SUMMARY OF TESTIMONY BY JOHN J. PHELAN, JR.
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TO THE SENATE BANKING COMMITTEE SECURITIES SUBCOMMITTEE
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My testimony covers three principal areas, namely, the philosophy and strengths of the New York Stock Exchange market system; the broad array of initiatives instituted by the NYSE since the October 1987 market break; and comments on S. 648, the proposed Market Reform Act of 1989.

THE NYSE MARKET SYSTEM

The fundamental principle underlying the NYSE market system is that the public interest should always come first. The NYSE implements this by designing operational and regulatory systems that emphasize fairness, openness, liquidity and direct interaction between public buyers and sellers of securities.

The basic strength of the system is derived from the diversity of its participants and the fact that no one group dominates the market. The principal participants are:

- Individual investors and institutional investors
- Member firms functioning as both agents and dealers
- Member-firm brokers acting as agents on the trading floor and representing the firms' customer orders
- Independent brokers on the trading floor handling customer orders on behalf of other member firms
- Dealers with assigned responsibility in individual securities on the trading floor known as specialists.

The unique interaction among these individual and institutional investors, specialists and the other trading professionals results in the enormous liquidity of the NYSE market system which none of the participating groups alone could provide.

This interaction also creates the most efficient pricing mechanism, one in which the price of a stock is established by public orders competing with each other. NYSE trading rules promote this direct interaction of public orders; and assigned dealers, or specialists, can neither dominate the market nor set the price in any stock.

Paralleling the operational system, the NYSE's expanding regulatory and market surveillance efforts, in conjunction with the SEC, underscore its commitment to operating the fairest possible market.

Besides its emphasis on fairness, liquidity, and direct interaction between public orders, a fourth way in which the NYSE market system supports the public interest is its openness. All trades are reported and publicized as they occur, with the price and volume of every trade on the NYSE floor recorded in a matter of seconds on our Consolidated Tape -- thus providing an immediate report and a continuous record for investors.

The NYSE hopes that the SEC will consult with the NYSE and other self-regulatory organizations before exercising this authority.

Large Trader Reporting

After surveying its member firms, the NYSE concluded that large trader reporting should be done through the SEC and reach across all markets. To meet legitimate concerns about unwarranted disclosure, the data could be compiled in a member firm's file and disclosed on request to an SRO or regulator. Rules should limit requests to narrowly defined purposes such as insider trading investigations or reconstruction of the market following an event like October 19, 1987. Inconsistencies in disclosure and audit trail practices between U.S. and foreign markets will affect international investors and could make enforcement difficult.

Risk Assessment for Holding Company Systems

The NYSE does not want to regulate holding companies, but it believes some agency such as the SEC should gather sufficient data to assess the financial soundness of holding companies that are parent companies of broker-dealers. As financial institutions enter non-traditional businesses not subject to self-regulatory oversight, they have the potential to create systemic risks domestically and internationally.

Coordinated Clearing and Settlement

The NYSE agrees that the clearance and settlement system for securities should be strengthened, and that clearance and settlement of securities and securities derivative products should be coordinated. But here again, a distinguished international private-sector financial body, The Group of Thirty, has pointed out the threats of national and international systemic risk involving even regulated entities.

CONCLUSION

For nearly 200 years the NYSE market system has been a leading force in the capital-raising and asset-allocation process that has been the bulwark of the U.S. economy. All the comprehensive measures taken by the NYSE over the past year-and-a-half to strengthen the system, coupled with the NYSE's traditional vigilance, will help maintain the Exchange's strong position and its contribution to the U.S. and world economy into the next century.

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Mister Chairman and Members of the Committee.

I'm delighted to be here. I would like, today, to give you a description of our market, as well as what we've done since the October 1987 market break.

I also would like to comment on several legislative proposals recommended by the Securities and Exchange Commission and introduced by you, Mister Chairman, and Senator Heinz.

Let me begin by giving you a brief background of the New York Stock Exchange.

The New York Stock Exchange has a varied and broad-based constituency made up of 555 member firms, 1,648 listed companies, 20,000 institutional investors, and 88,000 active Registered Representatives.

