

Richard G. Ketchum
Chief Regulatory Officer
New York Stock Exchange, Inc.

On
“Self-Regulatory Organizations: Exploring the Need for Reform”

Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises

Committee on Financial Services
United States House of Representatives
Washington, DC

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I. Introduction

Chairman Baker, Congressman Kanjorski and distinguished Members of the Subcommittee, I am Richard G. Ketchum, Chief Regulatory Officer of the New York Stock Exchange.

I want to thank the Subcommittee for providing this opportunity to address issues raised regarding the current structure of securities industry self-regulation, as well as to

discuss the SEC's November 2004 *Proposed Rule* on governance, reporting, recordkeeping, ownership and voting limitation requirements of self-regulatory organizations (Release No. 34-50699) and *Concept Release Concerning Self-Regulation* (Release No. 34-50700).

In this time in which America's securities markets are undergoing significant change, we applaud the idea of examining how self-regulation is operating and whether there are changes that would make it more effective in protecting investors. Stronger oversight of the securities industry is restoring investor confidence and leading to increased participation in the markets.

New York Stock Exchange Regulation ("NYSE Regulation") has primary responsibility to regulate our 400 member firms. These firms maintain 98 million customer accounts, or 84 percent of the total public customer accounts handled by broker-dealers, with total assets of over \$4 trillion. They operate from 20,000 branch offices around the world and employ 144,000 registered personnel. NYSE Regulation serves a vital role in policing this market.

Self-regulatory organizations ("SROs") in general and NYSE Regulation in particular have increased our regulatory resources and invested in technology to provide more effective oversight of broker-dealers and protect investors. Today, investors have access to more objective research, new and meaningful sales disclosure and greater governance transparency among companies listed on our market. Yet we can always do better.

Before I explore the subjects of today's hearing with you, I would first like to tell you a little about New York Stock Exchange Regulation.

II. NYSE Regulation

Over 700 employees work for NYSE Regulation, which consists of the Market Surveillance, Member Firm Regulation, Enforcement and Listed Company Compliance divisions, as well as a Risk Assessment unit and Dispute Resolution/Arbitration. While the priority of the NYSE is to promote the fairest and most efficient trading market, the priority of NYSE Regulation is investor protection.

NYSE Regulation plays a critical role in monitoring and regulating the activities of its members, member firms and listed companies, as well as enforcing compliance with NYSE Rules and federal securities laws.

Significantly, the SEC has appointed NYSE Regulation as the Designated Examining Authority for financial and operational (“FINOP”) issues for nearly all of the 170 firms that are members of both the New York Stock Exchange and NASD. Here there is no overlap or duplication.

The FINOP program of NYSE Regulation is focused on customer protection at the most fundamental level. Member Firm Regulation conducts annual examinations of brokers to make sure they are properly protecting customer assets and that they have enough net capital so that, if something goes wrong, customers will be protected. NYSE Regulation examiners have unique expertise to carry out this important mandate. Member Firm Regulation employs 125 financial and operational examiners who are trained to review for compliance with sophisticated and intricate SEC and NYSE Rules governing net capital and customer protection. In recent years, our FINOP examiners have uncovered numerous abuses including unauthorized use of customer securities, overcharging of interest on lending transactions and inappropriate short selling.

NYSE Regulation shares authority with NASD in sales practice oversight, as well as on a range of conflict issues, for the 170 firms that are dual members. It is here that the issue of regulatory duplication arises and where we and NASD have been most active in working to reduce overlap.

III. Governance Past and Present: Eliminating Conflicts of Interest

As much as we at NYSE believe in the wisdom of self-regulation, we believe just as passionately that independence is critical to robust self-regulation. In December 2003, the NYSE implemented—with the SEC’s approval—sweeping changes to its governance structure. Among other things, the NYSE became the *only* SRO to demand that *all* members of its Board of Directors (with the exception of CEO John Thain) be independent of the interests of NYSE members, member organizations that it regulates and corporations that are listed on the market. NYSE Regulation was functionally separated from market operations. A new position of Chief Regulatory Officer (“CRO”), which I am privileged to serve as the first, was created. The CRO reports directly to the Board of Directors through the Board’s Regulatory Oversight Committee. The most important result of these changes has been to ensure the independence of our decision-making.

The priority of NYSE Regulation is protection of the investor. There must never be the slightest doubt by anyone in the industry or investing public that NYSE Regulation’s decisions—whether in rule making, surveillance of our marketplace, an examination or an enforcement action—are based on anything but our best judgment, not on whether a particular firm may be competing with or providing orders to a competitor of The New York Stock Exchange.

In the past 18 months, NYSE Regulation has increased staff and technology resources. New senior management in the Market Surveillance, Member Firm Regulation and Enforcement divisions was appointed. A new department within Market Surveillance was created to analyze surveillances and propose new or modified surveillances of trading activities on the floor. New regulatory technology has been installed to establish better controls and accountability on the Floor.

We believe that these changes have resulted in NYSE Regulation being an effective, strong and independent regulator.

