock Exchanges, over 1,000 equity options, and industry sector and currency options.

Collectively, the Philadelphia, the Chicago, the Pacific, the Boston and the Cincinnati Stock Exchange form an essential pillar of our national market system. While we differ in many respects, we all make markets in stocks listed by the New York and, thereby, provide needed competition for the Big Board.

The regional Stock Exchange survived because competition forces us to innovate. For example, the Philadelphia employs an electronic system of remote competing specialists. On our exchange, many stocks have three or four specialists competing to offer the best price rather than a single specialist as on the New York.

But frankly, that should be their choice. Their market structure should be their own. And how they compete in the marketplace, the marketplace should ultimately determine their fate, not a regulator.

The legal and regulatory environment in which the regional exchanges operate must foster the broadest possible competition. Congress has already endorsed this view. In 1975, Congress told the SEC to promote, "Fair competition among brokers and dealers, among exchange markets and between exchange markets and markets other than exchange markets."

Congress understood that greater competition produces greater benefits for investors and more dynamic and fair markets. To maximize competition, exchanges and dealer markets must be free to compete in terms of all the services they offer investors. Markets obviously compete on price, generally the best bid and offer available on each market. We also compete on the basis of fees we charge, on speed of execution, the depth of our liquidity, the convenience of our technology, our trading rules and so on.

The Philadelphia believes that exchanges must also be free to compete on factors such as degree of order interaction and possibility for price improvement. So long as the SEC allows all exchanges the chance to explore different modes of trading, this competition between marketplaces will translate directly into benefits for investors.

Let me turn to the self-regulation functions for a second. The Philadelphia believes that self-regulation by individual exchanges has worked very, very well. Each exchange is most knowledgeable about its own trading system and trading rules, its own members and the dynamics of trading in its marketplace. As the local authority, each exchange is therefore better situated to assess conditions, enforce its rules and prevent violations than is a distant regulator.

Monopoly in regulation is as bad as monopoly in trading. The fact is is that self-regulation is not sole regulation. There is a tiered system of regulation. And it is very, very important, I believe, to keep the ethic of regulation, of integrity in the marketplace. To separate it would be a grave mistake.

The cornerstone of our financial system is the obligation of every player to self-regulate. And that should not be lost during this period of time.

While the PHLX does not support a single self-regulator, we do support regular evaluation by Congress and the SEC on how well

the Exchanges are doing their job. Recent events at the New York Stock Exchange may create a perception that exchange regulatory functions are subject to inappropriate influence.

Rather than abandoning self-regulation, the Philadelphia believes the SEC and the New York Stock Exchange should look at overall governance issues. That is the key; that is the problem. And Mr. Reed seems to be doing that.

Since 1997 in the Philadelphia, non-industry members have consisted of a majority, they have been a majority of our board. They have played a very influential role based on their enhanced participation in our governing committee. We believe that this structural change has been a very, very important part of the integrity and the enhancement of our regulatory program.

Exchange members also have an important role to play in exchange governance, particularly because they bring to bear critical knowledge of industry trends, operations, and practices. We don't want to dumb up the boards. We just want to make sure that there isn't a conflict of interest.

Therefore, they have, and should have, a significant role on exchange board and committees. But there is an appropriate balance that must be struck between public members' representation and how oversight is conducted in key functions such as regulation, audit, compensation, and nomination of future directors.

This is the best way to safeguard independence of the regulatory function through the governance. You have to have a majority public, and they have to be in the key areas to ensure that you don't have a conflict.

I will conclude by touching on two risks important to independent regulation.

First, we understand that the SEC is considering proposals that would affect the structure of market data revenues and the distribution among market participants. Exchanges are required to collect and disseminate market data from their members and incur costs in doing so. Revenue from the sale of that data is an important source of funding, particularly for regional exchanges.

Reducing the market data revenue available to regional exchanges would limit our ability to fund our operations, including regulatory functions, and to provide competition to the New York and to the NASDAQ.

A second concern is the creation or sponsorship by exchanges of programs for payment for order flow. Exchange-sponsored payment for order flow programs, in my view, are a conflict. We believe that these programs may create conflicts in the exercise of exchanges' self-regulatory obligations, and we have submitted a petition to the SEC and we have asked them to ban the practice.

A more complete statement of my views on these important matters is contained in my written testimony.

I want to thank the Chairman and the members of the committee for affording me the opportunity to share my views and those of the Philadelphia Stock Exchange.

[The prepared statement of Meyer Frucher can be found on page 103 in the appendix.]

Mrs. BIGGERT. Thank you very much, Mr. Frucher.

Mr. Colker?

STATEMENT OF DAVID COLKER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CINCINNATI STOCK EXCHANGE

Mr. COLKER. Madam Chair and other members of the Subcommittee, I would like to thank you for the chance to share my thoughts on the important issues of the day.

I would also like to thank Mrs. Biggert for her kind recognition of our presence and important place in the Chicago financial community. Thank you.

Last year, Cincinnati became one of the largest Stock Exchanges in the country. We recently set a trading record of 415 million shares and 900,000 trades. We currently trade 20 percent of all the business in NASDAQ-listed issues.

We have achieved this growth by being a leader in technology, market structure, innovation, cost reduction, and effective regulation.

For example, we were the first exchange to eliminate our physical trading floor and go totally electronic. We were also the first exchange to provide automatic executions in the Intermarket Trading System, as well as the first to develop a complete electronic audit trail for trading activity.

In addition, we were the first exchange to implement a competing specialist system and to combine that system with a professional time modification called preferencing to facilitate electronic internalization of order flow.

Finally, Cincinnati was the first exchange to share all of its excess transaction fee and market data revenue with its members. By combining the operating leverage that comes from being all-electronic with the adoption of a utility cost model, we have established ourselves as the low-cost provider of exchange services.

All these innovations have come in the face of enormous resistance to change by the incumbents. For too long we have had to live with policies that protect monopolies rather than promote competition. For too long policymakers have accepted the false belief that if only all order flow could be directed to one physical location, then customer order interaction would be maximized and the public investor would get the best price.

Lip service was paid to the idea of competition between exchanges, but if any of the non-primary exchanges came up with too good an idea and started capturing order flow, this accomplishment was viewed as a problem and labeled with the pejorative word "fragmentation."

Recent events, however, have called these beliefs and policies into question. More importantly, recent troubles in New York are symptomatic of deeper problems and highlight the need for the SEC to seriously address the outstanding market structure issues.

We hope that the current problems in New York will translate into constructive market structure modification so that the public investor can benefit from the interplay of true competition.

While Cincinnati certainly doesn't have all the answers, there are two issues, however, that we believe deserve immediate attention. First, we would like to address the unfairness that allows NASDAQ to monopolize the decentralized market model, a model that does not require price-time priority.

Exchanges have been trying for over two years to get SEC permission to compete with NASDAQ by adopting NASDAQ's model when the Exchanges trade NASDAQ issues. This request is just plain fairness and common sense; particularly in light of the fact that the empirical evidence shows that a decentralized trading model like NASDAQ's actually provides better execution quality than New York's auction market.

In a world where NASDAQ is handling 12 percent of all the trading in New York-listed issues, there is no longer any legitimate distinction between exchanges and the securities association, and therefore it is no longer appropriate to prevent Cincinnati from trading NASDAQ stocks in the NASDAQ style simply because it is an exchange.

If the SEC is unwilling to permit an exchange to make price-time priority voluntary because of perceived investor harm, then the Commission should act to equally protect investors who trade on NASDAQ by requiring NASDAQ to impose price-time priority.

Second, the Intermarket Trading System needs to be changed, as my compatriots have also said. Three developments are driving this need for reform.

First, the world is much more electronic than when ITS was first created. Second, the minimum trading variation has been reduced to a penny. And, third, the national best bid and offer is no longer a reliable indicator of the best available price.

All of this has created tensions and frictions as automated markets are struggling to interact with manual markets. No other market structure change would do as much to force New York to have to compete than the modification or elimination of the ITS trade-through and locked market rules.

The definition of best execution has evolved beyond just price and now really is defined as a variable set of expectations that include price, cost, speed, and certainty of execution. Best execution can no longer suffer the inherent delays in ITS.

If the SEC were to remove the constraints of the ITS trade-through and locked crossed-market rules, and require ITS participants to provide automatic executions, then the broker-dealer community would have the tools it needs to provide investors with best execution and the securities industry would begin to realize the full potential of a national market system.

In closing, let me just stress to you just how profoundly the capital markets have changed. Because of electronic markets it is an entirely different world than even a few years ago. Our regulatory overseers have to adapt to this change.

It is imperative that the rules establishing the structure of our markets change soon so that the full value of competitive choice can be unlocked. Anything short of that will only protect the incumbent exchanges and hurt the public investor.

Thank you.

[The prepared statement of David Colker can be found on page 92 in the appendix.]

Mrs. BIGGERT. Thank you very much, Mr. Colker.

Professor Coffee?

STATEMENT OF JOHN COFFEE, JR., PROFESSOR, COLUMBIA UNIVERSITY SCHOOL OF LAW

Mr. COFFEE. Good morning, Madam Chair.

As your final speaker, I will try to be brief and keep my message very simple; focused on the corporate governance issues.

When you pierce through the lurid tabloid-style details about Mr. Grasso's extravagant compensation, and when you get just beneath the surface, you hit the real public policy issue, that this embarrassment, this scandal, revealed a deep-seated conflict of interest.

Put simply, Mr. Grasso's 1995 and 1999 contracts were negotiated with a compensation committee of the New York Stock Exchange Board, all of whose members were Chief Executive Officers of broker-dealers.

In effect, the securities industry had a structure, under which, it held a carrot and a stick by which it could reward or punish, not just Mr. Grasso, but all the senior officers of the New York Stock Exchange, including those who had primary responsibility for regulatory and enforcement matters.

That compromises, at least in the eyes of the public, the independence of the New York Stock Exchange as a regulator. Mr. Donaldson testified yesterday that he considered it to be, "An inherent conflict to combine regulatory and market functions."

Okay, I think there is no need to further argue the point that there is a deep conflict of interest. What do we do about it? I think there are two potential models that the SEC would see. And I am going to suggest that the more conservative of the two is perfectly adequate. But we have to go all the way with that more conservative model.

That is, there is already a proven and workable remedy, which lies in what was done in 1996 when the NASD was reorganized. Following a scandal, at that time, the NASD was also in the public eye as an organization that had become dysfunctional.

And it solved the problem based on a committee led by Senator Warren Rudman, which recommended separating the two functions and placing all of the regulatory activities of the NASD in a new, wholly-owned subsidiary called NASD Regulation, which was in principle, to have an all independent board of directors having no contact with the securities industry.

Okay. That was done 1996, 1997. Once, and not so long ago, well within my professional memory, the NASD was seen by most as a tame and largely toothless tiger, not a very powerful enforcer.

Today, the world has changed. The NASD, or NASD Regulation is perceived by all as proactive and a very effective enforcer. What is the message? The message, I believe, is that independence makes a difference. Independence can improve the quality and the quantity of enforcement.

Now, please note that if we were to follow the NASD model, we would place all of the regulatory activities of the New York Stock Exchange in a wholly-owned subsidiary—call it New York Stock Exchange Regulation, Inc.—which would have independent directors having no contact with the industry. What would be the costs of doing that?

Let me suggest that there is no wrenching organizational change that follows from this simple step. No one even would have to

change their office, no lines of authority or reporting would be changed, no one becomes more distant. I am not suggesting having the New York Stock Exchange regulated by some super regulator located in Washington.

I am suggesting the same people doing it today, who continue to do their job, but they would have an independent board of directors to insulate them. And insulation is what you need, particularly when an organization faces increased competitive pressure.

In the past, the New York Stock Exchange did not face competitive pressure. As you are hearing, it is going to face more pressure for the future. When you look at what really happened in the NASD embarrassment in 1996, most commentators have said, as I summarize in my materials, that essentially a very zealous management of the NASD subordinated their regulatory responsibilities to their desire to maximize their marketing of their institution: the NASDAQ market.

That same thing could happen in the future to the New York Stock Exchange even if all compensation problems are resolved. Even though we have a perfectly clean system for determining the compensation of the New York Stock Exchange's officials, there is still the desire in the competitive world not to embarrass your organization. And that could lead to having regulators pull their punch.

Therefore, what you want is an insulated regulatory arm with its own board of directors. And the key role to that board of directors would really be to determine each year what is an adequate regulatory budget, because that is the invisible issue that no one else has yet mentioned.

You have got to have an independent board to say, "Here's what we need to function effectively." And that adds transparency to the process. That group could handle those issues.

My time has run out so let me not address anything more on this issue. Let me just add one final sentence. You have heard a lot of talk about other reforms that might be pursued. Let me say from some experience in this deal that there are very inconsistent goals in securities market regulation.

The public wants the lowest possible spread, the highest possible liquidity, the quickest possible execution, and oh, yes, a buyer and seller of last resort always there. Those things don't all go together. There are trade-offs. There are inevitable trade-offs.

You have to move incrementally. There is no magic bullet. And I would suggest to you that many of these problems require SEC study.

The one simple problem is minimized conflicts of interest. And if all we do is come back in a few months and have a better board for the New York Stock Exchange, we haven't protected and insulated the regulatory function.

That requires a truly independent board of directors so that enforcers know they will not be subject to invisible reprisals.

Thank you.

[The prepared statement of John C. Coffee, Jr. can be found on page 83 in the appendix.]

Mrs. BIGGERT. Thank you very much, and now we will turn to questions. And each of us will have five minutes, so I will yield myself five minutes for questions.

Mr. Glassman, in your testimony, you criticized the SRO framework. And self-regulation has been viewed as having certain advantages over direct government regulation.

Number one: that industry participants bring expertise and intimate knowledge of the complexity of the industry. And, two: self-regulation supplements the resources of the government, thus reducing the need for large government bureaucracies.

What do you say about these purported benefits? And do they justify the existence and continuing of the current system?

Mr. GLASSMAN. Yes. Madam Chair, I agree that there are benefits to, let us call it private regulation rather than government regulation, and that is, in fact, why I advocate private regulation.

But that regulation should be separate from the commercial activities of the institution that is being regulated.

So in my model what I would suggest would be something very similar to what is going on right now with the NASD's regulation of NASDAQ. NASD is a private company that has been contracted, that NASDAQ has contracted with, to provide its regulation.

There might be other private companies that could compete.

In fact, there could be public regulators who could also compete, and compete for the regulatory contract and would be paid by the institution being regulated. But I do not advocate this as an extra function for, for example, the SEC.

Mrs. BIGGERT. Okay, thank you.

Professor Coffee, when you talk about the independent directors—and I know Mr. Reed talked about the independent directors as excluding individuals from the trading floor and other broker-dealer industry, as well as the current CEOs of the listed companies, and he kept talking about how you need a professional board—so, who would serve on such an independent board that is not tied into the industry?

Mr. COFFEE. I think you could look at NASD Regulation. They also set up an independent board. There are people from the buy side. There are retired CEOs. There are people who once upon a time, five years ago, were chairmen. There are New York Fed bank Presidents. There are Nobel Prize economists in economics.

All of these people understand something about trading markets. They are not people who are very distant from it. And I think they would be interested in such a role.

I think there is going to be a lot of people who would be very interested in working with the New York Stock Exchange, either at the board of the entire exchange, or in a board specially focused on regulation.

On the regulatory board, you could have people who had formerly been the head of enforcement of the SEC. All those people know about enforcement and know what makes it work.

Mrs. BIGGERT. As long as there is no conflict of interest, then.

Mr. COFFEE. I think anyone who is going to be head of enforcement of an agency knows that there is body language by which the Chief Executive can signal to him he doesn't want this pursued, "This is embarrassing, this is messing up our IPO we had planned

for next year, or this is giving us a bad image, you are doing too much."

If you instead are insulated by a board of independent directors who know their function is to make you an effective regulator, I believe your behavior will be different and I think the change in behavior at NASDR is some evidence of that.

Mrs. BIGGERT. Thank you.

Mr. Putnam, I share the concern about the goat's curse of the Cubs. "Wait till next year!"

You talked about the 1990s investigation of the NASDAQ stock market that led to the separation of the regulatory to the NASD.

And then there is an ongoing investigation of the specialists for the New York Stock Exchange, and that has been in the paper this morning. Did that announcement color your speech as far as—the action against the five specialists—has that colored your view any more or was that expected?

Mr. PUTNAM. It was expected. And as a participant in the industry for 22 years, what goes on with the specialists on the floor of the New York Stock Exchange, since the first day I learned about New York Stock Exchange trading, it has been going on. So it is not recent.

Mrs. BIGGERT. And how would you recommend that the New York Stock Exchange restructure its market trade function to prevent the middlemen in the trading of securities from benefiting at the public expense?

Mr. PUTNAM. Again, I think that what I was trying to say is that when you have the head of the business wear the same hat as the head of the regulator, these inherent conflicts are going to exist. And we have seen this, "Right?"

So a very large paycheck goes out to the CEO of a monopoly who is also looking the other way when those people, who are the participants on the floor, are making a bundle of money by violating these rules and standards.

So you need to separate, at a minimum. I am not saying New York needs to spin off that regulator into a separate company that has no relationship to it, but, at a minimum, you can't have the same head of each organization.

In our PCX relationship, PCX is independent of us. They have a committee called the ROC, the Regulatory Oversight Committee. It is made up of independent directors. No relationship whatsoever to me. That is the ultimate jurisdiction.

On the regulatory side of that business, it governs ArcaEx, the Exchange. It is clean. There are no conflicts.

Mrs. BIGGERT. Thank you.

Mr. Kanjorski is recognized for five minutes.

Mr. KANJORSKI. Well, thank you very much, Madam Chairman.

One of the issues in the debate about the market structure that concerns internalization of customer orders—I know that some of the panelists have views on this issue—if internalization of orders increased, how will this affect the investors? And I would actually like an opinion of all seven of you, if I can.

But we can start off with the Philadelphia Exchange and then go to NASDAQ——

Mr. FRUCHER. I am sorry. Could you repeat the question just a bit? I have lost——

Mr. KANJORSKI. The issue of internalization.

Mr. FRUCHER. Oh, internalization.

Mr. KANJORSKI. Yes.

Mr. FRUCHER. I am glad you raised that issue. The SEC has taken a position on two issues. And three Chairman, actually that I have known, have all wagged their fingers at us and said both internalization and the question of payment for order flow is a terrible, terrible thing. And yet they proceed to move the ball forward in both those areas as they promised continuously to come out with a position paper to clarify their position.

Internalization itself is not necessarily bad; it is the degree of internalization. If you have extensive internalization, you have an inherent, or the potential for an inherent, conflict of interest. If you have a regulator—such as an exchange engaged in a taxing process where we take money from one player, give it to another player to buy order flow to the Exchange—it is inherently a conflict of interest.

That and issues like the ITS system really require leadership from the SEC. We need to know their position on these issues, and then you need to devise policies, or at least get comment from the public, including the affected public on where it stands.

So, I think that internalization and payment for order flow by exchanges are two issues that the SEC really must come forward before they allow a new exchange like the BOX, which is an internalization model, to proceed and before payment for order flow further erodes the integrity of the marketplace.

Mr. GREIFELD. Internalization really is another word for competition. NASDAQ has been about competition since its inception in 1972. And the market makers in the NASDAQ market structure provide execution solutions to investors. And they need to improve upon what is available through the NBBO.

And what we have today is a very clear measuring stick and it is called the Dash 5 stats. And that is what the SEC mandated when they collected the data. And the Dash 5 stats clearly show that NASDAQ's competitive model yields a better outcome for investors.

In my testimony, I have made reference to the S&P 500, where our spreads are tighter; our speed of execution is quicker. That does not happen by accident. That happens because we have competition; we have competition between ECNs, we have competition between market makers who are trying to offer a better execution solution.

And that is in stark contrast to the competing model, where there is one specialist who is monopolous. NASDAQ has multiple market participants and it yields a better outcome, and you can track that through the Dash 5 stats.

Mr. COLKER. Mr. Kanjorski, if I may also, respond to that question?

Mr. KANJORSKI. Yes.

Mr. COLKER. Thank you.

First of all, internalization is a widespread practice on all exchanges. As Bob mentioned, the NASDAQ is really entirely an in-

ternalized market and also just on Cincinnati and the other exchanges. The empirical evidence, as Bob said, shows that, in fact, maybe it appears counterintuitive to people that are not in the business, but the empirical evidence shows that, in fact, internalized markets provide better executions than in the auction market.

And the reason is it gives the brokers better control over the execution quality for their own customers. It is like Wal-Mart wanting to keep control of their customers vs. sending it down to Target. And the reality is that all this activity is transparent. The SEC is requiring the Exchanges to disclose this information.

And so the customers see the quality of service they get. And you can bet that if they are not getting the service they need, they are going to go to a competitor. So, internalization is really a necessary tool in the community to keep control over execution quality and efficiency of execution.

Mr. KANJORSKI. Yes?

Mr. LACKRITZ. Mr. Kanjorski, I think that internalization is an inevitable result of deregulation of Commissions and encouraging competition. Since the regulatory structure that we favor should encourage competition, internalization and payment for order flow obviously are outcomes of that.

But that doesn't mean that the transactions are removed from other kinds of considerations in the regulations, such as best execution. The broker-dealer still has the obligation of getting best execution for the customers under any circumstance.

And so there is a check and a balance to protect against any kind of abuse or excess that result from it. But the existence of internalization really is a natural outgrowth of competition and, therefore, it is not a bad thing, although it sounds like it initially.

Mr. PUTNAM. I would agree that internalization is certainly an outgrowth of competition. It is one way that an investor can get a stock executed. But it is important, and there is some missing information here. Is a lot of that one-five data that we are talking about, so that measuring how a marketplace does; a big component of that is executions that occur in our system where internalization is not allowed.

In our system, price competition is rewarded. If you are the first one in line at the best price, you are guaranteed to get the next trade at that price. In that way, investors compete aggressively to make tight spreads, to be the next one in line.

There is a serious question today about whether exchanges should be allowed to play both roles. And I would say it is a serious mistake to change the definition of an exchange that takes the value of that price competition away by allowing an internalizer to merely match, to step in front of the next investor that is in line.

You will dilute the value of price discovery if you allow it. It is on the table today with NASDAQ's exchange application. It absolutely should be prohibited.

Mr. FRUCHER. Mr. Chairman, I just want to say, you know, every Chairman of the SEC in the last six years has raised questions about the question of internalization. What is internalization? It is one firm taking both sides of the market and that looks inherently like a conflict.

I think it is very, very important—it doesn't necessarily mean it is—it looks like it is a conflict. And I think that we really need guidance here from the regulator as to what their position is on these issues.

You can't just keep shaking your finger at it, saying it is a vile practice, and then not give us any direction or any insight on your thoughts.

I really think that we are all waiting for this SEC position paper on this issue so that we can have a reasonable debate. People with different business models obviously have different points of view, as you do on things like the ITS system.

But I think it is important for the regulator to step forward and give us its views so that this debate can begin.

Mr. COFFEE. For the future—I am giving you a slightly dissenting view here from the rest—for the future, the problem with internalization, which certainly is the product of deregulation, and it is not a sinister practice—it is predatory in design, but its problem is that it is a form of market fragmentation.

When the broker-dealer internalizes the order and trades at what the distant market price was, we are losing order flow that went into the former process of price discovery.

Today, NASDAQ trades less than 20 percent of NASDAQ-listed stocks. Maybe 30 or 35 percent are internalized, the rest go through ECNs which match limit orders in Cincinnati. Against that backdrop, if that trend continues, and if NASDAQ were to fall to trading something around 10-12 percent, we don't have the same deep, liquid market determining price discovery.

We have got 70 percent or more of the market being determined, with reference to a relatively thin market, because internalization effectively is drawing stock outside of the normal processes of price discovery. And I think the historic goal of the SEC is to make sure there is a deep, centralized, liquid market, and they have a reason to be nervous about excessive fragmentation.

If the orders fragment away from the central market, over the long run I think there are some dangers to small investors.

Mr. PUTNAM. My branding speech, though: Cincinnati exchange, ARCA exchange, ECNs, NASDAQ.

Mr. COLKER. I have one quick thing. What people may not realize today is that the market really is centralized electronically. There is no give-up of interaction in market information today simply because of internalization.

Anybody who is internalizing or trading in any other fashion has complete information today on their PC of the market information of every other exchange and ability to route. So, there really is a centralization. And fragmentation really is just a pejorative word for competition.

Mr. KANJORSKI. I have never seen Jim without an opinion. Did you want to throw yours into——

Mr. GLASSMAN. Actually, thank you, Congressman.

I actually don't have a very strong opinion on this. I am generally in favor of internalization, but I think you have heard from people who are more expert than I am.

You probably never thought you would hear me say this.

Mr. KANJORSKI. Very good.

Mr. GLASSMAN. Thank you.

Mr. KANJORSKI. Thank you, Madam Chair.

Chairman BAKER. [Presiding.] Thank the gentleman.

Mr. Shays?

Mr. SHAYS. Thank you, Mr. Chairman.

Mr. Chairman, I am grateful that all of these gentlemen are here. I was kind of enjoying the fact that there were few of us here so we could ask lots of questions. I was feeling very honored that so many would speak to so few.

As I see Mr. Glassman and Mr. Coffee, I view you more as disinterested parties, in the sense that you are not speaking for the businesses that you are involved in.

Mr. Glassman, when I heard you speak, I said, "Yes, I agree with everything. It was pretty definitive and so on." If you were listening to Mr. Coffee, he started to qualify—educate me a little bit more about all of these other things I should consider—he went beyond your area of discussion.

Where would you disagree with him?

Mr. GLASSMAN. Well, I think that Mr. Coffee was saying that he feels that as long as you separate the regulatory function from what is called the business function, within the same institution, but with different boards of directors, that you can do the job.

I don't want to misstate anything that he said. I would say, go all the way. I don't see why that is necessary.

What I would say would be essentially something similar to the, as yet, incomplete NASD NASDAQ separation where you have a business that contracts with a regulator—in this case NASDAQ contracting with NASD, or the NYSE contracting with NASD or anyone else that it chooses—and has a complete arm's length relationship, is a contractor, really.

And I think that would provide much more of a separation than what Professor Coffee just said. I don't have a huge disagreement with what he said, but I think at any rate that is the direction that it ought to go in.

Let me just repeat what I said in my testimony. I think this is a massive conflict of interest. And it is hard for me to even understand why there are——

Mr. SHAYS. I am kind of with you on that. So you reached me.

Mr. GLASSMAN. Okay.

Mr. SHAYS. I would probably make sure that my conflicts of interests are stated, given that NASDAQ is in the district that I represent. First, they are first among equals with this group, but obviously I have a conflict here.

What I would love to have—and I gather that the other exchanges have variations on what we are talking about, some don't go, "All the way," as you say, Mr. Glassman—but I would love to have someone speak to the issue of why the New York Stock Exchange has—in fact, I am almost feeling sorry for this organization and I never thought I would, given what everybody has said about it today—but given it has 84 percent of the trading that it has listed—and I believe NASDAQ has how much of the trading?

Mr. GREIFELD. Fifty-five percent.

Mr. SHAYS. Not 20?

Mr. GREIFELD. Well, we have 20 percent in our time price priority product called Super Montage. And then in addition to that, you have the market makers internalization, which represents another 30-something percent of the market.

So the percent of trades that happen in NASDAQ is around 55 percent. And I think it is important to note in tying back to Professor Coffee's point, before NASDAQ had execution systems, the way the Professor was defining it, our market share was zero.

So you have to understand that NASDAQ has never been about doing executions in and of itself. It is about providing competition in a given market structure where market makers can provide execution solutions.

Mr. SHAYS. So you have benefited by the competition, but there are others who want to compete with you. And are you in any way, can anyone accuse NASDAQ of opposing others from competing with what it is doing?

Mr. GREIFELD. No. I mean, post-1997, as I think a lot of panelists have said NASDAQ truly was an open, competitive environment. What you saw is when decimalization came about—and it was a good act of Congress that brought that on—you had a demand for an agency solution in our marketplace. And that demand was met quite effectively by the ECNs.

The market makers are geared around principle transactions. And when decimals made the spread so tight, they didn't want to act on a principle basis; the ECN stepped in NASDAQ marketplace and really helped drive the great outcome we see for investors today.

Mr. SHAYS. Let me quickly ask, "Can someone give me a keen defense of why we have to have specialists?"

Mr. FRUCHER. Yes. Specialists provide depth of liquidity to the market. I think everyone has a right, or should have a right, Congressman, to create and to execute their market structure. I think competition is a good thing.

The New York specialist is not the only specialist. We have multiple specialists in the same stock in Philadelphia, which I think is an advantage. It may work for us; it may not work for New York. A single specialist did not work for us.

I think market structure should be left to the individual market and the market will determine who the winners and the losers are. What you need to ensure is the integrity of the marketplace, an integrated national market system so that you can, in fact, have best executions for the customer.

So it is a question of integrity and competition. Those should be the two cornerstones. Regulation shouldn't determine New York market structure any more than it should the NASDAQ market structure, but frequently regulation does. And with all due respect to Mr. Greifeld's statement, before he got to NASDAQ, NASDAQ spent a whole lot of time trying to protect its own monopoly, if you will.

And Mr. Greifeld was on the other side——

Mr. SHAYS. You don't believe in being born again?

Mr. FRUCHER. What?

Mr. SHAYS. You don't believe in being born again?

Mr. GREIFELD. I am the same guy I was before.

I am the same guy I was, but I came to NASDAQ recognizing we are in an open, competitive environment and if we didn't have that, I probably would not have come to NASDAQ. And that is my background, that is what I like to do. And that is truly the——

Mr. SHAYS. I am going to let him get the last word, only because I am the constituent.

Mr. FRUCHER. You know, all politics is local.

Mr. SHAYS. All politics is personal. Thank you.

Chairman BAKER. Enough of that. Thank you.

Mr. Meeks?

Mr. MEEKS. Thank you, Mr. Chairman. I thought he was good.

Coming from New York or being from New York and finding basically the capital markets in particular are important to New York's economy, but it is also important for the cause of this nation.

In fact, I think that one of the reasons why the World Trade Center was targeted by terrorists is because they really want to attack our economy and our financial institutions. And all of you, including the New York Stock Exchange, are very important to our great economy.

And so, having you here at once and seeing you basically competing in that competition between you, I think that is a good thing. It is a good thing for me because competition is good, and I just wish that all of you and I hope that all of you prosper and become very prosperous and make a whole lot of money over the next coming years, because it is good for America, it is good for the American people.

I just have one—just trying to understand—one quick question that I will throw out to the group. And that is that some argue that there is a trade-off between attempting to receive price improvement and obtaining fast, certain execution speed.

My question is, "How often does a 10-to 30-second delay in execution cause a change in the original best price?"

Mr. GREIFELD. If I can respond to that.

Decimals, again, really represented a sea change in our environment. Before Congress mandated decimals, you had spreads that approached 25 cents, 12.5 cents. And you could argue, I think successfully then, that there was true value in running an auction on a floor, where you could save an investor a nickel or a dime, you could say that was worth the time differential.

But post-decimals, we see that stocks trade for the one-cent spread or a two-cent spread. I was with the CFO of Microsoft a week or so ago and I was reviewing his trading characteristics, and he actually trades with a net effective spread today less than a penny.

The investors in Microsoft do not want to wait. Once you have got the price discovery happening in the quote, where the spread is a penny, investors demand speed, first and foremost.

That was very public this week with Fidelity in the press, but it is also very much the concern of the retail investors. I talk to them on a regular basis and they care about speed. When they click on that buyer sale order, they want to see that execution come back.

So in the world that we live in today, where you have tight spreads as a result of decimals, speed is paramount.

Mr. PUTNAM. If I could add something. The 10-to 30-second price improvement period without competition, it causes this: the specialist probe. It is during those 10 to 30 seconds that all the shenanigans in the name of price improvement take place.

Now, you get a choice. If you have real competition without barriers, you don't like the food in that restaurant, you don't go there. But in our world, there is no choice to use us. There is no choice to use NASDAQ. There is no choice to use another venue for trading listed stocks because of the ITS plan rules.

It forces us, as competitors, to always go to the New York Stock Exchange because of this definition of what best price is. You have got to expand the definition of best price. So, like Bob's example, his son can choose to drink the Coke for 99 cents instead of running across the expressway and drinking the Coke for 98 cents.

I mean, this is absolutely the key ingredient to changing the New York Stock Exchange. It will not change on its own. The NYSE will stay in the condition it is today if it is not actually forced to change the way that it operates as a result of competition.

Mr. MEEKS. Mr. Coffee?

Mr. COFFEE. As I mentioned earlier, this is a field that has inherent trade-offs, and all good things don't go together.

Investors want the best price and they want maximum liquidity, and they want the fastest possible execution. They can't both be maximized at the same time. And different investors want different things.

I understand that Fidelity wants speed, and that is why Fidelity did criticize the specialist system. They are responding to the impact of decimalization. Decimalization reduced the spread to such a narrow level that specialists no longer provide the same level of liquidity and they force investors to break up large trades into smaller blocks; that takes longer to execute.

How much that costs you, depends on who you are. If you are a big trader, like Fidelity, the inability to trade large blocks like you could in the past is a severe injury.

If you are a small investor trading 500 shares as your typical order or less, you like the fact that the spreads are now down to 2.5 or 3 cents. So I think different investors want different things. And I think a complete thorough-going reform that eliminated the trade-through rules wouldn't work to the best interest of the smaller investor.

There are all kinds of compromises here, and I am not arguing against compromises that might permit some kind of opt-in systems for some investors who are willing to sacrifice.

But I think you want to keep the central market with a strong trade-through rule that tries to enforce best execution. I agree we could have some different definitions about what best execution was.

Mr. MEEKS. Mr. Chairman?

Chairman BAKER. Congressman Meeks?

Mr. MEEKS. This is a very complicated subject and everybody has a vested interest in the outcome of that subject. Even on my own floor, in Philadelphia, I would say if you went to three different

people who function on the Exchange, they all have different business models and they all would have a different point of view.

This is precisely the area, or the kind of area, that requires us to get some leadership.

I think the SEC needs to put its proposals on the table, not to dictate an outcome, but to start the dialogue and the debate, to elicit comments, to come to you and to present their views and get your views and to get our views as part of a public debate.

Because the rules are one aspect of it, and the structure of the ITS is the second, as Mr. Greifeld and others here have indicated.

Right now, you have a system—I think Harry pointed out—right now you have a system where you have 100 percent; you require a unanimous vote of the committee in order to change the ITS rules. Sometimes I think that is terrific. I am the small guy on the block and so it is good not to have the big guys be able to force change down our throat. And so, we have a veto.

But on the other hand, that veto is used, sometimes, to perpetuate a monopolistic position.

So the structure of ITS has to be looked at, as well as the rules. And one of the problems now is that the regulator is very reluctant to step in even though it has the authority to be an arbitrator or a judge as to what is appropriate behavior or what is appropriate rules, et cetera.

I think that needs to be clarified as well. I think there needs to be reform. I think there needs to be reform, not just of the rules, but of the process. And I think there also needs to be an arbitration process, if you will, by the overall regulator, the SEC, to ensure that there is fairness and equity.

Chairman BAKER. Thank you, Mr. Meeks.

Mr. Bachus?

Mr. BACHUS. Thank you.

This first question will be for Mr. Putnam in Archipelago.

Mr. Putnam, reading your testimony—and tell me if I am wrong—I get the sense that what you are saying is that the recent corporate governing issues at the New York Stock Exchange were not really the problem, they were the symptom of the problem. And that the symptom of the real problem was lack of competition in trading of listed securities. Is that——

Mr. PUTNAM. That is exactly the point. When you are in an environment—and, again, we have seen this, we have seen this before, we saw this with NASDAQ and the NASD as a monopoly—when the monopoly and the regulator are the same, the conflicts exist, one hand washes another, one side doesn't want to rock the boat to disrupt the other. And that is exactly the point.

Mr. BACHUS. So if competition existed, then they would be incented to have appropriate corporate governance rules?

Mr. PUTNAM. You want to watch the New York Stock Exchange change? Let that market share go from 80 percent to 60 percent. And that thing is going to change overnight.

I mean, my worst nightmare is that they change so fast that I can't make an impact myself, so that we actually have a differentiation to where people will choose us.

But today the problem is that you don't have the right to choose us. So if you want to fix it, you have got to scare them. And they

are only going to be scared if they think that they are going to lose some of that market share.

Mr. BACHUS. Okay. Let me ask you this: In your judgment, what are the greatest structural obstacles to competition in trading of listed securities?

Mr. PUTNAM. I think the two that I pointed out: one is when the chief of regulation and the chief of the business in this monopoly organization is the same person, members are afraid to speak up.

And we heard earlier today, we are going to go to the members and ask them what they think. Well, if you disagree with the New York Stock Exchange, they send the cops over to your office and start tearing your books and records apart. That is what happens. So they can't be the same person.

The second thing, again, is this ITS reform; we are not allowed under the current rules to differentiate ourselves, except in three securities where there is a pilot program going on. In those three securities, ArcaEx outweighs the New York Stock Exchange in market share: QQQQ, SPY, and DIA, the most liquid stocks in the world by three times.

They do one-third of the volume that we do every day in those stocks. There, they are forced to compete. And guess what happens, investors aren't getting cheated. We have better markets.

The reason why we have attracted that volume is because we offer this choice of immediacy at the best price. We cannot do that in the, what is it, 2,000 other stocks that trade on the NYSE.

Mr. BACHUS. Okay. Thank you.

Mr. Frucher, let me ask this question to you and the Philadelphia Stock Exchange.

And this is somewhat related to the specialists, but how does the Philadelphia Stock Exchange differ from the NYSE? What aspects of the Philadelphia Stock Exchange corporate governance and also the business model should Mr. Reed be looking at as he considers changes at the NYSE?

Mr. FRUCHER. Well, I would say that there were two fundamental differences. The first one, we went through our own corporate governance issues seven years ago. The SEC basically came down and told us to change, and we did.

And what we did was we totally restructured our board so it is 100 percent, there is a clear majority public directors. And when I mean public directors, I mean people like one of Professor Coffee's colleagues. You know, we have professors. We have deans of law schools and Presidents of colleges so that the corporate governance distinguishes it.

We believe we can conduct self-regulatory practices because the audit committee, which is three public directors, has a direct reporting responsibility that goes to them by our regulatory function. Compensation is done by public directors. Nominations done by public directors so that the governance, I believe, is the key.

Self-regulation is critical. You must have a culture of regulation and compliance. You understand. You want to have a local cop and not the FBI do your local law enforcement.

You have a tiered system. It's not a sole regulatory responsibility. You have the SEC there. And the other distinction here is that they have a broader function and responsibility New York and

at the NASD. They regulate the industry, and that's a different function than the self-regulatory function of the marketplace and that seems to be getting lost in this dialogue.

So we have to look at these separate issues. The other thing that we do differently in Philadelphia is that we have a multiple specialist system. So it's not just one specialist. Gerry Putnam has no specialists.

I think the marketplace should determine it. And New York will decide, as Mr. Reed said, whether or not the sole specialist system will prevail or survive.

I think what we are all saying is you need to have integrity. You have to have the appearance of integrity. You have to have open markets and access. Competition is the key, integrity and competition.

Mr. BACHUS. And your specialist there is competition.

Mr. FRUCHER. Yes. You have competing specialists within our marketplace.

Mr. BACHUS. Third question is for NASDAQ, Mr. Greifeld. Have there been any differences following the separation of NASDAQ from its regulator, NASD?

Do you believe this should be the model for the rest of the U.S. market community? And if so, why?

Mr. GREIFELD. There certainly has been dramatic differences. If you go back five or six years ago, the standard reputation, or standard conventional wisdom, was the NASD was essentially a toothless tiger.

