

**IMPROVING THE CORPORATE GOVERNANCE  
OF THE NEW YORK STOCK EXCHANGE**

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**HEARING**  
BEFORE THE  
**COMMITTEE ON**  
**BANKING, HOUSING, AND URBAN AFFAIRS**  
**UNITED STATES SENATE**  
**ONE HUNDRED EIGHTH CONGRESS**

FIRST SESSION

ON

**BROKER-DEALER SELF-REGULATION AND REGULATORY AUTONOMY  
WITH MARKET SENSITIVITY**

NOVEMBER 20, 2003

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# C O N T E N T S

THURSDAY, NOVEMBER 20, 2003

	Page
Opening statement of Chairman Shelby .....	1
Opening statements, comments, or prepared statements of:	
Senator Sarbanes .....	3
Senator Bunning .....	4
Senator Schumer .....	5
Senator Crapo .....	7
Senator Allard .....	8
Senator Chafee .....	8
Senator Corzine .....	18
Senator Sununu .....	19
<b>WITNESSES</b>	
William H. Donaldson, Chairman, U.S. Securities and Exchange Commission .	9
John S. Reed, Interim Chairman and CEO, New York Stock Exchange .....	31
Prepared statement .....	45



# IMPROVING THE CORPORATE GOVERNANCE OF THE NEW YORK STOCK EXCHANGE

THURSDAY, NOVEMBER 20, 2003

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

The Committee met at 10:06 a.m., in room SD-538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

## OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing shall come to order.

This hearing is part of the Committee's ongoing oversight of our national market system and the role of self-regulatory organizations. As a result of the controversy surrounding Dick Grasso's compensation, investors have questioned the New York Stock Exchange corporate governance standards and its effectiveness as a regulator.

Many have criticized the current structure of the Exchange's board of directors for being dominated by directors representing specialists and member firms and lacking sufficient independent directors. Many also contend that the Exchange's self-regulatory structure in which the chairman is essentially paid by the industry that he oversees, calls into question the Exchange's role as an unbiased regulator.

In early November, interim Chairman and CEO John Reed, who is with us today, proposed several reforms aimed at eliminating the conflicts of interest within the Exchange's governance structure. These proposals were approved by the Exchange's membership on November 18 and are currently awaiting final SEC approval. Mr. Reed proposed bifurcating the Exchange's governance structure into a board of directors and a board of executives. There will be, under that plan, 8 independent directors on the board and approximately 20 constituent representatives on the board of executives. Mr. Reed also proposed a litany of new disclosure practices to improve the transparency of the Exchange's operations. And, finally, Mr. Reed proposed the creation of a Chief Regulatory Officer who would report to the board's regulatory committee comprised of independent directors.

The public reaction to Mr. Reed's proposals has been decidedly mixed. Some have endorsed the plan for significantly altering the Exchange's board structure, improving the transparency of the Exchange operations and insulating the Exchange's regulatory function from the influence of its members. Others have criticized the

proposals for not going far enough to address conflicts at the Exchange. Some find the proposals deficient for failing to require the Exchange to separate its regulatory function from the business operations, contending that as long as the business and regulatory functions of the Exchange are combined within one entity, member firms will continue to influence the directors and impede proper regulation.

Some have also criticized the proposals for failing to require an independent chairman of the board and for neglecting to put a representative of the investing public on the board of directors.

The Committee has a significant interest in examining reforms to the Exchange's governance structure and understanding how any such changes will impact the Exchange's regulatory function. Given our reliance on self-regulatory organizations in actively monitoring our markets, I believe it is critical that the Congress, the SEC and, most importantly, investors have confidence that the self-regulatory organizations are on the job and keeping a watchful eye. Following the recent revelations of abuses in the mutual fund industry, many are questioning the effectiveness of the regulatory structures for our markets.

I understand that Chairman Donaldson has worked closely with Mr. Reed since he began his tenure at the Exchange. I fully expect the SEC to continue scrutinizing the governance structure and regulatory capabilities of the Exchange during the coming months. It seems to me that Mr. Reed's proposals may be the first step in a more lengthy reform process.

Mr. Chairman, I understand that the Exchange governance proposals are currently pending before the Securities and Exchange Commission and awaiting approval. Therefore, I recognize that you must refrain from providing us with certain confidential information regarding the SEC's deliberations.

Mr. Chairman, it has been a busy week for you. You have been here, this is your second time. You can just about move in if you want to.

[Laughter.]

Chairman SHELBY. Thank you for testifying before this Committee twice in one week, and I look forward to your testimony.

In addition, this morning—before I recognize Senator Sarbanes—the Committee will consider S. 1531, the Chief Justice John Marshall Commemorative Coin Act. This piece of legislation, introduced by Senator Hatch, with the support of 75 of our colleagues, will commemorate the 250th anniversary of John Marshall's birth. Often considered the founder of constitutional law, John Marshall is the longest-serving Chief Justice whose tenure, from 1801 to 1835, spanned 34 years and five Presidents. The influence of his decisions, most notably in *Marbury v. Madison*, established the principle of judicial review and ultimately helped shape and define our Nation's judicial system. A prominent figure in our Nation's history, it is fitting, I believe, to recognize and honor the Great Chief Justice, whose influence continues to be reflected, even in the Court's work today.

We will also be voting, when we get a quorum, on two important nominations this morning. Today's nominees, if confirmed, will play a vital role in overseeing the safety and soundness of our Nation's

financial institutions. Our nominees are Ms. Alicia Castaneda, nominated to be a Member of the Board of Directors of the Federal Housing Finance Board, and Mr. Thomas J. Curry, nominated to be a Member of the Board of Directors of the Federal Deposit Insurance Corporation.

Senator Sarbanes.

#### STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you, Mr. Chairman, and this is a very timely hearing on the governance and operation of the New York Stock Exchange. Actually, the Exchange is virtually as old as our country. It was organized in 1792, when 24 New York City stockbrokers or merchants met on Wall Street, under a Buttonwood tree, as we are reminded, to sign what was thereafter called the Buttonwood Agreement. To many, the Exchange, since then, has been an important symbol of capitalistic economic system.

Few institutions play as important a role in our economy as the components of our securities markets. These include the stock exchanges, the over-the-counter markets, and combinations of the two. Together, they form the central mechanism for raising capital for our businesses and for investing the savings of our citizens. Their reputation for maintaining fair, liquid, and efficient markets, and continuing to do so as the volume of shares traded daily has climbed ever higher, is what makes the U.S. markets the center of the international capital markets, and in my judgment, a very important and major economic asset for this Nation.

If the New York Stock Exchange is to continue to command the confidence of investors at home and abroad, it obviously will have to address effectively some serious questions have arisen in recent months concerning its governance, its strength as a self-regulatory organization, and the efficiency of its market-making mechanisms.

The adequacy of the Exchange's governance was brought into question by disclosures only a few months ago, which led to the resignation of its Chairman, followed by some members of the Exchange's Board.

Under the Securities Exchange Act, the Exchange has been granted the right, ever since 1934, to act as a self-regulatory organization, subject to SEC oversight. A recent SEC investigation of floor trading practices has cast doubt on the effectiveness of Exchange self-regulation. In fact, SEC Chairman Donaldson himself has said that there was a "distressing breakdown" in the regulation of trading-floor specialists, and according to a report in *The Wall Street Journal*, an internal Commission report, "paints a picture of a floor-trading system riddled with abuses, with firms routinely placing their own trades ahead of those by customers—and an in-house regulator, either ill-equipped or too worried about increasing its workload to care."

Further, changes in technology and the globalization of financial markets have led some to ask whether a trading floor in which brokers match buyers and sellers, and liquidity is maintained by "specialists" who trade in assigned stocks, is out-of-date. Most of the rest of the world has moved to electronic systems on which securities dealers advertise prices at which they will buy and sell securities, rather than matching buyers and sellers.

Each of these subjects obviously raise it to its own set of specific issues, and important issues are being raised about the independence of the Exchange's regulatory function. In fact, some have raised the question whether its regulatory operations should be spun off from the business function of the Exchange.

The cumulative impact of these questions have left the New York Stock Exchange facing major challenges at a very important time. Chairman Donaldson emphasized, during our last hearing on this subject, that the Nation's market structure and governance are the result of 200 years of growth and that it is important that the consequences of any regulatory or structural changes be carefully considered. I think that is an important admonition. But we also need to recognize that we have seen during the last few years that the trust in the institutions of our capital markets, once lost, is hard to regain.

The answers to the questions faced by the Exchange must involve a thorough and comprehensive review carried out of the Exchange's structures and functions by the Exchange itself, by the Commission, and by the Congress. And this hearing, Mr. Chairman, is a valuable step in that process, and I appreciate your convening it, and I welcome the opportunity we have this morning to hear again from Chairman Donaldson. I join you in welcoming him back before the Committee. Any time, Chairman Donaldson, we are happy to receive you, and we are also looking forward to the hearing from Mr. Reed and the subsequent panel.

Thank you.

Chairman SHELBY. Senator Bunning.

#### **STATEMENT OF SENATOR JIM BUNNING**

Senator BUNNING. Thank you, Mr. Chairman. I would like to thank you for holding this timely hearing today. Also, I would like to thank all of our witnesses for their testimony.

We all have been very concerned with the reports about the corporate governance issue and the New York Stock Exchange. I am very happy to see that the Exchange has moved to correct some of those problems. I look forward to hearing from Mr. Reed on exactly how the Exchange is going to change, and from Chairman Donaldson, who has been up here a lot, as we have said, we have a chair in the back that you can have and share with us any time.

Chairman DONALDSON. Thank you.

Senator BUNNING. You have been here a lot lately, and we are getting the SEC's take on the Exchange's proposals. It seems like this Committee has spent an enormous amount of time on corporate governance issues in the past couple of years. I wish we did not have to. I wish corporations and organizations would do a better job of behaving in self-policing. But, obviously, in many cases they have not, and Congress has been forced to get involved. That is not good.

I do not like it when we have to get involved. Sometimes we do a good job—such as when we passed the Sarbanes-Oxley Act last year—sometimes we do not, and at times we have overkill. But if we are forced to do something, we will do the best job we can.

Investors have taken a lot of hits over the past few years, and the Exchange's turmoil is another hit on investors' confidence. This



needs to end. I am hopeful the Exchange-proposed reforms will help restore confidence. I hope you end up with a strong, tough, and independent self-regulator that will work with the SEC and restore confidence.

It is essential that you have, for the American investor and the economy, to have that type of self-regulator. If your new model does not restore confidence, then there may be many on Capitol Hill who will feel the need to get Congress involved. You do not want that to happen. I do not want that to happen, but I know you really will try to get it done. Please make sure the reforms you make are thought out, executed well, fully disclosed, and the right ones.

Once again, Mr. Chairman, I want to thank you for holding this very timely and important hearing.

Chairman SHELBY. Senator Schumer.

#### **STATEMENT OF SENATOR CHARLES E. SCHUMER**

Senator SCHUMER. Thank you, Mr. Chairman, and I want to thank you for holding this hearing. You are really “Johnny on the spot” having timely hearings on important issues.

I want to thank Chairman Donaldson and Mr. Reed for being here on an issue of great importance, obviously, to me as a New Yorker, but also to all of America and the world, in terms of our financial system. I also want to thank Mr. Reed for taking this job. It was not an easy job, and your expertise is really important.

We are all here today because of the circumstances that led to the former New York Stock Exchange Chairman Dick Grasso’s resignation, and they are serious, and they have to be addressed. It is now clear there was not enough hands-on oversight, that there was too much abuse of the regulatory function, there were too many conflicts of interest. The new governance proposal that is the subject of the hearing today is an important step in that reform process. Government is really about trust. Is the right system in place to look out for all of the people’s interests, not just the insiders? My biggest concern with the market today is that although stock prices are way up, trust is down, and nothing is worse for New York or our markets if that continues. The stories are not getting any better, as the mutual fund scandals indicate. Trust is the glue that holds our markets together and makes this hearing so important.

I want to commend Mr. Reed for taking decisive action. I think your job, Mr. Reed, is a little like being a tightrope walker. Everyone knows what you need to do. There is a big audience watching, and there are a few people who may secretly be hoping that you fall off the wire. The trick is keeping the right balance, and that is what I think you have done.

On the one hand, we have very substantial reform. You have changed the board 180 degrees, from a large insider group to a small outsider group. I am impressed with the talent of the board members you have attracted. It is clearly a world-class group. You have realized the admonition that some degree of self-regulation, through an advisory board, listed companies and traders, who will know what rocks to look under and help ensure regulation keeps pace with the dynamic market.

People inside the business will know, and react, much more quickly to abuses than any regulator outside the business. We have seen that in the last while. But at the same time, you have cut the knot of conflicts of interest within that structure. It strikes me as a good balance. Self-regulation without conflicts of interest seems to me to be the right place to go. And I want to say that self-regulation—or lack of it—or having outside regulation is not a panacea. Unfortunately, in the past year, we have seen problems with all areas of our financial markets, highly regulated areas, less regulated areas, areas supervised by the SEC, areas supervised by SRO's.

I think the self-regulation debate is important, but we cannot forget the larger challenge of reinstilling some basic principles in the markets. Smart and unethical people will find a way around whatever regulatory structure we come up with if we fail to have strong rules and tough enforcement.

Finally, I believe your proposal leaves room for future adjustment. We make some major changes now, see how they go and adjust as necessary, and I think that is the right thing to do. This approach is important. Because while there is no excuse for governance issues and conflicts of interest that have come to light in management and governance of the NYSE, in the spirit of fixing what is broken, we need to be mindful that change can have unforeseen consequences. Striking the right balance is critical. You have renovated the structure of self-regulation without losing benefits, but we have to be careful not to throw out the baby with the bathwater, and there are real risks if we move in a precipitous or wrong-headed way.

We need to keep in mind that the Exchange is a huge asset for this country. It gives the United States home-field advantage, with the largest equity market in the world and the deepest pool of liquidity. It is home to almost \$15 trillion of market value. Thanks, in part, to the Exchange, the United States, and New York became—and remain—the global center for financial innovation.

We also need to recognize that in this global age there are other exchanges, some in other countries, that would love to take market share from the NYSE, particularly in a time of perceived weakness. From my State's perspective, of course, the Exchange supports thousands of jobs on the trading floor, it is supportive, et cetera, and it also supports jobs in both Senator Dodd's and Corzine's States.

But that is not the main issue here. The main issue is to have a deep liquid and unified market. So, I want to comment on what I think is one of the keys to the Exchange's success and related to this issue, and that is the unique specialist-based trading system.

