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**Chief Executive Officer**

**NYSE Group, Inc.**

**On**

**“A Review of Self-Regulatory Organizations in the Securities Markets”**

**Committee on Banking, Housing and Urban Affairs**

**United States Senate**

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## **Introduction**

Chairman Shelby, Senator Sarbanes, and distinguished Members of the Committee, I am John Thain, Chief Executive Officer of the NYSE Group. I thank you for the opportunity to address issues raised regarding the current structure of securities industry self-regulation. Given the sweeping changes affecting our nation's securities markets today, your examination of these issues could not be more timely. As many of the matters the Committee is examining are within the purview of NYSE Regulation, I want to state from the beginning that my comments reflect my perspective as the CEO of the NYSE Group, where I oversee the business of the Exchange, as opposed to the functioning of NYSE Regulation. That separate subsidiary is led by its own chief executive officer, Rick Ketchum, who reports directly to the NYSE Regulation Board.

### **I. The U.S. Needs to Remain the Global Leader in Financial Services**

We find ourselves at the center of sweeping changes: March 7, 2006 was a milestone in the 213-year history of the New York Stock Exchange. On that date, the Exchange became a publicly owned, for-profit company, the NYSE Group, and we began trading yesterday under the symbol NYX. In the days ahead, we will introduce new products, platforms, and strategies to modernize our business, increase our listings, serve our shareholders and gain market share against formidable, global competitors.

The competition from other exchanges in Europe, Asia, and the U.S., and our desire to keep not just the NYSE, but the U.S. markets ahead, is one of the primary drivers of the transformation we have undertaken at the NYSE. In an increasingly globalized world, foreign companies are avoiding the U.S. markets when they raise capital. A recent Wall Street Journal article provided some troubling statistics: In 2000, nine out of every ten dollars raised by foreign companies through new stock offerings were done in the U.S. But last year, the top ten IPOs measured by global market capitalization were not registered in the U.S. markets. Indeed, 23 out of 25 of the largest IPOs in the world did not register in the United States. That is a major concern for U.S. markets.

A number of well-capitalized Europe-based global exchanges are competing for the listing and trading of securities. The Deutsche Börse, Euronext and London Stock Exchange are all well capitalized, public, for-profit markets that offer broader product mixes, and they are positioned to compete aggressively to capture U.S. and global market share.

Our new structure will help us to compete with these markets and, we believe, help keep the capital formation and resulting job creation that is the lifeblood of the U.S. economy here in our own country, rather than fleeing to foreign markets.

As technology links domestic and international exchanges through instantaneous, electronic trading, transaction costs decline and investors are empowered. Investors today

can send their orders to virtually any market to invest in a plethora of products at very low costs. This has raised the bar of competition for U.S. exchanges.

The New York Stock Exchange is responding comprehensively, by transforming our structure, modernizing our market, and adapting our strategy. Becoming a public company will enhance our ability to invest in technology and to offer new products that investors from around the world want to trade. We will also have a currency for acquisition, allowing us to play an active role globally in the next stages of consolidation in the exchange space.

We will modernize our market and provide customers more choices by expanding our portfolio of product offerings and categories. With the Archipelago merger, we have begun trading options. We are planning to expand significantly trading in the bonds of our listed companies, driving down spreads and enhancing investment opportunities for retail investors. We will expand our listings business through a second listings platform that will provide growing companies that today cannot meet the high financial listing standards of the NYSE with a new choice: to list with Archipelago and begin on a track towards an NYSE listing.

As we champion innovation and choices for customers, we will redouble efforts to provide investors the most reliable, cost-efficient and competitive venue for trading our listed stocks. Specialists and floor brokers will continue to provide the best execution prices, best-quoted spreads among U.S. markets along with the deepest liquidity of any capital market in the world. These metrics of market quality translate into real savings. On February 9, 2006, we released the findings of a NYSE study that compared the market quality of 67 companies that transferred to the NYSE from Nasdaq from 2002 to 2005. The study showed that intraday volatility declined by 48%, average quoted spreads tightened by 46%, and execution costs to investors decreased by 38% on average for these companies after moving to the NYSE.