In terms of the investing public there were, at last count, 47 million Americans who were direct shareowners in America's corporations -- 70 percent of whom hold NYSE listed stock -- while 47 percent held only NYSE listed stock.

At the same time, another 140 million people were reported as indirect shareowners through insurance companies and pension funds, for a total of 187 million direct and indirect shareholders, all of whom have a common interest in preserving the fairness and orderliness of our equities markets.

In other words, the NYSE is a market with many constituencies and deeply planted roots in the American economy.

Working with, and on behalf of our multiple constituencies, the role of the NYSE is to:

- Promote the capital-raising process by maintaining an open, fair and liquid marketplace under normal conditions for the issuance and trading of securities.

- Provide investors -- large and small -- with a vehicle for managing their assets through investment.

- And promote effective self-regulation of the market and market participants for the protection of investors and the integrity of the marketplace.

Underlying this role is the fundamental philosophy of the NYSE market system, which is to provide investors -- to the greatest degree possible -- maximum fairness, openness, liquidity and direct interaction between public buyers and sellers of securities.

Our ability to accomplish these goals stems from the way the NYSE operates and from the interplay among the NYSE market system's broad array of participants.

In addition to individual investors and institutional investors, these participants include member firms functioning as both agents and dealers, member-firm brokers acting as agents on the trading floor and representing the firms' customer orders, independent brokers on the trading floor handling customer orders on behalf of other member firms, and dealers with assigned responsibility in individual securities on the trading floor, also known as specialists.

Let's take a closer look at the key professional participants who play such vital roles in the NYSE market system.

THE KEY PROFESSIONAL PARTICIPANTS IN THE NYSE MARKET SYSTEM

NYSE member firms are an integral part of the NYSE market system, including the broker-dealer organizations that serve the investing public.

These firms are represented on the trading floor by brokers who serve as fiduciaries in the execution of customer orders. These brokers use their knowledge, experience, judgment and trading skills to represent orders the firms send to the NYSE marketplace to be executed for customers.

Independent brokers perform the same fiduciary task for firms without their own trading floor representatives. They also provide expertise in trading strategies designed to take advantage of price spreads between different markets, which is known as arbitrage, and which can help maintain efficient prices. These independent brokers also serve as an extension of the member firms' network of trading brokers.

Both the member-firm and the independent brokers, acting on behalf of investors, have a primary responsibility to represent public orders entrusted to them -- helping to ensure each order the best price available at the point of sale within the context of the overall market.

Another key professional in the NYSE market system is the "upstairs trader," who works at a member-firm trading desk and is linked through sophisticated communications systems to the NYSE trading floor, as well as to other markets.

Representing the public, or their own firms, these traders commit capital to facilitate block orders for customers, engage in arbitrage between the equities markets and derivative products markets, and conduct proprietary trading, or trading for their firms' own accounts.

The final group of trading professionals -- the assigned dealers, or specialists -- operate in conjunction with all the other market participants. They are responsible for helping maintain fair and orderly markets in the securities assigned them.

They do this in four different ways:

- As dealers they trade for their own accounts when there is a temporary absence of public buyers or sellers, but only after public orders at specific prices which are in their possession have been satisfied at those prices.

- As agents, they execute orders entrusted to them by brokers, as well as orders awaiting a specific market price.

- As catalysts, they help to bring buyers and sellers together.

- And as auctioneers, they quote current buy and sell orders that reflect total supply and demand for each of the stocks assigned to them.

As a guide for specialists in the performance of their duties, we have developed the NYSE specialist job description (Attachment 1), which was revised three months ago to make these guidelines more specific.

In addition, our specialists are rated four times a year by their customers -- 20-to-30 of the more active brokers handling their stocks -- through the Specialist Performance Evaluation Questionnaire, which not only is used to measure performance by assigned dealers and provide a basis for ongoing improvement. The results are used by our Allocation Committee in determining who will get new listings.

We also monitor performance of assigned dealers by their ability to help maintain market continuity and depth.

