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Governance Issues at the New York Stock Exchange

BECG 035

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GOVERNANCE ISSUES AT THE NEW YORK STOCK EXCHANGE

"The New York Stock Exchange is long overdue for a very serious and thorough examination and overhaul of its governance. The very fact that they nominate their own board without any input from anyone else should not be tolerated."

- Nell Minow, Editor, Corporate-Governance Research Firm - The Corporate Library in August 2003.[1]

"Today, we take an important step towards a governance architecture with standards of independence and disclosure that are comparable to or stronger than those we require of our listed companies."

- John Reed, Interim Chairman & CEO – New York Stock Exchange (NYSE) commenting on the proposed NYSE reforms, in November 2003.[2]

PAYBACK TIME AT NYSE

On September 18, 2003, Richard Grasso (Grasso), Chairman and CEO of NYSE resigned amidst widespread criticism of his pay package and governance practices at NYSE. Earlier in August 2003, NYSE announced that Grasso had been given a lumpsum amount of $140 million from NYSE (covering two decades of deferred compensation, and retirement benefits). It also announced that Grasso's contract had been extended upto 2007 with an annual pay of $1.4 million, and an additional $1million annual bonus.

William Donaldson (Donaldson), Chief of the Securities and Exchange Commission (SEC)[3], commented that Grasso's compensation details raised serious doubts about governance standards at the NYSE. Donaldson sent a letter to the compensation committee head – Carl McCall (McCall) asking for more details about how Grasso's compensation package had been decided.

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[1] *NYSE Management, Board Conflicts Criticized By Investors Group,* www.securities.stanford.edu, August 1, 2003.

[2] *NYSE Outlines Proposals to Strengthen Governance and Names Candidates for New Board of Directors,* Press Release on www.nyse.com, November 5, 2003.

[3] Founded in 1929 by the U.S. Congress to monitor the securities industry and enforce punishments to those who violate the industry's regulations.

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The misgovernance at NYSE came to light in August 2003 when the Council of Institutional Investors (CII)[4] published a report which highlighted the shortcomings in NYSE's governance practices. The Grasso episode provided more ammunition to the critics of NYSE, who were demanding greater transparency in its working.

In September 2003, former Citigroup Co-CEO, John Reed (Reed) was appointed the new interim chairman and CEO of NYSE. Soon after taking over the charge, Reed announced that his first priority would be to reform the working of the exchange. On November 5, 2003, Reed announced proposed reforms in the governance practices of NYSE. The media, general public and industry sources welcomed the reforms saying that they were the step in the right direction. However, some were of opinion that more drastic changes should be brought in to ensure transparency in the operations of NYSE.

BACKGROUND NOTE

The history of the NYSE dates back to 1792 when the Buttonwood Agreement was signed by 24 New York-based stockbrokers and merchants. The agreement facilitated trading in securities between the signatories on a commission basis. In 1817, a formal organization – the New York Stock & Exchange Board (NYS&EB) was formed by brokers; the board also formulated rules and a constitution for conducting business. By 1824, the NYS&EB's annual trading volume had reached 380,000 shares and by 1835, the daily trading volume had increased 50-fold to 8,500,000 shares.

By the 1850s, the NYS&EB had started formulating rules and regulations for listing companies. In 1853, the listing standards were formulated, and these made it mandatory for listed companies to provide complete information about outstanding shares and capital resources. In the late 1850s and early 1860s, the NYS&EB witnessed a turbulent period. In 1857, there was a sharp downward movement in trade due to the collapse of the Ohio Life Insurance & Trust Company. The NYS&EB registered a 8-10% price decline in a single trading session and by year-end, the decline stood at 45%. In 1863, the NYS&EB changed its name to the New York Stock Exchange (NYSE). In the following year, a Committee on Stock List was appointed to oversee the listing of new securities on the exchange, thus initiating supervision and controlling of listing policies by the NYSE.

With the increase in trading volume, the NYSE introduced innovative methods for making trading more convenient. In 1867, for the first time, the stock ticker[5] was introduced enabling investors to know the current prices of the stocks. In 1869, the NYSE abolished 'watering stocks'[6] and introduced a new rule according to which all shares of companies listed on the NYSE had to be registered with banks or authorized agents.

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[4] Founded in 1985, the Council of Institutional Investors with around 130 pension fund members and more than $2 trillion in assets, seeks to address investment issues that affect the size or security of plan assets. Its objectives are to encourage member funds, as major shareholders, to take an active role in protecting plan assets and to help members increase return on their investments as part of their fiduciary obligations.

[5] A telegraphic system that continuously provides the latest sale prices and volume of securities transactions on exchanges. Information is either printed or displayed on a moving tape after each trade.

[6] Stocks issued in secret before the initial public offering (IPO) are called watering stocks.

In 1872, the NYSE created the Specialist System (Refer Exhibit I for a note on the Specialist System). By the mid-1880s, the NYSE had also introduced telephone and paging systems to increase trading. In 1889, the exchange formed its first subsidiary – **The New York Quotation Company,** for providing ticker services to its members. In 1892, the New York Stock Exchange Clearing House was formed to centralize securities transfers between brokers.