Capital is the lifeblood of American dynamism, innovation, productivity and prosperity. The global competition for capital is a contest of paramount importance for our country's future. Nothing is written in stone that decrees American capital will stay here or that global capital will continue to come here. The competition we face to keep America at the center of global financial markets is becoming tougher by the day. We must succeed in the future through superior, competitive performance in our financial markets, and through sound, forward-looking public policies. And those are the driving forces behind the transaction that has led us to create the new NYSE Group.

## **II. SRO Regulation**

As our markets are evolving, it is entirely appropriate, and, we think, necessary to examine the self-regulatory structure governing our financial markets.

In 2003, the NYSE faced a crisis like few it had ever known. The NYSE's governance structure was perceived to have broken down, its specialist firms were accused of self-dealing at the expense of customers, and public confidence in the NYSE reached historic lows. The NYSE, critics argued, could not effectively manage the conflicts of interest inherent in its structure. In swift reaction, however, the NYSE implemented – with SEC approval – sweeping changes to its governance structure. Among other things, the NYSE created a structure in which members of the Board of Directors were independent of the interests of the NYSE members whom they regulated. The new structure functionally separated market operations from regulation, assured the independence of regulatory decision-making, and installed a Chief Regulatory Officer (“CRO”) – Rick Ketchum, who reported directly to the Board of Directors through the Board's Regulatory Oversight Committee (“ROC”). The NYSE also separated the functions of Chief Executive Officer (“CEO”) and Chairman of the Board, installed new board members, including a new chairman, and hired a new CEO – me.

Based on over two years of experience, this structure has proven effective. The ROC played an active role in overseeing Rick's activities at NYSE Regulation ensuring that Regulation received both staff and technology resource increases, and in assuring its independence. Rick has been aggressive in the oversight of market and member firm activities and has been proactive by embracing a risk-based approach to regulation.

Under the new structure that was just approved by the SEC, we have sought to establish the NYSE Group as a model corporation guided by integrity and strict standards for transparency and accountability to our shareholders and the public. The new structure adheres to the principles that made our initial reforms two years ago effective – proximity with independence. Under our new structure, the independence of NYSE Regulation will be strengthened. While the market is now a for-profit entity, NYSE Regulation has become a separate, not-for-profit corporation. Members of the Board of NYSE Regulation will meet the independence standards of NYSE Group Board members, which precludes ties to member organizations and listed companies.

Most important, the NYSE Regulation Board will have a majority of directors who are unaffiliated with the NYSE Group. Their fiduciary obligation as directors will be to NYSE Regulation, undiluted by service on any other board within the NYSE Group.

**A. Maintaining NYSE Regulation within the NYSE Group will improve regulatory performance**

***A more knowledgeable regulator.***

While, as I mentioned earlier, NYSE Regulation is not part of my executive responsibilities, I am pleased to offer my views on the benefits of having a regulator that is proximate to the markets that I do run.

The rationale underlying self-regulation is straightforward: Regulators are in the best position to regulate when they are intimately knowledgeable about the activities they are

regulating. Market regulators who are integrally tied to the regulated market know the conduct and activities that they should be examining when they engage in compliance reviews and surveillance. This knowledge also allows regulators to know when rule changes are needed to address systemic concerns.

Based on my experience here at the Exchange, as well as in my previous position with a large broker-dealer, I believe a regulator with a real-time understanding of how the marketplace is evolving in the face of competitive forces has a better chance of keeping ahead of the curve and being integrally involved in shaping marketplace evolution to ameliorate any regulatory concerns. That real-time understanding can be obtained most effectively when the regulator functions on a day-to-day basis alongside the market it is regulating.

Similarly, a regulator who is proximate to the market is more likely to devise the optimal solution to a regulatory challenge or problem — one that is cost-effective and minimizes regulatory interference with sensitive market mechanisms. Proximity also reduces the risk of misaligning the performance incentives of regulatory personnel, avoiding the “small town speed trap” syndrome of police officers writing speeding tickets to fund municipal services rather than deterring reckless driving.

