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A GLOBAL VIEW: EXAMINING CROSS-BORDER EXCHANGE MERGERS

HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITIES AND INSURANCE AND INVESTMENT

OF THE

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

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

ON

CURRENT TRENDS IN CAPITAL MARKETS AND EXCHANGES, INCLUDING MERGERS AND ACQUISITIONS, AND PRECIPITATING FACTORS; AND THE IMPACT SUCH CHANGES HAVE ON REGULATION, MARKET PARTICIPANTS, AND INVESTORS

THURSDAY, JULY 12, 2007

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THURSDAY, JULY 12, 2007

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 9:59 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Jack Reed (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN JACK REED

Chairman REED. Good morning, let me call the hearing to order.

I want to thank Senator Allard, my colleague, for joining me this morning. We are looking at the issue of A Global View: Examining Cross-Border Exchange Mergers.

Globalization has led us to a crossroads. The world economy is developing a variety of factors including increased liquidity and improved regulatory structures by drawing both firms and investors to emerging markets. Furthermore, as technological obstacles to cross-border trading disappear and markets are increasingly dominated by hedge funds and institutional investors with appetites for international investments, exchanges seek a global presence to remain viable.

In an effort to preserve and improve their positions, exchanges are engaging in increased cross-border transactions through mergers and acquisitions of other exchanges. In light of this growing trend, we are here to examine the impact on market participants, investors, and the regulatory scheme.

The New York Stock Exchange, for example, has merged with Paris-based Euronext, forming a strategic alliance, also with the Tokyo Stock Exchange, and has invested in a 5 percent stake in India's National Stock Exchange.

NASDAQ acquired an increased stake in the London Stock Exchange before announcing it would merge with the Nordic exchange OMX.

These trends are not only confined to domestic markets, as the German-based Deutsche Bourse has announced its intent to buy the U.S.-based International Securities Exchange.

The increased alliance between exchanges has led to an increased interaction amongst regulators. In the United States, both the SEC and CFTC are engaged in cross-border conversations with regulators in Europe, China, Japan, and Australia, among others.

Additionally, the International Organization of Securities Commissions, IOSCO, has announced that by 2010 its 108 members must sign on to a memorandum of understanding that seeks to enable regulators to cooperate on enforcement in a timely, seamless manner.

In recent months the SEC has been prioritizing a number of regulatory reforms focused on providing foreign entities greater access to the U.S. securities markets. For example, the SEC is considering eliminating the need for non-U.S. companies to reconcile to U.S. Generally Accepted Accounting Principles. While this effort might ease the filing requirements on non-U.S. companies, some argue that the integrity of the International Financial Reporting Standards, the alternative filing, is not on par with and may, in fact, be dependent upon reconciliation to U.S. GAAP.

Additionally, the SEC is looking at a move to mutual recognition with foreign regulators with substantially comparable regulatory regimes and is examining whether foreign exchanges could place their screens with U.S. brokers in the United States without multiple registrations.

However, it is important that these efforts provide comparable safeguards for investors. And in considering such approaches, we must ensure that while the rulebooks may be similar on paper, their interpretation and enforcement by other regulators must be equally comparable.

The globalization of markets across product lines, as well as geographic boundaries, through increasingly sophisticated trading in multiple markets and multiple currencies and other complex transactions, significantly raises the potential to obscure illegal activities and avoid timely detection. In an effort to move forward with the times, the integrity and trust in the regulation of the U.S. exchanges, which has contributed so greatly to their success, cannot be compromised.

Today it is necessary to ensure that investors are sufficiently informed and protected in a new global marketplace. Regulators have historically focused on protecting domestic investors. In a global economy regulators must take a broader view. For example, the U.S. regulatory regime is designed to protect retail investors while many foreign regulatory regimes focus largely on wholesale and institutional investors. Thus, the ability of the regulators to meet their mandates of protecting investors while ensuring vibrant capital markets cannot be secured in the same manner across borders.

The role exchanges play in economic development, capital formation, job creation, innovation, cannot be ignored and we have a national interest in ensuring their continued vitality.

It is noteworthy that as local stock markets grow more liquid and well-regulated, 90 percent of the world's countries chose to list in their primary markets. For example, in 2006 18 of the global top 20 IPOs went public on domestic exchanges. In this regard, U.S. markets remain competitive as the most liquid, transparent, and capitalized in the world with the deepest retail base and solid institutions that protect investors.

In 2006, the U.S. launched the highest number of IPOs, 187, in the world and U.S. companies raised $34.4 billion in capital, second only to Chinese firms.

The hearing today is an opportunity to evaluate the current situation and get a full picture of the implications of these actions on the future of exchanges, as well as market participants, investors and regulators alike.

I want to thank the witnesses beforehand for their presence and for their testimony.

At this juncture, I would like to recognize Senator Allard for any comments he might have.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. First of all, Mr. Chairman, I would like to congratulate you on starting this Committee hearing 1 minute before it was scheduled to start. Usually around here things start late and it is a rarity when you start a meeting on time. But to start it ahead of time, that is just unheard-of.

Chairman REED. I think it is a function of spending my youth standing at attention.

Senator ALLARD. West Point graduate here.

I also want to thank you, Mr. Chairman, for holding this hearing of the Security Subcommittee to examine cross-border exchange mergers.

Over recent years, I have seen tremendous shifts in the capital markets. For many years, U.S. markets were the only place for investors to go. Today the U.S. markets remain the deepest and most liquid in the world but we are facing more competition from foreign markets. Capital is more mobile than ever and hedge funds, mutual funds, pension funds, and other investors are looking at markets around the globe both to find opportunities and to diversify their investments.

In response, exchanges also begin to look abroad for opportunities. As a result, we have seen a number of cross-border exchange mergers. The New York Stock Exchange merger with Euronext will create the world's largest exchange network. NASDAQ is merging with OMX, Europe's fifth-largest exchange. And NASDAQ has shown interest in a merger with the London Stock Exchange. According to the exchanges, these mergers have the potential to offer wider products and services to investors, lower fees, and offer more global services.

While these services have the potential to offer a number of benefits to investors, they also present challenges to both the exchanges as well as the regulators. Issues like the convergence of accounting standards, audit standards, mutual recognition and enforcement will present some complex matters. In considering how to better promote U.S. competitiveness globally, it is important to maintain strong investor protection and to not disadvantage U.S. firms.

So I would like to thank all of our witnesses for being here today as we examine these matters. The witnesses have a great deal of expertise in these most complex issues, and I am certain that they will help the Subcommittee gain a better understanding of the causes and implications of the cross-border exchange mergers.

I do apologize in advance that I will not be able to stay here for the entire hearing but it is not because of a lack of interest. I am very, very interested in what is going on among the exchanges and

our security markets and future markets and obviously will look closely at your testimony and be following these issues very, very closely.

Again, I would like to thank all of our witnesses and thank you, Mr. Chairman, for bringing up this important topic on the securities markets.

Chairman REED. Thank you very much, Senator Allard.

Senator CRAPO.

STATEMENT OF SENATOR MIKE CRAPO

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

I do not have an opening statement to make other than to say that I appreciate your holding this hearing. I am very interested in not only the dynamics that we are going to be looking at here with regard to cross-border exchange mergers, but also just the competitiveness globally of the United States and capital markets in general and what we can learn with regard to what is happening or what we can help to develop in terms of making the United States and helping the United States continue to be the strongest market in the world

Chairman REED. Thank you Senator Crapo.

Now I would like to introduce the first panel prior to their testimony.

Mr. Erik Sirri is the Director of Market Regulation at the Securities and Exchange Commission. In this role he is responsible to the Commission for the administration of all matters relating to the regulation of stock and option exchanges, national securities associations, brokers, dealers, and clearing agencies.

He is currently on leave from Babson College where he is a Professor of Finance. From 1996 to 1999, Mr. Sirri served as the Chief Economist of the Securities and Exchange Commission.

Mr. Sirri received his BS in Astronomy from the California Institute of Technology, an MBA from the University of California, Irvine, and his Ph.D. in finance from the University of California, Los Angeles. We have had the privilege of Mr. Sirri's testimony before. Thank you again for joining us, very much.

Mr. Ethiopis Tafara is the Director of the Office of International Affairs of the Securities and Exchange Commission. In this capacity, Mr. Tafara advises the Commission and senior staff on international legal and policy issues and also represents the Commission with foreign policymakers, foreign regulators, and international institutions on issues relating to securities regulation.

Prior to joining the SEC, Mr. Tafara served in several capacities at the Commodities Futures Trading Commission, including counsel to Chairperson Born and Acting Chief Counsel in the Division of Enforcement.

In addition to extensive Government service, he was a lecturer at the European Business School in Brussels and a partner in P&T Consultants in Brussels. He began his legal career at the Brussels office of Cleary, Gottlieb, Steen & Hamilton.

Mr. Tafara received a JD from Georgetown University Law Center in 1989 and earned an AB from Princeton University in 1985.

Thank you very much for joining us Mr. Tafara.

Mr. Sirri, please begin.

STATEMENT OF ERIK SIRRI, DIRECTOR OF THE DIVISION OF MARKET REGULATION, SECURITIES AND EXCHANGE COMMISSION

Mr. SIRRI. Chairman Reed, Ranking Member Allard, and members of the Subcommittee, thank you for the invitation to testify today about the recent trend of cross-border mergers and their impact on the markets, on investors, and on regulation. These developments present both new challenges and opportunities for U.S. securities markets and the SEC.

As markets have evolved, innovations in technology have eliminated many of the physical barriers to market access, with the result that exchanges worldwide have pursued alliances and mergers in order to more effectively participate in the global exchange business.

For example, in February of this year the New York Stock Exchange Group and Euronext merged their business under a U.S. holding company, NYSE Euronext. In addition, NASDAQ acquired a substantial minority interest in the London Stock Exchange, and recently announced an agreement to buy the Nordic stock exchange operator OMX. Further, Eurex, the European derivatives exchange, has agreed to acquire the U.S.-based ISE.

I believe a number of factors have precipitated the recent trend of cross-border exchange combinations. In recent years, most of the U.S. exchanges have demutualized. As a result, many U.S. exchanges have had access to new sources of capital and the means to consider mergers that would expand their business globally.

In addition, the demand for global trading opportunities has grown as more and more investors, both large and small, have begun to look abroad for investment opportunities.

Today, for example, nearly two-thirds of all U.S. equity investors hold foreign equities through ownership of individual stock in foreign companies or ownership of international or global mutual funds.

And finally, developments in technology and reduced communication costs have driven markets to become largely electronic, with the result that geographic boundaries have become much less relevant. This, of course, has made it easier and less expensive for investors to conduct cross-border securities activities.

To date, the regulatory issues faced by the SEC regarding cross-border exchange mergers have been relatively modest as the proposed transactions involving U.S. exchanges preserve their separate operation under a holding company structure. With the NYSE/Euronext, for example, the NYSE Group and the Euronext markets continue to operate separate liquidity pools in their respective jurisdictions.

The creation of a single holding company for these markets, in and of itself, does not raise substantial U.S. regulatory issues. Over time, however, I expect the global exchange groups will seek to further integrate their markets, whether through a consolidation of technology platforms, the provision of trading screens in each others jurisdictions, or the linking of their liquidity pools.

Depending on the scope of this integration, a wide range of core U.S. regulatory issues could be implicated, including those sur-

rounding exchange regulation, broker-dealer registration and listed company registration.

Global exchange initiatives such as these may very well promote competition and the efficiency of cross-border capital flows and thus have the potential to benefit markets and investors in the U.S. and abroad.

The core of the SEC's mission is to protect as investors, maintain fair and orderly markets, efficient markets, and to facilitate capital formation. As we approach these difficult global regulatory issues, we must be vigilant that U.S. investors are not left open or vulnerable to an inadequate disclosure or oversight requirement that puts them at an inappropriate risk.

Unquestionably, however, there is more that we can do to reduce cost and frictions of obtaining foreign securities within the U.S. without jeopardizing the protection of U.S. investors. In fact, we hope to work cooperatively with foreign regulators to raise standards for investors in all of our markets.

As you may know, the SEC has begun exploring the merits of a mutual recognition approach to facilitate global market access. Just last month we hosted a Roundtable on Mutual Recognition, where distinguished representatives of U.S. and foreign exchanges, global and regional broker-dealers, retail and institutional investors, and others shared their views on the possibility of mutual recognition.

Although the details of a viable mutual recognition approach are still in the early stages of development, in essence it would permit foreign exchanges and broker-dealers to provide services and access to U.S. investors, subject to certain conditions, under an abbreviated registration system. This approach would depend on these entities being supervised in a foreign jurisdiction that provides substantially comparable oversight to that that is in the U.S.

Mutual recognition would consider what circumstances foreign exchanges could be permitted to place trading screens with U.S. broker-dealers in the U.S. without full registration. Mutual recognition would also consider under what circumstances could foreign broker-dealers that are subject to an applicable foreign jurisdiction's regulatory standards be permitted to have increased access to U.S. investors without the need for intermediation by a U.S. registered broker-dealer. While this approach could reduce frictions associated with cross-border access, it would not address the significantly greater custodial and settlement costs that are incurred today when trading in foreign markets.

Given that the key focus of our mission is to protect U.S. investors, maintain fair and orderly markets, maintain efficient markets, and to facilitate capital formation, these exemptions from registration would depend on whether the foreign exchange or the foreign broker-dealer are subject to comprehensive and effective regulation in their home jurisdictions. To make this determination, the SEC would need to undertake a detailed examination of the foreign jurisdiction's regulatory regime, consider whether it has adequately addressed issues such as investor protection, fair markets, fraud, manipulation, insider trading, registration qualification, trade surveillance, sales practice standards, financial responsibility standards, and dispute resolution.

Such a challenging undertaking would be necessary to fulfill our obligation to protect investors, maintain fair and orderly markets, and facilitate capital formation.

Other requirements or limitations could also be appropriate. For example, any exemptions permitting mutual recognition should be limited, at least to start, to trading foreign securities so as to address concerns about the impact of this approach on the U.S. market activities. Similarly, exemptions could be limited to trading with market professionals and certain large sophisticated investors who could be expected to more fully appreciate the significance of directly trading with foreign markets and intermediaries.

Finally, this approach could also require the home jurisdiction of the foreign exchange and the foreign broker-dealer to provide reciprocal treatment to U.S. exchanges and U.S. broker-dealers seeking to conduct business in that country.

At the direction of Chairman Cox the SEC staff is developing a proposal regarding mutual recognition for SEC consideration as early as this fall.

I am grateful for the opportunity to provide you with this overview of the recent trend of cross-border exchange mergers and other related regulatory issues and I look forward to answering your questions.

Thank you.

Chairman REED. Thank you very much, Mr. Sirri.

Mr. Tafara, your comments please?

STATEMENT OF ETHIOPIS TAFARA, DIRECTOR OF THE OFFICE OF INTERNATIONAL AFFAIRS, SECURITIES AND EXCHANGE COMMISSION

Mr. TAFARA. Chairman Reed, Ranking Member Allard, and distinguished members of the Subcommittee, thank you for inviting me to provide my personal views on the emerging regulatory issues in the world's globalizing securities markets.

It is, of course, no surprise to anyone that the world stock markets are becoming increasingly global in their operations and their outlook. I understand that today's hearing is being held partly as a result of the recent series of mergers of U.S. stock exchanges with foreign counterparts leading to the theoretical, if not currently actual, possibility of a truly global trading platform.

Yet exchange mergers are only one aspect of the globalization of our capital markets. Indeed, in some respects, recent and proposed mergers stock exchanges such as the New York Stock Exchange and Euronext are a response to much broader market changes brought about by increasingly mobile investors, issuers and investment firms.

Today, technology makes it possible for even a novice to execute a cross-border trade via computer terminal. Indeed, from a purely technological perspective, there often is no difference between conducting a transaction on a domestic or a foreign market.

While the traditional trading floor might require an actual human being to be physically present in New York or Chicago to execute an order, an electronic network can allow an order to be executed from a computer terminal placed pretty much anywhere

in the world. In short, like capital, exchanges have become entirely mobile.

By technological changes offer us only a partial picture of the vast changes that have occurred to our markets over the past several years. Following World War II, widespread prosperity returned to the United States and this prosperity led to a large number of average citizens having sufficient savings to invest directly in the stock markets.

Yet during this period, most Americans invested entirely or almost entirely in U.S. stocks that were traded on U.S. markets. Recent data clearly shows that American investors, retail and institutional alike, increasingly invest overseas. Just between 2001 and 2005, U.S. investor holdings of foreign securities of all types nearly doubled from $2.3 trillion to $4.16 trillion. U.S. investor ownership of foreign equities during this same period increased from $1.6 trillion to $2.3 trillion.

This is hardly just a U.S. phenomenon. Regulatory and technological changes have brought down cross-border barriers and allowed, or in some cases forced, exchanges to respond to the changing demands of investors and other market participants. This new global capital market presents both promises and challenges to the SEC's mandate to protect investors, ensure fair, orderly, and efficient markets, and facilitate capital formation. The promises include greater competition in the market for financial service providers to the benefit of investors and issuers alike, an opportunity for investors to diversify their portfolio risk across borders more effectively and at less cost, and the ability of issuers to seek the lowest cost of capital wherever it might be. Yet the potential challenges are significant.

For many years now the Commission has been aware that the growing globalization in the world's securities markets poses unique enforcement risks. Historically, pursuing securities law violators when evidence has been located abroad presents challenges. It has been even more challenging for the Commission to repatriate defrauded investor assets if those assets have been secreted in another jurisdiction.

In response to this challenge, the SEC has worked closely with its foreign counterparts to develop a series of bilateral and multilateral information sharing agreements to facilitate the investigation and prosecution of securities law violators operating across borders.

Likewise, issuers and market intermediaries operating in more than one jurisdiction may face unique costs in the form of different overlapping and sometimes even contradictory regulatory requirements.

In addition to the Commission's ongoing efforts in the area of convergence of accounting standards, this past month the Commission held a public roundtable to discuss mutual recognition of foreign jurisdictions with regulatory systems comparable to that in the United States.

I expect the Commission will continue to grapple with these types of complex cross-border regulatory issues and I appreciate the opportunity to present my views and observations on these topics and look forward to answering your questions. Thank you.

Chairman REED. Thank you very much, gentleman.

Mr. Sirri, both you and Chairman Cox have outlined both the opportunities and risks of this new globalized securities market. As a practical matter, as you look out, one of the major risks I think you've illuminated is of unethical practice, market manipulation, et cetera. What specific steps can you take even now, before formal arrangements with other regulators, to react to those potential problems?

Mr. SIRRI. What you are raising is a very important issue. I think within the context of what we are looking at, we believe that the jurisdictions that we are going to be interested in dealing with are jurisdictions that absolutely internalize the importance of fair and orderly markets of the protection of investors. So I do not think we entertain dealing with markets where issues like rampant market manipulation would be present.

If that was the case, I think we would have a great deal of trouble coming to any kind of comparability determination. So I think the main way we intend to deal with it is to only entertain discussions with markets that have very similar approaches and philosophies to ours, not just by—and I want emphasize—not just by philosophy but also by practice. It has to be a practical consequence that, in fact, they internalize the importance of anti-manipulation rules and procedures.

Chairman REED. Are you developing a work plan, if you will—because we anticipate that this is happening, the marketplace is integrating—to begin to systematically look at these markets and verify all the issues that you listed in some type of orderly way?

Mr. SIRRI. It is a good requirement because what you are essentially getting it, I think, is what is the process whereby the staff would come to a schema to let us go through and recognize regimes. I think we are really dealing with this in two parts. The first part is really an exercise in, if you will, drafting and rule writing where we are considering what would the exceptions look like, the exemptions for the exchanges, the exemptions for the broker-dealers. How would we actually craft those exemptions?

The second part, which I think you are alluding to, is what would the procedures, what would the process be that you go through? What would the steps you lay out and what would be the indicia of comparability? That is also something that we are hashing out right now.

This is going on at the staff level and there are active conversations within the staff. The Chairman has asked that we put together a task force of the staff that includes representatives from my division, the Division of Market Regulation, Ethiopis' Division at the Office of International Affairs, Division of Corporation Finance and the Division of Investment Management, so as to get a holistic view of the regime.

That task force is working together right now. It is at a formative stage, but to get exactly at the issue you raise.

Chairman REED. You are suggesting, and I think properly so, that you would like a very high bar in terms of what countries you would deal with directly and essentially welcome into the marketplace and vice versa. But could you anticipate pressure to lower the bar from American exchanges who want to trade in some countries

who seem to be a little less reliable from other Government agencies, like the State Department perhaps, inadvertently who want to facilitate all types of commercial transactions? And how would you respond to that?

Mr. SIRRI. I think you put your finger on something that is quite important. Yes, we do anticipate various kind of pressures, whether it is from brokers, from exchanges, from certain classes of investors, or from other branches of the Government that have their own concerns, I think a lot of people have dogs in this fight, if you will, and have their own interest that they follow.

So I think our best approach to handle this is to stick very closely to our mandate. We have a focus, capital formation, investor protection, fair and orderly markets. And that is what we, in fact, intend to focus on. I think especially the regimes that we intend to deal with early on are regimes that we feel have really strong comparability to our own regimes. I hope and I think that will help us find our way through.

I think the Chairman has also voiced publicly his sense that by following such a procedure he hopes to raise the level of overall securities regulation globally by holding up a high bar, as you suggest, that not only will we only admit and recognize such regimes, but that other regimes that are perhaps more marginal would, in fact, rise up to our standards. So I think that is one of the hopes of our chairman.

Chairman REED. Thank you.

Mr. Tafara, let me move to some specific concerns. Mr. Sirri said it, you said it in your testimony, on paper, the forms, the structures might exist. But the practice is what you really are concerned about. What factors would you consider, specific factors, in terms of evaluating the comparability of regimes?

Mr. TAFARA. That is one of the difficult issues we will have to grapple with. As Erik has noted and as you have noted, mutual recognition really amounts to reliance in several areas. There's reliance on foreign laws and rules, reliance on their implementation, reliance on supervision by foreign counterpart, reliance on examination by a foreign counterpart, and at some level reliance on the enforcement regime they have in place.

The comparability assessment with respect to rules will be relatively easy. The more difficult part will be determining whether or not you can rely on a counterpart's examination and supervision. And there you will be looking at the intensity of the supervision. Is it like the intensity and the supervision that is undertaken by the SEC? What sort of examination program is it? How broad is it? How frequently do they do it? There will be a number of factors of that sort that will have to be considered to determine to what extent you can actually rely on the supervision examination or enforcement that is conducted by a foreign counterpart.

Chairman REED. Let me ask both of you quickly, and this might require a long response which you might subsequently submit. But Professor Ferrell, in his testimony, suggests that besides formal structures, an analysis of the bid-ask spread and, as he describes, the information asymmetry component of the bid-ask spreads. Is that type of analysis something you would be prepared to do or would see as useful? Mr. Tafara and then Mr. Sirri.

Mr. TAFARA. Yes. How you determine the comparability of a regime, how you measure it, I think will require that you look at a number of factors. I think you're going to have to look at the manner in which they actually conduct supervision and examination. But there are other factors that you could look at that are quantitative that may give you an indication of that nature of the regime in question.

Looking at inputs as well as outputs, how many enforcement cases are brought in a given period of time. The bid-ask spread is something that I have heard Professor Ferrell refer to and certainly something that should be examined as a potential indicia of comparability.

I think we will be looking at all sorts of factors of that kind, quantitative as well as qualitative, in making that determination.

Chairman REED. Do you have a comment, quickly, Mr. Sirri?

Mr. SIRRI. Yes, I do. As you have noted, I have been an academic. I think I spent half my life calculating bid-ask spreads as an academic. So I have a reasonably good feel about what they do. I think it is a reasonable thing to do because, as Ethiopis said, it is a quantitative measure. It gets at how well information is coming into a financial market. And as Ethiopis said, I think it is one thing you look at. I think there is a question about how much you rely on it. But I think it is a very reasonable and sensible thing to do.

Chairman REED. Just a final point before I recognize Senator Crapo. I presume you are also looking at the real budget that these enforcement agencies have to work with because in many respects that really defines the effectiveness and enthusiasm of the regulators.

Mr. SIRRI. Absolutely. That is a great example. It is a key input. Without a budget, you cannot reasonably expect any type of monitoring or supervision.

Chairman REED. Senator Crapo.

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

I think I will direct my questions to both of you and I would invite you to both respond to this. Just to kind of set the stage for where I am trying to go here, I want to talk about what the impact of terms of listings will be if we do actually implement a mutual recognition system.

Here is where I am headed. It seems to me—well, during the last 7 months or so there have been three critical studies that have been published regarding the competitiveness of the United States in capital markets. All of them have indicated, as does the testimony of NASDAQ and NYSE here today in their written testimony, have indicated the U.S. leadership in capital markets is declining. There are various reasons attributed to that by different experts but everyone agrees, or at least seems to agree, that one part of the problem is the extensive regulatory burden that is faced by those who operate in the United States.

With that background, the question I have is if we—and by the way, I like the notion of mutual recognition and I think we need to be moving in these directions. But I think we may want to go beyond mutual recognition to perhaps a reform of the U.S. regulatory system overall. That is where I am headed with my question.

If we maintain our current regulatory system in the United States, which I believe is too cumbersome and burdensome, but then grant mutual recognition to other jurisdictions, say London or Hong Kong or Shanghai or whatever, and make it so that a person or an entity can list in another jurisdiction but gain access to U.S. markets, why wouldn't that increase the tendency for increased listings outside of the U.S.? Do you understand my question? Would it do that? And what are the consequences of that?

Mr. SIRRI. It is a great question and I think it has been cast in many ways, regulatory, arbitrage and others. You bring up—I think the general point is that if you can access U.S. capital markets more freely, then list overseas in a lighter regulatory regime, are we going to lose listings in that sense.