By the end of World War I in 1918, the NYSE had replaced the London Stock Exchange as the world's investment capital. Over the next decade, the public issues of around 1,800 foreign companies had been offered in the US market. In 1920, the NYSE established the Stock Clearing Corporation to provide a centralized system to enable the delivery and clearance of securities among members, banks and companies. In 1923, the NYSE witnessed a bull run[7], during which stock prices increased rapidly for the next six years. The bull run came to end in 1929 with the onset of the Great Depression. The NYSE started restructuring itself in the late 1930s. In 1938, it hired its first full-time salaried president, and in the following year it opened its first public gallery enabling the public to witness trading and thus bringing greater transparency in its operations. In 1943, the NYSE started allowing women on the trading floor. Beginning in 1945, there was another bull run on the NYSE. This continued uninterrupted upto 1953. In 1954, the NYSE launched its first marketing campaign – ***'Own Your Share of American Business'*** with the aim of educating investors and increasing public participation in the stock market. In the same year, it also launched a monthly investment plan, which enabled ordinary people to invest around $40 per month in the market by investing in NYSE members' special accounts. In 1961, the average daily volume on the exchange surpassed 4 million shares and in 1966, NYSE's composite index called the common stock index was launched.

In 1968, NYSE faced a paperwork crisis as member firms failed to process the transactions on time causing delays in stock transfers and payments. The paperwork crisis resulted in the demand for more automation in the exchange. In the same year, NYSE established the Central Certificate Service (CCS) for transferring securities electronically. The CCS was succeeded by Depository Trust Company (DTC) in 1973.

In the mid-1970s, NYSE undertook various steps to upgrade the exchange through new technology. In 1976, the exchange introduced the fully automated Designated Order Turnaround (DOT) system, which made possible the routing of selling or purchasing orders electronically. In 1978, NYSE introduced the Intermarket Trading System (ITS), which provided an electronic link between NYSE and other exchanges, allowing brokers to access all exchanges to find the best bid/ask price[8] for a stock. In the following year, NYSE established a futures[9] market known as the New York Futures Exchange (NYFE) and the same year it began technological upgradation of the trading floor. In 1984, NYSE launched SuperDot 250 – an electronic order routing system linking member firms and specialist posts on the trading floor.

In 1993, NYSE announced an Integrated Technology Plan (ITP) to upgrade trading floor networks (hardware and software). This increased handling capacity to 1 billion shares a day. The implementation of the ITP was completed in 1995, and in the same year NYSE shifted to a three-

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[7] During a bull run, the prices of stocks keep increasing. A bull run denotes optimism in the market.

[8] The bid price is the price at which an investor, trader, or dealer wants to buy a security. The ask price is the price at which an investor, trader or dealer wants to sell a security.

[9] A contract specifying the future date of delivery or receipt of a certain amount of a specific tangible or intangible product. The commodities traded in futures markets include stock index futures; agricultural products like wheat, soybeans and pork bellies; metals; and financial instruments. Futures are used by business as a hedge against unfavorable price changes, and by speculators who hope to profit from such changes.

day settlement period[10] for listed equities. In the same year, Grasso was elected as chairman of the exchange. In 1996, NYSE launched its first real-time ticker on the CNBC and CNN-FN channels, and in the following year, it also started a wireless data system which allowed brokers to receive and execute orders from anywhere on the trading floor.

During the late 1990s, NYSE focused on upgrading technology because of increasing criticism of its outdated technology compared to NASDAQ's.[11] In 1999, the exchange had established a 3-D trading floor using up-to date technological systems such as plasma monitors and silicon graphics workstations to provide market information to the brokers. In 2000, NYSE shifted to decimal trading[12] and in the same year it announced plans for a NYSE Platform network comprising NYSE Direct+[13], NYSE MarkeTrac[14], NYSE OpenBook[15], Institutional XPress[16], and NYSE e-Broker[17].

The early 2000s saw investor confidence in stock markets plummeting due to the dotcom bust. Investor confidence took a further beating after terrorist attacks in the US[18], after which NYSE was closed for five days. In 2002, NYSE reported an average daily trading volume of 1.44 billion shares and annual revenues of $1.065 billion. The total number of listed companies on the exchange was 2,783. In mid-2003, NYSE was facing a lot of flak for its governance practices. Investors were additionally aggrieved to learn the size of Grasso's compensation package.

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[10] The date by which an executed securities transaction must be settled, by paying for a purchase or by delivering a sold asset; usually three business days after the trade was executed (T+3); or one day for listed options and government securities.

[11] National Association of Securities Dealers Automated Quotation (NASDAQ) is an automatic information network that provides brokers and dealers with price quotations on securities traded over-the-counter.

[12] In decimal trading the quotation and trading of stock or bond prices are stated in decimals, as opposed to quotation in fractions.

[13] An automatic-execution service for limit orders up to 1,099 shares, which enables users to opt for an immediate execution at the best bid or offer.

[14] An online investor tool providing a 3-D connection to the point of sale, bringing individual investors closer to the trading floor and creating additional transparency in trading. Features include a virtual representation of the trading floor with news, an activity map and historical price charts; customizable portfolio and index tracking; and detailed quote views and performance graphs.

[15] An information tool that offers a real-time view of the exchange's limit-order book for all NYSE-traded securities. Traders can see aggregate limit-order volume at every bid and offer price.

[16] An electronic gateway designed specifically for the needs of NYSE member firms and their institutional customers.

[17] A wireless handheld order-management tool facilitating seamless connectivity between floor brokers and off-floor locations by organizing orders, tracking executions, and speeding the flow of information. Using market "looks," a broker can provide his or her customer with current quotes, crowd participation, and other market insights directly from the point of sale.

