

**TESTIMONY OF CHAIRMAN WILLIAM H. DONALDSON
BEFORE THE
UNITED STATES SENATE COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
CONCERNING
IMPROVING THE GOVERNANCE OF THE NEW YORK STOCK EXCHANGE

NOVEMBER 20, 2003**

Good morning Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. I am very pleased to be here today to discuss the governance of the New York Stock Exchange. This issue is one that has received my attention from my very first days in office. I was confirmed as SEC Chairman in mid-February of this year. In March I wrote to the NYSE and other SROs asking for a thorough review of their governance, a review that has led to the changes at the NYSE under consideration today. While distinct from the issues of market structure, which the Commission is also working strenuously to address, this governance issue has been of great importance to me.

This issue has had my attention because of its importance for the markets. I have said in the past, and I say again today, that we have the world's most efficient and effective securities markets. But the success of our markets is directly dependent on the confidence that investors have in their integrity. This is particularly true with respect to the New York Stock Exchange. The NYSE has a leading role in our markets- as the largest equity market in the world; as the regulator of the nation's largest securities firms; and as the arbiter of corporate governance standards for many of the nation's largest corporations. The NYSE's leading role makes it imperative that the NYSE's own governance be above reproach.

The link between governance and the NYSE's role was recognized as far back as 1938 in the NYSE's Conway Committee Report, which said its recommended governance changes "really represent merely another step in the long evolutionary development of the Exchange as the Nation's primary securities market." It was also recognized in 1971, when the last major changes to the governance of the NYSE were shaped by a report by William McChesney Martin. Among other things, the Martin Report said the NYSE should be reorganized "to give proper recognition... of its public nature and the respective interests of the public, the companies listed on the exchange, and the members of the securities industry involved. In response to the Martin Report, the NYSE created a board balanced between securities firms and issuer, institutional investor, and public representatives. It also created a nominating committee that was independent of members and the NYSE board to select new candidates for the board. The NYSE itself became a non-profit, non-dividend paying corporation, owned by its members.

Although these 1971 changes in the governance of the NYSE were dramatic for their era, time brings new challenges, and even an institution once looked to as the model must respond to these challenges to retain its preeminence. As the Conway Committee said in 1938, "It is apparent to us that the organization of the New York Stock Exchange should be revised to accord with changing times and conditions."

The current pressing need for a review of the NYSE's governance was signaled by a series of recent events. In the Sarbanes-Oxley Act, the Congress entrusted the NYSE, as the listing market for the nation's largest companies, and other listing markets, with heightened responsibility to set standards for the governance of these listed

companies. This initiative raised the bar for the NYSE's own governance structure. In addition, the NYSE's selection of the Chairman of a financial services company that owned a large broker-dealer to serve as a public director called into the question the NYSE's board selection process, if not its dedication to the principle of a balanced board. And the reports of the compensation of the NYSE's Chairman and CEO gave further credence to concerns about the NYSE's governance process.

In March of this year, I wrote to the Chairman and CEO of the NYSE, as well as the heads of each of the other SROs, asking them to review their SRO's governance practices in light of the standards that had just been proposed for listed companies. In that letter, I expressed the view that, just as NYSE and Nasdaq were demanding that publicly-traded companies meet high governance standards in order to list on their markets, SROs must demand the same standards of themselves. I asked each SRO to undertake an exhaustive review of its governance procedures and report back to me by mid-May.

Each SRO submitted written responses that detailed its governance practices and, in my view, revealed some areas that appear to warrant improvement. Following my letter – and I hope perhaps in response to my letter – several SROs convened special governance committees whose mandates were to examine the strengths and weaknesses of that SRO's governance practices. The NYSE provided an interim report, but indicated that it was conducting a thorough review through a Special Governance Committee, which would subsequently provide the NYSE Board with a final report.

While the NYSE's review was still underway, and before issuance of its report, we learned of the NYSE's extension of the NYSE Chairman's employment agreement, as

well as its substantial payout of his accrued compensation. In response, I wrote to the head of the NYSE's Compensation Committee and Special Governance Committee asking for further information regarding the then-Chairman's compensation and the decision-making processes at the NYSE that led to his pay package. In my letter, I indicated that approval of such an extraordinary compensation package raised serious questions regarding the effectiveness of the NYSE governance structure, and asked the NYSE to provide me with detailed information regarding the then-Chairman's compensation arrangement and how it was approved by the NYSE Board.

In my view, the documents produced by the NYSE raised troubling questions about its governance. The then-Chairman's package was set by the Compensation Committee of the NYSE Board and approved by the full Board of Directors; however, the then-Chairman appears to have exercised considerable influence – both formal and informal – over the composition and operation of the Board and the Compensation Committee. In addition, it is not clear that the full NYSE Board or the Compensation Committee fully understood the intricacies of the then-Chairman's compensation arrangements, and the “ripple effects” the approval of one element had on the others. Finally, there appears to have been a lack of transparency at the NYSE regarding the operation of the Compensation Committee, and the nature and substance of its review of compensation matters. Without reaching any prejudgment about the NYSE constitutional changes, it may be that if there had been broader dissemination of information regarding executive compensation at the NYSE, the compensation would not have reached such extraordinary levels.

