Statement of
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Before the
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Regulation of the New York Stock Exchange
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Good Morning Chairman Shelby, Senator Sarbanes, and members of the Committee. My name is Richard Ferlauto, and I am the Director of Pension and Investment Policy at the American Federation of State, County and Municipal Employees (AFSCME), a union representing 1.4 million state and local government, health-care and childcare workers. I appreciate the opportunity to appear today on behalf of AFSCME and the nine million member AFL-CIO to discuss regulation of the New York Stock Exchange.

The appropriate level of regulation of capital markets is a key concern to us because it impacts on the financial condition and retirement security of every working family in this new ownership society. AFSCME members have their retirement assets invested by pubic pension systems with combined assets totaling over $1 trillion dollars. These public systems have lost more than $300 billion in assets due to the loss of market confidence following the scandals of Enron and WorldCom. In addition to these public funds, union multi employer-sponsored pension plans hold approximately $400 billion in total assets and are beneficial shareholders of corporate issuers through banks, brokers, and other custodians. All together, union members participate in benefit plans with over $5 trillion in assets, not including the dollars they invest as individuals. The institutional investment funds are highly indexed and are long-term owners as patient investors. Confidence in the markets, transparency and appropriate regulation are the foundation of their success as investors.

AFSCME and the AFL-CIO are convinced that the New York Stock Exchange (NYSE) and other self-regulatory organizations play a valuable role in the marketplace. We have been supportive of the NYSE's unique strengths as an in-person market maker. However, the NYSE's recent conversion to "for-profit status" and its unwise determination to retain and finance its regulatory unit within the NYSE Group creates a clear conflict of interest that we believe poses a significant danger to investors.

We urge Congress to call on the Securities and Exchange Commission (SEC) to directly regulate, or in the alternative, to support the creation of a genuinely independent organization to regulate the NYSE. Recent press accounts of a possible consolidation of NYSE and National Association of Security Dealers (NASD) regulation make it clear that the SEC must act with haste to protect the public interest.

Speaking to regulators and leading Wall Street executives about the NYSE Group's new structure at the Securities Industry Association's November 11, 2005 meeting, NASD Chairman and CEO Robert Glauber said, "There is a conflict in an enterprise operating as regulator." In fact, according to a recent report by Glass, Lewis and Company, the number of company restatements have surged, due in part to a lack of adequate internal controls. Now that the auditors have determined what was actually in these accounts, we are finding many of the problem companies were on the NYSE. In its new structure as a corporation, the NYSE has even fewer legal and financial resources to protect investors. Indeed, its regulatory unit has a glaring conflict of interest. Since making a profit would become even more critical to its ability to sustain its stock price, it makes its in-house regulatory arm a bigger issue.

Conflicts of Interest

We are very concerned about the potential for conflicts of interest. For example, the NYSE/Archipelago Holdings, Inc. merger, expected to become effective this quarter after SEC approval last week, comes after 213 years in which the NYSE operated as a not-for-profit corporation. The Exchange Act gave the NYSE "front-line" authority to regulate itself. While this structure has resulted in significant enforcement lapses, the new entity raises conflict concerns to an entirely new level.

Importantly, the SEC has shown a willingness to criticize the NYSE for lax oversight. In response, the NYSE has retained its regulatory unit as a "not-for-profit" division of the corporation, with a board that has at least 20 percent of its directors from outside the NYSE Group board. What this means, of course, is that 80 percent of the directors of the NYSE's regulatory unit can also be members of the NYSE Group board. These directors unfortunately do have an inherent conflict of interest since they have a duty to maximize returns for the shareholders of the NYSE Group. Consequently, the NYSE regulatory unit's actions may well have an adverse impact upon the revenues of the NYSE thereby putting conflicting directors who serve on both boards in a situation where the appearance of conflicts may be unavoidable.

Moreover, the NYSE regulatory unit's budget comes from the fines and fees that brokerage firms pay to it. If this does not create a conflict of interest for its Group board, any additional revenues for the regulatory unit must, according to the NYSE, come from the NYSE Group itself. Directors must then decide whether their duty to the NYSE Group overrides their duty to the NYSE regulatory unit. Either the directors agree to pay more for enforcement and potentially cut the revenues of the

NYSE Group, or they maximize revenues for the NYSE Group and cut the necessary revenues for the regulatory unit.

Recent Examples of NYSE's Problematic Self-Regulation

Our public fund investors have come to rely on the considerable efforts by New York Attorney General Eliot Spitzer and the SEC to correct for lapses in the NYSE's self-regulation. In the area of financial reporting, the NYSE has been lax in its supervision and when problems were discovered at companies such as Qwest, it took extended periods of time, in some cases over a year, before investors were once again able to receive reliable reports.

In another case, the NYSE's decision last October to allow Sovereign Bancorp to proceed with a restructured stock sale was a striking example of a conflict and the need for an independent regulator. Instead of requiring a shareholder vote on the proposed sale of more than 20 percent of Sovereign shares to Banc Santander, the NYSE's self-regulatory body allowed Sovereign to skirt the NYSE rule on the technical grounds that Sovereign only sold "treasury shares." Sovereign, as an NYSE listed company, virtually avoided any shareholder accountability.

Less than a month after its decision in the Sovereign matter, the NYSE also permitted Fannie Mae to skirt its filing rules, granting an exemption from de-listing requirements when it failed to file its financial statements on time. This certainly appears to be a serious conflict of interest in light of the fact that Fannie Mae pays the NYSE the maximum annual listing fee of $500,000.

Role of the Securities and Exchange Commission

The SEC is well aware of these concerns and has already identified serious issues related to self regulation of a "for-profit" entity. Its concept papers (File No. S7-39-04 and File No. S7-40-04) have pointed out that demutualization raises the concern that the profit motive of a shareholder-owned Self-Regulatory Organization (SRO) could detract from proper self-regulation.

We urge Congress to work with the SEC with the goal of eliminating self-regulation by the exchanges. The Commission should set timelines for pursuing reform goals and open the process through public roundtables and other forums allowing investor participation and public engagement.

The oversight role of the SEC might also be enhanced during this review of the self-regulatory powers of SROs. While the Commission has the power under the Exchange Act to approve changes in SRO rules, the full extent of its authority remains unclear and has caused concerns for investors for many years. For example, as investors focused on corporate governance, we believe that the Commission should have the ability to regulate listing standards contrary to the limitations posed on the SEC by BusinessRound v. SEC.

Despite these concerns, we are also afraid the SEC will not have the administrative capacity to guard against the NYSE's historically lax oversight. The SEC's annual report for 2005 reflects actual program costs of $917,650 million for the FY 2007 budget which is a cut back. The 2005 annual report also notes that staff turnover is up to 7.5 percent, the highest since 2001.

While we raise these concerns, we stress that AFSCME and the AFL-CIO are strong supporters of the NYSE and its in-person market. Moreover, we support a regulatory structure for the NYSE that fosters investor confidence, ensures fairness to all market participants, and encourages competition to promote efficiency in today's markets. This system should ensure that all exchanges meet or exceed established standards of investor protection and should prohibit "races to the bottom" by the ongoing lowering of regulatory standards and listing requirements. Equally important, the system should guarantee that regulatory oversight functions are adequately and securely funded.

The NYSE cannot, in any reasonable person's mind, be both a "for-profit" entity whose critical success is tied to growing revenues, including from listing fees, and at the same time be expected to take actions that would result in a negative impact on those fees. As we saw with the auditors, one cannot carry the water buckets for two masters at the same time.

I appreciate your time and attention regarding this important issue and would be happy to answer any questions you might have.