I know that it is not subject of today's hearing, but it has come under fire under the guise of reform. We clearly need to get to the bottom of charges that a few specialists may have violated the rules and regulations, and it is important we do that quickly, but that is not what the controversy is about.

Some are now arguing that specialists are outdated and that making the quickest trade on an electronic black box is more important than finding and delivering the best price. I could not disagree more. The human element at the heart of the specialist sys-

tem is still critical, and the proof is in the pudding. The NYSE specialist system beats competing markets, 100-percent electronic markets, and gets the best price 94 percent of the time on listed shares.

More importantly, most average investors, want the best price. That is what they think they are getting when they execute a trade. My father is a small stock trader. I know what he wants. I have asked him. He wants best price. He does not care if he has to wait 10 minutes to get the best price. He wants the best price. So it is not how fast; it is, rather, getting the best price, and the specialist system beats all others hands-down.

I hope today and other times, when we hear some criticism of the specialists, we recognize where it is coming from. It seems to me the cards are not always on the table. Some of the vocal critics are guilty of their own conflicts of interests through their ownership of rival electronic markets. I have heard a lot from some people in Fidelity. They say we have to get rid of the specialist system. They do not mention that Fidelity, a vocal critic of the NYSE, owns a big stake in Archipelago, an ECN and a competitor. Schwab is also part of an ECN.

I am not saying the specialist system does not need to make adjustments, but if we eliminate the specialist system by design or by accident, we risk fragmenting the market into many little electronic black boxes, where trades are quick, but prices suffer. It is in a fragmented, nontransparent market that investors suffer the most. That is where all of the behind-the-scenes tricks and things will occur, not in an open system. That is what we found. So keeping one efficient deep and liquid market, where orders compete head-to-head, is a goal that serves all investors worldwide. Fragmentation of the markets to me is the greatest nightmare we face, not just for New York, not just for America, but for every investor who wants to be treated fairly worldwide.

In closing, Mr. Chairman, I appreciate the indulgence of the Committee. This issue is important to me. I would ask that, while the governance reforms that are so important to maintaining trust in the NYSE are paramount, and we have to get them right, I also hope that we will hear about efforts to maintain the Exchange's place at the cutting edge of innovation and preeminence. We need to do that for the sake of investors worldwide.

Thank you.

Chairman SHELBY. Senator CRAPO.

#### **STATEMENT OF SENATOR MIKE CRAPO**

Senator CRAPO. Thank you very much, Mr. Chairman, Mr. Donaldson, and Mr. Reed. I appreciate you coming here before us. As has been indicated already, we seem to have a full agenda of issues relating to corporate governance and management of the problems that have arisen in our markets in the United States and globally every week, as we go through these issues in Congress, and I appreciate your constant and sincere attention to these issues.

Thank you very much, Mr. Chairman. I do deeply appreciate the concern that is being brought here and share the concerns that already have been raised by many of my colleagues. I look forward to the testimony we will hear today.

Thank you.  
Chairman SHELBY. Senator Allard.

**STATEMENT OF SENATOR WAYNE ALLARD**

Senator ALLARD. Mr. Chairman, I just have a few comments I would like to make.

First of all, I want to compliment you on having this hearing. We have had a lot of good hearings I think this past year, and as Chairman and the hard work that goes into the hearings, sometimes you are not recognized for the hard work, but I think lots of times it makes a bigger difference, and you do not get credit for it. And sometimes I think it is much better than passing legislation, more laws and whatnot if we can just get things to happen without legislation, and that is the value I think of close oversight, and I want to compliment you on all of that hard work.

This is a challenge with what we have facing today on confidence, and I agree with what my predecessors have said here on this panel. Trust and confidence is key. That is what we all want to look forward to. I am looking forward to the testimony. The New York Stock Exchange and the SEC have some serious challenges, and I want to hear what your solutions are, and we need to restore confidence as quickly as possible.

Here, in the United States, I view our exchanges, not just the New York Stock Exchange, but all of our exchanges, as premier in the world. There is no other country in the world that has the kind of exchanges that we have, and the New York Stock Exchange is always one that has been looked up to. And it is getting more and more competitive on a worldwide basis, and we have to make sure that we have that confidence because that is what separates us from the other markets.

I, as a small businessman, learned to appreciate the value of good records and accountability. And as you are looking on your internal controls and everything, you have to know what is happening, and so you need to be open, you need to know what is happening, you have the records and accountability, but it needs to be done within so that it is a minimal—we do not want to get carried away with our rules and regulations, but we need to have enough there that the customers have confidence that the management has confidence that they know what is happening in the business.

I look forward to hearing about what your reform proposals are, and I think that self-regulation can work when it is done properly, and I am hopeful, in this particular case, that that will happen.

Again, I would just like to thank Mr. Donaldson, Chairman of the Securities and Exchange Commission, for coming before the Committee, and I also thank Mr. Reed, Chairman and CEO of the New York Stock Exchange, for coming here. I know it takes away from your daily responsibilities, but this is important.

Thank you very much, Mr. Chairman.  
Chairman SHELBY. Senator Chafee.

**STATEMENT OF SENATOR LINCOLN D. CHAFEE**

Senator CHAFEE. Thank you, Mr. Chairman, and welcome to Mr. Donaldson and Mr. Reed. We look forward to your testimony.

Chairman SHELBY. Chairman Donaldson, welcome again to the Committee. Your written statement will be made part of the record in its entirety. You may proceed as you wish.

**STATEMENT OF WILLIAM H. DONALDSON  
CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION**

Chairman DONALDSON. Good morning Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. I am very pleased to be here today and to discuss the governance of the New York Stock Exchange. This issue is one that has received my attention from my very first day in office. I was confirmed as the SEC Chairman in mid-February of this year. In March, I wrote to the New York Stock Exchange and other SRO's asking for a thorough review of their governance, a review that has led to changes at the New York Stock Exchange under consideration today. While distinct from the issues of market structure, which the Commission is also working strenuously to address, as we have discussed before, the governance issue has been of great importance to me.

This issue has my attention because of its importance for the markets. As I have said in the past—and I will say again today—we have the world's most efficient and effective securities markets, but the success of our markets is directly dependent on the confidence the investors have in their integrity. This is particularly true with respect to the New York Stock Exchange. The NYSE has a leading role in our markets as the largest equity market in the world, as the regulator of the Nation's largest securities firms, and as the arbiter of corporate governance standards for many of the Nation's largest corporations. The New York Stock Exchange's leading role makes it imperative that the NYSE's own governance be above reproach.

The link between governance and the New York Stock Exchange's role was recognized as far back as 1938 in the New York Stock Exchange Conway Committee Report, which said it recommended governance changes which, "Really represent merely another step in a long evolutionary development of the Exchange as the Nation's primary securities market." It was also recognized again in 1971, when the last major changes in the governance of the New York Stock Exchange were shaped by a report by William McChesney Martin. Among other things, the Martin Report said that the New York Stock Exchange should be reorganized, "to give proper recognition of its public nature and the respective interests of the public, the companies listed on the Exchange and the members of the securities industry involved." In response to the Martin Report, the New York Stock Exchange created a board balanced between securities firms and issuers, institutional investors, and public representatives. It also created a nominating committee that was independent of members and the New York Stock Exchange board to select new candidates for the board. The New York Stock Exchange itself, at that time, became a nonprofit, nondividend paying corporation owned by its members.

Although these 1971 changes in the governance of the NYSE were dramatic for their era, time brings new challenges, and even an institution once looked to as the model must respond to these challenges to retain its preeminence. As the Conway Committee

said in 1938: "It is apparent to us that the organization of the New York Stock Exchange should be revised to accord with changing times and conditions."

The current pressing need for a review of the New York Stock Exchange's governance was signalled by a series of recent events. In the Sarbanes-Oxley Act, the Congress entrusted the New York Stock Exchange, as a listing market for the Nation's largest corporations, and other listing markets, with heightened responsibility to set standards for the governance of these listed companies. This initiative raised the bar for the New York Stock Exchange's own governance structure. In addition, the New York Stock Exchange's selection of the chairman of a financial services company that owned a large broker-dealer to serve as a public director called into question the New York Stock Exchange's board selection process, if not its dedication to the principle of a balanced board. And the reports of the compensation of the New York Stock Exchange Chairman and CEO gave further credence to concerns about the New York Stock Exchange governance process.

In March of this year, I wrote to the Chairman and CEO of the New York Stock Exchange, as well as to the heads of the other SRO's, asking them to review their SRO's governance practices in light of the standards that had just been proposed for listing companies. In that letter, I expressed the view that, just as the New York Stock Exchange and Nasdaq were demanding that publicly traded companies meet high governance standards in order to list on their markets, SRO's must demand the same standard of themselves. I asked each SRO to undertake an exhaustive review of its governance procedures and report back to me by mid-May.

Each SRO submitted written responses that detailed its governance practices and, in my view, revealed some areas that appear to warrant improvement. Following my letter, and I hope perhaps in response to my letter, several SRO's convened special governance committees whose mandates were to examine the strengths and weaknesses of the SRO's governance practices. The New York Stock Exchange provided an interim report, but indicated it was conducting a thorough review through a Special Governance Committee which would subsequently provide the New York Stock Exchange board with a final report.

While the New York Stock Exchange's review was still underway, and before issuance of the report, we learned of the New York Stock Exchange's extension of the New York Stock Exchange Chairman's employment agreement, as well as its substantial payout of his accrued compensation. In response, I wrote to the head of the New York Stock Exchange Compensation Committee and Special Governance Committee, asking for further information regarding the then-Chairman's compensation and the decisionmaking processes at the NYSE that led to his pay package. In my letter, I indicated that approval of such an extraordinary compensation package raised serious questions regarding the effectiveness of the New York Stock Exchange governance structure, and asked the New York Stock Exchange to provide me with detailed information regarding the then-Chairman's compensation arrangement and how it was approved by the NYSE board.

In my view, the documents produced by the New York Stock Exchange raised troubling questions about its governance. The then-Chairman's package was set by the Compensation Committee of the New York Stock Exchange board and approved by the full board of directors. However, the then-Chairman appears to have exercised considerable influence, both formal and informal, over the composition and operation of the board in the Compensation Committee. In addition, it is not clear that the full New York Stock Exchange board or the Compensation Committee fully endorsed the intricacies of the then-chairman's compensation arrangements, and the "ripple effects" the approval of one element had on the others. Finally, there appears to have been a lack of transparency at the New York Stock Exchange regarding the operation of the Compensation Committee and the nature and substance of its review of compensation matters. In my opinion, if there had been broader dissemination of information regarding executive compensation at the New York Stock Exchange, it is unlikely it would have reached such extraordinary levels.

In light of the governance issues at the NYSE relating to the then-Chairman's compensation package, I again wrote to the heads of each of the SRO's to ask for more details about the extent of public representation on their boards and key committees, including the compensation committees, the decisionmaking process with respect to the nomination of directors, their assignments to committees, the compensation of executives, and the SRO's past practices and current plans for public disclosure of these processes and compensation arrangements of key executives. Commission staff is in the process of assessing the responses of those SRO's.

As you know, Congress and the Commission have long recognized that self-regulation has both benefits and weaknesses. The principle of self-regulation is based on the notion that regulation can best be done as close as possible to the regulated activity. As a Congressional committee said in 1938, the alternative to SRO oversight will mean: "A pronounced expansion of the organization of the Securities and Exchange Commission, the multiplication of branch offices, a large increase in the expenditure of public funds, an increase in the problem of avoiding the evils of bureaucracy and a minute, detailed, and rigid regulation of business conducted by law." SEC Chairman William O. Douglas, back in 1937, said it all when he said: "By and large, Government can operate satisfactorily only by proscription. That leaves untouched large areas of conduct and activity, some of it susceptible of Government regulation, but in fact too minute for satisfactory control, some of it lying beyond the periphery of the law in the realm of ethics and morality. Into these areas, self-government, and self-government alone, can effectively reach."

The utility of self-regulation has been reiterated many times through the years in Congressional, Commission, and industry studies. In 1975, the House Commerce Committee said, "Perhaps expectantly, SRO regulation has, on occasion, been found seriously deficient, and it has not operated as effectively or as fairly as the public interest will require. Nonetheless, the Committee found that the system, on the whole, has worked and recommended that it be preserved and strengthened."

Where self-regulation has not worked, this often is the result of the inherent tension between an SRO's role as the regulator and as the operator of a market, and between its role as a regulator and a membership organization. Today, two key factors in addressing these conflicts are the independence of the SRO board from the interests of specific members or even specific users of the SRO's market and the independence of the regulatory function of the SRO from the self-interest of the members or the business interests of the market itself.

The independence of the regulatory function can be accomplished through a range of alternatives along a spectrum. At one end of the spectrum is an SRO that is wholly separate from any market, yet responsible for supervising member firms and the operations of unaffiliated markets. I would consider a model that has an autonomous regulatory office of an Exchange that is supervised and controlled directly by an entirely independent Exchange board to be toward the middle of this spectrum. I would also put the NASD-NASDR-Nasdaq model of separate regulatory and market affiliates overseen by a balanced board in this same middle category. At the further end is the prior New York Stock Exchange model of regulation and market combined in one entity under the direction of the Exchange CEO, and ultimately a balanced Exchange board. The appropriate regulatory structure for one SRO may not be appropriate for others, given their different memberships, sizes and regulatory responsibility. For all SRO's, however, the challenge before the Commission and the SRO's is to develop governance structures that help assure SRO regulatory programs that are effective, yet insulated from any undue influence of potentially conflicting business or membership pressures.

As you know, under the leadership of Interim Chairman John Reed, the New York Stock Exchange recently took a critical step toward governance reform that deserves our serious consideration. On November 7, the NYSE filed with the Commission a proposal that would amend the New York Stock Exchange Constitution to implement a series of governance changes at the New York Stock Exchange, including those designed to strengthen the independence of the New York Stock Exchange board and its key committees and better insulate the New York Stock Exchange regulatory function from its business as a market. These steps include creation of an autonomous regulatory office headed by a Chief Regulatory Officer who reports directly to a committee of the new, wholly independent New York Stock Exchange board. This board committee is responsible for ensuring the effectiveness, vigor, and professionalism of the New York Stock Exchange regulatory program. The Committee determines the budget, regulatory plan, and staffing of the regulatory office, assesses the New York Stock Exchange regulatory performance, and recommends compensation and regulatory actions to the independent board.

The New York Stock Exchange proposal is subject to Commission approval. Because of the significant public interest in the New York Stock Exchange's proposed governance reforms, the Commission immediately issued a notice seeking public comment on the NYSE's proposal. To assure widespread awareness of the New York Stock Exchange proposal, the Commission has both published it in



the *Federal Register* and highlighted it on the Commission's website. The comment period will extend through December 4. I encourage any interested persons to formally submit comments on the New York Stock Exchange's proposal for Commission consideration. Although the Commission reserves judgment on the proposal until all public comments are received and evaluated, I must commend the New York Stock Exchange, and in particular John Reed, for taking this substantial and critical first step toward revamping its governance structure.

