

GOVERNANCE OF THE NEW YORK STOCK EXCHANGE, INC.

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Throughout the last century – most recently in 1972 – the Exchange has periodically realigned its governance structure with its evolving role in the U.S. economy and with the concomitant changes in expectations about how the Exchange should represent its stakeholders in its governance. In the 1930s, reform focused on giving “upstairs” firms a greater voice in the Exchange’s affairs. Later, reform focused on creating a professional management and insulating it from undue member influence. By the early 1970s, reform led to adopting a corporate form and giving greater voice to non-owner stakeholders – listed companies and investors.

The Exchange’s Board of Directors has established a Governance Committee and charged it with considering how to realign the Exchange’s governance after three decades of change in our capital market. The Committee has determined to solicit the views of organizations and individuals representing the Exchange’s constituents through written submissions and in-person appearances. This paper seeks to assist commentators by providing a brief outline of the Exchange’s existing governance and its rationale.¹

The Exchange’s present governance structure contains five key components: a constituent, representative Board of Directors; standing and advisory committees; an independent Nominating Committee; professional executive management; and not-for-profit status. This paper describes the unique role and governance structure of the Exchange and outlines how these five components serve the Exchange’s mission.

Unique Role and Governance Structure

The Exchange is unique in its position as a member-owned cooperative and self-regulatory organization that serves the public as the nation’s principal securities market,² its principal self-regulator³ and its principal source of corporate governance standards.⁴

¹ To further inform commentators, the Exchange has posted on its website documents relating to its governance: www.nyse.com/nysegovernance.

² The capitalization of NYSE-listed companies is more than six times that of its nearest domestic competitor, and the Exchange’s daily dollar volume is nine times that of its nearest domestic competitor.

³ The NYSE is the designated examining authority for the major securities firms in the U.S., including the more than 250 member organizations that deal with the public and account for more than 85 percent of the public customer accounts handled by U.S. broker-dealers. About 550 of our employees work in our Regulatory Group. Approximately 2000 employees at the NYSE and its technology subsidiary, or 78 percent, work in our business operations.

The case for self-regulation – collective regulation by broker-dealers of themselves through a cooperative – proceeds from four precepts that involve trade-offs and, therefore, optimization: political accountability, market sensitivity, broker-dealer interdependence and a professional staff. Political accountability comes from oversight by Congress and the Securities and Exchange Commission. Market sensitivity comes from the self-regulator’s closeness to the market. The core idea is that a self-regulator is most likely to find the “best” right answer to a regulatory problem, thereby interfering no more than necessary with market mechanisms. Interdependence among broker-dealers arises in two ways: from the systemic financial risk resulting from their dealing with one another (each broker-dealer seeks to assure that *other* broker-dealers are financially responsible), and from their collective reputational risk resulting

Accordingly, its governance structure is quite different from that of its profit-maximizing listed companies.

Like the boards of our publicly-held listed companies, the NYSE Board is a policy-making body charged with giving strategic direction to the Exchange, providing guidance to its management and assuring management's accountability. But the roles diverge from that point.

A listed company board is typically deemed effective when it is tightly aligned with its company's shareholders in charting the company's direction and overseeing its management. However, although the broker-dealer members own our "brick and mortar" and contribute half our operating revenue,⁵ they are but one of three constituencies. The other two constituencies are our listed companies and the investing public – a public that is itself served by our member organizations, and that owns our listed companies.

The board of a profit-maximizing company monitors the division between ownership and control. Therefore, its governance structure must address the conflict of interests that can arise from that division. In contrast, those issues do not arise for the Exchange, which is precluded from paying dividends and whose equity is tied to its trading rights.

Instead, the Exchange's governance must reconcile the sometimes conflicting roles that the Exchange plays, give voice to its order-providing and listing customers, afford representation to its constituent "taxpayers",⁶ and assure that market professionals and issuers steer the Exchange clear of suboptimal regulation and listing standards without putting the "fox in charge of the chicken coop". As a result, the Board of the Exchange embodies a "legislative" model of checks and balances among constituent representatives.⁷ As a representative body, the Board seeks to serve the interests of the three constituencies of the Exchange though compromise and

from regulatory failure (each broker-dealer seeks to assure that the *other* broker-dealers do not lie, cheat or steal and thereby undermine public confidence). The point of a professional staff (beyond practicality and expertise) is, of course, to insulate the regulatory program from case-specific influence by member organizations. In the end, the case for self-regulation is much like that which Winston Churchill posited for democracy: self-regulation "is far from perfect..., but it is better than anything else that has been tried."