And if we fast forward to today and we look at the stats with respect to the amount of fines they collect and the fact that they are functioning as the tough cop on the beat, we see that good things have happened. So there has been dramatic change in really a few years when you look at it from an historical context.

So it has worked, it has worked well. We think it truly is the only way to go forward. I believe that you can set up separate boards and you can convince yourself and you can convince professionals that this is the right way to go. And we heard that from Professor Coffee.

But in my direct discussions with retail investors, they don't buy it. Why create that inherent conflict? Why have any NYSER? Separate it out. If you are going to have a separate board, you are 80 percent of the way there. Get it 100 percent, and you will eliminate that issue in investors. And I think we all: New York, NASDAQ, everybody here will benefit from that.

Mr. BACHUS. Have you actually been adversely affected by having the New York Stock Exchange marketplace and the regulator under the same roof?

Mr. GREIFELD. Yes. I tie back to the comment. I flew back to New York last night and I had dinner with one of the large bulge-bracket firms, and I said, "We want you to post two-sided bids and offers upstairs for listed stocks."

And this was a senior person there. And in spite of everything that has transpired in the last month or two, he said, "You have to understand, New York is our largest regulator."

And for them to now actively post markets to effectively compete with the specialists, they are reluctant to do it. So, when you have

that separation, and when that potential retribution threat goes away, that is when you will introduce real competition into this phase.

Mr. BACHUS. Okay. Final question, then a series of questions.

Why do you feel the modification or repeal of the trade-through rule would be a desirable change? And is that a NASDAQ position or have you heard from other market participants who share your view?

Mr. GREIFELD. Well, it is certainly a NASDAQ position. And I believe this is one of the positions in the industry that you truly have broad consensus. Everybody that I know and have talked to is for reform or repeal of trade-through.

It really is a rule that in today's day and age is protectionism. And it is protecting New York's volume; it is protecting them from competition. It is allowing the specialist to be the only person making markets in the stock.

So to the extent that we can have reform, you will see true competition in the trading of listed stocks and you will have a better outcome for investors as a result.

Mr. BACHUS. Final question and this follows up on that: the trade-through rule. Is it your position that all listed stocks should be traded in any approved venue or whether or not it is the primary listing venue?

Mr. GREIFELD. Well, we at NASDAQ are the primary listing venue for 3,500 stocks. And as I said, 45 percent of the volume doesn't trade in our market.

And I think that is good for investors. And it has resulted in helping competition and forces us to continue to improve. And we think that should be the outcome with respect to New York.

They will become a more effective competitor and yield a better outcome for investors if they are forced to compete.

Mr. BACHUS. Okay. All listed stocks traded in any approved venue?

Mr. GREIFELD. Yes.

Mr. BACHUS. Thank you. Thank you very much.

Chairman BAKER. Thank you, Mr. Bachus.

Chairman Leach?

Mr. LEACH. Thank you, Mr. Chairman. And I appreciate your allowing a non-Subcommittee member to come.

I have just been trying to seek perspective. And it strikes me all markets depend on confidence and we have had that confidence shattered. And I am struck by, despite the vigorous discussion here, the silence of much of corporate America.

And one has a sense that silence relates to a concern that frankness might have a downside to their individual companies. But all of us were a bit surprised by one person's compensation and in the world in which a lot of people get a lot of big compensation, that doesn't seem overly startling.

But the strong impression was that it was an insider's compensation based on full implicit understanding that the insider was protecting an insider's game. And that is the issue on the table. And then when you have an issue of confidence, the question is, "How do you rectify it?"

And obviously there can be a role for government. Several of you have suggested the SEC's preeminence in this regard. But in addition, when you comment on competition, in a free market economy, competition is often antidote. And so to stress competition I think is startlingly important.

And that is one of the reasons why one is taken very strongly by some of your testimony, Mr. Greifeld.

Now having said that, there are definitions. And I got in a little bit late here, but I keep reading in newspaper article after newspaper article, "What is the problem?" Ninety-three percent of the trades are done on the best price basis.

And I am saying to myself, "What is the definition of best price? Is there a criteria out there that everyone accepts that statement?" So I want to go to you, Mr. Greifeld.

There is an assertion that 93 percent of the trades are at the best price for the consumer at the New York Stock Exchange. Is that a true statement?

Mr. GREIFELD. To answer the second part of your question first, I think that is an impossible question to answer in that there is not competition to yield a better price. So I think when they say 93 percent, they are defining it within the strict confines of an essentially noncompetitive market.

And what we are here today to say is, "Let us introduce competition into that marketplace and let us yield a better outcome."

It is very interesting to note that with certain listed stocks, they trade very actively on the NASDAQ stock market, in spite, of the current rule environment. And they trade that way because certain investors just cannot tolerate the special system any longer.

So, we are saying, "Let us have competition and we will yield the outcome for investors that we need."

With respect to your first question on governance, I think certainly that is at the heart of a lot of different issues. And clearly, we believe the NASDAQ model is the right model. But what you have to realize, and you folks do better than I, there is so much effort going on with corporate governance. And I think exchanges should follow along in their draft.

We, as a publicly traded company, follow Sarbanes-Oxley, we are struggling with Sarbanes-Oxley 404, like the rest of the world, we are subject to F.D. and I have to have people stop me from saying things on a regular basis, and I will become well-trained on that soon enough.

And we also have an independent board of directors that has a tough comp committee. And certain executive officers cannot be approved by the comp committee. It has to go to the full board.

So I think governance will solve a lot of problems. We have the governance structure in place for all of corporate America. And I don't see why that just doesn't apply to exchanges en masse.

Let us go with that.

Mr. LEACH. Let me return to a topic that you have discussed several times, and this is just an issue of buying on account, I have heard this all my adult life and how this is very helpful to the system when it comes from the New York Stock Exchange's perspective.

And I can visualize situations where it is. I can't visualize what might have been the case 30 years ago on a thinly traded stock being the same thing today when you have options of electronics in many environments.

And therefore, when you look at the trends, which is, that the trends are that the makers of markets are increasing their percentage of buying on account rather than decreasing at a time when the need seems to be less. Does that strike you as inherently a conflict of interest or not? Is this one of the great moral issues of American economics or is it one of the very practical circumstances on the world's largest trading floor?

Mr. GREIFELD. Well, it is certainly counterintuitive because I agree completely with the thought. As the stocks become more and more liquid and trade more and more actively, there is less and less reason for dealer intervention. So if you look at the New York Stock Exchange and their actively traded stocks have increased dealer intervention, I think it is a symptom of something that is not right.

What we like about the NASDAQ model, with the growth of ECNs in our market, you see the ability for buyers and sellers to get together electronically at a very low cost. And we have 300 market makers. And that is really the same thing as a specialist in that they will commit capital, but you are getting that to the right balance of where they should be in the market.

So market makers going back in the NASDAQ market was 100 percent of the volume 10 years ago. Today, they are about a third. And we think that is approaching the proper balance, based upon the trading characteristics of our stocks.

Mr. LEACH. And so, when you emphasize the word "speed," you are really talking about the trained dealer intervention?

Mr. GREIFELD. I didn't catch the last part.

Mr. LEACH. When you were talking about the speed, you are really talking about the issue of dealer intervention?

Mr. GREIFELD. That is part of it. The second part of it is they are trying essentially to run an auction where the auction has little value. And in that period of time where they are running the auction, that is when the dealer can intervene and sometimes, as we see in the paper today, not for the benefit of the investors but, obviously, for his benefit.

Mr. LEACH. Well, I would only like to stress that the history of regulation, to the degree there is a history of regulation and economics, is to protect the small guy and that means Main Street rather than what we figuratively refer to as Wall Street.

One has a sense that New York has been a bit slow. And most of us know people that we respect a great deal in these markets. I think there is nothing more insensitive to say than to say someone's livelihood might be reduced. But that is what is partly at stake.

But I think that the great state for the system is to have confidence in it. And confidence is the overwhelming issue and there is no other issue that is more important. And confidence depends upon an assumption of minimalist conflicts of interest and total integrity.

And that raises a lot of issues that I think the SEC is empowered to handle, Congress could address, although I, frankly, think you are more likely to get a better result from the SEC than you are in your Congress.

But I would just say as a citizen representing a group of very small investors. The one thing you don't want in the American system is a question of confidence. And many of us inherently are very proud of the New York Stock Exchange, but I think this is a time for some change.

Anyway, thank you very much, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

We have come to the end, but, unfortunately, I haven't had my turn. So, I just want to—in listening to the discussion, it has been very informative, very helpful, to some extent troubling—Mr. Frucher, I think it was your example when you talked about the individual buying the 98-cent Coke and walking across the street.

You were the Coca-Cola man?

Mr. GREIFELD. Yes. That was my son.

Chairman BAKER. Okay.

But Mr. Frucher, maybe along a similar thing was talking about standardization in national market regulation, and that is not an Eliot Spitzer question. It means an ability to trade under similar rules wherever the venue might exist.

If we are to achieve a national regulatory structure where you can go buy the cola at $.98 or $.99, depending on whether you want it with ice or without, doesn't that lend itself to a single national regulator in order to enable that activity to be uniformly governed and to give everybody free access to whatever market they want to go to?

As I understand, most of you have expressed concerns about the consequences of the trade-through rule and limiting access of customers to products that are listed at the New York Stock Exchange.

But somebody be un-delicate. Are we saying we need to do more than just worry about corporate governance at the New York Stock Exchange; that we need to rebuild the blocks?

Mr. COLKER. Mr. Chairman, I would be happy to address that briefly.

I think we really have a unified regulatory scheme, and that is the SEC which oversees all of the Exchanges. And on a routine basis, inspects the Exchanges to make sure that they can enforce their rules on best execution.

Chairman BAKER. But at this point, if I wanted to buy ABC stock, I can't go anywhere I want to if it is listed on the New York Stock Exchange. There are constraints on where I can exercise that trade.

Mr. FRUCHER. Well, there are limitations. The fact of the matter is they have 82 percent. That means 18 percent is, in fact, traded somewhere else. What, in fact, is happening is that New York has rules that have effectively protected it.

What we are saying is you have to reduce some of those rules. But the issue of regulation——

Chairman BAKER. Well, I think that is exactly my point. I am suggesting that we may need to be more aggressive. We may need to review everybody's rules.

If we are going through the painful exercise of shrinking the New York Stock Exchange Board in attempting to provide the appearance and reality of self-regulation, with an interim Chairman in a window, in which every person who is a stakeholder has questions about what is going on out there, the difficulty presents an opportunity.

And we ought not be looking at necessarily just the New York exchange alone, but the rules that govern the function of our capital market system to enable us to transition to whatever we all ultimately know it is going to look like five years from now anyway.

The Congress should not be an interference lobby to make it more costly to ultimately get to the reform goal. And to great extent, the Congress drags its feet; the SEC has not yet acted. We are in the midst of a confidence crisis with investors. Why don't we fix this thing?

And I am looking for the plan. I mean, I recognize everybody has a particular view of the current system from their own stakeholder position, as I think you did indicate.

Mr. FRUCHER. Yes.

Chairman BAKER. And each of us has a reason to want to protect or promote that perspective. How do we get to the broader view where we are not taking Archipelago or the Philadelphia Exchange or somebody else's perspective as a committee exercising its responsibility in public policy and help formulate the construction of an open, transparent capital market, where you can go buy what you want where you want to go?

Mr. FRUCHER. Mr. Chairman, I think that you have hit a lot of points right on the head. And I want to make that nexus, that connection; because I think it is an important one.

A lot of the problems associated with competition was a function of a regulator effectively protecting noncompetitive situations, so that a single regulator—let us just say the SEC—has allowed the ITS rule and the trade-through rule to exist.

That is not a question of self-regulation. That is a question of central regulation that has, in fact, created barriers to competition.

It was only under the pressure from people like yourselves and yourself included, that the SEC only seven years ago changed the rules to have Rule ATS that allowed open competitive markets that brought in electronics.

You are right. Everybody is going to be a lot more electronic, certainly floor-based exchanges are either going to be hybrids or they are going to be electronic.

The issue is you want to have different kinds of structures with different kinds of rules and different kinds of technology. You want to have 1,000 flowers bloom and give the investing public the opportunity to invest in a number of different ways.

What has to be uniform is the integrity of the marketplace and the access to the marketplace. But the rules shouldn't be similar. And the notion of regulation really does start at home. A bank has to be responsible for its tellers. A market has to be responsible for

its players. But that doesn't mean that they are the only regulatory player.

They can't be. We are not a sole regulator, we are a self-regulator. On top of that there should be different regulators. The issue of self-regulation of the marketplace seems to be confused with self-regulation of the industry.

We currently have two regulators—actually three—that regulate the industry: the broker-dealers, outside of the trading community. You have NASDR, you have New York and you have the SEC.

That isn't, you know, a self-regulation issue. It is a designation that New York is the listing market and the NASDAQ, now through NASDR, becomes the regulator of the industry.

These are very interesting, very complicated questions. You want to have multiplicity. You want to have different kinds of systems and approaches. But what you need to have is independence in that regulatory process.

You have to have independent directors ensure the integrity of that market, whether it is local or whether or not it is central. And that is the key. So a lot of it does come back to governance. But you have helped create the most robust, most liquid marketplace in the world by enhancing competition.

And that means different rules, different technologies and 1,000 flowers blooming.

Chairman BAKER. Thank you, sir.

Mr. Lackritz?

Mr. LACKRITZ. Thank you, Mr. Chairman. I would echo what Sandy has just said, but also address the issue about how to design, you know, the architecture of this entire system.

We talk about investors' interests first, which is the most important principle for the self-regulation and for the regulatory structure. We are talking about different kinds of investors. We have retail investors, individuals on the one hand, and we have institutions on the other.

They have different preferences for the way they want to trade. For some of them, time is of the essence. Certainty is of the essence. Anonymity is much more important than anything else. And for some, price is the most important.

That says to me, and I think it is reflected in the structure, that the key is regulation that promotes competition, promotes transparency, and ensures integrity. And if you could keep those principles in the forefront, and at the same time, you get the expertise of people close to the market regulating it, that allows the system to evolve in a way that takes advantage of technological innovation, provides the best service to investors, and assures that investors are going to get the best execution.

Chairman BAKER. Let me give you a bank analogy. And these are old numbers, but it still makes the point. At one juncture a study indicated that if you were to do a transaction at the teller window, it would cost the bank $1.30. If you were going to do the same transaction through the ATM, it would be 67 cents. And if you had access to do it online, it dropped to 4 cents.

Now, I as an individual, on many occasions when I call the bank, I want to talk to a teller. I don't want to have a nice recording telling me what their business hours are.

So I make a choice whether I want to go get cash for dinner at the ATM or whether I really want to go in and talk to a person, but that gives me the flexibility. I am not arbitrarily steered toward any particular point of service; I make the choice as the consumer of the product.

Secondly, as a consumer of product, I want to understand the cost I cannot apparently see today, where somebody on the other end of the phone line, even if I am talking to them, may be engaged in activities that are not disclosed to me that don't offer me the clinical best price to which Mr. Leach referred, that the best price may be determined by the regulatory constraints. It is the best price because we don't let anybody else look.

That is not the best price, not in the common investor's mind. And I guess that is what I am driving to. I don't think it necessarily is prejudicial to any one participant's stake in future markets necessarily as to survival. There may be readjustments in the percentages.

But I think people will pick, when the institutional investor wants large block trades instantaneously, he goes that route. When it is someone investing for their retirement, and it is a $1,000, they want to know who it is getting, where it is going, what am I going get and the full service treatment. That is great.

I am not confident that the rules we now have enable me to be able to make an informed choice as to what I am getting until after I get that lovely statement at the end of the year which requires my CPA and three of my neighbors to tell me what I lost.

So, we are looking for a simple way through this mess, which apparently is very convoluted. And without delaying what has been a much longer hearing than anyone probably expected, I want to ask each of you from your various professional perspective, we are not looking to jump to any quick remedy because we understand the value that the system currently makes to our overall economic vitality.

But we have got to start talking about blueprints. Recognizing that each of you will have varying reasons for your particular perspective, the committee really needs to have, whether it is trade-through rule concerns, whether it is a grand scheme, whether it is regulatory, whether you defend the current system and think is how we make it work better; really reach out to this panel of experts and say, "Let the committee hear from you further detail about your views as to what directions the committee should consider."

There will be others to follow this panel in the weeks to come. It will not be something the committee will casually engage in. There are considerable concerns, we think, as a matter of public policy, need to be reconciled. And we want to work with those who understand the markets to ensure we develop the best product.

Unless, anyone has further comment—yes, sir?

Mr. GREIFELD. Just as a follow up, we published a white paper yesterday, which we will be happy to give you copies of, with respect to our positions as NASDAQ, on a variety of these mortgage structure issues that are facing us all.

Chairman BAKER. Terrific.

Yes, sir?

Mr. GLASSMAN. Could I just make one comment that sort of ties together the last two discussions.

Your mention of choice, which I think it really is perhaps the most important thing. Right now, because of the trade-through rules, people don't have choice. And I think that is one of the reasons that the New York Stock Exchange has been able to maintain the system that it has now.

But if it were pushed, it were buffeted by competitive winds there is no way that the current self-regulatory system could exist, I don't think. Because, for competitive reasons, it would have to be modified to serve the interests of the actual customers; but right now it is insulated.

So, the first thing that ought to be done, certainly, is to end the SRO. But really, the reason that it exists at all is because of the trade-through rules and I think that needs to be addressed.

Chairman BAKER. Yes, sir.

Mr. FRUCHER. Mr. Chairman, if I hear you correctly—and I hope I did—I want to congratulate you on what I hear you saying.

You are saying that you are going to start and this Committee is going to help engage this community, and the broader community, in a dialogue on a lot of these market structure issues.

Some of these things have really been dormant for the last couple of years. I mean, the NASDAQ application, whether it goes up or down, shouldn't be sitting here for three years. And my, as a smaller exchange, my rules sit behind his rules, my rules to allow us to compete with him is dormant because we were waiting three years for a resolution on his application.

So whether or not, through your structure, you are going to engage this debate and have the regulator come forth with its proposals or whether or not you end up with statute that, in fact, directs it, I congratulate you and I want to pledge the support of the Philadelphia Stock Exchange and myself to this endeavor as best we can.

Chairman BAKER. Well, I don't know that we will be helpful in the process, but I think we will engage in the process.

Mr. FRUCHER. You know, transparency always helps, in any forum.

Chairman BAKER. I would only point to my experience with investment banks, analysts, mutual funds, GSEs; be careful what you ask for. But I will say that this is a process, and we don't intend to jump off a cliff and, ill-advisedly, take the wrong step.

But I have got to tell you, over the last several years, becoming more conversant with the way in which the capital markets have functioned, it looks like a novel written by Stephen King to a great extent. Every time I turn the page, I get a new surprise, and it isn't always good.

And I think what we want to do is to take the surprise out, get it to where somebody, a member of Congress, can understand it. And get it to that level. And then I think we have got something transparent and understandable that our constituents can engage themselves in as well.

If there are no further comments, I do appreciate your participation and your helpful comments. And we look forward to hearing from you again soon.

The meeting is adjourned.
[Whereupon, at 2:28 p.m., the Subcommittee was adjourned.]

A P P E N D I X

October 16, 2003

Opening Statement

Chairman Michael G. Oxley

Financial Services Committee

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

"Reviewing U.S. Capital Market Structure: The New York Stock Exchange and Related Issues"

October 16, 2003

I want to thank the Capital Markets Subcommittee chairman, Richard Baker, for holding this important and timely hearing this morning. He has shown fine leadership on investor protection issues.

The New York Stock Exchange is an important symbol of capitalism here and throughout the world. It has a rich and storied history, and has served investors well for over 200 years.

The past year, though, has been a difficult one for the Exchange. Highly publicized controversies have tarnished the image of the NYSE, and have led many to call for changes to the corporate governance of the Exchange, its role as a self-regulator, and also to its defining characteristic, the auction market system.

These calls for reform have heightened the urgency of a thorough review and modernization of the regulatory and operational structure of our capital markets. As electronic trading and the growth in investor participation in the securities markets have transformed those markets, problems have arisen that were never envisioned when many of the significant rules affecting market structure were put into place.

Indeed, the notion of a securities market as its own regulator is now in question. Several years ago, in response to a scandal on the over-the-counter market, the governance of the Nasdaq market was reformed considerably, leading to a separation of its regulator from the market. Today, some are calling for a similar change to regulation of all exchanges.

The corporate governance of exchanges is now receiving the kind of close scrutiny that corporate America underwent leading up to, and since the passage of, Sarbanes-Oxley. It is vitally important to investor confidence that the management of the exchanges that are at the heart of our capital markets be held to the highest possible standards of integrity and transparency.

Increasingly, institutional investors are calling for reforms of the NYSE's specialist system. Some view the specialist as an unnecessary middleman who impedes the efficiency of the marketplace. Even if the NYSE is correct about its ability to achieve "price improvement," large investors say they place a higher value on speed of execution and anonymity.

If we wanted to build a stock market from scratch, would it be run by humans or computers? Why does the NYSE control 80 percent of the trading volume of its listed companies when Nasdaq controls only about 20 percent of the volume of its member companies? Have current rules and regulations contributed to these results? How does the current structure benefit or harm investors? These are important questions. Fortunately, we will hear from an esteemed group of witnesses this morning that can provide answers.

Mr. Reed has come out of a well-deserved retirement to accept this challenging position and is off to an impressive start.

I look forward to the testimony of all of the witnesses and yield back.

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Statement of Congressman Michael N. Castle

Capital Markets Subcommittee Hearing on
"Reviewing U.S. Capital Market Structure:
The New York Stock Exchange & Related Issues"

October 16, 2003

Thank you Chairman Baker and Ranking Member Kanjorski for holding this hearing before the Capital Markets Subcommittee today. The issue before us an important one. In light of recent scandals that have hit the securities market, from concerns surrounding trading practices to extremely high and seemingly hidden compensation packages for executives, it is more important than ever that we continue to strive for a higher level of corporate governance.

I am pleased this committee undertook the reforms we achieved in the passage of the historic Sarbanes-Oxley Act of 2002, but we must not stop there. The Sarbanes-Oxley legislation strengthened the oversight of the Securities and Exchange Commission (SEC) and created the Public Company Accounting Oversight Board (PCAOB) to ensure proper accounting practices are followed. I applaud the work of Mr. John Reed, who is serving as the interim Chairman of the New York Stock Exchange (NYSE), the tone he has set at the stock exchange is a most positive and necessary step. The one dollar salary Mr. Reed is earning as interim Chairman is a true testament to his goal of bringing reform to the NYSE.

It is important we question the status quo. During the series of hearings to be held by the Capital Markets Subcommittee, a number of issues on how the markets can be most positively structured must be addressed. First and foremost, we must restore investor confidence. Unfortunately, our market structure has become tarnished. I know a number of my constituents are concerned with the market place. They want to invest in stocks but with a slow economy coupled with market place scandals, they are very tentative to take that step back into the market. We must identify and address the steps that need to be taken. The proposals put forth by Mr. Reed, such as re-examining board membership, ethics codes and greater transparency, are a positive first step, but as a market structure we need to continue to identify the best practices and execute them.

I look forward to hearing from Mr. Reed and all of our panelist today. Today, the Capital Markets Subcommittee holds its first in a series of hearings on market structure -- I am pleased will continue to investigate these matters and to ensure that our investors and markets continue to be provided the best possible structures.

STATEMENT OF THE HONORABLE
Wm. Lacy Clay
Before
The Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

"Reviewing US Capital Market Structure:
The New York Stock Exchange and Related Issues"

October 16, 2003

Mr. Chairman, in excess of 100 million individuals in this country own stocks, mutual funds or some type of financial instrument regulated by the New York Stock Exchange (NYSE). When we take into consideration the numbers that pension funds represent, over 75% of all households in the country have pecuniary interests in the structure of the NYSE. Since such a broad spectrum of the population is affected by the issues relating to this industry, transparency of regulation is necessary.

The NYSE is a nonprofit organization owned by its 1,366 for profit members. The exchange is also a self-regulatory organization charged by the Securities and Exchange Commission with overseeing its member firms. It is this description of a self regulated organization that causes much of the concern among investors, both individual and corporate.

The NYSE is also undergoing a change in the position of chairman and chief executive with Richard Grasso resigning and John Reed replacing him on an interim basis. There were concerns raised over the level of compensation of the past chairman and these concerns further included those of conflict of interests on various levels of operations for the exchange to regulate itself.

The trading practices of several specialist firms are being investigated by the NYSE and the SEC. Many believe that specialists too often trade for their own accounts at the expense of investors and should be required to be more transparent with their trading books. Additionally, there are issues about promoting competition and reforming the rules of the NYSE.

I am eagerly awaiting the testimonies of the various witnesses today and especially want to hear what the new chairman, Mr. John Reed has to say about his plans for reforming the role and size of the board and, more importantly, the makeup of the board. I also have a keen interest in hearing about the "powerful, entrenched (though unnamed) interests that don't want to see much change" according to Mr. Reed.

This is but the first of many hearings on this subject of US capital market structure and I want to be deliberate in assessing the needs for reforming this vital asset of our economy. I want to see if the reforms that Mr. Reed and the NYSE are contemplating are sufficient and are indeed legitimate reforms instead of measures designed to quiet those who seek changes.

Mr. Chairman, I ask unanimous consent to submit my statement into the record.

Statement of the Honorable Rahm Emanuel
U.S. House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
October 16, 2003

Re: Hearing on "Reviewing U.S. Capital Market Structure: The New York Stock Exchange and Related Issues"

Mr. Chairman,

Thank you for holding this important hearing to assess the need for market structure reform. I appreciate that our distinguished guests, including interim New York Stock Exchange Chairman John Reed and NASDAQ President & CEO Robert Greifeld, have taken the time to share their views with us on this matter. As a former investment banker and member of a public company's board of directors, I am keenly aware of the need for a robust regulatory system to ensure that the exchanges promote investor protection, fair competition, efficiency and transparency.

While the self-regulatory organizations have served investors well, recent events raise questions about whether SROs are meeting their obligation to serve the interests of individual and institutional investors, rather than those of exchange officials and special interests. SROs serve a variety of functions: they are marketplaces, regulators, and member-owned businesses facing intense competitive pressures. The advent of electronic exchanges, ECNs, and alternative trading systems has made the landscape increasingly muddled and complicated.

Given the marketplace evolution and corporate governance concerns, SEC Chairman William Donaldson's decision to undertake a thorough review of SROs is a wise one. As the Chairman stated, the ideal solution is to have "multiple, competing markets," that at a minimum have the same corporate governance standards for themselves that they require of their listed companies. Any new solution should also flexible enough to accommodate the differences that exist among the exchanges. A one-size-fits-all solution, while well-intentioned, would not be workable across markets and exchanges.

I look forward to working with the SEC and with my colleagues in Congress as we consider appropriate steps to ensure the integrity of the exchanges and the capital markets. Sarbanes-Oxley was a critical first step in addressing corporate governance issues that have plagued the markets in recent years. However, as demonstrated by recent events, there is still much work to be done. The hedge fund and mutual fund scandals, continuing auditor independence issues, and exchange governance issues are evidence of the continuing disregard in some quarters for shareholders' and investors' interests. We must continue to do all we can to root out these abuses and restore investors' trust in the capital markets.

October 16, 2003

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Hearing entitled, "Reviewing U.S. Capital Market Structure: The New York Stock Exchange and Related Issues."

Thank you, Mr. Chairman, for holding this important hearing, the first in a series that will allow us to review conditions in our U.S. capital market. I look forward to our witnesses' testimony and am especially interested in hearing more regarding ongoing reforms within the New York Stock Exchange (NYSE) to deal with recent questions on appropriate corporate governance within the Exchange.

I applaud John Reed, Interim Chairman and CEO of the NYSE, for his commitment to this process and would like to hear more details regarding reported plans to reduce the size of the Exchange Board from twenty-seven members to ten or twelve and the creation of an advisory committee to accommodate Wall Street chief executives separate from the Board. This committee needs to be fully informed on this issue and to discuss whether or not it continues to be appropriate and effective to allow the NYSE to serve as its own regulator.

Over its 211 year old history, the "open outcry" system has remained in use at the NYSE. I am interested in hearing more on the reforms that have been made in the business practices of "specialist" firms throughout the exchange's history as significant advances in technology have taken place. Questions have recently been raised regarding the trading practices of specialists and potential conflicts of interest; I look forward to hearing more from our witnesses on this issue as well.

Thank you again Mr. Chairman for calling us here today and for your leadership in this area. I look forward to an informative session.

OPENING REMARKS OF THE HONORABLE RUBÉN HINOJOSA
HOUSE FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON CAPITAL MARKETS
"REVIEWING U.S. CAPITAL MARKET STRUCTURE:
THE NEW YORK STOCK EXCHANGE AND RELATED ISSUES"
OCTOBER 16, 2003

Chairman Baker and Ranking Member Kanjorski,

I want to thank you for calling this first in a series of hearings on market structure. It is my understanding that the focus of today's hearing will be corporate governance issues at the New York Stock Exchange and the regulatory role of exchanges. We will also be examining what has been referred to as the "potential conflicts of interest that are created by a regulator overseeing itself."

In light of recent developments in the capital markets, particularly the reported New York Stock Exchange actions against the five largest specialist firms today, I look forward to hearing the testimony of Interim Chairman Reed and to learning what initial changes, if any, he believes must be made to corporate governance at the New York Stock Exchange. In addition, I look forward to hearing from the regional exchanges represented here today, the associations, the American Enterprise Institute and from Professor Coffee who has been studying, teaching and testifying on the capital markets for years.

I understand that the Senate Banking Securities Subcommittee held another hearing on market structure yesterday at which SEC Chairman William Donaldson testified. Chairman Donaldson expressed certain concerns about the current corporate governance at the various exchanges, and after the hearing, he reportedly stated that SEC approval for the new listing standards proposed by the NYSE and Nasdaq is ``imminent". I welcome today's witnesses' comments on the SEC Chairman's testimony and remarks to the press if they are familiar with them.

Again, Chairman Baker, I want to thank you for holding this timely and important hearing. I look forward to learning more about our capital markets from today's and future witnesses and to possibly working with you and Ranking Member Kanjorski should this Subcommittee conclude that it needs to formulate legislation to change corporate governance or encourage the exchanges to adopt certain best practices.

I yield back the balance of my time.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON REVIEWING U.S. CAPITAL MARKET STRUCTURE: THE NEW YORK STOCK EXCHANGE AND RELATED ISSUES

THURSDAY, OCTOBER 16, 2003

Mr. Chairman, we meet today to review generally the structure of our Nation's capital markets and examine specifically corporate governance issues at the New York Stock Exchange. In recent years, a variety of securities industry participants have questioned one or more aspects of the regulatory structure of our capital markets. Recent events at the New York Stock Exchange have also brought to light some of the potential conflicts that exist in a self-regulatory model. I therefore congratulate you for convening this well-timed hearing.

Debates on market structure focus on such important issues as competition, the definition of an exchange, access to market data, information transparency, and technological advances. Each of these issues has evolved considerably in recent years. As a result, we have come to a crossroads, facing a number of decisions that could fundamentally alter the structure of our capital markets for many years to come.

As my colleagues well know, I have made investor protection one of my top priorities for my work on this committee. I consequently share your concerns, Mr. Chairman, that our committee must conduct vigorous oversight to examine whether the regulatory system for the securities industry is working as intended and to determine how we could make it stronger.

In addition, I continue by and large to favor industry solving its own problems through the use of self-regulation. Since the enactment of our federal securities laws, U.S. stock exchanges have served both as marketplaces for securities trading and as regulators of their member companies. For the last seventy years, this system has worked remarkably well on balance in protecting the integrity of our markets. In order for self-regulation to endure, however, the system must maintain the confidence of investors.

We developed the self-regulatory model under the stewardship of William O. Douglas, who before he became a Supreme Court justice determined that it was "impractical, unwise and unworkable" for the federal government to try to regulate our decentralized securities markets directly. In order for self-regulation to work, he also determined that the Securities and Exchange Commission needed to keep a "shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use, but with the hope it would never have to be used."

Despite my strong support for self-regulation, recent events at the New York Stock Exchange have revealed some of the conflicts that exist in a self-regulatory model and the need for effective federal oversight. I consequently look forward to hearing from the interim head of the New York Stock Exchange about his recommendations for eliminating and abating these conflicts within his organization. In particular, I want to learn his thoughts as to how we should best separate the exchange's regulatory and commercial functions.

(more)

Additionally, I look forward to hearing from our distinguished witnesses on the second panel, which includes representatives from some of the regional exchanges, noted securities industry experts, and other market participants. Their observations will help us to understand how the New York Stock Exchange might restructure its internal governance system. They will also help us to understand more about other important market structure subjects.

As we begin this series of hearings on market structure issues in the 108th Congress, I must caution my colleagues on both sides of the aisle to move carefully and diligently in these matters. In testimony before the Senate yesterday, SEC Chairman Donaldson indicated that the Commission would be focusing with increased intensity on the structure of our equities markets in the upcoming months. It is my hope that the Commission will move expeditiously in these deliberations. It is also my hope that our securities market participants and their federal regulator will resolve these issues without unnecessary congressional interference.

In closing, I want to assure each of our witnesses that I approach the market structure debate with an open mind. Their comments about these matters will help me to discern how we can maintain the efficiency, effectiveness and competitiveness of our Nation's capital markets into the future. I also look forward to continuing to work closely with you, Mr. Chairman, and with others as we address these multifaceted, complicated and important matters so that we can conduct effective oversight over our capital markets and ensure that we maintain an appropriate and sufficiently strong supervisory system for them.

Statement of Peter T. King

before the
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"Reviewing U.S. Capital Market Structure: The New York Stock Exchange and Related Issues"

October 16, 2003
10:00 AM, 2128 RHOB

Mr. Chairman, I want to thank you for holding this important hearing today on the topic of market structure. My understanding is that this is the first of a series of hearings to examine the strength, resiliency, and regulatory structure of our capital market structure and I commend you for your commitment to strengthening the already preeminent market place in the world.

Mr. Chairman, as a senior New York member on the Committee, I am compelled to weigh in with regard to the New York Stock Exchange (NYSE) and what that institution means to our state, the city itself, and my constituents.

As you know, Mr. Chairman, the NYSE is the key to New York City's dominant status as the "financial capital of the world." As the home to almost fifteen trillion dollars of market value—over six times the value of any other market—the Exchange is also crucial to the New York economy. It employs some 3,000 traders and clerical staff on the trading floor itself, 1,500 Exchange employees, and countless other jobs associated with the NYSE.

Obviously much has been made in the press over the last few months concerning internal issues of compensation and the functionality of the NYSE board. I am confident that NYSE will do what is necessary to work through this and we will likely hear today from Mr. Reed efforts to that end. I am, however, concerned that others would use this opportunity to suggest that somehow the NYSE as a market place is broken or dysfunctional to the point of needing a complete regulatory overhaul. Mr. Chairman, given the fact that in the last eight years over 1500 new companies have listed on the NYSE and that market cap during that time has more than doubled, it would seem that businesses see value in the NYSE.

Mr. Chairman, those of us from New York have a special connection to the NYSE. I trust that as the committee moves forward in examination of the various structural mechanisms that make up our U.S. market, the committee will be mindful of the "Big Board's" successful record. I look forward to working with you to ensure that market participants and investors have the strongest market place to conduct reliable, efficient business.

I yield back my time.

Opening Statement
Congressman Ed Royce (CA-40)
16 October 2003
"Reviewing U.S. Capital Market Structure: The New York Stock Exchange and Related Issues"

Mr. Chairman, thank you for holding this timely hearing to address recent developments at the New York Stock Exchange ("NYSE" or "exchange"). I would also like to thank all of our witnesses for coming here today.

Mr. Reed, you are to be commended for stepping into your current role at a particularly difficult time for the NYSE. I have reviewed your prepared remarks today and was very pleased to see that you are addressing a number of corporate governance issues at the exchange.

1. The NYSE board is too large and needs reform.

2. The NYSE also needs to alter the make up of those that serve on the board.
   - It seems odd to me that regulatees are represented on the board and have a say in the compensation of their regulator. It would be as if bank CEOs decided the compensation of the Comptroller of the Currency.
   - I believe the NYSE's largest constituencies should be represented on the board. As a holder of some $6.7 trillion of assets, the mutual fund industry should have at least one board seat.

3. The NYSE should consider separating the dual roles of its CEO. There are clearly times when the role of regulator conflicts with the role of business leader.

Finally, in my view the exchange should not limit itself to examining corporate governance issues. I have felt for some time that the NYSE needs to do a better job of explaining the benefits of the specialist system to the marketplace. I was very troubled to learn of this morning's news that five specialist firms had engaged in improper trading activity.

Mr. Chairman, thank you for your leadership on this issue. I look forward to the testimony from our panelists today. I yield back.

Testimony of Professor John C. Coffee, Jr.,
Adolf A. Berle Professor of Law
and Director, Center on Corporate Governance,
Columbia University Law School*

Before the Subcommittee on
Capital Markets, Insurance and Government Sponsored Enterprises of the
Committee on Financial Services

United States House of Representatives

October 16, 2003

ENSURING INDEPENDENCE, PROMOTING INVESTOR CONFIDENCE:
Governance of the New York Stock Exchange as a Quasi-Public Entity

Introduction

* As a matter of full disclosure, Professor Coffee has served as a member of the Legal Advisory Committee to the New York Stock Exchange and continues as an Emeritus member. He has also been a member of the Legal Advisory Board to the National Association of Securities Dealers ("NASD") and is a current member of the Economic Advisory Board to Nasdaq. All are unpaid positions with respect to which no compensation was received by him in any form. Professor Coffee has also been retained from time to time as an expert witness by the New York Stock Exchange's Enforcement Division in connection with its disciplinary proceedings and is currently serving in such a capacity in one outstanding case.

Reasonable people may disagree about whether the New York Stock Exchange ("NYSE") has experienced a major scandal or only an excruciating embarrassment. Still, from a public policy perspective, that is not the issue. Rather, the critical issue is whether the conflicts of interest that have been vividly exposed compromise the NYSE's ability to perform its role as a principal regulator of the world's deepest and preeminent equity securities market. Here, the most disturbing recent revelation has not been the extravagance with which Mr. Grasso and other senior staff were compensated, but rather that securities industries officials dominated the compensation committee that set their compensation levels. To the extent that there is any possibility that the securities industry can use its de facto ability to determine the compensation or tenure of senior NYSE officials, the industry potentially acquires both a carrot and a stick by which to reward or punish the behavior and attitudes of those officials. The result is to unacceptably compromise the independence of the NYSE as a regulatory institution.

To state this assessment is not to claim (and I do not claim) that any specific enforcement or related regulatory decision made by the NYSE was in fact so compromised, or even affected, by the prospect of greater or lesser compensation. I know of no such evidence; nor do I have reason to doubt the integrity of any NYSE official. Still, the public has read a recent page one story in The Wall Street Journal describing how Richard Grasso, as the chief executive of the NYSE, badgered the NYSE specialist who handled the market in AIG's stock, in response to complaints made to Mr. Grasso by the CEO of AIG, which executive had served as a member of the NYSE board compensation committee that determined Mr. Grasso's compensation.[1] If the public

[1] See Kate Kelly and Susanne Craig, "At Behest of AIG Chief, Grasso Pushed NYSE Firm to Buy Stock," The Wall Street Journal, October 3, 2003 at A1.

perceives that the NYSE's chief executive intervenes in matters as pedestrian as the performance of a specialist at the behest of an industry director, it will also likely believe that he might signal--directly or implicitly--to NYSE enforcement officials that a specific case should not be pursued or that a line of inquiry should receive a lower priority. Again, one need not conclude that interventions on this basis actually occurred to recognize that the current governance structure of the NYSE is flawed, because a regulator, like Caesar's proverbial wife, must remain above suspicion. Hence, reforms are necessary to insulate and protect the regulatory functions of the NYSE.

