The End of the SRO

Reform Requires That Exchanges Completely Separate Regulation From Business and Adopt a Public-Ownership Model

Testimony of
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Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives

Hearing on
"Reviewing US Capital Market Structure: The New York Stock Exchange and Related Issues"

October 16, 2003

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Mr. Chairman, Mr. Kanjorski and Members of the Subcommittee:

My name is James K. Glassman. I am a fellow at the American Enterprise Institute, host of the website TechCentralStation.com and a syndicated financial columnist for the Washington Post, the International Herald Tribune and other newspapers. One of my main concerns is the nexus between finance and public policy, especially as it affects small investors.

The recent resignation of Richard Grasso, chief executive officer of the New York Stock Exchange, in the wake of controversies over specialist activity, board composition and compensation, has provided a once-in-a-lifetime opportunity to reform a management structure built on a massive conflict of interest – a structure that is unworkable and rotten at its very core.

So far, this opportunity has been squandered.

I hope that this hearing, coming at such a critical time, will help reverse a course that will inevitably lead to more scandals and a further erosion of confidence.

The New York Stock Exchange, in its 211-year history, has been the most prominent and powerful symbol of capitalism and free markets in the world. Its stature has been severely diminished in recent years. The remedy is reform – to put an end to an unconscionable conflict through two steps: 1) separating the regulatory and business functions of the exchange and 2) making the NYSE a public company, owned by thousands of outside shareholders, just like the nearly 3,000 companies that the exchange itself lists.

The reform would be relatively simple to achieve, and it would inevitably provide small investors – the people that concern me most – with better service at lower cost and would increase their trust in the integrity of markets, a trust that has been badly shaken in the past two years.

Separation Is the Foundation

The foundation of any reform of the exchange is separation.

The regulatory function of the New York Stock Exchange (and of every exchange and market) must be separated, by contract and by structure, from its commercial trading function. As the best insurance against conflict, the NYSE and the NASDAQ should become public companies, with a majority of their shares owned by outside shareholders who would choose directors. A system of electing board members – whether there are 27 or 17 -- based on the constituencies they represent is doomed to failure. All directors must be rowing in the same direction, toward the same goal.[1]

Unfortunately, top officials New York Stock Exchange and the Securities & Exchange Commission have not emphatically supported separation – nor have they even said, to date, that they believe it deserves serious consideration.

To the contrary, John Reed, the interim CEO of the NYSE, has said that "he would seek to keep the exchange and its regulatory arm 'tightly coupled.'"[2] And, in a hearing Sept. 30 before the Senate Banking Committee, William H. Donaldson, the SEC chairman, "suggested it would be a mistake to completely split off the Big Board's self-regulatory function." Despite some "hiccups through the years," Mr. Donaldson said that "self-regulation has 'worked pretty well.'"[3]

Some might see hope in the impressions received by state pension fund officials who met with Mr. Reed earlier this week. They said that Mr. Reed told them he wants reform, but he is battling entrenched interests on the exchange. "He indicated that there are a lot of powerful folks there that don't want to see much change," Iowa Treasurer Michael L. Fitzgerald said at a press conference.[4] This resistance, however, is a manifestation of the problem that Mr. Reed was selected to overcome. The system itself must end, and the occasion is here.

Congress has an important role to play in ending the travesty of the "self-regulatory organization," or SRO, model that governs the NYSE. Without separation, scandals such as those involving Mr. Grasso and specialists will multiply and Americans will properly question why regulators and elected officials have allow a system that destroys the trust of investors to continue.

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[1] Writing in the Wall Street Journal Oct. 15, 2003, columnist Holman Jenkins also advocated public ownership of the NYSE: "…an adult ownership structure is becoming not just advisable but urgent."
[2] "Reed Won't Call for Separating NYSE's Roles," by Ianthe Jeanne Dugan and Susanne Craig, The Wall Street Journal, Oct. 3, 2003.
[3] "Self-Regulation Faulted, But Donaldson Favors Caution; Chicago Exchange Settles Charges," by Deborah Solomon, The Wall Street Journal, Oct. 1, 2003.
[4] "Powerful Interests Said to Resist Change at NYSE," by Ben White, Washington Post, Oct. 15, 2003.

