Testimony of NYSE Interim Chairman and CEO John Reed

"Improving the Corporate Governance of the New York Stock Exchange"

Before the U.S. Senate Committee on Banking, Housing and Urban Affairs

November 20, 2003

Chairman Shelby, Ranking Member Sarbanes and Members of the Committee:

My name is John Reed. Thank you for inviting me to testify today concerning corporate governance at the New York Stock Exchange. I assumed the role of Interim Chairman and CEO for a very focused but challenging task: to reform the Exchange's governance and leave behind a board and a leadership in which the public can place its trust.

In my testimony today, I will first outline some recent developments in the Exchange's modernization of its governance and its election of its new board. Second, I will talk about the critical issue of self-regulation—both why broker-dealer self-regulation through the NYSE remains the best answer for the U.S. capital markets and how our new governance architecture better addresses the conflicts inherent in self-regulation. Third, I will provide some more details concerning the autonomy of our regulatory function. Last, I will outline our essential next steps.

Collectively, we face many challenges. This Committee and the Securities and Exchange Commission are now dealing with several key issues that will shape the securities industry for a generation. The securities industry itself—from the corporate suite to the mailroom—must again embrace the principle that putting investors first is the only way to do business. Standing astride the industry's epicenter, the Exchange must lead this renewal to ensure that the industry regains the trust and confidence of its customers, the SEC and this Committee.

Recent Developments

The day before yesterday, the membership of the Exchange overwhelmingly approved my proposal to create a governance architecture that empowers a small, outside board of directors to lead this renewal. Subject to approval by the SEC, for the first time in its 211-year history, the Exchange's board will be independent both from the Exchange's management and from the Exchange's members and listed companies. The membership also voted to populate our independent board with eight seasoned and talented leaders:

- Madeleine K. Albright – former Secretary of State
- Herbert M. Allison, Jr. – Chairman & CEO of TIAA-CREF
- Euan D. Baird – Chairman of Rolls-Royce and former head of Schlumberger
- Marshall N. Carter – former Chief Executive of State Street Corporation
- Shirley Ann Jackson – President of Rensselaer Polytechnic Institute
- James S. McDonald – CEO of Rockefeller & Company
- Robert B. Shapiro – former head of Monsanto
- Sir Dennis Weatherstone – former Chairman of J.P. Morgan

If the SEC approves our new structure, these individuals will serve until June 2004. Thereafter, the entire board will stand for election in June of each year.

As you know, I accepted this challenge in the wake of disclosure that the Exchange's board had failed in how it set its executives' compensation, and then failed again in how it met the crisis that resulted from that disclosure. It has since become evident that the board also failed to foster a regulatory system that anticipated and mitigated the regulatory risks arising from the vast changes in our industry over the last decade. These failures all point to a board too large and too conflicted to effectively govern the Exchange.

The NYSE's 31-year-old corporate governance structure had quite simply not kept pace with either best practices in corporate governance or the tremendous changes in the nature of our constituents. Specifically, the Exchange's governance had to be revamped to manage conflicts of interest and to increase transparency. To meet the special challenge of serving as both a marketplace and the vehicle by which our members regulate themselves, the Exchange's governance also needed to meet and, indeed, surpass the independence standards to which our listed companies adhere. The changes that our membership approved this week create the framework to accomplish these goals.

From the outset, it was clear to me that the NYSE needed a competent, engaged board free of conflicts and parochial agendas and dedicated to the NYSE's long-term interests. It was also clear that the NYSE would not recover its voice and legitimacy as a leader of the U.S. capital market until the public saw it as an example of good governance and capable of properly managing its own affairs. An "insider board" was not acceptable—not in general and certainly not as the supervisor of our regulatory function.