Before analyzing possible reforms, however, a rival perspective must be noted. It argues that self-regulatory organizations ("SROs") are hopelessly compromised and should be simply abandoned.[2] Instead, all regulatory power should be placed, these critics would argue, in the hands of a governmental body (presumably, the SEC). A long debate has continued for decades over this issue,[3] and no consensus has emerged. Still, it should be noted that proponents of self-regulation can claim that it has several virtues:

> (1) Self-regulation is funded by the industry, not the public. The industry in effect taxes itself to pay the budget of the NYSE. This both spares the federal government direct expenditures that it would pay if the SEC fully assumed these enforcement obligations, and it ensures that SRO enforcement will not be dependent on Congressional appropriations (which were at points during the 1990s, sufficiently

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[2] For perhaps the sharpest critique of self-regulatory organizations, see Subcommittee on SEC, Senate Committee on Banking, Housing, and Urban Affairs, SECURITIES INDUSTRY STUDY, S. Document No. 13, 93rd Cong., 1st Sess. (1993) at 145; see also Dale Osterle, Comments on the SEC's Market 2000 Report, 19 Iowa J. Corp. L. 483 (1994)

[3] For some of the standard "public choice" critiques, see Susan M. Phillips and J. Richard Zecher, THE SEC AND THE PUBLIC INTEREST (1981); Paul G. Mahoney, The Exchange As Regulator, 83 Va. L. Rev. 1453 (1997) (favoring self-regulation); Adam C. Pritchard, Markets As Monitors: A Proposal to Replace Class Actions With Exchanges as Securities Fraud Enforcers, 85 Va. L. Rev. 925 (1999) (arguing that exchanges have good incentives to combat fraud).

> choked off that the SEC's ability to enforce the law was impaired);
> (2) SROs, including in particular the NYSE, have a proximity to the market that the SEC lacks. Some violations can be handled far more quickly and expeditiously by the market itself than by referral to a government enforcer; and
> (3) SROs have broad authority to enforce ethical as well as legal standards, in particular by adopting rules that affirmatively "promote just and equitable principles of trade" and require compliance with standards of commercial honor.[4] In contrast, the SEC basically is authorized to combat fraud and require full disclosure. Nor is it likely that broader authority to enforce softer "just and equitable" principles would be given to a governmental agency.

To summarize, a key point here is that important synergies may arguably be realized by maintaining a regulatory function within the market center, rather than simply appointing a governmental body to monitor the market center. This point is undoubtably debatable, but I would caution against throwing out "the baby with the bath" by transferring all regulatory responsibilities away from the NYSE.

But if self-regulation is to work, it must be protected and insulated. How is this best achieved? Much depends on the future market structure of the NYSE. The following proposals recognize that if the NYSE fundamentally changes its character (by, for example, becoming an electronic dealer market), the optimal location and identity of its regulatory functions might also change. Nonetheless, I will begin with the world as it exists today.

II Specific Proposals

For self-regulation to work, it is necessary not only that an independence enforcement arm be able to evaluate and prosecute cases without interference, but that the regulatory functions of the NYSE receive adequate funding. The social cost of Mr. Grasso's extravagant compensation may be measured at least in part by the funds that were diverted away from enforcement or investment

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[4] This point was well made by Justice Stewart in his dissent in Silver v. New York Stock Exchange, 373 U.S. 341, 371 (1993).

in a greater monitoring and market surveillance capacity. The following proposals respond to this need:

A. Proposal One: Transfer the Enforcement Functions of the NYSE to a Wholly-Owned Subsidiary of the NYSE Which Would Have An Entirely Independent (i.e. Non-industry) Board of Directors. This is, of course, the basic strategy that the SEC followed when it reorganized the NASD in the late 1990s. Following a different scandal and at the recommendation of a committee chaired by then Senator Warren Rudman, the regulatory and market operations of the NASD were split, and a special subsidiary--NASD Regulation, Inc ("NASDR")--was created.[5] This organizational reform was a response to "criticism that the NASD had allowed its competitive role in marketing Nasdaq to outweigh its regulatory responsibilities."[6] The instant proposal would be structurally different in one respect: Instead of the NASD owning two subsidiaries (Nasdaq and NASDR), thereby dividing its markets and regulatory operations, the NYSE would own a single subsidiary--let's call it, NYSE Regulation, Inc. (or "Reg. Inc."). For Reg. Inc. to be credibly independent of the NYSE, two criteria would have to be satisfied: (1) Reg. Inc. would have to have its own board, each of whose members were independent of the securities industry and (at least ideally) were not members of the NYSE board; and (2) Reg. Inc. would be entitled to call upon the NYSE for an adequate budget. This latter criterion of financial independence could be satisfied either (i) by a long-term contract that guaranteed an adequate budget to Reg. Inc., which

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[5] See Deborah Solomon, "SEC Is Looking to the 'Nasdaq Model,'" The Wall Street Journal, October 14, 2003 at p. C-11.

[6] See Jerry Markham, A Comparative Analysis of Consolidated and Functional Regulation: Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan, 28 Brooklyn J. Int'l L. 319, 330 (2003); see also, In the Matter of National Association of Securities Dealers, Inc., Sec. Exec Act Rel. No. 34-38, 542 (August 8, 1994)

Reg. Inc's own board would set (within some outer limits), or (ii) by bylaw and charter provisions adopted by the NYSE under which it would agree to fund any budget requested by Reg. Inc., unless the SEC determined the Reg. Inc. budget request to be excessive.

An advantage of this wholly owned subsidiary approach is that it involves the least wrenching changes and organizational dislocation. The NYSE's enforcement staff would simply be transferred to this subsidiary but would experience no real changes in their work routine or internal organizational structure. To the extent that this staff had good working relationships with the NYSE's staff, they should not be disrupted. Quite literally, no NYSE staff official would be required to move an office or report to different personnel--but the NYSE's regulatory arm would become more independent without becoming more distant or organizationally remote.

In contrast to this proposal, the NYSE's new CEO, John Reed, has recommended (at least as an initial measure) a far milder remedy. Under his proposal, the NYSE would simply establish a new board committee that would oversee all regulatory matters at the NYSE, which committee would be staffed only by non-industry directors.[7] In my judgment, this is inadequate. It overlooks, first, that the head of NYSE enforcement reports on a daily basis to the NYSE's CEO, who would in turn be responsible to a board significantly populated by industry members, and, second, that there must be a mechanism to assure enforcement for an adequate budget.

B. Alternative B: Transfer the Regulatory Functions and Enforcement Personnel of the NYSE to NASDR and Require the NYSE to Enter Into a Long-term Contract With NASDR for Enforcement Services. This is the far more radical alternative, and it would far greater dislocation and organizational trauma. NASDR already serves as the regulator by contractual arrangement for

[7] See Landon Thomas, Jr., "Stock Exchange Chief Backs Smaller Board," New York Times, October 15, 2003 at C-2.

some smaller exchanges, and there might be some economies of scale if it grew to cover the NYSE as well. The case for this more sweeping remedy is that NASDR would be incontestably independent of the NYSE and that NASDR is perceived by many to be the more proactive and aggressive regulator. The case against this proposal is both that the tradition of competition and suspicion between the NYSE and Nasdaq might cause NYSE market officials to cooperate only more warily with NASDR and that any synergies associated with the close connection between the NYSE and its existing enforcement staff might be lost.

As a practical matter, there seems little or no possibility that the NYSE would adopt such a reform, except under intense compulsion by the SEC. Nonetheless, if the structure of the NYSE were to be radically changed (and, in particular, if it were to become a dealer market operating in greater competition with ECNs and other markets), this might be the more logical structure because the NASDR would grow over time into the "self-regulator" for all these markets. Also, NASDR already has experience in overseeing a dealer market (which NYSE does not). Still, it is questionable whether an industry structure under which the NASDR served as the regulator for most exchanges really amounted to self-regulation. Instead, NASDR might become simply a duplicate "second SEC."

C. Reforming the NYSE Board: The Case for a Super Majority of Non-Industry Directors. Insulating the NYSE's regulatory arm is not a complete remedy. If the NYSE's CEO were still subject to the carrot-and-stick threat (or inducement) of reduced (or increased) compensation set in part by the industry, such a CEO could still find ways to influence regulatory or other activities to promote the industry's, rather than the public's, interest. The NYSE has already proposed that all members of its board's compensation committee come from outside the securities industry. This is an important start, but it still leaves the NYSE CEO subject to a threat that he might be fired (or not

re-appointed) by a coalition of directors led by industry members dissatisfied with a particular CEO's excessively "activist" posture.

The concept of an independent majority or supermajority requires, however, that we focus on who is truly independent. The NYSE regulates not only broker-dealers and specialists, but also listed companies. Thus, any realistic definition of independence must exclude officers and directors of listed companies as well. In this light, the majority of directors should come from representatives of investors--or, more precisely, the "buy side." This would include institutional investors, pension funds, and individual investor organizations. I will not attempt to prescribe how great a supermajority of the NYSE board should be independent of the securities industry and listed companies, but I do not believe that there is any need for their total exclusion. Rather, to the extent that the NYSE's regulatory arm is insulated in a separate subsidiary with its own independent board, it seems excessive to require that both boards be entirely independent.

D. Separate the Positions of CEO and Chairman of the Board. This reform has been called for by many. It is certainly desirable, but it is probably the least critical of the foregoing reforms. The case for it increases to the extent that the NYSE's regulatory arm is not placed in a separate subsidiary with its own independent board. I should note that in recommending this reform I am not necessarily endorsing it for all public companies. The unique fact about the NYSE is that it is both a market center, subject to strong competitive pressures, and a regulator. This enhances the case for a non-executive chairman whose first priority would be the NYSE's public role.

CONCLUSION

A final comment seems appropriate. Securities exchanges in the United States have only been reformed in the wake of major scandals. The NASD is the product of the Maloney Act passed in 1938 in response to NYSE President Richard Whitney's conviction for embezzlement. The

Amex was reformed following scandals in the 1960s; and Nasdaq, following the "missing odd eighth" scandal in 1996. In this light, it is now or never. Reforms never come during a bull market.

Testimony

Of

David Colker

President & Chief Executive Officer
The Cincinnati Stock Exchange

Before the

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Committee on Financial Services

On the

Reviewing U.S. Capital Market Structure: The New York Stock Exchange and Related Issues

Thursday, October 16, 2003

Written Testimony
Of
David Colker
President & Chief Executive Officer
The Cincinnati Stock Exchange

Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Committee on Financial Services

October 16, 2003

The Cincinnati Stock Exchange ("CSE," "Cincinnati," or "the Exchange") welcomes the opportunity to offer comments to the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises regarding the structure and operation of the U.S. capital markets. Early last year CSE grew to become the third largest stock market in the country. Last month we set a new daily record of 415 million shares and 900,000 trades. We now handle 20 percent of all trading in Nasdaq listed securities, 10 percent of all trading in American Stock Exchange ("AMEX") listed stocks, and 1 percent of all trading in New York Stock Exchange ("NYSE") listed securities. We have achieved this growth through a combination of technical and market structure innovation, aggressive cost competition, and effective regulation.

Cincinnati was the first exchange to eliminate its physical trading floor. We created an electronic trading system that now routinely processes 300 trades a second, and we established an open systems architecture that gives our members the choice of using exchange trading technology, their own technology, or technology provided by a third party vendor. We were also the first exchange to automate its interface with the Intermarket Trading System ("ITS"), thereby providing automatic executions for ITS orders from other market centers. Finally, the Exchange combined its innovative competing specialist system with a time priority rule modification called "preferencing" to create a trading environment that combined the advantages of the NYSE's unitary specialist system and Nasdaq's decentralized market structure.

On the cost side, CSE has established itself as the low-cost provider of exchange services. In 1997, when the broker-dealer community expressed concern about the high cost of trading and market data, CSE responded by becoming the first exchange to develop a program – called the Specialist Operating Revenue ("SOR") program – that significantly reduced these costs by committing the Exchange to share all of its excess trade and market data revenue with its members. Cincinnati was able to do so by combining the operating leverage that derived from its electronic trading model with a commitment to operate on a utility cost basis, just like a true mutual company. Other exchanges and Nasdaq have now followed our lead and begun offering similar revenue-sharing programs.

With regard to regulation, CSE takes pride in its record of providing effective oversight of CSE trading activity. Cincinnati was the first exchange to develop a complete electronic order audit trail that captures an electronic footprint of all exchange trading activity. In 1996, after Nasdaq was ordered by the Securities and Exchange Commission ("the SEC" or "the Commission") to develop an electronic audit trail, it was Cincinnati that Nasdaq came to for help with what became OATS.

All of this innovation has come in the face of enormous resistance to change. For too long, we have had to live with policies that protect monopolies rather than promote competition. For too long people have accepted the false belief that, if only all order flow could be directed to one physical location, then customer order interaction would be maximized and the public investor would always get the best price. Lip service was paid to the idea of competition between exchanges, but if any of the non-primary exchanges came up with too good an idea and began capturing order flow, this accomplishment was somehow viewed as a problem and labeled with the pejorative word "fragmentation."

Recent events have called these underlying beliefs and policies into question. Troubles at the NYSE are symptomatic of monopolistic business practices and highlight the need for prompt action by the SEC to address serious outstanding market structure issues. While we do not wish trouble on anyone, we are hopeful that the current problems NYSE is experiencing will translate into an opportunity to develop constructive modifications to the National Market System ("NMS") so that it can benefit from the interplay of true competition. In the end, it is public investors who will be the beneficiaries of a more transparent, freely competitive capital market structure.

We certainly do not seek to answer all the market structure questions today. There are two issues, however, that we believe deserve immediate scrutiny:

- The Commission should expeditiously approve CSE's Voluntary Book Filing or, in the alternative, impose price/time priority throughout Nasdaq and the NASD's Alternative Display Facility ("ADF"). Nasdaq and the ADF share a monopoly in that they are currently the only markets permitted to trade Nasdaq-listed and NYSE-listed securities without intra-market price/time priority. (Nasdaq now handles 12% of all the share volume traded in NYSE-listed securities.) For two years CSE has sought Commission approval of a rule change that would begin to level the playing field between CSE and these over-the-counter ("OTC") markets by eliminating price/time priority on CSE for Nasdaq-listed securities. If the Commission is unwilling to permit an exchange to operate without intra-exchange price/time priority because of perceived investor harm, then the Commission should act to equally protect investors in the OTC markets by requiring those markets to impose price/time priority when they trade Nasdaq-listed and NYSE-listed securities.

- ITS is in need of reform. No other market structure change would do as much to force NYSE to compete for order flow than the modification or

elimination of the ITS trade-through and locked/crossed rules. ITS was created because of the need to enhance a broker-dealer's ability to provide best execution. Ironically, today ITS often is an impediment to best execution because of the requirement to wait for the slowest common denominator of manual market updates and manual executions. With the modification or elimination of the trade-through and locked/crossed market rules, investors could seek an execution that is best for them rather than what is best for a manual market specialist.

Best Execution, Voluntary Book, and Price/Time Priority

The principle of best execution bears significantly on how markets operate internally as well as how markets compete among each other. CSE believes that the competition it has injected into the marketplace has enhanced best execution and promoted the Congressional goals of protecting investors and maintaining a fair and orderly market.

Best execution is at law a broker-dealer obligation. Generally, best execution has been interpreted to require a broker-dealer to obtain the best available price, but other terms in addition to price are also relevant to the equation. For example, best execution is also defined by "the size of the order, the trading characteristics of the security involved, the availability of accurate information affecting choices as to the most favorable market in which execution might be sought, the availability of technological aids to process such data, the availability of economic access to the various market centers and the costs and difficulty associated with achieving an execution in a particular market center."[1] Moreover, with the advancement of data communication and processing technology and the advent of trading in decimals, speed and certainty of execution have assumed a place equal to price for many traders.

Because of the elusive nature of best execution, the Commission has never promulgated a separate best execution rule or explicitly defined best execution. In enforcing the obligation of best execution, therefore, self-regulatory organizations must be guided by the expectations of customers and whether broker-dealers have met these expectations. All customers are different from each other and no single market structure fulfills all customer expectations, expectations that define the parameters of best execution.[2] Only through diverse, competing market structures may all customers find the mechanisms that satisfy their expectations.

A broker-dealer can only maximize its best execution performance through a market structure that promotes the greatest flexibility in order execution. Flexibility in order execution must operate on two levels: within markets and across markets. Consistent with the protection of investors and maintenance of fair and orderly markets, exchanges should be free to implement rules that increase the opportunity for brokers to meet the execution expectations of their customers. By promoting broker-dealers', exchanges' and associations' use of advanced

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1 Exchange Act Release No. 38672 (May 23, 1997), 62 FR 30485 (June 4, 1997).

2 Larry Harris, *Trading and Exchanges – Market Microstructure for Practitioners,* Oxford University Press, 2003. "Markets fragment because traders are not all identical and because their trading problems differ considerably. Some market structures therefore better serve the needs of some traders than other market structures do." *Id.* at 530.

technology in execution and order routing systems coupled with efficient rule sets that refrain from imposing regulatory distortions of natural order interactions, the CSE believes that the Commission may enhance the interests of public investors and redirect the NMS towards the forward-looking goals expressed by Congress in Section 11A of the Act.

In attempting to offer the necessary order execution flexibility, CSE, two years ago, proposed to make order interaction on our market voluntary among CSE members.[3] Like that which already exists in the Nasdaq's and the NASD ADF's market structures, the CSE's Voluntary Book would alter price/time priority so that CSE members obtain increased flexibility to seek the best method of executing their customer orders. Equally important, however, the Voluntary Book would expand customer order execution opportunities while promoting, not harming, best execution principles. For example, CSE's proposal would not change its members' obligations with respect to "Manning" requirements, the firm quote rule, or the limit order display rule. By altering our price/time priority principles, CSE would merely be providing a broker-dealer with more flexibility to achieve its customers' goals. That a broker-dealer must still comply with best execution and other CSE and Exchange Act requirements ensures that a broker-dealer's decision to execute a trade in a given market at a given price is rooted in its customer's interest, not its own.

CSE's Voluntary Book Filing follows upon earlier CSE amendments to price/time priority. CSE's Preferencing Rule,[4] which modified time priority for professionals, has created a more competitive environment for exchange-listed securities. By adopting a rule that permits CSE dealers to execute customers orders without regard to the time priority of other CSE dealer orders, bids, and offers, the CSE introduced elements of a Nasdaq-like market structure into an exchange for the first time. In approving preferencing on CSE, the Commission recognized that, "the CSE combines the features of both exchange and over-the-counter markets."[5] While the Commission was cautious in supporting preferencing at its inception, CSE has proven that the quality of executions pursuant to a program that waives time priority is equal to, and often exceeds, the quality of executions on the auction markets for exchange-listed securities. As the data published pursuant to Rule 11Ac1-5 demonstrates, CSE execution quality under our preferencing model consistently exceeds that of the NYSE and the Amex, both manual specialist markets. For example, in trades up to 2000 shares, CSE outperforms the NYSE in effective spread (2.8 to 4.83), execution speed (14.7 to 20.5 secs.), and percentage of trades outside the quoted market, *i.e.*, disimproved (15% to 36.9%). Clearly, CSE customers have benefited from the elimination of time priority through better prices and faster service.

CSE is seeking to expand on the benefits of preferencing through its Voluntary Book Filing. Again, CSE believes that the Rule 11Ac1-5 statistics of markets without price/time priority demonstrate the merits of CSE's proposal. In transactions up to 2000 shares in exchange-listed securities, Nasdaq, a dealer market without price/time priority, consistently outperforms the NYSE in effective spread (3.16 to 4.83), execution time (16.4 to 20.5 secs.), and shares disimproved (17.4% to 36.9%). In Nasdaq-listed issues, Nasdaq's numbers are even

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[3] Exchange Act Release No. 45405 (February 6, 2002), 67 FR 6558 (February 12, 2002). ("Voluntary Book Filing").

[4] CSE Rule 11.9(u).

[5] Exchange Act Release No. 37046 (March 29, 1996), 61 FR 15322 (April 5, 1996).

better – effective spread (2.54), speed (4.6 secs), and shares disimproved (9.2%). Interestingly, the market without price/time priority (Nasdaq) executes outside the National Best Bid or Offer ("NBBO") four times less -- 9.2% compared with 36.9% -- than the market that trumpets the necessity of price and time priority (NYSE). If the absence of price/time priority were to harm customers, as NYSE claims, the data should show the opposite. CSE believes the facts speak plainly for the principal that efficient markets, even absent price/time priority, more effectively promote best execution.

CSE believes that the Voluntary Book Filing is the natural progression in market structure given decimalization and advances in data communication, order routing and order management systems. The Voluntary Book offers a flexible approach to order interaction coupled with the obligation of best execution. Under an effective regulatory oversight program, the CSE believes that such an open trading market structure is necessary for it to compete with other markets and attract liquidity. As the Rule 11Ac1-5 statistics demonstrate, price/time priority need not dictate the execution process. Rather, satisfying the expectations of customers through instantaneous execution systems offers a higher likelihood that customers will receive what they expect to receive: best execution.

The Commission, however, seems inclined to disagree. Our Voluntary Book Filing as well as Nasdaq's exchange application have languished at the Commission for over two years, largely because of the price/time priority issue. Apparently, in the Commission's view an exchange must provide price/time priority in order to properly handle customer orders because they would otherwise suffer a failure of best execution. If that is the case, what then will the Commission do for the millions of customer orders executed every day in Nasdaq-listed and NYSE-listed securities on the OTC markets, where price/time priority is not required? Are these investors being disserviced every day? Are they not entitled to the same duty of best execution?

CSE believes that customer orders traded in the OTC markets should be subject to the same standards that the Commission imposes on the exchanges. If price/time priority is an absolute – and CSE categorically disputes that is should be – then it is only fair that price-time priority be applied in all securities, regardless of where they trade. We find it hard to imagine that investors believe (1) that their orders in Microsoft, a Nasdaq-listed security, are subject to different and lesser protection than their orders in IBM, an NYSE-listed security; and (2) that their orders in IBM, if executed in the OTC markets, are subject to different and lesser protection than if their IBM orders were traded on an exchange. If price/time priority is as vital as the Commission seems to indicate, the fact that Microsoft is listed on Nasdaq and trades predominantly in the OTC market should not deprive investors of price/time priority, nor should investors be deprived of such protection when they trade NYSE-listed securities in the OTC markets.

In conclusion, CSE submitted the Voluntary Book Filing to enhance its members' execution opportunities and to seek a level competitive playing field with Nasdaq. We believe that investors are better served by providing greater flexibility in how their orders are executed. However, if the Commission is not inclined to agree, CSE respectfully requests that the Commission impose price/time priority across all securities, wherever listed and traded. CSE

can compete as long as our competitors are subject to equal regulation, which in this case is comparable rules on price/time priority.

ITS Reform

In formulating the NMS in 1975, Congress and the Commission were reacting to the market structure as it existed in the early 1970s. In 1978, the Commission stated that: "the major problems to which the idea of a national market system is addressed are those arising from 'market fragmentation,' or the existence of multiple, geographically separated forums in which trading in the same security occurs. . . These problems include, among others: (1) the need to perfect existing mechanisms for the disclosure of information concerning all completed transactions in multiply-traded securities; (2) the absence of a comprehensive, composite quotation system displaying buying and selling interest in those securities from all markets; (3) the inadequacy of existing means available to brokers for routing orders to and among markets in pursuit of the most favorable execution opportunities; and (4) the lack of a mechanism to provide nationwide agency limit order protection affording time and price priority to such orders regardless of geographical location."[6]

Although subject to renewed debate, the exchanges and the NASD have addressed the last sale issue through the development of the Consolidated Tape Association ("CTA") and the quotation issue through the Consolidated Quotation System ("CQS").[7] The creation of the Intermarket Trading System was a partial response to the third and fourth issues identified in 1978. ITS permits the routing of orders from one market to another and imposes trade-through and locked/crossed quote liability to protect bids and offers in the ITS markets. However, ITS attempts to enhance best execution at the exchange level, not at the broker level identified by the Commission as the place where the problem and obligation exist.

At the time of its creation, the Commission believed that ITS was only a step toward the solution to the order routing issue. The Commission proposed in addition to ITS that the markets create a universally available message switch, permitting brokers and dealers to route orders for the purchase or sale of qualified securities from their offices to any qualified market trading in that security.[8] This system would have required brokers and dealers, *i.e.*, those with the duty of best execution, to assume control of their efforts to provide best execution to their customers rather than rely on secondary order routing at the point of execution on the exchange level. In other words, the burden of best execution would have clearly been on broker-dealers.

Because of resistance from the brokerage community as well as the NYSE, the Commission abandoned the universal message switch system. Brokers argued that a universal message switch would eliminate broker discretion by forcing automatic routing of all orders on the basis of machine-displayed quotations.[9] "The commentators noted that such a system would virtually eliminate differences in execution services and competitive opportunities created by

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6 Exchange Act Release No. 14416 (January 26, 1978), 43 FR 4354 (February 1 1978).

7 Among the markets trading Nasdaq-listed securities, Nasdaq acts as securities information processor and disseminates a consolidated trade and quote data stream.

8 *Id.* at 4358.

9 Exchange Act Release No. 15671 (March 22, 1979).

those differences. It was also argued that, in routing orders, brokers must consider factors other than price. . . ."[10] In abandoning the universal message switch, the Commission recognized that broker discretion to best fulfill its customer needs should be permitted to flourish.

Twenty-three years later, brokers still argue that best execution requires that they be permitted to route orders to the market of choice on the basis of factors other than price. Even with the development of sophisticated smart routing systems that can read the current NBBO and instantaneously ship orders to markets with the best prices, brokers and their customers insist on sending orders to other venues because of the overall quality of execution offered by faster, more certain systems. Execution efficiency and investor access to quote, trade, and execution quality data have effectively supplied the necessary ingredients of the NMS, but the antiquated structure of ITS now serves to frustrate the continued evolution of the system.

To further address the fourth problem (nationwide price and time priority for limit orders), the Commission originally proposed to implement a Central Limit Order File. However, even while proposing the Central Limit Order File, the Commission recognized: "the possibility that introduction of a system based upon the absolute time priority concept could have a radical and potentially disruptive impact on the trading process as it exists today."[11] Rather than impose the Central Limit Order File, the Commission allowed the markets to develop ITS to provide limit order protection. However, the Commission acknowledged that flaws in ITS would prevent it from providing such protection:

> [f]oremost among the necessary changes is a reduction in the length of time required to enter commitments to trade and receive execution or rejection reports. Currently, the complexity of order entry procedures and the two-minute time interval provided for execution or rejection appears to discourage brokers from using the system, particularly during periods of active trading. ***Although the ITS participants are experimenting with a one-minute time period, this enhancement would appear to be insufficient if ITS is to be used for the purpose of ensuring nation-wide public limit order protection.*** Ultimately, the exigencies of active trading in multiple locations probably will require systems enhancements which reduce response times to significantly less than one minute.[12]

With all the technological advancements of the last twenty-plus years, ITS has only been able to agree to reduce the order commitment time period for execution or cancellation to thirty seconds. In today's fast paced market environment, this is unacceptably slow for brokers trying to meet their obligation to provide best execution.

As competition from electronic markets like CSE developed in the late 1990s, the Commission again considered a CLOB as a potential means of solving what it perceived as a

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10 *Id.* at 9.
11 *Id.* at 5.
12 *Id.* (emphasis added).

problem of market fragmentation.[13] Repeating history, however, the securities industry largely rejected the Commission's CLOB proposal because a CLOB would impair the ability of market centers to compete. The Commission again recognized the potentially deleterious effects of mandating price/time priority (such as the elimination of any incentive to enhance technology or to reduce cost) and concluded instead that enhanced disclosure of order execution data, while not imposing nationwide limit order protection, would create standardized terms for measuring execution quality.[14] Based on this data, investors and order-routing brokers could make informed decisions when choosing an execution venue.

CSE agrees with the disclosure approach and, as discussed below, believes the available data highlights the quality of execution occurring away from the auction-based manual markets. Moreover, CSE believes that today's technology, combined with disclosure, eliminates the harmful consequences of market fragmentation. Other market microstructure analysts agree. Larry Harris, Chief Economist for the SEC, writes:

> All traders therefore want all other traders to trade in the market structure they prefer. Differences among traders, however, cause them to prefer diverse market structures. . . . The resulting fragmentation suggests that some of the cost-reducing benefits of market consolidation may be lost . . . These concerns would be well-founded if traders in various market fragments did not know - - and respond to - - market conditions in other fragments. . . . Market diversity, however, does not necessarily imply inferior price formation and high transaction costs. ***Traders can obtain the benefits of consolidation in fragmented markets when information flows freely between market fragments, and when some traders can choose which fragment in which to trade.*** These two conditions are sufficient to coalesce a fragmented market into a unified complex of diverse segments."[15]

With market data from all execution venues readily available in real time as well as order routing systems that can instantly send orders to the best market, the conditions for a "unified complex of diverse segments" exists today. For this reason, CSE believes it is time to reevaluate the ITS rules which impose anti-competitive costs on executions in ITS eligible securities.

The Commission recognized in 1979, and reiterated just a year ago, that ITS is not functioning as an efficient order routing system or a nationwide system for public limit order protection. The then-Chairman of the SEC confronted the individual ITS Participants with the results of studies conducted by the Commission's Office of Economic Analysis ("OEA") and the Office of Compliance Inspections and Examinations ("OCIE").[16] OEA found that during a five-day period, 39.5% of the executions in the QQQs traded-through a better-priced quote of another

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[13] Exchange Act Release No. 42450 (February 23, 2000), 65 FR 10577 ("Fragmentation Release").

[14] *See* Exchange Act Rule 11Ac1-5.

[15] Larry Harris, *Trading and Exchanges – Market Microstructure for Practitioners*, *supra* note 2, at 533 (emphasis added).

[16] *See, e.g.*, letter from Harvey L. Pitt, Chairman, Commission, to David Colker, President & Chief Executive Officer, CSE, of October 1, 2002.

ITS Participant.[17] While the Commission stated that the ITS trade-through provisions were designed to help ensure best execution, it recognized that "these rules and the ITS itself were designed at a time when the order routing and execution facilities of the markets were much slower, intermarket competition less keen, and the minimum quote increment for exchange-listed securities was 1/8 of a dollar ($0.125)."[18]

CSE believes that the extraordinary number of trade-throughs demonstrate two things:

- Best execution can no longer suffer the delays inherent in ITS. In active markets with decimal pricing, brokers require immediate execution at current market prices, not at prices subject to the delays of manual specialists. Market participants migrate to models that produce the most efficiency unless regulatory restraints are applied. In this context, that means a market model that provides instant, certain execution at the price desired without regard to the trade-through rule.
- ITS fails as an intermarket linkage because of embedded option values both in the commitment time period as well as in the trade-through complaint process. Specialists in manual floor-based markets routinely ignore or delay execution of ITS commitments through selective use of Firm Quote Rule[19] exceptions, gaining option value over the sending party. Moreover, trade-throughs are only challenged when the option value held by the party traded-through exceeds the differential between the price traded-through and the then current price of the security. These options have nothing to do with the efficient routing of orders to seek best execution but rather with the protection of market models that may provide acceptable efficiency for select members but clearly fail to meet the needs of all investors.

The Commission acted over a year ago to provide some relief from the burdens of ITS.[20] The Commission stated that "with the introduction of decimal pricing and technology changes that have enabled vastly reduced execution times, the trade-through provisions of the ITS Plan have increasingly limited the ability of a Participant or ITS/CAES Market Maker to provide an automated execution when a better price is displayed by another Participant that does not offer automated execution."[21]

The Commission acted on this problem by granting a *de minimis* exemption from the trade-through provisions of the ITS Plan for certain exchange-traded funds ("ETFs"), which the Commission believed were particularly restricted by the ITS Plan. The *de minimis* exemption permits transactions in ETFs that are effected at a price not more than three cents away from the best bid and offer quoted in the NMS. The Commission settled on a three-cent standard in order to "avoid compelling broker-dealers to use ITS unless the expected price improvement is greater

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17 *Id.*
18 *Id.* at 2.
19 17 CFR 240.11Ac1-1.
20 Exchange Act Release No. 46428 (August 28, 2002), 67 FR 56607 (September 4, 2002).
21 *Id.*

than the de facto cost of using ITS. The de facto cost of using ITS is largely due to the option value of the commitments that broker-dealers give to dealers in other markets when trying to obtain better execution prices."[22]

CSE applauds the Commission for acknowledging and seeking to neutralize the inherent option costs of ITS. In removing the constraints of the ITS trade-through rule, the Commission stated goal is to "provide investors increased liquidity and increased choice of execution venues while limiting the possibility that investors will receive significantly inferior prices."[23] CSE supports the three-cent *de minimis* modification to ITS. That modification, however, did not go far enough. CSE believes that the Commission should expand the *de minimis* relief to all ITS eligible securities. In this manner, the Commission will expand the opportunities for brokers to satisfy their customers best execution expectations while protecting customers from receiving execution prices that may not reflect the best available price at any given time.

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The above comments reflect CSE's views on just two of the market structure issues confronting the capital markets. Naturally, others will have different views. What is important, however, is that the government recognize that the troubles being focused on by the press today are symptomatic of deep market structure issues that have gone unattended for too long. We urge members of the Subcommittee to ask questions of the Commission as well as of the market participants in order to sharpen the focus on these matters. The need is real. Whether it is Nasdaq's exchange application, CSE's Voluntary Book proposal, ITS reform, or other concerns, market structure issues must be addressed now if we are to enhance the efficiency and preserve the credibility of our capital markets.

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22 *Id.* at 56608.

23 *Id.*

Statement of Meyer S. Frucher, Chairman and Chief Executive Officer,
The Philadelphia Stock Exchange,
Before the House Subcommittee on Capital Markets, Insurance and GSEs
October 16, 2003

On behalf of the Philadelphia Stock Exchange, Inc. (the "Phlx"), I appreciate the opportunity to participate in this hearing on market structure issues. The decisions made, or not made, by legislators and regulators on questions of market structure will have a direct impact on the U.S. capital markets and the ability of those markets to meet the needs of both issuers and investors. The Phlx believes that issuers and investors are best served by a market structure that promotes competition.

This statement will describe the Phlx's vision of the broadest possible competition, including between exchanges with different business models and between exchanges and dealer markets. It will summarize steps that the Phlx is taking to make itself more competitive and offer the Phlx's views on the competitive implications of certain specific market structure issues. To understand better the Phlx's perspective on all these topics, this statement first provides information about the regional securities exchanges in general and the Phlx in particular.

Role of Regional Securities Exchanges

The nation's regional securities exchanges – the Phlx, Chicago, Pacific, Boston and Cincinnati Stock Exchanges – collectively form an essential pillar of the national market system. They are the descendants of the more than 100 local exchanges that

existed 100 years ago. While they differ in many respects and with regard to many aspects of their business models, the five regional stock exchanges share an important role: they all make markets in stocks listed by the New York Stock Exchange ("NYSE") and thereby provide needed competition to the Big Board. The NYSE's share of trading in the stocks it lists regularly exceeds 80%, a dominance that almost surely would invite government scrutiny in any other industry. The Phlx believes this dominance is unhealthy for investors.

Today's regional stock exchanges survive because the competitive environment in which they operate forces them to be innovators. The Phlx and a number of the other regional securities exchanges employ an electronic system of remote competing specialists, described below. On the regional exchanges, many stocks have three or four specialists competing to offer the best price, rather than a single specialist setting a price as on the Big Board. The regional securities exchanges were the first to adopt innovations as essential as the securities clearing house, continuous net settlement of trades and automated execution of small orders – all improvements that the NYSE adopted after the regionals had first paved the way.

Background on the Philadelphia Stock Exchange

The Phlx is the oldest securities exchange in the United States. The Phlx is both a stock and an options exchange. It trades over 2000 stocks listed on the NYSE and American Stock Exchange ("Amex"), over 1000 equity options, 13 industry sector options created by the Phlx, and 100 currency pairs. For the most recent month, September 2003, equity options volume on Phlx was over 10 million contracts. This represented roughly 14% of total U.S. options trading. Total equity trading on the Phlx in

2002 was a record 2.4 billion shares. Equity volume on the Phlx for September 2003 was over 277 million shares. This figure was up 43% over Phlx equity volume for September 2002 and represents approximately .5% of all trading in NYSE-listed stocks and 1.5% of all trading in Amex-listed stocks for the month.

While the Phlx is comparable to the NYSE in age and tradition, its method of equity trading differs from the NYSE's in an important respect. While both the NYSE and the Phlx use a floor-based specialist system, the Phlx employs competing specialists rather than a single specialist per stock. The Remote Competing Specialist System implemented by the Phlx in 2002 lets specialists make markets and trade from remote sites. This secure communication network expands trading beyond a fixed number of specialists to enable qualifying firms to operate from their offices. It means that more than one equity specialist can make a market in an eligible stock, so order flow providers can direct orders to the specialist of their choice. The result is a boundless market center permitting virtually unlimited access to qualified specialists and customers alike.

Need for Market Structure that Promotes Competition

The existing structure of the U.S. capital markets is fundamentally sound. U.S. capital markets remain the deepest, most liquid in the world. But policymakers and market participants alike should remember that competition, more than any other single factor, has created and characterized those markets. It is advisable periodically to review market structure, to evaluate whether it continues to promote competition to the greatest extent possible or whether developments in technology, market practices or other areas suggest that market structure has become outmoded. It would be both ironic and

unfortunate if elements of market structure intended to promote competition had come to impede it instead.

Congress has already endorsed the view that market structure should promote the broadest possible competition. The Securities Acts Amendments of 1975 granted the Securities and Exchange Commission ("SEC") authority to "facilitate the establishment of a national market system for securities."[1] In so doing, Congress told the SEC to promote "fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets."[2] Congress understood that greater competition produces greater protection for investors and more dynamic and fair markets.

To maximize competition, exchanges and dealer markets must be free to compete in terms of all the services they offer investors. The price at which different markets are willing to execute a trade, their best bid and offer, is the most obvious criterion on which markets compete. It is not the only one, however, and it may not even be the most important one for every investor and every trade. Markets compete on the basis of the fees they charge for execution; the speed of execution; the depth of their liquidity; the convenience of their technology; the advanced functionalities they may offer, such as "volume weighted average pricing" and block trading; and their trading and other rules.

The Phlx believes that exchanges should be free to compete on the basis of their business models. Since enactment of the Securities Exchange Act of 1934 (the "Exchange Act"), and indeed before that time as well, exchanges have been characterized by centralized auctions, including trading rules that govern the sequence of trading in a

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1 Securities Exchange Act Sec. 11A(a)(2).
2 Securities Exchange Act Sec. 11A(a)(1)(C)(i).

particular security. Every exchange has rules of priority and precedence of bids and offers. The Exchange Act does not, however, mandate a single exchange business model.[3] The Exchange Act does not mandate the degree to which an exchange operates with a central limit order book, nor does it specify a required degree of order interaction or opportunity for price improvement. Should the SEC be inclined to try to promulgate a single standard to address these issues, the agency will quickly find it lacks a principled basis on which to do so. The statute gives scant guidance, for example, as to how much order interaction an exchange must provide, and whether that interaction must actually take place over some period of time or must only be theoretically possible under the exchange's rules. Further, the SEC would be hard-pressed to argue that the statute requires each and every facility of a national securities exchange must offer the same degree of interaction.