The End of the SRO

This hearing concerns broader aspects of capital market structure, but I want to focus my attention on the crucial issue of the self-regulatory organization, an idea whose time, if it had ever truly come, is now clearly gone.

In a recent speech, Mr. Donaldson recognized that the urgent "need to restore the moral and ethical underpinnings of America's corporate and financial institutions -- at a time when so many of these institutions are still recovering from revelations of serious malfeasance."[5] The major institution most in need of restoring its moral and ethical underpinnings is the New York Stock Exchange.

The New York Stock Exchange is two things: It is a business, and it is the regulator of a business that happens to be itself.

This status, as a self-regulatory organization, is at the heart of recent scandals. The insurmountable conflict between the NYSE's two roles is the main reason that Mr. Grasso was paid so much, a package worth a reported $187.5 million at an institution that has not been notably profitable lately. After all, what company – given the opportunity – would *not* pay its own regulator a hefty sum?

The regulatory arm of the NYSE is said to be distinct from the rest of the organization, but who is kidding whom? "Many Wall Street firms are happy with the current arrangement because the NYSE's regulatory unit has been perceived to be much weaker than that of other securities regulators," reported the Wall Street Journal last month. "Defense lawyers and critics say the NYSE's softer investigative role stems from conflicts inherent in running a marketplace and policing members."[6]

Alternative to the Conflict of Interest

The NYSE's self-regulatory status must end. The alternative is to separate the regulated from the regulator. The regulator does not have to be a government agency, although it could be. And the exchange would not be a completely passive party. It would choose its regulator and be responsible for the choice. Investors could judge for themselves whether this selection was merely self-serving or whether the regulator was serious about protecting them.

The model exists today. The National Association of Securities Dealers (NASD), a private entity with an annual budget of $400 million and a staff of 2,000, already regulates both the NASDAQ Stock Market and 5,330 securities firms. The NASD used to own NASDAQ outright and the structure was self-regulatory, but three years ago, as the NASD says on its website, "we decided to sell NASDAQ, in order to concentrate solely

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[5] William H. Donaldson, speech to the Foreign Policy Association, New York, Sept. 25, 2003 (http://www.sec.gov/news/speech/spch092503whd.htm).

[6] "McCall Confirms IPO Is Considered as Way to Split Market's Role," by Laurie P. Cohen and Ianthe Jeanne Dugan, The Wall Street Journal, Sept. 19, 2003.

on our core mission, ensuring market integrity and investor confidence."[7] The separation was part of an effort by the SEC to remedy serious trading improprieties at the NASDAQ that emerged in 1996. It has worked well, but it is still incomplete:

> While NASD is Nasdaq's nominal parent, the market and regulatory operations are housed in separate subsidiaries and are controlled by separate boards of directors. NASD, which has a contract with Nasdaq, registers member firms, writes rules to govern their behavior, examines them for compliance and disciplines firms that break the rules…. Nasdaq still handles some of its own regulation, namely the day-to-day surveillance of the market. The separate boards are made up of industry participants, who may have their own interests at heart. And while a wall separates them, the regulatory arm and the market are part of the same entity. NASD is the majority controlling shareholder in Nasdaq -- at least until Nasdaq gets approval to become a stock exchange. Once that happens, Nasdaq plans to split off completely from NASD and continue contracting with the regulator.[8]

To achieve complete separation, the SEC should move quickly to grant exchange status to NASDAQ. A similar complete separation should be effected for the NYSE. Both exchanges would then be free to launch Initial Public Offerings.

How well does the NASDAQ model work?

