Intelligent Investing Transcript
Transcript: Duncan Niederauer
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Steve: No Stimulus II

Hello, I'm Steve Forbes. It's a pleasure to introduce our featured guest, Duncan Niederauer, chief executive officer of NYSE Euronext. His firm, which runs the New York Stock Exchange, has had a front row seat to the market downturn and recession. It's also seen a lot of changes lately, with the American Stock Exchange acquisition and creation of the New York Block Exchange. My conversation with Duncan follows, but first--

The Obama administration has floated the idea of a second stimulus package. Are they crazy? The funds from the first stimulus package haven't been spent and they want to get started on a second?

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Reckless deficit spending will only serve to weaken the dollar and our economy. Treasury Secretary Timothy Geithner and Fed chairman Ben Bernanke need to defend the greenback. A promise not to monetize future government debt would help. Some resistance to a second so-called stimulus is crucial.

Only $56 billion of the $787 billion stimulus has been spent so far and what's planned doesn't look good. The government is wasting money on pork barrel projects designed to keep congressional incumbents in their seats. That's no way to get an economy moving.

President Obama has gone on the greatest check-writing binge in our history, with the exception of the Civil War and World War II. If we're going to stay on this financial planning path of spending our way out of the recession, President Obama should cut the FICA tax in half for the next 18 months. That will put money in consumers' hands, where it needs to be.

In a moment, my conversation with Duncan Niederauer.

NYSE's Optimist

Steve Forbes: Duncan, good to have you with us. First of all is a general comment about the state of the markets now, in terms of IPOs. We were talking before we went on camera about secondaries. Is activity bullish?

Duncan Niederauer: I think so, Steve. And first of all, thanks for having me with you today. As you probably saw earlier in the year, I was one of the few voices of optimism when I thought everybody was pretty pessimistic. And then I got cautious coming into the summer, after the big run up in March and April. But I would have to say, with what we've seen the last three months, not a lot of IPOs, but hundreds of billions of dollars of secondary issuance, and the markets absorbed that supply, and steady as she goes.

Rebranding Specialists

Forbes: You've made a few changes at what we used to call the Big Board. One of the big ones, of course, is the old specialist system, which you now call designated market makers.

Niederauer: Right.

Forbes: How are they different from the old, traditional specialist, and what do they bring that the specialist did not, or the other exchanges don't?

Niederauer: It's a couple of significant differences. My view, when I got there, was that the old specialist system was outdated for today's markets.

Forbes: You had felt that way for a long time.

Niederauer: Yeah, for a long time before I got there. And things were moving too quickly. I thought, if we were going to stay relevant, we had to redefine what the role of that primary market maker was all about. So, part of the switch to designated market maker, quite honestly, was a rebranding so people would think of it broadly as something different than what the old specialist meant.

But one part we didn't want to give up was, we wanted our primary market maker, which we now call a DMM, to have obligations that we think help differentiate our marketplace. I want somebody to make a market in an issuer's stock not matter what the volatility levels are, no matter how hot the kitchen gets, we think that's very, very important. So, they still have obligations like the old specialist did, but we've changed a lot of the rules, so they don't have information advantages like the old specialist did either. We thought that was outdated for today's marketplace.

Forbes: And you've mentioned that you think your firm now has some trading efficiencies, which are highly important. Can you quickly enumerate some of them?

Niederauer: I think what's unique is the market model that's different. I think we have an ability, I view it as a real-time lever, where we've got a floor, we can intervene human judgment and no other all-electronic marketplace can. Even our own all-electronic marketplace we run the NYSE Arca platform. That's all electronic to compete with the other all-electronic markets like NASDAQ, like Direct Edge, like BATS.

We're going to keep the floor at the NYSE, because we think what makes it unique is you look at a period like September and October, volatility explodes, clients wanted to trade blocks of stock, not 500 or 1,000 shares at a time. We were the only market that was effectively positioned to do that at any time during the day. So I think that makes it fairly unique.

