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ENSURING INDEPENDENCE, PROMOTING INVESTOR CONFIDENCE:
Governance of the New York Stock Exchange as a Quasi-Public Entity

* As a matter of full disclosure, Professor Coffee has served as a member of the Legal Advisory Committee to the New York Stock Exchange and continues as an Emeritus member. He has also been a member of the Legal Advisory Board to the National Association of Securities Dealers ("NASD") and is a current member of the Economic Advisory Board to Nasdaq. All are unpaid positions with respect to which no compensation was received by him in any form. Professor Coffee has also been retained from time to time as an expert witness by the New York Stock Exchange's Enforcement Division in connection with its disciplinary proceedings and is currently serving in such a capacity in one outstanding case.

Introduction

Reasonable people may disagree about whether the New York Stock Exchange ("NYSE") has experienced a major scandal or only an excruciating embarrassment. Still, from a public policy perspective, that is not the issue. Rather, the critical issue is whether the conflicts of interest that have been vividly exposed compromise the NYSE's ability to perform its role as a principal regulator of the world's deepest and preeminent equity securities market. Here, the most disturbing recent revelation has not been the extravagance with which Mr. Grasso and other senior staff were compensated, but rather that securities industries officials dominated the compensation committee that set their compensation levels. To the extent that there is any possibility that the securities industry can use its de facto ability to determine the compensation or tenure of senior NYSE officials, the industry potentially acquires both a carrot and a stick by which to reward or punish the behavior and attitudes of those officials. The result is to unacceptably compromise the independence of the NYSE as a regulatory institution.

To state this assessment is not to claim (and I do not claim) that any specific enforcement or related regulatory decision made by the NYSE was in fact so compromised, or even affected, by the prospect of greater or lesser compensation. I know of no such evidence; nor do I have reason to doubt the integrity of any NYSE official. Still, the public has read a recent page one story in The Wall Street Journal describing how Richard Grasso, as the chief executive of the NYSE, badgered the NYSE specialist who handled the market in AIG's stock, in response to complaints made to Mr. Grasso by the CEO of AIG, which executive had served as a member of the NYSE board compensation committee that determined Mr. Grasso's compensation.[1] If the public perceives that the NYSE's chief executive intervenes in matters as pedestrian as the performance of a specialist at the behest of an industry director, it will also likely believe that he might signal--directly or implicitly--to NYSE enforcement officials that a specific case should not be pursued or that a line of inquiry should receive a lower priority. Again, one need not conclude that interventions on this basis actually occurred to recognize that the current governance structure of the NYSE is flawed, because a regulator, like Caesar's proverbial wife, must remain above suspicion. Hence, reforms are necessary to insulate and protect the regulatory functions of the NYSE.

Before analyzing possible reforms, however, a rival perspective must be noted. It argues that self-regulatory organizations ("SROs") are hopelessly compromised and should be simply abandoned.[2] Instead, all regulatory power should be placed, these critics would argue, in the hands of a governmental body (presumably, the SEC). A long debate has continued for decades over this issue,[3] and no consensus has emerged. Still, it should be noted that proponents of self-regulation can claim that it has several virtues:

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[1] See Kate Kelly and Susanne Craig, "At Behest of AIG Chief, Grasso Pushed NYSE Firm to Buy Stock," The Wall Street Journal, October 3, 2003 at A1.

[2] For perhaps the sharpest critique of self-regulatory organizations, see Subcommittee on SEC, Senate Committee on Banking, Housing, and Urban Affairs, SECURITIES INDUSTRY STUDY, S. Document No. 13, 93rd Cong., 1st Sess. (1993) at 145; see also Dale Osterle, Comments on the SEC's Market 2000 Report, 19 Iowa J. Corp. L. 483 (1994)

[3] For some of the standard "public choice" critiques, see Susan M. Phillips and J. Richard Zecher, THE SEC AND THE PUBLIC INTEREST (1981); Paul G. Mahoney, The Exchange As Regulator, 83 Va. L. Rev. 1453 (1997) (favoring self-regulation); Adam C. Pritchard, Markets As Monitors: A Proposal to Replace Class Actions With Exchanges as Securities Fraud Enforcers, 85 Va. L. Rev. 925 (1999) (arguing that exchanges have good incentives to combat fraud).

