Means and Ends: NYSE Regulation, NYSE Group, and the Matter of Togetherness

Hearing on *A Review of Self-Regulatory Organizations in the Securities Markets*

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

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I. Introduction

Mr. Chairman, Senator Sarbanes, and members of the Committee, thank you for inviting me. My name is Henry Hu and I hold the Allan Shivers Chair in the Law of Banking and Finance at the University of Texas Law School. My testimony today reflects preliminary personal views and does not represent the views of my employer or any other entity. In the interests of disclosure, I had served without compensation on the Legal Advisory Board of the National Association of Securities Dealers.[1]

While the topic of today's hearing opens the door to a number of important issues, I would like to focus on the delicate questions raised by the relationship between NYSE Regulation and NYSE Group. In the new environment in which the New York Stock Exchange (the Exchange) operates on a for-profit basis, I am especially concerned by the issue of "togetherness"—the structural and institutional bonds that link NYSE Regulation and NYSE Group—and the potentially troubling implications for regulation.[2] Ironically, the Exchange has long been the symbol of American capitalism, notwithstanding its nonprofit status. Now, as the Exchange is itself joining the capitalist parade, it holds a non-profit entity close to its heart.

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[1] I am on NASD's e-Brokerage Committee and anticipate being on NASD's Market Regulation Committee.

[2] I largely leave aside the related issue of regulatory duplication caused by the overlapping jurisdictions of the NYSE and the NASD. Among other things, the NYSE has represented to the SEC that it has undertaken to work with the NASD and industry representatives to eliminate inconsistent rules and duplicative examinations and to submit proposed rule changes within one year. *See* Securities and Exchange Commission, *Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Granting Approval of Proposed Rule Change and Amendment Nos. 1, 3, and 5 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 6 and 8 Relating to the NY Business Combination with Archipelago Holdings, Inc.*, Release No. 34-53382, 2006 SEC LEXIS 457, at 11-12 (Feb. 27, 2006) [hereinafter *February 27 SEC Order*],

This is a curious structure, one where ends and means don't quite seem to line up. From the standpoint of first principles, it is extremely difficult to ensure that an organization actually pursues the objectives the organization is supposed to pursue. As Members of Congress, you are well aware that bureaucracies often take on a life of their own—developing their own agendas and pursuing their own interests. Simply setting out the formal ends of an organization is not enough. Experience demonstrates that carefully-conceived legal and other mechanisms are essential. An expectation that the newly-configured Exchange can both fully pursue its regulatory ends at the same time as it fully pursues its shareholder wealth-maximization ends may represent the triumph of hope over experience.

I would like to emphasize that my concerns pertain to issues inherent in structural design and do not reflect on the capabilities of particular individuals. John Thain and Rick Ketchum are exceptional managers who have risen to extraordinary challenges. But, unfortunately, structures cannot be designed on the assumption that exceptional individuals will always be in place.

II. "Simple" Ends and Sophisticated Legal and Market-Driven Means: The Publicly Held Corporation

Even when relatively "simple" ends are involved, ensuring that an organization follows those ends is a difficult task. Elaborate legal and market-driven means are necessary, and they sometimes don't work. We need look no further than the publicly held corporation.

The theme of means and ends has dominated thinking about governance of publicly held corporations since the 1930s. In the classic Berle-Means framework, managers hold few shares but exercise substantial control over their firms. Although shareholders own the company, they face collective action problems in effectively overseeing corporate managers. Modern corporate governance has largely revolved around one question: What mechanisms will lead managers to act in the interest of shareholders, that is, to act in accordance with the formal ends of the corporation?

So, in terms of legal means, we have state substantive law (e.g., fiduciary duties such as the duty of loyalty owed by managers to shareholders) as well as federal disclosure requirements (e.g., proxy statements and annual reports). In terms of market means, we have institutional investor activism and the pervasive threat of corporate takeovers to discipline wayward managers.

