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The New York Stock Exchange: Governance and Market Reform

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Summary

On September 17, 2003, Richard Grasso resigned as chairman of the New York Stock Exchange (NYSE) after a public uproar over his $187.5 million pay package . Although Grasso is not charged with any violation of law or other wrongdoing, many see his compensation as symptomatic of fundamental problems in NYSE governance, regulation, and operations. Numerous reform proposals are under discussion, both within the NYSE, among regulators, and in Congress. First, the NYSE has proposed to restructure its board of directors to exclude representatives of the securities industry. Second, some see a conflict of interest in the NYSE's role as a self-regulatory organization: is its responsibility to enforce trading rules compromised by its devotion to its members' financial interests? Finally, the NYSE is the last major stock market where most orders are executed by humans on a trading floor rather than matched by computers. Would public investors benefit if the exchange (or its regulators) made reforms in market structure to foster competition with the NYSE's electronic rivals?

As the world's largest stock exchange and a key part of the U.S. economy, the NYSE is a central focus of Congress's oversight of financial markets. In October 2003, the House Financial Services and Senate Banking Committees held hearings on market structure and the future of the securities industry. Further hearings are planned. This report sets out the basic issues in NYSE governance and market structure, and will be updated as events warrant.

NYSE Governance

The New York Stock Exchange (NYSE) is a membership organization chartered as a non-profit corporation. Members range from the largest Wall Street firms to specialized brokers who conduct all their business on the exchange floor. The NYSE is also regulated at the federal level by the Securities and Exchange Commission (SEC), which has broad oversight powers, including the authority to modify, abrogate, or require the NYSE to adopt any rule it sees fit. NYSE management thus answers to two sets of masters: its membership of profit-seeking firms and individuals, to whom it is a source of revenue, and its government overseers, the SEC and Congress, who view it almost as a public

utility, whose fair and orderly operation is essential both to millions of public investors and to companies that sell stock and bonds to raise capital to create wealth and jobs.

Like most private corporations, the NYSE is run by professional managers who serve at the pleasure of a board of directors. Membership of the board of directors is divided between the NYSE's two major constituencies. Before the reform proposals now under consideration, the board consisted of 12 members from the securities industry (generally the heads of major Wall Street firms or NYSE floor brokers and specialists), 12 from outside the industry (who include CEOs of major corporations, directors of pension funds and other institutional investors, and other prominent individuals), and three members of NYSE management, including the CEO, who serves as chairman of the board. Because the board is responsible for hiring and compensating the CEO, it was the first target of reform proposals following the Grasso resignation.

On November 5, 2003, the NYSE unveiled a proposal for a restructured board. The new board would be composed of six to twelve independent members – no representatives from the securities industry would serve as directors. The board of directors would appoint a Board of Executives, consisting of about 20 representatives of broker/dealers, floor traders, institutional investors, and listed companies. The Board of Executives would act in an advisory capacity; the board of directors would have full control over the regulatory budget, auditing, executive hiring and compensation, and the nomination of directors.

The proposal must be approved by the NYSE membership. A vote has been set for November 18, 2003, to approve both the restructuring and an initial slate of eight directors, only two of whom currently sit on the board. The SEC must also approve. In a statement on November 5, 2003, the SEC indicated that it approved of the proposal, but that it might seek additional reforms.

The proposal would address some of the more salient concerns raised by the Grasso affair. Compensation of NYSE executives would no longer be set by those whom the exchange is supposed to regulate. Suspicions that the NYSE puts the interests of its members ahead of its duty to public investors might be allayed somewhat. However, to the extent that governance problems at the NYSE are judged to be severe, there are apparent limits to the effectiveness of board restructuring. As in private corporations, the NYSE board must leave day-to-day operations to management. To critics of the NYSE, the cause of the exchange's problems lies deeper; they see intractable conflicts of interest in the concept of self-regulation. Can an association of intensely profit-driven individuals and firms be expected to enforce rules for the protection of public investors, who are their customers — but sometimes also their competitors — in a cutthroat marketplace?

Self-Regulation

Self-regulation — the principle that the securities markets ought to bear a large part of the responsibility and cost of regulating themselves — has been a cornerstone of U.S. stock market regulation since the enactment of the basic federal securities laws and the creation of the Securities and Exchange Commission (SEC) in the 1930s. Under law and SEC regulation, stock exchanges are self-regulatory organizations (SROs), charged with adopting and enforcing rules to maintain fair and orderly trading. To some, this seems like foxes guarding the henhouse.