Continuity reflects change in price from one trade to the next. The more liquid the stock, the more it trades at minimal price variations. Market depth extends the concept of reflecting price movement to a sequence of trades for a specific amount of shares. The more liquid the stock, the smaller the price movement over the fixed amount of shares traded, and the better the depth of the market.

As part of our continuing efforts to make our assigned dealers perform at even higher standards, and also to reflect the continued emphasis we put on market depth, we have upgraded our depth standards from 1,000-share sequences to 3,000-share sequences. We plan further experiments with higher levels in the future.

In carrying out their functions and interacting with all the other components of the market, assigned dealers are required to provide expert leadership, helping to maintain smooth and continuous trading throughout the day.

This leadership role for assigned dealers requires them to use their own capital to buy and sell stock when it is needed to help maintain a fair and orderly market.

Assigned dealers cannot put their own interests ahead of public orders, and are obligated to trade for their accounts against the market trend to help maintain liquidity and continuity as the price of a stock goes up or down. They do not set the price of a stock on the NYSE; it is established by public orders competing with each other.

The fundamental principle of the NYSE market system is that the public interest should always comes first. While the basic strength of the system is derived from the diversity of its participants, no one group of participants dominates the market. Instead, all the professional components must -- and do -- subordinate their interests to those of public customers.

The enormous liquidity and basic strength of the NYSE market system stems from the active involvement of all the participating groups -- individual and institutional investors as well as member firms and assigned dealers.

And as demonstrated by October 19th, 1987, no one of them alone can maintain the level of liquidity in the market provided by all.

On that day, three of the the four major participants -- the individual investor, institutional investor and the member firm -- either were out of the market or were on the sell side -- leaving just one participant, the specialist.

The tough standards we had set for our specialists paid off on October 19th when, despite their overwhelming predicament, they performed well.

The SEC, in its report on the market break, said, “Although there were some instances of questionable performance. . .specialists as a whole met their market-making obligations”:

Following are some of the ways they met those obligations:

- Even though the Dow Jones Industrial Average dropped more than 500 points on that fateful day, NYSE stocks traded unchanged from, or within one-eighth of a point of, the price of the previous trade 73 percent of the time.

- On October 19th, specialists, or assigned dealers, intervened in the market nearly 18 percent of the time -- instead of the normal 10 percent -- to make purchases and sales for their own accounts, in an effort to maintain orderly markets under very difficult circumstances

- On the same day, assigned dealers traded against the market trend in 94 percent of their trades for the purpose of bringing balance to the market -- compared with an average of 88 percent.

Following the events of October 1987, we took additional measures to strengthen our assigned dealers.

We raised the minimum capital requirement for our assigned dealers tenfold to $1 million and tripled the minimum share position they must be able to maintain for each stock assigned to them to 15,000.

And, based on inadequate performance by a few assigned dealers during the October 1987 market break, we have reallocated eleven stocks -- or one-half of one percent of all stocks issued on the NYSE --- to other assigned dealers.

These steps reinforce the entire NYSE market system, which is the most efficient securities pricing mechanism in existence, and help maintain a level of liquidity that is possible only with such a breadth of public participation and professional expertise.

In addition to maintaining maximum public interaction, fairness and liquidity, the NYSE believes in openness, and operates in the sunshine as much as possible. All trades are reported and publicized as they occur, with the price and volume of every trade on the NYSE floor recorded in a matter of seconds on our Consolidated Tape, thus providing an immediate report and a continuous record for investors.

This means our last sales are not imputed, but are actual, real times of sale; and they are not estimated within a certain period.

That puts enormous discipline on our system. It means that our institutional and member-firm trading desks, as well as the brokers executing the order have a check throughout our system on every sale of every trading day, whether or not the trading professional actually participated in the order. This also serves as an added check on our assigned dealers. And it is, in fact, the best kind of regulator.

As a result any investor, individual or institutional, can participate in the NYSE market system at any time during the trading day and know exactly what is taking place. The individual investor anywhere in the country can talk to his registered representative or broker and know exactly what is going on at that time.

This is not necessarily the case in all markets around the world. London's stock exchange, for example, has introduced a controversial rule under which the prices of large trades in its leading -- or "alpha" -- stocks are not publicized until the day after the trade is completed.