This highly sophisticated system has evolved over many decades, with the benefit of both hard experience and new learning. Yet, in the cases of Enron, WorldCom, and other corporate debacles still fresh in our minds, all of the legal and market mechanisms—all four engines on the airplane—failed simultaneously. The scandals remind us of the difficulty of ensuring that corporate managers behave in a manner consistent with even "simple" ends. Today, our system

for the governance of the publicly held corporation, although the best in the world, is still a work in progress.

III. "Complex" Ends and Simple Means: NYSE Regulation-NYSE Group

Turning to the new corporate structure of the New York Stock Exchange, our previous example of the typical corporation with a relatively one-dimensional objective—serving shareholder interests—becomes far more complex. Here, the ends diverge along different paths: shareholder wealth maximization at the level of the holding company, but the fulfillment of regulatory responsibilities at the level of a wholly owned subsidiary. The governance question Congress and the Securities and Exchange Commission must consider revolves around this question: Are the legal and other mechanisms equal to the task of ensuring adherence to these complex ends?

A. The New NYSE Structure: The Ends

With this week's anticipated merger,[3] the businesses of the Exchange and Archipelago Holdings are now held under a single, publicly traded holding company: the NYSE Group. The Exchange's current businesses and assets are held in three separate entities: New York Stock Exchange LLC (NYSE LLC), NYSE Market, and NYSE Regulation. NYSE LLC will be a direct, wholly owned subsidiary of NYSE Group and is expected to hold all of the equity interests of NYSE Market and NYSE Regulation. The essential trading and regulatory activities which we had associated with the traditional Exchange will be operated, under the new system, by these latter two subsidiaries pursuant to two contracts. NYSE LLC is delegating the exchange business to NYSE Market under one contract. And, more importantly for our purposes, NYSE LLC is delegating certain of the regulatory functions to NYSE Regulation. NYSE Regulation is organized as a non-profit corporation under New York law and, as noted, is a wholly owned subsidiary of NYSE LLC, which in turn, is a wholly owned subsidiary of the NYSE Group.

The ends with respect to the new structure are more complex than with the usual publicly held corporation. The proper ends of the NYSE Regulation are to further most of the traditional regulatory functions of the Exchange: to engage in market surveillance, to regulate market firms, and to ensure that listed companies comply with Exchange rules.[4] The proper ends of NYSE Group center on maximizing the wealth of its shareholders. In certain circumstances, conflicts will arise between NYSE Regulation's regulatory goals and NYSE Group's shareholder wealth-

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[3] I am assuming the system as approved in the February 27 SEC Order and leave aside transitional provisions. Exhibits 5A through 5K of Amendment No. 8 to the proposed rule change relating to NYSE's business combination with Archipelago Holdings setting forth the text of the NYSE rules and the governing documents, as proposed to be amended, are available at http://www.sec.gov/rules/sro.shtml [hereinafter *SEC-Approved NYSE Documents*]

[4] *See* Certificate of Incorporation of NYSE Regulation, Inc., reproduced at *SEC-Approved NYSE Documents*, *supra* note 3, at Article II (specifying the formal purposes of NYSE Regulation) [[hereinafter *NYSE Regulation Certificate of Incorporation*]

maximization goals. In such circumstances, in theory, NYSE Regulation's regulatory mission is to trump the interests of the parent company's shareholders.

B. NYSE Regulation: The Means

A variety of means are used to try to ensure that NYSE Regulation adheres to its regulatory mission. Some of the key steps are:

(1) NYSE Regulation CEO and Board[5]

(a) The CEO of NYSE Regulation will report solely to NYSE Regulation's board. The CEO will be a member of this board and may not be an officer or employee of any unit of NYSE Group other than NYSE Regulation.

(b) NYSE LLC will choose NYSE Regulation directors, subject to the following constraints:

(i) All directors on the board of NYSE *Regulation* (other than its CEO) are required to be "independent" as to NYSE *Group* under NYSE *Group* guidelines (i.e., independent from management, listed companies, and member organizations). Thus certain NYSE Group directors can serve as directors of NYSE Regulation.

(ii) A majority of the directors of NYSE Regulation will be persons who are not NYSE Group directors. These "Non-Affiliated Regulation Directors" are nominated by the "Nominating and Governance Committee," a committee consisting solely of NYSE Regulation directors.