Senator CRAPO. Right.

Mr. SIRRI. I think that is one of the tensions that we feel here.

I would point out that today institutional investors have pretty broad access to capital markets globally. And so the procedure that we are talking about here is really one of reducing frictions. In the process of going through this page mutual recognition regime and considering it, we have talked to various market participants. For instance, I have asked questions of institutional investors. Today are our restrictions on say trading—the kind of things that are dealt with in the exchange proposal—are they such that you do not hold securities that you would otherwise hold if those screens came here? And the answer is uniformly no.

The reason is because large institutional investors either have trading offices overseas, they have well-developed correspondent relationships with internationally active brokers and such.

What we are really talking about here is reducing some of the costs and increasing the efficiency of access. I think it is less likely to be wholesale access to markets that they otherwise did not have. So I am hopeful that—the arbitrage principle, I think, is very important but I am hopeful that is not that forceful. But it is something that we are wary of and it is a tension we feel.

Senator CRAPO. Mr. Tafara.

Mr. TAFARA. With respect to this question of competitive, I always struggle with it. I do not know whether the U.S. market is less competitive. It is certainly facing greater competition. I think there are deep pools of capital around the world now. And in essence, issuers have choice, have a choice as to where they list.

Sometimes they make choices that have nothing to do with the lack of competitiveness of one market and have more to do with the fact that, for example, a Chinese company may list in Hong Kong because by virtual of proximity and language it gets better analyst coverage and decides it is the better place for it to list.

Indeed, as Erik has indicated, today what you find is that capital is quite mobile. So they do not have to list in the United States for U.S. capital to come and actually invest in that company. They will go to the Hong Market or wherever it is to purchase the securities.

Indeed it is a metric, listings is a metric that is used to determine competitiveness. I think it is one metric and I am not sure it is necessarily the best metric. You look at the 144A market in the United States, it is a very, very active, deep, and well functioning market and increasingly so. That may be an indicia of com-

petitiveness that favors the U.S. The cost of capital in the U.S. is still the lowest in the major capital markets. So there is several indicia you can look at with respect to competitiveness and, depending on which one you look at, you mean come to a different answer.

However, I do agree that one of the things we have to do is to make sure that our regulatory regime reflects the current markets and that is something that I think is an ongoing process which the Commission engages in and needs to engage in.

With respect to regulatory arbitrage, it is a major concern. The principle thing you worry about with a mutual recognition regime is are you allowing your system to be arbitraged? I think that is why it is very important that we look very carefully at the objective criteria that we develop for comparability. You have to determine whether or not you have come up with criteria that do not create an incentive for somebody to move offshore and yet have the same access to U.S. investors, as you have indicated.

That is what we are reflecting upon. It certainly is a major concern on the staff and I expect of the Commission.

Senator CRAPO. I thank both of you. I understand that other markets are now becoming more competitive and capital is becoming much more available globally. I think not too long ago if you wanted to raise $1 billion you pretty much had to do it in the United States. Now you can do it in a number of markets around the world. And so I understand that the competition that is growing and the loss of listings and IPOs and so forth is not all attributable to problems with our system.

I do believe though that there are reasons beyond simply the growth of other markets that are resulting in some of these difficulties and that we need to pay attention to it very closely. And I think that this issue of mutual recognition as we get further into it is going to highlight that need. I guess what I am saying is I think that we do need to look at the U.S. regulatory system.

There are other pieces of the problem, not just the regulatory system, but I think that we need to look at the U.S. regulatory system. So while at the same time we are evaluating other nations' regulatory systems to see if they are adequate, perhaps we need to take a look at our own to see if it is adequate and as effective as it could be.

Chairman REED. Thank you very much, Senator Crapo.

We have an opportunity now for a short second round which I would like to take advantage of.

We have been talking, and I think Senator Crapo has opened up a very useful line of questioning, about regulatory standards. I think Mr. Sirri and Mr. Tafara, you both suggested we want to keep the bar high. We raised the bar a bit recently with the Sarbanes-Oxley legislation.

Mr. Tafara, I think you have looked at some of the implications worldwide with the suggestion that many other, or at least several other, major exchanges and countries have started to adopt these because they feel they want to raise the bar, also. Can you comment on that trend?

Mr. TAFARA. Certainly. In the wake of Sarbanes-Oxley I spent a fair amount of time traveling the world explaining to people what was happening in the United States and, quite friendly, catching

a fair amount of grief. But then an interesting thing happened, the financial scandals that we had here replicated themselves elsewhere and jurisdictions started scrambling for solutions and realized that many of the solutions may have already been devised here in the United States.

So what you find now in many of the major jurisdictions, major markets, is that they have taken on board much of the same Sarbanes-Oxley reform that was instituted here in the United States. So you see PCAOBs being created in various jurisdictions, changes in auditor independence requirements, auditor rotation requirements, making sure that the audit committee is the one that is responsible for hiring and firing the outside auditor, making sure that the audit committee is comprised primarily or entirely of independent directors. So much of what we have done in the United States now is the law in major markets around the world.

Even Section 404, which has been the subject of some controversy in the United States, the idea of 404 has actually been taken on board in most jurisdictions where there is an expectation that there be a report that is issued by a company with regard to internal controls. And even in some jurisdictions they have gone as far as to do what we have done here, which is to require that there be an auditing component to it as well.

It is a phenomenon that has spread by virtual of financial scandals being not just simply a U.S. event, but scandals that have replicated themselves elsewhere.

Chairman REED. Thank you very much.

Mr. Sirri, Ms. Culhane in her testimony, states that the growth of internationalization and dark pools are cause for concern as they undermine the transparency that is a hallmark of our markets and limit access by public investors to these investment opportunities.

Do you share this view as a concern?

Mr. SIRRI. Let me answer that question in two ways. First, we are very aware obviously of dark pools. It is an interesting name and an unfortunate meant in some ways.

Chairman REED. It makes me think of a Steven Lucas name.

Mr. SIRRI. Most of these are crafted as alternative trading systems so there is a regulation within the SEC that provides for such systems.

We have taken a view toward our markets that is very different than many of the views that are taken globally. We have taken a view that says rather than having one or two central exchanges, we have allowed various market venues to exist. And that has come with a number of benefits.

I think we see very low trading costs here. We see a lot of innovation in our markets. So we do have a couple of very traditionally large markets but we also have a smaller regional set of markets and we now have, as you point out, up to 30 alternative trading systems that are in existence, in some ways more.

I think there are benefits with these and there are some things that we, as a regulator, have to watch for. The benefits, as I have suggested, are technology, lower tradings costs, and innovation.

The things that we watch for actually are related to issues like manipulation. Are these pools really dark? Is there activity going on with these pools that we need to be concerned about? We have

been monitoring these. I have personally been traveling around to various sponsors of these pools. We have not seen problems yet but we are watching for them.

I also want to point out that by structure these pools are limited in size. If a pool gets to be more than 5 percent of the trading volume, additional transparency requirements devolve around these pools. So today, overall volume of these pools is roughly about 15 percent of volume. Were that to climb significantly higher, we might have other concerns. But today they remain fairly limited.

Chairman REED. Thank you. I think, for the record, too it is George Lucas and not Steven Lucas in Star Wars. My movie trivia has to be sacred and accurate.

A final question. One of the complaints that you hear and I hear, and it goes I think to Senator Crapo's concern about the actual effect of regulation, is the long period for the approval of rule filings and rule changes for new products in the various—through the SEC.

Can you comment on that in terms of the validity of the criticism? And also, is that one of the things that I think Senator Crapo is suggesting that we can really reform our own procedures not so much by changing dramatically the rules but by more quickly working on delivering products?

Mr. SIRRI. It is a fair question to ask. SRO rules have to be filed with the Commission and the Commission has to approve them. There are a number of tracks whereby that happens. I want to point out this is a statutory provision, so the statute requires this process.

But there are a number of channels through which rules can go. Today over half of our rules, over half of our rule filings are effective upon filing, so-called B3a filings. Which means the minute that they drop down upon us they become effective.

We have also been working as a staff to increase the speed through which rule filings flow. So we are very cognizant of this and we work as best we can with the SROs.

But the point you raise is a valid one. Around the world many, many, in fact most exchanges, do not have the same kind of rule filing requirements that are placed in our statute. We are cognizant of that. Quite frankly, as these exchanges come in, the pressure will be greater and we will have to pay increased attention to the streamlining and the efficiency of our rule filing process.

This it something I know I have had conversations with our Chairman with. I think he is very focused on it, and he is very sensitive to it. I think we, as a staff, are as well.

Chairman REED. Thank you very much, gentlemen. Senator Crapo.

Senator CRAPO. Thank you very much. I want to just follow up in one area briefly.

In 1990 the SEC adopted Rule 144A, which has already been referenced here. As you know, that rule allows the sale of unregistered securities to qualified institutional buyers.

The growth in capital formation with a 144A component has been dramatic. By the statistics I have here it has increased more than threefold since 2002 to $1.5 trillion globally. 2006 was the first year that global equity capital formation with a 144A tranche exceeded

the global equity capital formation on NASDAQ, NYSE, and AMEX combined.

The question I have is a number of people have indicated that this raises a cause for concern in terms of whether, by this growth of being able to access U.S. capital without registering in the United States, is resulting in basically an ability to get past the regulatory system of the United States and is, as we talked about before, driving listings elsewhere.

Do you agree with that? Or what do you attribute the phenomenal growth of the use of 144A markets?

Mr. SIRRI. The 144A markets are a very important portion of our capital market. Traditionally it is a fixed income segment of our market. It is a safe harbor. What it embodies is the recognition by the Commission that there are segments of our capital markets that do not require the full protection of U.S. securities laws. That is QIBs, the qualified institutional buyers, folks who have more than $100 million under management, such people are competent and comfortable acquiring securities, purchasing them, and reselling those securities without the full protection of U.S. securities laws. The fixed income markets have functioned very well with these for some period of time.

So I want to make two comments with respect to that. Even within this narrow branch there are markets within the fixed income where folks who have offered securities this way will, in fact, after the fact register those securities, fixed-income securities. So it is not just a—it is an important conduit. But registration even within the fixed income domain has a place and adds value to these securities.

You are bringing up a point within the equity markets and I think it is just a recognition of that same class of investors that say that we are comfortable buying outside the protection of the U.S. securities laws.

I think you are setting off a valid distinction. You are setting off a distinction between the 144A markets here and the listed markets here, which I think is a fair comparison to make.

Another one I think that is reasonable to look at is the 144A markets here and the foreign listing markets, where of course there would be no regulation at all. I think the development of the 144A markets here really should be viewed in juxtaposition to the foreign listing or release overseas. In that sense, those same institutional buyers would have had no trouble buying overseas because for reasons that we discussed earlier. They do trade globally today anyway.

Senator CRAPO. Mr. Tafara, did you want to add anything?

Mr. TAFARA. The only thing I was going to add is what Erik said at very end, in that in many was you should look at the 144A market as a market whereby you have brought the transactions onshore. They could have transpired elsewhere.

Indeed, there would have been no difficulty for these qualified institutional buyers to buy the securities on the foreign market. This actually is a way to bring the transactions onshore. In that respect, it may actually be a positive development.

Senator CRAPO. Do you have any idea as to why the explosive growth has taken place in the 144A market?

Mr. SIRRI. On the equity side of that market?

Senator CRAPO. Yes.

Mr. SIRRI. I do not really know, for certain, but there has been increased interest in that market. We have seen various systems that are requests for systems. The NASDAQ has come with us to a PORTAL system that asks for the resale of those securities. Goldman Sachs has a GSTRue, a single broker system, that provides for liquidity in that market.

I think it is just a mark of the sophistication of our capital markets. That is there is more innovation in these markets.

Systems like PORTAL were old systems. They were systems that were developed a long time ago and basically went on the shelf because there was not that much interest. But as you quite correctly point out, interest has revived. I am not sure of the exact reason for it. And I cannot even say whether it will persist.

Senator CRAPO. Mr. Tafara.

All right. Thank you, Mr. Chairman.

Chairman REED. Thank you very much, Senator Crapo.

Thank you gentleman. And if there are additional questions from my colleagues, I would hope we would get them to you in a very, very quick order and you would respond appropriately.

Thank you for your excellent testimony.

Let me ask the next panel to come forward, please.

Let me now introduce the second panel.

Ms. Noreen Culhane is the Executive Vice President of the Global Corporate Client Group at New York Stock Exchange Euronext. In this role she is responsible for the Exchange's worldwide efforts to attract new listings and to serve listed companies. Ms. Culhane manages business development, client service, marketing and sales support function, the initial public offering process, and structured products for the Exchange's listings business worldwide.

Before joining the New York Stock Exchange, Ms. Culhane spent said 20 years at IBM. Ms. Culhane serves on the management committee for the New York Stock Exchange.

She holds a graduate degree in education from the College of New Rochelle and completed the Advanced Management program at Harvard University.

Ms. Adena Friedman is the Executive Vice President of Corporate Strategy at NASDAQ Stock Market. Her responsibilities include identifying and developing strategic opportunities for the world's largest electronic stock market and overseeing its data products business unit.

Ms. Friedman joined NASDAQ in 1993. She previously served as Senior Vice President and Executive Vice President of NASDAQ Data Products prior to her current role.

Mr. Allen Ferrell is the Greenfield Professor of Securities Law at Harvard Law School and former John M. Olin Research Professor in Law, Economics and Business. He additionally serves as the academic expert on shareholder rights on the Committee on Capital Markets Regulation and as a member of the Board of Economic Advisers to NASD.

Professor Ferrell holds a BA and an MA from Brown University, a very fine school, a law degree from Harvard Law School, almost

good, and a PhD in economics from Massachusetts Institute of Technology. I am parochially minded. Brown is a great place.

Mr. Damon Silvers is the Associate General Counsel for the AFL–CIO where his responsibilities include corporate governance, pension and general business law.

Mr. Silvers is a member of the PCAOB's Standing Advisory Group, the Financial Accounting Standards Board User Advisory Council, the American Academy of Arts and Sciences Corporate Governance Task Force, and the New York Stock Exchange Stock Options Voting Task Force.

Prior to working for the AFL–CIO, Mr. Silvers was a law clerk at the Delaware Court of Chancellery for Chancellor Wayne T. Allen and Vice-Chancellor Bernard Balick.

Mr. Silvers received his JD and MBA from Harvard University.

I thank you all. Your statements are included in the record. Please take 5 minutes to summarize your comments and make any comments you would like.

Ms. Culhane.

STATEMENT OF NOREEN CULHANE, EXECUTIVE VICE PRESIDENT OF THE GLOBAL CORPORATE CLIENT GROUP, NYSE EURONEXT

Ms. CULHANE. Mr. Chairman and members of the Subcommittee, I am Noreen Culhane, Executive Vice President of NYSE Euronext. Thank you for inviting me here to testify. We greatly appreciate your leadership in holding this hearing.

Just 16 months ago, the NYSE was a member-owned not-for-profit exchange focused solely on NYSE listed stocks. Today, NYSE Euronext is a multiproduct global company with a market cap of $21 billion. We serve as a good proxy to demonstrate the three themes that are driving exchange transformation, demutualization to gain access to capital and a currency for acquisitions, diversification to enter new asset classes with better economics such as derivatives, and globalization to address investors' desire to diversify portfolios, tap into non-domestic markets, trade across time zones and hedge risk.

This transformation of the exchange business is producing significant benefits for investors, issuers, shareholders alike. But some trends, such as the growth of off-exchange trading are cause for concern.

In NYSE securities, off-exchange trading increased from 13 percent in January 2005 to 20 percent of share volume in May 2007. As participants in the markets take their order flow off-exchange, and particularly when they internalize by trading between customer orders in their own accounts, they compromise the integrity of the price discovery process by not exposing their order flow to the broader market. This disadvantages investors, especially small investors, who may not get the best price.

Another concern is the decline in the U.S. share of global IPO business. Last year for the first time Hong Kong and London each raised more in IPO proceeds than the New York Stock Exchange. Factors include the costs and benefits associated with Sarbanes-Oxley. We are misaligned. But recently the SEC and PCAOB ac-

tions will address this, only if the audit firms internalize the guidance that regulators have issued.

Second is the cost associated with reconciliation to U.S. GAAP, which the SEC is successfully addressing by promoting the recognition of IFRS.

Third is the cost of litigation in the U.S., in particular class-action lawsuits. Financial centers outside the U.S. simply are not similarly burdened. The need for litigation reform is clear and compelling.

At the same time we are addressing these challenges, the viability of alternatives available to non-U.S. companies in the form of more liquid and well-governed home markets, as well as increasingly vibrant private placement market in the U.S., has made U.S. listings less critical to successful capital raising. The amount of capital raised by foreign issuers with a 144A component grew from $57 billion in 2004 to over $137 billion in 2006, more than double what was raised in U.S. registered offerings.

This trend away from public markets undermines transparency, sidesteps corporate government protections, and limits access by retail investors to investment opportunities.

But there is also good news. Under Chairman Cox's leadership, the SEC has taken a forward-looking and global view of capital markets. As a result, we have seen promising beginnings of a dialog between U.S. and European regulators. The SEC has made a bold move in promoting the concept of mutual recognition, to allow U.S. investors to trade securities listed on foreign exchanges without requiring these securities or the exchanges themselves to be registered with the SEC. This would permit more efficient trading among markets, expand the availability of capital, promote transparency and increase opportunities for market participants on a global scale.

It is important that the College of Regulators be included at the outset, as it comprises regulatory authorities from a number of countries, including the UK's FSA. There would be significant competitive consequences of a decision by the SEC to take a country by country approach.

It is also important mutual recognition be accomplished in a way that permits U.S. public investors access to the global markets. Appreciating that some limits have to be imposed, we recommend limiting the nature of the securities that can be traded to well-known seasoned issuers and diversified funds such as ETFs, rather than limiting access to only institutions or wealthy investors.

Last, in today's rapidly evolving global marketplace, our ability to innovate and compete is hindered by the lengthy review process at all SRO rules must undergo. Foreign competitors as well as U.S. futures exchanges and other markets that compete with our stock exchanges are not subject as such procedural hurdles. We are working to modernize the specialist role, to provide new market data products to Internet providers and others, to facilitate the listing and training of new ETFs and exchange-traded investment products, along with many other initiatives to make our markets stronger, more liquid, and more competitive. Whether we succeed is largely dependant on the efficiency of a regulatory review process over which we have little control.

Thank you for giving me the opportunity to speak today. I look forward to answering your questions.

Chairman REED. Thank you very much. Ms. Friedman.

STATEMENT OF ADENA FRIEDMAN, EXECUTIVE VICE PRESIDENT OF CORPORATE STRATEGY, NASDAQ STOCK MARKET

Ms. FRIEDMAN. Good morning, Chairman Reed, Senator Crapo, and distinguished members of the Subcommittee on Securities. I am Adena Friedman, NASDAQ's Executive Vice President of Global Strategy and Data Products, and I appreciate the opportunity to testify before the Subcommittee at this moment of extraordinary transformational change in the world markets.

We have entered a new era in which it no longer makes sense to think in terms of multiple trading platforms. Global market consolidation is both inevitable and ultimately desirable for investors worldwide. Major markets are publicly owned, increasingly transparent, highly competitive, and keenly attuned to customer needs. In this environment, the benefits to customers offered by consolidation gain a new urgency and importance.

NASDAQ welcomes the inevitability of global exchange consolidation and we have been a leading player in the process. We are well positioned and prepared to compete across the globe. We have the world's fastest, most transparent, most reliable technology.

The stock exchange of the 21st century is an electronic data network, and like any network gains greater efficiencies through expanded scale and scope. Let me cite a specific example of how consolidation can provide greater efficiency, lower costs and better trades.

Almost 2 months ago, in a $3.7 billion transaction, NASDAQ and OMX, a major European exchange based in Stockholm, announced that we would combine to create the world's broadest exchange and premier technology provider with 4,000 listed companies from 39 countries reflecting an aggregate market cap of $5.5 trillion.

With this merger we can offer brokers and traders the ability to connect with exchanges around the world through technology that can handle stocks, bonds, derivatives, and other trading instruments. Issuers will receive enhanced services, market participants will benefit from better streamlined technology, and investors will have a broader menu of services from the OMX Group.

American markets are in a strong competitive position. We must also realize, however, the global economic environment is changing in ways that challenge traditional assumptions. The United States still represents the largest pool of equity capital in the world. In fact, last year the U.S. lead the world in IPOs, with over 187 offerings. But maturing markets are rapidly catching up and becoming viable alternatives to the United States. Notably, last year 22 of the top 25 IPOs chose to list outside the U.S. In this highly competitive, unforgiving international environment, no country can afford unilateral self-imposed handicaps.

Despite all of our business planning, our technology and innovative product offerings, I can tell you from personal experience that there is no certainty that the NASDAQ or other U.S. exchanges will be successful in maintaining their leadership position in the world economy.

In my discussions with overseas exchanges, I constantly encounter questions about the risks and costs associated with U.S. regulation, a factor that has played prominently in the much studied movement of IPOs abroad.

We also get difficult questions about the perceived unpredictability and uncertainty associated with future U.S. regulatory policy that impede our ability to compete for investors against global competitors whose business initiatives do not face this array of regulatory impediments and inertia.

Mr. Chairman, an important factor in the ability of U.S. exchanges to compete effectively and find partners in the process of consolidation will be the ability of Congress to continue to support the investor protections so important to our capital markets while rooting out the kind of overregulation that can handicap the continued evolution and growth of the U.S. capital markets as they compete.

Senator Schumer has been particularly helpful in this regard, commencing a study with Mayor Bloomberg to examine ways for the U.S. to remain competitive and we appreciate his leadership.

I would like to offer the Committee the falling specific recommendations designed to address these issues. They include first, Congressional reaffirmation that U.S. laws apply solely within the United States.

Second, regulatory certainty for exchanges, including the notion that there will not be differential regulatory standards for U.S. exchanges and foreign exchanges operating in this country.

Third, recognition that the modernization of our regulatory system is critical as companies and investors are increasingly choosing to seek and commit capital outside the United States.

And fourth, serious consideration of a principles-based environment of regulation that will enable exchanges to act quickly and decisively to meet domestic and global competitive pressures without diminishing investor confidence in the capital markets.

I appreciate the opportunity to testify before the Subcommittee on these important issues. Thank you.

Chairman REED. Thank you very much. Professor Ferrell.

STATEMENT OF ALLEN FERRELL, GREENFIELD PROFESSOR OF SECURITIES LAW, HARVARD LAW SCHOOL

Mr. FERRELL. Mr. Chairman, distinguished members of the Committee, it is a great pleasure and a privilege to justify here today. So thank you.

When I was thinking about this topic, the topic of cross-border mergers, it occurred to me there is many gateways into the topic. The gateway I would like to talk about or begin with is an event that happened in 1993. That was the first demutualization of a stock exchange, the Stockholm Stock Exchange, where it went from being a membership-owned organization to an organization that was-for profit and publicly traded. Indeed, the Stockholm Stock Exchange listed on itself.

After that event, the floodgates were opened and many exchanges demutualized in the following years. The Helsinki Exchange in 1995, Copenhagen in 1996, Amsterdam in 1997, Australia in 1998, Hong Kong in 2000, of course the New York Stock

Exchange, NASDAQ and many, many other exchanges likewise demutualized.

I think an important question is why did these exchanges demutualize? What implications does that have for regulatory policy? And how does that connect up with cross-border exchanges?

I think the reason why we see demutualization, again beginning in 1993, is just the intense competitive environment that was created by the reduction in computing and telecommunication costs, which made it much easier to set up competing execution facilities and made it much easier to route orders around the world. That forced exchanges to move to a more competitive organizational structure.

Demutualization enabled exchanges to have more efficient decisionmaking process. It was a way—demutualization, in many cases, was a way of buying out vested interests, members that had a vested interest in old technology and old trading systems, to buy them out, to transfer ownership to a new set of owners that would be more willing to adopt competitive trading systems. Often, but not always, that meant electronic trading systems.

Finally, demutualization enabled exchanges to more easily engage in mergers because now there was a currency with which you could merge. That is the shares with ownership rights. So demutualization is a function largely of competition but that also created a new set of possibilities for exchanges, including electronic trading and increased cross-border mergers.

I think what the regulatory issues that the SEC and regulators around the world face as a result of demutualization, as a result of electronic trading being adopted, and finally cross-border mergers are several. First is regulatory arbitrage. Are you going to have the proper incentives as an exchange to set your regulatory budget if you are facing fierce competition for listings and trading against other trading venues? Do you, as an exchange, have proper incentives to regulate oneself, particularly with respect to listing standards, when you list on your own exchange?

And a perennial issue in the United States is an exchange that has self-regulatory obligations. Are there going to be proper incentives to regulate competitors if your self-regulatory obligations require you to regulate non-members in trades that occur on the exchange?

And so those are the regulatory issues that I think this raises.

I am going to end my remarks by making a few observations on mutual recognition, which is a direct outgrowth of the rise of cross-border trading, the adoption of electronic trading so geographical location is less important, and these cross-border mergers.

I would modestly offer three observations that I think should inform the SEC's approach in deciding whether a foreign regulatory regime is comparable to the U.S. regulatory regime.

First is a lot of focus has been, and rightfully so, on looking at the regulations and statutes of the foreign regime and seeing whether they provide for investor protection comparable to the U.S. I also think it would be very important, complementing that analysis, is to look at how well do those capital markets actually work in these foreign jurisdictions? Financial economists, the World Bank, and many other organizations have spent a lot of time put-

ting together financial data that provide indicia of how well those markets are working. Part of that is the bid-ask spread but there is many other outcome measures that one could use as well.

That also has the benefit of moving away from qualitative judgments to more quantitative.

A second observation I would quickly make is the fact that foreign jurisdictions may face different regulatory problems in the United States and that might call for a different appropriate regulatory response.