In conclusion, I would like to thank the Committee for recognizing the importance of effective governance of the NYSE and other self-regulatory organizations. I look forward to continued input from your Committee. Thanks again for inviting me. I would be delighted to answer any questions.

Chairman SHELBY. Thank you, Chairman Donaldson.

Mr. Chairman, many people contend that the Exchange's proposals do not get at the root of the problems at the Stock Exchange. Some believe that after the reforms are implemented, we will be left with a situation perhaps where the Exchange's regulators will continue to report to a board elected by members of the Exchange.

Mr. Chairman, as head of the SEC, how do you respond to that criticism, that as long as the members select the directors, then the institutional conflict remains and true regulation will not occur. Have you heard that?

Chairman DONALDSON. Yes. You know I have to reserve judgment, basically, until all of the public comment—

Chairman SHELBY. So, when you say the "first step," is that in the context of all of it?

Chairman DONALDSON. Well, no. All I want to say is that this is out there for the public to comment on, and I want to make sure that everybody recognizes that.

Chairman SHELBY. But you are very cognizant of the concerns.

Chairman DONALDSON. The structure is set up in such a way, and I will not go through the details of that structure, that, in effect, every possible safeguard has been given so that the reporting of the regulatory function, the compensation of those involved in implementing it, and so forth reports to an independent board, and that the CEO of the New York Stock Exchange, whether that be a Chairman and CEO in one person or two separate functions, will have absolutely nothing to do with the regulatory function and so that the regulatory function will not be compromised.

Now, to address your specific question, there will be an opportunity for the board to have its own nominating committee, to nominate new directors as their terms expire, and I think that, fundamentally, you have a group of shareholders, if you will, who are called seat-holders, who have tremendous investments in their seats, and I believe they will understand that the integrity of the Stock Exchange, the integrity and the independence of the board is something that we should not, and could not, and would not allow to be compromised in terms of an election process.

Chairman SHELBY. It is in their interest, is it not?

Chairman DONALDSON. I would also say that—

Chairman SHELBY. But is it not in their interests to have integrity first, a board that functions well, too? It is in the interests of the seat-owners, the owners of the seats on the Exchange for the Exchange to work well, to be independent as much as you can, to function well, to not be in the critical path every day.

Chairman DONALDSON. I think that the fundamental proposal that Interim Chairman Reed has put forward has, at its core, a totally independent, highly experienced group of former executives or sitting executives, and I think that that is absolutely critical to the going forward of the Exchange.

In terms of what happens in the future, there will be continuing elections of new boards as the years go on, and I think the self-interests of the owners of the Exchange, I mean, the seat-holders of the Exchange, will be such that they will not even begin to dare to change the integrity of the process.

Now, having said that, there is scope for, and responsibility for, the SEC to oversee the governance of the Exchange. And should there be any deterrence from the new course that is being set out here, we have the power, and the independent board of directors has the power, to make sure that any changes in directorship that do not meet our standards do not happen.

Chairman SHELBY. Mr. Chairman, you have been quoted as stating that the SEC will continue to consider further marketwide reforms, including governance, and regulatory reforms and additional reforms beyond what Mr. Reed proposed. You have alluded to this already.

Assuming that the SEC approves Mr. Reed's proposals that you are now considering, what are the SEC's next steps in evaluating the Exchange's market structure, including the role of specialist and its regulatory function.

Chairman DONALDSON. Well, I would answer that in two phases. Number one, this is, if approved, definitely a first step. I think the second step is to give the new independent board an opportunity to function, and give it an opportunity to move in as it, I am sure will, in the evaluation, reorganization and so forth of the regulatory function itself.

There is a second part of this which is not in the purview of the New York Stock Exchange itself, and that is market structure. In other words, there will be, as we have talked about before in this Committee, and as we are working on very diligently right now, there will be changes in market structure coming down the pike that will affect the way the New York Stock Exchange operates, but I think that is separate from the issue of the governance of the Exchange. And separate from the paramount issue, as far as I am concerned, is the locus of this regulatory function.

Chairman SHELBY. Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman. And I thank you for your testimony, and I understand that you do not want to pre-judge whatever the SEC does. I guess it is pretty clear from your comments I think it is a good structure, and I think you should go with it and then see how it works, just as you said.

But let me ask you, I guess you heard what I had to say. Do you worry about fragmentation of the markets? Do you worry, and do you think, that the one has anything to do with the other. Chang-

ing the regulatory structure, whether it is done by the NYSE itself or by the SEC or the SEC recommends changes, has an effect on the market issues, the way stocks are traded, the things that are within the SEC's exclusive purview.

Chairman DONALDSON. We are very concerned, as we deal with market structure, about fragmentation.

Senator SCHUMER. Good.

Chairman DONALDSON. We are very concerned also with the arrival on the scene in recent years of new ways of trading stocks, and in particularly electronic ways, ECN's. And by the way, the electronics at the New York Stock Exchange are much greater than they are given credit for.

Senator SCHUMER. And much changed over the last 10 years.

Chairman DONALDSON. Yes. Having said that, our dilemma, if you will, is to try to create a structure that involves bringing together the benefits of some of the so-called "rapid markets," the nanosecond trading that we have talked about before in this Committee, the ability to execute in seconds—and that, of course, has been exacerbated by the decimalization of spreads and the fact that you have just a penny between the bid and the ask, and you have a nanosecond ability to trade—trying to make that way of trading available to those who want it. And there is a segment of the market population that wants to interface that with the price improvement auction market specialist system that has stood for years for getting a better price for people.

And I do not throw out the idea that speed is important to some people, and I definitely do not throw out the idea that getting a better price is important to probably a lot more people.

So the job here is to bring these two systems together in a way that basically gets for the public investor out there what they want.

Senator SCHUMER. And without fragmenting the markets because the depth and liquidity of markets, I believe, you tell me, not only is the best system and gets the best price, but also is the best one for openness, for regulation, to avoid the problems that we have seen throughout the financial markets in the last while.

Chairman DONALDSON. Well, there are two aspects to what you are saying, Senator, and that is we are not only talking about speed, price improvement, and fragmentation, but we are also talking about liquidity. We are also talking about the massing of liquidity. And, again, there are all sorts of statistics about who has the better prices and so forth. I do not want to get into that now, but I just would remind the Committee of the importance of the liquidity pool that exists at the New York Stock Exchange.

Senator SCHUMER. So you share my worries about fragmentation.

Chairman DONALDSON. And particularly in times of stress, and I do not mean this to be a brief for the New York Stock Exchange because there are other markets here, and there are other ways of trading. But I think, since we are talking about the New York Stock Exchange this morning, I just cannot pass by without making that statement: The liquidity and the liquidity that develops in down markets, when I say "liquidity," that is depth of markets. It is a great national asset that we have there, and we do not want fragmentation to break that up.

Senator SCHUMER. Correct. Let me ask you this, and I could not agree more with your comments, and I am glad to hear you were saying them. I think that if most people study the markets without any specific bias, they would agree with that comment.

Does technology not, the trick here I guess is to harness the technology and keep the depth and liquidity.

Chairman DONALDSON. That is it.

Senator SCHUMER. That is a tough job.

Chairman DONALDSON. Yes.

Senator SCHUMER. And in my view, that has been a strength of the New York Stock Exchange. As you may know, I was a critic of the Exchange 5 years ago and got them pretty mad because I thought they were not moving quickly enough to deal with that issue, but I think they have, and I think they have done a pretty good job of that. And maybe while they were focusing on that, they let some of these other things go by the wayside that you, and Mr. Reed, and others have to correct now because you need both. There is no question about it.

I guess my fundamental question—he is telling me my time is up—is it an either/or proposition?

Chairman DONALDSON. Either/or in what sense, Senator?

Senator SCHUMER. Either/or the governance issues, and the regulatory issues, and the technology, trading, liquidity issues—can we not have both?

Chairman DONALDSON. We have to have the purest governance structure that we can possibly create. We have to have the cleanest separation of responsibility for regulation that we possibly can create, and not to repeat myself, I believe that can be created in a number of different ways, and I do not think we should mistake form over substance here. I believe that the concept that John Reed has come up with has gone a long way, almost all the way toward the separation of that responsibility from the business side of the Exchange.

In terms of market structure, I do not think it is an either/or situation. I think that we will be coming up with what we hope are approaches to the structure of the market that will get the best of these two different worlds, if you will, without throwing out the liquidity and so forth that have made the New York Stock Exchange successful.

Senator SCHUMER. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Bunning, thank you very much for your indulgence.

Senator BUNNING. Thank you.

Chairman Donaldson, I would like to follow up on something that the Chairman spoke about earlier. It seems to me, in most cases, that self-regulation does not work. Self-regulation does not work, whether it be mutual fund self-regulation, whether it be New York Stock Exchange self-regulation, whether it be the Federal Home Loan Bank self-regulation, whether it be Fannie Mae and Freddie Mac self-regulation or wherever we are going.

And in the proposals that Mr. Reed has, there is still self-regulation, and I want to know how investors' confidence is going to be restored in the New York Stock Exchange or any exchange, for that

matter, mutual funds, whatever it might be, if we still have the fox in the henhouse.

Chairman DONALDSON. I think that the failures of self-regulation are what has caused the changes that are going on right now at the New York Stock Exchange. I think the governance aspect is only one part of self-regulation. I think that if you go back in history, I believe that the fundamental decision that was made in 1933 and 1934 to give the right of self-regulation down to the people who are operating the markets was the right decision. I think if we had gone the other way and had a Securities and Exchange Commission or some other agency that tried to run these markets from Washington, we would have had a bureaucracy, and we would have had a Federal expenditure that would have impeded the growth of the markets.

Senator BUNNING. Mr. Chairman, I am not going to violently disagree with you, but we had an antique called the Securities and Exchange Commission and the Act of 1934 that made certain rules and regulations in governing the security markets. Just like the Social Security System was founded a few years later, we have made strong changes in how we operate Social Security, and we are about to do it again somehow because it needs to be done.

While we have this great opportunity because we have found some major flaws in what we have been doing, I am not going back to 1934 and saying that was a good thing to do. Maybe it was in 1934, but it is not in 2003.

Chairman DONALDSON. I could not agree with you more, Senator, and I do not mean to imply that we are going back. I just use that as a reference point. What I do believe is what we are attempting to do now is to gain from our experience with self-regulation and to change the rules, as you suggest, to enhance self-regulation. I think it is too soon to simply say self-regulation does not work and to throw it out.

Senator BUNNING. Well, history dictates otherwise. And I am an old baseball player, and when owners in baseball elect the commissioner and run the game, the health of the game is in jeopardy.

You need someone with a knowledge of the game but outside of the game. That is what I think is almost essential if we are going to restore investors' confidence in these markets. Without investors' confidence, I do not give a darn how good the exchange is run and how great the executions are and if it is a nanosecond and we get the best price. The investor has to have confidence in that market. And if we do not restore that investor confidence, that market is going to go to England, that market is going to go somewhere other than New York.

I would suggest in the regulatory section of governance that we really look at who is the last person to have the say, because it is essential that that not be somebody from the floor, that it not be somebody from one of the brokerage businesses, that it be somebody that has the knowledge but is a separate, independent operator. And I would suggest that you look at that, and I thank you for your time.

Chairman DONALDSON. Senator, can I just thank you, and I hear what you are saying, and I believe that the structure that has been put forth—and it is only a first step—does exactly what you say.

It has taken all that conflict out from those who were responsible for—it has taken the conflicts inherent in what seat-holders want, what floor brokers want, what institutions want, and so forth. It has put it aside, and that is to be run as a business. And it has taken the regulatory side of things and has as pure a structure as you could possibly conceive of, even though it is still in under the same umbrella, it is a structure inside that goes from independent regulatory function reporting to an independent board who has on it nobody with special interests. That is the nature of this board.

Senator BUNNING. Well, we will see how it works.

Chairman DONALDSON. Okay. Thank you for your comments, Senator.

Chairman SHELBY. Senator Corzine.

#### **STATEMENT OF SENATOR JON S. CORZINE**

Senator CORZINE. Thank you, Mr. Chairman.

Welcome back, Chairman Donaldson. It seems like you spend a lot of time here these days. Unfortunately, the read of the newspapers I think makes that far too important the reality of what we see in the markets. It is going to be disappointing to all of us who have been a part and have benefited from markets, and I must say the ongoing revelations we see almost day-to-day is extraordinarily disturbing to me. And I think this discussion of the New York Stock Exchange, which is really emblematic of the greatness of our markets in its totality, needs to make sure that we do this right, because there is this—there has to be a serious erosion based on the multiplicity of events, starting with the corporate problems that we had in the late 1990's and the early part of this decade, the mutual fund discussion that we had the other day. I am personally seriously disturbed by the events in the foreign exchange market revealed, at least to the public, yesterday.

I think that is why it is so important that in one of the most important institutions we get it absolutely right, and I congratulate Mr. Reed for taking on this herculean task. I think his own personal integrity is one that starts us off in the right process.

But I do have some sympathy for looking for the purest response because I think the seriousness of the nature of the undermining of the confidence that people have with regard to the integrity ultimately is the fundamental issue that will determine whether we have price, speed, depth, breadth, liquidity, and the capital formation function going on, and that somehow or another we have to get that restored in an absolute sense. And I think that the pattern that is established here is essential.

I did not mean to give a statement. I have a formal statement, Mr. Chairman, that I will put into the record, but this discussion and the quality of leadership we have seen so far on this from the people at the exchange post some of the problems I think has been terrific. But I do not know whether it goes far enough in my view.

I want to take off on a question—I think I understood the question that Senator Schumer was talking about, either/or. I think the governance issue is absolutely linked to the structural issue because ultimately the governance issue is where you are going to get the best perspective and effort to drive to the results. And then you are going to actually, even outside of the regulatory function, make

sure that the best structural ideas that are laid down get implemented and executed.

Am I missing something? I think they are actually linked.

Chairman DONALDSON. I do not think you are. If I understand what you are saying, I think the structure of the governance of the New York Stock Exchange is the fundamental fountain from which the integrity of the place will flow. And I think that the structure that has been suggested by Chairman Reed goes amazingly far in that direction.

Having said that, you know, the structure is out for comment. It is out for people to make their own judgments and come back to us with them. I believe it is a first step. And, again, without prejudicing the listening to other people's views that we will do, I will do, the Commission will do, I believe that this step probably deserves a chance. I think that, if it does not work, if that board itself says it does not work and cannot work, they have the power to go one step further if they want, if they determine that somehow this structure is imperfect.