The Phlx believes investors will benefit more if exchanges are free to compete on such aspects of their business models as degree of order interaction and possibility for price improvement. The marketplace can decide the optimal level of interaction and price improvement; market participants would benefit from the opportunity to choose between different models. So long as the SEC allows all exchanges, and not just a select few, the chance to explore different modes of trading, this competition between marketplaces will translate directly into benefits for investors.

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[3] Section 3(a)(1) of the Securities Exchange Act and Rule 3b-16 promulgated by the Commission set forth the definition of a national securities exchange. Section 3(a) defines an exchange as "a marketplace or facilities for bringing together purchasers and sellers of securities..." Rule 3b-16 expands on this concept by providing that an "organization, association or group of persons" constitutes an exchange if it provides a marketplace or facility that "(1) brings together the orders for securities of multiple buyers and sellers; and (2) uses established, non-discretionary methods...under which such orders interact with each other..."

While the Phlx supports the greatest possible competition on the basis of business models, competition between exchanges and broker-dealers known as electronic communication networks ("ECNs") must not be skewed by differential regulation. The SEC's Regulation ATS[4] enhanced the ability of ECNs to compete for liquidity. As noted above, the Phlx believes that ECNs benefit investors through lower costs and increased innovation. However, investors are denied potential benefits from innovation by exchanges if exchanges must compete with ECNs while inappropriately bearing greater regulatory burdens. To the extent ECNs look and act like exchanges, they should have the same obligations as exchanges regarding the handling of orders. The Phlx believes that creating greater opportunities for ECNs to operate cooperatively with and through regional exchanges would improve the balance among the goals of continued innovation; investor protection; and a level playing field.

Innovation at the Philadelphia Stock Exchange

The Phlx is determined to shape its future proactively through continued innovation. The Phlx intends to be a low cost, highly liquid, technologically advanced marketplace, while still retaining the advantages of a floor-based auction market. Projects underway at the Phlx that will help the exchange achieve this goal include demutualization; electronic trading of options; and electronic trading of Nasdaq-quoted stocks.

Demutualization

Last year the Phlx management proposed to its Board a plan to "demutualize" -- to transform the institution from a member-owned institution to shareholder ownership.

[4] SEC Release No. 34-40760 (December 2, 1998).

While still relatively new to the U.S. marketplace, the concept of an exchange as a shareholder-owned institution is now the prevailing model overseas. In London, Frankfurt, Tokyo, Hong Kong and elsewhere, stock exchanges have demutualized.

Demutualization will allow the Phlx to respond more quickly and more forcefully to the market forces that are reshaping the securities world. A shareholder-owned capital structure will allow the Phlx to maintain its competitive strength while making it easier for the exchange to enter relationships with strategic and financial partners and to access the capital markets. This can translate into significant new investment in the Phlx. Rather than membership, the Phlx intends to utilize trading permits, which will provide broader access and deeper liquidity to the exchange's core equity and options markets.

For these reasons, after nearly a year of review and discussion, the Phlx Board of Governors on October 1, 2003 approved a demutualization plan. The Phlx membership and seat owners will vote on this plan later this fall. If adopted by the membership, the Phlx will submit the plan for approval by the SEC, which approval would be expected in the first quarter of 2004.

Electronic trading of options

The Phlx is transitioning its options trading toward a more electronic trading environment, while maintaining the advantages of floor-based trading. The exchange is developing a series of enhancements that will increase liquidity, speed executions, and reduce the need for manual handling of options orders by specialists. By giving much greater electronic access to competing market makers, the enhancements will also promote greater quote competition. In particular, they will allow competing market makers to "stream" quotations from the options floor and ultimately from remote

locations. The Phlx has filed the rules for the initial phases of this program with the SEC and expects to make further filings to implement the next phases.

Phlx Trading of Nasdaq Stocks

The Phlx has also submitted to the SEC proposed rule changes relating to trading Nasdaq stocks.[5] Under the Phlx's proposal, Phlx members and non-members could send orders in Nasdaq stocks to a Phlx floor broker, who could match customer orders and execute them on the Phlx. Alternatively, they could place orders on a limit order book maintained by the exchange.

In addition, the Phlx proposal is intended to provide a new venue for providing exchange services and regulation to ECNs. ECNs are electronic broker-dealers that typically match buy and sell orders on a pure agency basis. Competition from ECNs for execution of trades in Nasdaq stocks has benefited investors through lower costs and increased innovation. Under SEC rules, ECNs must report their matched orders through a self-regulatory organization, that is, through a securities exchange or the National Association of Securities Dealers ("NASD"). Their choices for doing so are limited. Only the NASD and the Cincinnati Stock Exchange currently offer viable programs for the reporting of matched orders in Nasdaq stocks.

Under the Phlx proposal, ECNs and other Phlx members could electronically submit to the Phlx for execution and trade reporting matched orders meeting certain eligibility requirements in Nasdaq stocks. The Phlx would use the market data revenues it would receive for reporting trades in Nasdaq stocks first to pay for operating and regulatory costs. The Phlx would then distribute a portion of the remainder to ECNs based on the number of Phlx executions of their trades in Nasdaq stocks. The Phlx

[5] SR-Phlx-2002-73.

believes its proposal would increase competition, to the direct benefit of ECNs and the indirect benefit of the many individual and institutional investors who use them.

Need for Prompt Action by the SEC

For the Phlx and the other regional exchanges to survive, they must innovate. To innovate, they must receive prompt consideration of their proposals by the SEC. The Phlx hopes that its proposals described above will be considered in a timely manner. The Phlx has great respect for the dedicated and insightful staff of the SEC's Division of Market Regulation and will work cooperatively to resolve any concern.

Unfortunately, SEC consideration of innovative filings has not always been timely. In the absence of direction from the Commissioners, the staff is limited in the degree to which they can make decisions on filings. The Phlx hopes that the full complement of new Commissioners at the SEC will shortly be able to provide that direction. The SEC staff is working on market structure proposals for the Commissioners to consider.[6] The Phlx hopes these will be ready shortly and stands ready to work with Chairman Donaldson and his colleagues to fashion principles by which proposals by the Phlx and its competitors can be evaluated without undue delay.

Other Market Structure Issues

The Phlx would like to address certain additional market structure issues and their potential to enhance or inhibit competition. The Phlx believes that broader application of market data revenue sharing would benefit investors through greater competition. On the other hand, payment for order flow by exchanges inhibits competition by interfering with

[6] "Remarks before the American Enterprise Institute," Commissioner Paul S. Atkins, May 7, 2003.

market forces. Finally, the Phlx will share its views on decimalization and self-regulatory functions of exchanges.

Market Data Revenues and Revenue Sharing

Pursuant to the Exchange Act and SEC rules, exchanges must collect quotation and last sale information from their members and be members of National Market System plans that consolidate and disseminate that information. Exchanges must also enforce member quotation and trade reporting requirements and surveil for that compliance. In support of the goals of the National Market System, exchanges must maintain trading systems and communications networks.

Revenues from the sale of this market data helps exchanges defray the costs of meeting the statutory public policy objectives and serves as an important source of funding. This is particularly true for regional exchanges, which do not have issuer listing fees as a revenue source. The Phlx understands that the SEC is currently considering proposals that could have the effect of potentially reducing market data revenues available to exchanges. Any such proposal would severely limit the ability of the regional exchanges to fund their operations, attract participants to their markets, and provide competition to the NYSE.

Not only is distribution of market data revenues to exchanges important, but so is exchanges' freedom to use those revenues. Once received by an exchange, revenues are fungible. Sharing of market data revenues is but one financial incentive that an exchange may use to attract participants to its markets. Other methods currently used by exchanges include liquidity provider rebates; fee caps; volume discounts; temporary and permanent fee waiver; and payment for order flow programs. Numerous exchange programs for

sharing market data revenues with exchange members are currently in effect for stocks listed on the NYSE and the American Stock Exchange. The Chicago Stock Exchange, Boston Stock Exchange, and Cincinnati Stock Exchange have all had programs that fund various types of member credits, at least in part, out of revenues from the consolidated market data tapes for NYSE- and Amex-listed stocks.

However, the SEC has taken a very different tack with respect to exchange programs to share revenues from market data in Nasdaq-quoted stocks. In the first half of 2002, Nasdaq, the Cincinnati Stock Exchange and the Pacific Exchange all adopted pilot programs for sharing of market data revenues they received with respect to Nasdaq stocks. On July 2, 2002, the SEC invalidated these programs by abrogating the respective filings filed by the three markets.[7] The SEC took no action against the programs described above for sharing market data revenues in NYSE- and Amex-listed stocks.

The Phlx feels that the inconsistent nature of the SEC's approach to market data revenue sharing by exchanges is inhibiting competition. There is no logical distinction between sharing market data revenues in respect of Nasdaq stocks and NYSE and Amex-listed stocks. Refusing to allow Phlx and other exchanges to share market data revenue in Nasdaq stocks entrenches Nasdaq's position in trading Nasdaq-quoted stocks and hinders competition by other venues.

The exchanges are in the best position to determine the implications of market data revenue sharing measures on their overall revenues and to ensure that their self-regulatory programs are sufficiently funded, from whatever source or combination of sources. The SEC's regular examinations, its authority to require exchanges to modify

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[7] SEC Release No. 34-46159 (July 2, 2002).

their self-regulatory programs in areas needing improvement, and its authority to bring disciplinary actions ensure that the exchanges discharge their regulatory responsibilities. So long as they discharge their obligations, exchanges should have the opportunity to determine what is in their competitive interests and to implement those decisions. This competition would quickly translate into benefits for investors.

Payment for Order Flow by Exchanges

The Phlx believes strongly that exchange-sponsored programs to pay for order flow have a damaging effect on U.S. markets – particularly in the market for listed options. While these programs vary somewhat from exchange to exchange, they typically involve an assessment levied by an exchange on the specialist and market makers in the trading crowd. The specialist then uses the funds collected to attract orders, such as by paying broker-dealers for options orders they direct to the exchange.

Phlx believes that exchange-sponsored payment for order flow programs, which are prevalent in the listed options market, interfere with market forces, thereby reducing competition. Exchange-sponsored programs create a known and stable price point (the exchange-levied fee) that affects negotiations between specialists and order flow providers. They establish a rate at which the specialist's arrangements with order flow providers are subsidized. In this way, exchange-sponsored payment for order flow programs may cause distortions in the market, such as reduced quote competition and inferior customer service or research.

Exchange-sponsored payments for order flow may also create conflicts of interest in the exercise of exchanges' self-regulatory obligations. An exchange must enforce compliance by its members with the securities laws, including its members' obligation to

achieve best execution for their customers. When an exchange sponsors and promotes a payment for order flow program, its regulatory objectivity may come into question.

In August 2001, the Phlx suspended its exchange-sponsored payment for order flow program in the options market. At that time, the Phlx Board of Governors reserved for the Chairman the authority to reintroduce the practice if competitive pressures so warranted. In November 2002, the Phlx reluctantly reinstituted a payment for order flow program in its options business. Despite its conviction that exchange-sponsored payment for order flow is unhealthy for U.S. markets, the Phlx felt compelled to respond to those exchanges that maintain the practice. To do otherwise would place the Phlx at an untenable competitive disadvantage. Because not all of the options exchanges are willing to eliminate their payment for order flow programs, the Phlx has petitioned the SEC to adopt a rule banning such programs.[8]

Decimalization

Decimalization is one of the most significant to U.S. securities markets change in the last 20 years. Where most participants in the U.S. securities markets had quoted and traded in fractions – in eighths or sixteenths of a dollar – decimalization requires participants to quote stocks in dollars and cents. Beginning in 2000 and continuing in 2001, the U.S. self-regulatory organizations have required their members to quote in Minimum Price Variations denominated in decimals -- $.01 for stocks and $.05 and $.10 for options.

[8] Letter from Meyer S. Frucher to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, regarding "Options Exchange Payment for Order Flow Programs; Petition for Rulemaking," February 3, 2003.

Members of Congress were among the strongest supporters of decimalization.[9] They deserve commendation for their focus on the potential benefits decimalization can bring to investors. For example, decimal pricing of securities may be easier for investors, particularly retail investors, to understand than pricing in fractions. Investors may also experience lower transaction costs to the extent pricing in decimals causes narrower trading spreads – the difference between the bids and the offers for particular securities.

Although decimal pricing may have produced benefits for investors, it has produced challenges as well. With the number of price increments increasing from 16 per dollar to 100 per dollar, less liquidity may be available at each price point. In turn, the price point representing the "national best bid and offer" may be a less revealing snapshot of trading interest. A recent study suggests decimalization has led to higher trading costs for actively managed mutual funds.[10] Some institutional investors believe that decimalization has led to increased instances of exchange specialists stepping ahead of customer orders by one penny.[11]

Decimal pricing is producing challenges for market intermediaries as well. To the extent decimalization has narrowed trading spreads and increased volatility, it increases risks for exchange specialists and market makers. They are discouraged from providing liquidity in certain securities. Specialists and market makers on regional exchanges have been particularly affected, with many firms ending or reducing their participation in the

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[9] See, e.g., H.R. 1053, the "Common Cents Stock Pricing Act of 1997," introduced by Rep. Mike Oxley on March 13, 1997.

[10] "Common Cents? Tick Size, Trading Costs, and Mutual Fund Performance," by Professors Nicholas Bollen of Vanderbilt University's Owen Graduate School of Management and Jeffrey Busse of Emory University's Goizueta Business School.

[11] See, e.g., letter of Craig Tyle, General Counsel, Investment Company Institute, to Richard Grasso, Chairman, New York Stock Exchange, March 1, 2001.

markets. Withdrawal of specialists and market makers only hurts investors, through reduced competition and less available liquidity.

Given these factors, the Phlx believes at a minimum that the marketplace would benefit from an impartial review of the impact of decimalization on the trading environment. The Subcommittee might consider asking the General Accounting Office to study the effects of decimalization. Such a study could address issues such as whether decimalization has affected available liquidity for certain securities; investors' trading costs; and the usefulness of market data. The Phlx feels that the implications of decimalization should be well understood before any further reduction in minimum quoting and trading increments further, such as to pennies for options or sub-pennies for equities.

Self-Regulatory Function of Exchanges

Recent developments at the NYSE and elsewhere have focused attention on the self-regulatory obligations that the Exchange Act places on all national securities exchanges. Self-regulation has been a hallmark of the U.S. capital markets since the Exchange Act was enacted. While it is entirely appropriate to review this important element of the U.S. securities markets, no conclusions should be reached hastily or in response to isolated incidents.

The Phlx believes that self-regulation by individual exchanges has worked well overall. A single self-regulator might well develop into a centralized monolith, with an insular mentality and a lack of understanding of changes in technology, changes in the marketplace, and other emerging issues. Regulation by individual marketplaces involves better-informed regulation better suited to the individual exchange. Among the bases on

which U.S. exchanges compete against each other is different methods of trading. These different methods are reflected in different technology and trading systems from exchange to exchange and accordingly in different trading rules as well. Each exchange is most knowledgeable about its own trading systems and trading rules, its own members, its members' trading strategies, and the dynamics of trading in its marketplace. Each exchange is therefore best situated to enforce its rules and detect violations involving such abuses as tape painting, wash trading, front running and the like. As in other contexts, in this situation "local authorities" are better situated to assess conditions and develop and enforce rules than is a distant authority located in Washington or New York.

The Phlx sees no advantage to a single market regulator with oversight across all markets trading any particular type of security.[12] To the contrary, such an approach would likely result in inefficient and inappropriate regulation of exchange members and quite possibly anticompetitive outcomes. Each market center, other than those that have "outsourced" a portion of their regulatory functions, currently uses its own methods to meet the level of surveillance, compliance and enforcement required by the Exchange Act. The exchanges strive to identify the most appropriate means of carrying out these responsibilities. Some exchanges use more automation, some more manpower, while some embed regulatory mandates into the algorithms used in their trading systems. Such algorithms make it impossible for certain rules to be violated or alert members and surveillance times to possible violations. At the same time, the SEC routinely inspects the adequacy of the self-regulatory organizations' regulatory programs, the competency of their staff; and their compliance with the Exchange Act and the SEC's rules.

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[12] See Letter from Meyer S. Frucher to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, regarding "Request for Comment on Nasdaq Petition Relating to Regulation of Nasdaq-Listed Securities, Release No. 34-47849, File No. S7-11-03," June 17, 2003.

The Phlx sees particular disadvantages to a single-regulator concept if that regulator has authority over members that hold memberships on competing markets. Exercise of regulatory authority by such an entity might result in the imposition of anticompetitive policies or rules on competing exchanges. The Phlx would not support such a structure.

Recent events at the NYSE may create a perception in some minds that exchange regulatory functions do not have sufficient structural independence from inappropriate influence. Rather than complete separation of trading and regulatory functions, the Phlx believes the SEC and NYSE should look at overall governance issues. The Phlx reformed its governance extensively in the late 1990s. Since 1997, non-industry members have constituted a majority of the Phlx's Board.[13] The Phlx believes that members and member organizations have an important role to play in exchange governance, where their expertise on boards and committees is invaluable. However, to safeguard the independence of the regulatory function, an appropriate balance must be struck between public and member representation on exchange and other self-regulatory organization boards and on committees overseeing such key functions as audit, compensation and nominations.

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The Phlx is thankful to have this opportunity to share its views with the Subcommittee. The Phlx looks forward to working with Members of Congress, the SEC, its fellow self-regulatory organizations and market participants to craft improvements to market structure that will benefit investors through increased competition.

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[13] See Letter from Meyer S. Frucher to The Honorable William H. Donaldson, October 3, 2003.

The End of the SRO

Reform Requires That Exchanges Completely Separate Regulation From Business and Adopt a Public-Ownership Model

Testimony of
James K. Glassman
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Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives

Hearing on
"Reviewing US Capital Market Structure: The New York Stock Exchange and Related Issues"

October 16, 2003

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Mr. Chairman, Mr. Kanjorski and Members of the Subcommittee:

My name is James K. Glassman. I am a fellow at the American Enterprise Institute, host of the website TechCentralStation.com and a syndicated financial columnist for the Washington Post, the International Herald Tribune and other newspapers. One of my main concerns is the nexus between finance and public policy, especially as it affects small investors.

The recent resignation of Richard Grasso, chief executive officer of the New York Stock Exchange, in the wake of controversies over specialist activity, board composition and compensation, has provided a once-in-a-lifetime opportunity to reform a management structure built on a massive conflict of interest – a structure that is unworkable and rotten at its very core.

So far, this opportunity has been squandered.

I hope that this hearing, coming at such a critical time, will help reverse a course that will inevitably lead to more scandals and a further erosion of confidence.

The New York Stock Exchange, in its 211-year history, has been the most prominent and powerful symbol of capitalism and free markets in the world. Its stature has been severely diminished in recent years. The remedy is reform – to put an end to an unconscionable conflict through two steps: 1) separating the regulatory and business functions of the exchange and 2) making the NYSE a public company, owned by thousands of outside shareholders, just like the nearly 3,000 companies that the exchange itself lists.

The reform would be relatively simple to achieve, and it would inevitably provide small investors – the people that concern me most – with better service at lower cost and would

increase their trust in the integrity of markets, a trust that has been badly shaken in the past two years.

Separation Is the Foundation

The foundation of any reform of the exchange is separation.

The regulatory function of the New York Stock Exchange (and of every exchange and market) must be separated, by contract and by structure, from its commercial trading function. As the best insurance against conflict, the NYSE and the NASDAQ should become public companies, with a majority of their shares owned by outside shareholders who would choose directors. A system of electing board members – whether there are 27 or 17 -- based on the constituencies they represent is doomed to failure. All directors must be rowing in the same direction, toward the same goal.[1]

Unfortunately, top officials New York Stock Exchange and the Securities & Exchange Commission have not emphatically supported separation – nor have they even said, to date, that they believe it deserves serious consideration.

To the contrary, John Reed, the interim CEO of the NYSE, has said that "he would seek to keep the exchange and its regulatory arm 'tightly coupled.'"[2] And, in a hearing Sept. 30 before the Senate Banking Committee, William H. Donaldson, the SEC chairman, "suggested it would be a mistake to completely split off the Big Board's self-regulatory function." Despite some "hiccups through the years," Mr. Donaldson said that "self-regulation has 'worked pretty well.'"[3]

Some might see hope in the impressions received by state pension fund officials who met with Mr. Reed earlier this week. They said that Mr. Reed told them he wants reform, but he is battling entrenched interests on the exchange. "He indicated that there are a lot of powerful folks there that don't want to see much change," Iowa Treasurer Michael L. Fitzgerald said at a press conference.[4] This resistance, however, is a manifestation of the problem that Mr. Reed was selected to overcome. The system itself must end, and the occasion is here.

Congress has an important role to play in ending the travesty of the "self-regulatory organization," or SRO, model that governs the NYSE. Without separation, scandals such as those involving Mr. Grasso and specialists will multiply and Americans will properly question why regulators and elected officials have allow a system that destroys the trust of investors to continue.

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[1] Writing in the Wall Street Journal Oct. 15, 2003, columnist Holman Jenkins also advocated public ownership of the NYSE: "...an adult ownership structure is becoming not just advisable but urgent."
[2] "Reed Won't Call for Separating NYSE's Roles," by Ianthe Jeanne Dugan and Susanne Craig, The Wall Street Journal, Oct. 3, 2003.
[3] "Self-Regulation Faulted, But Donaldson Favors Caution; Chicago Exchange Settles Charges," by Deborah Solomon, The Wall Street Journal, Oct. 1, 2003.
[4] "Powerful Interests Said to Resist Change at NYSE," by Ben White, Washington Post, Oct. 15, 2003.

The End of the SRO

This hearing concerns broader aspects of capital market structure, but I want to focus my attention on the crucial issue of the self-regulatory organization, an idea whose time, if it had ever truly come, is now clearly gone.

In a recent speech, Mr. Donaldson recognized that the urgent "need to restore the moral and ethical underpinnings of America's corporate and financial institutions -- at a time when so many of these institutions are still recovering from revelations of serious malfeasance."[5] The major institution most in need of restoring its moral and ethical underpinnings is the New York Stock Exchange.

The New York Stock Exchange is two things: It is a business, and it is the regulator of a business that happens to be itself.

This status, as a self-regulatory organization, is at the heart of recent scandals. The insurmountable conflict between the NYSE's two roles is the main reason that Mr. Grasso was paid so much, a package worth a reported $187.5 million at an institution that has not been notably profitable lately. After all, what company – given the opportunity – would *not* pay its own regulator a hefty sum?

The regulatory arm of the NYSE is said to be distinct from the rest of the organization, but who is kidding whom? "Many Wall Street firms are happy with the current arrangement because the NYSE's regulatory unit has been perceived to be much weaker than that of other securities regulators," reported the Wall Street Journal last month. "Defense lawyers and critics say the NYSE's softer investigative role stems from conflicts inherent in running a marketplace and policing members."[6]

Alternative to the Conflict of Interest

The NYSE's self-regulatory status must end. The alternative is to separate the regulated from the regulator. The regulator does not have to be a government agency, although it could be. And the exchange would not be a completely passive party. It would choose its regulator and be responsible for the choice. Investors could judge for themselves whether this selection was merely self-serving or whether the regulator was serious about protecting them.

The model exists today. The National Association of Securities Dealers (NASD), a private entity with an annual budget of $400 million and a staff of 2,000, already regulates both the NASDAQ Stock Market and 5,330 securities firms. The NASD used to own NASDAQ outright and the structure was self-regulatory, but three years ago, as the NASD says on its website, "we decided to sell NASDAQ, in order to concentrate solely

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[5] William H. Donaldson, speech to the Foreign Policy Association, New York, Sept. 25, 2003 (http://www.sec.gov/news/speech/spch092503whd.htm).
[6] "McCall Confirms IPO Is Considered as Way to Split Market's Role," by Laurie P. Cohen and Ianthe Jeanne Dugan, The Wall Street Journal, Sept. 19, 2003.

on our core mission, ensuring market integrity and investor confidence."[7] The separation was part of an effort by the SEC to remedy serious trading improprieties at the NASDAQ that emerged in 1996. It has worked well, but it is still incomplete:

> While NASD is Nasdaq's nominal parent, the market and regulatory operations are housed in separate subsidiaries and are controlled by separate boards of directors. NASD, which has a contract with Nasdaq, registers member firms, writes rules to govern their behavior, examines them for compliance and disciplines firms that break the rules.... Nasdaq still handles some of its own regulation, namely the day-to-day surveillance of the market. The separate boards are made up of industry participants, who may have their own interests at heart. And while a wall separates them, the regulatory arm and the market are part of the same entity. NASD is the majority controlling shareholder in Nasdaq -- at least until Nasdaq gets approval to become a stock exchange. Once that happens, Nasdaq plans to split off completely from NASD and continue contracting with the regulator.[8]

To achieve complete separation, the SEC should move quickly to grant exchange status to NASDAQ. A similar complete separation should be effected for the NYSE. Both exchanges would then be free to launch Initial Public Offerings.

How well does the NASDAQ model work?

A recent report by the General Accounting Office, the investigative arm of Congress, found that the NASD levied $211 million in fines in 4,715 cases between 1997 and 2002. By contrast, the NYSE levied only $19 million in fines in 256 cases over the period.[9]

The comparison is not entirely fair since the NASD has a broader field to cover for its penalties. Nevertheless, the evidence indicates that the NYSE is a more lenient self-regulator. "The NASD takes its enforcement role much more seriously," said New York attorney Bill Singer, who defends clients before both the NASD and the NYSE. "If you had a choice, you'd rather be sanctioned by the NYSE."[10]

Again, that stands to reason. The NASD has one job: to regulate. The NASDAQ has one job: to build its business as a commercial marketplace for a reputation for bringing buyers and sellers together with fairness, low cost and high speed.

The Specialist Anomaly

Under the current model at the NYSE, 1,366 for-profit members own a non-profit institution. Clearly, the members will attempt to run that institution in ways that benefit themselves. Such a system is fraught with peril, but it might work – if did not have a

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[7] See www.nasd.org.
[8] "SEC Is Looking to 'Nasdaq Model," by Deborah Solomon, The Wall Street Journal, Oct. 14, 2003.
[9] "SEC and CFTC Fines Follow Up," U.S. General Accounting Office, July 2003, GAO-03-795, p. 41.
[10] Op. cit., The Wall Street Journal, Sept. 19, 2003.

regulatory component. But it does, and, very clearly, the NYSE engages in practices that are often at odds with the best interests of investors.

A good example of such practices is the specialist system, which brings buyers and sellers together on the floor of the exchange to complete about 80 percent of trades. That system -- which permits about 400 traders from just seven firms, with inside knowledge, to enhance their own accounts as well -- is an anomaly, an antique among the world's major exchanges. Why does it persist? The exchange argues that specialists provide liquidity and maintain an orderly market. Such claims are dubious, at best. In fact, the obvious reason the system continues is that it is immensely profitable for the specialists themselves.

For example, in a recent presentation at the American Enterprise Institute, economist Brian Becker contrasted the NYSE system of market-making through specialist firms that each handle the shares of an average of about 400 individually listed NYSE stocks with the NASDAQ system of 400 market-making firms. While NYSE's stocks have a single market-maker on the floor, the average NASDAQ stock has over 10 competing market-makers.[11]

"The NYSE and the NASDAQ," according to Deutsche Bank, "are fundamentally opposite organizations: the NYSE is a floor-based auction market, the NASDAQ is an electronic dealer-driven market." At this moment in history, it would seem that an electronic market, with high speed and greater competition, makes more sense. That is the form that has been adopted around the world, from London to Tokyo.

Certainly, the NYSE can choose any operational form it wishes. Government should not interfere in the choice itself, but it is clear that the operational form, with its emphasis on specialists and limited competition, is a function of the ownership – and the board composition – of the NYSE. The losers are investors. Some are beginning to speak up. Scott DeSano, head of global equity trading at Fidelity Investments, the largest mutual fund family, recently criticized the specialist system, calling instead for "an electronic system such as that used by the Nasdaq Stock Market, in which computers pair buy and sell orders with no human go-between."[12]

The power of the floor is undeniable, and it is rooted in the profitability of the specialist firms. Mr. Becker calculates their pre-tax margins at 35 percent to 60 percent, compared with 9.7 percent for the industry category SIC 6211 (security brokers, dealers and flotation companies).[13] One reason this profitable cartel exists is that the specialists are enormously powerful within the NYSE itself. For example, two or three representatives of specialist firms – currently those of Van der Moolen Specialists USA, LLC, and Fleet

[11] "The NYSE and NASDAQ," presentation by Brian Becker, Precision Economics, LLC, at a conference on "The Profitability of New York Stock Exchange Specialists," American Enterprise Institute, Oct. 8, 2003 (http://www.aei.org/events/eventID.636,filter./event_detail.asp).
[12] "Fidelity Urges NYSE to Revamp Trading Operation," by John Hechinger, The Wall Street Journal, Oct. 14, 2003.
[13] Ibid.

Specialist, Inc. – typically sit on the board at any time. In addition, the CEO of Bear Stearns Cos., which has a minority interest in Bear Wagner, is vice chairman of the NYSE board, and the CEO of the Goldman Sachs Group, Inc., which owns a fourth specialist, Spear, Leads & Kellogg, also sits on the board.[14] The four firms represented on the board account for about three-quarters of the dollar volume of NYSE trading.[15]

Specialists are currently under investigation for trading irregularities by the SEC and one has already been fined. This is an old story at the NYSE, but there are more recent ones. In October 2002, Martha Stewart, CEO of Martha Stewart Living Omnimedia, resigned from the board just four months after joining it. She was under pressure from investigators examining her possible role in an insider-trading scandal involving another company, Imclone Systems. The investment bank of another director, Kenneth Langone, was charged by regulators with unlawful profit-sharing activities in connection with initial public offerings of stock.

Richard Grasso, the NYSE's chairman, first came under public criticism for serving on the board of Computer Associates International, whose accounting was subject to a criminal investigation. He also admitted that he had neglected to file timely statements for stock compensation from Computer Associates over five years. He resigned from that board but continued to serve on the board of Home Depot, Inc., which Mr. Langone co-founded in 1978. The NYSE was also criticized by Eliot Spitzer, the New York attorney general, after it nominated Sanford Weill, CEO of Citigroup to its board as a "public" representative in March. Mr. Weill withdrew his name.[16]

Then, in August, the details of Mr. Grasso's pay package was announced. On Sept. 16 four top pension funds called for his resignation, which occurred the next day.

This train of events, while not exactly predictable, should not have been surprising. As Sarah Teslik, executive director of the Council of Institutional Investors, put it, "The nicest thing you can say about the NYSE and their performance is that they are set up in such a way that you can't expect them to do a good job. And they have not disappointed us."[17]

The Congress, the SEC and the exchanges and markets themselves have the opportunity to end the conflicts that brought about the current scandals by establishing a new regulatory regime – one built on choice, competition, strict compliance and investor protection.

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[14] See http://www.nyse.com/about/p1020656067652.html?displayPage=%2Fabout%2F1022221392205.html.
[15] Op. cit., Becker.
[16] These events are related in "Down in Front," by James K. Glassman, www.TechCentralStation.com, April 21, 2003.
[17] "Closing Bell for the NYSE," by Kim Clark, U.S.News & World Report, June 9, 2003.

Picking Your Regulator

Why choice? Why should the NYSE or any other exchange be able to pick its regulator? Research indicates that when regulators compete for business, the result is better regulation. In addition, the institution that does the selecting takes responsibility for its choice and is judged by investors accordingly.

For example, U.S. corporations choose the state in which they are chartered, and that state's corporate law prevails. States compete to offer rules that are sensible both for corporations and investors. Landmark research by Roberta Romano, a Yale University law professor, has found that this competition does not result in a "race to the bottom" – but just the opposite. Competition produces strong, clear regulations that benefit managers, employees, investors and the economy. A company that chooses a state with a lax regulatory regime will be penalized by investors, who will demand a high risk premium (and lower price) for its stock.

In a book published last year, Romano extended the model to the regulation of individual public companies. "Under such an approach," she wrote, "corporations would be able to select their securities regime from among those offered by states, the SEC, and even other nations, with the result that securities would compete for firms' registrations."[18]

Competition, she argues, yields the best results, not just in the commercial marketplace but also in the regulatory marketplace.

When it comes to securities exchanges, the choose-your-regulator principle would be even easier to put into practice since, while there are thousands of corporations, there is only a handful of exchanges. The NYSE might, instead of choosing the NASD, contract, for example, with the New York attorney general to establish a separate regulatory regime, or with a new private entity established expressly for exchange regulation.

What the NYSE should not do is regulate itself.

The era of the SRO is over. Separation and public ownership – not convoluted new formulas for board composition – are needed to protect the investing public, to provide better service and, not coincidentally, to make exchanges better businesses.

Thank you.

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[18] Roberta Romano, The Advantage of Competitive Federalism for Securities Regulation, The AEI Press, Washington, D.C., 2002, p. 3.

Testimony of
Robert Greifeld
CEO and President
October 16, 2003
The NASDAQ Stock Market
Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Of the
House Financial Services Committee Hearing on
Reviewing US Capital Market Structure: The New York Stock Exchange and Related Issues

Principles of Market Structure Reform: Investor Choice, Competition and Fairness

Chairman Baker, Ranking Member Kanjorski and members of the Subcommittee,

Thank you for inviting me to testify before you today. As you may know, I became the CEO and President of the NASDAQ Stock Market some 5 months ago. I consider NASDAQ to be a unique asset of the U.S. economy whose success is driven by how well it serves the individual investor. Although technology, regulation and complex market structure issues are a part of my daily life, most major decisions affecting NASDAQ's future can be and should be viewed from the perspective of the individual investor. My premise today is that the individual investor is best served by free choice, competition and fundamental fairness.

Of course, every aspect of this country's capital markets is affected by the decisions of public policy makers. In this regard, we are fortunate to be served by an institution like the SEC with its expertise and tradition of excellence.

I have learned that the SEC can say "yes," and can say "no." And for a manager in a fiercely competitive market, when they don't say anything, this means "no" as well. So as we examine the issue of capital market structure, I urge you to encourage the SEC to be deliberative and cautious, but also expeditious. Their actions or inactions have a direct effect on the investor experience and the continued viability of America's capital markets which create the jobs and economic growth we all seek.

With respect to the debate about securities market structure, the Securities and Exchange Commission is faced with critical decisions at a unique time in our economic history. Now is the time to face these decisions. At the top of the list I would put three issues: reform of the trade through rule, the need to separate the securities regulator from the securities market, which in our case means approving NASDAQ's Exchange application,

and, the need to ensure uniform regulation of the marketplace by addressing the emergence of trading in sub-pennies.

The SEC should keep in mind three fundamental principles as it seeks to solve the emerging issues of market structure: promoting investor choice, promoting competition and ensuring the competitiveness of U.S. capital markets.

Principles of Market Structure Reform

With regard to competition, NASDAQ competes for every listing, every quote, every execution, and every trade report, and we feel other markets should do so as well. Competition has always been good for NASDAQ. Our open architecture has facilitated competition. We have nearly 300 market makers who are willing to commit capital to help with the execution of buy and sell orders. NASDAQ's market structure promotes efficiency, and market quality statistics mandated by the SEC bear this out. At NASDAQ, the speed of execution is faster than ever and the spreads are tighter than ever.

Many argue that a floor-based monopoly can produce short-term benefits. But history and economics show that monopoly power is corrupting and is bad for citizens, markets and investors. In a decimalized environment, the monopoly enjoyed by floor-based markets fails to deliver the degree of price improvement needed to justify departing from the principles of competition and fairness. Competition forces market participants to focus on how best to serve the customer and the investor. Rapid technological strides, as well as decimal pricing, have helped to promote the spread of electronic markets and should lead to a reappraisal of market structure.

Reform of the Trade Through Rule

With regard to the most important market structure issue, it is important to understand that there are "haves" and "have- nots." There are markets that have electronic, competitive models and there are markets that are stuck with closed, specialist based monopoly models. The issue here is fair competition and the fact that one market model currently dictates how the others operate. Electronic trading has revolutionized trading on NASDAQ, but the listed arena is frozen in time. When electronic orders try to move in the listed environment, they are held up for an "eternity of seconds" because of the trade through rule. Trading in NYSE-listed stocks is slowed to the pace of the slowest market. Speed is the critical consideration for many market participants.

The trade through rule is a twenty-year-old provision of an SEC-approved plan for trading NYSE and Amex listed securities. It forces investors to send their orders to floor-based markets through an antiquated linkage, instead of allowing investors to decide for themselves whether they wish to route their orders to faster, more transparent, electronic markets.

In the era before fully electronic markets and lightning-fast private linkages, the SEC mandated that the trade through rule was needed to ensure that investors' orders were

executed fairly. Because only floor-based markets existed at the time, the SEC premised the rule on the physical limits of floor-based trading.

Decimalization has starkly highlighted the benefits of electronic trading. Before share prices were decimalized, bid-asked spreads were often 25 cents or more. If I could cut the spread by a nickel, there was much to be gained by spending the time looking for such savings. But share prices are now decimalized. Actively traded stocks have a one-penny or two-penny spread. The effective spread for Microsoft is only eight tenths of a penny

Consumers often prefer to pay extra for a gallon of milk at the convenience store round the corner than to travel a couple of miles for cheaper milk at the supermarket. The same is true for investors. Many want to be able to choose to trade quickly, sometimes forgoing a penny or two in order to ensure they have their order filled rapidly. But they can't because of trade through. They have to trade at the pace of the slowest market – the floor-based exchange. Clearly, now is the time for reform of the trade-through rule.

The trade through rule is an anachronism. Investors are no longer homogenous. Investors have different needs. Investors want the freedom to choose faster markets or anonymous executions or markets with lower costs. The trade through rule stifles investor choice by forcing investors to use slow, manual markets. It stifles competition and innovation by protecting the monopoly of a single specialist. If investors could send their orders to faster, more transparent electronic markets, it would force specialists to compete for orders by, among other things, narrowing their spreads and executing trades faster.

Investor orders subject to the trade through rule actually receive slower, more costly executions than orders that are free of it. The SEC's own execution quality statistics -- the 11Ac1-5 or "Dash 5" statistics – show that NYSE stocks subject to the trade through rule have wider spreads. And trades are executed more slowly and expensively.
The trade through rule should be repealed as quickly as possible. As SEC commissioner Paul Atkins said in a recent speech, the trade-through rule may actually "prevent individual investors and professional traders from obtaining an execution that meets their needs." The SEC has already acknowledged the failure of the trade through rule by exempting the trading of the QQQ, Spiders and Diamonds – among the most heavily traded stocks in the world – from the strict requirements of the rule. The SEC should let investors decide what they need, avoid the appearance that they favor one market over others, and promote competition.

Separating the Regulator from the Market

Much is being written these days about corporate governance within the exchange itself. America's exchanges rely on the trust of investors. At the moment NASDAQ is in the process of separating from its regulator, the NASD, based on the belief that separation is the only structure that works for our market. As CEO and President of NASDAQ, I can't imagine explaining to Congress that my regulator hat was on one day and off the next.

This is why we contract with NASD to provide our market with unsurpassed regulation. NASD regulators are on the case 24 hours a day, seven days a week. It is untenable to combine a market center with a regulator in one corporate parent. It would be as if the FDA had an ownership interest in Merck.

NASDAQ does not simply list public companies; it is itself part of the environment of public companies. No NASDAQ CEO has ever sat on the board of a listed company. NASDAQ is subject to Sarbanes-Oxley and adheres to the same listing requirements that we impose upon our listed companies. This list includes standards such as Sarbanes-Oxley 404 and Regulation FD.

NASDAQ will not complete the task of separating from the NASD until it becomes an exchange. Until then, although we are in different companies, the NASD still has voting control over NASDAQ. Neither the NASD nor NASDAQ wants to continue in this limbo with the NASD and NASDAQ in the same corporate family.