And then finally, mutual recognition is not an all or nothing proposition.

With that, I will end my testimony and thank you again for having me.

Chairman REED. Thank you very much. Mr. Silvers, please.

STATEMENT OF DAMON SILVERS, ASSOCIATE GENERAL COUNSEL, AFL–CIO

Mr. SILVERS. Good morning, Chairman Reed. Thank you for the opportunity. And Senator Crapo, thank you for the opportunity to be here.

We are going through a period of dramatic change in the very nature of our capital markets. 10 years ago the New York Stock Exchange could be actually described as a place where securities are traded, a place located in New York City, USA.

Today while that building still exists, the New York Stock Exchange is many other things, a brand, a component of an international holding company, a network of trading software, and the building is less and less important. Rather like the role of the original Disneyland in the Disney Corporation.

Thus we live in an age of convergence, convergence in accounting systems and potentially of securities regulation across national borders, what we are talking about when we talk about mutual recognition.

In this context, policymakers in the United States need to consider the following three national interests that we have, permanent national interests, as the process of globalization moves forward in our capital markets.

First, we have an interest in ensuring that our Nation's capital markets and the global capital markets direct resources to sustain wealth generating activity in the U.S. economy.

Second, we have a profound interest in strong investor protections for Americans who invest their savings and their hopes in the global capital markets.

And third, we have an interest, and a very strong one, in maintaining and growing capital markets activity, actually human beings doing things, in New York and the other financial centers of the United States.

The labor movement worldwide, including the AFL–CIO, is concerned that our increasingly global capital markets are having difficulties providing financing with time horizons appropriate to the needs of operating businesses. In Europe the labor movement labels these trends in a negative fashion as "financialization." I have attached to my written testimony a lengthy speech by the leader of the European labor movement on this subject.

A powerful way to conceptualize this concern is to consider the fact that in 2006 there was approximately $2.4 billion invested through capital markets and alternative energy technology venture capital. That sounds like a big number until you consider that the video game industry generated $7.6 billion in revenue.

Overall our accounting and disclosure systems, our corporate governance system, and our tax regime all need to be oriented toward encouraging our markets to produce sustainable long-term value in the real global economy. This has been the consistent theme motivating the labor movement's advocacy of improved corporate governance, accounting and auditing systems, our support for giving long-term investors voice on corporate boards, our concern about leveraged finance and short-term strategies pursued by hedge funds and LBO firms, and our concerns about the universal adoption of mark-to-market accounting that may undermine the unity of operating businesses to accurately disclose their results.

However, we have heard recently that these issues that I just described are not the real national interest of the United States. We have heard recently that the real problem that our markets face is that we protect investors too much. We hear this message primarily from people and institutions who desire to have weak global standards. Make no mistake about it, when you talk about mutual recognition you talk about a process by which genuine global standards are going to begin to be set. These folks either want weak global standards or want to have access to our high-quality markets without complying with our investor protections.

Currently, as has been remarked already today, our markets provide a higher multiple for corporate earnings, earnings that have been certified essentially by our strong regulatory structure than other markets worldwide.

Now there are issuers that it simply cannot meet our standards and do not list here, and others that for noneconomic issues are simply unwilling to do so. But the vast majority of issuers globally are economically ration and will raise capital in those marketplaces and regulatory structures where the cost of capital is lowest. And I think the recent data on IPOs that the Chairman raised will bear that out.

Now there is another dimension, in addition to investor confidence and strong investor protections, that define our competitiveness. One that is important today and will become much more important as we move toward a single unified global capital market. The future of New York and other major cities as financial centers really does depend not just on regulation and market structure at the public policy level. It depends on the strength of those cities and those areas of economic activity in terms of their educational institutions, the sophistication of their telecommunications infrastructure, and the efficiency of their transportation systems. Substandard public education, traffic and airport gridlock, and outdated telecom systems are the real long-term enemies of American competitiveness in the capital markets.

Let me end by quoting something that has been relatively well-publicized recently that I think defines that threat. In 2006, 25 individuals who managed hedge funds in the United States made three times in personal income what the entire 80,000 people who

teach in the New York City schools that train the majority of the people who work in our capital markets. And yet those people, those 25 individuals, paid a lower marginal tax rate than those school teachers did.

If we are not prepared to invest in education for the average American or to pay the taxes necessary to fund our infrastructure and stabilize our Government finances, we will undermine the very foundations of our capital market competitiveness just when those conditions will become more and more important in a truly globalized market.

Let me conclude and thank you for the—the AFL–CIO would like to thank you for the opportunity to consider this very important subject of the future of our markets, the importance of investor protections, and the linkage of these issues to the overall health of our economy and our society.

Thank you.

Chairman REED. Thank you very much, Mr. Silvers.

Senator Crapo, your questions, please?

Senator CRAPO. Thank you very much, Mr. Chairman. I have to leave in just a few minutes and so I apologize. I appreciate you letting me start out here.

Because I have to leave so quickly, I just want to ask one question and I want to just ask Ms. Culhane and Ms. Friedman to respond because I will not have more time than that. Mr. Ferrell and Mr. Silvers, if you would like to respond, I would just like to get a written response from you.

The question I have goes back to the issue I was talking about in my other questions of the previous panel. Namely, is our regulatory system in the United States correctly positioned or do we need to evaluate our own system as we look at other systems?

Really what I am getting at with this question is I am very interested in the way that the United Kingdom or Japan have gone to a single regulator, which is more principles-based. And it seems to me that we could make significant progress in the United States in continuing to have strong customer and investor protection and strengthening our market integrity and achieving effective regulatory compliance but still move toward a more principles-based regulatory system.

I just would be interested in your comments on that.

Ms. FRIEDMAN. Thank you, Senator.

We agree with that in general. I think that it is very important that we do not ignore the fact that the foundation of the American markets has been based on a retail investor and we do have to make sure that we are very cognizant of the need to protect those investors. Whereas if you look in Europe, in particular, it has been more—the foundation is more on the institutional investor.

So looking at a principles-based approach has to be very carefully measured against the need to make sure that our investor protections are well in place. But we do believe that there is a more efficient way for the capital markets to be able to continue to innovate, provide product to those retail investors without the need to file every single rule with the SEC.

And we do believe that a principles-based approach, and we have been much more exposed to that in our conversations in Europe

and elsewhere, provides a foundation where the exchanges can have principles that they have to live by but you will still have the flexibility to act on smaller things in providing new product without the need for a lengthy review process by the SEC.

We do support that and hope that we consider that for the future of our markets.

Ms. CULHANE. Senator Crapo, thank you for the question. I would echo much of what Adena has just said.

I will say that I do not think this is either/or type of a question. I think there is room for a middle ground here. You suggested earlier perhaps a review of the entire revelatory process. We have an excellent regulatory process in the U.S. capital markets. It is part of what has made us so strong. Focus on the individual investor is critically important. That is the heart and soul of our country.

Nonetheless, we find ourselves in a competitive global environment and we need to continue to review—all of us, every single component of financial securities and securities industry marketplace—to ensure we really are doing right by investors and also remaining competitive on a global stage.

Like Adena, we have had lots of opportunity to interact with our colleagues in Europe. And it has been very interesting as we have gone through merger meetings and training sessions to learn that their relationship with their regulators is a little different. And I mean it in this way: it is a much more collaborative, we are in this together, sort of a mentality and approach.

What I am learning is that they begin at an early stage in the development of rules and processes to have a lot of collaborative discussion, and in the end reach common ground on what is really in the best interest of the communities they serve, to the same communities that we serve.

So we applaud much of what Chairman Cox has undertaken in the review, for example, of Sarbanes-Oxley, in the move to recognize IFRS, in this move to have mutual recognition with other markets. We applaud all of that. We want to be as helpful in that process as we can.

I do think that our eye on the competitive stage is critical as we move forward here.

Senator CRAPO. Thank you very much.

Chairman REED. Thank you very much, Senator Crapo.

I want to thank all of the panelists for excellent testimony and I wanted to just continue the line of questioning. If Professor Ferrell and Mr. Silvers have a comment on Senator Crapo's question, we could get it in the record now. If you do not, then that is fine also.

Mr. FERRELL. In terms of the general issue of competitiveness in the world market, I think we are in a position of strength. But I do think there are specific issues that do need to be addressed. I think some of those have been addressed by the SEC recently, making it easier for firms to deregister, which makes it more likely that they would be willing to come in. Recognizing IFRS I think is a positive step. I do think there are still issues even with the recent reforms in terms of 404 costs for small firms. I think that is an issue that needs attention.

That is not really an issue that goes to our competitiveness in terms of listing because small and medium firms in foreign countries are unlikely to list. But it is still an issue of ensuring a low cost of capital.

I guess one other issue that often comes up when you talk—that I have heard from foreign firms when I talk to them about their listing decisions in my academic research is the concern that if they trade 3 or 4 percent of their market cap in the United States, if 3 or 4 percent of their shares trade in the United States, they can be sued in District Court in a securities class action suit for 100 percent of their shares. So I think there is a mismatch there, in terms of liability and the percentage of shares that are traded that creates competitiveness problems in the listing arena.

With that, I will end.

Chairman REED. Mr. Silvers, any comments?

Mr. SILVERS. Thank you, Senator Reed.

I think that you see in this discussion the movement of a dialogue which at one level is about a series of very discrete items, for example the question of whether foreign issuers ought to be allowed to delist, a rather straightforward and practical problems in certain ways. A discussion like that quickly shifts to a very broad discussion about whether we ought to consolidate our regulatory structures or whether we ought to move from what is allegedly a rules-based system to what would allegedly be a principles-based system.

I think that most investors in the United States, whether individuals or institutions, are open and constantly open to revisiting on a practical level those aspects of our regulatory system that become either outdated or need to be rethought.

However, those two big ideas are deeply problematic from an investor and public interest perspective, and let me explain briefly why. First, our regulatory structure in the financial markets involves two very distinct types of regulation. One, in our banking system, is a system of regulation fundamentally designed around an insured deposit system where the goal is essentially safety and soundness with very intrusive bank regulation that watches the operations and the financials of the insured banks on the kind of—in a substantive way.

Our securities regulation is a disclosure-based regime in which risk and loss are just part of a game and where there are thousands and thousands of market actors. Many, many more regulated entities than there are in the banking system.

These two systems cannot be smushed together and achieve either system's goals, in our opinion.

Second, the principles versus rules debate is kind of, in our view, a non-debate. Any system that works at all has to have both principles and rules. If it does not have principles, the rules are easily gamed by smart people. If it does not have rules, market actors cannot figure out exactly what they need to do, how they can be sure that they are acting in a manner that is actually consistent with law and regulation.

A move toward an all principle system is a move that, in fact, the business community and the market-making community does not want. They say they want it. They do not want it. The reason

why they do not want it is because a genuine principles-based system, genuinely enforced, would mean that you would always be second guessed. Anything you did as a market actor could be looked at in the light of the principles and found to be a violation of the law. Nobody actually wants to live by that system.

People who are advocating weaker investor protections in this country use the notion of a principles-based system as a code word for deregulation which again is essentially an attack on the fundamental foundations of what makes our marketplace superior. Our marketplace is superior because we have real investor protections that are truly enforced by competent and well resourced regulators.

People bring their money to this country and are prepared to accept a lower multiple on corporate earnings because they have confidence that their earnings are real, the numbers are real, their money is really somewhere where they can get it back.

Attacking those things, whether you attack them directly or through code words, is a profoundly risky and dangerous thing to do.

Chairman REED. Ms. Culhane and Ms. Friedman, we have talked and the previous panel talked about the pressures because of this new globalized market and pressures that you feel every day. One of the areas where you have to be active is the standards for listing on your exchanges. I am sure you are seeing already other companies coming to you that do not quite meet your listing standards but they can go over to other markets.

How practically do you deal with that downward pressure on standards? The issue I talked with Mr. Sirri about how do you keep the bar high? Ms. Culhane and Ms. Friedman, both of you, please.

Ms. CULHANE. Thank you.

Our standards are, as you know Mr. Chairman, they are filed with the SEC, they are disclosed and they are strictly adhered to. They are bright line tests. So there is not a lot of discussion or what I would call ability on our part to, in any way, shape them differently from what they are.

I will say the New York Stock Exchange has an excellent track record of listings. We have had a very active listings calendar this year, both domestically and internationally. And interestingly, particularly from emerging markets such as China, India, and Brazil. Some of these companies are very, very large but others are not. They are small and mid-type companies who seek the U.S. capital markets for many of the reasons that Mr. Silvers just outlined.

We really believe, and one of the things that we have done in order to help us reach a broader audience of listing opportunities, listing prospects, is to build a second listing platform in NYSE Arca with a set of standards that are different from the New York Stock Exchange's. Yet, they are still fully transparent and strictly adhered to. They are strong standards.

We have no interest in developing a set of standards such as those that we find in some European markets where there really are no standards, where anybody can basically come and list securities there. We find those markets, frankly, to be very illiquid. We find there to be very little investor interest in those products.

The New York Stock Exchange, we believe, is the hallmark of exchanges globally. We have excellent standards, very high quality

companies who have done extraordinarily well on a global stage. And our plan is to keep that at that level not just because it serves investors well but frankly, it serves us well in keeping the brand equity of the New York Stock Exchange as stellar as it is globally.

Chairman REED. Ms. Friedman, your comments.

Ms. FRIEDMAN. Thank you.

I actually echo a lot of what Noreen said because of the fact that NASDAQ has been very clear in making sure that it provides for capital formation at different levels of development of individual issuers. We have, therefore, put our market into three tiers. The highest tier of our market action actually has the highest listing standards in the world.

The one thing that we are very clear on is we never want to see a race to the bottom. In fact, we want to create competition as a race to the top.

We do understand that there are pressures being put on the U.S. markets by other exchanges that may not have the same listing standards but we are just not interested in following that track. We are interested in making sure that if a company chooses to list in the United States and chooses to list on NASDAQ, that they are there with very strict rules, very strict standards, and that they are ready to live by those standards.

It is really a matter of making sure that the cost of complying with the standards not only set by NASDAQ but also set by the U.S. Government are not to the extent that it keeps them out of the market overall.

One thing that we have been very pleased to see is the efforts by the SEC to look at 404 and really examine 404 much more closely with the PCAOB to make sure that the cost of compliance with 404 is not overly onerous but the principles of 404 and Sarbanes-Oxley itself stays intact.

So it is really a matter of making sure that the burdens of listing in the United States or the requirements are very clear, are very strictly adhered to, but are not so costly as to make it so that they just have no interest in coming here in the first place.

We are very pleased and very proud of the fact that companies that come list in the United States do tend to enjoy higher valuation because of the investor protections that they are afforded here in the United States and the stamp of approval. But at the same time we want to make sure that they have the ability to come here in a streamlined and efficient manner.

Chairman REED. Thank you.

This issue also can be characterized, as I think Mr. Silvers mentioned, as convergence of standards. And we are all hoping that the tide goes up and not out.

One area though is I think sometimes we presume that our standards are the best and the toughest, et cetera. But I wonder, Professor Ferrell and Mr. Silvers, if you look overseas, particularly in the area of shareholder rights, are there things that we should be trying to import into our regime that do not exist?

Mr. FERRELL. In terms of shareholder rights, the work I did for the Committee on Capital Markets Regulation was on the shareholder rights issue. In this regard, there is a lot of reference to London today in these discussions. I think the UK takeover panel

and the substantive rules concerning takeovers in the UK and how they enforce those standards in the UK are something that we could learn a lot from. This really goes to a State corporate law issue and Delaware corporate law and not so much SEC regulation. But I think the UK has a very good system in terms of shareholder rights in the context of takeovers.

Basically in the UK—and I am simplifying here a little bit—if you, as a firm, want to adopt a poison pill which basically makes it impossible for a takeover to occur, if you want to adopt a poison pill, you have to get shareholder ratification to do that. Under Delaware corporate law, again it is a simplification, there is fairly loose constraints on the ability to do that.

So my bottom line here in terms of shareholder rights is I think the UK has a very pro-shareholder rights approach and you can see that particularly in the takeover context. That is simply not true under Delaware corporate law. I think there is a lot of empirical evidence and theoretical reasons to believe, that I could go into, that the UK approach is something that the U.S. could learn from.

I think this discussion is not just that we have high standards and other foreign jurisdictions can meet them, but also that we can learn from other jurisdictions as well. And I think this would be an example of that.

Chairman REED. Thank you.

Mr. Silvers your comments, and then I want to yield to Senator Schumer.

Mr. SILVERS. Thank you, Chairman Reed.

I think that Professor Ferrell's comments are very apt. In general, long-term institutional investors do not always oppose the use of a poison pill but they want a say in it. They want to be able to know that it is being used responsibly.

I think, in addition to what Professor Ferrell said, there is an issue that is very much in front of it, I alluded to it in my testimony, and that the SEC is facing right now, which is the role of long-term investors in selecting corporate directors.

In the United Kingdom there are several mechanisms by which investors can do so. Because there is a relatively concentrated marketplace in the UK, those mechanisms tend not to actually be used formally. People sit in a conference room and let the company know that they want to nominate directors, and since 20 or 30 institutions hold at least a plurality of the stock of most UK public companies, it is a pretty straightforward process.

In the United States, where we have a more diversified ownership base, you need different mechanisms to accomplish this. But it is very clear that when foreign investors come to our markets, when we talk to our counterpart pension funds in the UK, in Scandinavia, what they say to us is we think the investor protections, in many ways, in the United States are superior. The major problem here is that you have very weak boards of directors and that we as investors do not really have a way of holding them accountable. They point particularly to issues of executive pay in that regard.

Chairman REED. Thank you very much.

I have additional questions for a very short second round, but Senator Schumer.

Senator SCHUMER. Thank you, Chairman Reed, and I very much appreciate your having this hearing. This is a time when we are fighting to remain competitive in capital markets. The world is, of course, is becoming—has become one, especially when it comes to intangibles such as what we are talking about here. So it is critical that in Congress we begin to seriously discuss these measures to ensure continued U.S. leadership in the global financial services marketplace. The hearing is a great thing to do.

Now mergers such as the New York Stock Exchange's merger with Euronext and NASDAQ's acquisition of OMX are historic and for the first time U.S. companies are owning and operating capital markets in foreign countries. Who in this room would not want to see that be successful? It really helps America stay No. 1.

So I think it is important that we facilitate that success. At the top of the list, of course, is if we are going to apply U.S. regulations to these foreign exchanges in any way we will chase them away. I have got to tell you, faced with the choice of having U.S. involvement or chasing everybody away and letting it go somewhere else, you know where I stand on that. So I think it is really important that we do that.

But then we have to talk about how to both keep our system of regulation, it works, it is good for investors, and at the same time not lose the whole ball of wax to the least common denominator out there because companies will want to flee to the lowest regulation. Because it is not in their long-term interests but it is sometimes in their short-term interest.

So I would like to ask a few questions about that. We are talking about mutual recognition between U.S. and foreign regulators. I think that is great. I wish I had been able to be here earlier, Mr. Chairman, for the SEC's testimony.

But I would like to ask our panelists, it is another part of this, we want to reconcile U.S. and foreign regulation. At the same time, U.S. regulation is one big mess in the sense that we have competing regulators with different ways and ideas. Companies in London, they have the FSA and they are the law. Here we have 10 different regulators and they sometimes say contradictory things. The report that Mayor Bloomberg and I put out said that that was one of the keys, to have one system of regulation.

The CFTC is off there on its own, it is a different type of regulator than the SEC. The products are blending and merging. We are never going to merge the two of them. But one of the things we recommended is the same regulatory framework apply to both, so there are not contradictions.

Secretary Paulson, Chairman Bernanke have both expressed a desire to help move in that direction. I was wondering what each of the panelists thinks about that? We can go from left to right, Ms. Culhane. If you agree, just be brief. If you disagree, you can be a little longer.

Ms. CULHANE. Thank you, Senator Schumer.

I think that the basic fundamental thing here is that we really are all operating, as you aptly point out, on a global stage. If you look to simply at the U.S. capital markets in a vacuum, you might have one set of answers or responses and a go slower mentality might be appropriate.

In today's world as we stand very much interlinked on so many different levels, it really is appropriate for us to consider all the options that are available.

As I said earlier, I am not sure there is any one-size-fits-all perfect answer to the way regulation should work. But looking, as other industries have done, at best practices, best principles, and trying to come to some determination collaboratively on how we might work together——

Senator SCHUMER. You mean within the U.S. or U.S. versus foreign?

Ms. CULHANE. I mean globally. I mean within the U.S. but I also mean outside of the U.S., as well.

I would say that if you look at the College of Regulators in Europe, those were different markets who came together and established this notion of a College of Regulators who did two things. One, they began to harmonize the rules between and among the markets and between and among different asset classes. But two, they were also kept as a principle No. 1 investor protection. But as principle No. 2, they sought to ensure the competitiveness of their markets on a global stage through their regulatory framework.

I think these are things that we do not have to invent. We can look to other places and emulate.

Senator SCHUMER. Thank you, Ms. Culhane. Ms. Friedman.

Ms. FRIEDMAN. Thank you, Senator Schumer.

We are supportive of looking at the regular structure of the United States and realizing that while we have different needs than maybe perhaps the regulators in Europe, with the fact that so much of our foundation is built on the retail investor. We also have to recognize the fact that our clients, whether it is the investors or the broker-dealers or the issuers, they are very global in nature. If we look at the way that investors are investing in different instruments, they are very much looking across instruments. They are not choosing to invest just in equities or just in fixed income or just in derivatives. They are using those instruments interchangeably.

Therefore, they should have a regulatory structure that allows for them to be able to invest in those instruments in a way that is streamlined, efficient, and still preserves the investor protections.

So the convergence or at least of these of the standards of regulation with the United States is certainly in the interest of the investors, and therefore is in the interest of exchanges.

Senator SCHUMER. Mr. Ferrell.

Mr. FERRELL. I agree with the substance of your remarks. Thinking back to past fights between the SEC and the CFTC as to jurisdiction over different products and the amount of effort that went into that, it is not effort well spent to fight over jurisdiction. And so I do think clarifying jurisdiction, to have some kind of—pulling it together in some kind of overall regulatory framework makes a lot of sense. And we can learn from London on that.

Chairman REED. Thank you. Mr. Silvers.

Mr. SILVERS. Senator Schumer, you have put your finger on the one of sort of regulatory merger and I think we would pretty

strongly support, even though you said you did not think it was practical. The notion that there is something profoundly different between the markets that the CFTC are regulating in the derivatives area and what the SEC is regulating is foolish. There are two other areas where we are not so enthusiastic.

Senator SCHUMER. It started with pork bellies and equities and now it is not.

Mr. SILVERS. Essentially you can trade the same thing and do it in one jurisdiction or the other. That is not only, I think, inefficient but dangerous.

Pushing securities and bank regulation together we think is a bad idea. And we think that the calls that have come to essentially get rid of the state regulatory system in securities and banking is also foolish. The reason why we think it is foolish is because that system is a backstop.

I think we learned, thanks to the efforts of some fine civil servants in New York State, that when one part of our regulatory system weakens dramatically and threatens our markets very integrity and competitiveness, we have a backstop. We think that is extremely important.

Senator SCHUMER. We only went over by 10 seconds, so I thank the panel for their succinct and on-the-point answers.

Thank you, Mr. Chairman.

Chairman REED. Thank you, Senator Schumer.

I should point out publicly the leadership role that Senator Schumer has played in terms of all these issues. Ms. Friedman already recognized you, Senator, but you have really been a champion in terms of making sure that our markets remain competitive. Thank you very much, you and the Mayor.

I should also point out, too, that we will ask the GAO and process GAO to look at the issue that blurring these product lines, the derivatives, et cetera, and the continued usefulness of the functional difference between CFTC regulation and SEC regulation. We will look forward to that study.

Let me ask a few concluding questions. First, Professor Ferrell, there was mention before on Rule 144A of the huge increase, and I think Ms. Culhane also mentioned it. Do you have any sorts of insights in terms of what is driving it? Does this represent a challenge to the regulators in terms of its growth?

Mr. FERRELL. I do not think you can draw any inferences, positive or negative, from the mere fact that—although important—that the 144A market has grown dramatically. There could be benign explanations as well as troubling explanations for that.

So I would prefer to look at specific issues and look at the evidence in terms of whether the regulation is working optimally and not draw any broad conclusions just from the rule 144A market.

I will make one other point on that, and Erik Sirri alluded to this in his testimony. It is perfectly possible for a security to be placed in the 144A market and end up in the public markets at some point via Rule 144 transaction or via a PIPE transaction. So the mere fact that it is unregistered at one point does not necessarily mean that it is going to be unregistered forever. That is, I think, an important point to keep in mind, as well.

Chairman REED. There is some indication, I think, that a lot of these 144A transactions actually involve, obviously involve, huge international participation, either securities of companies listed outside of the United States or United States money going there.

Mr. FERRELL. Absolutely. I am sorry, I did not mean to interrupt.

You see foreign listings or public offerings in foreign markets or foreign capital raising and very often in conjunction with that foreign transaction raising capital you have capital being raised in the United States via Rule 144A. So you could have a 144A arm of the transaction in the U.S. in conjunction with capital raising in foreign markets. It is very common.

Chairman REED. And doesn't that, to a certain degree, sort of distort the perception? The perception is this is now outside of the United States, all of this capital is being raised overseas, our markets are not participating. When, in fact, in many cases through 144A our markets are participating quite actively in these global transactions. Is that an accurate assessment?

Mr. FERRELL. My sense is a significant portion—I do not have the figures offhand—a significant portion of the 144A is in conjunction with foreign companies raising capital in the U.S. in conjunction with other jurisdictions.

Chairman REED. Ms. Culhane, please.