At the same time, we had to get fast enough to be competitive with the rest of the marketplaces. So when I got there with some of my key lieutenants, one of the things we embarked on was an 18-24 month redo of the technology, so that our technology is now as fast as everyone else, just about, when we need it to be. But then we have that ability to intervene human judgment, real-time, if we have to.

Trading Technology

Forbes: Now, you mentioned that your exchange now offers technology to financial firms and exchanges. Can you elaborate a little bit on that?

Niederauer: So, what I've tried to do since I was CEO is shift the focus of the company. We're not going to give up being an exchange or an operator of markets. But we're also thinking and behaving more like a technology company. Because I think in the end, the exchange of the 21st century is going to look more like a technology and processing company.

So a lot of the acquisitions we've done in the time I've been chief executive were acquisitions of technology assets. In fact, four of the five acquisitions we've done were technology acquisitions. Only the Amex was an exchange acquisition. And so now one of the businesses that that puts us in, and we'll talk about this in our earnings call next week and we're going to start reporting it as a separate segment, is something we call NYSE Technologies.

So that's all of our technology products that we sell to customers on the buyside and sellside, and in some cases we also sell exchange infrastructure to other exchanges around the world, for example, like the exchanges in Brazil, Tokyo, Qatar, Malaysia and other places like that.

Forbes: So, looking out, how much of the business do you think will be in effect being a software, technology shop?

Niederauer: Well, if you think about our company, one of the quotes I've been using a lot lately is, "We're a company with its roots in the 18th century that's trying to compete effectively in the 21st century. And it requires a whole new way of thinking." And when I think of the different businesses or regions or products we'll be involved in three, five years from now, I think we're going to look a lot more like an applied technology company.

We've clearly got the platform, now it's about putting applications on top of that platform. And I think our job the next two to three years is to define what those applications are. So the platform is being a market operator and having the technology to operate those markets. Now the question is, what applications do you put on top of that? So I think we're going to end up looking a lot more like an applied technology company two, three years out.

Forbes: Now explain what advantage that'll give you over NASDAQ and numerous other competitors you have in the marketplace these days.

Niederauer: I actually don't think it's about advantages over the competition, because I think we're always going to have competition in certain parts of our business.

Forbes: So this is a whole new area.

Niederauer: Whether it's NASDAQ in the U.S., or the LSC in Europe or the big derivative exchanges for our derivative operation that we run out of the U.K. I don't think that competitive landscape is going to change too much. Although, there will probably be some consolidation. For us, it's redefining what an exchange in the 21st century is and diversifying the revenues away from where exchanges traditionally made all their money which was in transaction fees and data sales.

So I'm sure other exchanges are thinking about similar things, but to us it's reminding everybody we're already global. We're already a global exchange. Now can we be a global applied technology company.

Fast Money

Forbes: Wow. High frequency trading, the latest thing that's now supposedly undermining confidence and the integrity of transactions. Explain what you think of high frequency trading, and where you're placing the Big Board and what does it mean in terms of regulation, political reaction.

Niederauer: Right. I think everything gets a lot of regulatory attention today. So any new thing can assume it's going to be put under the regulatory microscope. And this is a new business. If we go back, if you and I were sitting here five or six years ago, people were just beginning to understand what electronic market making was all about. The technology had just gotten far enough at that time, Steve, that people could start to think about new business models that that technology was going to enable.

I actually am confused about why they're being discredited, and I'm not just saying that because some of them are big customers of ours. They're actually probably the most consistent source of liquidity provision in the market today. I actually don't think they added to the volatility in the crisis. If anything, the studies that we've done would suggest it's a pretty consistent provision of liquidity that would dampen volatility.

So our view is that liquidity provision is pretty important. I'm not sure why they're being accused of diminishing confidence in the U.S. equity markets, because I'm not able to make that connection. So it's an argument I don't support, actually.