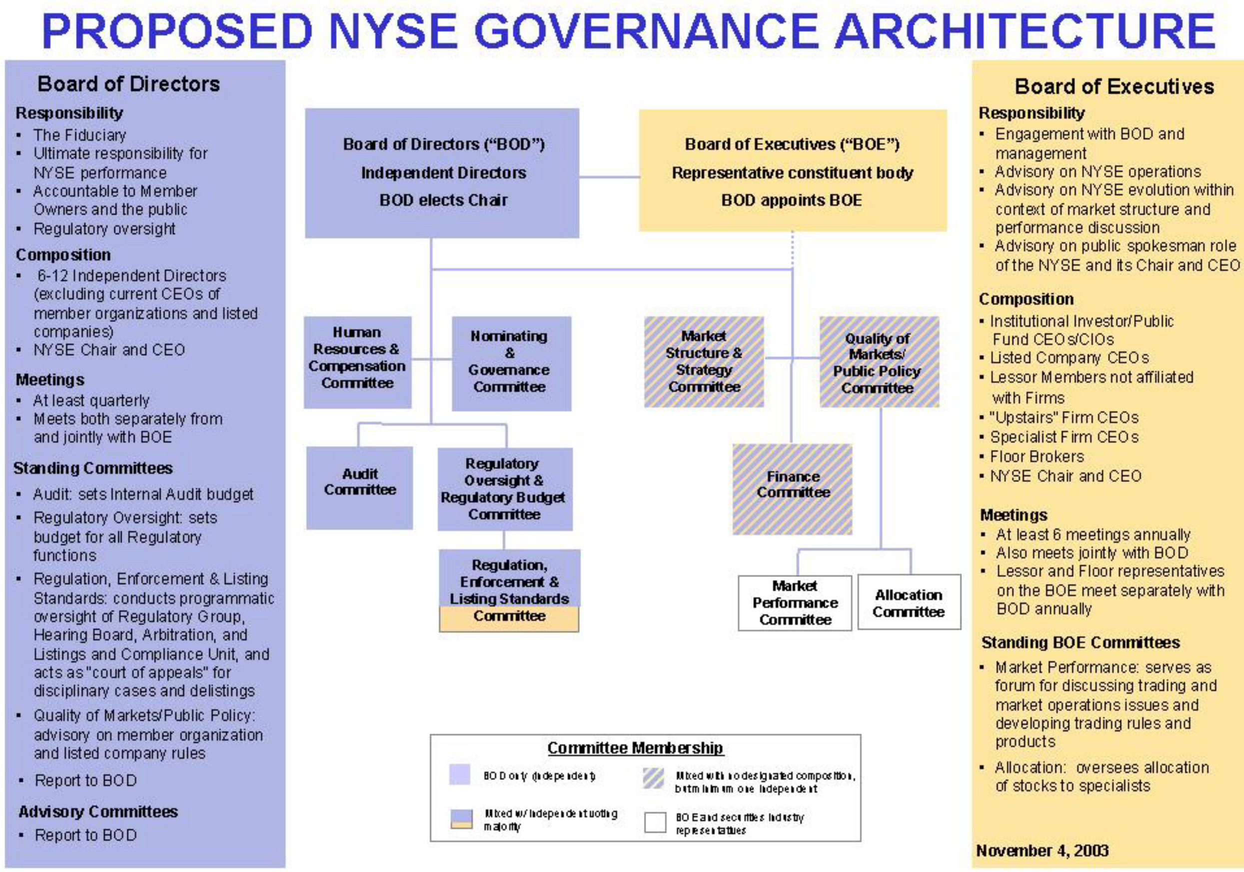
The membership vote changed the Exchange's Constitution to achieve three important objectives:

1) Place responsibility for governance, compensation and internal controls, as well as for supervision of regulation, in the hands of a board of directors that is independent both from NYSE management and from our members, member organizations and listed companies.

2) Separately preserve the existing engagement of the broker-dealer community and listed company community with the NYSE by creating a board of executives that will also include the executives of major public and private "buy side" entities as well as lessor members of the NYSE.

3) Make transparent our governance process, its participants, their compensation, and our charitable donations and political contributions.

The following diagram depicts the architecture we designed to achieve these objectives.



The proxy statement and supplemental letter that was sent to our membership earlier this month describe the changes in detail. Copies are available at this hearing.

Self-Regulation

Now I want to address an important issue that represents our industry's best chance for regaining the trust and confidence of investors: the reinvigoration of self-regulation. As you know, broker-dealer self-regulation is at the core of our nation's securities law as, indeed, it has been at the core of the NYSE since merchants first gathered on Wall Street 211 years ago to trade Revolutionary War bonds. Yet, the governance failures at the Exchange have laid bare the conflicts inherent in self-regulation. Critics have seized upon these failures to argue that the NYSE's regulatory arm should be severed from the Exchange. In essence, they are calling for the end of self-regulation. I strongly disagree with that view.

Self-regulation recognizes that shared settlement and reputational risk creates an interest in each member of the Exchange to assure the financial responsibility and fair dealings of every other member. Properly channeled through an independent, professional Exchange staff, self-regulation represents the best chance of devising optimal regulatory solutions that minimize interference with delicate market mechanisms.