Ms. CULHANE. If I could just comment, Mr. Chairman, I would say if you look particularly at last year's numbers and you see the enormous amount of proceeds raised on the Hong Kong Stock exchange, you can note that two of those transactions, two of the Chinese banks that listed, were the overwhelming preponderance of the proceeds raised. And both of them had significant tranches that were 144A capital raisings, much of which was sourced in the U.S. markets.

So to answer your question very specifically, it is growing very dramatically. And part of what is happening in non-U.S. markets is that a lot of those non-U.S. companies who formally would have come to the U.S. with registered offerings are now accessing the U.S. only through the 144A tract, in many cases—and we have been told directly—to avoid the requirement to comply with our governance standards.

And by the way, those are not available to retail investors. So on the one hand, it is protection for sure. On the other hand, a growing proportion of the proceeds raised and the availability of equity is not open or not available to retail investors.

Chairman REED. But there are many reasons why you would avoid registration listing, some good and some bad. So this is not without its——

Ms. CULHANE. It is not a simple one-size-fits-all and it is a complicated—I think it is a compensated topic.

Chairman REED. Ms. Friedman, please.

Ms. FRIEDMAN. Thank you.

We have been very, very interested in looking at the 144A trend because of the fact that NASDAQ, after 144A was created by the SEC, NASDAQ launched something called the PORTAL market which Mr. Sirri referred to earlier. And it really has been a dormant market for quite some time because of the fact that once institutions do buy these securities, they tend to hold them, they do

not trade them. And it has been a relatively intransparent market. It is not something where you can look at a bid-ask on a security or even see the last sale price.

So one of the things that NASDAQ has been looking at is relaunching PORTAL to create some transparency around the 144A market, making sure that that information continues to be available only to qualified institutional buyers, however making sure that it is not a completely dark market because of the fact so much money is being raised within the market.

Part of the reason why more money is being raised there is because the fact there are a lot more institutional investors involved in the markets than there were back in 1990 when the 144A was first approved.

Chairman REED. Thank you.

Mr. Silvers, do you have a comment?

Mr. SILVERS. Two things about this question.

One is that I think effectively if you look at the IPO market in the late 1990's for equity, the regulatory structures in a variety of ways had weakened to the point that we were effectively selling a product only fit for institutions to individuals. Those protections were strengthened. I think that that may have something to do with the then up following on strength of essentially an institutional market for IPOs in the 144A equity area.

I think there is a lot of caution, though. Professor Ferrell's caution about data, I think, is well taken.

The second point I would just make about all the debate about IPOs and equity is that there is enormous economic growth into Asia. And a lot of it is being run through present or formal parastatal companies tied to the Chinese government. Those companies are now seeking to go public in certain ways and they are simply not comfortable, both for good and bad reasons, with the panoply of investor and governance protections we have in the United States.

They are also, and this is completely legitimate on their part, they I think wish to list in place where the brokers and the market makers speak their language literally and that are geographically in proximity to them, just as large U.S. companies like to list here.

We are never going to be able to, without fatally gutting our investor protections, seize that market. The market for IPOs for Chinese parastatals is going to be a Hong Kong market unless we choose to offer a regulatory subsidy. Meaning unless we choose to essentially say to them, come here and sell to individuals as though they were institutions.

Now doing that is essentially subsidizing our capital markets at the expense of the investing public and that would be a really profoundly wrong thing to do.

Chairman REED. Thank you.

This has been an incredibly useful hearing. I thank you all for your excellent testimony in response to questions.

I would suggest, in fact announce, that we will keep the record open until Thursday, July 19th, for additional questions or statements by my colleagues and would asked if you receive a request for written response to respond within 10 days.

Thank you again for excellent testimony.

The hearing is adjourned.

[Whereupon, at 11:45 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

Statement of the
U.S. Securities and Exchange Commission

A Global View: Examining Cross-Border Exchange Mergers

Before the Subcommittee on Securities, Insurance, and Investment of the
U.S. Senate Committee on Banking, Housing, and Urban Affairs

July 12, 2007

Chairman Reed, Ranking Member Allard, and Members of the Subcommittee:

Thank you for inviting the Commission to testify today about the recent trend of cross-border exchange mergers, and their impact on the markets, on investors, and on regulation. These developments present both new challenges and opportunities for the U.S. securities markets and the Commission.

Current Trends in Capital Markets and Exchanges, Including Mergers and Acquisitions

Today, no one would dispute that the capital markets are becoming increasingly global. As the markets have evolved, innovations in technology have eliminated many physical barriers to market access, with the result that exchanges worldwide have pursued alliances and mergers in order to more effectively participate in the global exchange business.

For example, in February of this year, the NYSE Group and Euronext merged their businesses under a U.S. holding company – NYSE Euronext – to create the first trans-Atlantic equities market. Shares of NYSE Euronext are now listed on the NYSE trading in U.S. dollars, and on Euronext Paris trading in Euros. The U.S. headquarters of NYSE Euronext are in New York, and its international headquarters are in Paris and Amsterdam. The combined company comprises seven exchanges in six countries. Each of NYSE Euronext's markets, however, continues to be regulated in accordance with local requirements. Its European exchanges are overseen by the relevant European regulator, and the SEC continues to regulate NYSE and Arca, the U.S. exchanges.

In addition, Nasdaq has acquired a substantial minority interest in the London Stock Exchange, and recently announced an agreement to buy the Nordic stock-exchange operator, OMX. Further, Eurex – the European derivatives exchange – has agreed to acquire the U.S.-based International Securities Exchange.

I have no doubt that the trend of cross-border alliances and mergers will continue, and that these global exchange conglomerates will seek to further integrate their operations.

The Factors that Precipitated These Trends and Could Significantly Impact Them in the Future

I believe a number of factors have precipitated the recent trend of cross-border exchange combinations. In recent years, most of the U.S. exchanges have demutualized, usually by creating parent holding companies, and a number of those parent holding companies are now public companies. As a result, many U.S. exchanges have access to new sources of capital, and the means to consider mergers that would expand their businesses globally.

In addition, the demand for global exchanges has grown as more and more investors, both large and small, have begun to look beyond their own countries' borders for investment opportunities. Today, for example, nearly two-thirds of all U.S. equity investors hold foreign equities through ownership of individual stock in foreign companies or ownership of international or global mutual funds.

And finally, developments in technology and reduced communication costs have driven the markets to become largely electronic, with the result that geographic boundaries have become much less relevant. This, of course, has made it much easier and less expensive for investors to conduct cross-border securities activity.

The Role of Such Trends in the Changing Regulatory Environment

Globalization of the securities markets will clearly continue to present challenges for regulators in the U.S. and abroad. That said, to date, the regulatory issues faced by the Commission have been relatively modest, as the proposed transactions involving U.S. exchanges preserve their separate operation under a holding company structure. With NYSE Euronext, for example, the NYSE Group and Euronext markets continue to operate as separate liquidity pools in their respective jurisdictions. The creation of a single holding company for these markets, in and of itself, does not raise substantial U.S. regulatory issues. In essence, the Commission reviews the proposed governance and ownership structure of the new holding company to determine whether the SEC continues to have adequate tools to effectively oversee a U.S. exchange that is controlled by an entity not fully subject to its jurisdiction.

Over time, however, I expect the global exchange groups will seek to further integrate their markets, whether through a consolidation of technology platforms, the provision of trading screens in each other's jurisdictions, or linking their liquidity pools. Depending on the scope of the integration, a wide range of core U.S. regulatory issues could be implicated, including those surrounding exchange registration, broker-dealer registration, and listed company registration.

The Impact Such Changes Are Having and Could Have on Markets and Investors

Global exchange initiatives such as these may very well promote competition and the efficiency of cross-border capital flows, and thus have the potential to benefit the

markets and investors in the U.S. and abroad. A core SEC mission is to protect U.S. investors, so as we approach these difficult global regulatory issues, we must be vigilant in our efforts to ensure adequate disclosure and regulatory oversight for U.S. investors. At the same time, another core mission of the SEC is to foster capital formation, and we are mindful of the fact that today capital increasingly is being raised internationally, with securities trading on various exchanges.

Over the years, a number of foreign markets and jurisdictions have questioned whether registration of foreign exchanges and broker-dealers in the U.S. is essential to investor protection, if the foreign jurisdiction affords regulation comparable to that in the U.S. Some countries have complained that the U.S. "investor protection" mandate is used to protect the interests of domestic institutions and firms.

The SEC's response has generally been that our statutory mandate requires a high level of investor protection, while at the same time fostering capital formation, and that foreign exchanges and broker-dealers are welcome to do business here if – like their U.S. counterparts – they register, or for broker-dealers, if they comply with Rule 15a-6.

Unquestionably, however, there is more that we can do to reduce the costs and frictions of trading foreign securities in the U.S., without jeopardizing the protection of U.S. investors.

Opportunities and Challenges for the Exchanges, Regulators, and Investors Moving Forward

As you may know, the Commission has begun exploring the merits of a "mutual recognition" approach to facilitate global market access. Just last month, the Commission hosted a Roundtable on Mutual Recognition, where distinguished representatives of U.S. and foreign exchanges, global and regional broker-dealers, retail and institutional investors, and others shared their views on the possibility of mutual recognition.

Although the details of a viable mutual recognition approach are still in the early stages of development, in essence, it would permit foreign exchanges and broker-dealers to provide services and access to U.S. investors, subject to certain conditions, under an abbreviated registration system. This approach would depend on these entities being supervised in a foreign jurisdiction that provides substantially comparable oversight to that in the U.S.

For example, in the context of foreign exchanges, under the current U.S. regime, a foreign exchange that conducts business in the U.S. – for example, by placing its trading screens directly with U.S. broker-dealers – must register the exchange and the securities trading on the exchange with the SEC. In addition, in the context of foreign broker-dealers, under the current U.S. regime, foreign broker-dealers that induce or attempt to induce trades by investors in the U.S. generally must register with the SEC and at least one SRO. The SEC has, however, provided exemptions to foreign broker-dealers that

engage in a limited U.S. business, such as effecting transactions with U.S. institutional investors with the participation of a U.S.-registered broker or dealer. In addition, within the current regulatory framework a number of U.S.-registered broker-dealers today provide electronic access to foreign exchanges for their U.S. clients.

A mutual recognition regime would consider – for example, under what circumstances foreign exchanges could be permitted to place trading screens with U.S. brokers in the U.S. without full registration. Mutual recognition would also consider under what circumstances foreign broker-dealers that are subject to an applicable foreign jurisdiction's regulatory standards could be permitted to have increased access to U.S. investors without need for intermediation by a U.S.-registered broker-dealer. While this approach could reduce frictions associated with cross-border access, it would not address the significantly greater custodial and settlement costs that are incurred today when trading in foreign markets.

To satisfy the SEC's mission of investor protection and fostering capital formation, these exemptions from registration would depend on whether the foreign exchange and the foreign broker-dealer are subject to comprehensive and effective regulation in their home jurisdiction. To make this determination, the Commission would need to undertake a detailed examination of the foreign jurisdiction's regulatory regime, considering whether it adequately addresses such things as: investor protection, fair markets, fraud, manipulation, insider trading, registration qualifications, trading surveillance, sales practice standards, financial responsibility standards, and dispute resolution.

Other requirements or limitations may also be appropriate. For example, any exemptions permitting mutual recognition could be limited – at least to start – to trading in foreign securities, so as to address concerns about the impact of this approach on U.S. market activity. Similarly, exemptions could be limited to trading with market professionals and certain large sophisticated investors, who could be expected to more fully appreciate the risks of trading directly with foreign markets and intermediaries.

Finally, this approach could also require that the home jurisdiction of the foreign exchange and the foreign broker-dealer provide reciprocal treatment to U.S. exchanges and broker-dealers seeking to conduct business in that country.

At the direction of Chairman Cox, and drawing upon the valuable input received at the Roundtable on Mutual Recognition, Commission staff is developing a proposal regarding mutual recognition for Commission consideration. I expect the staff to have completed its initial work by the fall. In essence, the goal is to develop a regulatory approach that strikes a balance between securing the benefits of greater cross-border access to investment opportunities, while vigorously upholding the Commission's mandate to protect investors, foster capital formation, and maintain fair, orderly, and efficient markets.

Conclusion

The recent trend of cross-border exchange mergers, as well as the more general increased demand for worldwide financial services, challenges us to continue to view our markets, not in isolation, but rather as a part of the larger global marketplace. Globalization has the potential to provide great benefits for U.S. markets and investors. At the same time, the SEC must make sure that it has identified and appropriately addressed the risks of liberalized access by foreign markets and market participants to U.S. investors, so that our regulatory regime is not undermined, and our statutory responsibilities relating to U.S. investors and the U.S. markets are fulfilled.

I am grateful for the opportunity to provide you with this overview of the recent trend in cross-border exchange mergers and related regulatory issues. I am happy to take any questions you may have.

Noreen Culhane

Executive Vice President
NYSE Group

On

A Global View: Examining Cross-Border Exchange Mergers

Subcommittee on Securities, Insurance and Investment
United States Senate
Washington, DC

July 12, 2007

Mr. Chairman, Ranking Member Allard, and members of the Subcommittee, I am Noreen Culhane, Executive Vice President of NYSE Group, the U.S. subsidiary of NYSE Euronext. On behalf of NYSE Euronext and our Chief Executive Office John Thain, thank you for inviting me to testify today before the Subcommittee. We greatly appreciate your vigilant leadership in overseeing our capital markets at this critical point in their evolution. The subject matter of today's hearing is especially timely, given the unparalleled changes that not only NYSE Euronext but virtually all exchanges in the U.S. and globally are undergoing.

Demutualization, diversification, consolidation and globalization are key themes underpinning this transformation as exchanges follow the lead of the rest of the financial services industry. Recently, there have been a number of announced transactions that illustrate these themes. Some examples include the NYSE's acquisition of Archipelago and our merger with Euronext, the Chicago Mercantile Exchange's (CME) plans to merge with the Chicago Board of Trade (CBOT), the London Stock Exchange's (LSE) bid to merge with Borsa Italiana, Deutsche Bourse's bid for the International Securities Exchange (ISE), and Nasdaq's intention to merge with OMX. These mergers and acquisitions reflect the ongoing competition among exchanges to build scale and speed, generate increased liquidity, attract more investors, better serve issuers, and diversify risk.

I. A case study: NYSE Euronext

The dramatic changes to our own business model and structure illustrate how much this industry has evolved in a very short period of time. Just 16 months ago, the NYSE was a member-owned, not-for-profit exchange focused solely on NYSE listed

stocks. Today, NYSE Euronext is a multi-product global company with a market cap of $21 billion. Together, NYSE and Euronext represent the world's largest cash equities market. The aggregate market capitalization of all our listed companies totals $28.5 trillion. One-third of the world's cash trading takes place on our exchanges. In addition to our businesses in the U.S. and Europe, we have a strategic alliance with the Tokyo Stock Exchange, as well as a 5% stake in the National Stock Exchange of India.

We are also a much more diversified company. In addition to our equities business, NYSE Euronext offers futures, options, and fixed-income trading. Today, derivatives trading comprises 22% of our revenues.

We are also the world's leading marketplace for capital raising. Last year, in 2006, $68 billion of IPO capital was raised on our NYSE Euronext exchanges. For that year, capital raised on the NYSE alone was about $40 billion, and Hong Kong ($47 billion) and London ($44 billion) for the first time, each raised more in IPO proceeds than the NYSE. Nasdaq and AIM each raised about $18 billion last year. While these numbers show that our listings business is very competitive with other markets around the world, they also show that other markets are gaining ground quickly. I can't overstate how important it is for the U.S. to strive to make our markets even stronger – because our competitors are not far behind us and are quickly gaining ground.

I know that I am preaching to the choir when I say that the continued leadership by the U.S. in the global financial services marketplace is vitally important to this nation. The business of exchanges is the business of public capital formation. This translates into job creation and economic growth. The New York State Comptroller's October 2006

Report on the securities industry found that each incremental securities job leads to the creation of two additional jobs in other industries. We are grateful to you and your colleagues on this committee for making this topic a priority.

II. Evolution and Future of Exchanges

The changes at NYSE Euronext have reflected four themes, which can be used to characterize the developments in this industry generally. These developing themes in the exchange space—demutualization, diversification, consolidation and globalization—are very similar to what we have already seen happen in both commercial banks and investment banks.

First, demutualization. We have seen exchanges embrace demutualization for many of the same reasons that companies become publicly traded, namely, access to capital to fund growth and investment in new technologies, and availability of a currency to facilitate acquisitions. Demutualization provides the member-owners with a liquid asset, and gives employees the opportunity to participate in the exchange's success through equity ownership.

The same dynamics that propel exchanges to become for-profit, public companies, also push them to become more efficient, thus benefiting all investors and issuers as well.

The second theme is diversification. This is particularly true for the cash markets where growth is slow when compared to the derivatives markets (both the options and

futures markets), which have achieved a growth rate of 30% over the past four years and enjoyed much higher margins. The value of derivative financial contracts in 2006 exceeded $450 trillion, of which regulated exchanges handled less than 20%, creating significant opportunity for growth. By comparison, the value of trading in the cash equities markets was $40 trillion, while the value of trading in the fixed income markets was $65 trillion. Derivative futures contracts trade much more actively than stocks. In 2005, $51 trillion worth of stock was traded on Exchanges worldwide. In the same year, the value of trading in CME's short-term interest rate contracts alone was $413 trillion, and trading in all derivatives was several times that amount. The economics are clear and the resulting behavior predictable. Diversification will continue as a driver of consolidation, as exchanges seek higher margin businesses with more growth potential and reduced risk through diversified revenue streams.

Consolidation, the third theme, is driven by the need to invest in technology to meet investor demand for greater speed and capacity in transaction execution. Like many other financial services businesses, exchanges benefit from economies of scale. Prior to our mergers, NYSE, Arca, and Euronext each had teams of developers working to build new trading platforms and communications networks, and we each had separate data storage facilities. Our merger has enabled us to combine our efforts and utilize the same platforms on each exchange, reducing substantially our technology costs. Exchanges also thrive on concentration of liquidity. Exchange consolidation makes it easier for issuers to access deeper pools of capital around the world.

The fourth theme in the development of exchanges is globalization. Increasingly investors seek to diversify their portfolios, tap into the growth in non-domestic markets

and hedge risk. We must offer the ability and opportunity to trade products across time zones and asset classes on a global scale.

This transformation of the exchange business is producing significant benefits for investors, issuers and shareholders alike.

Investors are starting to enjoy the benefits of access to markets over multiple time zones, more efficient and cheaper access to investment vehicles through a single trading platform, and the ability to trade more diversified (and thus less risky) portfolios. Ultimately, these factors work together to improve market quality, delivering tighter spreads, greater depth, lower volatility and producing the concomitant enhanced returns for investors.

Issuers are seeking and getting the advantages of increasingly large liquidity pools, new listing alternatives and capital raising opportunities, easier access to both domestic and international investors, and lower cost of capital – and therefore higher valuations.

Our shareholders are getting the benefit of the cost savings and synergies we deliver across the combined NYSE-Euronext businesses, and the upside that comes with participation in faster growing products like derivatives, and increased exposure to global markets.

While much has been accomplished, much remains to be done to best position U.S. markets to deliver these benefits to investors, issuers and shareholders.

The consolidation in the exchange industry is by no means at an end. Every exchange is reexamining its business model with the goal of being well positioned to participate in the markets of the future.

Ultimately, we expect to see a relatively small number of large, multi-product, global exchange operators, of which NYSE Euronext will be one. Transactions between the U.S. and Europe are leading the way, but eventually Asia, as an increasingly important component of the global economy, will participate. Japan and India are important markets where NYSE Euronext has already formed formal alliances. China is also a very important region, one where we have strong relationships and believe that over time there will be opportunities to further strengthen these relationships through strategic alliances.

III. Key trends affecting the exchange business

We think there are three important trends that are affecting the exchange business.

The first development is the influence of technology on trading. Market participants are demanding speed, transparency and anonymity, all at lower cost. At the same time, the growth in algorithmic trading has substantially increased both order and transaction volume. In response to this confluence of factors, the NYSE has increased capacity, insured reliability, and will deliver turn-around speeds under 10-milliseconds by the end of 2007. In addition, customers here and in Europe want choice in execution models. Our Euronext and Arca brands provide full electronic trading, and our NYSE

Hybrid Market offers the benefits of electronic trading coupled with the pricing power of a floor-based auction market.

The second development is off-exchange trading, which includes internalization and trading on alternative trading systems, which are sometimes referred to as "dark pools." In NYSE securities, off-exchange trading increased from 13% in January 2005 to 20% of share volume in May 2007. As participants in the markets take their order flow off-exchange, and particularly when they internalize by trading between customer orders and their own accounts, they compromise the integrity of the price discovery process by not exposing their order flow to the broader market. This disadvantages investors who may not get the best price.

The third development is the continuing downward pressure on exchange fees, which is increasing the movement toward further consolidation. The explanation here is that exchanges have a very high degree of operating leverage. Once you have covered the fixed cost of an exchange, the incremental cost of a trade is quite low. This creates continued pressure to consolidate trading volume onto a single platform and thereby drive prices down.

IV. The Global Competition for Listings

Major exchanges in the U.S. are facing listing competition for a number of reasons, as has been widely discussed and debated in several reports on this subject, including Senator Schumer's report with Mayor Bloomberg on Sustaining New York's and the US' Global Financial Services Leadership, the report by the Committee on Capital

Markets: Reducing Regulation and Litigation While Enhancing Shareholder Rights Will Improve the Competitiveness of U.S. Capital Markets, and the report by the U.S. Chamber of Commerce's Commission on the Regulation of the U.S. Capital Markets in the 21st Century.

Attracting foreign listings is important to the continued leadership of the U.S. capital markets. While the NYSE has long been the global leader in attracting international listings, our share of non-domestic IPO's is declining. The NYSE and Nasdaq together listed 57% of the global IPO proceeds for companies that listed outside their home market in 1999, but that share declined to 18% in 2006. Overall, the U.S. exchanges' share of the global market cap of listed companies has shrunk from 46% in 1999 to 39% in 2006. The primary reasons for this are as follows:

1. There is a widely held view that the regulatory framework in the U.S. is burdensome and costly. The cost of internal controls reporting under Sarbanes-Oxley (SOX) has been the subject of much criticism in recent years. Recent SEC and PCAOB actions to modify what is required under Section 404 should prove helpful in addressing this concern. This will only be the case, however, if the audit firms internalize the guidance that the SEC and PCAOB have issued; otherwise the regulators' rationalization of Section 404 will be ineffectual.

2. The cost associated with reconciliation to U.S. GAAP has been a deterrent to listing in the U.S. We applaud the SEC for their proposed rules to eliminate the accounting reconciliation requirement by recognizing International Financial

Reporting Standards (IFRS). This is a significant step in insuring the continued competitiveness of U.S. markets.

3. The cost of litigation in the U.S., in particular class-action lawsuits, is one of the leading deterrents to companies considering listing in our markets. As Senator Schumer and Mayor Bloomberg observed in their report, "the legal environments in other nations, including Great Britain, far more effectively discourage frivolous litigation" and "the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of business -- and driven away potential investors." The need for litigation reform is clear and compelling.

These issues are well documented and frequently discussed. They are also not new. What has changed is the viability of the alternatives available to non-U.S. companies in the form of more liquid and well-governed home markets as well as an increasingly vibrant private placement (Rule 144A) market in the U.S. as the proliferation of hedge funds has helped increase the number of qualified institutional buyers (QIBs).

Growth of Viable Alternatives for Raising Capital

Local markets outside the U.S. have improved as a result of stronger corporate governance and regulatory standards as well as investments in technology. Increasingly, many companies are choosing to raise capital while only listing on their home country exchange. It used to be that if a company wanted to raise $1 billion, it only had little choice but to access the U.S. markets. Now there are many markets that can facilitate such an offering. In 2006, three of the top 20 global IPOs from India and China listed

solely on their domestic market while raising over $1 billion each. This would not have been possible five years ago.

Also, registration in the U.S. is increasingly unnecessary for a company raising significant capital from U.S. institutions. Private placements through Rule 144A have become an increasingly popular way for companies to access U.S. capital without having to comply with the regulatory burdens of registration. The number of Rule 144A private placements grew from 130 in 2004 to 204 in 2006. Even more telling, the amount of capital raised by foreign issuers with a 144A component grew from $57 billion in 2004 to over $137 billion in 2006. (Please see attachment.) By comparison, NYSE Euronext (NYSE and Arca markets only) and Nasdaq raised $58 billion last year. This phenomenon, and the growth of internalization and dark pools, raise cause for concern, as they undermine the transparency that is the hallmark of our markets, and limit access by public investors to these investment opportunities.

Regulatory Developments

On the regulatory front, we are optimistic about recent developments. Under Chairman Cox's leadership, the SEC has taken a forward-looking and global view of capital markets. As a result, we have seen the beginnings of a dialogue between the U.S. regulators and the European regulators that has already gone much further than some people would have thought.

The SEC has made a bold move in promoting the concept of mutual recognition, whereby the SEC would recognize a non-U.S. regulator as comparable to the U.S. regulatory scheme, and thereby allow U.S. investors to trade the securities listed on

foreign exchanges without requiring those securities or exchanges to be registered with the SEC; investors from recognized countries would also be offered reciprocal access to securities listed on U.S. exchanges. This would permit more efficient trading among markets by substantially easing the complexity of cross-border trading, resulting in expanded availability of capital and increased opportunities for market participants on a global scale.

In developing a mutual recognition scheme, there are some fundamental elements that should be incorporated. First, any mutual recognition initiative should include the College of Regulators at the outset. The College of Regulators comprises regulatory authorities from a number of countries, including the United Kingdom's Financial Services Authority, as well as the financial regulators of France, Belgium, the Netherlands, and Portugal. The U.S. SEC has already laid the groundwork for recognition of these regulatory regimes through the MOU they collectively signed in January of this year. There would be significant competitive consequences to a decision by the SEC to move forward on a mutual recognition program on a country-by-country basis.