> (1) Self-regulation is funded by the industry, not the public. The industry in effect taxes itself to pay the budget of the NYSE. This both spares the federal government direct expenditures that it would pay if the SEC fully assumed these enforcement obligations, and it ensures that SRO enforcement will not be dependent on Congressional appropriations (which were at points during the 1990s, sufficiently choked off that the SEC's ability to enforce the law was impaired);
> (2) SROs, including in particular the NYSE, have a proximity to the market that the SEC lacks. Some violations can be handled far more quickly and expeditiously by the market itself than by referral to a government enforcer; and
> (3) SROs have broad authority to enforce ethical as well as legal standards, in particular by adopting rules that affirmatively "promote just and equitable principles of trade" and require compliance with standards of commercial honor.[4] In contrast, the SEC basically is authorized to combat fraud and require full disclosure. Nor is it likely that broader authority to enforce softer "just and equitable" principles would be given to a governmental agency.

To summarize, a key point here is that important synergies may arguably be realized by maintaining a regulatory function within the market center, rather than simply appointing a governmental body to monitor the market center. This point is undoubtably debatable, but I would caution against throwing out "the baby with the bath" by transferring all regulatory responsibilities away from the NYSE.

But if self-regulation is to work, it must be protected and insulated. How is this best achieved? Much depends on the future market structure of the NYSE. The following proposals recognize that if the NYSE fundamentally changes its character (by, for example, becoming an electronic dealer market), the optimal location and identity of its regulatory functions might also change. Nonetheless, I will begin with the world as it exists today.

II Specific Proposals

For self-regulation to work, it is necessary not only that an independence enforcement

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[4] This point was well made by Justice Stewart in his dissent in Silver v. New York Stock Exchange, 373 U.S. 341, 371 (1993).

arm be able to evaluate and prosecute cases without interference, but that the regulatory functions of the NYSE receive adequate funding. The social cost of Mr. Grasso's extravagant compensation may be measured at least in part by the funds that were diverted away from enforcement or investment in a greater monitoring and market surveillance capacity. The following proposals respond to this need:

A. Proposal One: Transfer the Enforcement Functions of the NYSE to a Wholly-Owned Subsidiary of the NYSE Which Would Have An Entirely Independent (i.e. Non-industry) Board of Directors. This is, of course, the basic strategy that the SEC followed when it reorganized the NASD in the late 1990s. Following a different scandal and at the recommendation of a committee chaired by then Senator Warren Rudman, the regulatory and market operations of the NASD were split, and a special subsidiary--NASD Regulation, Inc ("NASDR")--was created.[5] This organizational reform was a response to "criticism that the NASD had allowed its competitive role in marketing Nasdaq to outweigh its regulatory responsibilities."[6] The instant proposal would be structurally different in one respect: Instead of the NASD owning two subsidiaries (Nasdaq and NASDR), thereby dividing its markets and regulatory operations, the NYSE would own a single subsidiary--let's call it, NYSE Regulation, Inc. (or "Reg. Inc."). For Reg. Inc. to be credibly independent of the NYSE, two criteria would have to be satisfied: (1)

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[5] See Deborah Solomon, "SEC Is Looking to the 'Nasdaq Model,'" The Wall Street Journal, October 14, 2003 at p. C-11.

[6] See Jerry Markham, A Comparative Analysis of Consolidated and Functional Regulation: Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan, 28 Brooklyn J. Int'l L. 319, 330 (2003); see also, In the Matter of National Association of Securities Dealers, Inc., Sec. Exec Act Rel. No. 34-38, 542 (August 8, 1994)

Reg. Inc. would have to have its own board, each of whose members were independent of the securities industry and (at least ideally) were not members of the NYSE board; and (2) Reg. Inc. would be entitled to call upon the NYSE for an adequate budget. This latter criterion of financial independence could be satisfied either (i) by a long-term contract that guaranteed an adequate budget to Reg. Inc., which Reg. Inc's own board would set (within some outer limits), or (ii) by bylaw and charter provisions adopted by the NYSE under which it would agree to fund any budget requested by Reg. Inc., unless the SEC determined the Reg. Inc. budget request to be excessive.

An advantage of this wholly owned subsidiary approach is that it involves the least wrenching changes and organizational dislocation. The NYSE's enforcement staff would simply be transferred to this subsidiary but would experience no real changes in their work routine or internal organizational structure. To the extent that this staff had good working relationships with the NYSE's staff, they should not be disrupted. Quite literally, no NYSE staff official would be required to move an office or report to different personnel--but the NYSE's regulatory arm would become more independent without becoming more distant or organizationally remote.