(iii) 20%, and not less than two of the NYSE Regulation directors will be chosen by members of NYSE LLC. These "Regulation Fair Representation Directors" are recommended by the "Director Candidate Recommendation Committee" (DCRC), a committee that is appointed by the NYSE Regulation board but does not consist of NYSE Regulation directors.

(iv) The Nominating and Governance Committee will nominate at least one director candidate to represent issuers and one director candidate to represent investors, according to a representation by the Exchange to the SEC.

(2) Committees of the Board and Committees Appointed by the Board

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[5] *See* Amended and Restated Bylaws of NYSE Regulation, Inc., reproduced at *SEC-Approved NYSE Documents*, *supra* note 3, at Article III (specifying directors and board committees) [hereinafter *NYSE Regulation Bylaws*]; *February 27 SEC Order*, *supra* note 2; Securities and Exchange Commission, *Approval of SRO Rule Changes Necessary to Effectuate Merger of NYSE and Archipelago Holdings*, Feb. 27, 2006 (press release: 2006-29).

(a) The NYSE Regulation board's "Compensation Committee" shall be responsible for setting the compensation for NYSE Regulation employees. Directors of the NYSE Group shall constitute a minority of the committee.

(b) Directors of the NYSE Group shall constitute a minority of the NYSE Regulation board's Nominating and Governance Committee. Members of the DCRC appointed by the NYSE Regulation board do not have to meet any independence requirements. Indeed, this latter committee must include specified numbers of individuals drawn from various NYSE Market members.

(c) The NYSE Regulation board will appoint a "Committee for Review" that will be comprised of any NYSE Regulation board member other than the CEO as well as persons who are not directors. A majority of the members voting on a matter must be NYSE Regulation directors. The other members will include representatives of members of NYSE LLC, specialists, and floor brokers. This committee will, among other things, review disciplinary decisions on behalf of the NYSE Regulation board.

(d) The Exchange has represented that it is expected that the audit committee of the NYSE Group board will perform the NYSE Regulation board's audit committee functions.

(3) NYSE Regulation Finances[6]

(a) NYSE LLC has delegated to NYSE Regulation the authority to assess NYSE LLC members in order to cover the costs of regulation. Subject to SEC approval, NYSE Regulation will determine, assess, collect, and retain examination, registration, arbitration, and other regulatory fees.

(b) NYSE Regulation will also receive funding independently from the markets for which it will provide regulatory services. For instance, the Exchange has represented that there will be an explicit agreement among NYSE Group, NYSE LLC, NYSE Market, and NYSE Regulation to provide "adequate funding" to NYSE Regulation.

(c) NYSE Regulation establishes and assesses fees and other charges on NYSE LLC members and others using the services or facilities of NYSE Regulation.

(d) NYSE LLC will not be permitted to use any assets of or regulatory fees, fines, or penalties collected by NYSE Regulation for commercial purposes or distribute them to any other NYSE Group-related entity.

(e) NYSE Regulation determines its annual budget and the allocation of its resources.

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[6] *See February 27 SEC Order*, *supra* note 2, at 128-32; Delegation Agreement (among NYSE LLC, NYSE Regulation, and NYSE Market), reproduced at *SEC-Approved NYSE Documents*, *supra* note 3, at II(A)(14)-(17) [hereinafter *NYSE LLC Delegation Agreement*]

(4) Promises of Non-Interference[7] and Delegation of Responsibility[8]

(a) A variety of provisions in the NYSE Group's certificate of incorporation and bylaws seek to preclude the NYSE Group from interfering with the self-regulatory obligations of NYSE LLC, NYSE Market, and NYSE Regulation. By way of example, NYSE Group board members must "to the fullest extent permitted by applicable law" take into consideration the effect that the NYSE Group's actions would have on the ability of such regulated subsidiaries to carry out their responsibilities under the Securities Exchange Act of 1934.

