

SR-NYSE-2003-34

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NYSE

December 12, 2003

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NY
Washington, DC 20549



Re: File No. SR-NYSE-2003-34

Dear Mr. Katz:

The New York Stock Exchange, Inc. (the "Exchange") has received from your colleagues copies of the comments received by the Securities and Exchange Commission (the "Commission") in connection with the proposed rule change filed by the Exchange on November 7, 2003. I appreciate the interest of the various commentators and their effort to share their views with you. As the Commission Staff requested, what follows is the Exchange's response to their comments.

I. Scope and Purpose of Proposed Rule Change.

The proposed rule change is intended to solve an immediate board-level governance problem faced by the Exchange. This rule change is necessary to eliminate conflicts of interest at the board level and to allow the Exchange to continue to function effectively as a marketplace, but it is not intended to address all the structural issues that the Exchange, and indeed our industry, now face.

I strongly believe our new proposed governance architecture is a vast improvement over the architecture that created the failure in compensation administration at the Exchange and in the Exchange's oversight of the specialists' discharge of their negative obligation. I am confident that our smaller, unconflicted Board of Directors ("BOD") will be well-suited to oversee the Exchange's response to specific issues such as the specialist investigation, and to guide the Exchange in the market structure discussions which the Commission will lead over the coming months.

II. Composition of the New Board of Directors and the Board of Executives.

Several commentators have expressed the view that the BOD should include one or more individuals intended to represent the interest of the public investor. I disagree. To understand, allow me to review the objectives of the new governance architecture:

- 1) Place responsibility for governance, Compensation and internal controls, as well as for supervision of regulation, in the hands of a BOD that is independent both from Exchange management and from the 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 (“BOE”) that **will** provide a balanced group of representatives not only of the broker-dealer and listed company communities but **also** of major public and private “buy-side” entities **and** individual investors, **as well as** lessor members of the Exchange.

In my view, the single most important feature of the proposed rule change is that, with the exception of the CEO, the BOD is completely independent. As the Exchange’s fiduciaries, our directors will not have the agenda of a customer, an owner or a user, and **will** not represent any single constituent group. For this reason, I believe it would be inappropriate to seek to specifically include BOD members that are representative of the buy-side or of any other particular constituent group.

The Exchange recognizes that individual investors are our ultimate constituency, and that institutional investors, listed companies, broker-dealers and the Exchange itself are all intermediaries and, as such, have interests that can conflict with the individual investors/shareholders to **whom** they **all** owe obligations of trust. But individual investors trading on the Exchange through broker-dealers in small volumes have interests that conflict with other individual investors who participate in the market through public or private funds trading in larger volumes. Issues like the trade-through rule point up these conflicts. The Exchange’s hard-won lesson is that the only way to sort out these issues without bias or conflicts is through an independent board whose primary **goal** is to “do the right thing” for the individual investor **as** such.

The director nominees for which our members voted were selected for their intelligence and analytic skills, for their independence of thought, and for their extensive experience leading, **and** serving on the boards of, complex companies and institutions. Each of them has indicated his/her availability for and commitment to the task, understanding well the significant time requirements entailed by the several important issues currently confronting the Exchange, the smaller board size and **the resulting** need for directors to serve on multiple committees and in liaison roles **with our** constituents. My organizational meetings **with** them indicate that they are energized by the complex issues facing the Exchange **and** committed to their resolution in a way that serves the interest of investors.

Some of the commentators also believe **that** there should be individual investor representation on **the** BOE. We came to the same conclusion based on input from **our** Individual Investor Advisory Committee, and have announced that the Exchange intends to modify its Constitution to add that category specifically to the BOE. Article V, Section **2** of the revised Constitution states that the BOE “shall provide a reasonably balanced representation of the many communities that come together in the Exchange: listed companies, investors, members and member organizations, and lessor members.” But Article V **also** contemplates that the membership of the BOE *can* be adjusted **to** fine tune

its representative structure, and the Constitution in fact contemplates that governance provisions such as Article V can be amended by vote of the BOD alone, without the necessity for a membership vote. We are taking advantage of that flexibility in adding the individual investor representative, and that same flexibility will allow the Exchange to make further changes as circumstances may warrant.