NASDAQ filed its application with the SEC on November 9, 2000, to become a national securities exchange. Exchange status for NASDAQ removes even the hint of a possible conflict of interest in the application of regulations by separating NASDAQ as an exchange with voluntary membership from the NASD and its compulsory membership requirements. Exchange status streamlines the governance of NASDAQ to eliminate the need to obtain the approval of two organizations and two boards for decisions that improve the market and deal with such things as market disruptions.

The SEC has already stated that NASDAQ is an exchange. For example, in December 1998, the Commission stated that "NASDAQ performs what today is generally understood to be the functions commonly performed by a stock exchange," and that "NASDAQ's use of established, non-discretionary methods bring it within the revised interpretation of 'exchange'." After a multi-year process, in 1999 the Commission laid out a detailed policy for the application of a broad definition of what constitutes an exchange. There is no basis in policy or fact for abandoning this broad definition. In fact, the Exchange Act goals of protecting investors and promoting competition "among exchange markets and between exchange markets and markets other than exchange markets" would be harmed, if a narrow approach was adopted and the past ignored.

One of the stumbling blocks to our exchange registration is that we do not mandate time/price priority. Some have suggested that the Commission should dictate a rigid concept of an "exchange" based on the floor-based, auction market model, for which the price/time priority is a key organizing principle. But it's worth noting that we do not mandate against price/time priority; in fact a large portion of the NASDAQ marketplace today actually trades with price/time priority. Compared with traditional exchanges that direct orders to floor-based, specialists, NASDAQ's decentralized structure of multiple dealers competing for orders gives investors faster execution speeds, superior quoted spreads, and lower transaction costs.

Uniformity in Regulation: Trading in Sub-Pennies is Harmful

There should be uniform rules across all markets that trade NASDAQ stocks. That is not always true. Let me give you one example. NASDAQ has alerted the SEC to an alarming trend in the trading of some stocks. Some ECNs are allowing market participants to quote and trade in sub-penny increments. The danger here is that some investors have the ability to quote and trade in these increments and some do not. Furthermore, sub-penny quotes threaten to erode the National Best Bid/Offer (NBBO) as a source of accuracy and investor protection – the NBBO does not show sub-penny quotes to ordinary investors.

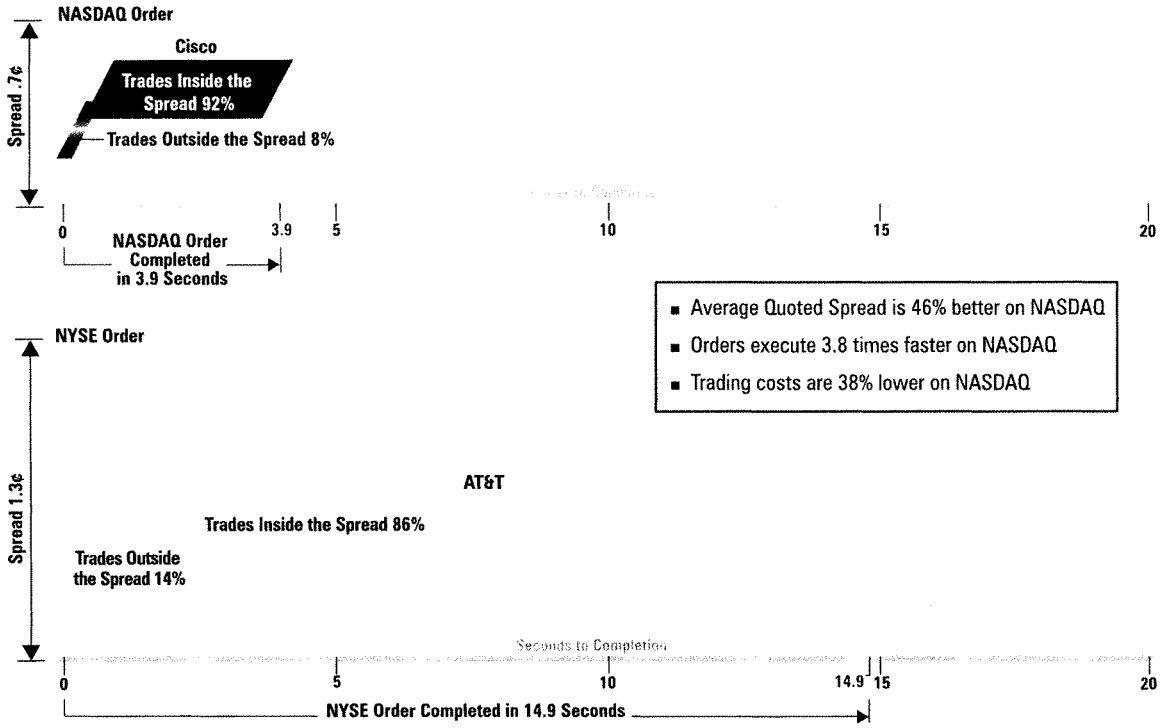
Most ordinary investors could not conceive of trading in hundredths of a penny. We fear that this creates two markets, one for sophisticated traders and one for other investors. Sub-penny quotes imply the re-emergence of hidden markets, which the SEC strove to eliminate through the Order Handling Rules. Such hidden markets facilitate and encourage the practice of "stepping ahead" of customer orders by economically insignificant amounts. Sub-penny trading has reached significant levels, accounting for 16 percent of NASDAQ trading. We think it is harmful and could erode investor confidence in the belief that "Main Street" and "Wall Street" play by the same rules. But if the SEC does not act quickly, we will be forced to accept no action as a policy decision endorsing sub-penny trading.

Should the SEC decide to allow sub-penny trading for all markets -- thereby avoiding a two-tier market -- then we must embark upon an educational campaign to equip the individual investor for the sub-penny trading environment. He or she should know that they can choose to buy or sell at sub-decimal prices. Everyone should play by the same rules and be afforded the same opportunities.

While we recognize the complexity of these market structure issues, we hope that action on them will not be delayed. As long as the Commission is guided by the need to preserve investor choice and to promote free and fair competition, investors will be protected.

I would be happy to answer your questions.

NASDAQ Trading of Cisco Systems Compared to NYSE Trading of AT&T

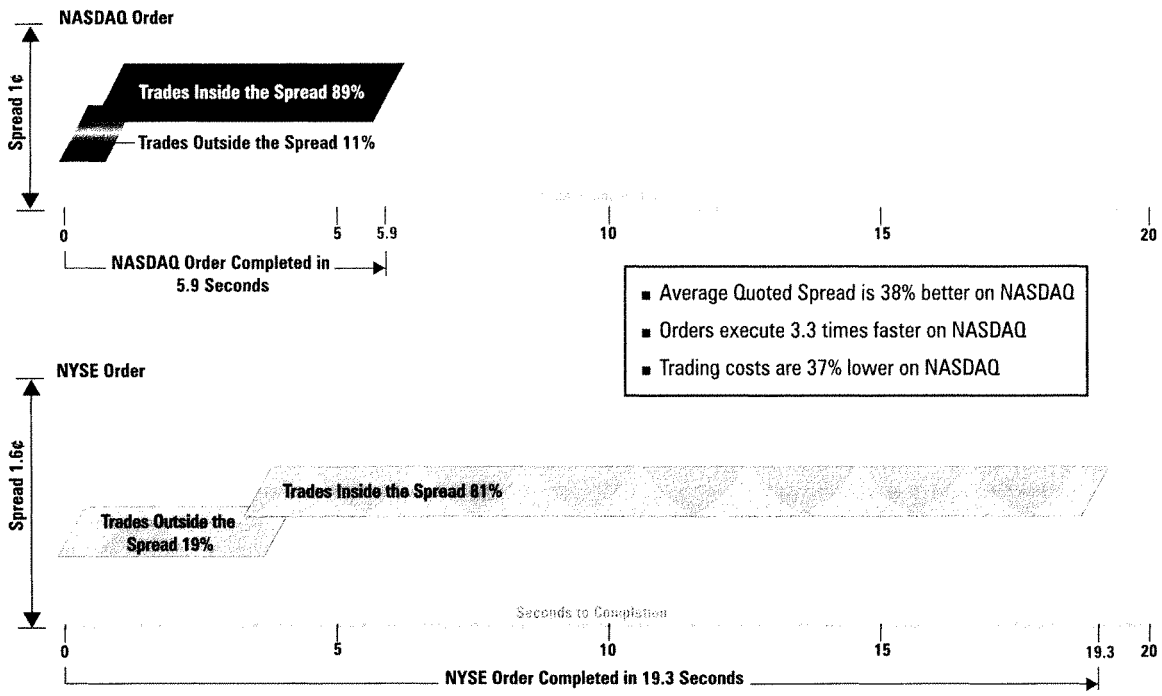


- Average Quoted Spread is 46% better on NASDAQ
- Orders execute 3.8 times faster on NASDAQ
- Trading costs are 38% lower on NASDAQ

Source: Market Systems Inc. Data as of August 2003

NASDAQ

Trading S&P 500 Stocks – NASDAQ Trading Compared to NYSE Trading



- Average Quoted Spread is 38% better on NASDAQ
- Orders execute 3.3 times faster on NASDAQ
- Trading costs are 37% lower on NASDAQ

Source: Market Systems Inc. Data as of August 2003

NASDAQ

Statement of
Marc E. Lackritz
President
Securities Industry Association
before the
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Hearing Entitled
"Reviewing U.S. Capital Market Structure: The New York Stock Exchange and Related Issues"
October 16, 2003

Introduction

Chairman Baker, Ranking Member Kanjorski, members of the Subcommittee, I am Marc E. Lackritz, President of the Securities Industry Association.[1] SIA commends you for holding this hearing and appreciates the opportunity to testify on the important topic of the U.S. Capital Market Structure.

Mr. Chairman, our securities markets have long been the most transparent, liquid and dynamic in the world. Their success has and will always depend on one word: *trust*. Without trust our markets would not exist. This trust begins with investors' trust in the brokers and other intermediaries who handle their money and execute their instructions. It extends to trust between all of the counterparties in the markets that their transactions will settle in a timely and accurate manner. It also encompasses trust that regulators will make fair and well-informed decisions about how to regulate these complex markets, and will enforce their rules evenhandedly.

[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Bankers Association, brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (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. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated $222 billion in domestic revenue and $356 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

In the past two years we have faced serious threats to these multiple layers of trust. Investors' trust has been shaken by a long bear market, accounting and audit failures, revelations of wrongdoing at the highest corporate levels, and serious allegations of wrongdoing by some financial market participants. Congress and regulators have taken decisive steps, through enactment and implementation of the Sarbanes-Oxley Act and tough enforcement actions, to restore trust in these areas. Now questions are being raised about trust in an important part of the regulatory underpinnings of our markets. Specifically, revelations about governance difficulties at the New York Stock Exchange ("NYSE") have spawned criticisms about purported conflicts between the NYSE's role as a marketplace and its role as a regulator of its own activities and those of its members. It is entirely appropriate for the Subcommittee to examine these issues.

SIA has given a great deal of thought over many years to the structure of self-regulation. Three years ago, in connection with the debate that was then ongoing about the role of self-regulation in light of proposals by both the NYSE and The Nasdaq Stock Market ("Nasdaq") to become for-profit entities, SIA commissioned a White Paper titled "Reinventing Self-Regulation." The purpose of the White Paper was to examine the purpose of self-regulation in light of major technological and competitive changes taking place in the securities industry, and to consider the advantages and disadvantages of different models for regulation of our Nation's securities markets. A copy of the White Paper, updated to reflect changes since its publication in 2000, is attached to my testimony.

Based on our experience with these issues, SIA believes that this debate should be shaped by several important considerations:

- **Investor Protection** – Regulation of markets and the securities industry should put investors' interests first and foremost. Effective, consistent and transparent regulation is

essential to keeping investors' trust, the most essential element in the success of our markets.[2]

- **Competition** – Regulation should promote competition, rather than favoring or protecting one market over another.
- **Uniform National Standards** – The regulatory system should ensure the primacy of the SEC as a strong national regulator. The system also should include appropriate roles for, and coordination with, the self-regulatory organizations ("SROs"), the states, and broker-dealer firms, to achieve uniform national standards.
- **Expert Regulation** – The regulatory system should be structured in such a way as to ensure that the regulatory staff overseeing day-to-day activities possess the requisite expertise necessary to perform their duties. This can best be achieved if the regulator has: (i) effective industry input into the regulatory process; (ii) the power and prestige to attract talented staff; and (iii) the ability appropriately to tailor regulation to fit the diversity of entities that it regulates, rather than relying upon a "one-size-fits-all" approach.

As explained in more detail below, the current model of self-regulation has generally worked well for our Nation in meeting each of these goals, and SIA believes that this model should be preserved. However, self-regulation can only survive if the public maintains its trust that the system works properly. SIA believes that action should be taken in the near-term to address concerns about the NYSE's dual role as both marketplace and regulator. One near-term step should be to separate clearly the NYSE's member regulatory function from its function as a marketplace. My testimony below will highlight considerations that should shape how that can best be done. Additional action to address the structure of self-regulation more broadly may take longer, but should also be considered. We have every confidence that the Securities and

[2] Section 3(f) of the Securities Exchange Act of 1934 (the "Exchange Act") provides that:

> Whenever pursuant to this title the Commission is engaged in rulemaking, or in the review of a rule of self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

Exchange Commission ("SEC"), under Chairman Donaldson's leadership, together with John Reed at the NYSE, will be able to respond to these concerns and separate the regulatory and marketplace roles of the NYSE in a manner that will lay to rest questions about the effectiveness of the NYSE's regulation of its marketplace and members.

Self-Regulation A System Worth Strengthening

SIA believes that a self-regulatory system with the proper checks and balances can provide a greater level of investor protection than might otherwise be achievable. Self-regulation contemplates self-policing by professionals who have the requisite working knowledge and expertise about the intricacies involved in the marketplace and the technical aspects of regulation, supplemented, of course, by government oversight. This tiered regulatory structure provides checks and balances, and can be both more effective and less costly than regulation by the government alone.

SROs are able to develop standards that can fill in the margins of federal statutes or regulation. Because self-regulators have an intimate knowledge of industry operations, trading, and sales practices, they have an ability to develop and revise rules on a frequent basis, keeping them up-to-date with market realities. Moreover, SRO rules often are designed to set ethical standards that exceed the legal minimums. For example, the NASD requires that its member firms adhere to "just and equitable principles of trade,"[3] a standard that in many instances exceeds the anti-fraud requirements of SEC statutes and rules. Because self-regulation utilizes the insight of those who are on the front line of marketplace developments, it can be more forward looking than traditional government regulation in anticipating problems. These characteristics mean that self-regulation can respond more quickly and directly to industry problems than direct government regulation.

[3] NASD By-Laws, Art. XI, §.1; Conduct Rule 2110.

A good recent example is the work of NASD on mutual fund breakpoints. In that instance, in late 2002 routine examinations by NASD examination staff identified a number of instances in which, due to flaws in internal operational systems and other complexities, broker-dealers had failed to deliver volume discounts known as "breakpoints" to investors purchasing mutual fund shares that offered breakpoint discounts. NASD responded by directing most major firms to conduct a "self-assessment" of their record of delivering breakpoint discounts to customers. NASD ensured that firms refunded their customers for any past breakpoint discounts that had been missed. NASD also assembled a joint "breakpoint task force" of representatives of the legal and operational side of the industry, as well as representatives from the buy-side and the utilities, to work with it on addressing the systems issues that led to the problem. The Task Force developed a series of recommendations to address the problems and is in the process of implementing those changes now. Thus, in a matter of months, NASD was able to work with the industry to identify and make recommendations for addressing a widespread operational problem and make whole any investors who had been disadvantaged by the problem.

Self-regulation is only one component in a larger regulatory system. SEC oversight is essential to that system. The SEC has been vigilant in overseeing the regulatory activities of SROs and has brought enforcement actions when necessary.[4] The SEC also can and has discharged the functions that self-regulators currently perform. But in most instances, the division of labor among the SEC and the SROs reflects a strategy for optimizing investor protection, while reducing claims on the federal budget. Accordingly, SIA believes that self-regulation plays a unique role in serving investors and should be maintained and strengthened.

Challenges Facing Self-Regulation

The most recent controversy regarding governance at the NYSE and compensation to its senior staff, along with charges that the NYSE has been slow to address some allegations of

[4] Most recently, the SEC accepted an offer of settlement from the Chicago Stock Exchange concerning its regulatory program. Release No. 34-48566 / September 30, 2003.

improper market behavior, have led some to question whether markets and member regulation can coexist. But before this most recent controversy, other events raised questions about the need to alter the current self-regulatory system. SIA has long advocated making timely improvements to self-regulation when appropriate, and strongly supported the elimination of unnecessary inconsistencies between federal regulation and self-regulation. Several factors may now suggest that the time is ripe for change.

1. Conflicts of Interest

When it enacted the Exchange Act and adopted the self-regulatory model, Congress recognized that there is an inherent conflict between the interest of an SRO in regulating itself and its members and its interest in promoting itself and its market. For example, an SRO might seek to impose regulatory requirements that are motivated more by a desire to generate fees for, or direct order flow to, its particular market rather than by a true regulatory need. To date, self-regulation paired with SEC oversight has worked as a check-and-balance system to contain more serious conflicts of interest. However, increased competitive pressures may exacerbate these conflicts of interest. Demutualization of exchanges (*i.e.*, the conversion of exchanges to for-profit entities) could also make these conflicts of interest more intense, as management may face increased pressure to cut the cost of regulatory functions, or use regulation for improper anticompetitive purposes, in order to maximize profits. Public trust and confidence in self-regulation will be badly damaged if the SEC and the SROs do not manage these conflicts effectively.

2. Competitive Considerations

In accordance with its congressional mandate, the SEC has fostered competition among markets in the National Market System.[5] As a result, we have seen the development of many

[5] Section 11A of the Exchange Act directs the SEC to "facilitate the establishment of a national market system for securities [in which there is] fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets...."

new or restructured trading systems, which has called into question the traditional pairing of markets and self-regulation. The development of Electronic Communications Networks ("ECNs") and other Alternative Trading Systems, the separation of Nasdaq from the NASD, the demutualization of Nasdaq and its application for exchange registration, are a few of the developments that have altered the existing landscape. ECNs compete with Nasdaq and the NYSE, yet must become members of an SRO.

One result of these changes is that now there is a greater theoretical danger that SROs can use their regulatory authority to harm competitors.[6] For example, an SRO could cite a member firm for failure to discharge its duty of best execution by routing orders to a competing marketplace.[7] For-profit markets, with fiduciary duties to shareholders, may face complex decisions about whether and how to sanction members for regulatory failures. Annette Nazareth, the Director of the SEC's Division of Market Regulation, recognized this critical point when she stated that "the trend toward demutualization and public ownership of exchanges raises several issues that merit further analysis . . . [D]oes the fiduciary responsibility of a board member to maximize shareholder value conflict with his or her duty to run a well-funded and vigorous self-regulatory operation? What steps can be taken to mitigate any potential conflicts?"[8]

In addition to competition within the National Market System, competition in the global marketplace also has to be considered. Here the concern is not so much potential conflicts of interest within U.S. regulators as it is inefficiencies in the system of regulation that create costs for U.S broker-dealers and U.S. market centers that foreign competitors do not face. As discussed below, many aspects of the current structure of U.S. securities regulation create issues of unnecessary duplication of effort and uncoordinated examination or enforcement actions. The

[6] SIA is not alleging that any SRO has used its authority inappropriately; we only note that such a risk exists. The separation of NASD and Nasdaq is premised, in part, on this concern.

[7] Again, as a theoretical matter, the improper use of regulatory power might actually harm investors in such circumstances, by forcing broker-dealers to execute trades in markets offering inferior executions.

[8] Remarks of Annette L. Nazareth, Director, Division of Market Regulation, SEC, before the Fourth Annual Securities Industry Association Conference on Market Structure, June 13, 2003.

problem is not limited to SROs, but also encompasses uncertainties about the respective roles of state regulators and the SEC in setting standards for participants in national markets.

3. Regulatory Redundancy and Inconsistency Hurt Investor Protection

The industry has long believed that duplicative and inconsistent regulation diminishes investor protection and contributes to the cost of regulation. All major broker-dealers and many smaller firms are members of more than one SRO. SROs currently impose differing regulatory requirements upon member firms. In May 2002, the General Accounting Office issued a report outlining concerns about multiple self-regulatory efforts and related competitive issues.[9] As a follow up to that report, the NYSE and NASD solicited comment on ways to improve regulatory consistency and the examination process. SIA made a number of suggestions in response.[10]

Inconsistent regulation may compromise investor protections for a number of reasons. Investor protections should not be subject to the happenstance of whether a broker-dealer is a member of one SRO as opposed to another. Differing requirements can raise the specter of "regulatory arbitrage" (moving from regulation under one SRO to regulation under a different one with more lenient requirements), undermining the efforts of some SROs to set better standards than others. Uniformity is not a goal in and of itself, and some differences, especially with respect to trading practices, may be justified.[11] But investor protection goals should drive the self-regulatory process, not historical accident or circumstance.

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[9] GAO, *Securities Markets, Competition and Multiple Regulators Heighten Concerns about Self-Regulation*, GAO-02-362

[10] Letter from Michael H. Stone, President SIA Compliance and Legal Division and Christopher Franke, Chairman, SIA Self-Regulation and Supervisory Practices Committee, to Barbara Sweeney, NASD, and Donald Van Weezel, NYSE, August, 19, 2002.

[11] Regulatory uniformity is a complex issue that goes beyond the scope of this testimony. Recently, the SEC published a concept release in response to a Nasdaq petition, which raises a number of these issues. Release 34-47849, File No. S7-11-03. With particular reference to trading rules, as distinguished from "upstairs" regulation, there may be justifications for regulatory differences in different markets. Generally, SIA supports trading and related rules that are consistent with broad principles, even if they are not identical under all circumstances. *See* letter from Donald D. Kittell, Executive Vice President, SIA, to Jonathan Katz, Secretary, SEC, June 27, 2003.

Redundant regulation also hurts investors. Investors ultimately pay for costs of compliance, through higher fees or costs. We owe it to investors to give them the best protection at the lowest cost. Having ten existing SRO rulebooks,[12] rather than one rulebook, increases the costs for each segment of the securities markets – the investors, the issuers, the broker-dealer members, the SEC and the SROs. The member broker-dealers must constantly monitor rule changes for each relevant SRO in order to maintain a working familiarity with the rules and to make any necessary modification to supervisory and compliance procedures. In addition, because any SRO rule changes must be reviewed by the SEC, the SEC staff's burdens increase as the number of exchange rule filings increase, resulting in delays in the regulatory approval process. The duplication of effort can be particularly noticeable when the various SROs each separately file similar or identical rule changes. For example, recently the NYSE and the NASD both adopted rules regulating analysts. Although the SROs have made substantial efforts to coordinate their respective rules, they are not identical. In part because of the inconsistencies and resulting confusion, SIA has taken the unusual step of asking the SEC to adopt rules that would supplant both the NYSE and NASD rules.[13]

Another example of duplicative regulation lies in the area of on-site SRO examinations of broker-dealers. Section 108 of the National Securities Markets Improvements Act of 1996 directed the SEC to improve coordination of SRO examinations.[14] That effort has reduced somewhat the duplication for, and unnecessary burdens on, firms. The SEC's Office of

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[12] Currently, nine national securities exchanges, including the American Stock Exchange ("Amex"), Boston Stock Exchange ("BSE"), Chicago Board Options Exchange ("CBOE"), Chicago Stock Exchange ("CHX"), Cincinnati Stock Exchange ("CSE"), International Securities Exchange ("ISE"), NYSE, Pacific Stock Exchange ("PCX") and Philadelphia Stock Exchange ("Phlx") and one national securities association, the NASD, are registered with the SEC under Section 6 and Section 15A of the Exchange Act, respectively.

[13] NASD Rule 1050 (Registration of Research Analysts) and amendments to Rule 1120 (Continuing Education Requirements) and Rule 2711 (Research Analysts and Research Reports) and NYSE Exchange Rule 472 ("Communications with the Public") and Rule 351 ("Reporting Requirements"). Such a step also would help coordinate policy with respect to SEC Regulation AC as well as with the Global Settlement on Analysts.

[14] *See* amended Section 17(k) of the Exchange Act.

Compliance, Inspections, and Examinations has worked diligently with the SROs to improve the situation, but these efforts have not permanently "solved" the problem and coordination remains a challenge.

Prospects for Change

SIA believes that there are opportunities to improve the self-regulatory structure and stands ready to contribute to that effort. SIA hopes that an improved regulatory structure can preserve the goals we share – effective and efficient regulation, which includes self-regulation.

Recently, critics allege that the corporate governance structure of the NYSE prevented meaningful oversight of staff compensation. At the urging of Chairman Donaldson, the NYSE is reconsidering that structure.[15] SIA welcomes efforts to improve corporate governance and transparency within the SROs.

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[15] Statement of the Honorable William H. Donaldson, Chairman, U.S. Securities & Exchange Commission Testimony Concerning Recent Commission Activity To Enhance Investor Protections before the U.S. Senate Committee on Banking, Housing and Urban Affairs, September 30, 2003

> I would now like to turn to an issue that is important both from a regulatory standpoint and from the standpoint of the investing public: the critical need for sound governance practices by self-regulatory organizations. I believe that self-regulatory organizations should be exemplars of good governance. At a minimum, SROs should demand of themselves the same high standards of governance that the New York Stock Exchange and Nasdaq proposed for their listed issuers in the wake of several widely publicized corporate scandals. To further that goal, this past March I directed each self-regulatory organization to undertake a review of its own governance practices.
>
> Since then, disclosure of the pay package awarded to the former Chairman of the New York Stock Exchange has heightened the scrutiny that the Commission, the securities industry, the investing public, and the media are paying to exchange governance standards that reflect the highest commitment to independent and transparent decision-making. Prior to the current controversy, the NYSE and a few other self-regulatory organizations instituted special governance committees to further study how their structures and processes might be improved. I applaud these efforts but I believe that more remains to be done. I have assurances that the NYSE's new interim Chairman, John Reed, will reexamine these governance issues in more depth. I look forward to working with Mr. Reed on this important initiative.

See also, "SEC is Looking to the 'Nasdaq Model'," *WSJ*, Oct. 14, 2003 at c11; and "Reed Won't Call For Separating NYSE's Roles" *WSJ*, Oct. 3, 2003:

The White Paper that SIA prepared in 2000 to examine these concerns evaluated the advantages and disadvantages of six different approaches to self-regulation. These ranged from maintaining the *status quo*, at one end, to simply abolishing self-regulation and moving the job of the SROs into the SEC, at the other extreme. While our White Paper does not recommend any single approach, it is a useful document for charting the opportunities and dangers on the road ahead.

This discussion would not be complete without consideration of how regulation can coexist with a market. One possible solution to these issues is to separate to some degree the trading activities of the market place from the regulatory functions. There are different ways to implement such an approach, such as by removing regulatory activities from the marketplace reporting lines and by putting them in a separate unit within that same organization. Regulatory activity would then be better able to enjoy both the benefits of self-regulation, while at the same time having meaningful and effective oversight, perhaps by public board members or committees. SIA believes that the time has come to consider in some manner separating out the NYSE's regulatory functions from its marketplace functions.

SIA stands ready, willing and eager to work with the Congress, the SEC, the SROs, and all other interested parties to address these important concerns.

Despite questions raised by investors and politicians about its self-regulatory status, the New York Stock Exchange appears unlikely to surrender its role as a powerful Wall Street regulator. Thursday, after his first board meeting as interim chairman, John Reed said he wouldn't recommend splitting off the Big Board's regulatory functions. Instead, he said he would seek to keep the exchange and its regulatory arm "tightly coupled," while at the same time examining possible changes that would address concerns about potential conflicts of interest.

Conclusion

Despite our recent problems, America's securities markets remain the envy of the world. The United States continues to offer investors and companies the most transparent, liquid and dynamic markets available, with unparalleled levels of investor protection. SIA wants to see the continued success of a thoughtfully regulated securities market in the U.S., one that maintains the trust of investors and all market participants. We are confident that, by working together, we can seize this opportunity to make improvements to the regulatory system that guards investors' interests. We hope to continue to play a role in this critical effort.

Thank you.

REINVENTING SELF-REGULATION

White Paper for the Securities Industry Association

January 5, 2000
Updated by SIA Staff, October 14, 2003

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I. INTRODUCTION

Sweeping changes are taking place in the securities industry. Technological developments have challenged many of the fundamental assumptions about how markets work and facilitated the creation of new competitive structures. Legislative and regulatory changes have broadened the options available to the market participants and these participants have taken advantage of these new opportunities. Alternative trading system ("ATS") and electronic communication networks ("ECNs") have proliferated, offering significant competition to traditional marketplaces. To respond to the increased competition, certain exchanges are considering plans to demutualize and become for-profit enterprises, while the National Association of Securities Dealers, Inc. ("NASD") declared its intent to spin-off and privatize the Nasdaq Stock Market ("Nasdaq").

In addition to technological change, investor confidence has been shaken by many events over the past three years, including the collapse of the "high tech" bubble, failures of corporate governance, and misconduct by some market participants. Important changes have been implemented to address these problems, most notably the Sarbanes-Oxley Act of 2002. Recently, fresh questions have been raised about the governance and oversight of the New York Stock Exchange, raising broader issues about the regulatory framework of market self-regulation and pressures to re-examine that framework.[1]

SIA believes that increased competition and additional opportunities for innovation lowers costs and otherwise benefits investors, issuers and the securities industry alike. The rise of the ATSs and conversions to for-profit structures, however, raise concerns regarding the markets' status as self-regulatory organizations ("SROs").[2] Specifically, the combined roles of SROs as market overseers and as competitors may affect the SROs' ability and willingness to perform all their functions adequately, fairly and efficiently.[3] The Securities Exchange Act of 1934 ("Exchange Act") requires SROs to act as quasi-governmental bodies in implementing the

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[1] *See, e.g.*, "Wide SEC Review May Revamp Structure of U.S. Stock Markets," *The Wall Street Journal*, A1, Sept. 19, 2003; "States Press SEC to Fix NYSE," The Wall Street Journal, C1, Sept. 25, 2003; "At Behest of AIG Chief, Grasso Pushed NYSE Firm to Buy Stock," *The Wall Street Journal*, A1, Oct. 3, 2003.

[2] Throughout this paper, we use the term "SRO" to mean any national securities exchange or registered securities association. Therefore, the term "SRO" will encompass all the functions of the exchange or association, including both its self-regulatory responsibilities and its role as a marketplace. The term "SRO," as we use it here, will not be limited to the regulatory function. If we are making a distinction between the market and regulatory functions of an exchange or association, we will specifically refer to the individual roles, using such terms as "marketplace" and "regulatory arm."

[3] SIA is mindful of the state regulators' continued involvement in the regulatory process, which provides important investor protection safeguards in addition to those afforded by SROs.

federal securities laws as well as their own rules. Yet SROs also are membership organizations and as such represent the economic interests of their members. In addition, SROs are marketplaces concerned with preserving and enhancing their competitive positions. As competition increases among marketplaces and SROs aggressively pursue strategies to increase their market share, it is possible that both the relationship of SROs with their members and the SROs' ability to carry out their self-regulatory duties impartially will be strained.

In light of these market changes, this paper examines the benefits and drawbacks of the current self-regulatory structure as well as a variety of possible alternatives to the status quo. Specifically, Section II of the paper describes various guiding principles which should be integral considerations in any attempt to streamline the current regulatory regime. Section III describes the status quo and several regulatory alternatives to the status quo. For each alternative, the paper explores the questions of whether the concept is technically and practically feasible and whether the concept would benefit the investing public.

II. GUIDING PRINCIPLES IN EVALUATING REGULATORY OPTIONS

A variety of factors should be considered in analyzing which regulatory structure would be most appropriate. These factors, each of which is described below, should be present in any future regulatory model:

- Foster Investor Protection;
- Preserve Fair Competition;
- Eliminate Inefficiencies;
- Encourage Expert Regulation;
- Promote Reasonable and Fair Costs of Regulation;
- Foster Due Process; and
- Encourage Industry Participation and Self-Regulation.

A. Foster Investor Protection

Investor protection has been a cornerstone of the U.S. securities laws and the affiliated self-regulatory regime since the securities laws were enacted in the 1930's. The Exchange Act clearly sets forth this important goal, stating that the Act was adopted to "insure the maintenance of fair and honest markets."[4/] Aside from any considerations of Congressional policy, bolstering public trust and confidence is essential to the future success of our Nation's capital markets, especially in light of the pressures that recent events have placed on investor confidence in the integrity of the markets. Any future regulatory scheme should continue to

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4/ Section 2 of the Exchange Act.

ensure that the public is protected from fraud and abuse, thus allowing the U.S. markets to continue to flourish. Two important aspects of investor protection in considering SRO issues are:

- ***Adequate Protection.*** Investors should be no less protected under a revised system than they are today.

- ***Core Safeguards.*** The core investor protection safeguards should not vary with the markets in which investors trade or the broker-dealer with which investors do business.

B. Preserve Fair Competition

Free markets and a competitive environment should determine the fundamental structure of the securities markets. Regulation should prevent fraud and abuse and ensure a level playing field. But, as Congress instructed when it enacted the Securities Acts Amendments of 1975 ("1975 Amendments"), regulators should foster, not dictate, the development of the national market system.[5/] To promote competition without undermining the beneficial aspects of regulation, this report suggests the following:

- ***Avoid Regulation of Competitors.*** The growth of ATSs and ECNs and electronic trading by the SROs, among other things, has heightened the competition between traditional SROs and their members who sponsor electronic trading systems, thus making the conflict of interest between regulators and their members a more serious problem today than when the self-regulatory system originally was conceived. The SROs' demutualization plans further aggravate the conflict situation. Therefore, any changes to the regulatory system should avoid or limit these conflicts of interest whenever possible.

- ***Embrace Technology and Innovation.*** Any changes to the self-regulatory system should leave it sufficiently flexible to avoid stifling the development of new trading practices and technological innovations by exchanges, markets and broker-dealers.

- ***Assure Robust Governance.*** Any regulator with a membership system should not unfairly favor the larger members over their smaller competitors, and should provide for adequate representation of minority members.

5/ *See* Section 11A of the Exchange Act (national market system should assure "fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets").

- ***Foster Global Competitiveness.*** Reforms must leave markets free enough to position them on a level playing field with their global competitors, without undoing any protections that have made them safe, attractive places to trade.

- ***Ensure Fair Debate.*** No regulator should seek retribution or exact regulatory sanctions against any person who participates in the public policy debates on regulation.

C. Eliminate Inefficiencies

In the interest of cost savings for investors, the securities industry and the public generally, the regulatory system should maximize efficiency, minimize redundancy, and ensure appropriate, up-to-date regulation. Such a system should encourage the adoption of effective internal controls and risk management policies that foster the financial and operational integrity of market participants. The regulatory system should achieve these goals by employing the cost-benefit analysis contemplated in Section 3(f) of the Exchange Act.[6/]

- ***Avoid Duplication of Examinations.*** One examining entity should be adequate for each broker-dealer. Duplicate examinations are wasteful and costly, and there is no evidence that they lead to better enforcement.

- ***Harmonize Regulation.*** The NASD, the New York Stock Exchange ("NYSE") and the other exchanges have different priorities with regard to many issues. These differing agendas result in a variety of inconsistent rules for multi-membership broker-dealers. Any extra costs caused by the inconsistent rulemaking should be avoided in the future.

- ***End Conflicting Interpretations.*** Multiple regulators also issue different interpretations of similar rules. This inconsistency undermines the authority of the regulators and imposes unnecessary costs on regulated entities.

- ***Limit Inconsistent Disciplinary Action.*** With each SRO wedded to its own agenda, the severity of sanctions (if any) for a given violation may vary depending on the enforcing SRO. Limiting this disparity should be a priority of any regulatory change.

[6/] Section 3(f) of the Exchange Act states: "Whenever . . . the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."

- ***Revise Obsolete Regulation.*** Regulations that were enacted years ago by some SROs have not been re-evaluated for their applicability and efficacy in today's trading environment. Cumbersome, obsolete regulation should be revised or deleted from the rulebooks.

- ***Foster Development of Effective Internal Controls.*** The regulatory system should support and encourage the development of effective internal controls by broker-dealers, including rigorous self-assessment and corrective action programs, without subjecting them to the undue risk of disciplinary action.

- ***Independent Arbitration Forum.*** To eliminate any possible competition between multiple arbitrators, customer complaints should be sent to a single, independent arbitration forum. Subject to SEC oversight, this adjudicator would settle disputes between the broker-regulator and its members and possibly disputes between brokers and their clients or markets and parties trading on them.

D. <u>Encourage Expert Regulation</u>

Any regulatory structure for the future should be crafted in such a way as to ensure that the industry is overseen by expert staff. In that regard, the following issues would seem to be important in ensuring that each SRO is a knowledgeable regulator.

- ***Encourage Specialized Knowledge in Regulator.*** The genius of self-regulation is that it puts regulatory decisions in the hands of people intimately familiar with the relevant facts. Any regulatory change should not abandon this valuable asset in favor of a distant, generalist regulator that is ignorant of the markets it regulates.

- ***Provide Regulator with Effective Industry Input and Resources.*** In order to promote expert regulation, regulators should be provided with effective industry resources to develop expert knowledge of market participants through a variety of channels – *e.g.*, advisory panels, focus groups, and town meetings.

- ***Ensure Regulator's Power, Prestige and Funding is Sufficient to Attract Qualified Staff.*** The pool of qualified regulatory staff is not large. If working at a self-regulatory organization is not sufficiently interesting, important, and adequately remunerative, no change in the regulatory structure will be adequate to ensure good regulation.

- ***Ensure Regulator Is Strong Enough to Participate in Larger Domestic and Global Regulatory Initiatives.*** The U.S. self-regulatory body should have a wide membership and expert leadership, so that its views on the future of securities regulation are well-considered and influential on a domestic and global scale.

- ***Tailor Regulation to Diversity of Regulated Entities.*** Regulation should be tailored to fit the diversity of regulated entities, not a "one-size-fits-all" approach. Encouraging regulatory specificity also may facilitate the development of expertise within the regulator.

E. Promote Reasonable and Fair Costs of Regulation

Costs considerations must be an integral part of the development of any new regulatory structure. The following principles should guide the evaluation process.

- ***Ensure Adequate Funding.*** Any future regulatory structure must be funded adequately to perform its regulatory functions.

- ***Share Costs of Regulation.*** The costs of regulation should be equitably shared (whether they are incurred directly or passed through indirectly) among all of the constituencies that benefit from it, including securities firms, issuers, investors and the markets themselves.

- ***Impose Cost-Based Fees.*** Costs should be apportioned to the industry on a fair basis and prices should be unbundled and cost-justified whenever possible. Imposing regulatory fees on the securities industry that exceed true costs of regulation acts as a tax on capital and imposes undue harm on the capital-raising system.

F. Assure Due Process

Any regulatory system should ensure that the public, investors and regulated entities are afforded due process. In particular, this due process principle would require the following:

- ***Implement Prospective Rulemaking.*** Regulatory actions should not occur in the enforcement context, but should be undertaken prospectively with appropriate opportunities for notice and comment.

- ***Use Enforcement Sanctions Appropriately.*** Regulation should focus less on enforcement of technical rule violations, and more on the evaluation and remediation of a firm's deficiencies or weaknesses. Enforcement should be reserved for egregious situations involving intentional or grossly negligent misconduct or situations where there is clear ham to markets or investors.