They have been given that power now by the change in the constitution. There is tremendous power that resides with that board in terms of taking it another step. And we will see where that goes.

Senator CORZINE. Let me ask something slightly less macro. Do you believe that there is the potential to transform the auction system into a technologically executed system? Is it possible to do?

Chairman DONALDSON. I guess anything is possible, you know, in this day and age in terms of technology. I believe that you can probably someday take an airplane and fly it from New York to Washington without any human beings flying it. I would not want to fly on that plane. And although that is a poor analogy, I think there is some merit here. I think the combination of technology and human judgment becomes particularly important in the marketplace, particularly important when there is stress in the marketplace. So, I think that the agency auction specialist system has to modify itself to have enough increased technology side-by-side, but, again, I am not prepared to throw human judgment out of it.

Senator CORZINE. Thank you.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Has he had a chance?

Chairman SHELBY. No, but you were here earlier.

Senator SARBANES. No, that is all right. Go on.

Chairman SHELBY. Okay. If you want to defer to Senator Sununu, that is fine with me.

Senator Sununu.

#### STATEMENT OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. I do not want to get into any trouble.

Senator SARBANES. Oh, no, you are not in trouble.

Senator SUNUNU. Thank you.

Chairman SHELBY. He is having a good day.

[Laughter.]

Senator SUNUNU. He deserves a very good day.

Chairman SHELBY. So take advantage of it.

Senator SUNUNU. Thank you.

Mr. Donaldson, the last time you were here, I asked some questions about specialist behavior, about their use of proprietary information, perhaps inappropriately, about practices of front-running, and whether there were rules that encouraged that kind of behavior or that facilitated that kind of behavior.

You gave a reasonable answer, I thought at the time. It was not especially specific, though. And the next day the SEC announced that it was taking action against five specialist firms for front-running and other violations of SEC rules. I guess I can understand why you were maybe a bit vague in responding to my inquiries.

What is the status of the action in those specific cases? What have the findings of the SEC been with regard to the rules violations in those cases? And what changes to specialist rules might you propose or recommend as a result of these cases?

Chairman DONALDSON. Well, there are two aspects to your question: One is violations of existing rules, and number two is an examination of those existing rules to see whether they should be changed. I think they are two very different things.

Clearly, there have been a series of events originally discovered, if you will, by the New York Stock Exchange regulatory system itself, that involves alleged breaking of those rules. The SEC moved in swiftly because we thought the possible breaking of the rules, if you will, went beyond what was being investigated. We broadened the investigation. And we are now in the process—and I am being very careful here because, you know, we do not comment on possible enforcement proceedings, for obvious reasons. But you can be sure that the SEC will take whatever enforcement actions are indicated by our surveillance system and act upon them.

I want to make sure that I am making it very clear that that is one part of the problem.

Senator SUNUNU. Okay. And I do want you to move forward to the second issue about the rules changes. But let me ask you, with regard to that answer, why did the SEC have to step in to broaden the investigation? Why in your opinion wasn't the investigation appropriately broad to begin with?

Chairman DONALDSON. I think that is a very legitimate question, and I guess the bottom line is there was what we considered to be a failure or something lacking in the oversight at the Stock Exchange itself. And that is why we stepped in, and that has been the problem, and that is a problem that needs to be solved.

Senator SUNUNU. But if I understand your answer to Senator Bunning's question, when you answered his question you seemed to suggest that the nature of this self-regulatory structure was not a problem, was not necessarily a limiting factor and that here you seem to suggest that the nature of the regulatory structure resulted in the SEC having to step in to broaden what in my view is a very important investigation.

Chairman DONALDSON. I think that what I was trying to say was that the concept of self-regulation is born of an attempt to accomplish two things: To have regulation close to the marketplace so that the marketplace can operate in rapidly changing times, to not have that regulation outside, disembodied by a bureaucratic organization that would impede the functioning of the market. And this is not to say that self-regulation cannot break down. And I think



we have a particular instance here where in that particular niche on the floor of the Stock Exchange it did break down.

But that is not a reason to throw it out, in my view. What you do about that is you change the rules and then you make sure that the rules are followed, and you change the reporting structure of the regulation to enhance the enforcement.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you.

Chairman SHELBY. We want this good day to continue.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman Donaldson, do you know how many people work in the Enforcement Division at the New York Stock Exchange as they carry out their self-regulation? Do you have any idea?

Chairman DONALDSON. Do I—I am sorry. I did not—

Senator SARBANES. How many people work in the Enforcement Division of the New York Stock Exchange?

Chairman DONALDSON. Broadly defined, in terms of both enforcement, surveillance, and so forth, I would say close to half of their employment is involved in that somehow.

Senator SARBANES. How many people would that be?

Chairman DONALDSON. Five hundred fifty.

Senator SARBANES. Five hundred fifty people. Well, I am interested in that figure because and I am not suggesting this as a remedy, but just in terms of the range of thinking that is done—it is constantly asserted that unless the Exchange does its self-regulation, the alternative would be a huge Government agency. I think is the way the phrase is put.

Now, how many people work at the SEC currently?

Chairman DONALDSON. Well, as you know, we are adding people. I cannot give you the exact up-to-date figure, but we started at the 3,200 level, and we are moving toward 4,000.

Senator SARBANES. Four thousand. The New York Stock Exchange, I understand, has 550 doing regulation.

Chairman DONALDSON. That is apples and oranges, though, Senator, because, you know, the regulation being done by those 500 people is very different than what the 4,000 people at the SEC are doing.

Senator SARBANES. Well, I understand that. But if the SEC were to do the regulation that the New York Stock Exchange does, conceivably the SEC could do it with an expansion of 10 to 15 percent in its current staff. I only throw that out to try to address this constant assertion that is being made that this alternative that maybe it should be done directly by an independent Government agency, that has none of these conflict problems built into it, would create this huge bureaucracy. It is thrown out as though, you know, it is going to require a doubling or tripling of the SEC.

If reasonable resources are now being devoted to it by the Exchange—and maybe there are not. Maybe they should have more people. But on this current calculation a significant but not an overwhelming increase in the SEC staffing would enable another alternative to be considered, namely, that the regulation be done directly.

Chairman DONALDSON. First of all, you are talking about not just one entity, the New York Stock Exchange. You are talking about 12 exchanges—

Senator SARBANES. So we would have to see what the NASD does and others. Yes, that is a reasonable—

Chairman DONALDSON. And all the other players in the marketplace, the ECN's and so forth. I mean, you have a major array of organizations.

Senator SARBANES. But the direct approach would eliminate a lot of these conflict problems, wouldn't it?

Chairman DONALDSON. And I think it would bring on a lot of bureaucratic problems.

Senator SARBANES. It is very clear that some people in the system at the Exchange have been prepared to feather the nest for everybody else in order to gain—to aggrandize themselves. Would you say that is correct? Actually, let me ask the question this way because I want to quote. *The Wall Street Journal* on November 3 wrote an article, and it quotes, I guess, from an SEC report. I am not sure this report has been made public yet. It says,

The SEC report paints a picture of a floor-trading system riddled with abuses, with firms routinely placing their own trades ahead of those by customers and an in-house regulator either ill-equipped or too worried about increasing its workload to care. And it concludes that when the New York Stock Exchange does act on investor abuses, the exchange often does little more than admonish the specialists in a letter or slap them on the wrist with a light fine. The SEC staff is concerned that the New York Stock Exchange's disciplinary program is viewed by specialists and specialist firms as a minor cost of doing business, that it does not adequately discipline or deter violative conduct, the report says. It adds that the four trading firms have no meaningful compliance programs for reviewing their specialists' compliance to various trading rules.

I want to make it very clear at the outset. The report they are referring to, as I understand it, deals with conduct that took place before Chairman Reed took over and moved in there in order to—

[Laughter.]

Senator DODD. The record should note he is smiling.

Senator SARBANES. Yes.

Chairman SHELBY. I think that is an acknowledgment.

Senator SARBANES. Before he moved in there to try to clean this thing up.

But does the *Journal* article, in your view, accurately describe what has been going on at the Exchange?

Chairman DONALDSON. Senator, you know, that was a journalistic review of a confidential report, and I do not think that it is perhaps fair for me to comment on the journalist's comments on a confidential report in terms of some of the language being used by the journalist. And I cannot comment on whether any of that language was used in our report.

And I do not mean to sit here and tell you that there was not a failure in supervision and there was not a failure in adherence to the rules and regulations of the Stock Exchange. And we are addressing that.

Senator SARBANES. Aside from the bureaucracy argument—and one would have to look carefully at the numbers and make some judgment about it—what other arguments are there against the SEC assuming these responsibilities directly?

Chairman DONALDSON. Well, I think in talking about bureaucracy, I think what you are—what I am talking about is a package that addresses a remoteness from where decisions have to be made, and a remoteness that will slow down the decisions that have to be made in a fast-moving marketplace. There are decisions all the time being made on the floor of the Stock Exchange by its own—not only the regulatory, the hired employees of the stock exchange, but the informal network of exchange governors and so forth on the floor that interpret those rules and make sure that they are being adhered to. And as you know, rules can be interpreted in a lot of different ways, so it is a day-to-day activity, and I think it does not fit with the concept of a Government agency operating out of Washington trying to do that.

Senator SARBANES. Of course, it could operate out of New York, too. I mean, the Chairman of the SEC could have an office right there in New York, and you could have a much larger—

Chairman DONALDSON. That is a great idea.

Senator SARBANES. You could have a much larger New York staff in order to do that. I mean, the ultimate aim is the honesty and integrity of the Exchange and how it works.

Now, we have a system where we have these self-regulating organizations under the oversight of the SEC. Now, if they are not producing the result—and, of course, some would argue, well, the SEC has fallen down, you know, on the job, for instance, on the mutual funds, but we are trying to boost your capacities now, and we have some good leadership at the SEC now. So we think progress is being made.

The question then becomes whether the system with the SRO's has so much conflict of interest almost built into it and abuses that you despair of making that system work in order to assure this overarching objective of the honesty and integrity of the trading floor there. And it is not clear. I mean, if someone said, "Well, you know, you are going to have to get 5 times—you are going to have to expand the SEC by a factor of 3 or 4 or 5, or something," then I would say, "Oh, wow, this is really big"—but, you know, just on this preliminary examination of this, the numbers are not in that category.

I guess in part I am sending a message not to Mr. Reed because I think he is trying to address this situation, but he has to deal with a big constituency up there. And presumably some of that constituency is resistant to change. He is trying to perhaps go as far as he thinks he can, but maybe it is not as far as he should go, and maybe the SEC will reach that judgment. And that is something we are going to have to look at. But the people that he is encountering who are resisting change and shaping up the organization itself in order to do it I think should be sent a message that the alternative of the direct assumption of responsibility by the Securities and Exchange Commission is not something that is so far out of proportion that it could not be considered.

I want to get the debate into a more open environment on these important issues, and that is the only reason I am putting these questions to you. I think the SEC—I know you are trying to make it work, and good luck. But I do not think you should just, in effect,

find yourself constrained in a way where you cannot say to people, well, if you cannot make it work, maybe this is going to happen.

Chairman DONALDSON. Senator, I understand your point, and I think that I would make a statement in terms of the reluctance to change and so forth. I think this is the greatest change that the New York Stock Exchange has seen during my lifetime in terms of the change of the constitution and the willingness of the owners, if you will, the seat-holders, to delegate to a totally independent board the future of the stock exchange.

And then, going back to your original question—is it just a matter of bureaucracy?—no. It is a matter of regulation that goes beyond law. It goes to integrity. It goes into certain concepts of integrity and business conduct that cannot be done by red-line laws. I think we have the same thing in corporate governance issues in front of us. We write the laws, we have independent audit committees, et cetera. But it is going to be the personal integrity that goes beyond the law. And I think that is what has to be reinstated at the New York Stock Exchange. And I think that is what this structure does.

Senator SARBANES. Well, I think that is a reasonable point. I would make this observation: When the securities laws were enacted in the 1930's, at a hearing before the Senate in which the representative of the accounting profession was at the table, one of the Senators asked, "Well, now, we are putting this whole system into place," he said, "but who is going to oversee the accounting industry?" They were setting up the SEC to oversee certain aspects of the securities industry. And the response that he got was, "Well, our conscience will do that, Senator."

And, of course, they were allowed all these years to proceed on that basis. But it did not seem to work, and that is now why we have Bill McDonough and his colleagues over at the Public Company Accounting Oversight Board.

Further, I would make one final observation. If the exchange were to commit these resources that they were committing to these outsized compensation payments, that would go a long way to funding an effective enforcement budget.

Thank you, Mr. Chairman.

Senator CORZINE. Mr. Chairman, would the Chairman object to a follow-on question? This leads right out of—

Chairman SHELBY. Would Senator Dodd yield you the time, do you think?

Senator DODD. No.

[Laughter.]

Go ahead.

Senator CORZINE. I actually wanted to ask about this SEC report that was reported in *The Wall Street Journal* on November 3. Is that going to be made public? If not, why? If so, when?

Chairman DONALDSON. This is a matter where the SEC has traditionally not made these internal reports public. I am not sure of the law on it.

I think a referral to Enforcement and an action by Enforcement would make these allegations public.

Chairman SHELBY. Senator Dodd.

Senator DODD. Thank you, Mr. Chairman. And let me thank you once again, Mr. Chairman, for having these hearings, and we thank the Chairman of the SEC for being back here. You may want to consider moving the SEC building a little closer to the Senate. We have a tunnel we are putting in over here. Maybe you could arrange it, given the frequency of your appearances here. We thank you very much and are looking to hearing from John Reed as well when he testifies.

Let me, if I can, Chairman Donaldson, follow up with a couple of questions. I do not know if you had a chance, with everything else you have got to do—there was a recent article—I think it is about 2 or 3 days old—in *Business Week*. I presume maybe John has looked at this thing, but it is “Too Little, Too Late, Mr. Reed?” A question mark on the end of it. And I want to raise the issue about the governance question, if I can, and there has been some discussion about whether or not the SEC may do more following on Senator Sarbanes’ questions that he raised with you.

The question that I have for you has to do with the possibility—or one of the criticisms that is being raised by some people. Most agree that the steps that have been taken so far are good steps in the right direction, but just on the governance question, let me raise this, if I can, with you.

What the *Business Week* article says—and I would ask unanimous consent, Mr. Chairman, that it be included as part of the record.

Chairman SHELBY. It will be included, without objection.