Forbes: So the idea that they're always going to be able to do these micro arbitraging at the expense of traditional investors, you think is wrong?

Niederauer: I don't think it's at the expense of traditional investors. I think we've got to get away from this notion that everything is a zero sum game. I think most investors I talk to aren't that concerned about where the next 500 shares trade, and what the bid offer spread is. They're concerned about making investment decisions that are typically of a long-term nature. So I don't think in the microsecond to microsecond world the investors that you and I would be worried about protecting are at all disadvantaged by this electronic market making activity.

Blocking The Blocks

Forbes: Now you've recently launched the NYSE Block Exchange. Can you elaborate on that?

Niederauer: So we have this joint venture with a number of sell side firms called the New York Block Exchange. And it was really in response to what a lot of our customers and the sellside's customers on the buyside were asking for. As you've observed from being a student of the markets for a while, the markets have never been more fragmented. It's never been more difficult to get block trades done and there's never been this much volume that is traded in an opaque way. So these so-called "dark pools," which have really actually grown in popularity collectively.

So, a lot of the buy side customers were coming to us saying, "Will someone please aggregate the information that's displayed and information that's in reserve or in the dark so that we can bring it into one place and we can actually trade blocks when we want to trade them and do it in a way where there's not much information leakage."

So that facility and the exchange is meant to bring the best of both worlds. We're making some good progress; it's not where I'd like it to be, yet, but I think it's going to be all about the connectivity to the buy side. And the more buy side customers we can get to have connectivity directly into facility, I think we're really on to something there. So we've had a few days where we've done five or ten million shares, but nothing to write home about yet.

Forbes: And, do you see a time coming where if you have a block you can actually put it out there and now feel you're going to get slice and diced?

Niederauer: I wish that would be the case, because as someone who's been in the markets for 25 years I wish we could get back to that. I thought that was a much better market. I just think information travels so fast now, that most customers have concluded that giving that information to the marketplace effectively amounts to giving the marketplace a free option. And we all know that, you know, selling options at zero is never a winning strategy.

So I'm afraid that we're going to have to figure out more creative ways where these things can be done somewhat behind the curtain. Reported very transparently, but I think the price discovery process continues to be difficult. We found in the crisis clients were willing to show their hand, because they realize that it was a critical situation. If they wanted to move a million shares, waiting for two or three days wasn't an option at that time.

And I was very proud of what we did at that time because we were able to discover prices very quickly. I don't think the customers were harmed by displaying what they had to get done. But on an ongoing basis, I think it's going to be tough to encourage everyone to come back into the daylight again.

Forbes: The whole thrust on regulatory reform, what do you see unfolding there? I'll just put my card on the table. I don't understand why they didn't bring in somebody like a Volker, bring in some people and do this in a systematic way instead of just throwing stuff out there and seeing what sticks and doesn't stick.

Niederauer: Certainly you're right. The approach so far seems to be more about putting some straw men out there, floating some trial balloons and seeing what the response is. I do think directionally they're headed in the right direction. Some of the trial balloons that have been floated, I think, are directionally correct.

I had probably hoped a little more that they'd have the appetite to bring the CFTC and the SEC together. And I'm still optimistic. While I know that would be challenging, I think harmonizing the approach that those two organizations take is very important. Putting all that aside, it's an era of re-regulation. And so we're going to continue to focus on what we think are the key principles.

We think it's got to be about investor protection. We think harmonization, as I alluded to, is important. I think we've got to bring a lot of these products that got us in trouble out of the shadows and into a more transparent environment. And then the thing that whenever we're down in Washington we're probably most focused on is, aside from those three things, is let's not re-regulation translate to overregulation.

We've got good regulation. The transparent regulated markets, like the ones we operate, performed beautifully. Maybe we can apply some of the existing regulation to other products. We're open to suggestions. But let's have smarter regulation or smarter application of regulation, not just more of it. Right, that's what we're shooting for.