***Cooperative regulatory risk assessment and sensible regulation.***

The coordination and communication that arises from affiliation also reduces the “us versus them” mentality that prevents cooperative regulatory risk assessment and management. Affiliation also creates a regulator with market sensitivity and a businessperson who understands regulation. Finally, the affiliation of a regulator with an exchange focuses accountability for the direct and indirect costs that regulatory activities impose on the market. Neither the effectiveness nor the efficiency of regulation becomes “someone else’s problem.”

***Preventive regulation to deter issues from arising in the first place.***

I also believe that proximity benefits the market participants being regulated. By taking early advice and input from the regulator, those being regulated can create a more effectively regulated environment by designing compliance and surveillance systems into their products and services.

A recent example of this is the NYSE’s development of the NYSE Hybrid Market<sup>SM</sup>. The NYSE designed the hybrid market to improve its competitiveness, achieve the efficiencies demanded by its customers and comply with Regulation NMS. We on the business side of the NYSE have benefited greatly by having Rick Ketchum and his team at the table. While we were designing our systems and building order types to meet the demands of the market, Rick was in a position to tell us whether NYSE Regulation would have the tools to properly regulate that platform. A “distant” regulator also could have vigorously regulated the hybrid market, but, by having NYSE Regulation involved in the

development of the hybrid market from the outset, regulatory protections were designed into the platform.

**B. NYSE Group's structure will protect the independence of the regulator**

*There is a strong market incentive for NYSE to maintain a robust regulator.*

We have heard the concern that self-regulation within a for-profit holding company structure that includes an affiliated market is problematic because the for-profit goals of a marketplace are in direct conflict with the regulatory duties of that marketplace. The premise underlying this argument is false. In order to attract listing and trading on their platforms, stock exchanges must run a fair, well-regulated marketplace, or risk losing business. Companies list on a trading venue in part to associate themselves with the branding that comes from meeting high standards in a regulated environment. In addition, broker-dealers send their order flow to a trading venue to seek access to liquidity in a fair and orderly marketplace. A trading scandal or a poorly regulated market undermines investor confidence and erodes business at a stock exchange. The reorganization of the NYSE in 2003 to separate the regulatory function from the marketplace and strengthen our regulator is a perfect example of the strong business incentives that are created by a perceived weakness in regulation. Accordingly, those of us running the business side of the Exchange have every incentive to ensure that the regulatory oversight of our listed companies, member organizations and trading platforms is robust.

*Conflicts are inherent in Self-Regulation: The corporate and functional separation of NYSE Regulation from the market guards against conflicts.*

No matter what model one chooses, self-regulation has inherent conflicts of interest. While we believe that our model sufficiently accounts for and addresses these conflicts, we acknowledge their existence and work to mitigate its potential for harm to the investor. Likewise, NASD and Nasdaq have inherent conflicts of interest because of their financial interrelationships and the fact that NASD has board members who would not meet standards of independence we have established for NYSE-Regulation Board members. With the SEC's approval of Nasdaq's exchange application and the impending separation of NASD and Nasdaq, the NASD is moving closer to true independence, but there remain financial interrelationships that create conflicts regardless of corporate structure. These include large dollar contracts for the NASD to conduct regulatory activities for Nasdaq, the American Stock Exchange and the International Stock Exchange as well as the proposed NASD Trade Reporting Facility, through which the NASD will provide a market it regulates, Nasdaq, with considerable revenues. Further, a key regulatory function, listing compliance, remains within Nasdaq as opposed to the NASD. We, however, moved this function to NYSE Regulation in July 2004 to ensure independent decision-making and remove potential conflicts of interest.

The question is not whether conflicts exist but rather how they are accounted for and controlled.

(Appendix A contains a more detailed description of the ways in which the NYSE Structure complies with the principles and proposed rules of Regulation SRO.)