We also believe it is important to insure that mutual recognition is accomplished in a way that permits U.S. public investors to access the global markets. Appreciating that some limits have to be imposed, we recommend limiting the nature of the securities that can be traded by U.S. public investors, such as to well-known seasoned issuers, and diversified funds such as ETFs. We do not believe any such restrictions are necessary for institutional investors, who are generally sophisticated enough to understand the risks entailed in cross-border trading. Allowing well-known, seasoned issuers to be traded on public exchanges in the U.S., based on their registration in a mutually recognized foreign

jurisdiction, will best insure the continued vitality of the public markets in the U.S., and also insure U.S. public investors continued access to the deep and liquid markets they rely on.

Another aspect of regulation that is significant to exchanges' ability to evolve and compete is the regulatory process that has been historically imposed on SROs. While this process made sense in previous decades, in today's rapidly evolving global marketplace, our ability to evolve our business model and innovate, and our ability to compete against other foreign and U.S. exchanges is hindered by the lengthy review process that all SRO rules must go through. Foreign competitors, as well as U.S. futures exchanges, and other markets that compete with our stock exchanges, are not subject to such procedural hurdles. We are working to modernize the specialists' role, to provide new market data products to internet providers and others, to facilitate the listing and trading of new ETFs and exchange traded investment products, along with many other initiatives to make our market stronger, more liquid, and more competitive. Whether we succeed is largely dependent on the efficiency of a regulatory review process over which we have little control. We are encouraged that under Chairman Cox's leadership, the Commission and staff recognize the importance of the U.S. markets' competitive position in the world and have made that a priority.

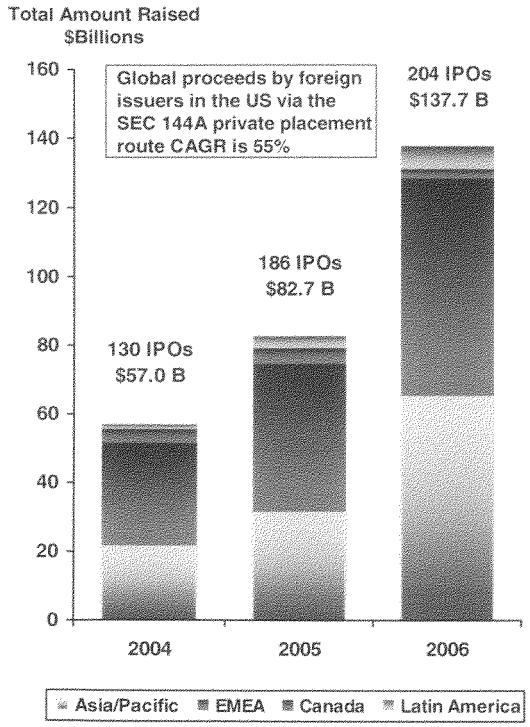
V. Conclusion

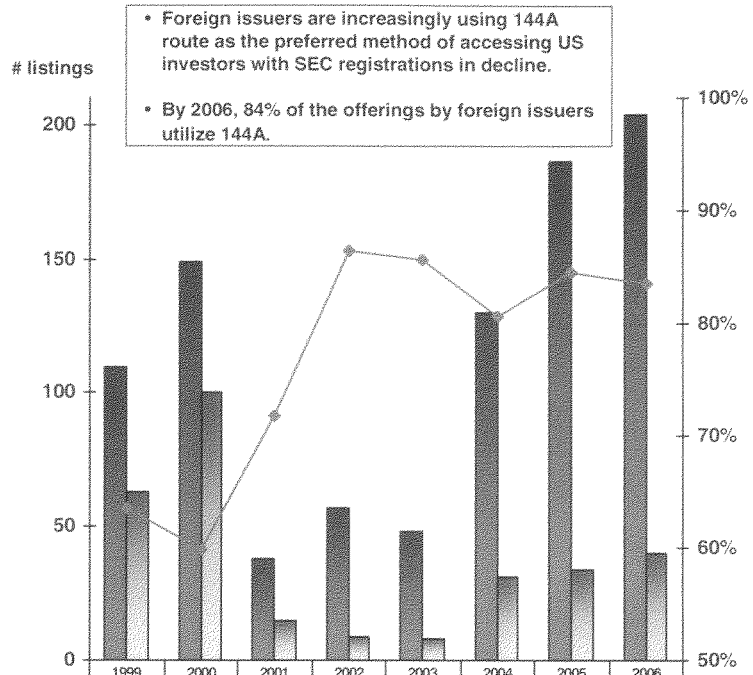
The speed of transformation of exchanges globally is remarkable. But we are really just catching up to where many other parts of the financial services industry find themselves – including the investment banking industry. As we, and our colleagues in

this business – here at this table – seek to diversify, globalize, and modernize, the beneficiaries will continue to be the investors, entrepreneurs, and workers at the companies whose growth is driven by the engine that is our capital markets.

Again, I thank you, Mr. Chairman, Ranking Member Allard, and all the members of the Subcommittee for giving me the opportunity to speak today and I look forward to answering your questions.

Growing 144A Deal Flow





	1999	2000	2001	2002	2003	2004	2005	2006
# 144A	110	149	38	57	48	130	186	204
# SEC Registered	63	100	15	9	8	31	34	40
% 144A	64%	60%	72%	86%	86%	81%	85%	84%

Source: Dealogic
Excludes Closed-end funds and REITs

Testimony of Adena Friedman
Executive Vice President, Global Strategy and Data Products
The NASDAQ Stock Market, Inc.

"A Global View:
Examining Cross Border Exchange Mergers"

Before the Subcommittee on Securities,
Insurance, and Investment of the
U.S. Senate Committee on
Banking, Housing and Urban Affairs

July 12, 2007

Good afternoon Chairman Reed, Ranking Member Allard, and distinguished members of the Subcommittee on Securities. My name is Adena Friedman. I am NASDAQ's Executive Vice President of Global Strategy and Data Products, and I appreciate the opportunity to testify before the Subcommittee at this moment of extraordinary, transformational change in world markets.

The subject of this hearing – Global Trends in Cross Border Exchange Mergers – is both timely and important because today we are facing a fundamental question: do we want the U.S. exchanges to continue to be a source of strength in the new world of globalization? Of course we do, and that is why NASDAQ is working to assure that current trends in cross-border exchange mergers produce results that benefit U.S. investors and the U.S. economy.

Global Trends In Equities Markets

Exchanges worldwide are entering a new era in which it no longer makes sense to think in terms of multiple trading platforms. The future of exchanges is all about technology, flexibility, and scale. The notion of "domestic" as opposed to "international" has become a distinction without a difference. Global market consolidation is both inevitable and ultimately desirable for investors worldwide.

The structure of world markets has changed rapidly and dramatically. Today major markets worldwide are publicly owned, increasingly transparent, highly competitive and keenly attuned to customer needs. Many of our corporate clients and broker dealer members are global in scope and scale. To meet their needs, exchanges must become global as well. In this new world of technology-driven, investor-owned exchanges, the benefits to customers offered by consolidation gain a new urgency and importance.

Opportunities Resulting From These Trends – Drivers of Globalization

NASDAQ has long recognized the opportunities created by the move to global equity capital markets. We have sought to partner internationally through a variety of vehicles including building alliances, taking minority investments in exchanges such as our 30% stake in the London Stock Exchange, and through mergers and acquisitions. Our benchmark indices have been traded internationally since 1999 and are currently licensed in 37 countries.

NASDAQ has been a leading player in the inevitable process of globalization, most notably with our announced combination with OMX. We have also seen the Deutsche Borse recently agree to acquire the largest equity options exchange in the U.S., the ISE. The NYSE has acquired Euronext. Several exchanges have acquired minority stakes in other markets, including Tokyo's 4.9% stake in the Singapore Exchange as well as Singapore and Deutsche Borse's respective 5% stakes in the Bombay Stock Exchange. Collectively, these actions are an affirmation that exchanges, once constrained to be predominantly national enterprises, are becoming global operations.

Let me cite a specific example of how consolidation can produce greater efficiency, lower costs, and better trades. Almost two months ago, in a $3.7 billion transaction, NASDAQ and OMX – a major European exchange based in Stockholm, Sweden – announced that we would combine to create the world's broadest exchange and premier technology company with 4,000 listed companies from 39 countries, reflecting an aggregate market cap of $5.5 trillion. We anticipate the combined exchanges will average 7.4 million trades a day, representing a value of over $60 billion.

In an era of unprecedented change and challenge for world markets, the NASDAQ-OMX combination creates a world exchange technology leader, opens new opportunities for growth and creates the potential for $150 million in synergies. Because of this transaction, issuers will receive enhanced services, market participants will benefit from better, streamlined technology as we combine the capabilities of both companies, and investors will have a broader menu of services from the NASDAQ/OMX Group.

The stock exchange of the 21st century is an electronic data network and, like any network, stock exchanges gain greater efficiencies through expanding their scale and scope. By merging with another innovative, technology oriented exchange, we can offer brokers and traders the ability to connect with exchanges around the world through a unified architecture that can handle stocks, bonds, derivatives, and other instruments. Much like a common protocol in cellular telephony, a unified architecture for accessing multiple markets lowers cost, increases access, and overall provides significant advantages to U.S. and foreign investors.

Challenges Facing U.S. Exchanges – The Impact of Globalization

Mr. Chairman, NASDAQ welcomes the inevitability of global exchange consolidation. We appreciate the fact that Congress and the SEC have done an admirable job overseeing our industry in a rapidly changing competitive environment as markets, regulators, and governments prepare for a new era in global investing.

We are well positioned and prepared to compete across the globe. We are absolutely convinced that globalized markets can produce benefits for U.S. investors and the American economy by fostering increased exposure to capital and deeper liquidity for our listed companies. We have the fastest, most transparent, most reliable technology in the world. The speed and efficiency of NASDAQ are unparalleled. For example, major European exchanges have recently announced technology upgrades that will bring their systems to 10 millisecond trade speed. Our exchange already offers trading speed of less than one millisecond.

We also realize that the global economic environment is changing dramatically and in ways that challenge traditional assumptions and ways of doing business. The United States – at almost $20 trillion – still represents by far the largest pool of equity capital in the world, but maturing markets are rapidly catching up. We appreciate that our customers have ready access to a broad menu of new global options.

Foreign markets are becoming viable alternatives to the United States. Governments in Europe, Asia, and elsewhere have liberalized and modernized their capital markets. Privatized

state enterprises and private companies are increasingly able to tap financial markets that would not have been available a generation ago. Notably, over the past decade, overall market capitalization of major foreign markets has been growing at 10% per year, while annual growth in U.S. markets has been about 6%. See Attachment 1.

It should be noted that U.S. investors and securities brokerage firms have played a significant role in the growth of foreign markets. U.S. brokers have gone overseas for two reasons: non-U.S. issuers want access to American investors and American investors want access to non-U.S. securities. The trend is unmistakable. Institutional and retail investors in this country have been increasing their holdings of non-U.S. investments at a 14% annual rate, while domestic holdings are increasing by only 8%.

Changes of this magnitude inevitably produce consequences. We can demonstrate, for example, that American markets remain the best and most efficient in the world. But in this highly competitive, unforgiving international environment, no country can afford unilateral, self-imposed handicaps.

It has been widely noted, for example, that the trend in IPOs is to move abroad in search of more lightly regulated markets. Some have even suggested that the center of gravity in financial markets may be shifting away from New York, and there is some evidence for this concern. IPOs offered on U.S. exchanges have fallen from over 40% of global capital to less than 17% over the past 10 years. See Attachment 2. Last year, 22 of the top 25 IPOs chose to list outside the U.S. In fact, PriceWaterhouseCoopers is projecting that in 2007 the mainland China exchanges will be recipients of over $52 billion in IPO value, which dwarfs the value raised in any other single country worldwide.

Globalization and the Regulatory Environment

Concern about the regulatory climate and appetite for litigation in the United States is unquestionably influencing entrepreneurial decisions on where to list IPOs. Provisions of Section 404 of Sarbanes-Oxley indisputably create an additional burden for companies choosing to list here – and some simply go elsewhere. Many of these issues have been recognized and are being addressed in a positive atmosphere.

Over the past year, the global competitiveness of the U.S. capital markets has been analyzed by the Chamber of Commerce, the Competitiveness Council, the Interim Report of the Committee on Capital Markets Regulations (also known as the Hal Scott Report), and the Bloomberg-Schumer/McKinsey Study. While differing in some respects, these analyses agree on one central fact: some United States policies, particularly in areas like Section 404, litigation, and immigration can have a major impact on the ability of U.S. financial businesses to compete in the global marketplace. NASDAQ applauds the work the SEC and PCAOB are doing to address some of the onerous aspects of internal controls and financial reporting, particularly with regard to risk and materiality.

While achieving a more level playing field is critical, it is also important to point out that reports of the demise of the U.S. IPO market are exaggerated. I see the trend of IPOs seeking

capital outside the U.S. as evidence of the growing strength of the markets in the emerging economies, rather than necessarily reflecting a weakness in the U.S. capital markets. In fact, NASDAQ's first quarter was our strongest performance in IPO listing since 2000.

We are seeing true strength in the area of new listings – more quality and better quality companies able to meet our higher listing standards. Two important factors work to our advantage, regardless of Section 404 of Sarbanes-Oxley and litigation. First is the superiority of our proven technology and trading platform. Second is the amazing potential of the American market. It may be easier or less rigorous to list elsewhere, but when the best companies in the world consider an IPO, they still realize that the incredible liquidity of U.S. markets and ready access to the world's most sophisticated investors consistently produce world class valuations and visibility.

For example, there is evidence to suggest that foreign firms dually listed in this country receive a premium of as much as 30% on their valuation when they add a listing on a major American exchange. The premium is more pronounced for countries with less rigorous regulatory regimes and looser systems of corporate governance. This evidence points to the conclusion that high standards lead to increased investor confidence and improved valuation.

In addition, U.S. stocks are more liquid than their foreign counterparts for a variety of reasons that include efficient clearing and settlement systems; multiple innovative and competitive stock exchanges; widespread adaptation of automation and technology by investors, brokers, and exchanges; and a favorable tax environment for capital income.

While on the subject of global competitiveness and new issues, I should also point out that American markets are world leaders in innovation. For example, IPOs are important, but they are not the only attractive option available to the international entrepreneur in search of capital. Many people are surprised to learn that last year more equity capital was raised in conjunction with Rule 144A private placements with Qualified Institutional Buyers (QIBs) than on the NASDAQ, the NYSE, and the AMEX combined. NASDAQ has over sixteen years of experience in PORTAL securities and later this year, subject to SEC approval, will launch an industry-wide, fully transparent quoting and trading system that will provide the first centralized location for displaying and accessing trading interest in 144A debt and equity issues.

Mr. Chairman, the U.S. capital markets have long been the envy of the world, but leadership is not an entitlement. The advantages enjoyed by U.S. markets that I just described represent where we are today, but not necessarily where we are headed. The world is changing around us and the pace of change is accelerating. With exchange consolidation, the dramatic emergence of new centers of capital representing real alternatives to U.S. markets fueled by the establishment of international investment banks, and the ongoing revolution in technology, no market – no matter how strong, advanced, or well-established - can afford to carry dead weight or self-imposed handicaps and hope to succeed in this intense global competition.

Unless we make some fundamental changes in our approach to regulation, America could squander its hard-earned edge in the capital markets. If we fail to acknowledge and adjust to a changing competitive environment, there is no guarantee that NASDAQ and other U.S.

exchanges will maintain their leadership position in the world economy. Let me be clear: we are not asking that our regulators always agree with us – we understand on matters of policy that institutions of government often have the final say – but we need expeditious decision-making. When we announce a proprietary initiative through a rule filing, our competitors react around the world. Often our competitor's response to our initiative is rolled out before we receive regulatory approval.

We note that Congress laid a foundation to create a highly competitive exchange environment in this country. That initiative has worked as intended. NASDAQ and the NYSE have gone public, we have brought transaction costs to near zero and we are fighting head-to-head for every trade and every listing. However, that competitive environment, when coupled with a rules-based, often overly deliberative regulator, creates a long-term challenge for maintaining the leadership position of the U.S. equity markets.

For example, I am responsible for NASDAQ's discussions, some publicly known and some not, with a number of exchanges around the world as well as with current investors in those exchanges. I can tell you that every conversation I have inevitably turns to the question of the risks and costs associated with U.S. regulation. My counterparts understand the importance of strong investor protection policies, regulatory oversight, and prosecution of misconduct. However, they almost invariably voice significant concerns that in the U.S. the regulatory regime is too stringent, oversight too aggressive, and litigation too pervasive.

Even more important, we frequently face difficult questions about the perceived unpredictability and uncertainty associated with future U.S. regulatory policy. We are asked to prove a negative – that U.S. regulation will not, at some future point, spread beyond the U.S. borders and impact issuers, broker dealers, and investors of foreign exchanges that choose to partner with an American exchange. These perceptions can call into question the attractiveness of NASDAQ – or any U.S. exchange – as a potential partner.

I referred earlier in my testimony to the significant advantages that will accrue from NASDAQ's combination with OMX, which is based in Sweden. At $3.7 billion, this is obviously a major transaction for us, and you can imagine my sense of disquiet when I picked up the "Financial Times" recently and read, "Sweden expresses concern over OMX deal." The reason? The Swedish government may oppose the deal because it could "undermine the Nordic exchange operator's competitiveness by making it too American and less European."

In my view, the fear expressed by the Swedish regulators and others is not based solely on the possibility of the application of Section 404 of Sarbanes-Oxley, or the threat of being subject to litigation in the United States, although these issues are prominent. What I hear, in addition, is an underlying concern about what the future may bring and uncertainty about what the U.S. Congress and regulators may require of an exchange that is not registered or operating in the U.S. but is owned by a U.S.-registered exchange. Those, I can assure you, are real-world concerns and they play a role in the real world process of globalization.

The impact of regulatory uncertainty is also apparent in dealing with potential foreign investors and trading partners who are amazed to learn that the market data business of all U.S.

exchanges has been held up, month after month, while the SEC considers a petition filed by the NetCoalition. NASDAQ has not had a single, substantive rule filing for any new data products approved in almost one year.

This type of delay and uncertainty raises troubling questions about significant portions of our business. In addition, it seriously impedes our ability to compete for investors and trading partners against global competitors whose business initiatives do not face this array of regulatory impediments and inertia.

Contrast these doubts and frustrations with the situation of our global competitors who frequently work hand-in-hand with their regulators to create opportunity and competitive advantage. For nearly half a century financial regulation in Europe has focused not only on investor protection but also on the effort to break down trade barriers in order to improve the competitiveness and liquidity of European capital markets. In the UK, the FSA views regulation as one tool at its disposal to create a world financial center – in London. The FSA is clearly of the view that regulators must be very wary of the damaging effects they can have on creativity, innovation, and competition.

In summary, Mr. Chairman, we are seeing dramatic changes in global markets accompanied by challenges and opportunities for exchanges and investors alike. There will be winners and losers; there will be consequences. An important factor in the ability of U.S. exchanges to compete effectively and find partners in the process of consolidation will be the ability of Congress to continue to support the investor protections so important to our capital markets while rooting out the kind of overregulation that can handicap the continued evolution and growth of the U.S. capital markets as they engage in a global competition.

Specific Recommendations to Help U.S. Exchanges Compete in Globalized Markets

NASDAQ would like to offer four specific recommendations for the Committee's consideration:

First, we ask Congress to reaffirm statements that U.S. laws apply solely within the United States and thus pertain solely to exchange activities within the U.S., thereby addressing concerns about regulatory overreach and the notion that U.S. regulators will take actions negatively affecting a foreign partner of a U.S. exchange. Individual legislators and regulators have been exceedingly helpful in stating this will not be the case, but skeptics remain.

Second, provide regulatory certainty for exchanges, including the notion that there will not be differential regulatory standards for U.S. exchanges and foreign exchanges that choose to operate in the United States. This would respond to frequently expressed concerns about the risk associated with operating an exchange under policies and procedures that create an inordinate delay in responding to competitive threats or seizing opportunities. Until regulation of markets is uniform and world wide, it would be inequitable and harmful to U.S. investors to allow unfettered access to our markets on the part of foreign exchanges that are not subject to SEC/CFTC oversight and issuers that are not subject to registration requirements by the SEC.

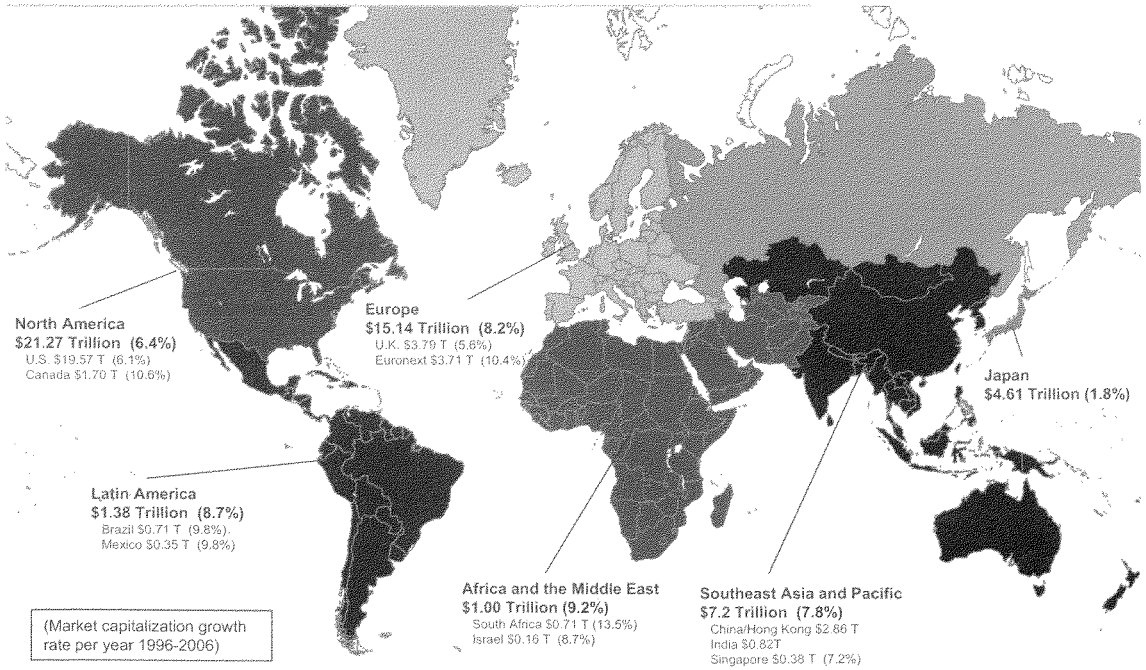
Third, we need to recognize that companies and investors have real choices beyond the U.S. markets or the U.S. system of regulation. We cannot assume that our leadership is an entitlement; it is not and that leadership needs to be earned anew all the time. It is earned by recognizing that we must constantly modernize our system of regulation and we cannot be so proud as to ignore advances and improvements made in other nations and by other markets.

Fourth, as much as the rest of the industrialized world has discovered, a principles-based environment of regulation would enable exchanges to act quickly and to compete domestically and globally while providing the regulatory oversight that gives investors confidence in the capital markets overall.

Thank you, Mr. Chairman, for the opportunity to share NASDAQ's views on these important matters.

Attachment 1

Domestic Equity Market Capitalization by Region* (2006) and CAGR of Market cap by Region* (1996 to 2006)



*As per statistics of the 51 exchanges that were members of the WFE as of December 2006 (in US Dollars). 1996 figures used to calculated growth rates have been inflation-adjusted to 2006 dollar levels.