(b) Certain regulatory responsibilities are delegated to NYSE Regulation. With exceptions, NYSE LLC delegates to NYSE Regulation the responsibility to establish and administer rules relating to the business of exchange members and enforce rules relating to trading on the NYSE Market and in NYSE-listed securities by member firms. A decision upon appeal to the NYSE Regulation board of disciplinary matters shall be the final action of NYSE LLC.

(c) The exceptions just referred to are not insignificant. Apart from NYSE Regulation disciplinary decisions, the NYSE LLC board can review, approve, or reject the actions of NYSE Regulation. In addition, NYSE LLC has the right to, among other things, resolve any disputes between NYSE Regulation and NYSE Market and coordinate actions of NYSE Regulation and NYSE Market "as necessary."

III. A Preliminary Evaluation

On the surface, the legal protections created by the Exchange to avoid conflicts and to protect the integrity of its dual functions appear robust. But a closer examination suggests that the legal means and market-based incentives in place may prove inadequate.

A. Legal Means: The "Minority of Directors" Theme

With regard to the legal framework, a fundamental assumption of the new governance structure is the notion that NYSE Regulation's independence will be preserved by limiting the participation of NYSE Group's insiders and directors on NYSE Regulation's board. The basic argument is that because "only a minority of directors" on NYSE Regulation's board and various committees will come from NYSE Group, the truly independent NYSE Regulation directors are in full control and completely directed to proper regulatory ends.

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[7] *See, e.g.,* Amended and Restated Certificate of Incorporation of NYSE Group, Inc., reproduced at *SEC-Approved NYSE Documents*, *supra* note 3, at Articles VI (Section 8), XI, XII, and XIII [hereinafter *NYSE Group Certificate of Incorporation*].

[8] *See NYSE LLC Delegation Agreement*, *supra* note 6.

I am not fully persuaded by this "minority of directors" argument. A minority position does not automatically equate to minor influence. For example, let's say that the chairman of the NYSE Group happens to be one of the members of NYSE Regulation's board. He would be the 800 pound gorilla in the room. His influence will inevitably far exceed his voting power as an individual board member.

Moreover, board meetings generally operate through consensus, not by actual contested voting. Thus, the fact that NYSE Group directors constitute a minority of NYSE Regulation's board does not render them powerless over important regulatory decisions. And the reality is that many corporate boards operate with a certain element of structural bias—a "go along to get along" mentality. Such bias, inherent in the governance of almost all publicly held corporations, may reduce the incentive for NYSE Regulation's independent directors to aggressively pursue regulatory matters that threaten the financial interests of their corporate parent.

Finally, apart from a possible fixed fee for attendance at each meeting, NYSE Regulation's bylaws prevent board members from being paid for their directorial services. This fact further reduces the likelihood that NYSE Regulation's independent directors will be willing to fully engage with those directors with the luster and prestige of being on the parent company's board.

B. Legal Means: The Relationship between NYSE LLC and NYSE Regulation

Another structural concern that warrants the Committee's attention is the relationship between NYSE LLC and NYSE Regulation. NYSE LLC is a wholly owned subsidiary of the NYSE Group and a vital element in the NYSE Group's efforts at shareholder wealth maximization. Although NYSE LLC lacks authority over NYSE Regulation's individual disciplinary actions and there is SEC oversight, NYSE LLC does have authority over general rules and other actions undertaken by the regulatory arm. These general rules will guide future activity by NYSE Regulation–including future disciplinary actions. NYSE LLC has explicitly retained the right to, among other things, resolve any disputes between NYSE Regulation and NYSE Market. The bottom line is that, other than as to individual disciplinary matters, NYSE LLC has extensive authority with respect to the behavior of NYSE Regulation.

C. Market Incentives

The above discussion has focused on "legalisms" and formal governance issues. As important is another question which is often overlooked—to what extent will reform of the New York Stock Exchange alter incentives and other market mechanisms that play a crucial role in our system of self-regulation. In the American model of corporate governance, incentives and related mechanisms are terribly important.

When properly designed, executive compensation packages can help to properly align the interests of managers with those of shareholders. Too often, we have seen compensation packages that instead create perverse incentives for managers, the detriment of shareholders as well as the public alike.