In contrast to this proposal, the NYSE's new CEO, John Reed, has recommended (at least as an initial measure) a far milder remedy. Under his proposal, the NYSE would simply establish a new board committee that would oversee all regulatory matters at the NYSE, which committee would be staffed only by non-industry directors.[7] In my judgment, this is inadequate. It overlooks, first, that the head of NYSE enforcement reports on a daily basis to the NYSE's CEO,

[7] See Landon Thomas, Jr., "Stock Exchange Chief Backs Smaller Board," New York Times, October 15, 2003 at C-2.

who would in turn be responsible to a board significantly populated by industry members, and, second, that there must be a mechanism to assure enforcement for an adequate budget.

B. Alternative B: Transfer the Regulatory Functions and Enforcement Personnel of the NYSE to NASDR and Require the NYSE to Enter Into a Long-term Contract With NASDR for Enforcement Services. This is the far more radical alternative, and it would far greater dislocation and organizational trauma. NASDR already serves as the regulator by contractual arrangement for some smaller exchanges, and there might be some economies of scale if it grew to cover the NYSE as well. The case for this more sweeping remedy is that NASDR would be incontestably independent of the NYSE and that NASDR is perceived by many to be the more proactive and aggressive regulator. The case against this proposal is both that the tradition of competition and suspicion between the NYSE and Nasdaq might cause NYSE market officials to cooperate only more warily with NASDR and that any synergies associated with the close connection between the NYSE and its existing enforcement staff might be lost.

As a practical matter, there seems little or no possibility that the NYSE would adopt such a reform, except under intense compulsion by the SEC. Nonetheless, if the structure of the NYSE were to be radically changed (and, in particular, if it were to become a dealer market operating in greater competition with ECNs and other markets), this might be the more logical structure because the NASDR would grow over time into the “self-regulator” for all these markets. Also, NASDR already has experience in overseeing a dealer market (which NYSE does not). Still, it is questionable whether an industry structure under which the NASDR served as the regulator for most exchanges really amounted to self-regulation. Instead, NASDR might become simply a duplicate “second SEC.”

C. Reforming the NYSE Board: The Case for a Super Majority of Non-Industry Directors. Insulating the NYSE's regulatory arm is not a complete remedy. If the NYSE's CEO were still subject to the carrot-and-stick threat (or inducement) of reduced (or increased) compensation set in part by the industry, such a CEO could still find ways to influence regulatory or other activities to promote the industry's, rather than the public's, interest. The NYSE has already proposed that all members of its board's compensation committee come from outside the securities industry. This is an important start, but it still leaves the NYSE CEO subject to a threat that he might be fired (or not re-appointed) by a coalition of directors led by industry members dissatisfied with a particular CEO's excessively "activist" posture.

The concept of an independent majority or supermajority requires, however, that we focus on who is truly independent. The NYSE regulates not only broker-dealers and specialists, but also listed companies. Thus, any realistic definition of independence must exclude officers and directors of listed companies as well. In this light, the majority of directors should come from representatives of investors--or, more precisely, the "buy side." This would include institutional investors, pension funds, and individual investor organizations. I will not attempt to prescribe how great a supermajority of the NYSE board should be independent of the securities industry and listed companies, but I do not believe that there is any need for their total exclusion. Rather, to the extent that the NYSE's regulatory arm is insulated in a separate subsidiary with its own independent board, it seems excessive to require that both boards be entirely independent.

D. Separate the Positions of CEO and Chairman of the Board. This reform has been called for by many. It is certainly desirable, but it is probably the least critical of the foregoing reforms. The case for it increases to the extent that the NYSE's regulatory arm is not placed in a separate subsidiary with its own independent board. I should note that in recommending this reform I am not necessarily endorsing it for all public companies. The unique fact about the NYSE is that it is both a market center, subject to strong competitive pressures, and a regulator. This enhances the case for a non-executive chairman whose first priority would be the NYSE's public role.

CONCLUSION

A final comment seems appropriate. Securities exchanges in the United States have only been reformed in the wake of major scandals. The NASD is the product of the Maloney Act passed in 1938 in response to NYSE President Richard Whitney's conviction for embezzlement. The Amex was reformed following scandals in the 1960s; and Nasdaq, following the "missing odd eighth" scandal in 1996. In this light, it is now or never. Reforms never come during a bull market.