III. Regulation.

Several commentators have stated the view that the regulatory and business functions of the Exchange should be placed in separate organizations. In contrast, one commentator, while strongly supporting self-regulation, expressed a concern that a lack of member participation on the BOD could actually hinder effective self-regulation.

As stated in the Exchange's November 7, 2003 filing, the proposed rule change does not ask the Commission to approve either the continuation of self-regulation in the United States or at the Exchange. Whether self-regulation should continue to be a lynchpin of the securities industry, and if so, how it should be structured, are complex issues on which there are divergent views requiring careful analysis. I understand that the Commission intends to address this and other market structure issues in the coming months. The Exchange looks forward to actively participating in this process, and I believe that our fully independent BOD, advised by the constituent BOE, will make a valuable contribution in assisting the Commission in carrying out this task.

If the Commission decides that broker-dealers should continue to regulate themselves through national securities exchanges, I believe that the Exchange's new governance architecture provides the best model for resolving and managing the conflicts of interest inherent in self-regulation while maintaining the marketplace proximity requisite for optimizing regulatory intervention in delicate market mechanisms. We have described in the purpose section of our filing, in my November 20, 2003 testimony before the Senate Banking Committee, and in my subsequent letters to Chairman Donaldson (November 25, 2003) and former Amex President Ralph Saul (December 9, 2003; testimony and letters enclosed for your convenience) how we expect to implement our model through an independent BOD and through our division of regulatory and marketplace functions within the Exchange, including by having a Chief Regulatory Officer reporting directly to the BOD. While our success or failure in implementing our model will inform the Commission's deliberations on whether self-regulation should continue, the Commission's approval of our model as consistent with the 1934 Act would in no sense decide the larger question.

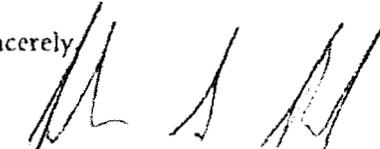
IV Conclusion

I hope this additional analysis is helpful. I have focused on the issues that appeared in multiple comment letters, without attempting to respond to every issue raised in every letter. However, I would be pleased to provide you with additional responses in respect of the other issues to the extent the Commission feels this is necessary. In general, however, my response to these other issues would be consistent with my comments above.

As explained above, the proposed rule change seeks to address a very immediate board-level governance problem. I urge the Commission to approve the proposed rule change

as soon as possible so that the Exchange can continue to function effectively as a marketplace while revitalizing its regulatory function and addressing other important issues from a much improved governance platform.

Sincerely,



John S. Reed
Interim Chairman and CEO

cc: William H. Donaldson

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 con-

ceasing 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.

ration 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

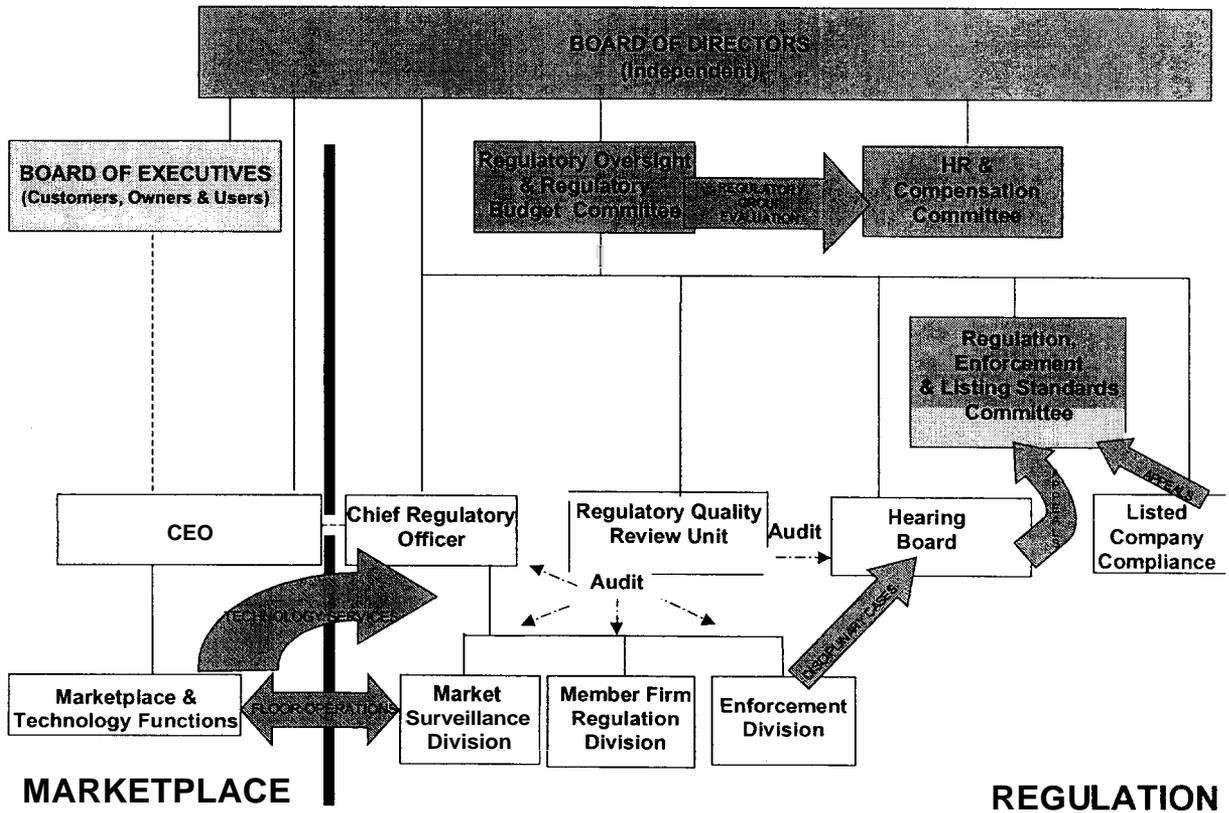
Now let me take some time to detail how our plan insulates our regulatory function from our marketplace. As noted, our outside, independent directors will be responsible for regulatory oversight and regulatory budgeting. More specifically, our new regulatory oversight committee will:

(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 re-

place 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.



November 25, 2003

The Honorable William H. Donaldson
Chairman
U.S. Securities and Exchange Commission
450 5th Street, N.W.
Washington, DC 20549

Dear Bill,

Given some of the comments in the Senate on Thursday, I thought that it would be useful to share **my** thinking as it relates to our proposal. You may want to consider this as a "comment" for the consideration of the Commission.

As you know, I was brought in to address a governance failure. I took my task to be –make **recommendations** that would fully address the historic problem and provide a robust platform for moving forward, but stop short of making decisions that would speak to the conversation about market structure **unless they could** not be avoided as part of my core mandate. (I am not managerially shy and have developed as **set** of views but have disciplined myself to stick to my mandate...to the frustration of many).

I have had a fair amount of experience with risk management and regulation and feel that the SRO model can quite properly fit within the governance structure of the NYSE. There are a number of design elements that make this so, First, a pure 'outside' "independent" Board is a core requirement (And, I would emphasize **pure** because as **you** know Boards rarely vote but reach conclusions and make judgments based on conversation and a mixed **industry/outside Board** is simply different than a fully outside Board in terms of that conversation...). Second, a special Oversight Committee of the Board with an obligation to assess the regulatory performance, to deal with regulatory issues **and** their resolution, approve an annual regulatory plan, approve both staffing and the regulatory budget – all of this surrounded by the need to publish the Committee's charter

as approved by the Board and publish an Annual Report (in the proxy) of the Committee's activities probably insures competent oversight. Third, it is also true that in the case of the NYSE, business issues are somewhat distant from the management. We host the environment (the Exchange) where members ply their trade and make their money but do not directly participate in their results. It is not that we are indifferent to the overall results...but still, there is a distance that helps the architecture. Fourth, there is no doubt but that the success of the NYSE requires a tough but fair regulatory regime that is publicly visible.

The final architectural element is that the SRO falls under "tight" SEC oversight,

Obviously, my mandate did not include any consideration of the global architectural issues. It seems to me that market regulation simply parallels the general issue of private sector regulation. What we are seeking is a robust and, effective array of capabilities and responsibilities with some targeting, self appraising and correcting features that will insure that our markets and the private sector will maintain their dynamic but within a "proper" pathway,

We start with Board and governance responsibilities as per a long history which very importantly holds Boards accountable, ending most recently with Sarbanes-Oxley. I would add (and we did for the NYSE) a clear obligation that the Chair is responsible for the Board's overall performance.