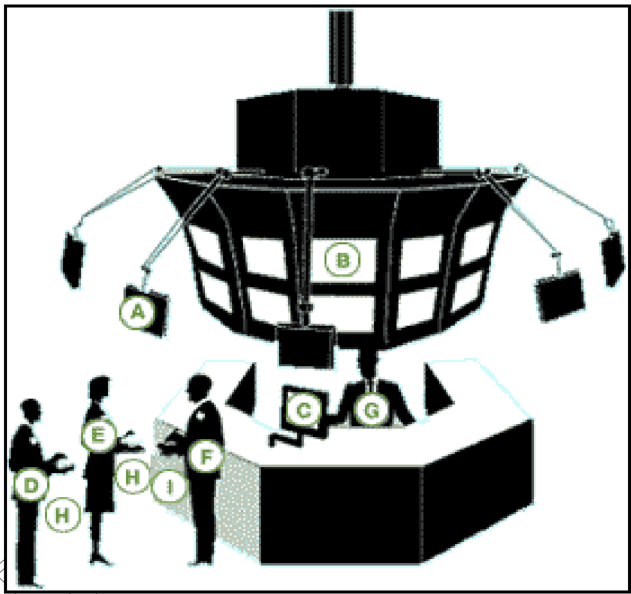
[18] On September 11, 2001, terrorists had attacked the US through airplane crashes on the twin towers of the World Trade Center and the Pentagon.

THE WORKING OF NYSE

NYSE is defined as a *"member-owned co-operative and self-regulatory organization that serves the public as the nation's principal securities market, its principal self-regulator and its principal source of governance standards."*[19] It comprises of three constituencies, viz., broker-dealer members, listed companies and the investing public. The specialist firms and floor brokers are grouped under broker-dealer members. The specialist firms employ specialists involved in the trading of stocks of particular companies.

At NYSE, trading takes place at one central location – the trading floor (Refer Figure I) where both buyers and sellers compete to get best price for their clients. Usually, each stock is assigned a trading post, with specialists managing the auction process.

FIGURE I
TRADING FLOOR



A - Post information display provides market information to specialist.
B - Flat panel display screen, which enables brokers to know prices of each stock.
C - Point of Sale Display Book enables specialist to handle volumes.
D, E – Brokers who execute customer buy/sell orders.
F - Specialist- order book for which the specialist has agency responsibility, assists in the recording and dissemination of trades and quotation changes, and facilitates the research of orders.
G - Specialist trading assistant working at point-of-sale workstation.
H, I - New York Stock Exchange Wireless Data System (WDS) transfers information to and from point-of-sale. Brokers were provided with an advance Hand Held Device (HHD) enabling them to receive orders electronically.

Source: www.nyse.com

NYSE has the authority to regulate securities firms dealing with public accounts in the US. The Enforcement Division oversees the working of listed companies. It is given powers to take

[19] www.nyse.com

disciplinary actions against firms violating the listing and disclosure rules of the exchange as well as ensuring the transparent working of the listed companies. NYSE also oversees the working of broker-dealer members to ensure a free and fair market.

GOVERNANCE STRUCTURE AT NYSE (Pre-reform)

NYSE's governance structure comprised five important elements: the ***Board of Directors (BoD), standing and advisory committees, a nominating committee, its professional executive management,*** and ***its 'not-for-profit' status.***

BoD and Standing and Advisory committees

The 1,366 broker-dealer members of the exchange elected the BoD which consisted of 27 members (12 industry directors, 12 non-industry directors and 3 members of the office of the chairman)[20]. (Refer Table I) No director was allowed to be on the board for more than three consecutive two-year terms. The NYSE constitution defined an industry director as "(1) an individual member, (2) an individual who is a principal executive, general partner or control person of a member organization, or (3) a principal executive of an organization whose "principal" subsidiary is a member organization."[21] Non-industry directors did not belong to the securities industry. The day-to-day working of the exchange was overseen by the board. The board played an active role in formulating policies and programs governing the working of the exchange. Further NYSE constituted various standing and advisory committees which were comprised of NYSE directors, to regulate the functioning of NYSE. The exchange had five standing committees, ten advisory committees and four international advisory committees (Refer Exhibit II).

[20] 12 industry directors were elected from the securities industry and 12 non-industry directors from the non securities industry representing public.