Since 1934, when Congress created the Securities and Exchange Commission, self-regulation has been wedded to government oversight. Since 1938, when the Exchange appointed its first full-time president, self-regulation has been effected through a professional staff. Since 1972, when the Exchange created a board that included, as one-half of its members, men and women from outside the securities industry, self-regulation has been enriched by the participation of customers of the industry.

As the securities industry evolved, so has self-regulation. In 1934, in 1938 and in 1972 when the self-regulatory model of the previous generation reached its limits, the answer to restoring investor confidence in the marketplace was to strengthen and modernize self-regulation, not to end it. I believe 2003 is no different.

At this latest point of inflection in the evolution of self-regulation, the Exchange must bring the independence that has characterized our professional staff to the board level. Yet, to be effective, our regulatory function must remain pervasively engaged with our customers, our member organizations and our other users. Our membership has now approved the architecture necessary to accomplish both charges. If the SEC concurs, our challenge will be to implement our new architecture to reinvigorate self-regulation by better addressing its inherent conflicts while maintaining the advantages I've just discussed.

In response to a question from Senator Shelby regarding the self-regulatory structure of the NYSE, Chairman Donaldson recently reminded this Committee that in the 1930s, the Commission wisely co-opted the Exchange's existing self-regulation mechanism so there would not be a huge, clumsy government bureaucracy. He recognized that today's key issues are (1) how the self-regulatory function is financed and (2) to whom the self-regulatory function reports.

Our new architecture addresses both of these issues. The NYSE Regulatory Group will now have its budget set by, and will report to, a board that consists of directors who are independent of both the securities industry and the companies listed on the Exchange. The board will appoint a Chief Regulatory Officer (CRO) who will report directly to the board, and no longer to the CEO. And to better enable the SEC, the investing public, and Congress to ensure that we adhere to our public purpose, the Exchange's governance is now transparent. Accountability is enabled.

Regulatory Autonomy with Market Sensitivity

Now let me take some time to detail how our plan insulates our regulatory function from our marketplace. As noted, our outside, independent directors will be responsible for regulatory oversight and regulatory budgeting. More specifically, our new regulatory oversight committee will:

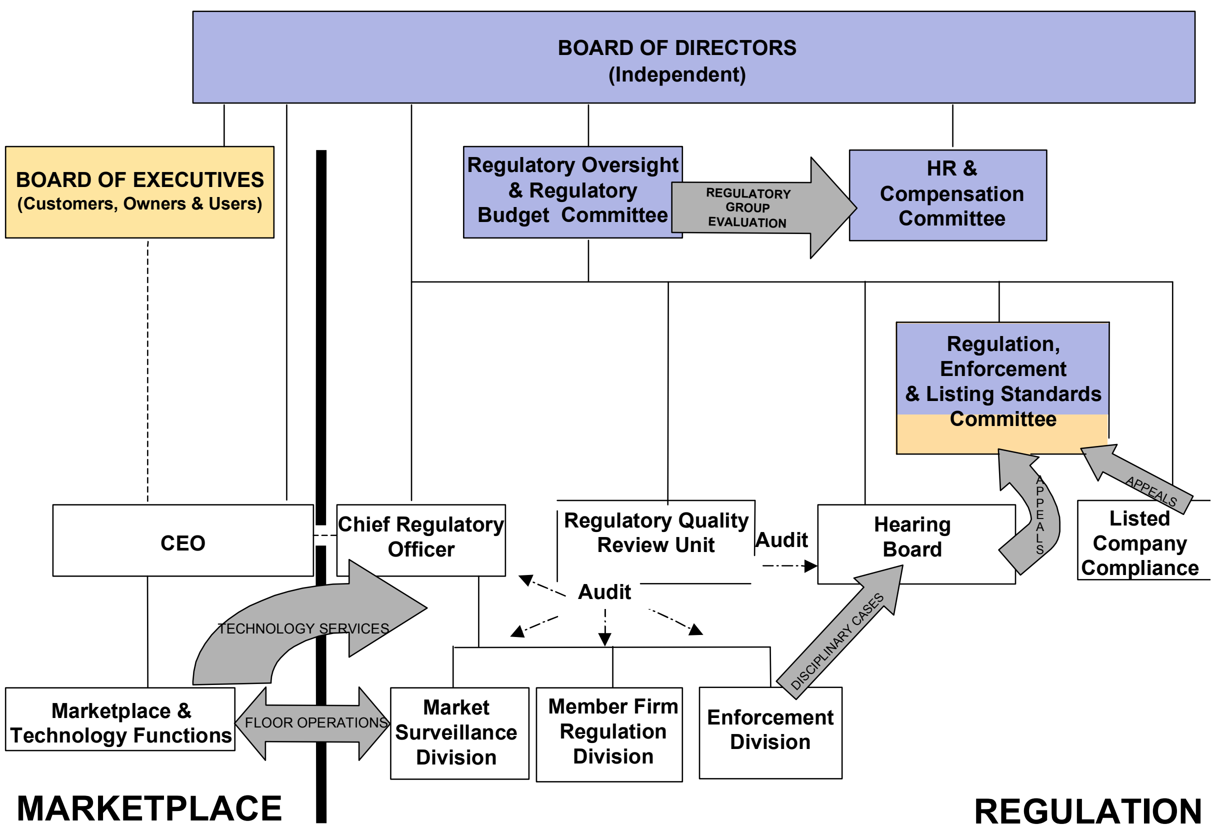
(1) Assure the effectiveness, vigor and professionalism of our regulatory program.