Senator DODD. It reports that the plan—and I am quoting—“allows just 40 members to nominate a director and 100 to nominate an entire slate.” It cites Jack Ehnes—I think that is how you pronounce his name, E-h-n-e-s—who is the CEO of the California State Teachers Retirement System, he says, “Having members in any way involved in setting up and getting board members nominated is a problem. It is a regulatory body with a public purpose, and in my mind, that is a clear conflict.”

The article goes on and quotes some other people as well. It quotes this fellow who is the North Carolina Treasurer, Richard Moore, as well here. Their concern is that you could end up having a wonderful board. This board, I think, that John has put together is a great board, but the possibility exists for the membership coming in and just getting rid of a board. There is a vote every June on the board. And I wonder if this has gone—and John will have a chance to talk about this as well when he comes up, but I would like your comments. I do not know if you have had a chance to look at this. But it is almost like you could drive a Mack truck through this when it comes to governance. And if you do, then you have got the very people back again picking the board again, and you are right back potentially where you were before.

Are you familiar with this?

Chairman DONALDSON. Well, I know you were not here earlier, Senator Dodd.

Senator DODD. I apologize.

Chairman DONALDSON. I tried to address that question, probably inadequately. You have a series of seat-holders, both leasees and lessors. Their asset is principally the value of their seat, and that

seat is dependent upon the perception and reality of the New York Stock Exchange having organized itself to service and serve the public and to serve the public investor. And I think any attempt by the electorate, if you will, to move back to something that was not working is not what is going to happen because that would be self-defeating from a commercial point of view. However, having said that, the SEC still has its oversight responsibility. And just as we moved at this point, we could move again.

Senator DODD. Well, am I taking from that that you would object—and the article goes on to suggest—I do not know which one of these individuals made the suggestion that the SEC should actually approve the board members themselves rather than just have oversight. Would you go further?

Chairman DONALDSON. Well, we basically are interested in comments such as yours that will be coming to us as people look at this proposal. And, you know, we will take a look at the comments. We will take a look at the questions that you put up. We will take a look, I am sure, at a lot of other questions. And I go back to what I have said before and what the Commission has said: This is a first step. This is a first step, and I think you cannot take all that has happened at the New York Stock Exchange, all that needs to happen, and take it out of the context of the reality now of needing to do something now. I think a structure has been brought in. I think there are people of the highest integrity involved. I think we probably should give them a chance to address some of these issues. And, again, I do not think this is the last step. I think it is a first step. And I do not want to prejudice where the Commission is going to come out on even this first step.

Senator DODD. I understand that, and I appreciate your point. It is a very rational and reasonable position to take. But also having been around here a number of years, there are moments when there is attention on these questions and that we will move on to other issues—we already are—involved with the mutual fund industry. There are going to be issues involving the GSE's. There are all sorts of questions coming up, and it is the natural inclination of these institutions and others for their attention to get diverted. And so there is a moment here in which we need to obviously take a look at all of this, and I agree with you that it has to be done thoughtfully and you need to think about what you are doing in all of this. And I do not need to tell this to you, obviously, as someone who has spent an adult lifetime working in this industry, how critically important this exchange is. Of all the exchanges, this is the gold-letter exchange. This is the one the world really looks to, and a sense of confidence in it, for investor confidence issues.

So there is a special responsibility, in my view, to really get this right and to send a message to people that we are getting it right. And, again, you can go overboard on this, and you have to be careful in doing that. But I would hope there would be some sense of urgency tempered by being responsible and thinking clearly through all of this, but that we do not miss this hour in time as other issues overtake us and we move on to other questions.

So things like the question of is the chairman of the board going to be independent, whether or not there is going to be a good oversight or just kind of we will look at it when problems arise, I would

like to hear more. And I am not going to press you on it today, but I would like to have you get back with some of these ideas and suggestions and give us some sense of where we should go.

Chairman DONALDSON. I think your comments are well taken, and without going overboard on my own observation, because John Reed has had to contend with what is going on in the Stock Exchange right now, but I believe that the very vote that was taken, the fact that it was an almost 100-percent vote for radical change, indicates something about the attitudes of that group of people there. And I also think, the structure that has been put forth and the type of people who have been brought on board as new directors says something about the new leadership.

I look forward to hearing the comments. I look forward to watching this thing evolve. And, clearly, the necessity now, I think, is to take a first step but to recognize it as just that, a first step.

Senator DODD. Thank you.

Mr. Chairman, Senator Sarbanes—and this may have been asked as well, so I will not pursue it. But on this inherent tension between the notion of being the regulator as well as creating the market issue—and you have addressed this in your comments—and whether or not the proposal that has been made fashioning the independence of the board and the independence of the regulatory function, how you marry those in an effective enough way so you can create the kind of confidence that there will be a solid oversight function is really rather critical. And I hope you will give that a lot of serious thought and get back to us. But I think Senator Sarbanes' line of questioning in that area—I regret it deeply. I have been a great advocate over the years of SRO's. I am saddened in many ways that we are even talking about having to go this route. But I do not know of anything to do in the short-run, but to get you more involved in this and get the SEC more involved. I wish I could think of some other idea that would not have to move us in that direction. But I do not think we are going to rebuild investor confidence in the country without the SEC getting a lot stronger. Maybe we will be able to come back to it at some point, but for the time being, I think we make a mistake if we assume that we can just rely on what has, fortunately, in many ways worked very, very well for many years, but does not seem to be doing the job today. So, I come down on the side of getting you more actively involved in this, the Commission I speak of.

Thank you, Mr. Chairman.

Chairman SHELBY. Mr. Chairman, I just want to go back briefly to the specialist role. I wish Senator Schumer were here now. He talked about it. Others did, and Senator Sununu asked some very important questions about some things that went on at the market and what has happened.

I just throw out to you that we all know that the New York Stock Exchange is very important to all of us as the capital markets. It is the largest. But there are other markets, and my predecessor here, Senator Gramm, used to talk about when the candle makers of America came to Washington to try to block the idea of electricity and the light bulbs for everybody that Edison came up with, and you know that story. But you also know, Mr. Chairman, you cannot block technology. Technology will ultimately prevail.

So how do we implement or integrate technology into a system where it has been the human being, you know, executing orders and so forth? Because I do not believe technology is going to go away. Can you manipulate technology? Absolutely. Humans learned to do that a long time ago. But humans manipulate a situation, as you well know, and he alluded to it earlier.

Whenever we are looking at the New York Stock Exchange or any market, I think to try to think technology in the future, the electronic market is not going to play a role, I think that is nonsense. You know, I think you have to do it. How you do it I do not know. But you cannot protect people from progress. The technology will trump it—or generally will. You might regulate it. You might try to do this. But, you know, I think history is a guide there.

Senator Sununu, I believe you had another question.

Senator SUNUNU. And it certainly relates to some of the points you were making.

Mr. Donaldson, do you consider the terms “best price” and “best execution” to be synonymous?

Chairman DONALDSON. Well, I think that there are different concepts of what best execution means to different people. There are certain people who consider the best execution to be an immediate execution. There are certain investors who are willing to sacrifice getting the best price in order to get a rapid execution. And that is the essence of the electronic markets, the ECN’s, versus the New York Stock Exchange. And that has been exacerbated by the decimalization and the penny-ization, if you will, because the benefit of gaining an extra penny may be not worth the wait to some people. But if you really get into what goes on in a market and the amount of transactions that take place at a single price point, you have to get below that—into spreads that are larger than pennies, and then price improvement really does mean something.

But I think the concept of best execution—I refuse to believe in my own mind based on my own experience that the concept of an organization that gets the best price for somebody is something that gets easily thrown away. Again, I will let Chairman Reed speak for the New York Stock Exchange. But I believe that the liquidity that is inherent in and developed on the floor of the stock exchange—again, I am repeating myself—in times of stress is unique. And I also believe that the meshing of human intelligence with technology is where things are going. And I think there is a characterization of the New York Stock Exchange, of a floor and people running around on that floor, that is an outmoded model. I think the technology on the New York Stock Exchange is cutting-edge. The electronics on the New York Stock Exchange are cutting-edge. It is just a matter of how much electronics and how much human judgment you use and put together and then mesh that with the ECN’s.

Senator SUNUNU. Would it be appropriate to paraphrase your answer as no?

[Laughter.]

Chairman DONALDSON. I will let you do that, sure.

Senator SUNUNU. And I do want to explore this a little bit. It is obviously relevant to the points made by the Chairman, but it was brought up, I think, in some of the opening statements as well. And



I appreciate and agree with the important points you make about technology and the utilization at the NYSE and the liquidity role that it plays and the important role that it plays in our capital markets. And I think you would have a hard time finding any disagreement on this Committee about those points.

But if someone wants to sell 100 shares of stock and an investor has placed a bid to buy 100 shares of that stock at \$20 and a specialist sees that bid to buy 100 shares of stock at \$20 and chooses to buy 100 shares for \$20.02 on their own account, would that be appropriate?

Chairman DONALDSON. Well, that particular circumstance you set up—I mean, the specialist has both an affirmative and negative obligation, and the specialist steps in—in terms of his affirmative obligation, the specialist steps in to make a market when the market—is to close the market and narrow the spread.

Senator SUNUNU. To make a market—to narrow the spread or to make a market when one is not available? Those are two different things.

Chairman DONALDSON. Well, both. I mean to make a market and to narrow the spread.

Senator SUNUNU. So you think that is appropriate? The hypothetical I just described where there is a bid to buy 100 shares at \$20, someone is offering to sell the shares at market, and the specialist buys on their own account for \$20.02, that is appropriate?

Chairman DONALDSON. I think the particular thing you are saying is that the specialist was stepping ahead in that instance, and that is—

Senator SUNUNU. I am sorry. I do not mean to be flip, but I really did not think it was that tricky a question. Is it appropriate or not appropriate?

Chairman DONALDSON. State it again, Senator.

Senator SUNUNU. Senator Shelby wants to sell 100 shares of stock. He says, “I am going to sell this stock at market.” Sell it at the market. I want to buy 100 shares of stock, and I offer \$20. The specialist has Senator Shelby’s request, has my offer, my bid to buy at \$20, and buys the shares, 100 shares, at \$20.02 for their own account.

Chairman DONALDSON. No sir, he would be stepping ahead of a public bid.

Senator SUNUNU. I would be inclined to agree with you. I just wanted to make sure that that was your answer, because that is a clear case where the person selling the shares got the best price—got a better price than what I wanted to buy them at, but it was not appropriate behavior, it was not right. And it is a simple point, and I think maybe most people understand it. But the best price only is not always the best execution. It is not always legal. It is not always legal, because if you are using proprietary information to take advantage of your position in a way that is not fair to the markets, then the markets are not being well-served, and ultimately customers are not necessarily being well-served.

So, I am sorry to belabor the question, but I wanted to make sure that you answered in a way that you were comfortable. And certainly if I misunderstood anything, feel free to correct it for the record.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Corzine, would you like to ask any more questions?

Senator CORZINE. I actually will repeat the question on the report because I did not hear the answer exactly. You are saying because it was involved with an enforcement action or mentioned or involved enforcement proceedings that it, therefore, would not be made public?

Chairman DONALDSON. No, what I said was that the report that the SEC gave to the New York Stock Exchange is a confidential report. A second step here would be a recommendation by our Inspection Division to refer that report to Enforcement.

If Enforcement decided, based on their own investigation, that an enforcement action was warranted, then an enforcement action would be taken, and that enforcement action would be made public, and the reasons for it would be made public. But during the enforcement process where the reinvestigation is going on, you would not divulge that. But it would come out if an enforcement action were taken.

Senator CORZINE. Certainly the elements of discussion that at least were categorized in the newspapers—again, commenting on comments of private memos is never an attractive element, but the commentary that surrounded the nonenforcement elements of it seem very germane to the discussion that we are having with regard to forming judgments about where one would go with some of these structural issues that we talk about, and maybe ultimately some of the corporate governance issues, very much germane to that discussion. So that to the extent that the elements that did not deal with Enforcement but were categorization, it would certainly be useful for those of us who are forming judgments about—or at least want to participate or have a responsibility to participate in the discussion have the best information available.

Thank you.

Chairman SHELBY. Mr. Chairman, we appreciate your coming. Again, as everybody says, we have a place for you back in the back here. You are welcome again, and I know you will be back. Let us continue to work for the right thing here.

Chairman DONALDSON. Thank you.

Senator DODD. We thank you for what you are doing.

Chairman SHELBY. We do.

Senator DODD. If the questions seem a little tough in some cases, it is because it is obviously a deep concern we share. But many of us have said it. I have said it before and I will say it again: I think you are the right person for the job today, and I have a lot of confidence in the work you are going to do.

Chairman SHELBY. I do not know if the Chairman is glad he took the job, but we are glad he did.

[Laughter.]

Thank you.

Chairman DONALDSON. Thank you.

Chairman SHELBY. We will go to our second panel, Mr. John S. Reed, the Interim Chairman of the New York Stock Exchange.

Mr. Reed, we appreciate your indulgence here today. These are important issues not only for the Senate Banking Committee but

also for all Americans. Your written testimony, which we have, will be made part of the record in its entirety. If you would, sum up your points as quickly as you can, because you can tell the day is moving fast.

**STATEMENT OF JOHN S. REED  
INTERIM CHAIRMAN AND CEO  
NEW YORK STOCK EXCHANGE**

Mr. REED. Yes, Mr. Chairman and Ranking Member Sarbanes, thank you very much.

If you could add for the record, to my written comments a copy of our proxy.

Chairman SHELBY. We will do that without objection.

Mr. REED. Let me just very quickly summarize what I would like to say to you.

First of all, let me say I enjoyed the prior session and could have stayed here listening for quite a while. Much that was discussed is quite germane, of course, to what I have been trying to do. And I am only sorry I could not have participated a little.

I was called in to deal with what was a serious breakdown in governance. The exact circumstances of what happened are not yet 100 percent clear, maybe never will be, but clearly we had a very fundamental breakdown in governance at the New York Stock Exchange which resulted in the departure of Mr. Grasso and my coming in. And my mandate was pretty simple: Try to understand what happened, propose a new governance structure, find a replacement for myself, and return to retirement. And that is what I am trying to do.

As you know, I did submit to the membership recently a proposal for a new governance structure that reflects my thinking on this subject and my assessment of what is going on and, in fact, my concern about many of the issues that have been raised here this morning.

The proposed structure, very simply, is that we create an outside independent board of directors—we have a slate of eight people that were voted for by the members on Tuesday—and that we maintain our contact with the industry through the mechanism of what we call a board of executives which consists of the customers of the Exchange, the owners of the Exchange, and the operators of the Exchange. This will be a forum that allows us to deal with the substantive issues associated with market performance and the evolution of market structure, but it will be a forum that is totally separate from and distinct from the responsibility with regard to governance of the Exchange itself and the fiduciary responsibility that the board of directors has to the New York Stock Exchange.