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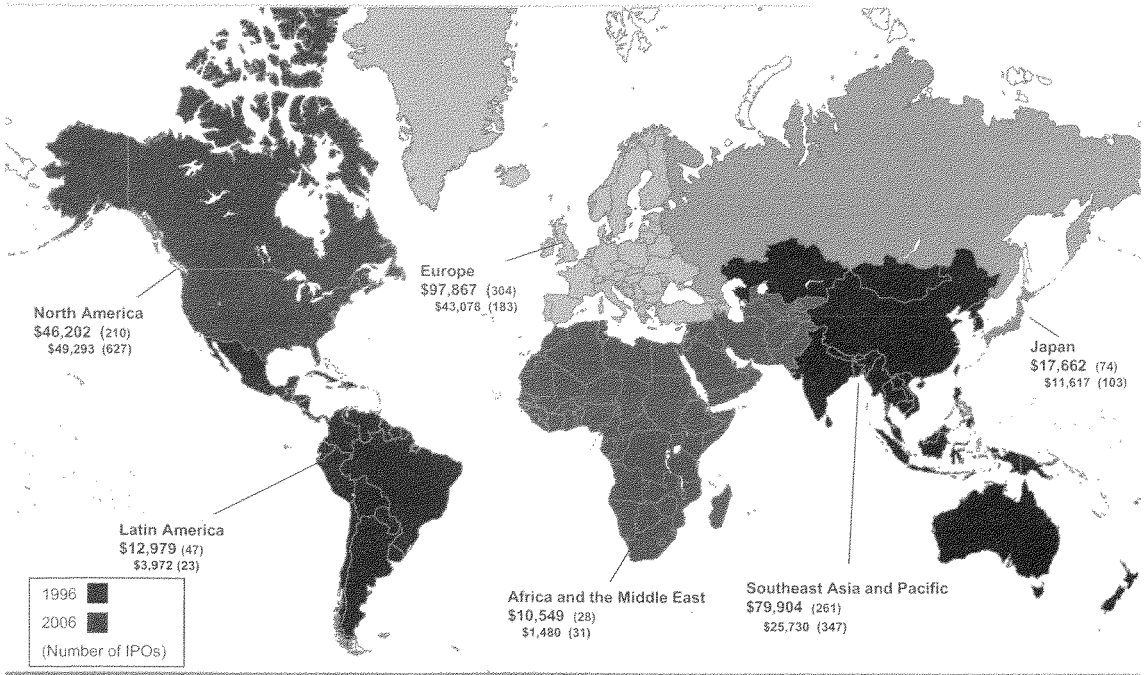
NASDAQ

Attachment 2

IPO Capital Raised by Region in 2006 versus 1996*



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Written Testimony Submitted by Professor Allen Ferrell
Greenfield Professor of Securities Law
Harvard Law School
Before the Senate Subcommittee on Securities, Insurance and Investment
"A Global View: Examining Cross-Border Exchange Mergers"
July 12, 2007

Mr. Chairman and distinguished members of the Committee, thank you very much for inviting me to testify today. I would like to begin my testimony by discussing what I consider to be one of the most important changes exchanges have undergone in the last fifteen years: demutualization. I would then like to tie the general phenomenon of demutualization to cross-border exchange mergers and the various regulatory issues that the U.S. and other countries face as a result of these cross-border exchange mergers.[1]

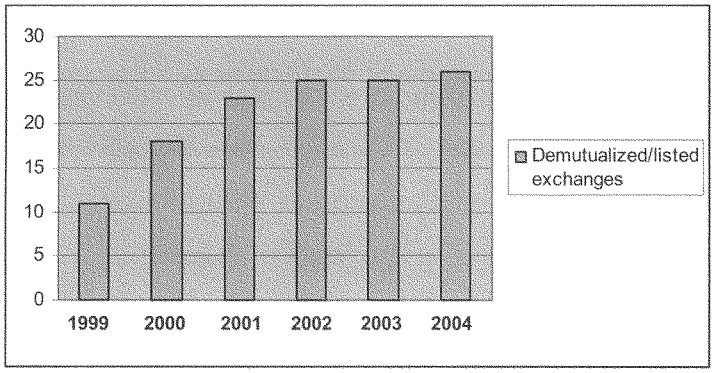
I. Demutualization of Exchanges

There has been a dramatic change in the organizational structure of exchanges over the course of the last fifteen years as they have converted into "for-profit" entities, and this has often been accompanied by a public listing of shares on the exchange itself

[1] In preparing this testimony, I have partially relied upon earlier papers I have written on the topic: U.S. Securities Regulation in a World of Global Exchanges, EUROMONEY (2007) (with Reena Aggrawal and Jonathan Katz); and Allen Ferrell, Demutualization and Exchange Owners' Incentives.

and the cross-border merger of exchanges. Demutualization involves moving from a membership-owned, typically non-profit, organization to a for-profit exchange owned not necessarily by its membership (i.e. those with trading rights on the exchange) but by those that own shares in the exchange.

In 1993, the Stockholm Stock Exchange became the first exchange to demutualize. It was followed by a wave of other exchanges, including the Helsinki Stock Exchange in 1995, the National Stock Exchange of India (created as a demutualized exchange in 1995), the Copenhagen Exchange in 1996, the Amsterdam Exchange in 1997, the Australian Exchange in 1998, the Toronto, Hong Kong, and London Stock Exchanges in 2000, Nasdaq in 2000, the Bombay Stock Exchange in 2005 and the New York Stock Exchange (NYSE) in 2006. The stock exchanges of Brazil, Sri Lanka, Pakistan, Philippines, and South Africa have announced plans to demutualize and list their shares. At the same time, the largest derivative exchanges such as the Chicago Mercantile Exchange, the London International Financial Futures and Options Exchange (LIFFE), the Chicago Board of Trade, and Eurex are either already publicly listed or are part of publicly listed parent companies—and others, including the New York Mercantile Exchange (NYMEX) in 2006 have demutualized and went public. The clear trend towards exchange demutualization and listing can be seen in the following graph, based on the World Federation of Exchanges' 2001-2006 annual surveys of its membership, charting the number of demutualized and listed exchanges.



The NASD restructured Nasdaq in 2000 by conducting a private placement and issuing warrants. On July 1, 2002 shares of Nasdaq started trading on the over-the-counter Bulletin Board and eventually migrated to the Nasdaq Stock Market in February 2005 after issuing shares in a secondary offering. Nasdaq acquired the BRUT ECN in 2004 and in 2005 acquired the INET ECN (owned by Instinet) for $935 million. Nasdaq expects savings of $100 million per year from synergies in technology, clearing, corporate overhead and market data products. Both Nasdaq and NYSE plan to enter the options business and increase the scope of the products that trade on their markets.

Regional exchanges such as the Boston Stock Exchange and the Philadelphia Stock Exchange are also transforming themselves by launching new trading platforms and forming joint ventures/strategic alliances with large firms such as Citigroup, Credit Suisse First Boston, Fidelity, Citigroup, Morgan Stanley and UBS. This trend is likely to continue in the future.

II. Technological Change is the Driver

This powerful global trend towards exchange demutualization – as well as other global trends in the capital markets such as cross-border exchange mergers, the rise of hedge funds, and the increasing importance of cross-border stock trading – are all, to a significant extent, a function of the dramatic reduction in computing and telecommunications costs in the 1980s and 1990s. Technological change has increased competition and forced exchanges around the world to adopt.

More specifically, the reduction in computing and telecommunication costs have reduced the once sizable fixed (and usually sunk) costs associated with establishing trading venues offering execution services that are needed to compete with incumbent exchanges. Moreover, these cost reductions have also substantially reduced the cost of sophisticated automated routing systems (such as the LavaTrading system), which are capable of routing orders to the lowest-cost trading venue regardless of whether that trading venue is the incumbent exchange or not. It is worth emphasizing that the increased competition in the market for execution services generated by these cost reductions has not been confined to developed markets. One study has found that a number of exchanges in developing countries have lost more than half their order flow to foreign exchanges.[2]

Numerous examples of increased order flow competition faced by exchanges can be given. One of the most dramatic and earliest examples was the London Stock Exchange's (LSE) introduction in 1985 of the SEAQi electronic trading venue, which directly competed for order flow in securities traded on the Stockholm and Amsterdam

[2] Claessens, Stijn & Klingebiel, Daniela & Schmukler, Sergio, 2002. "Explaining the Migration of Stocks from Exchanges in Emerging Economies to International Centres" CEPR Discussion Papers 3301.

stock exchanges. More recently, the LSE last year launched a new electronic market, called EuroSETS, in an attempt to attract order flow in Dutch stocks, which currently trade on the Euronext market. The LSE, as part of the launch, gave (for a limited time period) free exchange memberships. The LSE claims that transaction costs on this new platform are twenty percent lower than that of Euronext. Euronext, in turn, has started trading FTSE-100 stocks, which have traditionally traded on the LSE.

Another prominent, and very recent, example of increased cross-border order flow competition is Project Turquoise, a market set up by seven investment banks to compete with LSE. The seven banks are Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, Merrill Lynch, Morgan Stanley and UBS which collectively control a significant amount of investor order flow. They claim that this market will provide a lower-cost alternative to LSE and, in particular, be well-positioned to fill large orders for banks. There are recent reports that Societe Generale and BNP Paribas might be joining Project Turquoise. Project Turquoise will apparently contain both a public and non-public limit order book.

Foreign exchanges are not alone in facing increasing competition for listings and order flow. Exchange-listed stocks trade in overseas markets as well as in the United States. U.S. exchanges face competition not only for investor order flow in publicly traded stocks, but also for listings. And this competition is not solely from foreign exchanges, like London's AIM market, that have received so much attention in the press. Just last month, Goldman Sachs helped underwrite the private, non-registered sale of 15% of hedge fund manager Oaktree Capital Management for $880 million to approximately 50 large institutional investors. Shares in Oaktree Capital Management

can be brought and sold by large institutional investors on the new Goldman Sachs Tradable Unregistered Equity System (GSTRue). Tellingly, public equity offerings on the three largest stock exchanges – the New York Stock Exchange, Nasdaq and the American Stock Exchange – raised $154 billion last year compared to the $162 billion raised in the U.S. in private placements. Of course, the ultimate success of private trading systems like GSTRue will depend on a number of factors, such as the liquidity of shares traded on it, and the cost of ensuring that there are no more than 500 shareholders of any company traded on GSTRue. If the 500 shareholder threshold is crossed, then the company will likely have to register pursuant to the Exchange Act of 1934. Registration would trigger the requirement to periodically file the full panoply of Exchange Act reports, such as the 10-K, 10-Q and 8-K, as well as the requirements of Sarbanes-Oxley.

Also promoting competition and reducing costs were significant regulatory initiatives that reduced or eliminated the self-regulatory obligations of new competitors (Reg ATS for electronic trading networks (ECNs) in the U.S.) or permitted greater regulatory flexibility in accepting listings. Regulations, such as Reg. 144A and Reg. S in the U.S., enabled institutional investors to invest globally and in unlisted securities and made it easier for U.S. companies to offer securities globally. Under Regulation ATS, alternative trading systems (ATSs) had the option to register as an exchange or as a broker-dealer.[3] Registration as a broker-dealer eliminated the statutory obligation to become a self-regulatory organization, with the attendant cost burden. In the new environment, ATSs formed alliances with exchanges in order to combine the regulatory status of the exchange with the trading platforms of ECNs. The ECN benefited as it did not have to build regulatory costs into its business model and the exchange benefited

[3] See US SEC Regulation ATS, 17 CFR 242.300, *et seq.*

from the transaction and market data fee revenues generated by the ATSs. ECNs started executing and reporting trades through particular exchanges and sharing in data revenues. The interest of the traditional exchanges in the U.S. in establishing such alliances or outright mergers with ECNs has only increased as a result of Regulation NMS, which confers a regulatory benefit on exchanges that have automated access to their quotations. Paradoxically, some ECNs claim that Reg. NMS, and the SEC's previous order handling rules, has adversely affected their business model by requiring them to provide non-members with access to its quotes.

The response of incumbent exchanges around the world to increased competition has been, as discussed earlier, to demutualize so that exchanges are no longer owned by its members but rather by shareholders in a for-profit entity. Instead of each member having one vote, regardless of its size or the amount of order flow it routes to the exchange, a demutualized exchange has shareholders with one vote per share. This means that, in contrast to the consensus-based decision-making process that has historically characterized many mutual exchanges, decisions in demutualized exchanges are made by majority vote of shareholders just as with any other for-profit, shareholder-owned firm. Given the fact that ownership is legally distinct from trading rights in a demutualized exchange, even though some parties might happen to have both trading and ownership rights, a demutualized exchange is almost always a for-profit organization. The ability to earn a return on shares in the form of dividends or capital appreciation substitutes for the ability of members to earn a return by virtue of having trading rights on the exchange.

A demutualized exchange has a significantly enhanced ability to adopt low-cost execution facilities that are increasingly necessary to compete effectively against other low-cost trading venues. The old membership, which often has powerful vested interests in maintaining the existing trading rules and trading infrastructure even when this did not constitute the lowest-cost to traders, were in effect brought out in the form of share allocations in the demutualization process. Each Toronto Stock Exchange member, for example, received 20 common shares in the exchange in the exchange demutualization. It is typically the smaller members, such as floor brokers on the NYSE or the *hoekman* (specialists) on the Amsterdam Stock Market, which have resisted demutualization as they had the most to lose from a move to a more efficient, competitive trading structure which typically involves far more disintermediation and automation. Tellingly, new trading venues are almost entirely automated with less in the way of intermediation except for block trades and illiquid securities.

Tellingly, the execution facility that has often been adopted by demutualized exchanges (or are newly-created exchanges that were never mutual organizations to begin with) is an electronic limit order market, with time and price priority except for block traders, along with access to the execution facilities open to a wide range of participants. Direct access to the limit order book is typically extended to foreign traders via electronic linkages. The Paris Stock Exchange, which has had substantial success selling its trading system to other trading venues, and the Scandinavian stock exchanges are, for example, electronic limit order markets. Immediately after its demutualization in 1993, the Stockholm Stock Exchange allowed remote membership with direct unmediated access to the exchange. A recent cross-country empirical study has documented that the adoption

of electronic trading is often associated with a substantial increase in the efficiency of the trading process.[4] On a related note, Domowitz and Steil (2001) estimate that the adoption of a non-intermediated trading structure would result in execution costs up to a full third less than those that currently prevail on some of the incumbent exchanges.[5] In fairness, the efficiency of incumbent exchanges' trading systems has improved since the time of this study.

A demutualized exchange not only has an enhanced ability to adopt low-cost electronic trading facilities. Having publicly-traded shares associated with ownership enhances the ability of these exchanges to engage in cross-border mergers. Demutualized exchanges can engage in mergers just as other for-profit, publicly-traded companies do. Not surprisingly, one often observes cross-border mergers in the immediate aftermath of demutualization.

Advances in technology have also increased the ability of exchanges to offer specialized services to investors with special execution needs. As different members of an exchange begin to serve different clienteles, the potential divergence of interests between members of an exchange grows. This is a factor favoring demutualization. Reaching agreement among the members of an exchange as to what specific form a new competitive trading structure should take, as opposed to transferring that decision to a new set of owners through demutualization, is likely to be particularly difficult given wide differences in the types and size of rents that are being extracted by different members (floor brokers, specialists, large versus small broker-dealer firms, institutional versus retail traders) and severe informational asymmetry as to what these rents actually

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[4] Jain, P., Financial Market Design and the Equity Premium, Journal of Finance 60 (6): 2955.
[5] Domowitz and Steil, Automation, trading costs, and the structure of the securities trading industry (2001)

are and how they would change under different possible trading structures. Consistent with this explanation, empirical studies have found that bargaining tends to breakdown as informational asymmetry among bargaining parties increases despite there being large efficiency gains to be had. Also consistent with this is the observation that consumer cooperatives tend to only work when there is a high degree of homogeneity of interests among the consumer-owners. As consumers' interests diverge, the decision-making process of a cooperative can become unmanageable.

III. Regulation in a World of Demutualized Exchanges

The global movement of traditional stock exchanges to for-profit businesses has put pressure on the self-regulatory function of exchanges. A for-profit stock exchange, burdened with expensive regulatory duties (as a result of being a self-regulatory organization (SRO) under the Exchange Act), and competing with trading platforms that have lower regulatory burdens or no regulatory duties must grow its business to be successful. As with any business, profit growth may come from increased revenues or reduced costs. For a stock exchange, revenue growth must come from increased trading volume, by adding new listings or by acquiring other exchanges or trading platforms.[6] Cost reduction may come from a reduction in regulatory burdens or through economies of scale, such as the consolidation of separate market surveillance units and operating acquired trading platforms on existing surplus IT capacity. This emerging business dynamic may be driving a variety of fundamental changes in global regulation.

[6] The SEC concept release on self-regulation, identified several revenue sources for trading systems: Regulatory fees, Transaction fees, Listing Fees, Market Data fees and various minor miscellaneous fees.

There are concerns that this has placed undue strains on the regulatory structure. These issues have included the concern that trading might move to markets with lower regulatory requirements, the existence of inconsistent rules across markets, and that exchanges may reduce the rigor of their regulatory oversight in order to gain market share. There is also the concern that exchanges may be "too soft in regulating themselves and too severe in regulating competitors."[7] For example, the SEC in its concept release, and in an earlier concept release, discussed the possibility of regulatory arbitrage, whereby, for example, an exchange might reduce its market surveillance function to attract trading volume, or lower listing requirements to attract companies.

Policymakers have long looked to a strong corporate governance structure to balance the inherent conflicts within an SRO. In the U.S., Congress specified in the 1934 Act that a registered exchange "assure a fair representation of its members in the selection of its directors and ... provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker or dealer."[8] The recent attention to SRO governance as a response to changes in exchange structure, market competition, weaknesses in SRO regulatory programs and the most recent cycle of scandals continues this tradition. In 2003, William Donaldson, the Chairman of the SEC (and formerly a President of the New York Stock Exchange) noted that the SROs "play a critical role in our securities markets as standard setters for listed companies, operators of trading markets, and front-line regulators of securities markets" and asked the SROs to review their own governance practices.[9] This review made sense

[7] Fleckner, Andreas M., "Stock Exchanges at the Crossroads" . Fordham Law Review, Vol. 74, p. 2541-2620, 2006 Available at SSRN: http://ssrn.com/abstract=836464
[8] 17 USC 78(f)(b)(3)
[9] SEC File No. S7-39-04.

particularly in a period when the exchanges were requiring enhanced governance standards of firms listed on the exchange.

Because regulators and market participants have been concerned by the actual or perceived conflicts of interest and the possibility that SROs might put their commercial interests ahead of their regulatory responsibilities, they have insisted upon structural change and governance changes as a condition to becoming a for-profit exchange.[10] In the U.S., the two primary exchanges the NYSE and NASDAQ have both adopted structures in which the self-regulatory functions are in separate subsidiaries, with separate boards (much of these self-regulatory functions of NASD and NYSE are now being merged). Limits on member ownership have been adopted and procedures for dealing with exchange "self-listings" have been put into place.

At the NYSE, the board is now comprised exclusively of independent directors. A separate advisory board of industry representatives has been created to periodically meet with the Board to ensure sufficient industry input into exchange policy. But this advisory board has no voting authority and the actual board is required to meet periodically without participation from the advisory board. While the NASD structure does not require an exclusively independent board, it is required that the number of non-

[10] These issues have been discussed in several papers including: Reena Aggarwal, *Demutualization and Corporate Governance of Stock Exchanges*, 5 J. Applied Corp. Fin. 105 (2002); Andres M. Fleckner, *Stock Exchanges at the Crossroads*, Fordham Law Review, Vol. 74, p. 2541-2620, 2006, Roberta S. Karmel, *Turning Seats into shares:Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 Hastings L.J. 367 (2002) Amir N. Licht, *Stock Exchange Mobility, Unilateral Recognition, and the Privatization of Securities Regulation*, 41 Va. J. Int'l L. 583 (2001); Benn Steil, *Changes in the Ownership and Governance of Securities Exchanges: Causes and Consequences*, *in* Brookings-Wharton Papers on Financial Services.

industry directors equal or exceed the combined number of member-representation directors and industry directors.[11]

This conflict is evident in the demutualization process of several exchanges globally. For example, on November 1, 2001 the Tokyo Stock Exchange demutualized and changed its name to the Tokyo Stock Exchange, Inc. However, its planned listing has been postponed due to delays that are partially due to disagreements between the exchange and the Financial Services Agency (FSA) over the exchange's management structure as a listed entity. The regulator had demanded that the exchange separate its regulatory division from the stock trading-related division.

When the SEC issued a concept release in 2005 to discuss possible new approaches to self-regulation two of the four identified objectives pertained to SRO governance and the protection of funding for regulatory functions:

(1) the inherent conflicts of interest between SRO regulatory operations and members, market operations, issuers, and shareholders; ...

(2) the funding SROs have available for regulatory operations and the manner in which SROs allocate revenue to regulatory operations.[12]

Listed-exchanges have higher governance standards than those applicable to listed companies on the exchange. This reflects the unusual combination of conflicting objectives of an exchange compared to an ordinary company. While an ordinary company has a legal responsibility only to its shareholders to make a profit, an exchange has a regulatory function, an obligation to member firms and to listed companies, as well as a duty to maximize profits and shareholder value. These responsibilities are

[11] SEC Release No 34-53128, January 13, 2006. Order Approving Application of the Nasdaq Stock Market LLC for Registration as a National Securities Exchange.
[12] http://www.sec.gov/rules/concept/34-50700.htm#III

compounded by the higher standards for public companies' boards adopted following enactment of Sarbanes-Oxley. Under the new regulations adopted in 2003, all listed companies must have a board that is composed of majority independent directors. This is applicable to exchanges also. In addition key board committees, including the nominating, audit and regulatory oversight committees, must be composed solely of independent directors.

Other exchanges around the world have also adopted, often in response to exchange demutualization, governance requirements focused on board and committee structure. For instance, the Toronto Stock Exchange must have on its board of fifteen, seven directors who are independent directors. The Hong Kong Exchange board must have a majority of directors that are "public interest" directors.

Exchanges are also required to limit ownership and voting by broker-dealers. Historically exchanges were member-owned organizations but demutualization has raised the concern that a member's self-interest could compromise the self-regulatory function if a member controls a significant stake in its regulator. For example, an exchange might not diligently monitor a member's trading if the member is a controlling shareholder. The SEC has proposed that no one broker-dealer may own more than 20% in an exchange of which it is a member. Many exchanges around the world have ownership limits, often capping ownership by a single entity at 5%. For instance, the Singapore and Philippine Stock Exchange cap ownership by a single entity, absent a regulatory waiver, at 5%.

Listing of securities issued by an exchange or its affiliate on its own market creates new potential conflicts of interest. Conflicts regarding "self-listings" raise

concerns as to an exchange's ability to independently and effectively enforce its own or the Commission's rules against itself or an affiliated entity, and thus comply with its statutory obligations. If the security of the exchange or its affiliate is not in full compliance with the rules of the exchange there might be the possibility that such issues would be ignored. Securities of competitors might be listed, and therefore regulated, by the exchange that might also cause conflicts of interest. In the United States, under listing rules, the securities of exchanges and affiliates can trade and hence self-listings are allowed. However, the SEC has put additional safeguards in place in the form of proposed Regulation AL. The exchange's Regulatory Oversight Committee must certify that the securities satisfy the SRO's listing criteria before the securities can be listed. The exchange is also required to file a quarterly report with the SEC summarizing monitoring of the affiliated security's compliance with listing rules and surveillance of trading. This report must be approved by the Regulatory Oversight Committee. In addition, an annual report prepared by a third party will need to be filed.[13]

Many countries, concerned with potential conflicts of interest, require that self-listed exchanges be supervised by a governmental regulatory rather than by the exchange itself. This is true, for example, of the Australian Stock Exchange, the Hong Kong Stock Exchange, the Singapore Exchange and the Stockholm Stock Exchange.

IV. Some Observations on Mutual Recognition

A topic that has received a substantial amount of attention is the issue of "mutual recognition." Simply put, the question is this: When should the SEC deem a foreign

[13] For details see, http://www.sec.gov/rules/proposed/34-50699.htm

country's regulatory regime to be sufficiently comparable to that of the U.S. to permit exchanges and broker-dealers in that country to directly access U.S. investors without registering with the SEC or complying with other legal requirements that domestic U.S. entities must? This question is a pressing one due to the rise of cross-border trading and cross-border exchange mergers.

My modest goal in this section is to briefly make three observations that, in my opinion, should inform the SEC's decision as to whether to recognize a foreign regime as sufficiently comparable to merit mutual recognition.

(1) Perhaps most importantly, in assessing comparability, one should not confine one's attention solely to the foreign country's statutes and legal rules or the enforcement powers of its securities regulators. For many foreign markets, there is a large amount of capital market data that can speak to such issues as the level of disclosure or the level of insider trading. For example, it would be a useful exercise to analyze the bid-ask spreads, and the informational asymmetry component of the bid-ask spread, in assessing the quality of a country's disclosure regime. This is just but one example. Other indicators of market quality, such as liquidity measures or measures of earnings opaqueness, can and should also be utilized.

(2) In assessing comparability, it should be borne in mind that a foreign country's legal regime can differ from that of the U.S. regime for entirely legitimate reasons. For example, countries in Continental Europe and Asia (Australia aside) have concentrated ownership of firms. The U.S., Australia, and U.K. have dispersed ownership of firms. The conflicts of interest that

arise as a result of concentrated ownership, such as majority-minority shareholder conflicts, are different than those that result from dispersed ownership, such as that between management and dispersed owners, which can legitimately call for different regulatory responses.

(3) Finally, mutual recognition is not an all or nothing concept. Perhaps the most feasible way of proceeding would be to limit mutual recognition, at least initially, both in terms of types of foreign companies and types of U.S. investors who would have direct access. For instance, a foreign regime could be granted mutual recognition with respect to its largest, most closely followed firms for purposes of providing direct access to U.S institutional investors.

Testimony of Damon A. Silvers

Associate General Counsel

American Federation of Labor and Congress of Industrial Organizations

Before the Senate Subcommittee on Securities, Insurance, and Investment

Hearing on "A Global View: Examining Cross-Border Exchange Mergers"

July 12, 2007

Good morning Chairman Reed, and members of the Securities Subcommittee. On behalf of the American Federation of Labor and Congress of Industrial Organizations, I want to express our gratitude for being asked to contribute our views on the future of the U.S. capital markets.

Capital markets are enormously important institutions in our economy and society. Our capital markets allocate and direct the majority of the resources in our economy. Trillions of dollars of working families' retirement funds are invested through these markets, here and abroad. And finally, millions of Americans directly and indirectly are employed in these markets and the businesses and institutions that serve them.

But we are going through a period of dramatic change in the very nature of our capital markets. Ten years ago, the New York Stock Exchange could accurately be described as a place where securities were traded—a building on Wall Street in New York City, USA. Today the New York Stock Exchange is many things—a brand, a network of linked trading software, and yes, a building on Wall Street, but that building on Wall Street is

becoming less and less important—comparable say to the original Disneyland to the Disney Corporation. As the New York Stock Exchange and NASDAQ each acquires controlling interests in exchanges around the world, and as market makers become increasingly globally diversified, it becomes less and less clear what we mean when we talk about the U.S. capital markets.

Increasingly, the meaning of the term U.S. capital markets means those securities and transactions where the parties choose to be governed by the U.S. system of investor protections, and consequently, to conduct their transactions in dollars. Most such transactions are today largely organized and staffed in the United States, but increasingly, with the exception of some of the more menial and less lucrative tasks, the work of structuring transactions in U.S. registered securities can occur anywhere in the world you can get a T-1 line and convince properly licensed lawyers and brokers to live.

In this environment, the truth is that powerful market institutions, whether it is NASDAQ, the New York Stock Exchange/Archipelago, or any of the large firms, whatever their national origin, don't really care that much about whether U.S. markets are "competitive." And to the extent they still do, they will care much less in five years.