The ideal of market regulation is to protect public investors and put them on a level playing field with market insiders. But the current market price of an NYSE membership, or seat, is nearly $2 million. In addition to income from sales commissions and fees for various services, NYSE members earn substantial revenues from trading for their own accounts. Conflicts of interest may arise from the fact that public investors trading in the markets are not only NYSE members' clients, but sometimes their competition as well. From this perspective, recent allegations that NYSE firms have profited illegally by "trading ahead" of their public customers, and that the SEC had to prod the NYSE's investigation, come as no surprise.[1]

Arguments like these about the inherent flaws in self-regulation were heard in the 1930s. Still, Congress chose the system and has since expanded it. A common view would be that of SEC Chairman William Donaldson, who observed that self-regulation has worked "pretty well ... despite some hiccups through the years."[2]

There is widespread agreement that self-regulation has some advantages over direct government regulation. Government securities regulation has been likened to a buzz-saw, sometimes the proper tool, but other times less effective than the "surgeon's scalpel" of self-regulation.[3] In an area where shades of gray must be taken into account, SROs can set ethical standards for private market participants, an activity difficult or inappropriate for government. By handling a significant portion of enforcement cases themselves, SROs reduce the expense to the government of maintaining a large enforcement staff.[4] Finally, SEC enforcement tends to be reactive and after-the-fact; none of the worst market scandals of the past decade — the Nasdaq price fixing scheme, the post-Enron accounting frauds, or the corruption of stock analysts — was first uncovered by the SEC. (The SROs' record in these three episodes is no better, unfortunately.)

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[1] "Trading ahead," or frontrunning, occurs when a brokerage trades for its own account before executing a customer order that it believes will affect the market price. It is illegal. See: Laurie P. Cohen, et al, "NYSE Trading Probe Took Late, Sharp Turn," *Wall Street Journal,* Oct. 17, 2003, p. C1.

[2] Deborah Solomon, "SEC Won't Push Radical Change on NYSE," *Wall Street Journal*, Oct. 1, 2003, p. C1.

[3] Louis Loss and Joel Seligman, *Fundamentals of Securities Regulation*, 4th edition, New York, Aspen Law and Business, 2001, p. 734.

[4] In 2002, the NYSE pursued 255 enforcement actions. The SEC, with many more firms and individuals under its jurisdiction, initiated 598 in fiscal year 2002.

In short, abandoning self-regulation entirely is a minority position. However, some argue that self-regulation on the NYSE could be strengthened by separating the regulatory and enforcement apparatus from the competitive market operation. The model here is Nasdaq, which was spun off from its parent company and SRO, the National Association of Securities Dealers (NASD) following the exposure of widespread price fixing in 1994. An autonomous regulatory unit — NASD Regulation Inc. — was created, and the Nasdaq market began a transition (not yet complete) into a for-profit, stockholder-owned corporation.[5]

The analogy between Nasdaq in 1995 and the NYSE today is imperfect. The Nasdaq scandal involved many of that market's largest dealers and its most heavily-traded stocks. For several years, public investors routinely received inferior prices. The investigation of NYSE specialists involves alleged abuses on a much smaller scale; the problem may not be systemic, as Nasdaq's clearly was. A blue-ribbon investigation into NASD and Nasdaq — headed by Senator Warren Rudman — found that the governing structure was extremely cumbersome, in part because committees representing small groups of traders were able to obstruct reforms.[6]

It is possible, but not certain, that insulating the NYSE regulators from the profit-seeking traders would result in more vigorous enforcement and oversight. A critical question is how the SRO is to be funded if it becomes a separate entity. Moreover, if the enforcement function distances itself from the market, it might lose the advantages of an SRO and become a weaker duplicate of the SEC.

Market Structure

Some critics of the NYSE, including its competitors, view issues of governance and self-regulation as outward symptoms of an underlying problem. The NYSE's real problem, in this view, is that it clings to an obsolete trading model that benefits its members at the expense of public investors. The NYSE trading floor, where traders buy and sell in an auction market whose basic framework is two centuries old (supported, of course, by a vast array of electronics), is seen as expensive and inefficient.

Several versions of computerized, screen-based trading offer competition to the trading floor. Most major stock markets around the world have abandoned face-to-face trading. In the United States, computerized trading was pioneered by Nasdaq in the 1970s and 1980s, and refined in the 1990s by a new set of computerized exchanges, called "electronic communications networks," or ECNs. The basic concept of an ECN is to take full advantage of increases in computer speed and technology to handle the billions of shares that change hands daily in U.S. markets. Offers to buy and sell are matched

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[5] See CRS Report RS21193, *Nasdaq's Pursuit of Exchange Status and an Initial Public Offering*, by Gary Shorter.