A recent report by the General Accounting Office, the investigative arm of Congress, found that the NASD levied $211 million in fines in 4,715 cases between 1997 and 2002. By contrast, the NYSE levied only $19 million in fines in 256 cases over the period.[9]

The comparison is not entirely fair since the NASD has a broader field to cover for its penalties. Nevertheless, the evidence indicates that the NYSE is a more lenient self-regulator. "The NASD takes its enforcement role much more seriously," said New York attorney Bill Singer, who defends clients before both the NASD and the NYSE. "If you had a choice, you'd rather be sanctioned by the NYSE."[10]

Again, that stands to reason. The NASD has one job: to regulate. The NASDAQ has one job: to build its business as a commercial marketplace for a reputation for bringing buyers and sellers together with fairness, low cost and high speed.

The Specialist Anomaly

Under the current model at the NYSE, 1,366 for-profit members own a non-profit institution. Clearly, the members will attempt to run that institution in ways that benefit themselves. Such a system is fraught with peril, but it might work – if did not have a

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[7] See www.nasd.org.
[8] "SEC Is Looking to 'Nasdaq Model," by Deborah Solomon, The Wall Street Journal, Oct. 14, 2003.
[9] "SEC and CFTC Fines Follow Up," U.S. General Accounting Office, July 2003, GAO-03-795, p. 41.
[10] Op. cit., The Wall Street Journal, Sept. 19, 2003.

regulatory component. But it does, and, very clearly, the NYSE engages in practices that are often at odds with the best interests of investors.

A good example of such practices is the specialist system, which brings buyers and sellers together on the floor of the exchange to complete about 80 percent of trades. That system -- which permits about 400 traders from just seven firms, with inside knowledge, to enhance their own accounts as well -- is an anomaly, an antique among the world's major exchanges. Why does it persist? The exchange argues that specialists provide liquidity and maintain an orderly market. Such claims are dubious, at best. In fact, the obvious reason the system continues is that it is immensely profitable for the specialists themselves.

For example, in a recent presentation at the American Enterprise Institute, economist Brian Becker contrasted the NYSE system of market-making through specialist firms that each handle the shares of an average of about 400 individually listed NYSE stocks with the NASDAQ system of 400 market-making firms. While NYSE's stocks have a single market-maker on the floor, the average NASDAQ stock has over 10 competing market-makers.[11]

"The NYSE and the NASDAQ," according to Deutsche Bank, "are fundamentally opposite organizations: the NYSE is a floor-based auction market, the NASDAQ is an electronic dealer-driven market." At this moment in history, it would seem that an electronic market, with high speed and greater competition, makes more sense. That is the form that has been adopted around the world, from London to Tokyo.

Certainly, the NYSE can choose any operational form it wishes. Government should not interfere in the choice itself, but it is clear that the operational form, with its emphasis on specialists and limited competition, is a function of the ownership – and the board composition – of the NYSE. The losers are investors. Some are beginning to speak up. Scott DeSano, head of global equity trading at Fidelity Investments, the largest mutual fund family, recently criticized the specialist system, calling instead for "an electronic system such as that used by the Nasdaq Stock Market, in which computers pair buy and sell orders with no human go-between."[12]

The power of the floor is undeniable, and it is rooted in the profitability of the specialist firms. Mr. Becker calculates their pre-tax margins at 35 percent to 60 percent, compared with 9.7 percent for the industry category SIC 6211 (security brokers, dealers and flotation companies).[13] One reason this profitable cartel exists is that the specialists are enormously powerful within the NYSE itself. For example, two or three representatives of specialist firms – currently those of Van der Moolen Specialists USA, LLC, and Fleet

[11] "The NYSE and NASDAQ," presentation by Brian Becker, Precision Economics, LLC, at a conference on "The Profitability of New York Stock Exchange Specialists," American Enterprise Institute, Oct. 8, 2003 (http://www.aei.org/events/eventID.636,filter./event_detail.asp).
[12] "Fidelity Urges NYSE to Revamp Trading Operation," by John Hechinger, The Wall Street Journal, Oct. 14, 2003.
[13] Ibid.