In light of the governance issues at the NYSE relating to the then-Chairman's compensation package, I again wrote to the heads of each of the SROs to ask for more details about the extent of public representation on their Boards and key Committees (including the Compensation Committee); the decision-making processes with respect to the nomination of directors, their assignment to Committees, and the compensation of executives; and the SROs' past practices and current plans for public disclosure of these processes and the compensation arrangements of key executives. Commission staff is in the process of assessing the responses of the SROs.

As you know, Congress and the Commission have long recognized that self-regulation has both benefits and weaknesses. The principle of self-regulation is based on the notion that regulation can best be done as close as possible to the regulated activity. As a Congressional committee said in 1938, the alternative to SRO oversight would mean "a pronounced expansion of the organization of the Securities and Exchange Commission; the multiplication of branch offices; a large increase in the expenditure of public funds; an increase in the problem of avoiding the evils of bureaucracy; and a minute, detailed, and rigid regulation of business conduct by law." SEC Chairman William O. Douglas said in 1937, "By and large, government can operate satisfactorily only by proscription. That leaves untouched large areas of conduct and activity; some of it susceptible of government regulation but in fact too minute for satisfactory control; some of it lying beyond the periphery of the law in the realm of ethics and morality. Into these areas self-government, and self-government alone, can effectively reach."

The utility of self-regulation has been reiterated many times through the years in Congressional, Commission, and industry studies. In 1975 the House Commerce

Committee said, “Perhaps expectantly, [SRO regulation] has, on occasion, been found seriously deficient and it has not operated as effectively or as fairly as the public interest would require. Nonetheless, ...the Committee found that the system, on the whole, has worked, and recommended that it be preserved and strengthened.”

Where self-regulation has not worked, this often is a result of the inherent tension between a SRO’s role as a regulator and as the operator of a market, and between its role as a regulator and as a membership organization. Two key factors in addressing these conflicts are the independence of the SRO board from the interests of specific members, or even specific users, of the SRO’s market; and the independence of the regulatory function of the SRO from the self-interest of the members or the business interest of the market itself.

The independence of the regulatory function can be accomplished through a range of alternatives along a spectrum. At one end of the spectrum would be an independent entity or entities that would carry out the SROs’ regulatory functions. I would consider a model that has an autonomous regulatory office of an exchange that is supervised and controlled directly by an entirely independent exchange board to be toward the middle of this spectrum. I would also put the NASD-NASDR-Nasdaq model of separate regulatory and market affiliates overseen by a balanced board in this category. At the further end is the prior NYSE model of regulation and market combined in one entity under the direction of the exchange CEO, and ultimately a balanced exchange board. The appropriate regulatory structure for one SRO may not be appropriate for others, given their different membership, sizes, and regulatory responsibilities. For all SROs, however, the challenge before the Commission and the SROs is to develop governance structures

that help assure SRO regulatory programs that are effective, yet insulated from any undue influence from potentially conflicting business or member pressures.

As you know, under the leadership of Interim Chairman John Reed, the NYSE recently took a critical step toward governance reform that deserves our serious consideration. On November 7, the NYSE filed with the Commission a proposal that would amend the NYSE Constitution to implement a series of governance changes at the NYSE, including those designed to strengthen the independence of the NYSE Board and key committees, and better insulate the NYSE's regulatory function from its business as a market. These steps include creation of an autonomous regulatory office headed by a Chief Regulatory Officer who reports directly to a committee of the new, wholly independent NYSE board. This Board Committee is responsible for ensuring the effectiveness, vigor, and professionalism of the NYSE's regulatory program. The Committee determines the budget, regulatory plan, and staffing of the regulatory office, assesses the NYSE's regulatory performance, and recommends compensation and regulatory actions to the Board. Yesterday, the members of the NYSE approved unanimously the plan approved by John Reed.

The NYSE's proposal is subject to Commission approval. Because of the significant public interest in the NYSE's proposed governance reforms, the Commission immediately issued a notice seeking public comment on the NYSE's proposal. To assure widespread awareness of the NYSE's proposal, the Commission has both published it in the Federal Register and highlighted it on the Commission's website. The comment period will extend through December 4, 2003. I encourage any interested person to formally submit comments on the NYSE's proposal for Commission consideration.

Although the Commission reserves judgment on the proposal until all public comments are received and evaluated, I must commend the NYSE – and in particular John Reed – for taking this substantial and critical first step toward revamping its governance structure.

In conclusion, I would like to thank the Committee members for recognizing the importance of effective governance at the NYSE and other self-regulatory organizations. I look forward to continued input from the Committee on this important matter.

Thank you again for inviting me to speak on behalf of the Commission. I would be happy to answer any questions that you may have.