[6] National Association of Securities Dealers, Inc., *Report of the NASD Select Committee on Structure and Governance to the NASD Board of Governors*, 1995, 3 v.

electronically and often executed instantly.[7] In contrast to the thousands employed by the NYSE, an ECN handling a similar volume might have a staff of a few dozen.

The ECNs now handle over half the trading volume in stocks listed on the Nasdaq market, but only about 5% of NYSE volume. Why the discrepancy? The NYSE argues that its floor-based trading system produces superior prices, that orders sent to the specialists on the floor are often filled at prices better than the publicly quoted price, or "inside the spread." This "price improvement" disappears when the trading mechanism does nothing but match offers to buy and sell.

The ECNs counter that regulatory barriers act to preserve the NYSE's monopoly in its own listed shares, specifically the "trade through" rule, which mandates that orders in shares listed on an exchange be sent to the registered exchanges that make up the Intermarket Trading System and "exposed" there for a minimum of 30 seconds in search of price improvement.[8] This rule may sound innocuous to the layman, but NYSE rivals complain of an "eternity of seconds" which negates a primary advantage of ECN trading: speed of execution.[9]

It is difficult to evaluate the competing claims of execution quality and speed, market liquidity, and so on. Proponents of various market models have strong financial stakes in the outcome of the debate; the results of independent empirical studies are mixed; and the markets continue to evolve rapidly.

In the long run, the ECN market model may offer significant economies for traders and investors. NYSE member firms that do business with the public had gross revenues of $148.7 billion in 2002.[10] In an age of cheap computing power, this may simply be too high a price for intermediary services. In the short run, questions remain about the ECN trading model. How will it perform in a market crash? What are the effects on price-setting mechanisms and market liquidity of dispersing trading among many market centers? Can the ECN model support vigorous self-regulation and market oversight? While ECN order handling systems may prevent certain trading abuses seen on traditional exchanges, what new forms of abuse could emerge?[11]

To the unhappiness of some, but the satisfaction of others, the SEC has moved very slowly to address fundamental market structure issues. In 1997, the SEC issued rules that brought ECNs into the mainstream of trading of Nasdaq shares, and allowed them to increase their share of market volume. Recent testimony does not suggest that the SEC plans to sweep away the barriers that are said to keep ECNs from handling significant

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[7] For general background on ECNs, see CRS Report RL30602, *The Electronic Stock Market,* by Mark Jickling.

[8] For background on the ITS, see CRS Report RS20632, *The Intermarket Trading System and NYSE-Listed Stock,* by Gary Shorter.

[9] Prepared testimony of Nasdaq Chairman Robert Greifeld before the House Financial Services Subcommittee on Capital Markets, Oct. 16, 2003, p. 2.

[10] A breakdown by source is available at: [http://www.nysedata.com/factbook/main.asp].

[11] See, e.g., Robert Greifeld, op. cit., on sub-penny trading. (Quotes priced in increments smaller than one cent are invisible to some market participants.)

volumes of trades in NYSE-listed stocks. On October 15, 2003, SEC Chairman William Donaldson, before the Senate Banking Subcommittee on Securities, took note of the limited access to the NYSE. "The existing compulsory market-to-market linkage in stocks — the Intermarket Trading System (ITS) — applies only to NYSE and Amex stocks and, in the view of many, has been less than successful in overcoming obstacles to providing effective intermarket access."[12] At the same time, however, he endorsed the existence of separate market structures: "... I firmly believe our system of multiple, competing markets — on balance — has worked remarkably well. We have the world's most competitive and efficient markets."

No legislation bearing directly on market structure is before the 108th Congress. The SEC has authority under existing statutes to direct the NYSE and other SROs to modify any of their rules, and thus can effect changes in trading mechanisms (or exchange governance) by regulation. Continuing congressional interest, evidenced by hearings and other oversight activities, is driven by concerns about fairness to public investors and the efficiency and competitiveness of U.S. financial markets, and the existing statutory mandate that the SEC facilitate the development of a national market system for trading securities.[13]

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[12] Testimony before the Subcommittee on Securities and Investment, Senate Committee on Banking, Housing, and Urban Affairs, Oct. 15, 2003.

[13] Pursuant to the Securities Acts Amendments of 1975.