In the case of NYSE Regulation, compensation will be set by its board. But as discussed above, the board remains susceptible to NYSE Group's influence. In addition, because of likely differences in NYSE Group and NYSE Regulation compensation, the prospect of an alternative career path at the for-profit parent level may be attractive to those at NYSE Regulation. This may reduce incentives on the part of those at NYSE Regulation to take actions inconsistent with the goals of the NYSE Group.

Another matter of concern is the agreement that provides for "adequate funding" of NYSE Regulation. Who determines what is adequate? On what basis is "adequate" determined? How often is this determination reviewed and revised? Will NYSE Regulation's actions be influenced by the possible leverage over funding that NYSE LLC and NYSE Market may have?

Furthermore, NYSE Regulation provides regulatory services pursuant to contract with a limited term. There are no answers as of yet as to what happens when this contract terminates—and how this knowledge of an impending change would influence NYSE Regulation decisions. Has the Exchange fully considered what happens in the inevitable "end-game"? This is the Hong Kong-in-1999 issue.

D. NYSE Group Directors on the NYSE Regulation Board

The possible conflict between NYSE Group shareholder wealth-maximization goals and NYSE Regulation regulatory goals is brought into sharpest relief when looking at the duties of the NYSE Group directors who serve on the NYSE Regulation board. As a matter of corporate law, each such director has a divided allegiance. As an NYSE Group director, he owes a duty of loyalty to NYSE Group shareholders; thus, he must generally undertake decisions that would further the interests of the shareholders. As an NYSE Regulation director, he owes a duty to further the regulatory goals of NYSE Regulation. Can he serve two masters, especially when the two masters' goals differ in their very nature?

In the normal corporate law context, one situation in which corporations with common directors transact business with each other is where one corporation is the controlling shareholder of another corporation. To what extent will common directors participate in intercorporate dealings when there are real or apparent conflicts? If they do participate, to what extent should the dealings be voidable or subject to special scrutiny? Given that the case law with respect to common directors and the obligations of controlling shareholders do not provide clear guidance, the actual behavior of such NYSE Group directors may be especially difficult to

predict. Moreover, because of the special public responsibilities of the Exchange and the importance of public confidence, the mere appearance of self-interested behavior is troublesome.

IV. Conclusion

In conclusion, SEC Chairman Christopher Cox has stated that he intends to closely monitor the NYSE's performance under the new structure. This is commendable. It is also vital.

The not-for-profit NYSE Regulation within the for-profit NYSE Group structure is an experimental structure. It is one that is far more complicated than that of the usual publicly held corporation. The ends involved here cannot, as with the usual publicly held corporation, be essentially reduced to the single end of shareholder wealth maximization. Yet, ironically, the legal and market mechanisms in place here seem far more primitive than those operating in the publicly held corporation context. I worry whether, in fact, the mechanisms here are sufficient to ensure adherence to the stated goals.

But just because there are possible problems with this NYSE approach does not mean necessarily mean that some full or partial alternative is better overall—whether that alternative is a spun-off NYSE Regulation, a joint venture with the NASD, or something else. An apples for apples comparison is necessary. After all, even traditional not-for-profit self-regulatory organizations are hardly free from conflicts of interest. Far from it. But one advantage to a more traditional SRO is that we have experience. Moreover, the goals of such an SRO are simpler and do not get so intertwined with the goal of shareholder wealth maximization. Coming up with tolerably good organizational structures may be easier as a result. On the other hand, there are many benefits to the togetherness advocated by the NYSE. But the benefits of such togetherness do need to be weighed against the costs. And among the soft, hard-to-quantify, costs are the many uncertainties associated with a complicated experimental structure.

When the playwright Henrik Ibsen was ill, a nurse came to take a look. The nurse said to Ibsen that he "seemed to be a little better." Ibsen said "*[o]n the contrary*"--and died. It is important to go beyond a quick look. It is important to go beyond stated goals and to try to assess whether the legal and market mechanisms in place will in fact nurture and sustain those goals. I say "*maybe*."

Thank you.