Naked Shorts

Forbes: One issue, of course, is the whole thing on the uptick rule. One, why has the SEC been so slow in coming up with a new rule? And two, naked short-selling, is that still rampant?

Niederauer: I'll address the first one first. I actually think Mary's moved pretty quickly on this. So I think Chairman Shapiro's done everything she could have done. I think the ban never should have taken place last year. We thought that was a mistake from the beginning. We thought there was no obvious ways to transition out of the ban into a more normal situation.

We've come out pretty publicly and said, "There's got to be some kind of a rule set around shorting." Otherwise we just think it exacerbates volatility and erodes confidence because it really creates too many opportunities for manipulation. We don't think it has to be the old uptick rule. We think that's kind of outmoded for the markets we live in today. We think a bid test is completely appropriate, and--

Forbes: Can you describe the bid test?

Niederauer: A bid test is--think of the old uptick test as the stock had to be trading on an uptick for you to short it. Now that test would be applied to the best bid in the marketplace. And as long as that best bid is better or equal to the previous bid, our view is that's OK. You should be allowed to make that sale. You shouldn't have to wait for an uptick. You should be able to hit a bid. You just shouldn't be able to hit consecutive bids on downticks. So if the bid keeps moving down you shouldn't get to keep shorting. You should have to wait for the bid to be stable. Then it's OK in our mind to hit a bid and make a short sale. I don't think that hurts people from trading. I don't think it's a big friction. I'm never going to be able to prove to anybody that any kind of a bid test or an uptick test is beneficial, it creates a dis-benefit, never going to be able to prove that.

I don't think that's what this was about. I think this was about confidence. And I think it would make people feel that the game were more fair if there was some kind of a regime around short-selling. So that's important to get that right. We're in the camp that says if you're going to have a rule, it should be enforced all the time not just when a stock is in distress.

But even if we get that done, your second part of your question is the important part. What was really broken in this country was not the trading rules. It was the borrowing, lending and delivery rules. They were not being enforced. People were not borrowing stock and had no intention of borrowing stock when they shorted. And that was our big issue with the SEC in the previous administration. Enforce the rules.

Settlement's supposed to be T-plus-three in this country, not T-plus-100. And there were a lot more aged fails than people thought. So, I think tightening up those rules has made a big difference and has dramatically reduced the amount of naked short selling.

Lastly, Steve, the intraday activity we're never going to be able to stop. You're not going to be able to stop it. I'm not going to be able to stop it, even as the biggest exchange. If someone wants to short a stock in the morning and cover it in the afternoon, that's called day-trading, I'm not sure there's much we can do about that. So I don't really think that's naked short-selling the way the media talks about it. I think that was short-selling where the customer had no intention of borrowing and delivering that stock.

Forbes: And what about the role of ETFs in this?

Niederauer: I think that's another thing that's been overstated and misunderstood. So we've encouraged the ETF community as to say, "Listed derivatives actually have worked. They have been not a part of the problem that we had. It was the opaque derivatives that were unlisted and unregulated."

And I think we've encouraged the ETF industry to get the facts out there. Because there's a lot of speculation that these inverse or leveraged ETFs are creating all kinds of volatility. Given that most of the people who trade those at least in size at the institutional level are hedging the other side of that trade, it's not clear to me why those would be so heavily criticized either.

Because if I buy an inverse ETF which effectively is a short instrument, and I want to hedge myself, I'm going out and buying all the stocks in the marketplace that are the natural hedge for that transaction. So that sounds to me like index arbitrage that's been going on in this country for 30 or 40 years and has never been cited as an exacerbater of volatility. So that's my view on that one.

Regulatory Reform

Forbes: And in terms of other regulatory reforms, any quickly come to mind that you think they should be focusing on?

Niederauer: I think we've touched on a couple. I think it's going to be more about some of the things we already hit on. If these products that got to be so large can have that much impact on systemic risk in the U.S. financial system, I think the dealers have to accept that central clearing and some transparency is a price of wanting to be in those businesses.