I happen to think that it is a pretty good structure. I think it very clearly resolves the problem that we were trying to deal with in the first instance, which was the breakdown of the governance structure as it had to do with compensation and management of the Exchange itself. But, frankly, when I was looking at what to propose, I did not look only at how to resolve that problem. I really wanted to position the Exchange to be in a place where it could deal with all these very important issues that the Committee has been talking about.

I did not try to deal with these issues in my proposal. I did not think it was appropriate that you bring in somebody on a temporary basis and try to deal with the very important issues that you are talking about. What I did was try to create a structure that would be robust and would serve the investing public well and serve the Exchange well.

And so what I have proposed is an outside independent board. It will be responsible as a fiduciary for the well-being of the Exchange and the American public in that sense. They clearly have the capability. The people that I recommended for the original slate were people who have had experience as chairmen of big public companies, because the breakdown of our governance clearly reflected the fact that the prior board was ill-equipped to deal with some of the responsibilities that are associated with a good board of directors. There are four people on that list who have been chairmen for an extended period of time of major public companies.

I also recommended a number of people for that board who know something about markets and finance, and more importantly from my point of view, I put a good number of people on that board who know an awful lot about technology and are analytically strong, because some of the issues that have been raised here about the structure of markets and what constitutes good execution, ultimately are problems that are going to require important analysis.

We have a two-tiered structure in the sense that the discussions that require the input of the customer, be it on the buy side, be it on the sell side, or be it our listed companies, are going to be well represented on the board of executives. I have set it up so the board of directors can listen in, but this committee has nothing to do with the responsibilities of the board, and I frankly think it is a structure that is going to serve the Exchange well, and I think deserves the support of this Committee.

Everything can be improved upon. I do not have any doubt that as time goes on this also—but I think it is a good first step. I simply say to you that I think it is something that the members have voted for, indicating their own recognition of the need to make this kind of change. I look forward to your questions, where we can draw out some of the subtleties that you were talking about before.

Thank you.

Chairman SHELBY. Mr. Reed, thank you very much.

Some contend that you cannot eliminate the conflicts of interest at the Exchange unless you change the ownership structure. Some believe that as long as the business operations and the regulatory function are located in the same entity, then regulation will always be a secondary function. How do you respond to that assertion?

Mr. REED. I do not believe that is an accurate case. I think it is very much in the interest of the Exchange that it be well regulated. I believe that regulation of the Stock Exchange is like quality control is to Toyota.

Chairman SHELBY. Do the members know that? I agree with what you are saying. It is in the long-term interest of the Exchange to have no conflicts, no ethical problems, none of that, but do all the members know that?

Mr. REED. I would not say all. Clearly, there must be one who does not. But my experience with the Exchange is that they have

been sobered by the recent problem with Mr. Grasso and I think that the vote says something about what the Exchange thinks, and I believe that the members know full well that the integrity of the Exchange lies at the foundation of the Exchange.

Chairman SHELBY. It has to be number one, the integrity of the Exchange?

Mr. REED. It is number one. You have no market if you have no integrity. I think they fully understand that, so I do not see this inherent conflict.

I would also point out to you that 900 of the 1,400 members are retired, and so they just look at this as an economic interest. They are not active on the floor of the Exchange.

Chairman SHELBY. They own the seats.

Mr. REED. They own the seats, and they have rented them out, often to Merrill Lynch and to others who need to have seats on the floor, but they rent them as opposed to owning them.

But the point is, these votes, which are more than 900 out of 1,400, a pretty good majority, these are people whose primary interest is in the economic well being and hence the integrity of the Exchange.

Chairman SHELBY. Mr. Reed, you stated that the Exchange's regulatory arm should not be separated because regulators really have to be engaged with the members in order to be effective. It seems to a lot of people that the securities industry is one of the few major industries that continue with self regulation. Are there unique factors that make self regulation more appropriate in the securities markets than any other industries? If so, what are they?

Mr. REED. I think really, Senator, if you look at it carefully, all of your work with regard to audit committees and all the efforts with regard to public companies, we rely on the audit function that is contained within companies to ensure the integrity of the operation of those companies, and that is true in the banking industry or with regard to the internal audit.

It is true that we have external auditors in the banking industry, but they rely tremendously on the internal audit capability. Much in the legislation of Sarbanes-Oxley was designed to ensure that the audit committee could supervise appropriately the internal audit function, and that they certify that the accounting is done properly, and that they certify that controls are in place. So the fact of the matter is, we rely on self-audit and self-regulation throughout the entire private sector. We are not saying sole reliance. In the case of individual companies you tend not to have an outside agency that then sits on top of the auditors. In the financial community, be it banks, be it the New York Stock Exchange, you have banking regulators and the SEC that sits on top of the internal capability, the self-regulating capability, and have the capability to oversee and intervene, as Chairman Donaldson just said, if they believe that is not being carried out properly.

But the essence of what you all have put in Sarbanes-Oxley with regard to the oversight of the internal audit function of corporate America is contained in our proposal here. It is the committee of the board of directors, which is comprised totally of outsiders, to sit on top of the regulatory arm, approve the budget, the staffing, the compensation, the audit plan, so forth and so on. It is exactly the

same as exists in the Sarbanes-Oxley Act to ensure that that internal function is held to the highest standard. There are no foxes in the chicken coop.

Chairman SHELBY. But there are no criminal penalties there.

Mr. REED. With regard to?

Chairman SHELBY. The self governance.

Mr. REED. I am not a lawyer. I do not know about criminal penalties.

Chairman SHELBY. Sarbanes-Oxley has some criminal penalties.

Mr. REED. The board of the Exchange must come under those same laws with regard to their duties, and so it seems to me that that board that I am relying on to ensure that we get the integrity that we must have, that board which surrounds the self-regulatory process, has the same obligations to the public, I believe, as any public board would have.

Chairman SHELBY. Mr. Reed, what is your reaction—we have already been talking about and you have been here in the hearing—what is your reaction to allegations of trading misconduct by the specialists? Senator Sununu asked the Chairman about that, the status and so on.

Mr. REED. We clearly discovered that there were instances where the specialists misbehaved. That was originally discovered by the internal surveillance at the New York Stock Exchange. It later, as Chairman Donaldson says, was expanded in terms of its scope.

Chairman SHELBY. Is this widespread? Some people believe it is widespread.

Mr. REED. Let me try to put it in context. We looked at 3 years of activity in all shares. Approximately a billion transactions would have occurred in that time. Something less than a million transactions appear to us, “us” being both the SEC and the enforcement arm of the Stock Exchange, to have been inappropriate. They fall in three different buckets. We are in the process now of trying to ascertain, of those approximately one million transactions, just to what extent they were improper and to what extent they were not. Clearly, some significant portion was improper.

So, I would say there clearly were failures. There were failures to follow the rules, and the people involved, there are 450 individuals who work as specialists on the floor of the Exchange every day. There is some lumpiness, that is, this behavior is not uniformly distributed across 450 individuals. Some people have already been dismissed. It is quite likely that those people will never again work in any exchange.

There are some problems that are pretty evenly distributed, which causes an analyst to say there is a systemic problem. The great difficulty here has to do with a category where a specialist intervened in a transaction that would appear not to have been proper if you take into consideration that there was an electronic order on the book and if he had done his job properly he would have paid attention to it, but he did not.

We have corrected this going forward by putting a computer fix in so that the specialists cannot hit an execution button if that information is on the book. It stops him from being able to do it. That was not there in the years we are talking about.

Chairman SHELBY. Stopping them, rather than the specialists stopping themselves.

Mr. REED. The question is, and this is the—

Chairman SHELBY. True, though?

Mr. REED. Yes, sir. The question is, how long does that information have to be displayed for a reasonable person to decide that the specialist should have seen it? That is what I call waving for a taxicab in the rain. How often do you have to wave before you decide, the taxi did not want to stop. It was not that it did not see me, but he did, but nonetheless went on, which I would tell you happens in New York. But it is illegal. Taxis are supposed to stop, but it happens.

We have sliced it down to 5-second intervals. If you take a look at the incidents, in the difference between using a 10-second slice and 15-second slice there is a tremendous decay. In other words, if you say 10 seconds is the criteria, there are many more instances of missed opportunities than if you take 15 seconds. Obviously, the problem is to find out—and we will find out. There are mechanisms for finding out, and I was talking to some of the enforcement people in the SEC yesterday. I want truth. I am not trying to whitewash the specialists. If a specialist misbehaves, that hurts all of us because we promise the American public that if you go to the Exchange you will get a fair and decent transaction.

Senator DODD. Is misbehave the right word?

Mr. REED. Pardon?

Senator DODD. Misbehave has a tone or tenor to it that almost sounds venial. I mean we are talking about violating the law, are we not?

Mr. REED. I do not know if it is law or not, Senator. It certainly is regulation. There are very detailed rules on how specialists are supposed to operate. This violates these rules.

Chairman SHELBY. The Senator makes a good point.

Mr. REED. I do not know if they are embedded in the law or not. If they are, then they are violating—as far as I am concerned, if we do not serve the customer properly, we have failed.

Chairman SHELBY. Whatever it is, it is either illegal or unethical, is it not?

Mr. REED. And it is wrong, just wrong, period.

Chairman SHELBY. Both of those would be wrong.

Mr. REED. But my point is, to the specialists, and I have met with the head of the specialists, my point is if it is not right from a customer's point of view, I do not care what excuses, why, then it is not right, and we, (A) have stopped it, but (B) you are going to pay the money back, and (C) you are going to pay a fine. If there is a pattern—

Chairman SHELBY. Do they keep on being a specialist too?

Mr. REED. If there is a pattern of abuse that focuses on an individual, the answer is no. We will have to go to court because you are taking away a person's ability to work, but they will not be working as a specialist.

Chairman SHELBY. You are not going to be reluctant to do that, are you?

Mr. REED. I am not at all reluctant to do that, and I do not think that the owners or the major specialist firms are reluctant either.

Chairman SHELBY. Mr. Reed, a lot of people have brought up that the allegations surrounding specialist trading practices are symptomatic of the New York Stock Exchange by its regulatory structure. Assuming that the SEC approves your reform proposals and that the Exchange fully implements the reforms that you have brought forth, what additional reforms do you think that the Exchange must adopt to strengthen its regulatory function in light of recent criticism? Are you to that point yet?

Mr. REED. Clearly the criticisms are justified, and there is reason to assess where we are as a regulator. I intend to recommend to the new board, when we get it installed, that the first thing we do is that we bring in some outside experts, do a review of our regulatory competence, and use that as the basis for change to our regulatory function. Frankly, the idea of outside peer reviews of regulators is a very valid, and I think a potentially strong tool, to rebase and rethink just how good are we.

Chairman SHELBY. Mr. Reed, you are very familiar with the criticism that the reform proposals are lacking because they do not mandate an independent chairman. Also, what is your current thinking on whether the exchange should have an independent chairman, and if not, why not?

Mr. REED. I did not hard-wire it into the proposal changes to the actual constitution of the Exchange because I did not want to put future generations in a position where, every time you change chairmen, you have to go back to have a vote to change the constitution in the event that they do it differently. What I said is that we could either have a chairman and a CEO separate, or you could have it together. If you have it together you must appoint a lead director as in Sarbanes-Oxley, so I simply mirrored the private sector.

I frankly do not know which way we are going to end up going because finding the right person for this job is important. If we had a person who was exceptional but only was interested in the job in the event that he or she could have both chairman and CEO role, I sure would prefer that than to have a less competent set of people in a split role. I happen to have some personal sympathy for the idea that a split role may turn out to be a more appropriate one at this time. We do not yet have a board. It is very difficult for me to do my job. I do not want to be a dictator, talk about bad corporate governance. Having a visiting chairman is not great corporate governance.

Chairman SHELBY. He may not be a dictator, but it is a real time for leadership.

Mr. REED. It is a time and I think I am trying, without overstepping, to do that. But I am intending to meet with the proposed new board to see if they would allow me to move forward to bring to them, when they become legal, candidates for my position. I am going to press them. I have my own view, but I would like to get the benefit of their view as to whether they think a split is better or not. But we do provide for the lead director, and all of the responsibilities of the lead director with the board in the event we happen to end up with one person in the chairman and CEO role.

Chairman SHELBY. Mr. Reed, I understand you hired an outside law firm to examine the circumstances surrounding the approval of



Mr. Grasso's pay package. What have you learned from that investigation?

Mr. REED. Nothing yet. I have asked Mr. Daniel Webb to give us a verbal briefing on Monday of next week, and he is intending to give me a written report around the first week of the month of December.

Chairman SHELBY. Will you share that with us?

Mr. REED. I probably would prefer not to.

Chairman SHELBY. We might have to get you back down here.

Mr. REED. Not having seen the report, it is a little—

Chairman SHELBY. I know.

Senator Sarbanes.

Senator SARBANES. Let me just follow right up on the Chairman's question, because I was going to pursue that line myself. The *Financial Times* on November 6 wrote an article about bringing in the outside investigative attorney and former prosecutor, Dan Webb, to look into this matter. The article states that you expect to receive Mr. Webb's report by December 1, but that the report's findings will not be made public. The article goes on to say in justifying the decision to keep the report private, you said it could be highly embarrassing.

That does not strike me as an adequate rationale for keeping the report private. Is that the rationale for it?

Mr. REED. I have not seen the report, so I have no basis on which to form an opinion one way or another. Obviously, I have learned over the years that when something goes wrong, and something clearly did here, you better figure out what actually happened, and because to rely on the press or a similar source to tell you what happened is simply a mistake managerially.

I hired an outside law firm because I felt that having the confidentiality surrounding a lawyer-client relationship was important, and it was important to get people willing to talk to this lawyer. They are not obliged to do so by law. I did meet with the board of directors and ask that they all be willing to meet with Mr. Webb. They all have. I understand Mr. Grasso is meeting with Mr. Webb this week. I do not know that that is true, but that is what I was told. So everybody has been cooperating with Mr. Webb.

I think they cooperate with him in part because they understand it is important. We know it happened, but I think they believe there is some degree of confidentiality with regard to what they might say, and having that assurance helps in the process.

It is extremely important for us to understand what happened and it obviously is the basis I am going to use for my continued discussions with Mr. Grasso because there is a contract that was signed with him that is floating out there. He indicated publicly, but to my knowledge never in writing, that he intended to waive payments that he might potentially claim under that. I have no knowledge as to what he currently intends. I have never either met or spoken to Mr. Grasso, and I do not intend to until I have the benefit of seeing this report.