[21] White Paper on Governance, www.nyse.com

TABLE I
COMPOSITION OF THE BOARD (2002) **

DIRECTOR NAME	CATEGORY	PROFILE
Richard A. Grasso*		Chairman & CEO, NYSE
Robert G. Britz*		Executive Vice Chairman, President and Co-Chief Operating Officer, NYSE.
Catherine R. Kinney*		Executive Vice Chairman, President and Co-Chief Operating Officer, NYSE.
Laurence D. Fink	Non-Industry Director	Chairman and Chief Executive Officer, BlackRock, Inc.
William B.Harrison, Jr.	Non-Industry Director	Chairman and Chief Executive Officer, J.P.Morgan Chase & Co.
Carol Bartz	Non-Industry Director	Chairman of the Board, Chief Executive Officer and President Autodesk, Inc.
James E. Cayne	Industry Director	Chairman and Chief Executive Officer The Bear Stearns Companies Inc.
Mel Karmazin	Non-Industry Director	President & Chief Operation Officer, Viacom Inc.
Kenneth G. Langone	Industry Director	Chairman of the Board, Invemed Associates LLC
James M. Duryea	Industry Director	President, J. M. Duryea Inc.
Peter N. Larson	Non-Industry Director	Chairman and CEO (Retired) - Brunswick Corporation
Gerald M. Levin	Non-Industry Director	CEO (Retired) AOL Time Warner Inc.
John J. Mack	Industry Director	CEO, Credit Suisse First Boston
Joseph A. Mahoney	Industry Director	Senior Managing Director and Chief Administrative Officer - Bear Wagner Specialists LLC
Leon E. Panetta	Non-Industry Director	Director - Panetta Institute for Public Policy
Henry M. Paulson, Jr.	Industry Director	Chairman and CEO - The Goldman Sachs Group, Inc.
Christopher C. Quick	Industry Director	CEO - Fleet Specialist, Inc.
Juergen E. Schrempp	Non-Industry Director	Chairman of the Board of Management DaimlerChrysler AG
Larry W. Sonsini	Non-Industry Director	Chairman and CEO - Wilson Sonsini Goodrich & Rosati
William B. Summers, Jr.	Industry Director	Chairman, McDonald Investments
H. Carl McCall	Non-Industry Director	New York State Comptroller (Former)
George C. McNamee	Industry Director	Chairman, First Albany Companies Inc
David H. Komansky*	Industry Director	Chairman of the Board – Merrill Lynch & Co., Inc
Robert M. Murphy*	Industry Director	Vice Chairman & CEO – LaBranche & Co., LLC

Source: NYSE Annual Report, 2002
* Members of the Office of the Chairman
** This list is not exhaustive

Nominating Committee

The nominating committee consisted of eight members - four from the industry category and four from the non-industry category. The members of the nominating committee were elected for two years, and no member could be re-elected for the second consecutive term. The nominating committee nominated members to be elected to the BoD.

Professional Management

Though till the 1970s, the members of the exchange oversaw the day-to-day functioning of the exchange; from the early 1970s, a professional management team was appointed by the Chairman and CEO with the approval from the board to oversee administrative matters. But the executive vice-president of the exchange was directly elected by the board.

Not-for-Profit Status

Initially NYSE was formed as a membership organization, and in 1971, it was incorporated under the 'Not-for-profit' Corporation Act. The main aim of the exchange was stated to be maximizing the reliability and integrity of market functioning, rather than to maximizing profits.

NYSE COMES UNDER FLAK

Over the years, the style of governance at NYSE has attracted a lot of criticism chiefly on account of 'misgovernance' and the role of specialists. Analysts pointed out that the governance structure at NYSE had failed to deliver results, and that the NYSE had failed to safeguard the interests of the general public. However, finally, it was the controversy over its CEO's compensation that resulted in the eruption of the wrath of the media and the general public.

COMPOSITION OF THE BOARD

Analysts said that while NYSE demanded greater transparency in the operations of the companies it regulated, it did not itself maintain any transparency in its own working processes. The process of electing the NYSE board was not transparent and, in fact, the board was handpicked by the Chairman. Though the exchange claimed that its election process was fair and transparent, analysts pointed out that the candidates to be elected to the board were nominated by the nominating committee, which itself was regulated by the Chairman and the board members themselves.

In early 2003, as criticism of the system at the stock markets in the US mounted, SEC Chairman Donaldson asked all the exchanges and their regulatory bodies in the US to review their governance processes. At this point, NYSE requested the CII to prepare a report on the governance practices at NYSE. In August 2003, the CII submitted a very critical 47-page report on the governance practices at NYSE. In its report, the CII said, "The exchange's public purpose is to protect investors - but it is owned and operated by a profession that has its own needs to tend to. The big banks - the so-called broker-dealers - are not the only groups with interests to be considered, yet they wield massive influence over the NYSE."[22]

[22] English, Simon, *Wall Street report slams 'cosy' NYSE*, www.telegraphic.co.uk, August 8, 2003.

The CII reported that the directors on the board were too busy to devote the required time to regulatory matters. Most of the directors were top executives of companies and they had their own businesses to look after. The CII report stated, "Board members have too many connections among themselves to be effective."[23] For instance, Grasso was inducted into the board of Home Depot, while Home Depot's co-founder Ken Langone was a director at the NYSE.

Analysts felt that conflict of interests in the roles played by the members of the BoD was one of the main reasons for misgovernance at the NYSE. The role of the directors was to maintain a free and fair market environment and to ensure high standards of working to safeguard the interests of the public. But, this did not happen. There was a primary conflict of interest between the role played by members of the BoD in their capacity as members of the board and their role as CEOs or important officials in their primary businesses. Half of the directors who represented the board did business on the exchange, and the other half had companies listed on the exchange or had a close relationship with listed companies. Commenting on the role of non-industry directors, *Fortune* wrote, "But these people don't wake up each morning wondering how they can protect investors – they wake up thinking about how to make money for their companies, a noble goal to be sure, but not exactly the watchdog role the securities market might like."[24] Of the role conflict, Robert Mittelstaedt, vice dean and director – executive education, Wharton School of Business, said, "They are fundamentally different activities. You can't be both a regulator and an organization that is trying to draw companies [as members] and make it attractive for them to function on the exchange."[25]

THE ROLE OF SPECIALISTS

The specialist system at the NYSE also attracted considerable criticism. In April 2003, the SEC initiated an investigation against trading violations committed by specialists. The specialists were alleged to be involved in *front running*[26]. However, the NYSE refuted the charges and announced that SEC was inquiring into violation of the negative-obligation rule[27]. But analysts pointed out that the objective of the inquiry remained the same, though the rules violated differed. The primary question which the NYSE needed to answer was whether its specialists purchased shares at lower price with an intention to sell them afterwards for profit. The firms which faced investigation included – Spear, Leeds & Kellogg (a subsidiary of Goldman Sachs), Fleet Boston Financial, Bear Wagner (partly owned by Bear Stearns), LaBranche and Van der Moolen.