And, my guess is that the key on reg reform led by Secretary Geithner, I think, quite well so far, he's been very clear on the direction, is this isn't about standardizing all these things, and putting them on exchanges. Maybe I'm supposed to say that it should be about that, since a run a big regulated exchange. I think, if we want to attack the problem, though, the key part is first, to centrally clear these items, and secondly, to transparently report the prices at which trades are being transacted.

If you get those two things done, I think standardization is nice, it's interesting. I'm just not sure it's relevant. Most of the problem that we got ourselves into would be solved by eliminating bilateral clearing, centrally clearing these instruments and then using exchanges or other mechanisms who are in the data distribution business already to report the transactions that are taking place. The transactions might only be consumed by a sophisticated investor. That's fine. That's way more information than they had before. Enforcing these things to trade on exchange, when they're not easily standardized, that, to me, is the least of our worries right now.

CDS Clearing

Forbes: So if we have the centralized clearing, we'll avoid the suspicions of phony CDS transactions to put pressure on stocks, or make rating agencies think that, "Oh, maybe the bonds aren't what we thought they were," and start all of that?

Niederauer: I think it's possible. But, remember, as someone at the SEC said to me the other day, "You can't regulate what you can't see." And my view is, you can't risk manage what you don't understand.

Forbes: Right.

Niederauer: So, if there's no transparent reporting, and there's no central clearing, it's not difficult to understand why we ended up where we ended up. And our view is, if you centrally clear them, we'd know where the risk was, we'd understand who had what risk on their balance sheet, it would be a lot easier for investors to say, "Oh, I understand what's on the balance sheet. Now I have a little better sense of what's off the balance sheet."

And the regulators would be in position, I think, and this is a bit of a stretch, but I think the regulators would be in much better position with transparent reporting to see if there are any linkages from the CDS market to the equity market. Because you and I can sit here and talk about plus tick rules and naked short selling all day. I have a feeling there's a pretty clear linkage between, and during the crisis anyway, of what was going on in the CDS market, and what was going on in the equity market. And until we bring some more transparency to that, what regulator would have any hope of overseeing that effectively?

Forbes: You think we're moving quickly enough in that direction? I mean, this is not a brand new idea.

Niederauer: It's not a brand new idea. That would be one place where we could probably stand to move more quickly. I think the joint hearings we've had the last few days are a step in the right direction, but what needs to be laid out clearly is, who's got responsibility for index CDS.

My personal view is that should be the CFTC, because those look more like derivatives to me. And who's got responsibility for single name CDS, and my view on that is that should be the SEC, because the single name CDS market, if we don't think it's linked to the equity market, we're not paying attention. It's very, very linked to the equity market.

Forbes: And who's pushing to make that happen? Who's in charge?

Niederauer: You tell me. But I think the administration has a lot of balls in the air right now. So, in fairness to them, you know, you're trying to tackle energy policy, health care policy, and financial reg reform at the same time? Any one of those three is a pretty full plate. Financial reg reform has got to be tackled first, though, because if the financial engine in the country doesn't work, then Main Street doesn't work. Alright? So the other two are long hauls anyway. We should be focused on them, but energy and health care are not short term initiatives. It's going to take a decade or more to get all that right.

We've got to fix the financial system. And I think the administration, you're starting to see the Senate Banking Committee, House Financial Services Committee, they're stepping in the right direction. The question is, do we have the appetite to push through all the stuff that's going to have to get done, and it's not clear yet.

Lending Standards

Forbes: And on the credit markets, do you feel that how far are we to getting the credit markets working again, especially in securitization, consumer loans, and the like. That still seems to be jagged and sticky.