And at the same time, we are seeing an acceleration of the integration of global markets. One measure of that acceleration is the wave of international mergers of exchanges. A second is the apparent rapid progress of "convergence" in accounting systems. Just a week ago the SEC issued proposed rules under which non-U.S. companies could list on

U.S. exchanges without issuing GAAP financial statements.[1] Shortly before that the SEC announced its timetable for full convergence between GAAP and IFRS, which contemplates completion of convergence in 2009.

These developments lag behind the effective integration of world markets for large cap securities, corporate and government bonds, and an enormous variety of derivative instruments related to these securities and key indexes. Through hedge fund and private equity firm borrowing, these markets are linked to commercial banks worldwide. From both a systemic risk and a market conduct perspective, capital markets are already effectively global, not national.

We then have to think of these markets in phases – currently a situation when regulation is mostly national in scope, but market activity in increasingly integrated globally, the process by which rules for global markets will be created, and finally, the characteristics of the global market regime of the future.

In this context, policymakers in the United States need to consider the following three permanent interests we have as a nation in today's capital market structure, interests that will be equally present as we move toward an increasingly integrated single global capital market:

[1] Securities and Exchange Commission, 17 CFR Parts 210, 230, 239 and 249; RIN 3235-AJ90 (Proposed Rule) (July 2, 2007)

- Ensuring that capital markets direct resources to sustained wealth generating activity in the U.S. economy;
- Providing strong investor protections to Americans who invest their savings and their hopes in the capital markets;
- Maintaining and growing capital markets activity in New York and other financial centers in the United States.

In addition, we have further interests as a nation that are the result of what are hopefully temporary conditions in our economy. For example, as a result of our low savings rate, low tax rates and trade deficit, we are dependent on foreign investment to finance our imports and our government spending. Thus we have an urgent need to attract net positive inflows of foreign capital to the United States.

The labor movement worldwide is increasingly concerned that our increasingly global capital markets are increasingly unable to provide financing with time horizons appropriate to the needs of operating businesses. John Monks, the President of the European Trade Union Confederation, has labeled this combination of increasing leverage and shrinking time horizons for business investment "financialization." (See Appendix A). Here in the United States, the AFL-CIO has been a leading participant in an effort by the Aspen Institute that brings together investors and companies to promote a culture of long term value both in the markets and in the management of public corporations. Recently this effort led to the release of the Aspen Institute's Principles

entitled Long-term Value Creation: Guiding Principles for Corporations and Investors. (See Appendix B).

Over the last thirty years, the public capital markets have become responsible for allocating a greater and greater share of our society's resources, with a comparable diminishment in the relative role both of the public sector and of private financial intermediaries like commercial banks. This growth in the importance of the public markets has coincided with long term real wage stagnation in the United States, as well as our economy's prolonged failure to address increasingly dire economic threats, including 1) the problems associated with the combined issues of energy and the environment, 2) the crisis in health care, both in terms of coverage and cost, and 3) the crisis in retirement security. A powerful way to think about this problem is to consider that in 2006 there was $2.4 billion invested in energy technology venture capital. By way of comparison, in 2006 the video game industry generated $7.6 billion in revenue.[2]

Capital markets both reflect underlying economic conditions and shape them. While we cannot expect capital markets to be the sole provider of solutions to these profound problems, these markets need to be structured so they are pushing in the right direction. Our accounting and disclosure systems, our corporate governance systems, and our tax regime all need to be oriented toward encouraging our capital markets to produce long-

[2] The Video Game Association, http://www.theesa.com (checked July 11, 2007).

term, sustainable value in the real global economy. In recent years, this has been the consistent theme motivating the labor movement's advocacy of improved corporate governance, accounting and auditing—our support for giving long term investors more voice in selecting corporate boards, our concerns about leveraged finance and short term oriented investment strategies pursued by hedge funds and leveraged buyout firms, and our concerns that mark to market accounting not undermine the ability of operating businesses to accurately disclose the results of their actual business to their investors.

We have heard recently, however, that the real problem facing our markets is the threat posed by the existence of other capital markets in the world with comparably deep liquidity. We disagree. In an age of increasingly integrated global capital markets, the ambition to be the sole geographic location for significant capital market activity is both unrealistic and potentially threatening to our ability to remain the leading geographic location for such activity.[3] Today in both Europe and Asia, markets of sufficient depth located in financial centers of sufficient sophistication exist to plausibly compete with U.S. markets and with each other for business. These markets have a natural advantage in competing to offer capital raising services to operating companies located in their own geographic areas. They also will attract investment capital from their own regions for similar reasons.

Currently, U.S. markets appear able to nonetheless attract business from both Europe and Asia largely because it is cheaper to raise capital here than in non-U.S. markets.

[3] Goldman Sachs, "Is Wall Street Doomed?," *Global Economics Weekly* (Feb. 14, 2007).

Investors have confidence both in our underlying legal and economic institutions and in our specific investor protections. The result is that global investors are willing to pay a higher multiple for earnings that have been certified by our regulatory structure than for similar earnings paid by companies whose securities trade only on non-U.S. markets.[4] However, there are issuers who will not list on U.S. markets regardless of what our cost of capital advantages are. Some issuers simply cannot meet our standards, others are simply unwilling to. But the vast majority of issuers globally are economically rational and will raise capital in the market where the cost of capital is lowest. Our overall market strength and positioning depends on not relaxing those standards in an attempt to win 100% market share for our capital markets. Simply put, our markets cannot be all things to all people.

As we move toward more global market rules, the earnings premium investors bestow on U.S. markets is a measure of the confidence placed in our markets' investor protections. In the wake of the strengthening of U.S. investor protections after Enron, investors globally see the robust U.S. regulatory system as a model. Key ingredients of our model include independent national regulators backed by supporting layers of SRO and state regulation, independent accounting and auditing board, a multilayered disclosure system, and ultimate access to the courts for investors seeking to enforce both their rights to information and to corporate governance decision making.

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[4] Charles D. Niemeyer, "American Competitiveness in International Capital Markets," p. 2; *id.* at 3 (citing Hail, L. and Leuz, C., *International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?*, 44 J. Accouting Res. 485 (June 2006)); *id* (citing Doidge, C., Karolyi, A., and Stulz, R., *Why Are Foreign Firms Listed in the U.S. Worth More?*, Journal of Financial Economics, Volume 71(2), (205-238).

In the context of the move toward global market rules, calls to weaken U.S. investor protections by firms which themselves are global market actors may have more to do with hoping to weaken emerging global standards than with any genuine concern for U.S. competitiveness.

So one fundamental policy principle that should inform our government so long as we have a clearly distinct national market from a regulatory perspective is that our interest in strong investor protections and our interest in maintaining a healthy share of the world's total capital market activity are not in conflict, but are in fact mutually supportive.

In addition to strong specific investor protections, there are other background conditions that affect the ability of a nation to sustain capital market leadership. Healthy national savings rates, a stable currency, a commitment to the rule of law and to being a responsible member of the international community are all important preconditions to being able to attract and retain both investors and those seeking capital. In each of these areas, recent trends in the United States may be cause for concern.

But there is finally another dimension to competitiveness, one that is important today and will become more important as capital markets become more global. Ultimately, any country or city's ability to be a center of capital market activity depends on their ability to be a center of human capital, information technology, and transportation infrastructure. The future of New York and our other major cities as financial centers depends on the

health of their educational institutions at every level, the sophistication of their telecommunications infrastructure, and the efficiency of their transportation systems. Substandard public education, traffic gridlock, and outdated telecommunications systems are the real long term enemies of American competitiveness in the capital markets.

Ironically, one of the greatest threats to our leadership in the global capital markets may be embodied in the now often quoted statistic that in 2006, 25 individuals who managed hedge funds made three times what the 80,000 people who teach in the New York City schools earned, and yet paid a lower marginal tax rate on the bulk of their hedge fund earnings than those school teachers paid on their incomes.[5]

If we are not prepared to invest in education for the average American, or to pay the taxes necessary to fund our public infrastructure and stabilize our government's finances, we will undermine the very foundations of our capital markets, just when those foundations will become ever more important to our ability to sustain capital market activity in the United States.

Ultimately, capital markets appear on track to become increasingly global. If U.S. public policy focuses on maintaining the U.S. markets as the gold standard in investor protection, supported by continuous improvement in the key supporting structures of education, information technology, and infrastructure, we should be able to maintain our

[5] Jenny Anderson and Julie Creswell, "Make Less Than $240 Million? You're off Top Hedge Fund List, " *NY Times*, April 24, 2007.

position as the world's leading capital market and convert that position into a position of leadership as one geographic locus for an increasingly unified global capital market that has embraced the key principles that led our national capital market to flourish in an earlier age.

Introduction by:

John Monks

General Secretary
of the
European Trade Union Confederation

The Challenge of the New Capitalism

London, 14 November 2006

To be checked against delivery

JM/cd

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Those of you who knew Aneurin Bevan can probably guess his likely reaction to my choice of the title tonight.

Capitalism was capitalism to Nye. It was enduring and unchanging. It was the South Wales coalowners, it was the slave traders, Cecil Rhodes and other rapacious exploiters of working people in the Empire and at home. It was greed and selfishness, the drive for money dominating and twisting all other human motivations. (Bevan was often of course a lot more sophisticated then he might have been at a NUM weekend school giving the above speech. He appreciated the good things of life in full measure – even having at least a touch of what the French call 'un socialiste caviar'.)

But I don't think he would have taken easily to a concept of the new capitalism. Many things do remain the same but my thesis tonight is that capitalism has changed in very important ways and that the Left generally has few intellectual, philosophical or political answers, at least as yet. It therefore warrants the use of "new" and the formulation of a new strategy to deal with it. My purpose tonight is to encourage others also to pursue these questions.

Since the collapse of communism under its own internal contradictions, capital has the whole world, more or less, at its feet. It can go most places seeking the best returns. It is afraid of nothing – there is no

competing system which threatens its expropriation. This struck home to me vividly when Bill Clinton visited Vietnam towards the end of his Presidency. You won the war, observed Clinton wryly, but, now, to survive, you are observing the rules of world capitalism. He could have added "Our rules, American rules".

There is still protectionism in many parts of the world. I was interested last week to see that even in the open economy of Sweden, the Wallenberg family and its foundations, which act as a holding company for several of the big Swedish multinational companies, are being accused of protecting Scania, the truck manufacturer against a German takeover. Not everyone is allowing the new capitalism a clear run but the pressures are on.

You can see it in rising levels of inequality. If you work in the global economy, especially in its financial sectors, rather than manufacturing, chances are you are doing well. Exceptionally well, if you are at executive level.

On the other hand, the new workshop of the world is China and it is being followed by other developing countries with inexhaustible supplies of cheap labour – and access to capital. The impact on some sectors of the UK economy like textiles and footwear has been devastating.

Most of all, you can see it in the operation of financial markets. Since the 1980s, changes in regulation and technological developments have led to huge changes in the way financial markets work, in the role of banks, and in the rise of new investment forms.

The City view is that this trend is almost wholly beneficial, moving financial markets closer to 'perfect competition' and optimal outcomes. At most there is concern about two issues: illegal activity (fraud etc) and possible systemic risk. But, recent developments point to a whole series of concerns, including accounting scandals: the cases of WorldCom, Enron and others have shown that market mechanisms combined with existing auditing rules and regulation are inadequate to protect investors, workers and pensioners against the risk of fraud. This is new rootless capitalism without any geographical responsibilities, as shown for example, by HSBC hinting, threatening, that it might relocate its headquarters outside the UK.

Stock options are also a concern. One increasingly popular method to align shareholder and managerial interests has been for the former to grant the latter stock options. This has created huge incentives for managers to pump up stock prices. This encourages short-term thinking on the part of managers. Costly, long-term investment projects (including R+D) are likely to come under increasing pressure to produce fast results or be abandoned.

Pressure from pension funds is also a recent phenomenum. The general pensions crisis, plus the increasingly market-driven pension system in a number of countries (with competition to generate higher returns) is increasing the 'activism' of pension fund managers.

They are increasingly investing in riskier assets (notably hedge funds). They are increasing the demand for returns made from investments in productive companies, depriving the latter of resources, and are restructuring their portfolios more frequently, reducing firms' certainty with regard to future funding. (On average, investment funds hold stakes in German companies for less than 2 years). Many of us with pensions are also shareholders and we should worry that pensions are getting shakier as this new capitalism, which is supposed to act for us, grows in strength.

Private equity funds are also a big concern: Their most damaging strategy (asset stripping) is to buy up companies whose share price has, for whatever reason, fallen below the value of its assets. The latter are sold off at a profit. Fund managers grow rich while (good) jobs are lost and established companies (with consensual industrial relations systems) are destroyed.

In other cases firms are bought up and then 'restructured', before being sold off at a profit. The wider economic impact of such practices depends, of

course, on the nature of the restructuring carried out. The German bathroom equipment producer Grohe is an example of a successful company systematically run down by successive takeovers. There are many British examples.

What is certainly the case is that private equity fund involvement is almost always highly leveraged. In other words the buy-out is debt financed: the purchased firm becomes responsible for servicing these debts. Woe betide the highly leveraged Manchester United if it ceases to be able to attract full houses at Old Trafford.

The consequent drive for higher returns inevitably exerts downward pressure on wages and conditions. Even where jobs are not lost, private equity owners are perceived to be less interested in the longer-run and in more technical issues of the particular branch of production, and much readier to challenge existing norms, procedures and structures, especially those relating to workers, unions, and works councils. That in turn threatens workers' commitment to the company for which they work, their willingness to invest in firm-specific skills etc. Not much scope for partnership working there.

Costly defensive strategies are also of concern. The potential damage from hedge funds is not limited to actual takeovers; the pressure to avoid hostile takeovers forces incumbent management to take actions that

bolster the firm's share price in the short run (including postponing selling assets investment and, making workers redundant) with damaging effects on the longer-term performance of the company. It cannot be easy running a firm doing difficult things when you are up for sale every day and every night of every year.

Banking finance is changing. In many European countries banks with close links to 'their' industrial companies have traditionally been the main channel of external finance. In addition, in some, publicly owned (and various forms of cooperative) banks were important. This model was characteristic, in particular, of Germany, Austria and other successful economies into the 1980s (at that time it was widely held in the English-speaking countries to be a superior system to our Anglo-Saxon model).

However, more recently, these countries have moved towards a greater role for stock markets (equity finance) on Anglo-Saxon lines, reflecting, not least, the perceived, recent superior performance of these economies. This breakdown of close bank-company relations has caused major problems, especially in Germany where small and medium enterprise in particular have faced a credit crunch. The existence of public banks – criticised by the orthodoxy for alleged inefficient capital allocation – also enabled broader regional development aims to be pursued and inter-company linkages to be taken into account in lending decisions. In addition such lending is much less pro-

cyclical and, last not least, government guarantees effectively reduced the cost of capital. Yet the pressure is on to wipe out public-sector banking in Europe.

I plead guilty to being one of those who underestimated the impact of the changes. Some of you will remember that when I became General Secretary of the TUC in 1993, I put promoting workplace partnership at the centre of the TUC's programme for the future. I did not fully appreciate what was happening on the other side of the table. Indeed until my daughter's boyfriend got a job with a hedge fund, I did not appreciate fully what a hedge fund did. After his explanation, my first question to him was "Joe, is it legal?"

The concept of partnership with capital was not one Bevan would have warmed to – and plenty of other trade unionists feel the same way. To them, partnership is class collaboration, sleeping with the enemy. To others, if partnership was just at workplace level and not in the strategic commanding heights of the economy, it was an unequal partnership. "Like one man and his dog" sniffed one critic.

But my motivation was rooted in experience of the successful post war reconstruction process in many European countries, underpinned by partnership between unions and employers. Sometimes it led to effective incomes policies with more cohesive, solidaristic unions and wider collective bargaining agendas than the UK. Often it had produced more

successful, higher productivity companies in sectors where our companies were failing.

I was also struck on my many visits to British workplaces by how much shop stewards and workers wanted their companies to be successful; and not just because the penalties of failure were evident in the high levels of bankruptcy and unemployment which characterised the 1980s and early 1990s. They wanted to be proud of what they did, of the successes they had achieved. Few just recited a list of problems and grievances. Alienation was uncommon.

So partnership deals, based on mutual respect, with high productivity swapped for commitments to train workers and maintain employment, or at least avoid compulsory redundancy, were our cause.

It was not original: earlier advocates had included Bill Jordan, John Edmonds, and, I suppose, Eric Hammond, although his no strike clauses did much to discredit the term partnership.

As many of you know, the TUC set up the Partnership Institute, the Labour Government followed with the Partnership Fund and various others like the IPA continue to spread the word.

But my question now is - partnership with who? And what has been happening on the management side?

Some partnership companies have thrived. Tesco and Barclays Bank have prospered and attribute some of that to their improved industrial relations arising from partnership deals.

Others have disappeared, tragically Rover whose "New Deal" was an early pioneer of partnership agreements. Many others have been absorbed into multi-national companies with worldwide reach and global brands, often with no UK ownership involved.

One thing is for sure – the changes in company structure have been rapid and profound and the challenge for unions is often identifying who the partners are, - or if like Bevan you don't like the word "partners", who should we be negotiating with? Have we any allies and pressure points? What is the union future under the new capitalism?

These are key questions to address tonight.

Take a glance at the UK economy. Some have used the term "Wimbledonisation" – that is, we provide a good location but the top prizes are won by foreigners. That is not wholly accurate in relation to every part of the economy but when you look at foreign ownership of investment banks and many other major financial and professional services companies; at the utilities, at the carplants and at the airports; at the current sales of Corus Scottish Power possibly AMEC and John Laing; at the current hawking round of our biggest

manufacturer, British Aerospace, to American buyers, a picture emerges, outside pharmaceuticals and petroleum, of foreign companies owing much of the commanding heights of the British economy – not to mention Manchester United and Chelsea, the current commanding heights of the Premier League. There is, we have learned, a price for everything.

I often muse - where are the nationalist parties on this 'clear out' sale of British assets? Where are the Conservatives and UKIP when we need them? They have a lot to say when there is the merest hint of a little more shared sovereignty at European level. But on the unfettered sale of our key national assets, they are dumb. Or, possibly, they have friends earning handsome fees arranging the sales. (Not quite Bevan's famous "vermin" speech describing the Tories at Belle Vue, Manchester but a little Bevanite touch that).

Apart from selling our commanding heights, we have the onward march of shareholder value and its importance in setting executive remuneration. Time was when executives' rewards bore some relation to those of other employees and they were in the same pension fund. These links have gone, and, among other things, it is contributing to the weakening of many pension funds for employees.

Executive pay rose 28% last year. Incomes Data Services recently reported that never in its 15 years of monitoring executive pay have so many earned so

much. Until recently I had not realised how much time and energy some boards spent on setting their own remuneration and incentives. Of course, they are negotiating with themselves and when you are in that position, you find it easy to give yourselves the benefit of every doubt. Comparability may have less relevance to most workers than it used to, now we are in a low inflation era. But it is still a potent principle in the boardroom. "Make sure we stay in the upper quartile" is the campaign slogan but they have no need to put it on a banner and take to the streets.

They seem oblivious to how this makes them appear to the rest of their work forces. More and more they resemble the Bourbons – and they should be aware of what eventually happened to the Bourbons. This shameless attitude contrasts incidentally with what is happening in Germany where Siemens have cancelled a 30 % executive pay increase after a debacle with the sale of their mobile phones business. It would not have happened here – the debacle possibly, the cancelled pay increase, certainly not.

Optimists hope that all this will be contained by better informed, more active shareholders. After all, today's shareholders are largely pension funds and life insurance companies and mutuals, seeking to get as high a return as possible for members, for us, and millions like us. They hope that our values will put pressure on the tycoons and boardroom titans to behave responsibly and improve governance.

I have to hope that they are right, and I recognise the sincerity of some people in this field, but I cannot help but notice that some investors who are proud to work to a corporate social responsibility agenda can also be the toughest seekers of high returns. Thus the world's largest pension fund is switching more and more over to hedge fund investment. The Californian Public Employees Retirement Scheme recently won approval to invest up to 25% of its portfolio in hedge funds. Railpen, the UK rail fund, has invested £ 600m and Sainbury's has trebled its exposure to hedge funds.

Of course, as Janet Bush said recently in the New Statesman, hedge funds are not new, just notorious. They have been around since the late 1970s. But their scale is accelerating and the funds they manage are equal to the GDP of the eighth largest economy in the world – Brasil – and have grown 5x since 1998.

Yet how many of us have much understanding of what a hedge fund is? Here is a definition from "Google"

"The term hedge fund has come to mean a relatively unregulated investment fund, often a partnership rather than a corporation in form, and characterized by unconventional investment strategies (ie., strategies other than investing long only in bonds, equities or money markets).

"Hedge funds use alternative strategies such as selling short, arbitrage, trading options or derivatives, using leverage, investing in seemingly undervalued securities, trading commodity and FX contracts, and attempting to take advantage of the spread between current market price and the ultimate purchase price in situations such as mergers. When strategies become extremely complex hedge funds may acquire potential and unanticipated risk of catastrophic losses."

Other relevant facts – they are attracting many of the nation's best young science brains on the promise of fabulous rewards. They are often based in tax havens. Most of the world's most prominent banks run such funds in conjunction with more orthodox activities. And they are looking for quick returns – around 15% pa. National regulators do not know what to do and are fearful if they do anything, the funds will emigrate entirely. The German Vice Chancellor, Franz Müntefering called them "locusts". He was right.

It should be the European Commission which takes this on if nation states are too timid to do so. But the EU internal market commissioner, Charlie McCreevy recently ruled out new rules, saying hedge funds played a crucial role and put the "fear of God" into company boards – for the benefit of all – he claimed. It is the Americans, burned by huge financial scandals who look at least a little more likely to act. What is evident is that no-one in the UK is facing or dare face the challenge – and something like 70% of Europe's hedge

funds are London-based, except of course for tax purposes; 80% of the world's hedge funds operate from the Cayman Islands as regards tax.

I have concentrated on hedge funds and their bewildering array of variations to indicate how powerful the financial services sector has become. But if hedge funds are the Provisional Wing of the sector, then there's plenty of more mainstream players contributing to the situation of debt financed, casino capitalism, with public companies, unless very strong, being chips on the gambling tables.

For trade unions we know that this capitalism, when it penetrates sectors such as food and beverages, hotels and catering, accelerates layoffs, casualisation and outsourcing. It "adds volatility to a destructive mix which is profoundly destabilising for workers and their unions." The International Union of Food and Hotel Workers has direct experience of this, as member confederations come to the international union for aid in helping to turn back particular company offensives.

Often these offensives are promoted by the investing shareholders, as they seek huge rates of return. Unions seeking to bargain over changes in conditions or negotiate the impact of restructuring, or challenges to closures, run up against the new financial power brokers. These people are not so interested in arguments about improvements in production or services , increased productive capacity, new product

lines, long term viability of markets or consumer needs. They want their quick returns.

Some may say, it was ever thus in business but let's look at a few examples from the food and beverage sectors:

- Heineken in 2006 announced half year results which earned profits 56% higher than the previous period and simultaneously announced the cutting of 1,000 jobs in the following year.
- The brewers, Inbev announced a 15,3% increase in earnings and plans to cut 360 jobs at the same time; having already shut my favourite Boddingtons brewery at Strangeways, Manchester.
- Nestlé announced a 21 increase in net profits while promoting job insecurity, losses and outsourcing, casualisation, production transfers and closures.
- Gate Gourmet is perhaps the best known case in the UK. It was in the news for weeks as the doughty Asian women working for the catering company supplying British Airways fought for their jobs. Gate Gourmet had been bought by the private equity firm, Texas Pacific – now chasing AMEC by the way. The new company planned a period of "organic growth" which began, in the words of the IUF "a meticulously planned assault on trade unions, beginning at Heathrow". The company stealthily hired hundreds of contract workers before mounting an attack on the existing workforce and their working conditions. You saw the scenes on TV no

doubt, with hundreds of older women in Saris standing on a roundabout, on strike for their jobs, and being told by an American manager they were sacked.

Often the problem we face here is that the fund managers who control these companies, in effect, do not see themselves as employers. In few systems are they defined as employers and have none of the legal obligations that employers have. In the case of Gate Gourmet, that company denies that the management decisions it took have anything to do with Texas Pacific, although it does acknowledge its fiduciary duty to the investor company. I almost said "parent company". In days gone by, I could have used that as an accurate, legal definition, but the new investment funds are not 'parents'. They want to run their children's lives but they are not parents…nor employers.

So we are seeing therefore is a yet further disintegration of the social nexus between worker and employer. This relationship, dating back to the industrial revolution and beyond, has produced layer upon layer of employment law and, importantly a culture containing broad social rights and obligations. The new capitalism wants none of it. It wants to be foot loose and fancy free, without obligation. In the old days, when trade unions – especially those in North America – realised that corporate campaigning could be more effective than striking, we had some

noticeable successes. But what if the ultimate owner is a hedge fund?

Can you go and lobby the AGM, as we did with our corporate campaigns? Can you organise with other disgruntled groups of share-holders as we did then? Not so easy.

The European Central Bank is worried about all this even if Mr McCreevy is not. The US authorities are worried too. But the fear to act is widespread and deep rooted. No longer does the Ford Motor Company treat its banks and investors with a degree of disdain, demanding their services on Ford's terms. The new titans are not the old ones. For Ford then, read Goldman Sachs now. It is the capital markets who call the shots.

So must we all get used to a new language of leveraged finance, second lien loans, mezzanine finance, syndicated loans, global share insurance, credit default swaps, collateralised debt obligations and so on?