G. Encourage Industry Participation and Self-Regulation

The securities industry should continue to play an active role in monitoring and shaping new regulatory developments that affect how broker-dealers may conduct their businesses. Regulatory decisions divorced from the realities of the marketplace would be a disservice to the investing public and an impediment to the capital formation process in general.

- ***Foster Integrity and Independence of Self-Regulation.*** A regulatory system should be responsive to the needs of all market participants – issuers, investors and broker-dealers alike – with minimal bureaucratization and politicization.

III. POTENTIAL REGULATORY MODELS

In light of these principles this report considers six options for responding to the many changes taking place in the securities markets. These are (1) the Status Quo, (2) the NASDR Model, (3) the DEA Model, (4) the Hybrid Model, (5) the Single SRO Model and (6) the SEC-Only Model. The evaluation of each model is based on an analysis of its advantages and disadvantages within the context of the guiding principles set forth in Section II.

A. Option 1: Status Quo

1. Structure

One response to the changes taking place in the securities markets is to retain the status quo. Currently, nine national securities exchanges, including the American Stock Exchange ("Amex"), Boston Stock Exchange ("BSE"), Chicago Board Options Exchange ("CBOE"), Chicago Stock Exchange ("CHX"), Cincinnati Stock Exchange ("CSE"), International Securities Exchange ("ISE"), NYSE, Pacific Stock Exchange ("PCX") and Philadelphia Stock Exchange ("Phlx") and one national securities association, the NASD, are registered with the SEC under Section 6 and Section 15A of the Exchange Act, respectively.[7/] In addition, given the pending exchange application of Nasdaq and the business interest in exchange status, it is likely that the number of exchanges will increase in the future.

Each of these SROs performs two basis functions: (1) the operation and promotion of a marketplace and (2) the regulation of the market center and the broker-dealer members of the market center. These regulatory functions are broad and diverse, covering surveillance of market activity, rulemaking, auditing of member firms for compliance with rules, disciplinary actions against member firms and their associated persons for rule violations and the arbitration of disputes. By continuing this structure, marketplaces would retain their affiliated self-regulatory functions or allocate those responsibilities to another SRO pursuant to Section 17(d) of the Exchange Act.[8/] They would be permitted to keep the functions in the same

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7/ Other entities, such as clearing agencies and the Municipal Securities Rulemaking Board, meet the definition of an SRO set forth in Section 3(a)(26) of the Exchange Act. SROs other than the national securities exchanges and associations, however, are outside the scope of this paper.

8/ Rule 17d-2 under the Exchange Act permits SROs to establish joint plans for allocating the regulatory responsibilities imposed by the Exchange Act with respect to common members. An SRO participating in a regulatory plan is relieved of regulatory responsibilities for a broker-dealer member of such SRO if those regulatory responsibilities have been designated to another SRO under the regulatory plan.

corporate entity, even if the organization decides to demutualize, or to establish the regulatory arm of the SRO in a separate affiliated entity. The SEC would continue to oversee each of the SROs. A chart depicting the current regulatory structure is attached in the appendix as Option 1.

2. Advantages

The current self-regulatory model has served both the securities industry and public investors well for many years. In evaluating possible alternatives to this model, this tradition of excellence should not be forgotten. The advantages of this model include:

Competition and Innovation. As the strength of the U.S. capital markets reveals, the present structure is flexible enough to encourage important innovations while at the same time ensuring that investors and other market participants are protected from fraud and abuse. As we discussed above, the markets, in fact, are taking advantage of these opportunities, thereby holding their own against global competitors.

Conflicts of Interest Debatable. In Section III(A)(3) below, we discuss in more detail the potential for increased conflicts of interest associated with demutualized exchanges and the current competitive environment of the securities market. The existing SROs tend to believe that, although the heightened possibility of conflicts of interest is a problem in theory, it may be less of one in practice, notwithstanding current criticisms from some quarters. The SEC has many years of experience in recognizing and addressing SRO conflicts of interest and that experience may be sufficient to overcome any increased conflicts brought about by market changes. In further support of the idea that the conflicts in a demutualized world are manageable within the current structure, foreign markets that have demutualized believe that they can regulate fairly in spite of potential conflicts.[9/]

Regulator Familiar With the Market. The blending – as opposed to the separation – of market and oversight responsibilities may enhance the regulatory process. A variety of regulatory issues, particularly those associated with trading on the market, may best be addressed by a body with first-hand experience operating a market and overseeing the broker-dealers operating therein. The current regulatory structure in which the SROs both regulate and operate markets means that the regulatory function is informed by the vast reservoir of experience the SRO derives from operating its market. Furthermore, as markets develop – electronically or otherwise – surveillance and other regulatory systems are instituted concurrently.

Regulatory and Legislative Change Unnecessary. Continuing to regulate the markets as they are today would require no significant rule or legislative changes. Any

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[9/] *See, e.g.*, Australian Stock Exchange: Fact Book, Information Memorandum (1999) (demutualized since 1998, the Australian Stock Exchange continues its self-regulatory regime, overseeing market integrity, participation, conduct and listings). *See also* Chicago Mercantile Exchange Plan for Demutualization (Nov. 2, 1999) (CME states that it believes it can continue to perform its self-regulatory functions effectively as a for-profit exchange).

perceived limitations with the current structure could be addressed on an incremental, issue-by–issue basis. For example, the SEC could encourage greater coordination between the SROs on broker-dealer examinations, as recommended by a recent SIA study.[10/] Or, if obsolete regulation is considered a problem, measures could be taken to modernize the rules at issue.[11/]

3. Disadvantages

The current regulatory system can be, at times, complex, expensive and unfair. Some of the disadvantages of the current system are described in more detail below.

Conflicts of Interest Strain Public Trust and Confidence. As Congress recognized in enacting the Exchange Act and adopting the self-regulatory model, an inherent conflict of interest exists between the regulatory and market roles of the SROs. Specifically, the interests required of an SRO to regulate itself and its members are in conflict with its interests in promoting itself. For example, an SRO may utilize its regulatory power to imposed purely anti-competitive restraints as opposed to those justified by regulatory needs. Similarly, the SRO may resist change in the regulatory pattern because of vested economic interests in its preservation or insufficient knowledge of newly developing market conventions or investor needs. Indeed, these inherent conflicts percolate into the ongoing debates concerning the market data fees and bond market transparency initiatives.

To date, self-regulation paired with SEC oversight has proven effective, through a check and balance system that has managed to contain more serious types of conflicts of interest. The rise of ATSs and the push for the demutualization of existing exchanges, however, raise the question of whether the conflicts of interest will deepen to the point where regulatory change is needed. In conjunction with the introduction of the Order Handling Rules[12/] and Regulation ATS,[13/] more ATSs have been developed.[14/] These electronic trading systems increasingly have

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10/ Regulatory Examination Survey Report, Securities Industry Association (June 1998) ("Examination Report").

11/ *See, e.g.*, NASD Notice to Members 98-18 (Oct. 1998) (entitled "NASD Regulation Requests Comment on Whether Some Rules Should be Repealed As Obsolete or Amended To Provide Institutional Customer Exception").

12/ *See* Exchange Act Rel. No. 3719 (Sept. 6, 1996), 61 Fed. Reg. 48290 (1996) (adopting release for Order Handling Rules).

13/ *See* Exchange Act Release No. 40760 (Dec. 8, 1998), 63 Fed. Reg. 70844 (1998) ("ATS Release").

14/ Since the adoption of the Order Handling Release, the Commission has recognized a number of systems as ECNs. *See* ATS Release at 70865, n. 178 (mentioning, as examples, Instinet, Bloomberg Tradebook, Island, Archipelago, REDI, Attain, Brut, the Strike system, and PIM Global Equities – some of which have merged or otherwise consolidated in recent years). Similarly, the number of other ATSs – in addition to the ECNs – has risen dramatically since the adoption of Regulation ATS.

been seen as competitors to the existing SROs, attracting order flow with promises of better, cheaper and speedier executions than those of the SROs. In fact, by 2000, news reports commonly reported that ATSs accounted for 30% of the trading in Nasdaq securities;[15/] that percentage has increased even more since then. The NASD and NYSE have recognized this competitive threat and have countered with electronic trading proposals of their own.[16/]

Although this appears to be a success story of innovation spurred on by the competition in the market, various issues remain with these developments and their relationship to the present self-regulatory structure. Under Regulation ATS, all ATSs must be registered as a broker-dealer and, therefore, must be registered with and regulated by the very SROs with whom they are competing. This regulation of direct competitors exacerbates the existing conflicts of interest inherent in the basis self-regulatory structure.

In addition to the competition from ATSs, SROs also are increasingly faced with competition from other SROs. For example, the competition between the options markets has escalated with the onset of multiple listings. Similarly, the repeal of NYSE Rule 390 is likely to accelerate competition among the NYSE, the NASD, the regional exchanges and third market firms. Such competition raises concerns about the SROs' ability to regulate firms when they are competing for those firms' order flow, particularly the SROs' ability to enforce best execution obligations for that order flow.

The conflict of interest is further aggravated by the pending structural changes by Nasdaq[17/] and the demutualization plans under consideration at certain exchanges. As for-profit, public companies, a market may risk, for example, inappropriate cost-cutting of regulatory functions or anti-competitive oversight of its competitors. In addition, as public companies,

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15/ *See, e.g.*, "Levitt Urges Central Market To Price Stocks," Wall St. Journal (Sept. 24, 1999) ("At present, the rapidly expanding ECNs account for about 30% of the volume of Nasdaq trading"). ATSs, however, have not had as great a competitive impact in the market for NYSE securities. The repeal of Rule NYSE 390, however, may pave the way for greater off-exchange trading of NYSE issues. *See, e.g.*, "NYSE Scraps Limit on Member Trade In Other Venues, but Seeks an SEC Rule," Wall St. Journal (Dec. 3, 1999).

16/ *See, e.g.*, "NYSE Studying Electronic System to Fill Small Trades Automatically," Wall St. Journal (Nov. 5, 1999) (responding to the threat of electronic competitors, the NYSE proposed a new electronic trading system for the automatic execution of small orders); "Nasdaq Agrees to Adopt Auction System To Trade Its Shares and NYSE Issues," Wall St. Journal (Dec. 10, 1999) (taking advantage of the repeal of NYSE Rule 390, the NASD proposed an alliance with Primex and Wall Street's largest brokers to form an electronic auction market for NYSE-listed stocks).

17/ *See, e.g.*, Testimony of Frank G. Zarb, Chairman and CEO, National Association of Securities Dealers, Inc., Hearing on Public Ownership of the U.S. Stock Markets, Before the Senate Banking Committee (Sept. 28, 1999) (discussing recapitalization and restructuring of the NASD).

these organizations must answer to their shareholders – who may include competitors of the exchange as well as competitors of the regulated members of the exchange. The for-profit structure may also raise due process concerns because the regulatory fines would flow to the SROs' bottom line.

Duplicative and Inconsistent Regulation. As we describe below, today's self-regulation is characterized by a high degree of redundancy and its attendant costs.

Broker-Dealer Examinations. Broker-dealers that are members of a number of SROs have been subject to multiple, overlapping SRO examinations.[18/] In general, the requisite examinations are costly and time-consuming, and frequently more so than necessary. For example, broker-dealers commonly report a need for better trained examiners and more targeted examinations.[19/] The frustration and costs associated with each examination is multiplied when the firm must undergo a similar examination several times by different regulators.

The SEC and the SROs have attempted to minimize some of the inefficiencies of multiple exams by establishing joint examinations programs,[20/] but sufficient duplication remains to justify concern.[21/] In addition, although the goals of the cooperative programs are laudable and necessary, practical coordination of the SROs on examinations has not yet been achieved.[22/] In the joint examinations, the respective teams of examiners may agree on the format, but they remain subject to the different agendas and direction of their respective SROs.[23/] Unlike the

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18/ *See* Examination Report at 3, 24.

19/ The duration of exams varied widely – from 2.8 days for a state exam to 8.8 days for an NASD sales practice exam to 23.8 days for a CBOE sales practice exam – suggesting a lack of logic as to the scope of the exam. *See* Examination Report at 3, 24.

20/ The necessity for such cooperative undertakings itself points up the inefficiency in the system.

21/ According to the Examination Report, the coordinated process was no magic solution. Only 26% of firms requested coordinate exams and only 60% of those thought the process worked as expected. Examination Report at 3.

22/ *Id.* at 3, 24.

23/ The Examination Report found that:

> Of those firms requesting a coordinated exam, more than half (53.8%) reported that examining authorities did not conduct entrance interviews together; the same proportion (53.8%) reported that examining authorities were on-site at the same time; 85.7% of the firms that had examiners on-site at the same time reported that examiners did divide up their tasks; firms were evenly divided about whether or not examiners requested the same documents; in most instances (83.3%),

(continued...)

present process, a truly coordinated examination process must have a clear division of responsibilities and a willingness on the part of the examiners to accept the findings of another SRO's examiners, and this may not be easily achievable given the competition among the various SROs.

Rulemaking. The redundancy problem also reveals itself in the rulemaking process. At times, broker-dealers that are subject to the oversight of multiple SROs may need to comply with multiple and inconsistent rules on the same issue. Furthermore, even when the various SROs have identical rules on a certain issue, each SRO may interpret those rules differently. The risk of such inconsistencies increases as the number of SROs increases.

Having ten existing SRO rulebooks, rather than one rulebook, increases the costs for each segment of the securities markets – the broker-dealer members, the SEC and the SROs as a group. The member broker-dealers must constantly monitor rule changes for each relevant SRO in order to maintain a working familiarity with the rules and to make any necessary modification to supervisory and compliance procedures. In addition, because any SRO rule changes must be reviewed by the SEC, the rule filing expenses of the SEC increase as the number of exchanges increase. The duplication of effort is particularly noticeable when the various SROs each separately file similar or identical rule changes. Correspondingly, the SROs as a group expend unnecessary resources internally to consider and prepare rule filings which duplicate filings of other SROs.[24/] In all likelihood, the costs for the duplicative and inconsistent rules and rulemaking procedures will increase with the addition of any new exchanges.

Discipline and Enforcement. Like the rulemaking process, the broker-dealer members of multiple SROs must contend with inconsistent discipline and enforcement efforts from the multiple SROs. Each SRO has its own unique focus and interpretation for what activity constitutes a rule violation and what the appropriate sanction is for that violation.

Regulatory Competition. Competitive pressures may influence the regulatory decisions of the SROs. For example, to maintain its status as a tough regulator and to attract additional order flow based on its positive reputation, an SRO may resort to enforcement actions, rather than targeted remediation, to address rule violations. Similarly, the opposite situation may result. The competitive regulatory environment may encourage SROs to apply lax standards to

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examiners did not conduct an exit interview together; and, finally, about sixty percent (57.7%) indicated that the coordination process worked as expected.

Examination Report at 3.

24/ An exchange's rule filings undergo a detailed internal development process involving in-house review, member comment, board approval and the formal filing.

increase their membership roles. This may lead to a race to the bottom in which marginal firms become members of the SRO which has the least rigorous standards.[25/]

Limited Feasibility. In the past, the SEC has suggested that a for-profit demutualized exchanges will need to create a separate corporate entity for their regulatory operations (see Option 2). Although the SEC has not instituted rulemaking in this regard, it appears likely that at least some changes to the status quo will be required.

B. Option 2: Multiple Exchanges with Separate Boards and Information Barriers for Their Regulatory Arms (NASDR Model)

1. Structure

An internal corporate restructuring which segregates the market and regulatory roles of any demutualized SROs may address some of the concerns about the current regulatory structure and its application to the changing marketplace. This option would be very similar to the status quo. The multiple SROs, existing and future, would continue to exist and each SRO would continue to operate and regulate its market and members. The only difference between this option and the status quo is that each of the demutualized SROs would be required to undergo a corporate restructuring much like that undergone by the NASD.

As currently envisioned, the SRO would create a parent holding company, with at least two subsidiaries. One subsidiary would contain the regulatory arm of the SRO, which would have the SRO's examination, rulemaking and disciplinary authority, and the other subsidiary would contain the market center. A separate and independent board would govern each subsidiary and information barriers would separate the decisionmaking of one subsidiary from the other.[26/] The NASDR Model is pictorially represented at Option 2 of the appendix.

2. Advantages

The NASDR Model has the advantages discussed above in reference to the status quo. Additionally, however, the corporate restructuring in this option is intended to improve upon the status quo by reducing the conflicts of interest caused by the demutualized, for-profit exchanges.

Reduces Conflicts of Interest. By strictly segregating the regulatory and market functions, this option seeks to focus each subsidiary on its respective responsibilities. The board of the market center subsidiary would concentrate on promoting the market center and maintaining its competitive status. The board of the regulatory arm would focus on the

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25/ For a report alleging such regulatory arbitrage, *see* "Some Day Traders Make Short Sales of IPOs In Strategy Facing Some Regulatory Hurdles," Wall St. Journal (Aug. 18, 1999).

26/ Other corporate structures which effectively separate the regulatory and market functions of the SRO would also be permissible.

regulation. With the corporate separation and the information barriers in place, each board's aims and goals should not infiltrate the decisionmaking of the other board, thus decreasing the likelihood of inappropriately anti-competitive regulation.

Prior Experience with NASDR Model. The SEC and the industry have experience with this type of restructuring because of the NASD's creation of a separate, independent subsidiary, called NASD Regulation, Inc. ("NASDR"), responsible for the regulatory obligations of the NASD. Such experience provides valuable data for evaluating the NASDR Model generally and improving upon it, if necessary.

In 1996, the NASD created NASDR in response to a variety of criticisms aimed at its market and regulatory responsibilities. In 1994, amid criticism of the NASD's self-regulatory capacities, the NASD appointed a Select Committee on Structure and Governance, chaired by former United States Senator Warren Rudman to review the regulatory and governance structures of the NASD and Nasdaq.[27/] This Committee inquired into the appropriateness of the NASD's structures for governance and oversight and operation of the Nasdaq stock market, the NASD's regulatory and disciplinary processes, the extent to which the NASD provided for appropriate representation of its constituencies, and its policy and rulemaking processes.[28/] The Committee concluded that the NASD's governance structure "blur[r]ed the distinction between regulating the broker-dealer profession and overseeing the Nasdaq stock market."[29/] To correct these deficiencies, the Committee suggested that the NASD reorganize its corporate structure such that the Nasdaq market and NASD's regulatory functions would be in separate subsidiaries of the NASD, and that the NASD and these two subsidiaries would each have 50% or greater public representation on their boards of directors. Former Chairman Levitt noted the improved regulatory oversight of the reorganized NASD, stating that "[s]ince the SEC's historic enforcement action . . . the NASD has adopted an unprecedented number of changes to improve the fairness and efficiency of its operations."[30/]

Minimally Disruptive. In comparison to the other possible regulatory models discussed in this paper, this option represents only minimal or incremental change from the status quo. The model does not divest any SRO of its regulatory or other functions; it merely requires the SRO to repackage its existing roles. Furthermore, this repackaging may be fairly easy to accomplish through SEC rulemaking which could set forth guidelines for the segregation of the SROs' regulatory arms.

27/ Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market (Aug. 8, 1996) ("21(a) Report") at 4.

28/ *Id.*

29/ *Id.* (citing Executive Summary of Report of the NASD Select Committee on Structure and Governance (Sept. 15, 1995)).

30/ "SEC, Justice Agree: Much Progress at NASD and Nasdaq," 10 Sec. Indus. News 48 (Dec. 7, 1998).

3. Disadvantages

Conflicts May Persist. Although the internal segregation of the regulatory and market roles of the SRO may reduce conflicts of interest to a certain extent, conflicts may persist. After all, the two functions remain in the same entity and that entity as a whole has an interest in promoting its own interests. For example, if the SRO uses the holding company structure, the board of the holding company still oversees the actions of both of the subsidiaries. Furthermore, despite the corporate separation and firewalls, each of the subsidiary's boards will consist of industry members per the Exchange Act's fair representation requirements.[31/] Therefore, although each board will contain different people, the actual interests of the people on each board are likely to be very similar.

Only Addresses Conflicts Issues, not Duplication and Inconsistency. This model is designed to address only one of the problems in the current regulatory structure – conflicts of interest. It does not attempt to address any of the other disadvantages of the current situation. In particular, it ignores the costly duplication and inconsistencies of multiple SROs.

C. Option 3: Multiple SROs with Firms Designated to a Single SRO for Examination Purposes (DEA Model)

1. Structure

A third possibility would involve allocating inspection responsibilities among the SROs and expanding the concept of a designated examining authority.[32/] The Commission has used its authority under Sections 17 and 19 of the Exchange Act to allocate to particular SROs oversight of broker-dealers that are members of more than one SRO "(common members").[33/] For example, in order to avoid unnecessary duplication, the Commission appoints a single SRO as the DEA to examine common members for compliance with financial responsibility requirements.[34/] When an SRO has been named as a common member's DEA, all other SROs to

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31/ Sections 6(b)(3) and 15A(b)(4) of the Exchange Act.

32/ A disadvantage of the DEA Model and the NASDR Model, individually, is the limited problems each model confronts. To address a greater number of these concerns, the DEA and NASDR Models could be combined in one structure. Here, the SROs would be required to reorganize their corporate structure so as to segregate the regulatory and market functions and each firm would be examined by only one SRO, the DEA. By combining the two approaches, a greater number of regulatory issues are addressed, thus increasing the advantages and decreasing the disadvantages of each model standing alone. A full discussion of the benefits and drawbacks of the NASDR and DEA Models are set forth above in Sections III(2) and (3), respectively.

33/ *See* Sections 17 and 19 of the Exchange Act and the rules thereunder.

34/ With respect to a common member, Section 17(d)(1) of the Exchange Act authorizes the Commission, by rule or order, to relieve an SRO of the responsibility to receive (continued...)

which the common member belongs are relieved of the responsibility to examine the firm for compliance with applicable financial responsibility rules.[35] Pursuant to recent legislation, Congress has called for improved coordination of supervision of members and elimination of any unnecessary and burdensome duplication in the examination process.[36]

Under this model, the SEC would require the DEA to expand its oversight duties of the common member. Like the current DEA program, each firm would be examined by one designated SRO, instead of multiple SROs. The DEA would be responsible for inspecting for compliance with its own rules as well as the rules of the other SROs. Like the status quo and the NASDR Model, this option would leave the current regulatory structure as is except for reallocation of examination responsibility. A chart portraying this model is attached in the appendix as Option 3.

2. Advantages

Eliminates Duplicate Examinations. In addition to the advantages of the status quo discussed above, the DEA Model would streamline the examination process and minimize the costly, duplicative examinations performed by multiple SROs.

3. Disadvantages

Improvement Limited to Duplicate Examinations. A disadvantage of this approach is its narrow focus. It only attempts to lessen the duplicative efforts of the SROs, leaving the conflicts of interest issues unaddressed. Furthermore, the focus on the SROs duplicative efforts is limited to broker-dealer examinations. The model fails to address the redundancies and inconsistencies in the multiple SROs' rulemaking and enforcement initiatives.

Interpreting Another SRO's Rules. In practice, expanding the authority of the DEA may increase costs, inconsistent action among the SROs and conflicts of interest between competing market centers. For example, the costs for each DEA may increase because each DEA must expend significant resources to maintain a working knowledge of the rules of each of the other SROs in addition to its own rules. Although the process may reduce overlapping exams, the broker-dealers may not realize significant cost savings because the DEA may find the interpretation and application of the other SROs' rules during the examination process more difficult than the relevant SRO's examiner. Furthermore, under this approach, the risk of inconsistent interpretation of any given rule increases. Using the expanded DEA concept, the potential exists for ten different interpretations of the rule of one SRO. Finally, by bestowing

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regulatory reports, to examine for and enforce compliance with applicable statutes, rules and regulations, or to perform other specified regulatory functions.

[35] *See* Exchange Act Rel. No. 23192 (May 1, 1986), 51 Fed. Reg. 17426 (1986).

[36] *See* Section 108 of the National Securities Markets Improvement Act of 1996, Pub. L. 104-290.

upon the DEA the front-line responsibility for interpreting and applying the rules of another SRO, this model may aggravate the conflicts between competing SROs by creating an incentive to construe another SROs rules in an anti-competitive fashion.

Conflicts of Interest Persist. Like the status quo, this option fails to address the conflict of interest concerns presented by demutualized, for-profit exchanges.

D. Option 4: One SRO for Member Firms: Markets Regulate Their Own Trading (Hybrid Model)

1. Structure

Another proposal that has received increased attention recently would restructure self-regulation on the basis of function, rather than on the basis of firm membership. Regulation would be broken down into two separate and distinct areas – one which relates to trading and markets and the other which relates to the operation of the firm and capital requirements. All the non-market-related self-regulatory functions would be combined into a single organization which could function irrespective of the various markets. Therefore, "each market would maintain the regulatory and surveillance functions solely for its own market – but member regulation, sales practices and all other aspects of intermarket trading would be overseen by a single SRO."[37/]

Division of Responsibilities for Non-Market-Related Regulation. This single, non-market-related SRO ("Firm SRO") would assume, for all registered broker-dealers, the rulemaking, surveillance and enforcement functions performed by the exchanges and the NASD with regard to all activities other than those specifically associated with the trading markets.[38/] For example, only the Firm SRO – rather than ten or more SROs – would have jurisdiction over, among other things, sales practices, industry admission standards, financial responsibility requirements (like net capital and margin requirements), competence of personnel and recordkeeping rules. This Firm SRO would be assigned the responsibility for conducting examinations of broker-dealers. In addition, it would be solely responsible for disciplining infractions of the Firm SRO's rules. The current SROs would relinquish control over all this non-market-related regulation. As a prerequisite for this model, all registered broker-dealers must be a member of this organization. The SEC would oversee all of the activities of the Firm SRO, like it does today for the NASD and the exchanges. The Hybrid Model is represented in Option 4 in the appendix.

Division of Responsibilities for Market-Related Regulation. The market-related regulation may be divided between the Firm SRO and the market SROs in at least two ways. Under one variation, the Firm SRO would not have any rulemaking, surveillance or enforcement

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37/ *See* Levitt Speech.

38/ Presently, in large part, the NASD surveils, administers and enforces the Municipal Securities Rulemaking Board's ("MSRB") rules applicable to municipal securities dealers and the Department of Treasury's rules applicable to government securities dealers. As currently envisioned, the Firm SRO would assume these responsibilities.

authority for access to the trading facilities, operation of the trading facilities, or the establishment and enforcement of listing or qualification standards for issuers. Each market center would have responsibility for trading-related activities, subject to SEC oversight. Therefore, the markets would continue to adopt and enforce rules as they do today, but their overall jurisdiction would be limited to trading regulation.[39/]

Under a second variation, the market SROs would retain their rulemaking authority with regard to trading activity, *e.g.*, access to the trading facilities, operation of the trading facilities and the establishment and enforcement of listing or qualification standards, but they would not have any enforcement authority with regard to those rules. The market SROs' authority would be similar to that of the Municipal Securities Rulemaking Board.[40/] The Firm SRO would be vested with the authority to enforce the trading rules of the market SRO. However, the market SROs would have the limited power to determine whether a rule violation may have occurred.

Governance. Although the governance of the Firm SRO may be structured in a variety of ways, any chosen structure should satisfy several basic principles. First, the board of the Firm SRO would consist of 50% public governors. Moreover, a system should be established to ensure that the organization attracts qualified public board members. Second, the remaining 50% of the board should be representative of all members of the industry over which the SRO has disciplinary authority, *i.e.*, all registered broker-dealers. In particular, the board selection process should ensure that smaller entities are fairly represented. This heightened fair representation requirement could be achieved through a carefully crafted nomination and voting process for selecting the board. Third, the Firm SRO members should not only be represented in the governance, but they also should be an effective and integral part of the functioning of the Firm SRO. An expanded advisory committee structure could provide the members with a voice in the new organization. Finally, it should be assumed that this organization would not in any way participate in the governance of any marketplace as such.

2. Advantages

Strengthens Investor Confidence by Reducing Conflicts of Interest. The introduction of a Firm SRO may eliminate some inherent conflicts of interest that are caused by today's SROs' dual capacities as regulators and markets. The Firm SRO in charge of the non-trading regulation would no longer have any direct connection to a profit-driven pursuit and,

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39/ Presumably all markets, including ATSs registered as such, would operate in this manner.

40/ The MSRB is the primary rulemaking authority for the municipal bond market. Although Congress gave the MSRB the task of proposing and adopting rules governing dealers in municipal securities subject to the oversight of the SEC, Congress did not give the MSRB the power to enforce its rules. Responsibility for the examination and enforcement of MSRB rules is delegated to the NASD for all securities firms and to the Federal Deposit Insurance Corporation, the Federal Reserve Board and the Comptroller of the Currency for banks.

therefore, it would have no incentive to brandish its regulatory authority in an anti-competitive fashion.

Minimizes Duplicate and Inconsistent Regulation. The consolidation of the non-market-related regulation under one roof should improve the quality, uniformity and comprehensiveness of today's approach to non-market-related regulation of broker-dealers. For example, the economies of scale of this approach should eliminate or reduce many of the inefficiencies and unnecessary costs present in the current regulatory system.[41/] The Firm SRO would significantly reduce or eliminate (1) duplication of examinations, inspection reports, surveillance and other areas of overlapping jurisdiction; (2) the need for the maintenance and staffing of multiple SROs; (3) the inefficiency of monitoring and complying with two or more SROs; (4) inconsistent rules and rule interpretations and inconsistent enforcement thereof; (5) and the attendant costs of each of the above to the industry.[42/]

Reduces Regulatory Competition. Replacing the oversight functions of ten competing SROs with one Firm SRO should eliminate regulatory competition at least in the non-market-related oversight functions. This should address both race to the top and race to the bottom issues.

Functional Regulation. The Hybrid Model is likely to produce beneficial regulation because it links supervisory duties to expertise, and in particular, it leaves the technical details of trading regulation to the entities best equipped to understand them.

Feasible Approach. The question remains as to whether the concept of a Firm SRO is feasible in view of the present industry structure and the traditions that accompany it. From a political standpoint, this approach is supported by some powerful interests, just as it is

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41/ It is important to note that the cost savings realized by combining the self-regulatory functions into one organization may not be as great as anticipated. The new regulatory body would require an administrative structure and support staff that currently is shared with their host SRO. Funding for the operations of a single regulatory body would continue to be provided by the industry members, so that there may not a significant decline in their overall operating costs.

42/ For the most part, an SRO's regulatory expenditures are not required to be disclosed to the public, and therefore, the SROs' financial statements generally do not disclose the costs associated with various regulatory functions or services. The one exception is the NASD which separates the expenses of the NASDR and Nasdaq. *See* Exchange Act Rel. No. 42208 (Dec. 9, 1999), 64 Fed. Reg. 70613 (1999). The lack of useful cost information makes a detailed analysis of the cost benefits of the Hybrid Model difficult. Such a study was performed in 1975 and that study concluded that a potential savings to the industry of approximately 35% of previous regulatory expenditures was possible, primarily as a result of the "elimination of various areas of regulatory duplication." *See* Memorandum from Richard N. Priest, Vice President, NYSE, to Jack Schindel, Treasurer, NASD (June 12, 1975).

much opposed by others. From an operational and legal standpoint, however, the concept appears feasible.

Legally Feasible. To create the Firm SRO, the Commission must cause today's SROs to relinquish non-trading authority over their members and must create a new organization with the necessary self-regulatory powers. The Commission currently has at its disposal many, if not all, the legal tools necessary to implement this hybrid concept. For example, under Sections 17(d), 11A, and 19(c) of the Exchange Act, the Commission has the authority to require the existing SROs to relinquish authority over their members if so directed. In addition, the SEC's new exemptive authority[43/] may be used to relieve the existing SROs of any non-market-related duties which are mandated under the Exchange Act.[44/] Similarly, the new Firm SRO may be formed as an SRO pursuant to Section 19 of the Exchange Act, just as traditional SROs are formed, and the SEC may again utilize its exemptive authority to relieve the Firm SRO of inapplicable requirements. The SEC's use of its existing authority in this situation may require rulemaking to implement this approach.

Operationally Feasible. From an operational standpoint, the industry has the capability to implement the concept because the job to be performed by the Firm SRO is collectively being done today by the exchanges and the NASD. Thus, there is sufficient personnel with the necessary technical expertise to continue to perform the job on a consolidated basis. The existing examination and surveillance structures may be modified for utilization by the Firm SRO. Indeed, cooperative efforts among SROs and the Commission to relieve duplicative regulation are paving the way toward uniform surveillance. Finally, the current use of technology-based surveillance programs should facilitate the transfer of responsibilities to a Firm SRO.

In addition, this hybrid approach has seen a level of SEC and Congressional approval and industry support in the past. For example, former Chairman Levitt stated that he found this hybrid approach "intriguing,"[45/] although he reserved judgment as to the best regulatory approach pending further study. Annette Nazareth, Director of the SEC's Division of

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43/ In 1996 Congress provided the Commission with broad authority to exempt any person from any of the provisions of the Exchange Act. *See* Section 36 of the Exchange Act.

44/ *See, e.g.*, Section of the Exchange Act (an exchange must be able "to enforce compliance by its members and persons associated with its members, with the provisions of this title, the rules and regulations thereunder, and the rules of the exchange").

45/ *See* Speech by SEC Chairman Arthur Levitt, Columbia Law School, New York, N.Y. (Sept. 23, 1999) ("Levitt Speech").. *See also* Speech by SEC Commissioner Laura Unger, Bond Market Association, Fifth Annual Legal and Compliance Seminar, New York, N.Y. (Oct. 28, 1999). *See also* "Battle Lines Forming Over Single SRO Plan," Securities Industry News (Oct. 18, 1999) (stating that Commissioner Unger supports single SRO plan.)

Market Regulation,[46] has similarly expressed her interest in the Hybrid Model. Others in the industry, including broker-dealers and SROs, also see value in this approach. For example, support for this approach has a long history with the SIA. The first SIA chairman endorsed this approach in 1973 during consideration of the national market system legislation.[47]

Centralization of Regulatory Expertise. Another benefit of this approach is the centralization of regulatory expertise and experience in one entity. Rather than dispersing the talented regulatory staff throughout many different SROs, the experienced regulators would join the one Firm SRO, thus limiting the constant issue of inexperienced regulators.

More Effective Liaison. Because the Firm SRO will speak with one marketplace and business neutral voice, it may prove to be a more effective liaison than the multiple SROs on matters of regulatory importance with the SEC, various governmental agencies, the states, global regulators and competitors and other organizations.

3. Disadvantages

Separation of Market and Surveillance. Separating the self-regulatory function of the securities markets from the operational market functions may degrade self-regulation by lessening the familiarity of the regulators with market processes. Synergy is lost when the two functions are separated.

Bureaucratic Tendencies. Any single entity which by its very nature is free from the pressure of peer competition can become intransigent and bureaucratic. Initiative and effort at self-improvement may diminish. Although Congressional and SEC oversight as well as a member-controlled decisional process should reduce that possibility, self-regulation without competition may not be a regulatory enhancement.

Boundary Issues. In some cases, the line between firm oversight issues and trading issues may be hard to draw. Some areas of oversight, like net capital, for example, may clearly fit within the jurisdiction of the Firm SRO. Other rules, however, like frontrunning, may have both trading and non-trading characteristics. For these rules, the Firm SRO and the marketplaces may both have a legitimate interest in the development, surveillance and enforcement of those rules.

46/ *See, e.g.*, "SEC's Nazareth Finds 'More Intriguing' Hybrid Structure for Market Regulation" (Oct. 15, 1999) ("A hybrid model [as opposed to a single SRO], Nazareth told the [National Society of Compliance Professionals] makes sense. She reasoned that each market – which more often than not will be electronic rather than having a trading floor – has an interest in retaining its own integrity.")

47/ *See* Report of the Subcommittee on Securities, Senate Committee on Banking, Housing and Urban Affairs (19743) (SIA Chairman Robert Gardiner stated that self-regulatory activities would be more effective if broken down into two separate and distinct self-regulatory areas – one for trading and markets and the other for firm and capital requirements).

Remaining Conflicts of Interest Regarding Trading. Although the conflicts of interest are reduced for non-market-related oversight, SROs still may set trading rules that disadvantage member broker-dealers that run competing markets or send order flow elsewhere. Like the current situation, the SEC's continued oversight and scrutiny of the trading rules and their enforcement as well as antitrust laws may or may not be sufficient to limit these conflicts of interest.

E. Option 5: All-Purpose Single SRO (Single SRO Model)

1. Structure

The regulatory structure also could be revised by expanding the concept of the Hybrid Model discussed above. Specifically, the trading regulation – in addition to the non-market-related regulation – would be moved into a single, all-purpose SRO ("Single SRO"). Therefore, the Single SRO would be vested with all rulemaking, surveillance and enforcement responsibility for all areas of regulation. Concurrently, the exchanges and the NASD would be divested of all their self-regulatory authority, leaving each as a marketplace, much as ATSs are today. The Single SRO Model is set forth in chart form in Option 5 of the appendix.

2. Advantages

Like the Hybrid Model, the Single SRO should (1) decrease duplicative and inconsistent regulation; (2) centralize regulatory experience; (3) act as a more effective liaison to other organizations; and (4) be legally and practically feasible. In addition, the Single SRO would be advantageous for the following reasons:

Eliminates Remaining Regulatory Competition and Conflicts of Interest. The already reduced regulatory competition and conflicts of interest of the Hybrid Model will be completely eliminated in the Single SRO because all self-regulation, including trading and non-trading oversight, would be vested in a single entity.

Erases Boundary Issues of Hybrid Model. Placing all regulatory responsibilities in one entity eliminates any jurisdictional overlap.

Level Playing Field Among Competing Markets. Regulation ATS defined an ATS as an exchange which does not "set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization" or "discipline subscribers other than by exclusion from trading."[48/] Stripping an exchange of its self-regulatory obligations makes it equivalent to an ATS. Therefore, the competitive position of each trading system in the market will solely depend upon its products and services, not its regulatory status.

Broader – if Not Deeper – Knowledge of Regulated Entities. By overseeing all market participants – traditional broker-dealers and trading systems alike – the Single SRO

48/ Rule 300(a) under the Exchange Act.

would have a comprehensive perspective of the securities industry. The deeper knowledge of the industry, however, may escape the regulator as described below in the disadvantages section.

3. Disadvantages

The Single SRO has many of the same disadvantages of the Firm SRO, including the risks of bureaucracy. The Single SRO, however, may have additional weaknesses, as described below.

Risk of Being Redundant of SEC. Farther removed from real industry concerns, the Single SRO could become a superfluous layer of regulation that adds little to the oversight provided by the SEC. Although the self-regulatory governance structure of the Single SRO may limit the risk, it can not be completely eliminated as a possible concern.

No Synergy with New Business Systems. Under the current regulatory system and even with the Firm SRO, the technical details of trading regulation remain with the entities actually engaged in the trading activity. By removing the trading regulation to a remote entity, the synergy between the trading systems and the regulation is lost. For example, as exchanges and other market participants innovate, their systems would not be as well designed for easy surveillance because regulators could no longer shape development of the technology. The coordinated and concurrent innovation of the trading systems and their corresponding surveillance programs is forfeited.

F. Option 6: Single Regulatory Organization (SEC-Only Model)

1. Structure

Finally, a more drastic suggestion involves abolishing the concept of self-regulation entirely and expanding the duties of the SEC to cover all the regulatory responsibilities currently performed by the SROs, including the direct oversight of the market centers and broker-dealers. The SEC would become the sole rulemaker, examiner and enforcer for the industry. The SROs would be stripped of their self-regulatory responsibilities, thereby becoming mere marketplaces.[49/] Firms would no longer be subject to the oversight of any SROs, just the SEC. Firms and exchanges would only influence the ultimate regulatory standards through the comment process at the SEC or through Congressional action. A chart representing the SEC-Only Model is located at Option 6 of the appendix.