This was not the first time the specialist system had come under scrutiny. In 1999, NYSE entered into a settlement with the SEC to make the specialist system more transparent.[28] However, with fresh allegations against specialists surfacing again in 2003, analysts felt that not much had been done to bring transparency into the system. In the early 2000s, when businesses were reeling under

[23] English, Simon, *Wall Street report slams 'cosy' NYSE,* www.telegraphic.co.uk, August 8, 2003.

[24] Lashinsky, Adam, *NYSE: Who's Minding the Store?* Fortune, March 24, 2003.

[25] *How to Restore Credibility at the NYSE,* www.knowledge.wharton.upenn.edu, September 24, 2003

[26] An illegal activity in which a trader takes a position in an equity in advance of an action which he/she knows his/her brokerage will take that will move the equity's price in a predictable fashion.

[27] The negative obligation ensures that specialists do not get involved in the market on their own behalf when the market is able to "make itself" and sufficiently match buyers with sellers. This obligation on the specialists provides the public an opportunity to transact with one another without the intervention of the specialists.

[28] The SEC was investigating the charges of violations by specialists' way back in early 1990s. As a result of SEC investigation, one floor broker was banned from the securities industry.

pressure due to a slowdown, specialist firms at NYSE posted pre-tax profit margins of 35-37% against the 9.7% margin of corporate America as a whole. This raised questions about the working methods of specialists. Many felt that specialists took unfair advantage of their exclusive knowledge of investor orders.

Analysts were also critical about execution of orders at NYSE. Investors could not execute their buy/sell orders immediately as they were required to go through specialists or floor brokers paying high commissions.

THE FINAL ASSAULT- CEO COMPENSATION

Finally, NYSE also faced increased criticism because it did not reveal its executive compensation figures. Under increasing pressure from the media and SEC, the NYSE announced its executive compensation figures in August 2003. These figures indicated that Grasso had been paid a lumpsum amount of $140 million for his services and that his employment contract had been extended upto the year 2007. The exchange revealed that Grasso would be receiving around $1.4 million as salary per year and a bonus of $1 million per year in the period 2003 to 2007. In addition, Grasso was entitled to receive around $48 million in the future as benefits.

Grasso's pay package attracted criticism from all quarters. Under pressure, Grasso announced that he would not take the $48 million. Grasso's pay package was publicly criticized by Donaldson. Donaldson issued a statement saying that Grasso's pay package raised doubts about the NYSE administration and asked NYSE to submit the minutes of the meetings in which Grasso's compensation had been finalized. Meanwhile, the Washington Post[29] reported that members of the executive compensation committee were appointed by Grasso himself. The composition of the compensation committee was thus under public scrutiny too. It was apparent that the compensation committee comprised of executives from companies which were regulated by the NYSE. Further as *Fortune* reported, one of the NYSE directors had claimed in an email that board members who were not in the compensation committee, did not know about the break-up of Grasso's pay package.[30]

Refuting the allegations that the compensation package was not properly drawn up, NYSE said that it acted on the advice of HR consultants. It said that it had taken advice from Hewitt Associates[31] regarding Grasso's compensation and that it had hired an independent consultant – Vedder Price[32] to assess the CEO's compensation. Independent analysts however felt that Grasso's pay package should have been more in line with the salary drawn by the chief of SEC who earned around $142,500 per annum. But some felt that there was nothing wrong in the NYSE chief being compensated on par with top financial services industry executives. However, analysts considered Grasso's pay package high even when compared to industry salaries.

Even NYSE insiders criticized Grasso's compensation deal. The members of the exchange were furious that while the operating income and volume of trade on the exchange were declining, Grasso had rewarded himself so handsomely. It was reported that the cost of operating on NYSE

[29] Leading US news paper.

[30] Tully, Shawn, *See Dick Squirm*, Fortune, September 15, 2003.

[31] Established in 1940, Hewitt Associates is a global outsourcing and consulting firm delivering a wide range of human capital management services.

[32] Founded in 1952, Vedder, Price, Kaufman & Kammholz is a law firm. The firm advises organizations on corporate responsibility and other related matters.

had increased by over 30% during 2000-2003. Public resentment against Grasso increased further as two large pension funds in the US demanded his resignation. Under the unrelenting pressure, Grasso resigned in September 2003.

THE CLEAN-UP EXERCISE

Reed who took over as the interim chairman and CEO of NYSE in October 2003 initiated reforms at the exchange. He conducted interviews with the specialists, outside critics and experts on the kind of reforms to be initiated in the exchange procedures. Many suggested that NYSE should go the NASDAQ way by separating the regulatory function.[33] Further, it was also suggested that the specialist system should be done away with, and the NYSE should opt for electronic trading.

However, to the disappointment of many, Reed announced that he intended to keep the specialist system and would be focusing only on restructuring the NYSE board and bringing more transparency into the decision-making process of the exchange. Defending the specialist system at NYSE, Reed said, "Computer systems find liquidity but they don't add any liquidity. The specialist system brings capital into the system. All the studies suggest this is helpful."[34] Though he agreed that the specialist system delayed the speed of transactions, Reed was of the opinion that reviewing the whole trading system would not be very easy.