Obviously, the purpose of the report was to help me in my job, and to help the Stock Exchange, and it probably is a better report because it does have the potential of staying private.

Chairman SHELBY. Senator Sarbanes, can I ask him a quick question?

Senator SARBANES. Certainly.

Chairman SHELBY. You plan to share that report once it is finished with the SEC?

Mr. REED. Again, I have made no commitments whatsoever. I did tell the SEC at the beginning that I was doing this. The SEC asked if they could talk to Mr. Webb to be sure that the scope of the investigation was something that they felt was appropriate. I understand they did speak to Mr. Webb. I did not check. I just know that they met. I assume, but do not know, that the SEC thought the scope was proper. If I think it is the right thing to do, and I think my objective here is to serve the New York Stock Exchange and the American public, I would be quite happy to share this with the SEC, with the Committee, with whomever. I just do not want to be on the record up front, not having seen the report, not having any idea what is there. As you know, one has to be cautious in this modern world just throwing raw material out into the public domain.

Senator SARBANES. I will take that for now, although I again underscore, I do not think embarrassment is an adequate rationale.

Mr. REED. I do not either, Senator. If that was the question, I share your view. Embarrassment is not the rationale.

Senator SARBANES. On November 11, the *Financial Times* had an article that said "The big board must end its costly costume drama." They went on in an editorial and said, "Even at a theoretical level, the specialist system makes little sense for the top 500 listed U.S. companies. Why have a middle man to ease trading in the most liquid stocks in the world? In practical terms it is a recipe for abuse. Specialists can trade ahead of large customer orders, using privileged knowledge to make proprietary profits or favor other investors." The article went on: "While specialists have a place for illiquid small cap stocks, an electronic auction book is sufficient for large listed companies."

I would like to get your view of that comment, because this issue is being raised in a lot of places. I would just be interested in your response to that.

Mr. REED. I disagree with the editorial, and I think it is superficial. It seems to me that the auction market, which is a combination both of the specialist and the broker, is quite robust, and seems, from everything I have seen, to be extremely effective at what it tries to do. It is true that under normal circumstances for the most liquid stocks, the role of the specialist, per se, is minimal. Five hundred is a big number. I think the most liquidity is much smaller than 500 stocks. But if you really look at it, what exists in the Exchange today is, number one, an electronic capability that does exist—we call it Direct Plus—to go into the market electronically and consummate a transaction at the then-price. There is no price improvement. It is the then-price, and it is an ECN built into the Exchange for all practical purposes, and about 7 percent of our transactions are done that way. We could expand its capacity as time goes by.

If you are a computernik—and I have written code and know a little bit about computers—and you say, okay, how could we auto-

mate this thing? You could imagine that you could replicate the specialist function because it is pretty rules-based, and you could replicate it with an intelligent system, and it would be an expert system. It is not trivial, but it is probably doable. It becomes the second feature of the specialist system that is more difficult to replicate. They put capital at risk, on an average day about \$5 billion. So you would have to, on the other side of this computer, have somebody willing to allow the computer to commit capital. In other words, the specialists create liquidity. An ECN finds a market, but it does not create any liquidity. The specialist system actually injects liquidity into the market by the specialist buying or selling securities, and as I say, on a typical day \$5 billion, not a trivial sum.

The thing that would be hardest to replicate, interestingly, is the broker. There are two ways to get through to the specialist. One is to put an order on the screen, what we call a DOT system, where you have an electronic introduction of the transaction, and the other way is to hand it off to a broker. Now, to write a computer program that would tell a broker—just imagine you go to Sotheby's and you want to buy a Picasso, and you are going to write a computer program that is going to tell your representative in the auction there when to raise his paddle. That depends on getting a feel for the market and seeing who else is waving paddles. I have watched—and I will tell you, I think you could write an expert system to replicate the specialist much more easily than you could write an expert system replicating when the broker goes into the market and how he or she presents the order.

There is important price advantage for an investor in utilizing the broker's activity. In other words, I would guess from what I have observed that if you hand an order off to a broker who then goes and deals with a specialist, you could see very significant price improvement, whether you are buying or selling, because the broker senses whether he is going to wait a half an hour and come back because the customer wants to buy and he sees the market is going down. A computer, boom, you have done it. You bought. You bought at whatever the price is. The broker has the choice of when to introduce the order and there is important price benefit.

Is there room for an ECN? There absolutely is. Do we have an ECN embedded in the New York Stock Exchange? Yes, we do. It is called Direct Plus. It is a pure computerized execution. Could we expand Direct Plus, because it is limited now to 1,000 shares plus an odd lot, so 1,099 shares. So it is designed for people like you and me who might buy 500 shares or whatever. That is an ECN embedded today in the Stock Exchange. You get the price of the market the instant that the order happens to hit. Can you present yourself electronically to the Exchange so that the specialist sees your order there electronically? Yes. About 70 percent of the volume, 99 percent of the transactions, but only 70 percent of the volume goes that way, because the people who understand the market tend to go to a broker and get the benefit that the broker offers in terms of introducing the order at a time that is appropriate to the order.

Would I, as an average citizen, want to throw away that market? I would not. I think, contrary to the *Financial Times*, that there is room to have a specialist system even on a very liquid stock because even on a very liquid stock, it is like buying and selling a

house. If you want to sell your house and you say, I have to do so in the next 2 weeks, the price you get is going to be quite different than if you say I am willing to wait a month or two. The advantage of this auction system, the specialist is wonderful. We love him. And he injects capital into the market and facilitates the functioning of the market, but it is the combination of the broker with the specialist that constitutes the auction system.

There is much greater robustness there than is visible to the naked eye, and no one is going to accuse me of not believing in computers. I spent my life trying to computerize the world, and I love ECN's and so forth. I will tell you, I have written a lot of software. I would hate to try to replicate that full auction market with an expert system.

Now, it can be done. I mean, we have bombs that seem to be able to fly through windows and buildings. I am not saying that it is inconceivable that it be done. But it is a difficult task right now.

So my sense, Senator, is where we are going to end up is going to be with a hybrid system. There are going to be ECN's. They will be on the floor of the New York Stock Exchange. They could be in California or wherever. But there is going to be an auction market also. And, interestingly enough, the more sophisticated people—I do not mean the bigger buyers; I mean the more sophisticated people—understand that that auction market does significantly improve the price you get if you are selling or the price you pay if you are buying. And I would really be quite concerned about taking it away as an alternative. I do not say everybody must use it, but it should be there.

The other thing is when you have disruptions in the market and it is not smooth, then a system that has the combination of brokers and specialists has a robustness that is going to be awfully hard to write into a bunch of computer code.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Schumer.

Senator SCHUMER. Thank you, and what you said is music to my ears, Mr. Reed.

I think it is interesting that much of this hearing, which was dedicated to governance, has moved to market structure. I believe the reason is a very simple one. The two have some relationship, although many—I would say many—who were against the specialist system want to use the governance issues to undo the specialist system when one does not necessarily lead to the other.

But the other is that the governance part of this is relatively easy compared to the market structure part of it. No one is ever going to be paid \$130 million again, even if we did nothing. We have seen certain specialists not obeying the rules, and I think the way they were regulated and punished was too lax. But that is naturally going to change even if we did not change structure a bit.

We should change structure, but that is the easy part. The hard part is the issues that you have just touched on in your questions with Paul Sarbanes and Chairman Shelby, that Chairman Donaldson and I touched on earlier. And that is the real challenge here.

Now, for me this is both parochial and catholic—parochial because I care about New York, but catholic because we in America and we in the world want to have the best markets we can.

And so one question I have—I agree with you about the specialist system, and it is true, right? The studies all show that 94 percent of the time the specialists get the best price.

Mr. REED. That is right.

Senator SCHUMER. Some may not care about best price or say speed is more interesting to me, and there is no argument why speed shouldn't be—if that is the consumer's choice, why that should be there. But that does not necessarily mean you have to do it in five different ECN's. You could have a system that maximizes speed because they are all black boxes in one place. Is that correct?

Mr. REED. That is correct, yes.

Senator SCHUMER. Okay. So, you know, now there is a point of competition, developing a better model. I understand that. But it does not necessarily follow.

Here is my question, and I think this is a question that many who are against the—there has been competition. Any stock can go to a black box, and since the NYSE made the changes—and Grasso, for the problems he had, deserves credit for that, in my opinion, and he does not get it. In the world we work, you know, the pendulum swings. He is a god one day and he is the devil the next. There should be a little more balance there, but both ways.

But the walk was that even though there was competition, under Grasso the number of companies that decided to go, even big companies, to the NYSE went up. The amount of trading went up. And the argument the other side makes is, well, Grasso strong-armed people, that this was not competition in its pure form, but, rather, that he was able to force people to do something that might not be in their economic interest.

How much of that was there? It seems to me companies that are trading their stock, their lifeblood, are going to look for the best thing economically for them, not, these extraneous things. It may have happened in one or two instances when it is a borderline situation, and that was terrible and it should change. But give me your thoughts on that.

Mr. REED. I have heard the same comments you have. As you know, I was not there at the time, so it just has to be hearsay, by definition. But I will tell you, the proof of the pudding to some extent is that Mr. Grasso is not there today, and we continue to run approximately the same numbers. We continue to have listings. We have not lost, to my knowledge, any listings. And we continue to run about 82 percent of the transactions, meaning there are 18 percent of the transactions involving our stocks that are consummated elsewhere, but it is not a number any different than when Mr. Grasso was there.

So to the extent that he was holding this back artificially, one would have expected to have observed it in the current set of numbers, and we have not. It cannot have been massive, and it cannot have been an immense build-up, or we would be experiencing it.

Senator SCHUMER. Well, I guess, devil's advocate here, it will take a while for people to realize this.

Mr. REED. I suspect people who were strong-armed know very quickly when the strong arm is no longer around their throat.

Senator SCHUMER. Okay. Another question. What are the challenges for the NYSE, particularly in light of foreign competition? Even whatever is here is going to be under our regulatory structure, and overall I think our regulatory structure, if you look at a 50-year period and even taking into account the lapses of the last several years, has served us fairly well. We have these deep, liquid markets that are now quite democratized.

My worry is that we will go to a lowest common denominator, that some foreign black box will say no regulation, you are not an exchange, you can do whatever you want, and at least in the short-term, some who will think the system is not going to rook me—usually big, sophisticated people will go over there because they can save the cost of regulation, which may be milli-cents, but when you trade a lot it matters.

What is your worry about foreign competition and how the NYSE specifically, and America in general, can deal with that problem?

Mr. REED. Well, clearly, if we start moving toward pure ECN's—which, by the way, are harder to regulate than human markets.

Senator SCHUMER. Of course.

Mr. REED. There is a risk that once you get into that kind of arena, people cannot tell the difference and they will go to foreign markets, or wherever, if it appears they could pick up a millionth of a cent and so forth. And you could see a fragmentation of markets and a dissipation of any center of trading, which would be horrendous for the capital markets of the world.

Senator SCHUMER. Right.

Mr. REED. You also will find, I am pretty sure, that if Europe can manage to get an economic recovery going—and in the case of Japan, I think they probably do have one going—you are going to see activity in other currencies and in other markets that is going to have an impact on the flows that go through the U.S. markets.

Our defense has to be that we run the best market in the world and that we keep that liquidity. You made the point better, Senator, than I can. That pool of liquidity is everything. I have been on the issuer side. Many here may remember in the 1990's, Citibank had to go three times to the capital markets for capital at a time when we needed it. And there were people in the U.S. Congress who thought we were illiquid and that we could not get there.

I looked at every market in the world. If we could issue a piece of paper in Tokyo or London that would have gotten us our capital, we would have done so, and I tried. I went to London first, thinking that maybe in the London markets I would find an appetite that I could not find in New York.

The reality is I did three issues in the New York stock market, and the reason I did is that is where the money was. And not only is it there normally, but also for companies that are going through difficult times, which is when you need capital—either when you are a start-up and no one knows anything about you, or when you are a good company but you are going through a transition or what have you—the depth of the market that exists today in New York is the resource available to issuers in order to access people who are willing to provide capital in exchange for the potential upside.

If we saw a fragmentation toward international markets, I assure you that that capital does not go to funny black boxes. And we need to keep our system robust, that kind of capital, which does exist in the New York Stock Exchange, and the reason we have foreign companies list here is they, too, understand that the capital that is most willing to take a businessperson's risk is in the New York Stock Exchange. And the risk of this competition of black boxes—I could just see a wonderful black box in Nassau. I would rather live in the Bahamas in terms of the weather—

Senator SCHUMER. Not me.

Mr. REED. —and I could be a software guy, but I will tell you, the integrity of the system requires its location in this country, and it is my job to try to ensure that we take the steps to assure the investing public that there is nothing about the governance or the responsibility that exists at the New York Stock Exchange that is anything but a plus.

I do not want to just be neutral. I do not want to be seen to be merely adequately governed. We have to be governed in a superior way. Frankly, I think the proposal we have in front of the SEC and the individual directors who have agreed to serve, if they can serve, will meet that commitment. You are not going to meet it in a day, but that is a board that is capable of meeting its responsibilities, which is intellectually capable of dealing with some of these challenges that we are facing, and was designed with that in mind.

I knew what the job of the board was going to be. It has access to people in the industry who are at the core, and for the first time, by the way, including the buy side, which has never before been officially represented. But we have access to the industry competence, including the industry criticism, which I think is important to listen to, but that board is competent to deal with these issues in a responsible and totally transparent way.

And so I think it is the right first step. I am not suggesting that any one step is the end. This is an evolutionary pathway. But I think it is the right first step on that evolutionary pathway.

Senator SCHUMER. Two quick final questions, and thank you, Mr. Chairman.

Number one, you touched on this. I think it is important to emphasize it. It is your belief that the problems we have had with specialists or others taking advantage of their customers would be far easier for somebody, a broker-dealer or whatever, to manipulate on a black box than in a specialist system. Is that correct?

Mr. REED. Without question.

Senator SCHUMER. So the great irony—and this is the second question—is those who are using the governance problems to try and kick the specialist system out are really involved in a J-curve, in a sense, you know, they will accomplish what they want in the short-run, and it could end up boomeranging on all of us in the long-run.

Do you agree with me that some of them have conflicts of interest?

Mr. REED. Oh, without question. You know, there is no question that Mr. Grasso's departure opened up the door for people with quite legitimate competitive aspirations to make use of this problem, which admittedly we have, not only to raise legitimate issues

about governance, but also to advance their competitive cause and to gain a voice at a time when the New York Stock Exchange seems to have lost its voice.