2. Advantages

Avoids Limitations of Self-Regulation. By abolishing self-regulation entirely, any concerns associated with self-regulation are also eliminated. The inherent limitations in allowing an industry to regulate itself are well known:

[49/] For example in Regulation ATS, ATSs are specifically defined as exchanges which do not perform self-regulatory functions. *See* Rule 300 under the Exchange Act.

> the natural lack of enthusiasm for regulation on the part of the group to be regulated, the temptation to use a façade of industry regulation as a shield to ward off more meaningful regulation, the tendency for businessmen to use collective action to advance their interests through the imposition of purely anti-competitive restrains as opposed to those justified by regulatory needs, and a resistance to changes in the regulatory pattern because of vested economic interests in its preservation."[50/]

With oversight limited to the SEC as the sole regulator, these disadvantages of self-regulation would no longer be a concern.

Ends Duplicative and Inconsistent Regulation. Because the SEC would replace the regulatory activities of ten existing SROs, duplicate examinations, multiple and overlapping rules and conflicting interpretations and disciplinary actions would end, along with their associated costs.

Regulatory Expertise. Increasing the already considerable power of the SEC would serve to augment its status in the U.S. and the global securities industry. Furthermore, the more powerful and potentially more prestigious SEC could attract and keep talented staff, rather than competing with other regulators for that expertise.

3. Disadvantages

Although the adoption of the SEC-Only Model may eliminate many of the disadvantages of the current structure, including conflicts of interest and costly duplication, the structure will likely introduce a host of new problems. For example, Congress specifically avoided the creation of a massive SEC because of the fear that it would be monolithic, intractable, inflexible and unaccountable. Described below in more detail are a variety of possible pitfalls associated with this complete revamping of the regulatory structure of the securities industry. Given the many advantages of self-regulation over direct governmental regulation, some aspect of self-regulation – even in a modified form – is likely the better route. *See* Option 6 in the appendix for a chart of the SEC-only structure.

Minimal Industry Input. In the current self-regulatory regime, the regulated entities, both the markets and the broker-dealers, are intimately and constantly involved with the regulatory process. The expertise and intimate familiarity with complex securities operations which members of the industry can bring to bear on regulatory problems can not be underestimated. Furthermore, self-regulation has the advantage of making the people who are subject to regulation actual participants in the regulatory process. By providing an opportunity to participate in the regulatory process, self-regulation may make the members of the securities industry more aware of goals of regulation and their own stake in them while at the same time making the imposition of regulatory controls more palatable because those regulations are more

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50/ Securities Industry Study, Report of the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, United States Senate (April 6, 1973) at 145.

workable. Replacing self-regulation with direct agency oversight would distance the regulated entities from the regulatory process, thereby depriving the SEC of the benefit of their expertise and depriving the regulated entities of more direct input into the regulation which controls their day-to-day business operations.

Expensive and Bureaucratic. The principal reason Congress has relied so heavily on self-regulation in the securities industry to date is "the sheer ineffectiveness of attempting to assure [regulation] directly through the Government on a wide scale."[51/] Scrapping self-regulation and vesting that regulatory power in the SEC would involve "a pronounced expansion of the SEC, the multiplication of branch offices, a large increase in the expenditure of public funds, an increase in the problem of avoiding the evils of bureaucracy and a minute, detailed, slow and rigid regulation of business conduct by law."[52/]

History of Failure. In the past, the Commission administered a program in which it directly oversaw certain broker-dealers, a program which ultimately was ceded as a failure. The SECO (SEC-only) program, initiated under former Sections 15(b)(8), (9), and (10) of the Exchange Act, applied to any broker-dealer registered under Section 15 of the Exchange Act that was not a member of a national securities association, *i.e.*, the NASD ("non-member" broker-dealers).[53/] Enacted in 1964, these provisions empowered the Commission to establish for non-member broker-dealers and their associated persons a regulatory regime comparable to that adopted by the NASD for its members and their associated persons. In Rules 15b8-1, 15b9-1, and 15b10-1,[54/] the Commission established specific procedures and norms of conduct closely paralleling those of the NASD in areas such as qualification of associated persons, fees and assessments, standards for supervision of securities employees, discretionary accounts, and suitability of recommendations.[55/] Specifically, Rule 15b8-1, enacted in 1965, empowered the Commission to proceed directly against registered SECO broker-dealers for failure to comply with these established standards.[56/]

51/ Hearing on H.R. 7852 and H.R. 8720 Before the House Committee on Interstate and Foreign Commerce, 73rd Cong., 1st Sess. at 514 (testimony of John Dickinson).

52/ S. Rep. No. 1455, 75th Cong., 3d Sess. 3 (1938).

53/ For a discussion of the SECO rules, *see* Exchange Act Rel. No. 7697 (Sept. 7, 1965), 30 Fed. Reg. 11673 (1965); Exchange Act Rel. No. 8135 (July 27, 1967), 32 Fed. Reg. 11637 (1967); and Exchange Act Rel. No. 8308 (May 8, 1968), 33 Fed. Reg. 7075 (1968).

54/ *See* Rules 15b8-1, 15b9-1, and 15b10-1 under the Exchange Act.

55/ Exchange Act Rel. No. 32018 (Mar. 25, 1993), 58 Fed. Reg. 16151-01 (1993).

56/ *Id.* n.11 (listing Commission actions).

Congress abolished the SECO program and the SEC rescinded Rule 15b8-1 in 1983.[57] In testimony before the House Subcommittee on behalf of the Commission, SEC Chairman John S. R. Shad testified about a comprehensive management study of the SECO program, which concluded that the SECO program was unnecessarily costly and diverted the SEC's limited resources away from areas of major concern, merely to duplicate the functions of the NASD. In fact, the study projected that greater expenditures would be required in the future to ensure that SECO firms were regulated as stringently as NASD firms.[58]

Chairman Shad also testified that SROs were better able than the Commission to maintain ethical standards for the industry and to perform certain oversight functions. The House Report on the matter also cited the limitations of enforcement and compliance remedies available to the Commission in comparison to the remedies available to the NASD.[59]

The failure by the Commission was specifically examined by the Commodity Futures Trading Commission ("CFTC") in conjunction with its review of the National Futures Association's application for registration.[60] As a result of the CFTC's review, it concluded that a program that required direct CFTC regulation for certain futures commission merchants would be difficult to administer, and the CFTC lacked sufficient resources to devote to such direct regulation.[61]

In addition, currently, no constituency favors the "SEC-Only" concept. For example, no commentators or industry participants have advocated the model. Even if Congress supported the SEC-Only Model in theory, it would be reluctant to approve the necessary SEC budget increases – even if they were paid out of existing SEC fees. Current surplus SEC fees are used for other purposes. Given the combined opposition of Congress, the SEC, NASD and NYSE, among others, the likelihood of this model becoming a reality is quite small.

IV. CONCLUSION

The changing market environment and the need to bolster investor confidence demand a review of the current regulatory structure of the securities industry. The analysis of

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57/ *See* Public Law 98-38, Sec. 3, 97 Stat. 205, 206-07 (1983), codified at Sections 15(b)(8) and 15(b)(9). *See also* Exchange Act Rel. No. 20409 (Nov. 22, 1983), 48 Fed. Reg. 53688 (1983).

58/ The House Committee report stated "that any attempt to put SECO regulation on a par with that provided by the NASD would require significant expenditures by the Commission for additional staff and administrative costs." H.R. Rep. No. 98-106, at 7 (1983).

59/ *Id.* at 6.

60/ Registered Futures Associations; Mandatory Memberships, 17 CFR Part 170 (June 7, 1983), 49 Fed. Reg. 26304-01 (1983).

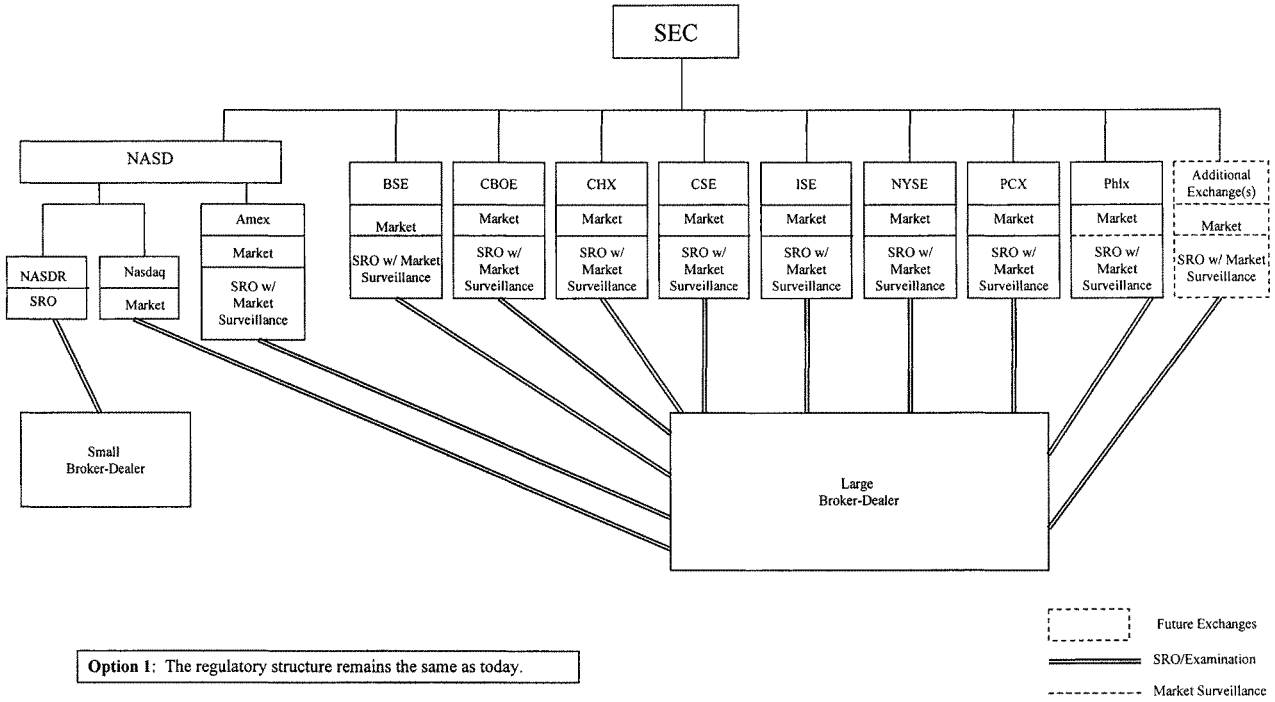
61/ *Id.*

the various regulatory alternatives in this paper is intended to facilitate a discussion as to the most beneficial way to respond to these new developments.

In addition, this analysis is intended to establish the conceptual framework for evaluating the issues specific to the SRO funding structure in the future. Each of the six regulatory models discussed above is compatible with competing alternatives for assessing and allocating the costs of regulation. At present, SROs rely on four primary sources for the funding: (1) regulatory fees and assessments, which are paid by an SRO's members; (2) transaction services fees, which are paid by anyone who uses an SRO's facilities for executing, reporting and clearing transactions; (3) listing fees, which are paid by corporate issuers; and (4) market information fees, which are paid by all those who use or distribute the financial information disseminated by the SROs, including information vendors, broker-dealers, institutional investors, retail investors, the options and futures markets and others.[62/] The issue of whether and how these sources of funding should be restructured and redistributed is subject to an ongoing SEC debate. The outcome of that debate is expected to further inform the Subcommittee's assessment of the different regulatory models.

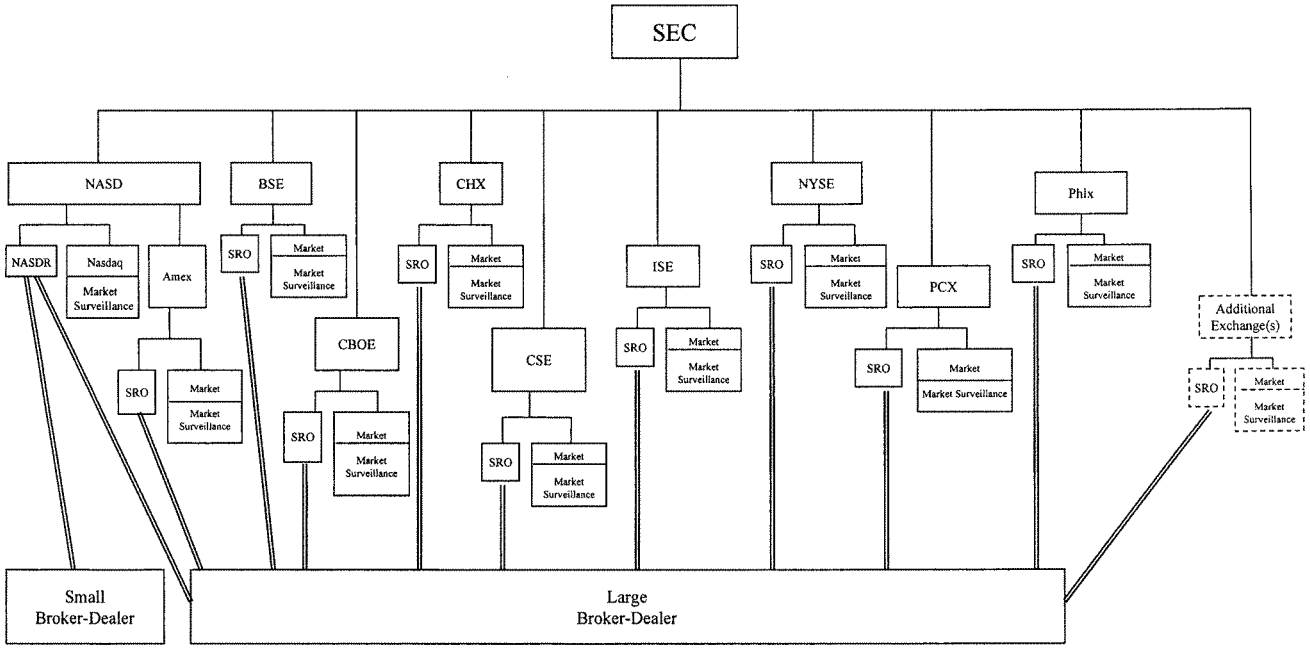
[62/] Exchange Act. Rel. No. 42208 (Dec. 9, 1999), 64 Fed. Reg. 70613 (1999).

OPTION 1: Status Quo



Option 1: The regulatory structure remains the same as today.

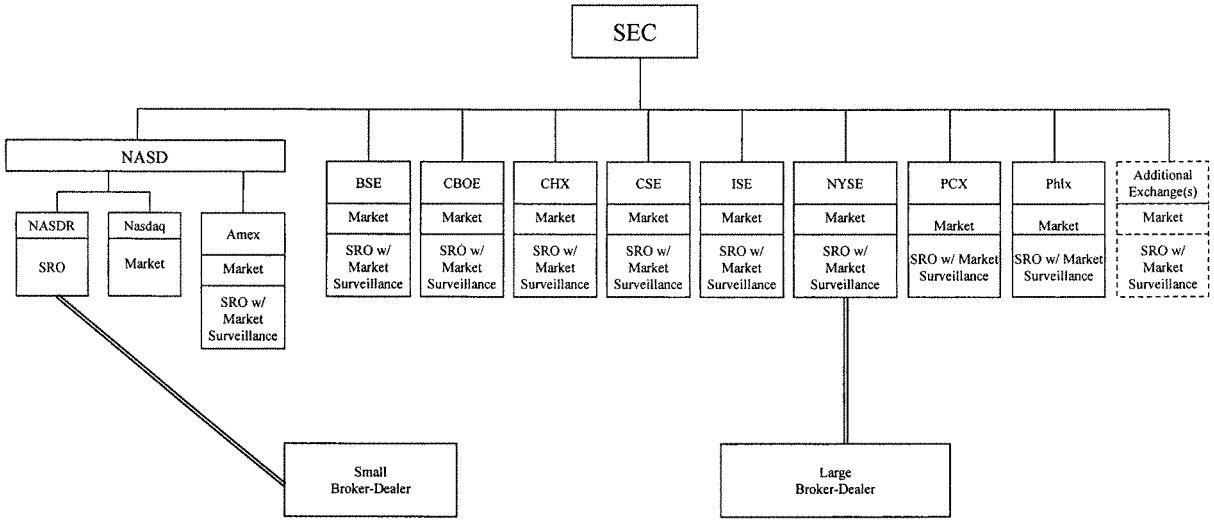
OPTION 2: NASDR Model



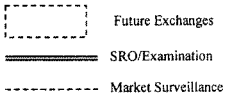
Option 2: The multiple SROs continue to exist and each SRO would continue to operate its market and regulate its market and members. Each demutualized SRO, however, would separate its self-regulatory functions from the market-place it regulates by creating a NASDR-like subsidiary for the SRO's examination, rulemaking and disciplinary authority.

Future Exchanges
SRO/Examination
Market Surveillance

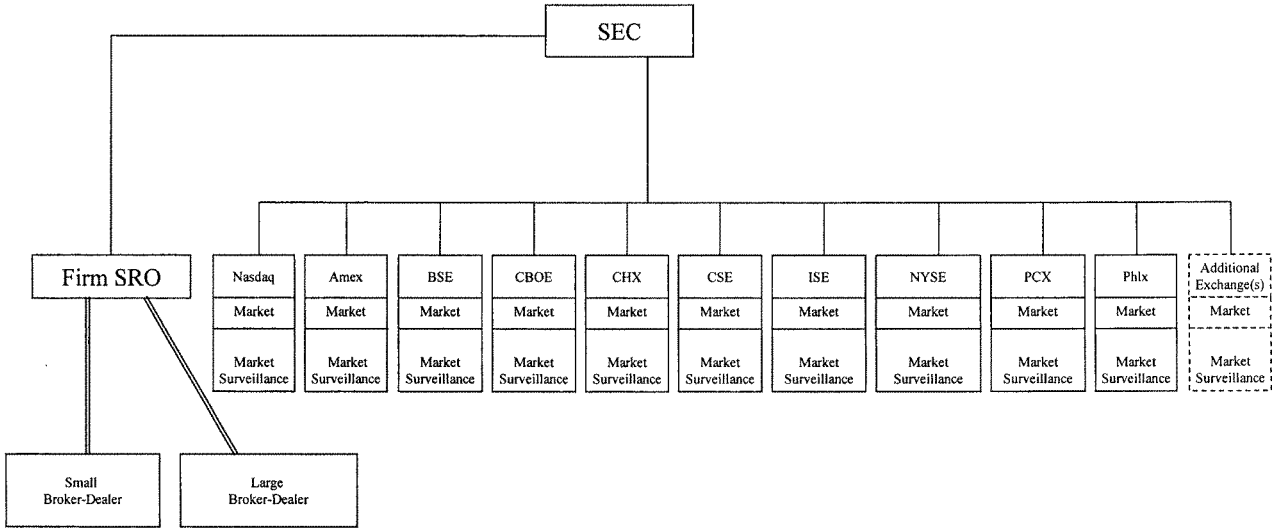
OPTION 3: DEA Model



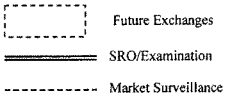
Option 3: The multiple SROs continue to exist and each SRO would continue to operate its market and regulate its market and members. Each firm, however, would be designated to a single SRO for examination purposes.



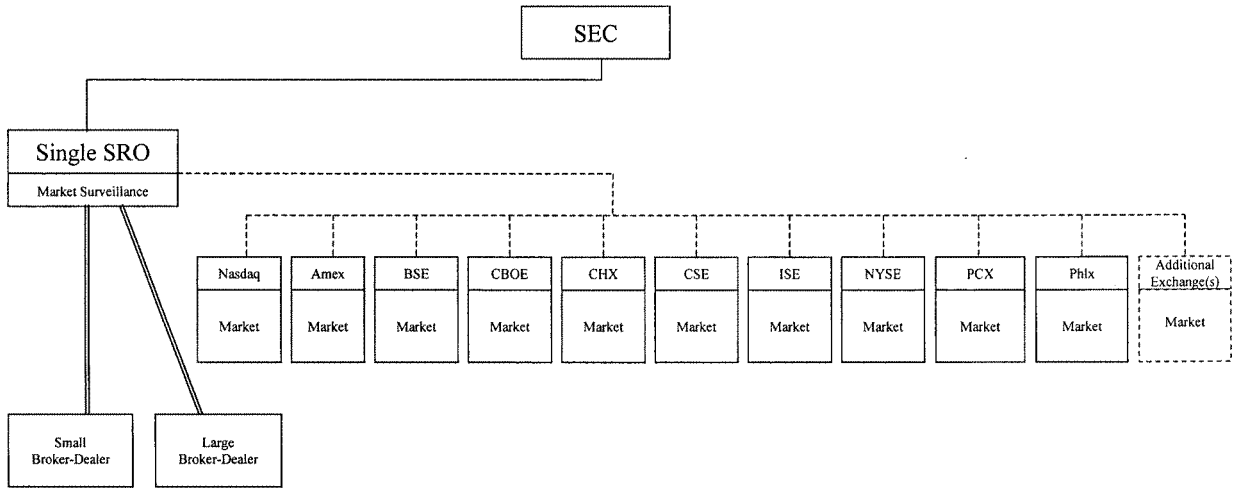
OPTION 4: Hybrid Model



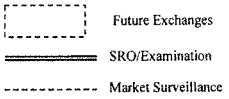
Option 4: Each market would retain its market-related self-regulatory responsibilities. A single SRO – the "Firm SRO" – would, however, assume, for all registered broker-dealers, all the non-market-related rulemaking, surveillance and enforcement functions performed currently by the exchanges and the NASD. A further sub-alternative is to limit the marketplaces only to rulemaking and/or surveillance, but require the Firm SRO to conduct all enforcement activities.



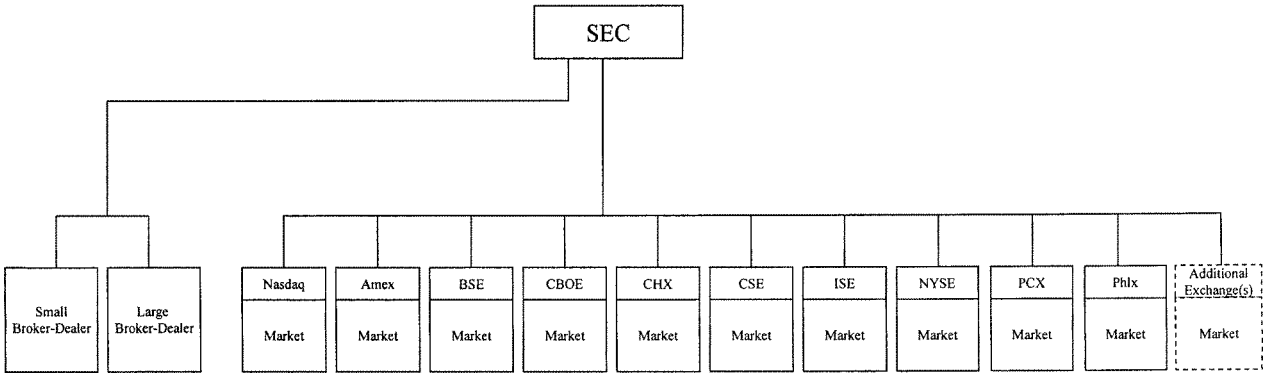
OPTION 5: Single SRO Model



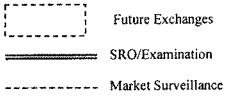
Option 5: The SROs would be stripped of their self-regulatory responsibilities, thereby becoming mere marketplaces. A single SRO would be responsible for all the regulatory functions currently performed by the SROs, including both market-related and non-market-related responsibilities.



OPTION 6: SEC-Only Model



Option 6: The SROs would be stripped of their self-regulatory responsibilities, thereby becoming mere marketplaces. An enhanced SEC would be responsible for all the regulatory functions currently performed by the SROs.



WRITTEN STATEMENT OF GERALD DEAN PUTNAM

CHAIRMAN & CHIEF EXECUTIVE OFFICER

ARCHIPELAGO HOLDINGS, L.L.C.

CONCERNING

"REVIEWING U.S. CAPITAL MARKET STRUCTURE:

THE NEW YORK STOCK EXCHANGE AND RELATED ISSUES"

BEFORE

COMMITTEE ON FINANCIAL SERVICES –

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND

GOVERNMENT SPONSORED ENTERPRISES

UNITED STATES HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

OCTOBER 16, 2003

Chairman Oxley, Chairman Baker, Vice-Chairman Ose, Ranking Member Kanjorski, and other distinguished members of the Subcommittee, I am Jerry Putnam, Chairman and Chief Executive Officer of The Archipelago Exchange or "ArcaEx," and am pleased and honored to submit my written statement to you. I commend the Subcommittee for holding this timely hearing on the status of U.S. capital market structure and, in particular, for performing a thorough examination of the regulatory and competitive fitness of the structure of our listed equity marketplace. [1]

Now is a historic time to take up this critical review and encourage, if not spur, balanced and market-oriented reform of our listed equity markets. While Congress has been tackling very weighty issues – everything from war in Iraq to accounting reform to threats of terrorism to national energy policy – our capital markets have persisted despite the shock of 9/11, the bursting of the Nasdaq bubble, and the corrosive exhaust of corporate scandals. Notwithstanding their remarkable resilience, the market structure underlying our listed markets – in contrast to the vibrant and healthy over-the-counter marketplace – evidences all the lethargic and inefficient symptoms of anti-competitive and monopolistic pathology. And, when discussing the guts of our listed markets, that conversation today essentially begins and ends with the NYSE and its 80% market share and the inter-market mechanisms and regulator truncheon that they leverage to protect that market share.

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[1] The "listed marketplace" is defined as those national securities exchanges and self-regulatory organizations that trade NYSE- and AMEX-listed securities, as well as securities listed on their own markets, and include ArcaEx (as a facility of the Pacific Stock Exchange), Boston Stock Exchange, Philadelphia Stock Exchange, Cincinnati Stock Exchange, Chicago Stock Exchange, NASD (Nasdaq 3rd Market) and, of course, the NYSE and AMEX, themselves. These listed markets interface and interact with one and other in accordance with inter-market regulations and rules governed by national market system committees and by the Securities and Exchange Commission (SEC). In contrast, the "over-the-counter (OTC) marketplace" is defined as those national securities exchanges and self-regulatory organizations that trade Nasdaq securities and include many of the entities listed

It was only a few years ago that under the discerning leadership of Chairman Oxley and other Members of this Subcommittee that our capital markets ushered out the anachronistic Spanish "pieces of eight" (*e.g.*, 1/8s, 1/16s) and ushered in the "era of the penny" (or decimalized trading). The result has been the equivalent of a billion dollar "tax cut" for investors. Here, this Subcommittee is in a position to effect another round of stimulative "tax cuts" for investors by tearing down the now ancient walls and draining the medieval moat that protect the well-fortified NYSE and replacing them with a splendid kingdom built on a foundation of competition, market forces, and customer choice.

I. Recipe for Success: A Heaping Tablespoon of Competition

You can hardly pick up a financial newspaper or magazine or cruise your cable channels without reading or hearing the headlines: "Conflicts of Interest Involving Commingled Regulator and Marketplace," or "Governance Conflicts of Marketplace Board of Directors Consisting of Regulated Entities," or "Doubts about Execution Quality for Investors Delivered by Inside Players in Monopoly Marketplace." Of course, I am talking about the New York Stock Exchange in 2003, right? No, I was actually referring to the **Nasdaq marketplace** in 1995. (Well, my statements really apply to both.)

My literary point is that the overarching issues of propriety and potential malfeasance now confronting the NYSE are not historically novel ones. To the contrary, we witnessed the same and similar problems during the Nasdaq price-fixing scandal of the mid-1990s that

immediately above such as ArcaEx. The "OTC marketplace" is structured under a wholly different set of inter-market regulations, rules, and committees than the "listed market."

culminated in sanctions being brought by the SEC and the Department of Justice. [2] As you will recall, the Nasdaq scandal involved, principally, conflicts of interest between the NASD regulator and its commingled Nasdaq marketplace; and, investors being substantially disadvantaged by inside players (market makers) for the direct benefit of those same inside players. With this history serving as our guide, the seeds of NYSE reform and "fixing" the listed marketplace reside in the ashes and renovation and later rejuvenation of the OTC marketplace.

Of the several reforms exacted on the OTC marketplace, none was more profound and did more in benefiting investors than the lowering of entry and competitive barriers. This was accomplished through the introduction of market structure changes commonly referred to as the Order Handling Rules. [3] Not surprisingly, lower barriers cultivated an environment – primarily driven by Electronic Communication Networks (ECNs) and Alternative Trading Systems (ATSs) – resulting in the introduction of rapid technological innovation, unprecedented cost efficiencies, and an "investor comes first" ethos. What once was a Byzantine playground for insiders doling out dubious execution quality to investors, the OTC marketplace today – which consists of competitors like ArcaEx, Nasdaq, Instinet, and the Cincinnati Stock Exchange – provides more choice, functionality, speed, efficiency, and, yes, ***better execution quality*** (as recent studies show) than the NYSE.

With the past serving as prologue, and the injection of competition proving to be just the right antidote to cure the OTC marketplace, we would respectfully suggest that the same medicine be administered to cure the ills of the NYSE. That medicine being good old-fashion

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[2] *See* Report Pursuant to Section 21(a)of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market, SEC, August 8, 1996.

[3] Securities Exchange Act Release No. 37619A (September 6,1996), 61 FR 48290 (September 12, 1996) (File No. S7-30-95).

"competition." Over the years, the NYSE has installed anti-competitive barriers that have taken several shapes and forms (*e.g.*, NYSE Rules 390, 394 & 500). Today, however, the manifestation of NYSE anti-competitive barriers is the Inter-Market Trading System (ITS) Plan, its "trade through" provision, and the ITS Operating Committee that "administers" the ITS Plan. As the Order Handling Rules ignited reform by introducing competitors and transforming the OTC marketplace into a highly dynamic one, so too will reform of the "trade through" provision of the ITS Plan, which will lower competitive barriers and introduce authentic competitors to the NYSE marketplace. Put succinctly: what the Order Handling Rules did for the OTC marketplace, ITS and "trade through" reform will do for the NYSE marketplace. And, as was the case in the OTC marketplace, the investor will be the ultimate winner.

II. ArcaEx: Rooted in Competition

The seeds of ArcaEx were sown in the immediate aftermath of the Nasdaq scandal. I read the Order Handling Rules in late 1996 and identified an opportunity to design a business based on a simple but, at the time, quite revolutionary principle: "do the right thing" by creating a level playing field for all investors in an industry filled with conflicted insiders and unnecessary intermediaries. I reasoned that any business model that was good for customers (investors) would be a profitable one for Archipelago. Along with MarrGwen and Stuart Townsend – and my mortgage banker, I might add – I founded the Archipelago ECN (the regulatory predecessor to ArcaEx), which was one of the new competitors to enter the OTC marketplace in 1997.

We branded our business model as "best execution" by delivering to our customers: (1) access to full and timely market information; (2) fast electronic and anonymous executions; (3) sophisticated order types and other value-added functionality; and, arguably our biggest contribution to market structure, (4) algorithmic outbound routing to guarantee best price when that price did not reside at Archipelago. The outbound routing innovation was confirmation of one of the congressionally-articulated goals in mandating the development of the National Market System in 1975. [4] Archipelago created an electronically linked marketplace and, thus, a large virtual pool of liquidity, where customers were given electronic access to best prices at other marketplaces. Archipelago conducted business by the credo: no special handshakes, no backroom deals, no free options, and no conflicts; instead, all investors compete using the same tools and possessing the same market data information. That was our competitive differentiation.

In late 2001, after working with the dedicated staff of the SEC for two years, the SEC Commissioners unanimously approved ArcaEx to operate the first totally open electronic stock exchange. ArcaEx became operational to trade listed stocks in 2002 and OTC shares in 2003. Today, ArcaEx is ***the largest electronic stock exchange in the world*** (based on dollar volume) and is the ***second largest exchange in the United States*** (based on trading volume). From literally zero volume as an ECN in 1997, ArcaEx now handles 28% of the trade volume in the OTC marketplace and 4-5% in the listed-marketplace, and is the largest marketplace for Exchange Traded Funds (ETFs), including QQQ, the most actively traded equity product in the world. Archipelago handles about 650 million shares a day with a record day approaching three-quarters of a billion shares.

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[4] *See* National Market System (NMS) Amendments of 1975 to the Securities Exchange Act of 1934.

Importantly, ArcaEx's business success is matched by its regulatory and compliance success. In the same spirit of "doing the right thing" for investors by operating an open and un-conflicted trading platform, ArcaEx designed its marketplace to eliminate legal or regulatory conflicts by **not engaging** in the regulation of its own marketplace. Instead, ArcaEx operates as a facility of and is regulated by the independent Pacific Stock Exchange (PCX). The lines between business, which is operated by ArcaEx, and regulation, which is operated by PCX, are bright and distinct. As CEO of ArcaEx, all business employees and no regulatory employees ultimately report to me. On the other hand, all regulatory employees of PCX who oversee ArcaEx report to its CEO, Phil DeFeo. Additionally, PCX has its own Board of Directors that is separate from ArcaEx. The PCX Board is charged with its own fiduciary and regulatory obligations independent of ArcaEx's. In the ArcaEx/PCX model, the conflicts involving a regulator wrapped tightly and integrally around a marketplace do not exist.

III. The Roadmap: Competition Through Reform of ITS

Like other exchanges, ArcaEx was compelled to link to the NYSE via ITS and sign onto the ITS Plan, which includes a general prohibition on "trade through." "Trade through," as defined in the ITS Plan, was designed for a 1970s market structure when all exchanges were slow and manual- and specialist-based ones. In today's electronic world, it limits customer choice and dumbs-down "best execution" to the lowest common denominator of the slowest markets, which often consist of conflicted specialists who use "trade through" to their profitable advantage.

Joining ITS and signing onto "trade through" is a *sine qua non* to operating an exchange, and the NYSE clearly recognizes and uses that against its competitors. How? ArcaEx's

experience serves as a representative proxy. In order to join the ITS club, we had to endure a NYSE "hazing process" for months and months before we were "initiated" on NYSE "take it or leave it" terms. The NYSE was in a position to extract unreasonable concessions (blood) from ArcaEx because the ITS Plan is governed by a one-blackball structure where the NYSE can arbitrarily veto the entry of competitors. Further, in order to amend and modernize the ITS Plan (read: reform it), the NYSE can and does use its blackball (or threatens so) to stifle much-needed innovation.

Case in point: the SEC and much of the industry have called for (demanded) ITS reform over the last 18 months. The ITS Operating Committee, which includes exchanges with many divergent interests, was actually able to work in good faith and hammer out a couple of reform proposals that included much compromise. The NYSE (and AMEX) blackballed these reforms, the result being infinite filibuster for reform with no opportunity for cloture. The upshot: by employing its anti-innovation blackball, the NYSE has maintained the status quo and its 80% market share by compelling fast electronic markets, and their customers, to play at the glacial speeds of the NYSE. It's Coke dictating Pepsi's business model.

Like "trade through," ITS technology that links the listed-exchange markets was developed decades ago and is, for all intents and purposes, prehistoric. Electronic markets have passed this technology on the superhighway countless laps ago.

As noted, our experience teaches that the NYSE uses the ITS Plan to suit its competitive purposes. It also hypocritically ignores and violates the ITS Plan when its terms do not meet its competitive purposes. Our databases are stuffed full of examples where NYSE wantonly violates the trade through rule by ignoring better prices at ArcaEx. In those instances, the

NYSE's own customers are left holding the bag when they get "worse execution" at the NYSE. As an all-electronic market, our prices can be accessed and executed in less time than it takes a flash bulb to fire. Despite that, the NYSE has traded through our better prices, and harmed their own customers, up to 7,500 times in a single week.

There is a glimmer of hope. The SEC itself initiated a pilot program over a year ago introducing "trade through" reform to the most actively traded equity product in the world, QQQ, and two other ETFs, SPY and DIA. The pilot has been a smashing success for investors and best execution. QQQ, for instance, maintains a 1-cent spread and deep, liquid markets throughout the trading day. ArcaEx now handles 25-30% of QQQ volume, while the Instinet ECN and the Island ECN handle 18% and 11%, respectively. The NYSE, in this brave new (reformed) world, executes a mere 5%. (No wonder the NYSE is fighting "trade through" reform.)

The SEC is now considering whether to expand on this success and broaden ITS reform to other securities. We respectfully comment that such a broadening would lower barriers, encourage competition, bring long-overdue reform to the listed marketplace, and ultimately benefit investors.

IV. Conclusion

The Inter-Market Trading System (ITS) – its rules, technology, and governance structure – is broken. Meaningful reform will occur at the NYSE and in the listed marketplace only when entry and competitive barriers are lowered to promote authentic competition. ITS is the manifestation of those barriers and, thus, must be reformed in order to cultivate market-wide reform. The experience of the Nasdaq scandal of the mid-1990s and the phoenix-like renewal of the OTC marketplace in its wake reconfirm that authentic reform is best achieved in a competitive and dynamic marketplace. We would argue the same holds true for the NYSE and listed-marketplace.

Testimony

New York Stock Exchange, Inc. 11 Wall Street New York, NY 10005 www.nyse.com

NYSE

John S. Reed

Interim Chairman and Chief Executive Officer

**"Reviewing U.S. Capital Market Structure:
The New York Stock Exchange and Related Issues"**

**Subcommittee on Capital Markets, Insurance and
Government-Sponsored Enterprises**

Committee on Financial Services

**U.S. House of Representatives
Washington, D.C.**

October 16, 2003

Testimony of NYSE Interim Chairman and CEO John Reed

"Reviewing U.S. Capital Market Structure:
The New York Stock Exchange and Related Issues"

Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Financial Services Committee

October 16, 2003

Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee:

My name is John Reed. Thank you for inviting me to testify today in connection with your review of the U.S. capital market structure, and in particular, the role of the institution that stands at the epicenter, the New York Stock Exchange. I assumed the role of Interim Chairman and CEO for a very focused but challenging task: to modernize the Exchange's governance and leave behind a board and a leadership in which the public can place its trust.

I accepted this challenge in the wake of public disclosures that revealed that the Exchange's governance had failed in how it set its executives' compensation, and then failed again in how it met the crisis that resulted from disclosure of that compensation. These failures revealed a board too large and too conflicted to effectively govern the Exchange.

The NYSE's 31-year-old corporate governance structure has quite simply not kept pace with either developments in the best practices in corporate governance over the last three decades or the tremendous changes in the nature of our constituents. Specifically, the Exchange's governance must be revamped to manage conflicts of interest and increase transparency. The Exchange's governance must comply with the governance standards to which our listed companies adhere, and indeed, must go beyond those standards in order to meet the special challenge of serving as both a marketplace and the vehicle by which our members regulate themselves.

Before describing some of the governance changes we are working to implement, I want to address an important issue that underlies much of the discussion about the Exchange's governance failures: the issue of self-regulation. As you all know, self-regulation is at the core of our nation's securities laws and has been at the core of the NYSE since its formation more than 140 years before the adoption of the laws. Yet the governance failures at the Exchange have laid bare the conflicts inherent in self-regulation. Critics have seized on this to argue that the NYSE's regulatory arm be severed from the Exchange – in essence they are calling for the end of self-regulation. I respectfully but strongly disagree with that view.

Self-regulation places the regulators very close to the regulated, both physically and in terms of knowledge and experience. This proximity gives self-regulators insight into issues of regulatory concern and the ability to devise effective solutions that minimize interference with market mechanisms. Moreover, self-regulation is one of two legs of a larger regulatory regime that includes government regulation by the Securities and Exchange Commission and the Congress. The nation's best chance for assuring effective regulatory oversight of our securities markets and their participants does not lie in the direction of cutting off one of those two legs.

