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Comments on the Development and Regulation of U.S. Equities and Derivatives Markets

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Mr. Chairman, Ranking Member Bayh, and members of the committee, I am Paul Bennett, Senior Vice President and Chief Economist at the New York Stock Exchange (NYSE or Exchange). On behalf of the New York Stock Exchange and our Chief Executive Office John Thain, thank you for inviting me to testify today before the Subcommittee. The NYSE greatly appreciates your leadership in overseeing the international aspects of our nation's evolving financial markets. We find ourselves at a critical point in that evolution, and your attention to these issues could not be more timely as we seek to maintain the competitive leadership of U.S. financial markets in the world and to protect the interests of investors, both individual and institutional.

I. Evolution of today's financial markets

The New York Stock Exchange is the world's largest cash equities market. We serve 90 million investors, the institutional community and over 2,700 of the world's leading corporations. The companies listed on the NYSE have a total global market capitalization of $21 trillion. During the first nine months of 2005, our average daily trading volume was 1.61 billion shares, worth over $55 billion a day. We are an important cog in the capital formation engine, helping to provide companies and investors with opportunities that translate into job creation and economic growth.

You have asked us to speak about the growth of the derivatives market and its role in the U.S. economy. While the NYSE does not run a derivatives market today, the importance and growth of that market have had a significant impact on the NYSE, and have helped shape our strategy for the future.

Equity Market

The U.S. equity market has grown steadily in the past decade. The consolidated daily volume in the US equity market, including both the listed market and OTC market, has reached about 4 to 5 billion shares a day representing $80 to $100 billion traded daily.

Decimalization and technological innovation have continuously decreased costs for investors on the US equity market. According to the GAO's 2005 study on the Securities Market, costs for institutional investors have decreased by 30% to 53% overall, and by 90% for individual investors.

Today there are more buyers and sellers than ever before. Forty-two percent of adults in the U.S. today own shares; moreover, since 1990, the portion of U.S. households' assets in equities and mutual funds has nearly doubled, from 9.6% to 16.8% at the end of the second quarter in 2005.

The NYSE is committed to providing those investors the highest value proposition. And to do so, we must recognize the new realities of financial services. Today's market differs greatly from that of a generation ago. The diversified products, the rise in electronic trading, and the globalization of our capital markets have utterly transformed the way our markets work.

Derivatives Markets

The biggest financial story of this era may be the bold and imaginative new ways we are creating to manage risk, reduce the costs of hedging, and make markets more efficient. For investors, the result is an explosion of new opportunities to invest in new products on new platforms.

A derivatives market that started with futures contracts on agricultural commodities, like butter, milk and live cattle, in the 19th century, has turned into the principal means for investors to manage their risk no matter what the investment. Today, options, futures, swaps and other innovations have become widely used and even required risk management tools for sophisticated investors and financial intermediaries. While the $100 billion daily trading is an impressive figure in the equities market, it has not escaped our attention that the value of contracts traded on the Chicago Mercantile Exchange (CME) averaged over $2 trillion a day for the first 6 months of 2004.

And while volume on the NYSE remained relatively flat in 2004, total volume in equity options, both in the U.S. and abroad, soared by nearly 30%. From 1995 to 2004, options volume has increased by 400%. Over that same period, the total number of options contracts traded in the U.S. has risen from 288 million to 1.2 billion.

For futures, the CME's 2004 annual volume was more than 787 million contracts, representing double-digit volume gains for the fifth consecutive year. The Chicago Board of Trade's (CBOT) 2004 annual volume reached nearly 600 million contracts, a record high for the CBOT and the third consecutive record-breaking year for the CBOT.

Competitive Landscape

In addition to the growth in new products and platforms, today's financial markets are facing a new global challenge to the traditional leadership of U.S. capital markets.

There is now greater mobility of capital, greater international participation in local markets, and greater competition among markets in different geographical areas. Financial institutions, investment firms, and other financial intermediaries have increased their trading across national boundaries, in numerous different markets, outside traditional exchanges and even directly among themselves.

Today, traditional rivals like the Deutsche Börse are becoming better capitalized, and better competitors. While this is true for the equities market, it is especially true in the derivatives market. Eurex, which is jointly owned by Deutsche Börse and SWX Swiss Exchange, is the world's largest future and options market for euro denominated derivative instruments. In addition, according to Eurex's monthly statistics from third quarter 2005, it has the largest market share in terms of contract turnover for the entire international options and futures markets—12.84%. The next four biggest players are CME (11.28%), CBOT (7.69%), Chicago Board of Options Exchange (CBOE) (5.44%), and the International Securities Exchange (ISE) (4.88%).

And investors are responding to these opportunities. An increasing portion of U.S. portfolios is going overseas into non-U.S. investments. Since 1990, in U.S. investors' portfolios, the equity portion alone of non-U.S. stocks has nearly tripled, from 6.0% to 16.8%.

In addition, the NYSE's competitors have become stronger through demutualization and consolidation. In response to growing competition, many marketplaces in both Europe and the U.S., such as the London Stock Exchange plc and Nasdaq, have demutualized to free themselves from the constraints of their membership structures and to provide greater flexibility for future growth. In recent years, the number of new market entrants, the need to respond to the globalization of capital markets, and the desire to provide global, cross-border services to clients has also led to a wave of consolidation, both in the U.S. and abroad.