Specialist, Inc. – typically sit on the board at any time. In addition, the CEO of Bear Stearns Cos., which has a minority interest in Bear Wagner, is vice chairman of the NYSE board, and the CEO of the Goldman Sachs Group, Inc., which owns a fourth specialist, Spear, Leads & Kellogg, also sits on the board.[14] The four firms represented on the board account for about three-quarters of the dollar volume of NYSE trading.[15]

Specialists are currently under investigation for trading irregularities by the SEC and one has already been fined. This is an old story at the NYSE, but there are more recent ones. In October 2002, Martha Stewart, CEO of Martha Stewart Living Omnimedia, resigned from the board just four months after joining it. She was under pressure from investigators examining her possible role in an insider-trading scandal involving another company, Imclone Systems. The investment bank of another director, Kenneth Langone, was charged by regulators with unlawful profit-sharing activities in connection with initial public offerings of stock.

Richard Grasso, the NYSE's chairman, first came under public criticism for serving on the board of Computer Associates International, whose accounting was subject to a criminal investigation. He also admitted that he had neglected to file timely statements for stock compensation from Computer Associates over five years. He resigned from that board but continued to serve on the board of Home Depot, Inc., which Mr. Langone co-founded in 1978. The NYSE was also criticized by Eliot Spitzer, the New York attorney general, after it nominated Sanford Weill, CEO of Citigroup to its board as a "public" representative in March. Mr. Weill withdrew his name.[16]

Then, in August, the details of Mr. Grasso's pay package was announced. On Sept. 16 four top pension funds called for his resignation, which occurred the next day.

This train of events, while not exactly predictable, should not have been surprising. As Sarah Teslik, executive director of the Council of Institutional Investors, put it, "The nicest thing you can say about the NYSE and their performance is that they are set up in such a way that you can't expect them to do a good job. And they have not disappointed us."[17]

The Congress, the SEC and the exchanges and markets themselves have the opportunity to end the conflicts that brought about the current scandals by establishing a new regulatory regime – one built on choice, competition, strict compliance and investor protection.

Picking Your Regulator

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[14] See http://www.nyse.com/about/p1020656067652.html?displayPage=%2Fabout%2F1022221392205.html.
[15] Op. cit., Becker.
[16] These events are related in "Down in Front," by James K. Glassman, www.TechCentralStation.com, April 21, 2003.
[17] "Closing Bell for the NYSE," by Kim Clark, U.S.News & World Report, June 9, 2003.

Why choice? Why should the NYSE or any other exchange be able to pick its regulator? Research indicates that when regulators compete for business, the result is better regulation. In addition, the institution that does the selecting takes responsibility for its choice and is judged by investors accordingly.

For example, U.S. corporations choose the state in which they are chartered, and that state's corporate law prevails. States compete to offer rules that are sensible both for corporations and investors. Landmark research by Roberta Romano, a Yale University law professor, has found that this competition does not result in a "race to the bottom" – but just the opposite. Competition produces strong, clear regulations that benefit managers, employees, investors and the economy. A company that chooses a state with a lax regulatory regime will be penalized by investors, who will demand a high risk premium (and lower price) for its stock.

In a book published last year, Romano extended the model to the regulation of individual public companies. "Under such an approach," she wrote, "corporations would be able to select their securities regime from among those offered by states, the SEC, and even other nations, with the result that securities would compete for firms' registrations."[18]

Competition, she argues, yields the best results, not just in the commercial marketplace but also in the regulatory marketplace.

When it comes to securities exchanges, the choose-your-regulator principle would be even easier to put into practice since, while there are thousands of corporations, there is only a handful of exchanges. The NYSE might, instead of choosing the NASD, contract, for example, with the New York attorney general to establish a separate regulatory regime, or with a new private entity established expressly for exchange regulation.

What the NYSE should not do is regulate itself.

The era of the SRO is over. Separation and public ownership – not convoluted new formulas for board composition – are needed to protect the investing public, to provide better service and, not coincidentally, to make exchanges better businesses.

Thank you.

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[18] Roberta Romano, The Advantage of Competitive Federalism for Securities Regulation, The AEI Press, Washington, D.C., 2002, p. 3.