Niederauer: You're absolutely right. I think there's more signs than media is giving the markets credit for the markets being open again. It goes back to one of your first questions when we sat down, you know, the media likes to report on IPO's, and yet, there's been a tremendous amount of secondary issuance and debt issuance, so the markets are clearly open, much more than you would believe if you just looked at IPO statistics, relative to any other year. That's the good news. The companies would say, "Well, the debt markets are open, but boy, the prices are pretty high." So, I think that's why you've seen a lot of secondary equity issuance, because, as you and I were discussing off camera, that's pretty cost effective right now. I think that's a pretty effective way of shoring up the balance sheet, as you mentioned.

Now the challenge is, the debt part of the capital markets, there has to be this cascading effect that we haven't seen yet. Too many small businesses I talk to, and small companies I talk to, are having a very difficult time getting their hands on capital at a price that makes any sense for them to grow their business. And that part of the system, from what I can tell, is still broken.

The big banks will say they're lending. I will tell you anecdotally, I'm having difficulty finding evidence of that. And if we don't have that cascading effect where small businesses, be they public or private, can get their hands on some of this capital at prices that allow them to grow their business, I think the engine that always brings America out of these downturns is going to have a tough time getting started.

Forbes: So, what should the Fed do to get that process moving? I mean, Bernanke's talked about aggressively buying some of those securities, but he hasn't done much yet.

Niederauer: No, he's certainly done a lot of other things. And I think they've been pretty clear and pretty aggressive on that. I think they've been counting on the banks to follow through, and the banks have not followed through. And I can tell you, just to get some personal evidence, I went out and applied for a home equity line of credit that I didn't actually need. I figured the terms were pretty good, I would try.

Steve, I can tell you from personal experience, the amount of information that the lenders wanted now, compared to what they would have wanted two or three years ago, remarkable. Most people just wouldn't take the time to run that gauntlet. And what they're saying without saying it, is, if you don't have a nearly perfect credit score, don't bother applying. And that's dangerous.

So, whether this Bernanke's responsibility to get the banks to get the money in motion, whether that's administration's responsibility to point the stimulus plan more clearly at small business development, you're guess is as good as mine. But one of those two things has to happen, because I can tell you, the money's not finding its way to Main Street yet.

Forbes: Just one anecdote on that, a small business, a successful one, been using American Express for years. I was told, "We want to see your personal tax returns."

Niederauer: Pretty interesting, right?

Forbes: Wow.

Niederauer: Yeah, pretty telling.

Forbes: And, yeah, talk about an inhibitor.

Niederauer: Yeah.

Forbes: So, what's your bold prediction for the future?

Niederauer: How long's the future?

Forbes: One year, five years, one week.

Niederauer: Yeah, yeah, because I've stopped talking about five years. When I think of how much the markets have changed, and our industry particularly, I mean, you go back five years ago, most exchanges were mutually owned organizations. They weren't public, they were natural monopolies, in most countries of the world. And now, it's probably one of the most dynamic industries, it's undergoing more change that any one.

I think that the key for the next year is going to be, we're six months into a new administration. They're incredibly ambitious. They've spread a lot of hope and optimism. I think that's starting to bring confidence back. If you and I are sitting in these chairs a year from now, has all of it really made a difference? You know, I travel all over the world in this job, as I know you do in yours.

When you got to a place like China, I know it's easier for them, in a more centrally controlled government, to get things working faster. You don't have to open your eyes, hardly, to see the evidence of their stimulus plan. It's everywhere. There's building going on. There's infrastructure work being done everywhere. The things they're doing in the rural parts of the country to build domestic demand, it's very, very visible, even if you've never been to China before, and don't know where to look.

It's hard to find that evidence here, right? So, we've heard some big numbers. We've talked about a lot of things that are going to help. I think we've got to be a little more patient, and wait for it to help. But if we haven't seen meaningful signs of it making a difference a year from now, I'm going to have a very less optimistic outlook. So, that's kind of my near term view. And then, I think I've already talked about, for our industry, I think it's time to evolve what it means to be an operator of markets around the globe, and that's what we're trying to do with our own company.

Forbes: Duncan, thank you very much.

Niederauer: Thank you. Nice to be here.