⁴ Twenty-eight of the 30 stocks in the Dow Jones Industrial Average and 427 of the stocks in the S&P 500 are listed on the NYSE.

⁵ Listed companies contribute an additional one-third of our operating revenue, and institutional investors and other non-members contribute the remaining 15 percent.

⁶ Section 6 of the Securities Exchange Act of 1934 (the "1934 Act"), which governs registration of exchanges, requires that an exchange's rules "provide for the equitable allocation of reasonable dues, fees and other charges among its members and issuers and other persons using its facilities." Section 6 recognizes that each Exchange constituent benefits from the Exchange and must fairly share in its funding. Thus, constituent representatives determine our budget and allocate the resulting costs through fees.

⁷ The Exchange adopted this "legislative" model from the blueprint that then-former Federal Reserve Chairman William McChesney Martin, Jr. laid out in his 1971 report to the Exchange, "The Securities Markets". The Securities Acts Amendments of 1975 subsequently incorporated Chairman Martin's legislative governance model into Section 6 of the 1934 Act, which reads in relevant part, "The rules of [an] exchange [must] assure a fair representation of its members in the selection of its directors and administration of its affairs and [must] provide that one or more directors shall be representative of issuers and investors and not be associated with [any] member"

consensus. When debate closes, each Director is charged with putting aside the parochial interests of his or her constituency and voting in the best interests of the institution and the investing public.

As the client of our member organizations and as the owner of our listed companies, the investing public is the Exchange's ultimate constituency. Thus, although investors in public companies do not hold shares in the Exchange itself, the Exchange recognizes that its own interests, and the interests of its member organizations and listed companies, must align with the interests of the investing public.

The Board of Directors

Under the Exchange's Constitution (by-laws), the NYSE Board currently consists of 27 members: 12 "industry" directors; 12 non-industry directors⁸ representing the investing public, institutional investors, and listed companies; and three members of the Exchange's professional management. The 1366 broker-dealer members of the Exchange elect one-half of the non-management directors each year. Thus, the non-management directors comprise two classes of twelve directors each whose terms expire in alternate years. Each year's class consists of six industry directors and six non-industry directors. No director may be elected to more than three consecutive two-year terms.

The Exchange's Constitution requires that an "industry director" be (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. The Constitution accords representation to several industry segments: member organizations doing a public business and operating from the New York City metropolitan area; member organizations doing a public business and operating from outside the metropolitan area; specialists; non-specialist member organizations from the metropolitan area that are not national in nature; and Floor brokers. Any director who loses his or her qualification as an industry director ceases to be a director.

To ensure that non-industry directors represent constituencies distinct from the industry directors, no non-industry director may be affiliated with a broker-dealer. In addition, no non-industry director may control or be employed by a company that has a broker-dealer as a "significant" subsidiary. The Constitution charges the Nominating Committee to consider for nomination as non-industry directors representatives of listed companies and representatives of financial institutions and insurance companies that are significant investors in equity securities,⁹

⁸ The Exchange's Constitution designates non-industry directors as "public" directors. The Constitution coined this term in 1938 when it first included three non-industry directors on the Board. In today's parlance of corporate governance, "public" has come to have quite a different meaning. Accordingly, this paper uses the term "non-industry".

⁹ Upon the repeal of the Glass-Steagall Act and comparable laws segregating the insurance business, the acquisition of broker-dealer subsidiaries by "financial institutions and insurance companies" created interpretive issues regarding Board qualifications with respect to the industry/non-industry distinction. In 2001, the Exchange used principles drawn from the pre-repeal ownership by bank holding companies of securities subsidiaries to interpret the "principal" subsidiary standard in the definition of an industry director and the "significant" subsidiary standard in the definition of a non-industry director. It determined that the fact that a financial institution had a member organization subsidiary would not preclude the institution's CEO (who, by definition, cannot serve as an industry

taking care to avoid a concentration of nominees from any one area or industry. Traditionally, the Nominating Committee has considered non-industry candidates in three general categories: chief executives of major public corporations, representatives of major investors in equity securities and leaders in public fields (for example, former public officials and prominent academics).