On November 5 2003, Reed announced his proposed reforms in the methods of governance at the NYSE. It was proposed that the board would have independent directors with the responsibility of supervising regulation, governance, compensation and internal administration. Reed also announced that the BoD would be appointing an executive board (BOE) comprising of representatives from broker/dealer members, listed companies and the general public. Further, it was stated that BOE would meet regularly to discuss issues related to marketplace operations, membership, listed companies, market structure and performance. The exchange would also have a Chief Regulatory Officer who would be appointed by the board of directors and he would report to the Regulatory Oversight Committee (Refer Table I for details on the BOD and BOE).

[33] After various scandals rocked NASDAQ in the mid-1990s, NASDAQ separated its regulatory function to totally independent body – NASD.

[34] Liston, Broward, *NYSE's Reed to Keep Specialist Trading*, www.washingtonpost.com, November 4, 2003.

TABLE I
WORKING OF BOD & BOE (Post-reform)

PARTICULARS	BOD	BOE
Responsibilities	Board would act as a trustee. BOD would be answerable to the members and SEC.	Basically it would be an advisory body giving guidance on the working of the exchange.
Composition	It would comprise of 6-12 directors excluding current CEOs of member organizations and listed companies, the NYSE chairman and CEO.	It would consist of members from Institutional Investors/ CEOs/CIOs of public funds, CEOs of listed companies, lessor members[35], CEOs of specialist firms, floor brokers, the NYSE Chair and CEO.
Meetings	The BOD would meet at least quarterly and it would also have joint meetings with BOE.	It would meet at least 6 times a year. The lessor and floor members would be meet the BOD separately.
Standing Committees	Under the new governance system, the BOD would constitute the following standing committees: • Audit Committee: This committee would be set the internal audit budget. • Regulatory Oversight Committee: This would set the budget for all regulatory functions. • Regulation, Enforcement & Listing Standards Committee: This would oversee the regulatory group, hearing board, arbitration and Listings and Compliance Unit, and act as "Court of Appeals" in case of disciplinary and delisting hearings. • Quality of Markets/Public Policy Committee: This would act as an advisory on the issues related to member organizations and listing rules.	Under the new system, the BOE would constitute the following standing committees: • Market Performance: This committee would serve as forum to discuss issues related to trading and market operations and develop trading rules and products. • Allocation: This would oversee the allocation of stocks to specialists.
Advisory Committee	This committee would report to the BOD.	

Source: www.nyse.com

Under the proposed reforms, the 27-member board of NYSE would be reduced to 6-12 directors. It was also reported that none of the directors would be from the securities industry or from the listed companies on NYSE. However, it was stated that executives from the securities industry would serve in advisory committees of the exchange (Refer Exhibit III for the proposed governance architecture of NYSE).

The proposed changes met with mixed reactions. While SEC reacted positively saying that the proposed reforms were a step in the right direction, the US's largest pension fund California Public Employees' Retirement System Board (Calpers) said that the proposed reforms were not enough to regain investor confidence, and asked SEC to reject the proposals. Sean Harrigan (Harrigan),

[35] Lessors are the ones who own right to trade on the NYSE, but lease them to the trade brokers.

President – Calpers, said, "Our proposal at this point in time is just that the proposed governance model that Mr. Reed has put forth be rejected by the Securities and Exchange Commission. Self regulation, in my opinion is highly risky and simply will not work."[36] Harrigan was of the opinion that the new proposals would not bring in any changes in the governance system of the NYSE but was just "shuffling the chairs".

Some were of the opinion that, though Reed was expected to bring in drastic changes in the NYSE working by abolishing the specialist system, he did not favor this as it would be difficult to get the approval of the exchange members when it came up for voting. They felt that since he was an interim Chairman and CEO of the exchange, Reed had concentrated only on the board structure and governance practices, rather than on the tricky issues such as the working of the specialist system. It was felt that by adopting a moderate approach, Reed had gained the support of the floor members. The proposed reforms of the NYSE were put to vote on November 18, 2003 and gained the acceptance of the members of the exchange. In December 2003, however, Calpers filed a suit against NYSE and specialist trading firms in the US District Court, Southern District of New York, alleging fraud and negligence in regulatory functioning resulting in high costs for investors. It was alleged that "specialists, in conjunction with the NYSE routinely engaged in 'wide-ranging manipulative, self-dealing, deceptive and misleading conduct' that hurt public investors seeking to trade stocks."[37]

The most important question that still remains is how far the reforms initiated by Reed will ensure transparency in the working of the board. And more importantly whether the new board will be able to bring greater credibility to the exchange.

QUESTIONS FOR DISCUSSION:

1. Analyze the working and corporate governance set up at NYSE and comment on the same. Do you agree that NYSE failed to meet the expectations of investors in regard to governance practices?

2. Some analysts were of the opinion that controversy regarding Grasso's compensation was one of the main reasons for the overhauling of the NYSE governance system. Analyze the impact of the controversy over Grasso's compensation, on NYSE and its reputation.

3. Though most brokers and investors had a positive reaction to the reforms bought in by the exchange's interim CEO John Reed, a majority also felt that more had to be done to bring in greater transparency. Do you think the reforms suggested by John Reed are enough or does more need to be done? Justify your answer.

[36] *Calpers: NYSE Proposal Not Good Enough,* www.money.cnn.com, November 6, 2003.