***Independent directors represent a majority of the NYSE Regulation board of directors.***

As noted above, the board governing NYSE Regulation is structured to ensure the independence of the regulator from the marketplace. Every director of NYSE Regulation, except for Rick, will be independent of broker-dealers, New York Stock Exchange-listed companies and management of NYSE Group. A majority of the directors of NYSE Regulation must be persons who are not directors of NYSE Group. These requirements insulate NYSE Regulation from the for-profit interests of NYSE Group and from the interests of the other entities and persons that NYSE Regulation regulates. The final form of this structure evolved out of the careful review conducted by the SEC before approving our merger rule filing.

NYSE Regulation has a separate compensation committee that will be appointed by the NYSE Regulation board of directors. A majority of the members of this compensation committee must be persons who are not directors of NYSE Group. NYSE Regulation will also have a separate nominating and governance committee. As with the compensation committee, a majority of the members of this nominating and governance committee must be persons who are not directors of NYSE Group.

Any disciplinary decision of the NYSE Regulation board of directors will be deemed to be final and is not subject to review or approval except by the SEC. In addition, with respect to the promulgation of rules and regulations, any proposed changes to them must be published in the *Federal Register* and will be subject to public comment and the SEC approval process. Moreover, the SEC oversees all of NYSE Regulation's regulatory responsibilities.

Finally, the Chief Executive Officer of NYSE Regulation will report solely to the NYSE Regulation board of directors and will not be an officer or director of NYSE Group. In addition, neither he nor any other NYSE Regulation employee will be permitted to own NYSE Group stock or options.

***NYSE Regulation board members should not be affiliated with industry, in order to protect against conflicts of interest.***

Some have made arguments that broker-dealer members should be members of the Board of NYSE Regulation.

We disagree. The presence of member organization executives on the board of an entity charged with regulating those member organizations raises potential conflicts of interest that can interfere with effective regulation. The NYSE learned this lesson and, in 2003, restructured its board from a constituent assembly into a corporate-type board comprised of directors wholly independent from those that it regulates. Significantly, we

work closely with key legal and compliance officials at our member firms to identify unnecessarily burdensome regulatory requirements. We believe that industry access without industry control appropriately manages the inherent conflicts of self-regulation.

Direct involvement of constituents in the selection of our independent directors is another matter. Through our Director Candidate Recommendation Committees, member organizations of New York Stock Exchange LLC select at least 20%, and no less than two, of the directors of the boards of the New York Stock Exchange LLC, NYSE Market, and NYSE Regulation. In addition, there is a formal director nomination petition process incorporated into our rules, as well as many informal ways in which our constituents can suggest director candidates.

This structure not only carries forward the NYSE's former governance structure, which required that each director of the NYSE be independent from constituents, but also complies with the SEC's proposed rules regarding fair representation of members in the governance of a registered exchange.

***No particular NYSE member organization will have undue influence on NYSE Group or its subsidiaries.***

Under the NYSE Group certificate of incorporation, there are limitations on the concentration of voting power and ownership of NYSE Group stock to ensure that no member organization or other stockholder will exert undue influence on the NYSE Group or its subsidiaries, including NYSE Regulation. Specifically, the certificate of incorporation requires that no person (either alone or together with its related persons) will be entitled to (1) vote more than 10% of the total number of votes entitled to be cast on any matter or (2) beneficially own shares of stock of NYSE Group representing in the aggregate more than 20% of the then outstanding votes entitled to be cast on any matter.

***NYSE Regulation will be independently and fully funded.***

New York Stock Exchange LLC and NYSE Market have entered into a contractual agreement with NYSE Regulation to provide funding to NYSE Regulation. The Pacific Exchange, now known as NYSE Arca, has entered into a similar services agreement with NYSE Regulation. NYSE Regulation will also collect regulatory fees from the members it regulates, and will collect fines from persons who are disciplined by NYSE Regulation for rule violations. Under the operating agreement of New York Stock Exchange LLC, New York Stock Exchange LLC will be prohibited from using any of these regulatory fees, fines or penalties for commercial purposes. Moreover, because NYSE Regulation is a New York not-for-profit corporation, NYSE Regulation may not distribute these fees and fines in the form of a distribution or dividend to New York Stock Exchange LLC.