A significant portion of what we are hearing—not all, but a significant portion—is from people arguing for their own competitive position and other financial intermediaries trying to move some of the profits from one financial intermediary to another financial intermediary, without any benefit whatsoever to the ultimate customer. We are getting the typical private sector, great American response. You lose your voice a little bit. Everybody piles on, some of it quite legitimate, some good, but there is an awful lot of comment that is being authored by competitors who are simply trying to improve their competitive position.

Senator SCHUMER. And illegitimately using the real problems to make a different argument when the one does not have much to do with the other.

Mr. REED. Yes, quite unrelated. Quite unrelated.

Senator SCHUMER. All right. Thank you, Mr. Chairman.

Chairman SHELBY. Chairman Reed, you are not saying there is not real competition out there sometimes?

Mr. REED. There is real competition. I would assure you, since arriving back from my retirement, the one thing I have found continues to exist here is lots of interested people trying to advance their own possibilities.

Chairman SHELBY. Absolutely. Well, that is the nature of the market, is it not?

Mr. REED. It is indeed, and we all depend on it.

Chairman SHELBY. Mr. Reed, we thank you for your appearance, and we hope to get you back sometime.

Mr. REED. Thank you, Mr. Chairman.

Chairman SHELBY. The hearing is adjourned.

[Whereupon, at 12:51 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]



**PREPARED STATEMENT OF JOHN S. REED**  
INTERIM CHAIRMAN AND CEO, NEW YORK STOCK EXCHANGE  
NOVEMBER 20, 2003

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, my name is John Reed. Thank you for inviting me to testify today concerning corporate governance at the New York Stock Exchange. I assumed the role of Interim Chairman and CEO for a very focused but challenging task: To reform the Exchange's governance and leave behind a board and a leadership in which the public can place its trust.

In my testimony today, I will first outline some recent developments in the Exchange's modernization of its governance and its election of its new board. Second, I will talk about the critical issue of self-regulation—both why broker-dealer self-regulation through the NYSE remains the best answer for the U.S. capital markets and how our new governance architecture better addresses the conflicts inherent in self-regulation. Third, I will provide some more details concerning the autonomy of our regulatory function. Last, I will outline our essential next steps.

Collectively, we face many challenges. This Committee and the Securities and Exchange Commission are now dealing with several key issues that will shape the securities industry for a generation. The securities industry itself—from the corporate suite to the mailroom—must again embrace the principle that putting investors first is the only way to do business. Standing astride the industry's epicenter, the Exchange must lead this renewal to ensure that the industry regains the trust and confidence of its customers, the SEC and this Committee.

**Recent Developments**

The day before yesterday, the membership of the Exchange overwhelmingly approved my proposal to create a governance architecture that empowers a small, outside board of directors to lead this renewal. Subject to approval by the SEC, for the first time in its 211-year history, the Exchange's board will be independent both from the Exchange's management and from the Exchange's members and listed companies. The membership also voted to populate our independent board with eight seasoned and talented leaders: Madeleine K. Albright—former Secretary of State; Herbert M. Allison, Jr.—Chairman & CEO of TIAA-CREF; Euan D. Baird—Chairman of Rolls-Royce and former head of Schlumberger; Marshall N. Carter—former Chief Executive of State Street Corporation; Shirley Ann Jackson—President of Rensselaer Polytechnic Institute; James S. McDonald—CEO of Rockefeller & Company; Robert B. Shapiro—former head of Monsanto; and Sir Dennis Weatherstone—former Chairman of J.P. Morgan.

If the SEC approves our new structure, these individuals will serve until June 2004. Thereafter, the entire board will stand for election in June of each year.

As you know, I accepted this challenge in the wake of disclosure that the Exchange's board had failed in how it set its executives' compensation, and then failed again in how it met the crisis that resulted from that disclosure. It has since become evident that the board also failed to foster a regulatory system that anticipated and mitigated the regulatory risks arising from the vast changes in our industry over the last decade. These failures all point to a board too large and too conflicted to effectively govern the Exchange.

The NYSE's 31-year-old corporate governance structure had quite simply not kept pace with either best practices in corporate governance or the tremendous changes in the nature of our constituents. Specifically, the Exchange's governance had to be revamped to manage conflicts of interest and to increase transparency. To meet the special challenge of serving as both a marketplace and the vehicle by which our members regulate themselves, the Exchange's governance also needed to meet and, indeed, surpass the independence standards to which our listed companies adhere. The changes that our membership approved this week create the framework to accomplish these goals.

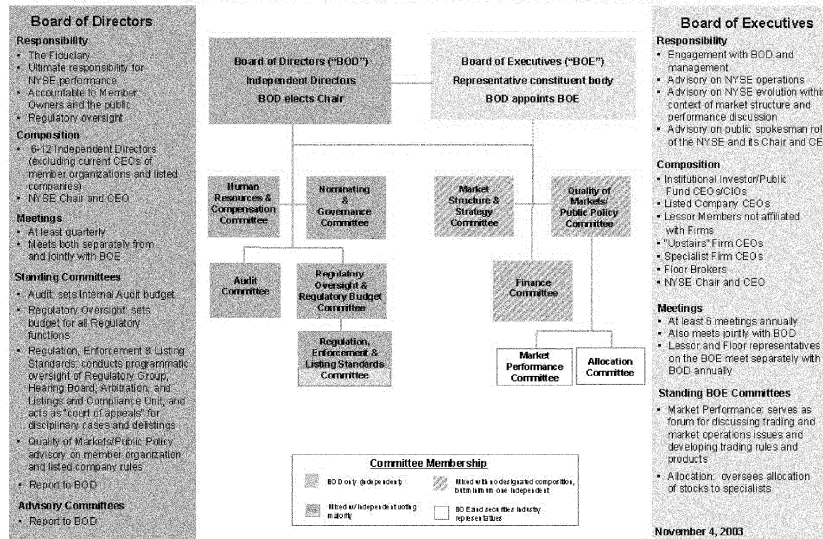
From the outset, it was clear to me that the NYSE needed a competent, engaged board free of conflicts and parochial agendas and dedicated to the NYSE's long-term interests. It was also clear that the NYSE would not recover its voice and legitimacy as a leader of the U.S. capital market until the public saw it as an example of good governance and capable of properly managing its own affairs. An "insider board" was not acceptable—not in general and certainly not as the supervisor of our regulatory function.

The membership vote changed the Exchange's Constitution to achieve three important objectives:

- Place responsibility for governance, compensation and internal controls, as well as for supervision of regulation, in the hands of a board of directors that is independent both from NYSE management and from our members, member organizations, and listed companies.
- Separately preserve the existing engagement of the broker-dealer community and listed company community with the NYSE by creating a board of executives that will also include the executives of major public and private “buy side” entities as well as lessor members of the NYSE.
- Make transparent our governance process, its participants, their compensation, and our charitable donations and political contributions.

The following diagram depicts the architecture we designed to achieve these objectives.

### PROPOSED NYSE GOVERNANCE ARCHITECTURE



The proxy statement and supplemental letter sent to our membership earlier this month describes the changes in detail. Copies are available at this hearing.

#### Self-Regulation

Now I want to address an important issue that represents our industry’s best chance for regaining the trust and confidence of investors: The reinvigoration of self-regulation. As you know, broker-dealer self-regulation is at the core of our Nation’s securities law as, indeed, it has been at the core of the NYSE since merchants first gathered on Wall Street 211 years ago to trade Revolutionary War bonds. Yet, the governance failures at the Exchange have laid bare the conflicts inherent in self-regulation. Critics have seized upon these failures to argue that the NYSE’s regulatory arm should be severed from the Exchange. In essence, they are calling for the end of self-regulation. I strongly disagree with that view.

Self-regulation recognizes that shared settlement and reputational risk creates an interest in each member of the Exchange to assure the financial responsibility and fair dealings of every other member. Properly channeled through an independent, professional Exchange staff, self-regulation represents the best chance of devising optimal regulatory solutions that minimize interference with delicate market mechanisms.

Since 1934, when Congress created the Securities and Exchange Commission, self-regulation has been wedded to Government oversight. Since 1938, when the Exchange appointed its first full-time president, self-regulation has been effected through a professional staff. Since 1972, when the Exchange created a board that included, as one-half of its members, men and women from outside the securities industry, self-regulation has been enriched by the participation of customers of the industry.

As the securities industry evolved, so has self-regulation. In 1934, in 1938, and in 1972 when the self-regulatory model of the previous generation reached its limits,

the answer to restoring investor confidence in the marketplace was to strengthen and modernize self-regulation, not to end it. I believe 2003 is no different.

At this latest point of inflection in the evolution of self-regulation, the Exchange must bring the independence that has characterized our professional staff to the board level. Yet, to be effective, our regulatory function must remain pervasively engaged with our customers, our member organizations, and our other users. Our membership has now approved the architecture necessary to accomplish both charges. If the SEC concurs, our challenge will be to implement our new architecture to reinvigorate self-regulation by better addressing its inherent conflicts while maintaining the advantages I have just discussed.

In response to a question from Senator Shelby regarding the self-regulatory structure of the NYSE, Chairman Donaldson recently reminded this Committee that in the 1930's, the Commission wisely co-opted the Exchange's existing self-regulation mechanism so there would not be a huge, clumsy Government bureaucracy. He recognized that today's key issues are (1) how the self-regulatory function is financed and (2) to whom the self-regulatory function reports.

Our new architecture addresses both of these issues. The NYSE Regulatory Group will now have its budget set by, and will report to, a board that consists of directors who are independent of both the securities industry and the companies listed on the Exchange. The board will appoint a Chief Regulatory Officer (CRO) who will report directly to the board, and no longer to the CEO. And to better enable the SEC, the investing public, and Congress to ensure that we adhere to our public purpose, the Exchange's governance is now transparent. Accountability is enabled.

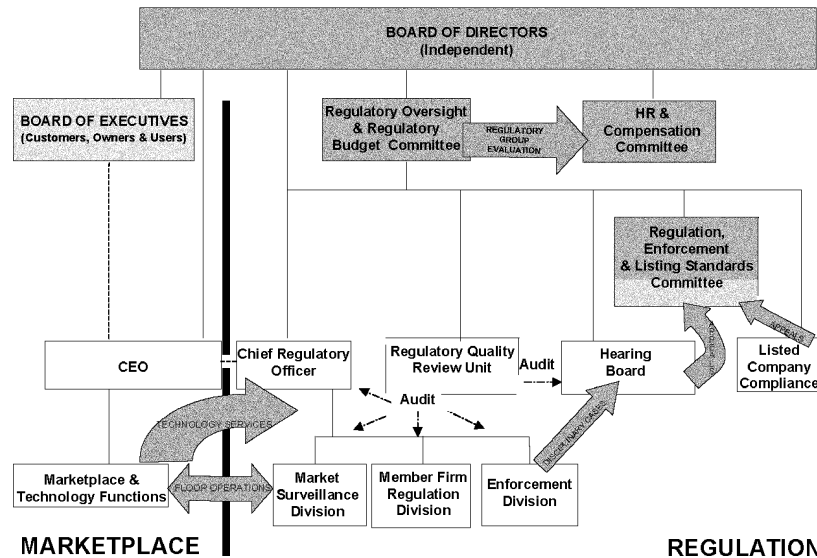
**Regulatory Autonomy with Market Sensitivity**

Now let me take some time to detail how our plan insulates our regulatory function from our marketplace. As noted, our outside, independent directors will be responsible for regulatory oversight and regulatory budgeting. More specifically, our new regulatory oversight committee will:

- Assure the effectiveness, vigor, and professionalism of our regulatory program.
- Determine the budget, staffing, and technological resources for the various regulatory units of the Exchange.
- Assess the Exchange's regulatory performance and recommend compensation and personnel actions involving senior regulatory personnel directly to the Human Resources and Compensation Committee for action.

This means that our independent board, through its regulatory oversight committee, will decide how to allocate resources to ensure that our regulation function is adequately funded and staffed.

**PROPOSED NYSE REGULATORY ARCHITECTURE**



As the diagram depicting the regulatory architecture indicates, while the regulatory function remains close to the marketplace, only the independent directors bridge the substantive division between the marketplace and the regulatory function. In particular, the CEO, while a vital partner to the CRO, does not supervise the CRO.

#### **Next Steps**

So what is next? First and foremost, we await SEC action on these governance changes. I want to note that the SEC staff gave us enormous help by critiquing our proposal before we sent it to our membership for a vote. In addition, we are grateful for the extraordinarily quick path to publication in the *Federal Register* that the SEC staff provided in order to start the 3-week comment period.

We believe that the SEC can find our architecture to be consistent with the Securities Exchange Act—the statutory standard that governs its review. The new architecture empowers a board of directors with the independence to address issues objectively and the constituent input to address them intelligently. Directors who have the degree of independence and experience that our governance architecture promises—as evidenced by the quality of our new board—will assure that the Exchange’s regulatory function is both independent and robust. Thus, we believe our architecture guarantees the independence of our regulatory function both from members and member organizations and from inappropriate linkage with our marketplace, while assuring the function’s sensitivity to the market.

Nevertheless, we note that we are not asking the SEC to approve either the continuation of self-regulation through the NYSE or in the United States generally. That issue should be addressed in the context of how well the new board implements both the architecture and the necessary programmatic changes to our regulatory function.

Thus, while the Exchange does seek the SEC’s approval of what we regard as a greatly improved architecture for self-regulation, it does not seek the SEC’s determination of the future of self-regulation at this time. All the Exchange seeks at this time is the SEC’s approval of a transitional structure that allows it to move from the current situation to one in which a board of independent, distinguished and experienced men and women can take on the formidable challenges facing the Exchange. We are hopeful that the SEC will see the wisdom of our proposal, review it expeditiously, and approve it in short order.

Second, the new board will hold its organizational meeting next week. Among its first tasks will be to identify the appropriate person or persons to replace me as Chairman and CEO, and to identify a person to assume the responsibilities of Chief Regulatory Officer. Thus, upon the SEC’s action, we will have a new board and permanent management in place, that can then begin to demonstrate that the new governance structure works and thereby begin to restore investor confidence in the institution of the NYSE. This new leadership, the board of directors and the board of executives, will also be in a position to openly and collectively address issues of market performance, access and market structure that—in addition to self-regulation—are important to the continual modernization of our capital markets.

To conclude, I want to assure you that we understand the damage done to investor confidence as a result of the Exchange’s governance failures. We believe that we are on the right path to creating and implementing a governance process that will reduce and manage the conflicts of interests inherent in self-regulation, and provide greater transparency to ensure accountability. And we will not lose sight of the critical business of the NYSE—the business of operating the world’s deepest and fairest equity market for the benefit of investors and listed companies.

Again, thank you for the opportunity to appear before you today. I would be happy to answer your questions.