I think we must. All this is too important to be left to the practitioners who have a vested interest in obscuring what they do from the rest of us. At the very least, we must understand and debate much more fully what they do – that they are speculating as much as legitimately hedging risk and that these practices are dangerous to economic stability, traditional industry

and jobs. I would like to see the City pages of the press more challenging and less respectful on these matters.

So what else can we do? The answers are not easy. If you believe like me that the recent relative success of the UK economy has been based on rising house prices, mostly fuelled by earnings from the financial services sector and perhaps, more recently, the increase of the public sector, you can understand that the Government worries about clumsy intervention with negative or unintended consequences.

But, we should stop according financial services a specially privileged place in the UK economy. It was the only industry specifically mentioned in the Treasury's five tests for possible euro entry yet UK overseas earnings from the City are still only one tenth of those from exporting goods. With all the pressures, the old capitalism is not dead. It needs help and respect, not laissez faire neglect. It needs to stand up for itself, speak with a louder voice and not be in awe of financial markets. The CBI need to become a lot clearer that they must stick up for industry not just – as they do on autopilot - against trade union lobbying and any hint of regulation. They need to compete against the overmightly financial sector.

Second, we should examine – and I am currently pressing the EU to do this and will continue to do so at the forthcoming macro economic dialogue– how capital markets fund research and development and

innovation - if indeed they do. I believe that the next big idea after the IT revolution will be environmental technology. So, more tellingly, does General Electric of America and they are directing their R+D towards this area. Will the city slickers earn at least some of their fat bonuses by backing inherently risky ventures on tough issues like climate change and renewable energy. Some hopes I fear. Short term thinking is the enemy of innovation and R+D.

Can we therefore revisit the idea of a National Investment Bank providing capital for productive purposes in key areas of scientific and technological challenge? This now would need to be set in the context of the single market in Europe but we must find a way of supporting serious R+D and innovation. We cannot not rely on the market, especially with the way it is evolving.

Next, we should expose – and prosecute, fiercely, corporate wrong doing. This is not victimless crime. The perpetrators are robbing us all and should not receive an easy time. The Americans are showing the way again, rightly ignoring the CBI's unctuous concern for those Britons caught up with the Enron scandal.

Next, politics should not be intimidated by what is going on. The present disenchantment with politics reflects a feeling that it has no answers to the big issues. The Labour Government on some issues – for example child poverty, Africa, the NHS - is trying hard

to make a big difference. On other issues, especially on achieving a high level of employment, it has succeeded; who honestly thought 10 years ago that we would get anywhere near full employment ever again? We are not proud of the quality of some of the jobs but the achievement is real. It would have been appreciated by Nye Bevan even if he would have been bemused by the Government Ministers and ex Ministers criticising so loudly and confusingly the outcomes of the record spending on his beloved NHS. You don't need an Opposition and the Daily Mail if your own side accentuates the negatives.

Yet I am critical of the Government for swerving away from confronting the rise of this new, overmighty capitalism. Their worry was, and is, overmighty unions. The reality is overmighty financial capitalists. Yet there were some signs of early promise, never realised. In 1996, Tony Blair made a speech in Singapore calling for stakeholding, not shareholder value, to guide us into the future. He was following Will Hutton's praise for the Rhineland model of Germany and France in his best selling book – "The State We Are In" which had called for entrepreneurial accountability to unions, communities, the environment as well as shareholders. I was elated and wrote immediately an article for the Times hailing this Damascus-like conversion.

My elation was brief. Before Mr. Blair's plane had touch down back at Heathrow, the speech's meaning

had been hastily redefined. It was made clear that there was no intention to re-empower unions, Labour was the friend of business and capital, not a promoter of stakeholding at all. The term stakeholding was never heard to pass the lips of the Prime Minister, nor the Chancellor, again.
But yet, but yet…

The latest companies Bill codifies the principle of what it calls "enlightened shareholder value". That requires a director to promote company success in the interests of the long-term, company employees, suppliers and customers, the community and the environment, and to maintain a reputation for high standards. I do not yet know what we can make of this but it is a welcome step in the stakeholding direction.

Finally, what should be the trade union response? We may not have always liked it but we knew where we were with the Ford Motor Company. Goldman Sachs by contrast is a foreign land and hedge funds are in a different universe. We won't achieve anything by cuddling up to them but there is wide scope for campaigning on the corporate reputations of at least the mainstream financial institutions. We should do this, and mobilise our own shareholder power. After all, workers are still around 50% of the trustees of some of our largest pension funds.

We should also throw our weight behind the new International TUC formed 2 weeks ago of socialist,

christian and former communist unions. It is burying old tribal conflicts in our own ranks to lead the fight against the dark side of globalisation and to campaign for taxation on the speculators such as the Tobin tax. We must support it to become a champion of good business practices, of decent relations with decent employers while ruthlessly fighting the speculators. I will be taking on the additional job of general secretary to a Pan European Region of the ITUC operating from Connemara to Vladivostock.

We must also use to the full the European dimension. A region of the world with 450 million people characterised by decent welfare states, public spending averaging around 40% of GDP, excellent public services in the main, the world's strongest unions, spreading democracy and union rights through Eastern Europe - this Social Europe seems to me to be a great source of union strength. It can take on the casino capitalists and to promote respect and rewards for those who accomplish real things in improving our society. We must encourage it to develop European rules for the games of the new capitalism, and to contribute towards drawing up global rules. It is no longer good enough – if it ever was for the Labour Government to fight off European initiatives to bring some greater co-ordination and order to financial markets.

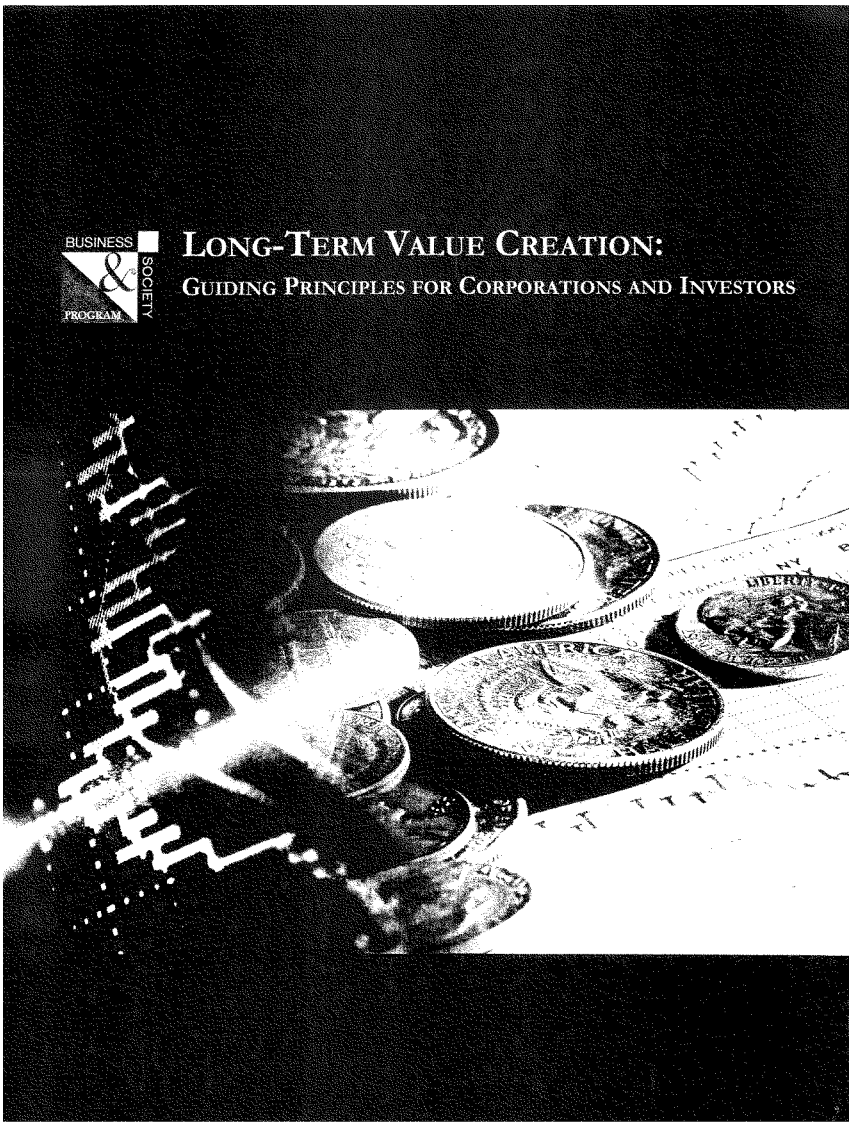
Nye Bevan was not a dreamer about a common European future. He regarded the Common Market as a vehicle for capitalism. Indeed it could have been so and

some are still trying to make it so. But so far trade union and socialist action – and to be fair Christian Democracy too - has made it something quite different. And Bevan was of course an internationalist who today would have recognised that the new global capitalism requires a global response. He would have recognised that in this as in other fields like world poverty and global warming, Britishness may be important but it will not be enough.

We have to fight the battle all the time. Every generation needs mobilising to preserve what we have and to promote progress based on the values of social solidarity. Following Vice Chancellor Müntefering reference to insects, I believe that the future must be based on the industrious bee, not the rampaging locust, on strong trade unions balancing capital, - yes, wherever possible, forming partnerships - and on active Government – at international, European Union, national and regional levels. We cannot rely just on active shareholders.

So tonight, chairman, I have taken you on a tour of trade union views of the new capitalism. As ever, the problems are clearer than the answers. But the memory of Aneurin Bevan demands that we undertake restlessly and urgently a search for these answers. Our future – the world's future - is too important to place in the hands of the new capitalists.

Thank you


BUSINESS
&
SOCIETY
PROGRAM
LONG-TERM VALUE CREATION:
GUIDING PRINCIPLES FOR CORPORATIONS AND INVESTORS

The Aspen Institute's Corporate Values Strategy Group (CVSG) is dedicated to re-asserting long-term orientation in business decision-making and investing. Members of the CVSG share concern about excessive short-term pressures in today's capital markets that result from intense focus on quarterly earnings and incentive structures that encourage corporations and investors to pursue short-term gain with inadequate regard to long-term effects. Short-termism constrains the ability of business to do what it does best – create valuable goods and services, invest in innovation, take risks, and develop human capital. CVSG members believe that favoring a long-term perspective will result in better business outcomes and a greater business contribution to the public good.

The Aspen Principles offer guidelines for long-term value creation for both operating companies and institutional investors. The Principles were created in dialogue with CVSG members who—as leaders in both investment and business—sought to identify common ground from many sources, including the Business Roundtable, Council of Institutional Investors, CalPERS, CED, TIAA-CREF and others. To fully understand the spirit and nature of the Principles, it should be noted that:

1. The Principles are not intended to address every issue of contemporary corporate governance, but instead are designed to drive quickly to action in areas that *all parties* agree are critically important. CVSG members share a deep concern about the quality of corporate governance and favor effective communication between and among executives, boards, auditors, and investors. CVSG members will continue to engage in independent activities related to corporate governance issues not addressed here.
2. In drafting these Principles, members of the CVSG sought consensus and agreed that an overly-prescriptive approach would slow progress. The Principles are thus offered as guidelines, and are not detailed at a tactical level. Investors and companies, especially boards of directors, have the opportunity to innovate and adapt them to meet individual and evolving circumstances.

The Aspen Principles address three equally important factors in sustainable long-term value creation: metrics, communications, and compensation.[1]

1. Define Metrics of Long-Term Value Creation

Companies and investors oriented for the long-term use forward-looking incentives and measures of performance that are linked to a robust and credible business strategy. Long-term oriented firms are 'built to last,' and expect to create value over five years and beyond, although individual metrics may have shorter time horizons. The goal of such metrics is to maximize future value (even at the expense of lower near-term earnings) and to provide the investment community and other key stakeholders the information they need to make better decisions about long-term value.

In pursuit of long-term value creation, companies and investors should…

1.1 Understand the firm-specific issues that drive long-term value creation.

1.2 Recognize that firms have multiple constituencies and many types of investors, and seek to balance these interests for long-term success.

1.3 Use industry best practices to develop forward-looking strategic metrics of corporate health, with a focus on:

- enhancing and sustaining the value of corporate assets,
- recruiting, motivating, and retaining high-performing employees,
- developing innovative products,
- managing relationships with customers, regulators, employees, suppliers, and other constituents, and
- maintaining the highest standards of ethics and legal compliance.

1.4 De-emphasize short-term financial metrics such as quarterly EPS and emphasize specific forward-looking metrics that the board of directors determines are appropriate to the long-term, strategic goals of the firm and that are consistent with the core principles of long-term sustainable growth, and long-term value creation for investors.

2. Focus Corporate-Investor Communication Around Long-Term Metrics

Long-term oriented companies and investors are vigilant about aligning communications with long-term performance metrics. They find appropriate ways to support an amplified voice for long-term investors and make explicit efforts to communicate with long-term investors.[2]

In pursuit of long-term value creation, companies and investors should…

2.1 Communicate on a frequent and regular basis about business strategy, the outlook for sustainable growth and performance against metrics of long-term success.

2.2 Avoid both the provision of, and response to, estimates of quarterly earnings and other overly short-term financial targets.

2.3 Neither support nor collaborate with consensus earnings programs that encourage an overly short-term outlook.

3. Align Company and Investor Compensation Policies with Long-Term Metrics

Compensation at long-term oriented firms is based on long-term performance, is principled, and is understandable. *Operating companies* align senior executives' compensation and incentives with business strategy and long-term metrics. *Institutional investors* assure that performance measures and compensation policies for their executives and investment managers emphasize long-term value creation.

In pursuit of long-term value creation, companies and investors should implement compensation policies and plans, including all performance-based elements of compensation such as annual bonuses, long-term incentives, and retirement plans, in accordance with the following principles…

3.1 *How are Compensation Plans Determined and Approved?*
Executive compensation is properly overseen by a compensation committee of the board of directors. The board recognizes that…

a) The compensation committee is comprised solely of independent directors with relevant expertise and experience, and is supported by independent, conflict-free compensation consultants and negotiators.

b) The compensation committee calculates and fully understands total payout levels under various scenarios.

c) Boards and long-term oriented investors should communicate on significant corporate governance and executive compensation policies and procedures.

d) Careful strategic planning, including planning for executive succession, helps the board retain a strong negotiating position in structuring long-term compensation. The succession planning process is disclosed to investors.

3.2 *What are Executives Compensated For?*
Corporate and investor executives and portfolio managers are compensated largely for the results of actions and decisions within their control, and compensated based on metrics of long-term value creation [see Principle #1].

3.3 *What is the Appropriate Structure of Compensation?*
Compensation that supports long-term value creation…

a) Promotes the long-term, sustainable growth of the firm rather than exclusively short-term tax or accounting advantages to either the firm or employee.

b) Requires a meaningful proportion of executive compensation to be in an equity-based form.

c) Requires that senior executives hold a significant portion of their equity-based compensation for a period beyond their tenure.[3]

d) Prohibits executives from taking advantage of hedging techniques that offset the risk of stock options or other long-term oriented compensation.[4]

e) Provides for appropriate "clawbacks" in the event of a restatement of relevant metrics.

f) Requires equity awards to be made at preset times each year to avoid the appearance of market timing.

g) Ensures that all retirement benefits and deferred compensation conform to the general goals of the compensation plan.

3.4 *How Much Are Corporate and Investor Executives Compensated?*
Corporations and society both benefit when the public has a high degree of trust in the fairness and integrity of business. To maintain that trust, the board of directors…

a) Ensures that the total value of compensation, including severance payments, is fair, rational and effective given the pay scales within the organization, as well as the firm's size, strategic position, and industry.

b) Remains sensitive to the practical reality that compensation packages can create reputation risk and reduce trust among key constituencies and the investing public.

3.5 *How is Compensation Disclosed?*[5]
Public disclosure, fully in compliance with SEC rules, includes, in clear language…

a) Individual and aggregate dollar amount of all compensation afforded to senior executives, under various scenarios of executive tenure and firm performance.

b) The compensation philosophy of the board and the specific performance targets that promote the creation of sustainable value in the long-term.

June 2007

1. As this document is a reflection of existing sources, the greatest level of detail is offered on executive compensation. See the Appendix for a full list of organizations and sources of these principles.
2. In accordance with the SEC's Regulation Fair Disclosure
3. However, there may be circumstances in which boards should allow the sale or transfer of an executive's equity to accomplish purposes that do not alter the long-term incentive nature of the compensation.
4. In situations where senior executives are permitted to make personal equity trades that relate to their compensation, such trades should be fully disclosed ahead of time.
5. The new Compensation Discussion and Analysis requirements address disclosure requirements of the SEC.

Appendix

Sources of the Aspen Principles

1. Business Roundtable Institute for Corporate Ethics and CFA Centre, *Breaking the Short Term Cycle*
2. Business Roundtable, *Principles of Executive Compensation*
3. CalPERS, *Corporate Governance Core Principles and Guidelines*
4. Committee for Economic Development, *Built to Last: Focusing Corporations on Long-term Performance*
5. Council of Institutional Investors, *Corporate Governance Policies*
6. Financial Economists Roundtable, *Statement on Executive Compensation*
7. The Conference Board, *Report of the Commission on Public Trust and Private Enterprise*
8. TIAA-CREF, *Executive Compensation Policy*

Other Resources

9. Buffett, *2005 Letter to the Shareholders of Berkshire Hathaway, Inc*
10. Caux Roundtable, *Principles for Business*
11. Davis / McKinsey Quarterly, *How to Escape the Short-Term Trap*
12. EBR Consortium, *Enhanced Business Reporting Framework*
13. Gordon, *If There's a Problem, What's the Remedy?*
14. Hodak, *Letting Go of Norm*
15. Jensen, Murphy and Wruck, *Executive Remuneration*
16. Kaplan and Norton, *Alignment*
17. Koller, Hsieh & Rajan / McKinsey Quarterly, *The Misguided Practice of Earnings Guidance*
18. Monks, *Corporate Governance in the Twenty-First Century*
19. Rappaport, *Ten Ways to Create Shareholder Value*
20. The Aspen Institute, *Corporate Values Strategy Group working groups*
21. The Conference Board, *Revisiting Stock Market Short-Termism*
22. United Nations, *Principles for Responsible Investment*
23. Wachtell, Lipton, Rosen & Katz, *Compensation Committee Guide and Best Practices*
24. Weil, Gotshal & Manges, *Seven Things Shareholders Want Directors to Understand in 2007*

THE CORPORATE VALUES STRATEGY GROUP

The following individuals played an instrumental role in developing these Aspen Principles. While all contributed to discussions and/or document revisions, the listing of their name should not be construed as an endorsement of the final Principles on behalf of either themselves or their organization.

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Ann Yerger, Council of Institutional Investors

THE ASPEN INSTITUTE

The mission of the Aspen Institute is to foster enlightened leadership, the appreciation of timeless ideas and values, and open-minded dialogue on contemporary issues. Through seminars, policy programs, conferences and leadership development initiatives, the Institute and its international partners seek to promote the pursuit of common ground and deeper understanding in a nonpartisan and non-ideological setting.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM NOREEN CULHANE

Q.1. A recent study found that cross-listing in the U.S. leads firms to increase their capital-raising activity at home and abroad. It concluded that "an exchange listing in New York has unique governance benefits for foreign firms." Moving forward, how do we preserve this premium?

A.1. We agree with the results of the Karolyi Study. It demonstrates that a U.S. listing, in addition to the home market, results in a valuation premium that more than compensates for the incremental cost of compliance with Sarbanes-Oxley. (See attached chart.) Global investors feel a new-found confidence when companies are willing to accept U.S. laws and regulations, and they value those companies accordingly.

Our concern is that there is a tipping point where foreign issuers, with ever-increasing alternative options for raising large amounts of capital, will see the cost of accessing the value premium of U.S. listing as prohibitive. We have therefore focused our attention on regulations that add to the cost of compliance without a comparable benefit for investors.

As I noted in my testimony, we have worked to lessen the costs associated with (1) compliance with Section 404 of Sarbanes-Oxley, (2) the reconciliation to U.S. GAAP and (3) litigation, particularly class-action lawsuits.

1. There is a widely held view that the regulatory framework in the U.S. is burdensome and costly. The cost of internal controls reporting under Sarbanes-Oxley (SOX) has been the subject of much criticism in recent years. Recent SEC and PCAOB actions to modify what is required under Section 404 should prove helpful in addressing this concern. This will only be the case, however, if the audit firms internalize the guidance that the SEC and PCAOB have issued; otherwise the regulators' rationalization of Section 404 will be ineffectual.

2. The cost associated with reconciliation to U.S. GAAP has been a deterrent to listing in the U.S. We applaud the SEC for their proposed rules to eliminate the accounting reconciliation requirement by recognizing International Financial Reporting Standards (IFRS). This is a significant step in insuring the continued competitiveness of U.S. markets.

3. The cost of litigation in the U.S., in particular class-action lawsuits, is one of the leading deterrents to companies considering listing in our markets. As Senator Schumer and Mayor Bloomberg observed in their report, "the legal environments in other nations, including Great Britain, far more effectively discourage frivolous litigation" and "the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of business—and driven away potential investors." The need for litigation reform is clear and compelling.

Since my testimony, the SEC has announced its intent to take a more comprehensive look at mutual recognition, beyond recognition of international accounting standards. As they explore opportunities to recognize standards met by foreign issuers governed by "comparable" regulatory regimes, there will be even fewer barriers to companies listing in the U.S.

Q.2. Some broker-dealers are reportedly concerned that the increased leverage major exchanges may derive from exchange consolidations might ultimately result in them charging brokers higher transaction fees. It has also been suggested that part of the reason that a number of major broker-dealers have invested in small regional exchanges like the Philadelphia Exchange and off-exchange trading venues like BATS is that the investments may offer them a hedge against such fee increases. Would you please comment on such concerns regarding major exchange consolidations and their possible future impact on broker-dealer transaction fees?

A.2. In general, exchange consolidation will bring system integration and better linkages to make for easier access and lower costs for customers. For example, Euronext, prior to our merger, integrated four markets and passed on savings to customers in the form of lower fees.

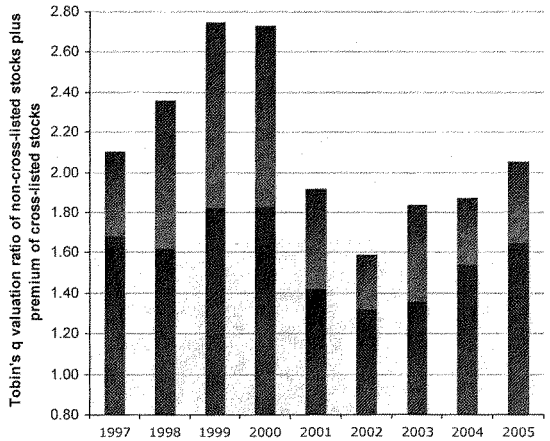
In the U.S., Exchange transaction fees have only gone one way in recent years, down. Regulations cap exchanges transaction fees at $0.003 per share. The NYSE only charges a fraction of that at $0.0008 per share to take liquidity and we charge nothing to post liquidity. (This results in a round-trip cost of only $0.0004 per share.) Exchange transaction fees are a sliver of overall brokerage commissions, which are in the one to four cent range per share range.

Broker-Dealers are investing in regional exchanges and ECNs like BATS to pressure exchanges to further drive down rates. BATS recently offered a $0.0034 per share rebate for posting a quote and charged only $0.0024 per share to take or execute against liquidity in the market. (This offering essentially paid customers $0.0010 per share to trade on BATS.) Given this competitive environment, there should not be any concern with exchange consolidation resulting in higher broker-dealer transaction fees. To the contrary, there should be more concern about below cost rebates forcing unnatural fragmentation of the market and the resulting inefficiencies that ultimately harm investors. There should also be greater concern about the significant growth in off-exchange trading (internalization, dark pools, ECNs), where the regulatory oversight is not as rigorous. Off-exchange trading has grown to about 24% of NYSE consolidated volume in October 2007 from 13% of total in January 2005, and the trend suggests that off-exchange trading will continue to grow.

Significant Valuation Premium for Non-U.S. Listed Stocks

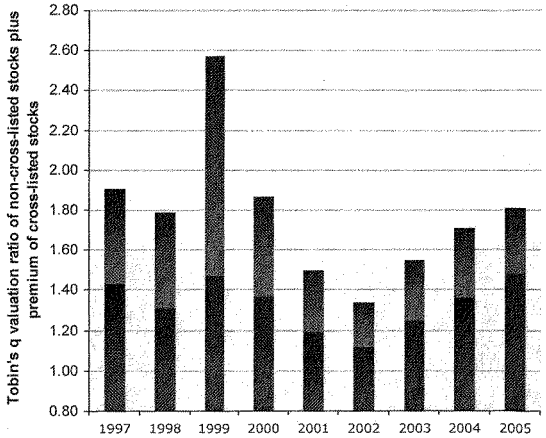
"The cross-listing premium is highest for those firms cross-listed on a major U.S. exchange, such as the NYSE" – The Valuation Premium for Non-U.S. Stocks Listed in U.S. Markets: 1997-2005 *

U.S.-listed stocks display an average 32.0% valuation premium for 1997-2005.
U.K.-listed stocks display an average 34.2% valuation premium for 1997-2005.



U.K./U.S. Cross-listed Stocks

Non-Cross-Listed Tobin's q | Additional Cross-listings Tobin's q Premium



All U.S. Cross-listed Stocks

Non-Cross-Listed Tobin's q | Additional Cross-listings Tobin's q Premium

Source: "The Valuation Premium for Non-US Stocks Listed in US Markets"; Andrew Karolyi, Charles R. Webb Professor of Finance, Fisher College of Business, The Ohio State University and Craig Doidge, Assistant Professor of Finance, Rotman School of Management, University of Toronto; January 3, 2007. [Full report available on www.nyse.com.]

Note: Tobin's q ratio: total assets less book equity plus market value of equity to total assets.