[37] *Calpers sues NYSE, alleges fraud,* The Economic Times, December 18, 2003

EXHIBIT I

A NOTE ON SPECIALISTS

The specialist system is unique to the NYSE system. There are around 443 specialists operating on the floor of NYSE, trading shares of around 2,800 companies listed on the exchange. These specialists work for the seven specialist trading firms registered with NYSE, and each specialist trading firm is allotted specific company stocks. Specialists undertake equity trading across various industries, and generally a specialist manages between five to ten stocks.

The main responsibility of the specialists is to act as a contact point between buyers and sellers and to maintain a free and fair environment in the market. It is the specialist's duty to ensure that each and every customer order gets a fair opportunity while trading to get the best price. Further, a specialist also ensures that there are no huge price variations in the stock between every trading session. Generally auctions are conducted at specialists' posts, considered as a point of sale. In order to perform the above duties, every specialist plays four vital roles: - that of an Auctioneer, an Agent, a Catalyst, and a Principal. The four roles of specialist are explained below.

- **Auctioneer:** As an auctioneer the main duty of the specialist is to provide the best ask and bid prices throughout a day. Ask and bid prices provided by specialists are transmitted across the world by market data systems instantly. It is the responsibility of a specialist to reflect the true market conditions through his quotes. He also interacts with the floor brokers and sees that order is maintained in the market.

- **Catalyst:** The specialist in the role of a catalyst tries to maintain the flow of orders. He keeps track of buyers interested in his specialized stock and informs them when someone places an order to sell stock. He interacts with the various parties bringing in sell and purchase orders and tries for price improvement[38] to see that everyone gets the best price.

- **Agent:** In the role of agent, a specialist is responsible for all electronically-routed orders. Sometimes a floor broker might leave the order with specialist for execution at a specified price. As an agent, the specialist should strive to hold the interests of his clients above his personal interest irrespective of order size. Commenting on the specialist's role as an agent, a specialist with LaBranche said, "The price should always reflect the supply and demand entrusted to you and represented in the trading crowd at a particular time. It is our job to pair off the orders and deal with imbalance. Whether it's an order for 100 shares or 100,000, each is just as important."[39]

- **Principal:** In his role as a principal, the specialist sometimes even provides capital to improve the liquidity of the market. A specialist does not provide huge capital for the market or determine the prices of the stocks; he steps in to provide capital only when there is a wide price fluctuation in the market due to gaps in the demand and supply of stocks. By providing capital to bridge the fluctuations in the market, specialists play an important role in reducing the price volatility in the markets. In order to maintain order in the market, a specialist buys or sells the stock with him adjusting the price movement. When price of the stock is increasing he sells the stock with him and when price is declining he creates a demand by buying the stock.

From the above, it can be seen that the roles of the specialist as principal and agent are quite critical. Analysts feel that both roles provide ample opportunity for specialists to manipulate the price movement of stocks and gain personally. To ensure that specialists are not exploiting their privileges, their performance is monitored by the NYSE Market Surveillance Division through advanced analysis and technology.

Adapted from the article *Inside the NYSE: The Specialist*, NYSE Magazine, March 7, 2003 and www.psgllc.com

[38] When a buy order is executed at a price lower than the current quoted offer, or when a sell order is executed at a price higher than the current quoted bid. In addition to quoting the best prices more than 90 percent of the time, the NYSE continuous auction market typically improves upon these quoted prices, allowing investors to get a better price for their shares.

[39] *Inside the NYSE: The Specialist*, NYSE Magazine, March 7, 2003.