This difference between the NYSE and other markets underscores our commitment to a market system in which openness for all investors is critically important. By providing investors with instantaneous price and volume information on each listed security throughout the day, we enhance the attraction of the NYSE market system to investors.

Investors generally recognize that the NYSE markets in those securities attract the largest number of public participants, and can accommodate the greatest amount of activity while minimizing price variations from one trade to the next.

In terms of competitive prices, the NYSE market system faces considerable competition from across the country.

As a rule, the interaction among buyers and sellers on the NYSE trading floor and with the upstairs trading desks produces the best prices for NYSE-listed securities.

But if a better purchase or sale price for a particular stock is available in another market at a particular time, brokers access the better price for their firms' customers through the automated Intermarket Trading System linking competing U.S. equities marketplaces.

ITS is the electronic communications network linking eight equities markets nationwide that permits NYSE brokers representing public customers, specialists and other professionals to seek the best prices in other marketplaces around the country.

We consider ITS to be the linchpin of the National Market System. Other systems dealing with quotations and trade reporting are important informational components of the NMS. ITS, however, is the vehicle for trading among the competing markets for listed stocks.

Since ITS was inaugurated in 1978, the number of shares executed over the system has grown from 42,000 to 1.9 billion in 1988, the number of trades from 68,000 to 1.8 million, and the number of securities from 300 to 1,816. Of these stocks, 1,488 are listed on the NYSE.

Although its purpose is to serve as a balancing system, the number of shares traded through the ITS in 1988 were more than any U.S. stock exchange except the NYSE and the Midwest Stock Exchange.

In 1988, 4 percent of all volume and 7 percent of all trades in NYSE listed issues were traded via ITS.

INITIATIVES DESIGNED TO REINFORCE THE NYSE MARKET SYSTEM

All of the strengths of the NYSE market system that I have been discussing have enabled the NYSE to adjust to the rapid changes that have confronted the securities industry in recent years.

This was especially true during the past 19 months, when we redoubled our efforts to reinforce the marketplace and our regulatory capability. During this we instituted nearly 30 initiatives -- separately and with other markets -- which have bolstered the NYSE market system.

These include steps that have enhanced intermarket cooperation, technology, regulation, and interaction with our varied constituents. The actions are consistent with the recommendations in the various government studies on the market break, including those by the Presidential Task Force on Market Mechanisms, known as the Brady Commission, and the Securities and Exchange Commission.

One of the most important steps we took was to launch a new program aimed at insuring small investors are not crowded out during market dislocations. To do this, we have set up a special express service to facilitate their orders. We call it the Individual Investor Express Delivery Service.

This service enhances the position of individual investors by giving transmission priority to small orders during unusually active markets. It provides accelerated routing through SuperDot, our electronic order-routing and reporting system, to individual investor market orders of less than 2100 shares whenever the Dow moves up or down 25 points from the previous day's close. Once triggered, the service stays in effect for the remainder of the day.

We don't expect this to be a disadvantage to our clients with large orders. In fact, to the extent that it attracts additional individual investors, it will increase liquidity in the market and benefit everyone.

Intermarket Cooperation

The NYSE started to develop ideas in the vital area of intermarket cooperation early in 1988 with the assistance of a committee of executives from leading securities and futures firms.

The primary result was a series of historic initiatives jointly worked out with the Chicago Mercantile Exchange, and all the equities, options and futures markets.

One was an agreement between the NYSE and the CME which provides that if the price on the Standard and Poor's 500 futures contract traded on the CME declines 12 points, the futures contract price would not be permitted to fall further on the CME for 30 minutes.

Action would be taken simultaneously at the NYSE, where the 12 point drop in the futures contract price would be roughly equal to a 96 point decline on the Dow.

Orders identified in our automated order delivery system as involving program trading in the NYSE-listed components of the S&P 500 will be diverted into a separate computer file for five minutes.

At the end of the five-minute period, the orders will be eligible for execution. In the event of an imbalance in the supply and demand for a stock that could not be handled in an orderly fashion, trading in that stock will be halted until the imbalance is resolved.