Standing and Advisory Committees

The NYSE Board maintains several standing and advisory committees. The standing committees generally include only Directors, while the advisory committees consist primarily of non-directors. Five of the standing committees are organized along functional lines: the Public Policy Committee, the Quality of Markets Committee (which makes recommendations to the Board on proposed rule changes),¹⁰ the Finance and Audit Committee, the Human Resources Policy and Compensation Committee, and the Committee for Review (which hears appeals from disciplinary and delisting decisions).

Like the Board itself, the advisory committees are organized to represent a range of constituencies, helping the Exchange to hear regularly from all of its constituencies and maintain a broad perspective on the market and its participants. For example, the Individual Investors Advisory Committee, the Institutional Traders Advisory Committee and the Pension Managers Advisory Committee represent various investor interests. The Listed Company Advisory Committee, which represents the views of U.S. listed companies, has European, Latin American and Pacific Rim counterparts. In addition, a number of advisory committees represent diverse industry interests, such as the Exchange Traders Advisory Committee, the New York Area Firms Advisory Committee, the Regional Firms Advisory Committee and the Upstairs Traders Advisory Committee. Finally, the Legal Advisory Committee draws practitioners from law firms and the legal staffs of institutional investors, member organizations and listed companies, as well as law professors.

Nominating Committee

Like the Board of Directors, the eight-member Nominating Committee reflects the Exchange's constituencies. Four members meet the qualifications of an industry director and four meet the qualifications of a non-industry director. The Nominating Committee chair alternates each year between the two categories of committee members. Generally since 1972, one industry member has been a specialist, one has been from a regional firm, one has been from a major firm doing a public business and one has been from an underwriting firm. The members of the Nominating Committee nominate their own successors, who are then elected by the

director) from serving as a non-industry director so long as the subsidiary's secondary equities business is not a significant portion of the institution's business taken as a whole. The interpretation recognizes that an Exchange director who is CEO of a listed financial institution controlling a member organization that is not a "significant" subsidiary wears the hats of an institutional investor, a listed company and a member organization. Thus, from the perspective of an Exchange constituent, he or she can be expected to weigh issues in proportion to the relative size of those hats.

¹⁰ Reporting to the Quality of Markets Committee is a committee of securities professionals, the Market Performance Committee, which monitors the quality, operational efficiency and competitiveness of the Exchange's marketplace.

members of the Exchange. Each Nominating Committee member serves for two years, and no committee member may be elected to a second consecutive term.¹¹

Professional Executive Management

Until 1938, the NYSE was managed on a day-to-day basis by a governing committee of Exchange members and a president who was chosen from among the members. Though administrative duties were delegated in 1938 to a non-member president, it was not until the early 1970s that the separation between members and professional management became absolute. Since that time, the Chairman of the Board, who is also the chief executive officer of the Exchange, has been elected by the Board and is a full-time employee. With the approval of the Board, he or she appoints all other officers except for the Executive Vice Chairman, whom the Board also elects directly.¹²

Corporate Status

For its first 180 years, the NYSE was an unincorporated membership association. In 1971, it incorporated under the New York Not-for-Profit Corporation Law. As a result, although the NYSE may generate net income (and pay taxes on that income and retain earnings), it cannot distribute its net income to its members outside of liquidation or other extraordinary circumstances. The “brick and mortar” liquidation rights are coupled with trading rights.¹³ The structure seeks to maximize the efficiency, reliability and integrity of the market, rather than to maximize profits as in the public company model.

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The NYSE is a private entity with a public purpose. It reaches for consensus among its constituencies to serve the interests of the investing public. Although the Exchange structured its current governance to serve those interests, it has not revised that governance structure significantly since Congress was deliberating on the legislation that later became the Securities Acts Amendments of 1975. Thus, the role of the Governance Committee is to assess that structure to see how the Exchange can make it serve even better the 85 million people who invest, directly and indirectly, through the Exchange.

¹¹ Note that the Exchange Nominating Committee is constituted not simply to be independent from Exchange management, but also from the Exchange Board. Since at least 1886, the Exchange Constitution has prohibited the Board from having any direct control over, or interlock with, the Nominating Committee.

¹² The Constitution also provides for the Board’s election of one or more non-executive Vice Chairman from among the industry directors.

¹³ The Exchange’s members benefit as owners of the Exchange primarily through the right to trade on the Exchange and through their collective self-regulation via the Exchange, not by receiving dividends from the Exchange or by appreciation of their equity. That trading right becomes more valuable when the Exchange attracts more liquidity and trading to the floor. This is only achieved through serving the listed companies and their owners by maintaining an efficient and fair trading market.