IV. Governance of NYSE Regulation Post-Merger

Once the merger of the New York Stock Exchange and Archipelago is approved, and a new holding company known as NYSE Group is created, the independence of NYSE Regulation will be preserved and strengthened.

The NYSE Group (with its New York Stock Exchange LLC and NYSE Market subsidiaries) will be a for-profit, publicly-traded enterprise. NYSE Regulation will be a wholly owned subsidiary of NYSE Group, but will be registered as a not-for-profit corporation. It will contract to perform regulatory responsibilities for the New York Stock Exchange, the Pacific Exchange and Archipelago.

NYSE Regulation will have its own board of directors. A majority of the NYSE Regulation directors will be NYSE Group independent directors. The remainder of NYSE Regulation directors will be unaffiliated with NYSE Group and independent from the marketplace. The chief executive officer of NYSE Regulation will be a director of NYSE Regulation. NYSE Chief Executive Officer John Thain will not have a seat on the NYSE Regulation board, nor will Regulation report to him.

NYSE Regulation will have two primary funding sources: regulatory fees from member firms and contractual agreements for regulatory services with the New York Stock Exchange, Archipelago and the Pacific Stock Exchange. As a discrete corporate entity, NYSE Regulation will be self-funding.

To ensure their independence, employees of NYSE Regulation will never receive stock or options of the NYSE Group. There must never be a question in the minds of investors that our regulatory decisions are blind to the interests of the business side of the Exchange.

This design will achieve the goal of enhancing the separation and independence of NYSE Regulation, while maintaining its proximity to the marketplace, in order to preserve its expertise and strengthen its mission of investor protection.

V. Regarding the SEC's *Proposed Rule*

It is within the context of these changes that were made to the governance structure of the New York Stock Exchange in December 2003, and the changes that will occur after approval of the merger between NYSE and Archipelago, that I want to briefly discuss the SEC's *Proposed Rule*. Generally, we are supportive of the *Proposed Rule*. Our current governance structure meets, and in many aspects exceeds, the proposed standards. After the merger, that will still be the case.

For example, the *Proposed Rule* would require that SROs that are national securities exchanges and registered securities association have a majority independent board. In fact, none of the members of the NYSE board of directors or our various committees work in the securities industry today, with the exception of our chief executive officer. *They are completely independent.*

VI. The SEC's SRO Concept Release

The SEC's Concept Release raises a series of thoughtful questions regarding the ability of self-regulatory organizations to meet heightened responsibilities as presently organized. In particular, the Commission noted the inherent conflicts of interest that exist between the SROs regulatory functions and their members, market operations, listed companies and, in the case of demutualized SROs, shareholders. The SEC also noted securities industry concerns about oversight of market participants by multiple regulators. The SEC then set out a number of possible alternative approaches ranging from enactment of the *Proposed Rule*, to a hybrid examination self-regulator, all the way to a universal non-industry regulator along the lines of the Public Company Accounting Oversight Board.

The NYSE feels strongly that the creation of a universal self-regulator or full dependence on governmental regulation would be a tragic mistake. In simplest terms, self-regulation offers the benefit of greater expertise, the ability to leverage government resources, and the ability to impose higher ethical standards than are required under Federal law.

Self-regulation fundamentally is based upon the belief that the most effective regulation occurs when the regulator is as close as possible to the regulated activity, thereby gaining specialized knowledge in overseeing market operations specific to that exchange. I see the benefits of applying this specialized knowledge everyday and I know Bob Glauber and Bill Brodsky do, as well.

When examining a member firm, it is critically important to have examiners who understand how a securities firm operates, the particular conflicts it may face in serving

the firm. Self-regulation also provides an effective means to allow industry access without industry control. NYSE Regulation, NASD and CBOE all reach out to engage knowledgeable industry officials on new rule proposals and interpretations of existing rules. The result is a regulatory scheme that protects investors by leveraging the expertise of the industry and a regulator steeped in the nuances of the specific marketplace.

Self-regulation is particularly important in times of profound changes in market structure. For example, by NYSE Regulation operating as an independent part of the NYSE, we have the opportunity to participate directly in the design and technological implementation of the NYSE's proposed Hybrid Market System. This puts us in the position to identify investor protection concerns at the beginning—before the new trading system is rolled out.

Of course, none of these benefits would matter if the NYSE did not properly address the conflict issues that the SEC properly puts forward. It is important to acknowledge that the NYSE has not always lived up to our own high standards in ensuring investor protection and market integrity. We are absolutely committed to learn from the mistakes of the past. That is precisely why we have imposed industry independence standards upon all of our Board Members and why the Chief Regulatory Officer reports directly to the Board of Directors. Self-regulation should permit us to be close enough to the market to make knowledgeable decisions while zealously protecting our independence.

The SEC also properly expresses concerns identified by the securities industry regarding unnecessary duplication that result from the present self-regulatory design.

While many of these concerns stem from an important increase in the breadth and aggressiveness of our program, as well as NASD's and the SEC's, we recognize that it is our collective responsibility to strive wherever possible to reduce unnecessary duplication.