### **C. NYSE Regulation is working to reduce regulatory duplication**

Separate and apart from the issue of the independence of NYSE Regulation is the issue of regulatory duplication. NYSE Regulation has committed to take steps to address the issue of duplication and has taken numerous steps over the past 12 months to do so. These include: developing a coordinated plan for examinations of firms with the NASD that divides responsibilities for each firm visited by regulators in a given year; coordinating with industry committees and organizations in response to major initiatives to harmonize interpretations and rule making; participating with other exchanges and markets in the Intermarket Financial Surveillance Group to share audit trail and coordinate financial monitoring; and coordinating on Enforcement actions to lessen duplicative efforts. That being said, while we recognize that these initiatives are a step in the right direction, we agree that there is more to be done.

In that regard, NYSE Regulation has pledged to the SEC that it will work to eliminate inconsistent rules, and to use its best efforts, in cooperation with the NASD, to submit to the Commission within one year, proposed rule changes, reconciling inconsistent rules and a report setting forth those rules that have not been reconciled.

In addition, as Rick and I have both said publicly, we are committed to finding other ways to reduce regulatory duplication, including exploring the possibility of forming a joint venture with the NASD. This joint venture would leverage the talent, expertise and experience of two seasoned regulators giving both organizations substantially authority and control over the regulation of the broker/dealers in securities industry. We believe the efforts taken to date, as well as our willingness to work with the NASD in a joint venture, demonstrate our substantial commitment to working through this issue.

### **III. Conclusion**

The corporate governance and trading scandals that led up to and followed Sarbanes-Oxley and other governance reforms hurt the reputation of the NYSE and other U.S. markets and hindered us in the competition for capital. We cannot afford to have ineffective governance or regulation going forward. Companies and investors need to trust U.S. governance standards and market regulation. We believe that our structure embodies the principles necessary to deliver on that goal.

We also need market regulation that is efficient. In order for the NYSE and other markets to compete globally, we need knowledgeable regulatory staff that is proximate to the market. They are in a better position to regulate in an efficient manner that does not unduly interrupt the workings of the market. We believe that our model accomplishes this goal as well.

Ultimately, the industry, markets and policy leaders all play a role in how competitive the U.S. remains. We believe that the new NYSE Group with its new governance structure

is properly positioned to do its part alongside all of you to fight to preserve the preeminence of the U.S. markets in this global race.

I thank the Chairman and the Committee for the opportunity to testify.

## APPENDIX A

This Appendix describes the way in which the NYSE Group structure and the NYSE Rules comply with the principles and the proposed rules of Regulation SRO:

- *Structural Separation of Regulation.* Regulation SRO provides that an exchange's regulatory program should be either structurally separated from the exchange's market operations and other commercial interests by means of separate legal entities, or functionally separated within the same legal entity from the exchange's market operations and other commercial interests. As set forth in the rule filing recently approved by the SEC in connection with our merger, NYSE Group plans to implement the alternative of full legal separation, with its regulatory operations to be conducted in NYSE Regulation and its market operations to be conducted by NYSE Market and NYSE Arca. NYSE Regulation is a separate not-for-profit entity within the overall NYSE Group structure. In addition, NYSE Regulation will have a separate board of directors, and each member of NYSE Regulation board of directors (other than the Chief Executive Officer of NYSE Regulation) must satisfy requirements for independence from management, listed companies and member organizations. A majority of the NYSE Regulation directors will also have to be persons who are not directors of NYSE Group or any other affiliate. Moreover, the NYSE's code of business conduct and ethics and culture of confidentiality will ensure the appropriate relationship between regulatory and market activities. The personnel of NYSE Regulation will also be prohibited from owning stock of NYSE Group. This corporate and governance structure will help ensure the independence of NYSE Regulation and its compliance with its regulatory responsibilities under the Exchange Act.
- *Chief Regulatory Officer.* Regulation SRO provides that the board of a securities exchange should appoint a Chief Regulatory Officer to administer the regulatory program of the exchange, and that the Chief Regulatory Officer should report directly to the proposed independent Regulatory Oversight Committee. The Chief Executive Officer of NYSE Regulation acts in the capacity of Chief Regulatory Officer of NYSE Group and its subsidiaries, and reports solely to the NYSE Regulation board of directors, which succeeds to the responsibilities of the NYSE's Regulatory Oversight Committee. In addition, the Chief Executive Officer of NYSE Regulation may not be an officer or employee of any unit of NYSE Group other than NYSE Regulation. The NYSE notes that it implemented this "direct line" reporting two years ago, when it was determined that the Chief Regulatory Officer would report directly to the Regulatory Oversight Committee of the Board of Directors of the NYSE. The NYSE respectfully submits that this governance structure has worked well to assure the autonomy of the chief regulatory officer and insulate NYSE Regulation from any competing interests of the NYSE.
- *Use of Proceeds from Regulatory Operations.* NYSE Regulation will determine, assess, collect and retain for regulatory purposes regulatory fees and fines. A large portion of NYSE Regulation's revenues will be derived from fees paid by member