(2) Determine the budget, staffing and technological resources for the various regulatory units of the Exchange.

(3) Assess the Exchange's regulatory performance and recommend compensation and personnel actions involving senior regulatory personnel directly to the Human Resources and Compensation Committee for action.

This means that our independent board, through its regulatory oversight committee, will decide how to allocate resources to ensure that our regulation function is adequately funded and staffed.

PROPOSED NYSE REGULATORY ARCHITECTURE



As the diagram depicting the regulatory architecture indicates, while the regulatory function remains close to the marketplace, only the independent directors bridge the substantive division between the marketplace and the regulatory function. In particular, the CEO, while a vital partner to the CRO, does not supervise the CRO.

Next Steps

So what's next? First and foremost, we await SEC action on these governance changes. I want to note that the SEC staff gave us enormous help by critiquing our proposal before we sent it to our membership for a vote. In addition, we are grateful for the extraordinarily quick path to publication in the Federal Register that the SEC staff provided in order to start the three-week comment period.

We believe that the SEC can find our architecture to be consistent with the Securities Exchange Act—the statutory standard that governs its review. The new architecture empowers a board of directors with the independence to address issues objectively and the constituent input to address them intelligently. Directors who have the degree of independence and experience that our governance architecture promises—as evidenced by the quality of our new board—will assure that the Exchange's regulatory function is both independent and robust. Thus, we believe our architecture guarantees the independence of our regulatory function both from members and member organizations and from inappropriate linkage with our marketplace, while assuring the function's sensitivity to the market.

Nevertheless, we note that we are not asking the SEC to approve either the continuation of self-regulation through the NYSE or in the United States generally. That issue should be addressed in the context of how well the new board implements both the architecture and the necessary programmatic changes to our regulatory function.

Thus, while the Exchange does seek the SEC's approval of what we regard as a greatly improved architecture for self-regulation, it does not seek the SEC's determination of the future of self-regulation at this time. All the Exchange seeks at this time is the SEC's approval of a transitional structure that allows it to move from the current situation to one in which a board of independent, distinguished and experienced men and women can take on the formidable challenges facing the Exchange. We are hopeful that the SEC will see the wisdom of our proposal, review it expeditiously and approve it in short order.

Second, the new board will hold its organizational meeting next week. Among its first tasks will be to identify the appropriate person or persons to replace me as Chairman and CEO, and to identify a person to assume the responsibilities of Chief Regulatory Officer. Thus, upon the SEC's action, we will have a new board and permanent management in place, that can then begin to demonstrate that the new governance structure works and thereby begin to restore investor confidence in the institution of the NYSE. This new leadership, the board of directors and the board of executives, will also be in a position to openly and collectively address issues of market performance, access and market structure that—in addition to self-regulation—are important to the continual modernization of our capital markets.

To conclude, I want to assure you that we understand the damage done to investor confidence as a result of the Exchange's governance failures. We believe that we are on the right path to creating and implementing a governance process that will reduce and manage the conflicts of interests inherent in self-regulation, and provide greater transparency to ensure accountability. And we will not lose sight of the critical business of the NYSE—the business of operating the world's deepest and fairest equity market for the benefit of investors and listed companies.

Again, thank you for the opportunity to appear before you today. I'd be happy to answer your questions.