There are many ways in which NYSE Regulation and NASD have already been coordinating efforts. Coordination of exams, rule making, and enforcement are three areas that have had the greatest impact on reducing regulatory duplication.

A. Exam Coordination

Beginning in 2005, NYSE and NASD developed a coordinated plan of examination that divides responsibilities for each firm visited by both regulators in a given year. Each regulator uses similar examination questions. Fifteen areas of examination are now part of this coordinated effort. For example, when NYSE Regulation examines a firm for compliance with anti-money laundering rules, the NASD does not review this area in its exam of that firm. If NASD examines a firm's compliance with business continuity planning rules, NYSE Regulation does not cover that topic in our exam. Results of these exams are shared between the two regulators. The joint exam program has received positive feedback from the industry and is working well.

B. Rule Making

Over the past two years, NYSE Regulation and NASD have worked together to review rules for differences and similarities and to conform them when it makes sense. The goal of these coordinated efforts is to provide the industry with a single interpretation that avoids confusion. NYSE Regulation and NASD staffs have weekly, sometimes-

daily contact regarding these issues. There are many examples of rules that have been harmonized through this process. They include the Research Analysts Conflicts Rule, Uniform Definition of Branch Office and Internal Control Rules. We believe great strides have been made in this area. Yet we cannot lose sight of the fact that the profile of NYSE member organizations is often different than an NASD firm. Many of the differences that exist in our rules are due to higher standards appropriate to expect of firms with greater resources. For example, our capital rules allow flexibility to impose more stringent reporting requirements to protect the investing public and the member organizations that serve them. We would not want to see this type of rule requirement diluted in the interest of uniformity.

C. Enforcement

In the area of Enforcement, we have worked jointly with NASD and the SEC to attack industry-wide problems, such as undisclosed revenue sharing and research conflicts of interests. We divide up the investigation, share documents and testimony transcripts. This permits us to quickly and effectively address industry-wide problems and return money to customers who have been harmed. In cases involving one firm or one issue, we coordinate with other regulators to ensure we are not duplicating efforts. We will not squander our resources investigating a firm for misconduct that has already been addressed by another regulator.

D. Increased Intermarket Coordination

Another area of regulatory coordination is the Intermarket Surveillance Group ("ISG"). The ISG, which was created in 1983 in response to the growing need among U.S. securities exchanges to share surveillance information, is today comprised of 29 North

American, Asian and European organizations that have a common interest in ensuring that the securities and commodities marketplaces are regulated effectively and efficiently. With the enthusiastic support of NYSE Regulation, the ISG has recently undertaken to evaluate initiatives designed to further consolidate trading information in a more uniform manner thereby reducing the need, as well as associated costs, of firms to provide information to regulators in different formats. For example, although the ISG now has in place a consolidated audit trail for equities and a recently developed consolidated options audit trail, the ISG will evaluate the consolidation of the equities and options audit trails to address more comprehensively possible trading abuses.

The SEC requested comment on the desirability of a hybrid SRO that would leave oversight of the markets as is but take responsibility for regulatory oversight of all broker-dealers doing business with the public. While this is certainly a constructive proposal that we are willing to explore, it is not easily implemented without losing much of the expertise critical to self-regulation. Member firm regulation today is not simply a matter of enforcing financial responsibility or customer suitability rules. It can also involve issues relating to illegal short selling, manipulative trading around offerings or control systems on trading desks. NYSE Regulation's Market Surveillance and Examination functions work closely together to ensure complete coverage of the wide range of trading and market abuses. A good examination program cannot be effective without substantial sophistication regarding market issues and coordinated with other Exchange regulatory functions.

Nonetheless, NYSE Regulation recognizes its responsibility to expand its efforts to partner with other regulators to further reduce or eliminate duplication. For that

reason, we are having an ongoing dialogue with our Board of Directors on these important issues. NYSE Regulation also is ready to meet with the SEC, NASD and other self-regulatory organizations to identify how we might better protect investors and reduce unnecessary duplication.

VII. Conclusion

Let me end with a personal note. I joined the Exchange as its Chief Regulatory Officer, a newly created position, to affirm the NYSE's commitment to regulation and to a regulatory arm unencumbered by commercial interests. I assumed this position based on a lifetime of devotion to regulation, both as a government official and an NASD executive, based upon the pledge that I would be granted a free hand to create a regulatory body unique in sophistication, resources and passion to protect the public. I knew I was building upon a two-century old tradition of excellence. I am proud of what has been accomplished thus far and appreciate the miles we have to go before our task is complete.

The issues that beset us today are not drawn on a clean canvas. They have arisen time and again and form the predicate for much of the legislation that successfully governs our securities markets today.

I would respectfully suggest that the novelty and uniqueness of the reconstituted New York Stock Exchange Regulation be afforded an opportunity to develop and be tested over time. In the interim, we recognize our responsibility to vigorously pursue means to reduce unnecessary duplication. We remain committed to continue to work with the SEC, our fellow regulators and this committee to improve and strengthen the SRO system and build on the great strides we have collectively made to date.