SEC Chairman William Donaldson told the Senate Banking Committee on September 30th (according to the *Wall Street Journal* of October 1) that, despite some "hiccups through the years," self-regulation has "worked pretty well." While the SEC and NYSE must work together to address conflicts that could impede the NYSE's ability to police its members, Chairman Donaldson said that "self-regulation is an important function due to the NYSE's expertise in market issues." Moreover, Chairman Donaldson noted that, while conflicts exist in the way members regulate themselves through the Exchange, it would be a "mistake to

completely split off the Big Board's self-regulatory function." I agree with Chairman Donaldson.

Rather than splitting off the Exchange's self-regulatory function, the Exchange must adopt governance structures that manage the conflicts of interests inherent in self-regulation while maintaining the key advantages of self-regulation I've just discussed. How do we do this?

In response to a question from Senator Shelby regarding the self-regulatory structure of the NYSE, Chairman Donaldson recently noted that in the 1930s the Commission wisely included a self-regulation mechanism so there would not be a huge government bureaucracy. He said that it has worked well. He stated that the key issues are (1) how the regulatory function is financed and (2) where the regulatory function reports in the governance structure, in order to avoid potential conflicts of interest. These are indeed the important questions.

The reforms we are working to implement address both of these questions. The answers to both questions are the same – the NYSE Regulatory Group must have its budget set by, and must report to, a board of directors that consists of a substantial majority of directors who are independent, not just of the Exchange's

management, but also of both the broker-dealer industry and the companies listed on the Exchange. And to better enable the SEC, the investing public, and indeed the Congress to ensure we adhere to our public purpose, the Exchange's governance must be made transparent. Accountability will not be avoided.

Let me be as specific as I can at this point in our redesign of our governance architecture. We are contemplating a NYSE Board of Directors comprised of a substantial majority of independent directors that would exclude individuals from the Trading Floor and other parts of the broker-dealer industry, as well as current CEOs of listed companies. The independent directors will be responsible for discharging the Board's crucial governance functions, including nominating, compensation and audit functions, just as independent directors perform these functions under our governance standard for listed companies. And as noted, these independent directors will be responsible for regulatory oversight and regulatory budgeting.

Regarding transparency, consistent with proposed rules under consideration by the SEC for public companies, the Exchange will publicly disclose information about the Exchange's director nominating process and the means by

which investors may communicate with the NYSE's independent directors. As applied by analogy to the Exchange, the SEC's proposed rule would, among other things, require disclosure concerning the Exchange's policy regarding consideration of individuals recommended by public investors as potential nominees to the Board; the procedures public investors are required to follow for suggesting nominees; the process for identifying and evaluating nominees; and any differences in evaluation if the nominee is recommended by a public investor. In addition, the Nominating Committee will establish a procedure to solicit recommendations from the investing public for nominees to the Board.

We will report annually and publicly on the compensation of the five most highly compensated officers of the Exchange (as well as director compensation) and provide detailed information on the compensation philosophy and methodology used to award that compensation. This detailed information will include information relating to appropriate industry comparisons, benchmarks, performance measures and evaluation processes. Let me note here that we have already disclosed substantially more historical compensation information regarding NYSE executives than our securities laws require of public companies.

The Exchange will also disclose relationships among the NYSE and its directors and executive officers, and how the Exchange addresses any conflicts that may arise from those relationships. Additionally, transparency demands that the Exchange make public disclosure of charitable contributions made by the Exchange and the NYSE Foundation, and we will do that as well. And consistent with the NYSE's new listing standards, the Exchange will annually publish its written Governance Principles, Codes of Ethics, and Board committee charters as well as the names of Board committee members.

By creating an independent Board charged with oversight of the Exchange's critical governance, control and regulatory functions and through transparency, I believe we will have applied the hard-won lessons of the Exchange's governance debacle.

I've spent a great deal of my time this morning addressing issues of self-regulation and governance. But lost in the swirl of recent events is the fact that the NYSE is a singular institution that has served American investors exceptionally well for many generations. Amidst its governance crisis, the NYSE continues to provide the deepest liquidity and the best executions for listed-stock trades; it continues to offer investors a range of reliable execution choices; it con-

tinues to attract listings of companies from across the country and around the world willing to adhere to our high standards; and importantly, it continues to offer fair markets backed up by a vigorous and effective regulatory program.

When considering reforms to the NYSE's governance, we must recognize the crucial role the NYSE plays in the global economy and our national well-being – it is a marketplace where nearly $40 billion of corporate securities change hands every day, it is the primary self-regulatory mechanism of the nation's major broker-dealers, it is the source of stringent corporate governance standards for issuers that choose to list their securities on the NYSE, and it gives voice to its constituents on public policy issues affecting our capital markets. As stewards of the world's preeminent venue for trading shares, we are charged with discovering the right steps to ensure public confidence in the Exchange while making even better what is already working so well at the Exchange.

As noted at the outset, it is my mission to address these governance issues head on before making way for a permanent NYSE chairman. But I know the members of this Subcommittee are deeply interested not only in making sure the Exchange incorporates the best governance practices and restores public trust, but also in assuring the resolution of the issues of market structure currently under re-

view by the SEC under Chairman Donaldson's leadership in a way that enhances the quality, cost-effectiveness and competitiveness of our capital markets. My expertise is not securities market structure, and my brief time at the Exchange has not provided me with the experience to address these issues with you in great detail, though there are experienced and knowledgeable professionals at the Exchange who can and who are available to the Subcommittee at any time. I do however want to respectfully suggest that critics of the Exchange's agency-auction market structure not use the Exchange's governance crisis to avoid a candid and principled discussion about market structure issues. Our nation's capital markets are simply too important to confuse the two sets of issues.

Those who suggest the NYSE's physically-convened market is outmoded in a digital era ignore the tremendous amount of technology brought to bear at the point of order execution on the floor the NYSE, including the choice provided to investors of an automatic electronic order execution. The simple fact remains – the NYSE attracts the deep liquidity that makes markets work efficiently and does so in a way that puts the individual investor on a level playing field with the largest institutional investors. There are those who have their own interests in seeing the Exchange's liquidity fragmented among other trading venues. One does not have to be an expert in securities market structure to appreciate that fragmenta-

tion can impair the price discovery performed by equity markets and do so in a way that disadvantages the individual investor.

To conclude, I want to assure you that we understand the damage done to the Exchange's reputation as a result of its governance failures and that we are on the right path to creating a governance process that meets today's needs. We will bring greater independence to the Board table to reduce and manage conflicts of interests and greater transparency in our governance processes to ensure accountability. We will do this without losing sight of the critical business of the NYSE – the business of operating the world's deepest and fairest equity market for the benefit of investors and listed companies.

Again, thank you for the opportunity to appear before you today. I'd be happy to answer your questions.

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Profitability Analysis of NYSE Trading Specialists

by

Brian C. Becker, Ph.D.*

June 2003
Draft

*President; Precision Economics, LLC (www.precisionecon.com); Washington, D.C. I would like to thank Andrew Parsons and Landon Zee of Precision Economics, LLC for their editorial assistance as well as Instinet Corporation for its financial assistance.

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"Van der Moolen," FBS Research Department, June 21, 2002.

Table 2 : Revenue Per Share (Mils)

Company Name	1Q2001	2Q2001	3Q2001	4Q2001	Full Year 2001	Source
Knight Trading Group, Inc. /2/	5.5	3.1	2.2	2.7	3.2	(1)
Van der Moolen Holding, N.V. /3/	29.2	21.9	23.2	23.0	24.2	(2)
LaBranche & Co. LLC /3/	14.3	13.1	10.6	12.5	12.6	(2)

/1/: Mil is one tenth of a cent.

/2/: Average revenue per share.

/3/: Revenue capture per share traded as principle.

Sources:
(1) http://10kwizard.ccbn.com

(2) "Van Der Moolen Holding, NV," Jefferies & Company, Inc., Update--March 8, 2002.

NYSE Specialists' Profitability

American Enterprise Institute
Washington, DC
October 8, 2003

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Overview

I. The NYSE and NASDAQ
   A. NYSE Specialists
   B. NASDAQ Market Markers
   C. Comparison between NYSE and NASDAQ

II. Analysis of NYSE Specialists' Profitability
   A. Traditional Profit Measures
   B. Profitability Reflected in Acquisitions and Market Values
   C. Spreads and Other Proxies for Profit

The NYSE and NASDAQ

NYSE Market Markers

- The New York Stock Exchange ("NYSE") is served by seven trading specialist firms that "make markets" for companies whose shares are listed on the exchange.

- Five of the seven are within the operations of publicly held corporations or are themselves publicly traded.

Specialist Firms	Public?
LaBranche & Co. LLC	Yes
Spear Leeds & Kellogg Specialists	Yes
Fleet Specialist, Inc.	Yes
Van der Moolen Specialists USA	Yes
Bear Wagner Specialists LLC	Yes
Performance Specialist Group, LLC	No
Susquehanna Specialists, Inc.	No

Source: Available at http://www.nyse.com/pdfs/specialist_list.pdf.

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NYSE Specialist Statistics

- The NYSE specialists trade 2,557 listed common stock securities (as of May 5, 2003).

- LaBranche and Spear Leeds & Kellogg Specialists trade the largest number
  - La Branche lists 581 (22.7 percent)
  - Spear Leeds lists 568 (22.2 percent)

- Distribution across the specialists with respect to volume is similar to that seen across the 250 most active stocks
  - Performance and Susquehanna constitute approximately 2-5 percent of volume by share and dollar
  - LaBranche, Spear Leeds, and Fleet make up approximately 70 percent of these volume measurements.

Source: Available at http://www.nyse.com/pdfs/specialist_list.pdf.

NYSE Specialist Statistics

Specialist Firms	Percentage Share of:			
	Common Stocks	250 Most Active	Share Volume	Dollar Volume
LaBranche & Co. LLC	22.7%	26.8%	28.2%	26.8%
Spear Leeds & Kellogg Specialists	22.2%	22.8%	21.2%	23.4%
Fleet Specialist, Inc.	16.8%	21.2%	18.8%	20.4%
Van der Moolen Specialists USA	14.7%	10.8%	12.1%	11.1%
Bear Wagner Specialists LLC	13.3%	14.8%	15.7%	14.8%
Performance Specialist Group, LLC	5.5%	0.0%	1.3%	1.3%
Susquehanna Specialists, Inc.	4.8%	3.6%	2.8%	2.2%

Source: Available at http://www.nyse.com/pdfs/specialist_list.pdf.

NASDAQ Market Markers

- NASDAQ has over 400 market-making firms.
- The average NASDAQ stock has over 10 competing market makers.
- NASDAQ network incorporates other trading systems such as ECNs (Electronic Communications Networks).
- With the advent of NASDAQ's SuperMontage, NASDAQ itself operates as an all-electronic automated market in a manner almost identical to ECNs.

Source: "Market Mechanics: An Educator's Guide to U.S. Stock Markets," available at http://content.nasdaq.com.

NASDAQ vs. NYSE

- As stated by Deutsche Bank, "The NYSE and the Nasdaq are fundamentally opposite organizations: the NYSE is a floor-based auction market, the Nasdaq is an electronic dealer-driven market."
  ("The U.S. Exchanges," Deutsche Bank, June 12, 2002.)

- NASDAQ covers a much smaller market capitalization than NYSE. The NYSE lists most companies with large market capitalization.

- NASDAQ operations are more computerized/automated than the NYSE.
  - NYSE floor receives more than 80 percent of the stock orders on its listed companies.
  - NASDAQ has seen its trading via ECNs increase from approximately 10 percent in 1996 to 49 percent by August 2002.

Source: Available at http://www.marketdata.nasdaq.com.

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Analysis of NYSE Specialists' Profitability

NYSE Specialists' Profitability

- "Anyone familiar with the year-in, year-out profitability of specialist firms knows the answer to this riddle [why NYSE seats cost $2 million]: The floor is a very profitable place to be."
  (Selway, James, "Five Myths About Listed Trading," *Transaction Performance*, Spring 2002.)

- Available Profitability Figures for Specialists from 10-K:
  - LaBranche is essentially only a trading specialist operation.
  - Fleet and Van der Moolen participate in other lines of business; however, they do report revenue and net income on their trading specialist operations.

Sources: Available at http://www.edgar-online.com, http://www.vandermoolen.com & http://www.bankofengland.com.

NYSE Specialists' Profitability

- For full year 2002, these specialists earned net income (pre-tax) that is approximately 35-60 percent of their revenues in the most recent full fiscal year, with Van der Moolen at the high end of the range at 61.0 percent.

Sources: Available at http://www.edgar-online.com, http://www.vandermoolen.com & http://www.bankofengland.com.

NYSE Specialists' Profitability

Specialist Name	Pre-tax profit (Millions) (2002)	Revenue (Millions) (2002)	Pre-Tax Profit/Revenues
LaBranche & Co. LLC	$166.1	$452.8	36.7%
Fleet Specialist, Inc.	$169.2	$325.0	52.1%
Van der Moolen Specialists USA	$153.5	$251.5	61.0%
Total	**$488.8**	**$1,029.3**	**47.5%**

NYSE Specialists vs. Industries

- In comparison to the 35-60 percent pre-tax margins of the NYSE specialists:
  - The total pre-tax margin earned in SIC 6211 (Security Brokers, Dealers, and Flotation Companies) was 9.7 percent in the year ended March 2002.
  - Firms in SIC 6282 (Investment Advice) earned pre-tax margins of 14.5 percent in the year ended March 2002.
  - Each of the SIC codes classified as "Finance and Insurance" earned pre-tax margins below those of the NYSE trading specialists.

Source: "Annual Statement Studies, 2002-2003," The Risk Management Association, Philadelphia, 2002.

NYSE Specialists vs. Industries

Financial SIC Codes (FYE 3/02)	Profit Margin
SIC #6211 Security Brokers, Dealers, & Flotation Companies	9.7%
SIC #6282 Investment Advice	14.5%
Range of Other SIC Codes	2.4%-19.9%
Average for NYSE Specialists	47.5%

Source: "Annual Statement Studies, 2002-2003," The Risk Management Association, Philadelphia, 2002.

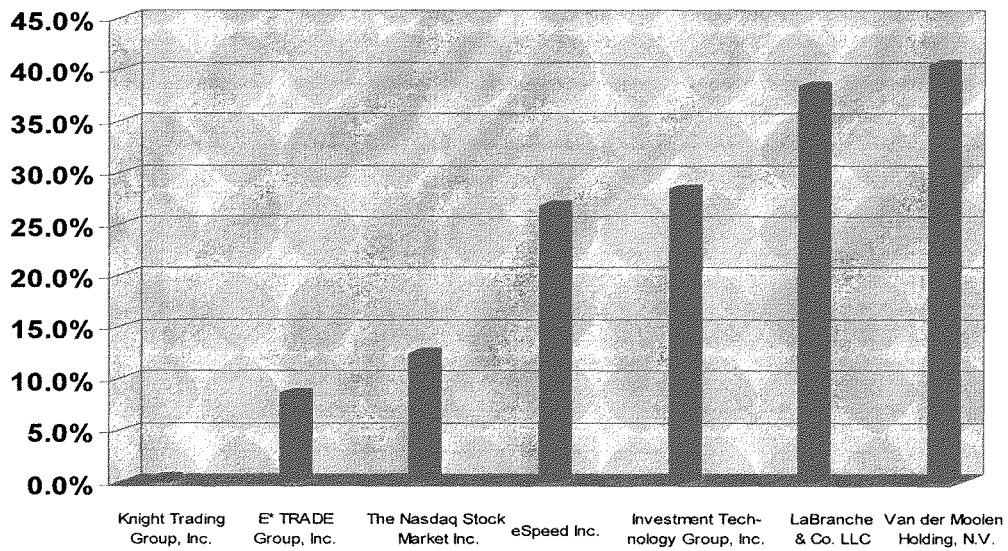
NYSE Specialists vs. Other Similar Firms

- NYSE Specialist Profitability Compared to Peers by Analysts: Jefferies & Company—January 23, 2003.

Company	Pre-Tax Margin
Knight Trading Group, Inc.	0.5%
E*TRADE Group, Inc.	8.6%
The Nasdaq Stock Market Inc.	12.5%
eSpeed Inc.	26.8%
Investment Technology Group, Inc.	28.4%
LaBranche & Co. LLC	38.4%
Van der Moolen Holding, N.V.	40.5%

Source: "Knight Trading Group, Inc.," Jefferies & Company, Update-January 27, 2003.

NYSE Specialists Pre-Tax Margin vs. Peers in 4th Quarter, 2002



Source: "Knight Trading Group, Inc.," Jefferies & Company, Update-January 27, 2003.

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Acquisitions of Specialists

- Tangible assets generally provide a relatively modest profit margin.
- Higher profit margins are generally associated with the ownership of valuable intangible assets (*e.g.*, market position, intellectual property, etc.).
- Analyzed the terms of the acquisitions of trading specialists in the past few years to assess their level of non-routine (intangible) profit being earned.
- Consistent with previous findings, trading specialist acquisitions include significant intangible value.

Acquisitions of Specialists

Acquisition	Acquirer	Acq. Price ($M)	Goodwill (Intangible) /Acq. Price
Robb Peck McCooey Financial Serv.	LaBranche & Co. LLC	439	102.1%
Wagner Stott Mercator, LLC	Bear Sterns Companies Inc.	625	61.9%
Scavone, McKenna, Cloud & Co.	Van der Moolen Specialists	48	98.7%
Stern & Kennedy, LLC	Van der Moolen Specialists	26	72.5%
Spear, Leeds & Kellogg, L.P.	Goldman Sachs Group Inc.	5,750	69.6%
Fagenson, Frankel & Streicher	Van der Moolen Specialists	76	89.9%
Webco Securities, Inc.	LaBranche & Co. LLC	50	57.5%
Henderson Brothers Holdings, Inc.	LaBranche & Co. LLC	228	89.7%
Total			**81.2%**

Source: "Van Der Moolen Holding, NV," Jefferies & Company, Inc., December 7, 2001.
Note: Three specialist acquisitions were removed due to lack of information.

NASDAQ and NYSE Spreads

- Recent reports suggest that NASDAQ trades more efficiently than the NYSE. Its effective spread of 1.5 cents is reported to be 40 percent lower than the NYSE.

- Similarly, it is reported to execute 81 percent of trades at the quoted price vs. only 60 percent for the NYSE.

- NASDAQ itself reports similar—slightly more favorable—numbers on S&P 500 stocks: (a) spreads that are 62 percent lower than NYSE and (b) transaction costs that are 56 percent lower than NYSE.

Source: "Trading Probe The Least of NYSE Worries," April 24, 2003, Available at http://www.forbes.com & http://www.nasdaq.com.

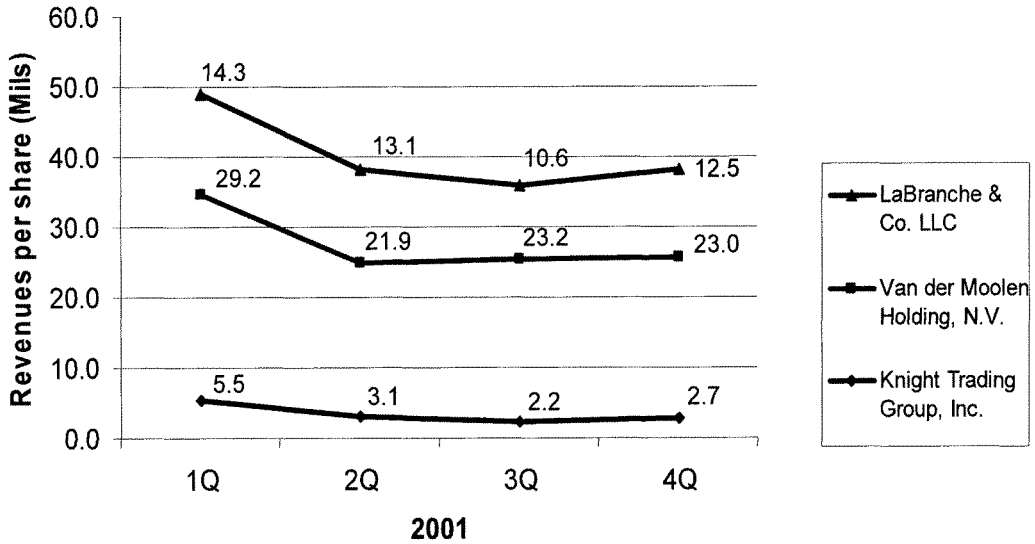
Revenues per Share

- Publicly available information suggests that the market makers of NYSE (specialists) derive more revenue per traded share than the corresponding revenue for the NASDAQ market makers.

- Focusing on the operations that are exclusively/majority in market making, a reasonable comparison is between LaBranche/Van der Moolen and Knight Trading
  - For the full year 2001, Knight's revenue captured per share was 0.3 cents.
  - Van der Moolen's and LaBranche's principal trading revenues per share were approximately 2.4 and 1.3 cents, respectively in 2001.

Sources: "Van Der Moolen Holding, NV," Jefferies & Company, Inc., December 7, 2001 & http://10kwizard.ccbn.com

Revenues per Share (Mils) per Quarter 2001



Sources: "Van Der Moolen Holding, NV," Jefferies & Company, Inc., December 7, 2001 & http://10kwizard.ccbn.com

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Conclusion

- NYSE Trading Specialist Profitability
  - Further research warranted
    - Other measures of profitability (different profit level indicators)
    - Examination of profits of privately held trading specialists
    - Examinations of profits of specialist arms of public companies
  - Initial results from available data
    - NYSE trading specialists are very profitable
    - Trading specialist profits exceed their peers and other publicly traded companies

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Dr. Becker has published approximately two dozen articles as a supplement to his consulting activities. In addition, he is a frequent speaker before government and private audiences on valuation topics. He has held teaching positions at the Business Schools of The Johns Hopkins University, Marymount University, The George Washington University, and the University of Pennsylvania.

Dr. Becker earned M.A. and Ph.D. degrees in Applied Economics from the Wharton School of Finance of the University of Pennsylvania. He earned a B.A. in Applied Mathematics and Economics from The Johns Hopkins University.

Abstract

The New York Stock Exchange ("NYSE") is served by seven trading specialist firms that "make markets" for companies whose shares are listed on the exchange. These firms—listed in **Table 1**—match up buyers and sellers. Five of the seven are within the operations of publicly held corporations or are themselves publicly traded.

There has been much recent discussion in the popular press regarding these specialist firms with regard to their practices and disclosures.[1] In addition, there has been significant academic literature analyzing these firms and their operations.[2] However, the research does not include a comparison of NYSE trading specialist profits to any benchmarks. This paper hopes to make a very specific contribution to this literature by:

- Comparing NYSE trading specialist profits with firms in similar industries as well as a cross section of other industries;
- Analyzing the trading specialists' valuations and the terms of the many acquisitions of trading specialists concluded in the past few years to assess their level of non-routine (intangible) profit being earned; and
- Comparing bid-ask spreads and revenue per share of NYSE and NASDAQ market makers.

Our research found that NYSE trading specialists earn very high operating levels of profitability. Their operating profit margins were consistently higher than those earned by firms in similar industries as well as a broad cross section of other industries. In addition to high operating profit levels, these firms saw higher spreads and revenue per share than their NASDAQ counterparts. Consistent with these findings, trading specialist acquisitions include significant intangible value.

These findings suggest that further research into this area is warranted. Subject to data availability, future profit level comparisons may consider investment (asset) levels. Also subject to data availability, the profits of the privately held trading specialists (and those part of consolidated public companies that do not report their specialist profits) should be examined.

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[1] For example, see "NYSE's Probe Focuses on Both Deeds and Words," The Wall Street Journal, May 5, 2003.

[2] For example, see Harris, Larry, "Trading & Exchanges: Market Microstructure for Practitioners," Oxford University Press, 2003.

Introduction

A. The NYSE and NASDAQ

Principally located in U.S. stock and option markets, trading specialists play a dual role in these markets. These roles consist of either matching orders between their clients or filling client orders directly from their own inventory. The largest stock exchange to implement such a specialist trading system is the NYSE. With one specialist per stock, it centralizes the pool of liquidity.[3] The NYSE executes about 85 percent of the volume in its listed securities.[4]

Although the NYSE and NASDAQ dominate equity trading in the United States, there are significant differences in their structures. As stated by Deutsche Bank, "The NYSE and the Nasdaq are fundamentally opposite organizations: the NYSE is a floor-based auction market, the Nasdaq is an electronic dealer-driven market."[5]

With over 400 market-making firms, the NASDAQ's market making differs from that of the NYSE. The average NASDAQ stock has over 10 competing market makers. In addition to traditional market makers, the NASDAQ network incorporates other trading systems such as ECNs (Electronic Communications Networks), facilities that match buy and sell orders directly through a computerized system without the intervention of a specialist or market maker.[6] See **Table 2**.[7]

NASDAQ covers a much smaller market capitalization than NYSE. The NYSE lists most companies with large market capitalization.[8] See **Table 3**.

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[3] "The U.S. Exchanges," Deutsche Bank, June 12, 2002.

[4] By contrast, AMEX trades less than half. On the NASDAQ, no market maker enjoys such a majority. Selway, James, "Five Myths About Listed Trading," *Transaction Performance*, Spring 2002, pp. 76- 80.

[5] "The U.S. Exchanges," Deutsche Bank, June 12, 2002.

[6] "Market Mechanics: An Educator's Guide to U.S. Stock Markets," in http://content.nasdaq.com/reference/market_mechanics.pdf.

[7] "Van der Moolen Holding, NV," Jefferies & Company, Inc., Update – March 08, 2002.

[8] The NYSE tends to list the larger stocks. As of June 2002, it was listing 87 percent of the S&P 500 as opposed to only 13 percent by NASDAQ. "The U.S. Exchanges," Deutsche Bank, June 12, 2002.

NASDAQ operations are more computerized/automated than the NYSE. While the NYSE floor receives more than 80 percent of the stock orders on its listed companies,[9] NASDAQ had seen its trading via ECNs increase from approximately 10 percent in 1996[10] to 49 percent by August 2002.[11] See **Table 11**. In addition, with the advent of NASDAQ's SuperMontage, NASDAQ itself operates as an all-electronic automated market in a manner almost identical to ECNs.

B. Seven NYSE Trading Specialist Firms

The NYSE trading specialist industry is dominated by publicly traded firms. As seen in **Table 4**, five of the NYSE trading specialists firms are operated by publicly traded corporations. The two remaining firms trade much smaller volumes.

The five publicly traded firms running specialist operations perform a variety of other financial services. LaBranche & Co. LLC ("LaBranche") is the "purest play" of the five, as its operations are essentially all in the specialist area. Van der Moolen Specialists USA ("Van der Moolen") has some operations outside of this area, but its specialist activities constituted 76 percent of its 2001 revenues.[12] The other three specialist operations simply represent a minority of the diversified operations of their parent companies. In addition to LaBranche, Van der Moolen and Fleet Specialist, Inc. ("Fleet") provide revenue and profit information for their specialist businesses.

C. Summary Statistics of NYSE Trading Specialists

The NYSE specialists trade 2,557 listed common stock securities (as of May 5, 2003). As seen in **Table 4**, LaBranche and Spear Leeds & Kellogg Specialists ("Spear Leeds") trade the largest number with the former listing 581 (22.7 percent) and the latter listing 568 (22.2 percent.)[13] The two privately held specialists—Performance Specialist Group, LLC ("Performance") and Susquehanna Specialists, Inc. ("Susquehanna")—list significantly fewer stocks than the five publicly traded companies.

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[9] Kelly, Kate and Craig, Susanne, "Fleet Specialist Unit Was Fined Before NYSE Moved on Trader," The Wall Street Journal, April 21, 2003.

[10] "The U.S. Exchanges," Deutsche Bank, June 12, 2002.

[11] See www.marketdata.nasdaq.com.

[12] See www.cbs.marketwatch.com.

[13] See www.nyse.com/pdfs/specialist_list.pdf.

Among the larger and more active stocks, the distribution across the specialists is similar, but more pronounced. As seen in **Table 4**, Performance and Susquehanna only constitute 3.6 percent of the 250 most active securities in total. LaBranche, Spear Leeds, and Fleet make up more than 70 percent of these active stocks. The distribution across the specialists with respect to volume is similar to that seen across the 250 most active stocks. Performance and Susquehanna constitute approximately 2-5 percent of volume by share and dollar. LaBranche, Spear Leeds, and Fleet make up approximately 70 percent of these volume measurements.[14]

When looking at the specialists among firms in specific indexes, the same general trends continue, but there are some differences. Fleet and LaBranche share the lead with nine stocks among the Dow Jones Industrial Average (neither Performance nor Susquehanna lists any stock in this index). Within the S&P 500, Spear Leeds lists slightly more than LaBranche, but LaBranche lists significantly more within the S&P 100 (neither privately held firm lists any stock in the latter index).[15]

[14] See www.nyse.com/pdfs/specialist_list.pdf.

[15] See www.nyse.com/pdfs/specialist_list.pdf.

Analysis

A. Traditional Profit Measures

1. Trading Profits Reported Publicly

NYSE specialist firms are reputed to be very profitable.[16] The Wall Street Journal stated last month, "Specialists remain among the most profitable business on Wall Street."[17] This reputation extends to the price of seats on exchanges (see **Table 12**):

> Anyone familiar with the year-in, year-out profitability of specialist firms knows the answer to this riddle [why NYSE seats cost $2 million]: The floor is a very profitable place to be.[18]

The specialist firms are also reputed to earn profits fairly consistently. As seen in an analyst report on Van der Moolen, "... all trading days have been in the black"[19]

Explicit profits and revenues are publicly reported for approximately 60 percent of NYSE trading specialist operations.[20] That is, LaBranche, Fleet, and Van der Moolen report operating profits on their trading operations, while the profits of the remaining specialist firms are not publicly reported.

- LaBranche is essentially only a trading specialist operation. As such, its consolidated financial results reveal its trading specialist revenues and profits.

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[16] See "The Bid/Ask Spread and Market Making," www.investorhome/daytrade/spread.htm.

[17] Ip, Greg and Craig, Susanne, "NYSE's 'Specialist' Probe Puts Precious Asset at Risk: Trust," The Wall Street Journal, April 18, 2003.

[18] Selway, James, "Five Myths About Listed Trading," *Transaction Performance*, Spring 2002, pp. 76- 80.

[19] "Van der Moolen," FBS Research Department, June 21, 2002.

[20] 60 percent of the total share volume of trading specialists.

- Fleet and Van der Moolen participate in other lines of business; however, they do report revenue and net income on their trading specialist operations.[21]

As seen in **Table 5**, these specialists earned net income (pre-tax) that is approximately 35-60 percent of their revenues in the most recent full fiscal year, with Van der Moolen at the high end of the range.[22]

2. Other Publicly Available Profit Information

Specialist profits have been studied and analyzed in a number of different ways. Research has determined that differences in profits exist across the specialist firms and that large stocks (volume and market capitalization) tend to generate most or all of the profits of the specialists. In fact, the smaller stocks may actually create losses. No systematic difference has been found, however, across specialists in terms of listing profitable or unprofitable securities.[23]

3. Comparison of NYSE Specialist Profits to Benchmarks

The use of benchmarking is a standard tool used by financial economists to determine whether prices, royalties, profits, or other economic returns are reasonable. It helps to set prices and value as well as to identify when such prices and values divert significantly from industry norms. Similar to the specialist context with the NYSE, the types of contexts where this is often employed involves financial returns that result from unique market structures (i.e., monopolies) or theoretical transactions necessary for reporting purposes.

Due to the market structure differences described above (i.e., no specific individual or firm holding near monopoly power over the trading of a specific security), there is no perfect NASDAQ benchmark corresponding to the NYSE trading specialists. However, the available data suggest that many of the primary companies involved in this area for NASDAQ are either less profitable than the NYSE trading specialists or not profitable at all:[24]

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[21] A large majority of Van der Moolen's business is in the specialist area. This explains why a number of analysts regard LaBranche as its " ... most appropriate publicly traded peer." See "Van der Moolen Holding, NV," Jefferies & Company, Inc., Update – March 08, 2002.

[22] This reflects all of the LaBranche operations, but only the specialist operations of Fleet and Van der Moolen.

[23] See, Corwin, Shane, "Specialist Performance and New Listing Allocations on the NYSE: An Empirical Analysis," *Journal of Financial Markets*, forthcoming.

[24] For example, LaBranche and Van der Moolen analysts compare those companies to Instinet, NASDAQ, and Knight Trading Group. "LaBranche & Co.," Jefferies & Company, Inc., Update

- The NASDAQ Stock Market, Inc. itself[25] reported pre-tax profit margins of 10.5 percent in 2002 (9.2 percent in 2001.)[26]

- In the fourth quarter of 2002, Instinet recorded a pre-tax loss, and Knight Trading Group, Inc. ("Knight Trading") recorded only a 0.5 percent pre-tax profit margin.[27] [28] See **Table 6**.

- In a recent analyst report, the two publicly traded firms with a majority of operations as NYSE specialists (LaBranche and Van der Moolen) reported higher profit margins than all of the other eight companies in the peer group determined by analysts.[29] See **Table 6**.

That is, based on publicly available data, the NYSE trading specialists earn higher operating profit levels than market makers outside of the NYSE.

b. Specific SIC Codes

NYSE trading specialists earn higher profit levels than other firms in their industry or related industries. **Table 7** compares the NYSE trading specialist profit levels with those of firms in Standard Industrial Classification Codes ("SIC") that cover the financial services industry. In comparison to the 35-60 percent pre-tax margins of the NYSE specialists:

– April 1, 2003 and "Van der Moolen Holding, NV" Jefferies & Company, Inc. Update – March 08, 2003.

[25] An analyst report valuing NASDAQ includes among the seven benchmark companies LaBranche, Van der Moolen, Knight Trading Group and Instinet. "The Nasdaq Stock Market, Inc.," Jefferies & Company, Inc., Update – March 11, 2003.

[26] See, for example, "The Nasdaq Stock Market, Inc.," Jefferies & Company, Inc., Update – March 11, 2003.

[27] "LaBranche & Co.," Jefferies & Company, Inc., Update – April 1, 2003.

[28] Both companies earned negative profits for the full year 2002. www.moneycentral.msn.com.

[29] Due to their other operations or privately held nature, no other NYSE specialist was included in this grouping. Instinet, NASDAQ, and Knight Trading were part of this peer group. This apparently includes all of Van der Moolen's operations. Its specialists profit margins were higher. "Knight Trading Group, Inc." Jefferies & Company, Inc., Update – January 27, 2003.

- The total pre-tax margin earned in SIC 6211 (Security Brokers, Dealers, and Flotation Companies) was 9.7 percent in the year ended March 2002.[30]

- Firms in SIC 6282 (Investment Advice) earned pre-tax margins of 14.5 percent in the year ended March 2002.[31]

- Each of the SIC codes classified as "Finance and Insurance" earned pre-tax margins below those of the NYSE trading specialists.[32]

c. All SIC Codes

The NYSE trading specialists earn higher profits than companies in other businesses—manufacturing and distribution.

- The median and mean pre-tax profit margin of manufacturing operations (SIC 2000-3999, etc.) during the past five years was approximately 2-5 percent. See **Table 8**.[33]

- The median and mean pre-tax profit margin of distribution operations (SIC 5000-5199) was always less than 3 percent during the past five years. See **Table 9**.[34]

B. Profitability Reflected in Acquisitions and Market Values

1. Profits Generated by Intangible and Tangible Assets

[30] "Annual Statement Studies, 2002-2003," The Risk Management Association, Philadelphia, 2002.

[31] "Annual Statement Studies, 2002-2003," The Risk Management Association, Philadelphia, 2002.

[32] This included 20 SIC Codes. "Annual Statement Studies, 2002-2003," The Risk Management Association, Philadelphia, 2002.

[33] This includes the years ended March 1998-2002. "Annual Statement Studies, 2002-2003," The Risk Management Association, Philadelphia, 2002.

[34] "Annual Statement Studies, 2002-2003," The Risk Management Association, Philadelphia, 2002.

Companies earn profits as a result of their tangible and intangible assets. As summarized above, "tangible assets" generally provide a relatively modest profit margin. Higher profit margins are generally associated with the ownership of valuable intangible assets (*e.g.*, market position, intellectual property, etc.).

2. Evidence of non-routine (intangible) profits/assets

The above analysis suggests that the NYSE specialists are generally earning profits far in excess of routine levels that would be indicative of holding no valuable intangible assets. This is corroborated by the dearth of tangible assets and the market value of the one firm that is the truest "pure play" specialist. As of April 1, 2003; only approximately 5 percent of LaBranche's book value was made up of tangible assets.[35] [36]

In general, the acquired specialist firms have reported significant levels of intangible assets. In fact, they typically constitute a majority of the acquired assets.

- The Goldman Sachs Group, Inc. ("Goldman Sachs") purchased Spear, Leeds & Kellogg, L.P. for $6.5 billion in 2000. This included approximately $5 billion worth of intangible assets.[37]

- From late 1999 through 2001, eleven specialists were acquired by LaBranche, Van der Moolen, Goldman Sachs, and Bear Sterns. As seen in **Table 10**, the majority of such acquisition prices were made up of intangible assets.[38]

C. Spreads and Other Proxies for Profit

1. NASDAQ and NYSE Spreads

Recent reports suggest that NASDAQ trades more efficiently than the NYSE. Its effective spread of 1.5 cents is reported to be 40 percent lower than the NYSE. Similarly, it is reported to execute 81 percent of trades at the quoted price vs. only 60 percent for the NYSE.[39]

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[35] At that time, its book value was reported to be $15.60 per share, with only $0.85 in tangible assets, "The Nasdaq Stock Market, Inc.," Jefferies & Company, Inc., Update – March 11, 2003.

[36] LaBranche has been acquiring a number of specialist firms since 1999. See "LaBranche & Co.," Raymond James & Associates, Inc., January 17, 2003.

[37] "Spear, Leeds & Kellogg Joins With Goldman Sachs," Monday September 11, 2000. See www.gs.com.

[38] "Van der Moolen Holding, NV," Jefferies & Company, Inc., Update – December 07, 2001.

[39] See "Trading Probe The Least of NYSE Worries," April 24, 2003, www.forbes.com.

NASDAQ itself reports similar—slightly more favorable—numbers on S&P 500 stocks: (a) spreads that are 62 percent lower than NYSE and (b) transaction costs that are 56 percent lower than NYSE.[40]

2. Revenue Per Share

Publicly available information suggests that the market makers of NYSE (specialists) derive more revenue per traded share than the corresponding revenue for the NASDAQ market makers. In focusing on the operations that are exclusively/majority in market making, a reasonable comparison is between LaBranche/Van der Moolen and Knight Trading. For the full year 2001, Knight's revenue captured per share was .3 cents.[41] By contrast, Van der Moolen's and LaBranche's principal trading revenues per share were approximately 2.4 and 1.3 cents, respectively in 2001. See **Table 2**.[42]

D. Future Research

Publicly available data suggests that NYSE trading specialists earn higher operating profit levels than NASDAQ market makers. With this research restricted to public data, further research is warranted. Subject to data availability, future profit level comparisons may consider investment (asset) levels. Also subject to data availability, the profits of the privately held trading specialists (and those part of consolidated public companies that do not report their specialist profits) should be examined.

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[40] It reports similar favorable comparisons with mid-cap stocks and companies 101-500 within the S&P 500. www.nasdaq.com.

[41] "Knight Trading Group, Inc." Bear, Stearns & Co., Inc., January 23, 2003.

[42] "Van der Moolen Holding, NV," Jefferies & Company, Inc., Update – March 08, 2002.