EXHIBIT II

NYSE COMMITTEES

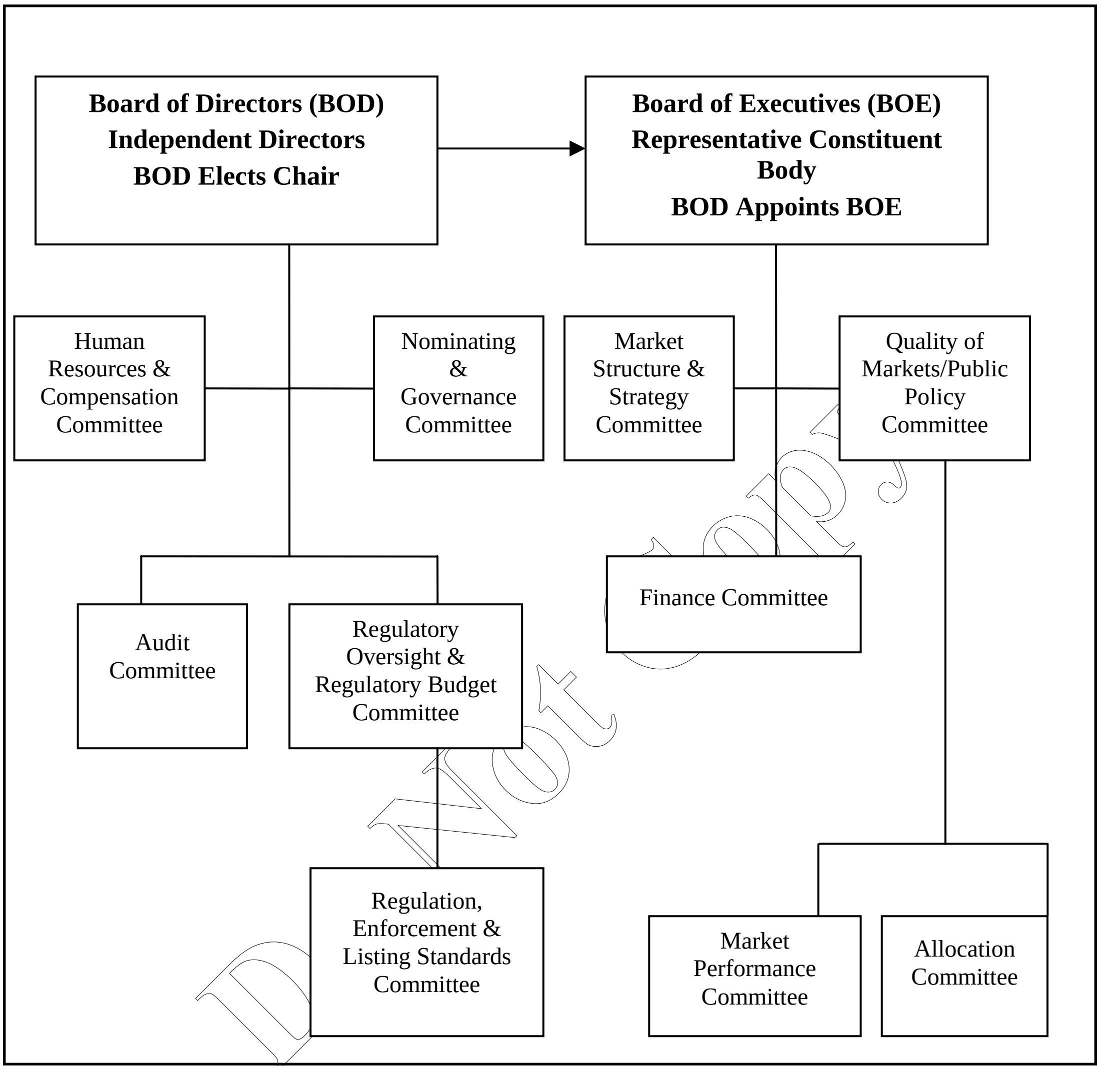
COMMITTEE TYPE	COMMITTEE NAME	FUNCTION
Standing Committees	Public Policy Committee	
	Quality of Markets Committee	Makes recommendations to the board on proposed rule changes.
	Finance & Audit Committee	Oversees the finance and audit matters of the exchange.
	Human Resources & Policy and Compensation Committee	Makes recommendations to the board on the compensation of board members and also oversees the HR issues of the exchange.
	Committee for Review	Hears appeals about disciplinary delisting decisions.
Advisory Committees	Individual Investors Advisory Committee	Advises on matters relating to individual investors. The committee advises on policies to enhance the interests of individuals investing in equities, options, futures and fixed-income securities. Also focuses on enhancing communications between individual shareholders and the NYSE board.
	Institutional Traders Advisory Committee	Advises on the impact of proposed trading rules and related developments on institutional investors. Also focuses on improving communications between the Exchange and institutional investors.
	Pension Managers Advisory Committee	Advises NYSE board on the impact of proposed rules on pension funds. Also strives to improve communications between pension managers and the NYSE.
	Listed Company Advisory Committee	Advises board on policy-related matters involving listed companies and the impact of rules and regulations on them.
	Legal Advisory Committee	Advises on legal and corporate governance matters that affect the NYSE, the securities industry or the US capital markets. The committee assists the NYSE staff on all corporate governance projects, regulation of the financial services industry, and legal matters relating to industry rules and regulations.
	New York Area Firms Advisory Committee	Advises on the impact of proposed rules on the NYSE specialty firms. It also acts as a communication channel between board and specialty firms by conveying their problems to the board.
	Regional Firms Advisory Committee	Advises on the matters relating to NYSE regional member firms. It also acts as an avenue through which regional firms convey their problems to the board.
	Regulatory Advisory Committee	Advises the board on the regulatory system including the self-regulation of the board.
	Upstairs Traders Advisory Committee	Advises on matters relating to increasing the efficiency of the NYSE marketplace. It also focuses on improving communication between the trading floor and trading desks.

	Exchange Traders Advisory Committee	It advises on matters relating to exchange markets and on ways to strengthen their operations. The committee also advises on the impact of proposed trading rules and other matters related to Exchange traders, and facilitates communication between the NYSE and traders.
International Advisory Committees	Asia Pacific Advisory Committee	Advises on issues related to international capital markets and the concerns of business and financial communities of the represented countries.
	European Advisory Committee	Advises the board on the views of European corporates on the role of the NYSE in international matters. Further it also focuses on the ways to strengthen communications between the NYSE and the European corporate community.
	International Capital Markets Advisory Committee	Provides feedback to the NYSE about its policies and programs in the international area, advises the Exchange on operating systems, and recommends programs to encourage foreign companies to list their securities in the US.
	Latin America Advisory Committee	Provides the board with the representative views and attitudes of the Latin American corporate community on the role of the NYSE in international matters. Advises on areas including: strengthening Exchange policies and programs dealing with the internationalization of the capital markets; facilitating multinational offerings of corporate securities; monitoring legislative and regulatory proposals that impose duties or responsibilities on corporate boards of publicly owned issuers; and strengthening communications between the Exchange and the Latin American corporate community.

Source: www.nyse.com

EXHIBIT III

PROPOSED CORPORATE GOVERNANCE ARCHITECTURE OF NYSE



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