organizations as a percentage of their gross revenues. NYSE Regulation does not anticipate any significant changes to these fees. New York Stock Exchange LLC, NYSE Market and NYSE Arca will also make contractual payments to NYSE Regulation in return for the regulatory services that NYSE Regulation provides to them. Moreover, NYSE Regulation will collect regulatory fines from persons who violate its rules and regulations. Regulation SRO provides that a securities exchange must direct monies collected from regulatory fees, fines or penalties exclusively to fund the regulatory operations and other programs of the exchange related to its regulatory responsibilities. The operating agreement of New York Stock Exchange LLC prohibits New York Stock Exchange LLC from using any assets of, or any regulatory fees, fines or penalties collected by, NYSE Regulation for commercial purposes or distributing such assets, fees, fines or penalties to NYSE Group or any affiliate other than NYSE Regulation.

- *Treatment of Regulatory Information.* Regulation SRO provides that exchanges must establish policies and procedures to prevent the dissemination of regulatory information to people who are not directly involved in carrying out the exchange's regulatory functions, in order to prevent the use of such information by those not directly involved in the exchange's regulatory function and to safeguard confidential regulatory information. The NYSE Group Certificate of Incorporation provides that, to the fullest extent permitted by applicable law, all confidential information pertaining to the self-regulatory function of New York Stock Exchange LLC contained in the books and records of any of the regulated subsidiaries that shall come into the possession of NYSE Group shall not be made available to any persons other than to those officers, directors, employees and agents of NYSE Group who have a reasonable need to know the contents thereof and shall be retained in confidence by NYSE Group and its officers, directors, employees and agents; and not be used for any commercial purposes. We note, however, that this does not prohibit NYSE Market from communicating information pertaining to the self-regulatory functions to NYSE Regulation for the purpose of ensuring compliance with rules and regulations of NYSE Regulation.

The NYSE has implemented several additional structural and governance changes to ensure its independence from issuers and market participants. For example, the NYSE Group certificate of incorporation contains ownership and voting limitations to prevent any stockholder or group of related stockholders from having undue control over NYSE Group (and therefore the SROs owned by NYSE Group). The NYSE Group certificate of incorporation also contains provisions that require:

- NYSE Group to give due regard to the preservation of the independence of the self-regulatory function of its SROs and to obligations to investors and the general public;
- NYSE Group not to take any action that would interfere with the effectuation of any decisions by the board of directors of its SROs relating to their regulatory functions

(including disciplinary matters) or that would interfere with the ability of its SROs to carry out their respective responsibilities under the Exchange Act;

- NYSE Group, its directors and officers, and those of its employees whose principal place of business and residence is outside of the United States, to submit irrevocably to the jurisdiction of the U.S. federal courts and the SEC for the purposes of any suit, action or proceeding pursuant to the U.S. federal securities laws, and the rules and regulations thereunder, commenced or initiated by the SEC arising out of, or relating to, the activities of its SROs; and
- The directors, officers and employees of NYSE Group, in discharging their responsibilities in such capacity, to cooperate with the SEC and NYSE Group's SROs pursuant to their regulatory authority.