We then ask that the audit function or a 'self regulating" function be under the oversight of a Committee comprised solely of competent outside independent Directors. We further ask that the Committee assess the performance of the auditors (or the self-regulatory function) and certify that proper controls are in place (proper regulatory competence) and approve the audit plans (regulatory plans). The Committee hires the auditors (the senior regulatory officer) and is empowered to employ outside Competence...lawyers, accountants, etc. (The charter of a Regulatory Oversight Committee should also provide for this,) The Committee reviews audit findings (regulatory findings) and monitors management's response, The Committee insures that a proper channel to pick-up and respond to outside criticisms (whistle blower) is in place and functioning. (The NYSE will too.) The Committee publishes its charter and reports on its activities annually,

The SEC sits on top of all of this, with full powers.

With regard to the financial industry, which has special importance, you could imagine an alternative array...one like the FSA in England, that would combine banking, security dealers, markets and listed company regulation (The industry is certainly consolidating along these lines.) in a centralized function. There is, however, no reason to imagine that a single consolidated regulator would be any

more effective than a dispersed model unless you believe that the model is compromised by its proximity to the entity being regulated. Even then, there is some reason to imagine that it would be equally dependent on an "FSA's" interaction with internal control functions (banking supervision engages with internal audit groups and internal risk management functions) and the only true difference would be the consolidation of regulatory functions across the industry. The fact is that a regulatory function has to be tightly coupled with the operations being regulated (I have seen it in banking, in the military procurement process, when I was on the Board of United Technologies, in the medical business when I chaired the Audit Committee of Memorial Sloan Kettering for twenty years and even in interaction with the FDA when I sat on the Scientific Committee of Pharmacia) and regulatory supervision as practiced by the SEC, the FSA, the Department of Defense, the Department of Health and Human Services or the FDA comes down to close supervision and intrusive review of internal capabilities and findings.

Keeping alert and responsive is a managerial issue and cannot be solved by architecture. This is a central problem in an FSA model and also in a dispersed set up as we have today.

I hope this is of some use.

Best regards,

A handwritten signature in black ink, consisting of a large, stylized letter 'A' with a horizontal stroke at the bottom.

NYSE

December 9, 2003

Mr. Ralph S. Saul
3030 One Logan Square
PO Box 7716
Philadelphia, PA 19192

Dear Ralph:

Thank you very much for your thoughtful comments on our proposed changes to **NYSE** governance. Your views on the importance and continued relevance of securities industry self-regulation paralkl mine, and your voice is a welcome addition to the public debate.

Your concerns about the **risks** we **run** by adopting the radical reforms we have proposed are completely justified, in my view. Member participation is essential in addressing regulatory issues, and I think you are very wise to observe that participation in governance makes regulation more palatable to the member and generates **awareness** of **what** regulation is all about.

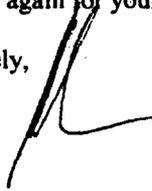
I strongly believe, however, that our regulatory function cannot achieve excellence if it is not vigorously supervised by the Exchange's **Board** of Directors. But having industry representatives serve on **the** Board of Directors creates the perception and reality of conflicts **of** interests." Managing those conflicts and their perception distances the **Board** from the regulatory function, compromising Board oversight. While industry participation on the **Board** may have been optimal in a prior time, I have concluded that it is ill suited to the **structure** of the industry today, and to the role that the NYSE is expected to play. I am convinced that it is only through a completely independent Board that the Exchange will be able to function, and **be** perceived to function, in the manner the public expects.

I **am** very aware that the key to success of our new model is active, constructive engagement between **the** independent Board of Directors and our constituent Board of Executives. I have deliberately kept our Board of Directors compact to ensure that it remains nimble, able to **meet** frequently both by itself and in conjunction with the Board of Executives, and able to interact as well with the other **committees** that **are** vital contributors to the Exchange.

Like you, I **am** **heartened** by Chairman Donaldson's public acknowledgement of the **importance** of self-regulation to **our** securities **markets**. I **am** also heartened that, **as** one **who has** experienced first hand the genius of our **self-regulatory** model, you have stepped forward to **advocate** for its preservation.

Thanks again for your thoughts and your interest.

Sincerely,



cc: William H. Donaldson

* there is no doubt but that the conflicts on the old Board are at the root of their failure as a fiduciary - most people worry about

the impact on our regulatory function the actual problem that brought me here was the reverse.