In order to compete effectively in this global climate, and in order to provide investors and issuers with the best possible marketplace, we must become a multi-product, global competitor.

We are looking at the possibility of expanding or adding new platforms in areas that can benefit from increased transparency. We are currently seeking an SEC exemption to expand our investor friendly corporate bond platform to trading unregistered bonds of our listed companies.

We are also making great progress in one fast-growing asset class, U.S. Exchange Traded Funds (ETFs), whose total funds have soared over 50% last year to $227 billion. ETFs provide investors an excellent way to manage risk and diversify by trading a portfolio of stocks in a designated area such as gold, natural resources, the S&P, or Chinese-based equities.

But ETFs represent only a single star within the giant constellation of financial markets. We need to expand our universe much more broadly in order to compete successfully.

NYSE is becoming a public, for-profit company to give us improved access to capital, and the ability to use stock as acquisition currency. We are merging with Archipelago, an outstanding, entrepreneurial company that is pioneering leading-edge trading platforms and customer focus.

That is also why we are building the Hybrid Market; we are responding to the demand of many of our customers for greater ability to trade electronically. The Hybrid Market will give customers the choice of two investor-friendly paths: either the sub-second speed of automatic execution, or the price improvement and best value that distinguish the auction market.

Ten years ago, these changes at the NYSE would have been unthinkable. But today, moving forward without these changes is what would be unthinkable. We must respond to investors' needs and thereby preserve the position of the U.S. as the leader in our global financial marketplace.

II. <u>Regulatory developments</u>

As you can imagine, there are also regulatory considerations that affect not only the competitive landscape but also dictate where and how individuals and their representatives invest their money. Two such examples are capital requirements for broker-dealers and margin rules for brokerage accounts.

Capital Requirements

For years, U.S. broker-dealers have moved much of their derivatives business overseas because of stringent capital requirements that make conducting such business in the U.S. less attractive.

In August of 2004, the SEC adopted rule amendments that established a voluntary, alternative method for broker-dealers to compute net capital. This rule allows them to use internal models to calculate net capital requirements for market and derivatives related credit risk. One condition to using this alternative method is that the broker-dealer's ultimate holding company and affiliates become consolidated supervised entities and consent to group wide oversight (consolidated supervision) from the SEC. Another condition is that the broker-dealer must maintain $5 billion of tentative net capital in order to participate, which limits the number of broker-dealers who are able to take advantage of this rule.

The Exchange currently has rule proposals before the SEC to modify its capital rules to reflect a different level of capital and to change its margin rules to accommodate derivatives business that may come back into the U.S. To date, five internationally active firms, including Goldman Sachs, Merrill Lynch, Bear Stearns, Lehman Brothers and Morgan Stanley, have either applied or been approved for CSE (consolidated supervised entity) status.

Relaxation of the capital rules by allowing firms to use internal models to compute charges has encouraged the firms using this alternative method to study whether to bring their OTC derivative dealers back into the U.S. broker-dealer. There is significant benefit to the firms from a legal netting standpoint to have all transactions with a single counterparty in one legal entity. They are studying the technology issues as well as other regulations that might be applicable before reaching a final decision.

Portfolio Margining

Another regulatory development that affects derivatives concerns potential changes to portfolio margining.

The evolution of the equities and derivatives markets puts into focus the need to ensure a sensible regulatory approach that will foster competition among markets and strengthen the U.S. position in the global marketplace.

As the Banking Committee's hearing last month on Commodity Futures Trading Commission (CFTC) reauthorization highlighted, it is essential that regulation of the security futures and equities markets maintain the competitive balance that was established by Congress in 2000 in the Commodity Futures Modernization Act ("CFMA").

One aspect of that regulation that has been under scrutiny is the margin rules that apply to different products. We strongly agree with the many participants in the financial markets, several of whom testified before the Committee, that portfolio margin rules should be developed not just for select sectors of the marketplace, but for all equity products. Currently, margins for security futures customers are calculated using a strategy-based approach, which computes margin requirements for each individual position or strategy in a portfolio. Portfolio margining, used for all futures contracts and for security options at the clearing level, is risk-based, and more accurately reflects economic exposure to the marketplace.

The NYSE is working with the NASD, CBOE, CFTC, and other commodities exchanges and market participants to develop a portfolio margin rule that would apply to all equities. We consider this initiative a top priority and will be working with our fellow regulators to produce a rule for SEC consideration by year-end.

III. <u>Conclusion</u>

Today's financial markets have evolved significantly over a relatively short period of time. Technological changes have increased the speed of transactions and reduced the costs of those transactions. The equity market has grown steadily, while the derivatives market has grown exponentially with the introduction of new products. The international competitive landscape has forced U.S. markets and market participants to think globally.

While some may see this change as a threat, the NYSE sees opportunity. Investors will increasingly need platforms that can meet all of their investment needs, including equities, futures, options or swaps. As the NYSE proceeds with its plans to become a publicly traded company and merge with Archipelago, thereby increasing our capitalization and diversifying our product offering, we are looking to take advantage of the opportunities that this new competitive landscape will present.

Mr. Chairman, and Ranking Member Bayh, and members of the committee, thank you for the opportunity to present this testimony. I look forward to answering your questions.