The other landmark NYSE-CME initiative involved all the major domestic exchanges and markets. This was the coordinated circuit-breaker concept, under which trading in equities and their derivative products are suspended for limited periods of time in cases of excessive market volatility.

The plan became effective last October as a one-year pilot program. It provides that if the Dow Jones Industrial Average falls 250 points from the previous day's close, automatic trading halts will be triggered on all U.S. equities, options and futures markets for one hour. If, after trading is resumed, the Dow declines another 150 points in the same day, trading will stop for an additional two hours.

So far, neither the circuit-breaker nor the shock-absorber plan has been activated, because the threshold points have not yet been reached.

But we believe that temporary trading interruptions of pre-designated lengths will provide vital cooling-off periods in times of extreme volatility. These interruptions will allow people to assess what is happening, and give investors greater opportunity to participate in the marketplace following such interruptions.

The NYSE and the CME also have jointly addressed the issue of frontrunning between futures and equities markets. Historically, the securities, options and futures markets each have had frontrunning rules for their respective markets which basically prohibit intramarket trading in front of a customer's order that takes advantage of prior knowledge.

As a result of our discussions, the NYSE and the CME developed a new definition for intermarket frontrunning between futures and equities, which is the execution of an order in one market based on prior knowledge of an order in another market that adversely impacts the customer. The NYSE has filed a proposed rule with the SEC aimed at preventing such abuses across equities and futures markets.

In addition, the NYSE has offered to provide the futures market with audit-trail information on stock trading to assist in surveillance for frontrunning.

I will have more to say about the upgrading of our audit-trail program internally later, in the initiatives section of my testimony.

Also in the interest of enhancing intermarket communication, we have taken a number of joint actions with other exchanges to increase the flow of shared information and to improve market surveillance.

In January 1988, the heads of several self-regulatory organizations met at the NYSE to discuss a variety of methods to improve communication among the equities, futures and options markets, and the NYSE has been meeting with regulators, other markets and industry groups in an ongoing effort to improve intermarket communication and cooperation.

A breakthrough achieved as a result of such meetings has been the recent establishment by the NYSE of an intermarket hotline to share information on an ongoing basis and to coordinate action during crises with all stock, options and futures exchanges and the National Association of Securities Dealers.

An earlier development involved a cooperative plan between ourselves and the CME that has eased volatility on expirations of the Standard & Poor's 500 futures contract. Under this plan, the expiration of the index futures contract has been moved from the close to the opening of trading on expiration Fridays, sometimes referred to as the Triple Witching hour.

Unfortunately, the American Stock Exchange and the Chicago Board Options Exchange, are not participants in the agreement. Thus, index options and individual stock options expire at the close of trading. Expiring all contracts simultaneously at the opening would create two benefits. First, any imbalances in the market would have an entire trading day to be worked off. Secondly, coincident expirations may create offsets in the two products. For example, on the last Triple Witching day -- March 17 -- when three contracts expired, 41 of 52 stocks had sell imbalances at 9 AM, and 29 of 52 had buy imbalances at 3:30 that same afternoon.

We believe the degree of such imbalances could be mitigated if there were consistency throughout the industry as to the time of these contract expirations.

We also are working with the Intermarket Surveillance Group, which consists of representatives from commodities and securities exchanges and clearing entities, to establish cross-market sharing of financial and clearing information.

Talks are continuing within the ISG on developing unified systems of surveillance and processing trades and facilitating responsibilities between different markets.

The commodities markets dealing in index futures attended an ISG meeting on intermarket surveillance, and the Commodities Futures Trading Commission participated as an observer. And the NYSE heads a sub-group of the ISG whose purpose is to better identify trading violations and promote information sharing.

In a further step, we are working with the Monitoring Coordinating Group, whose members are from securities markets and clearing and depository entities, to coordinate use of financial, operational, clearing and settlement and deposit information.

Technological Advancements

A second major group of initiatives undertaken by the NYSE over the past 19 months involves the enhancement of technology, which provides basic support for the NYSE market system and is an area we have been very active in over the years.

In just the last five years, the NYSE has spent more than $200 million improving the technology in our marketplace. And as one of our major initiatives over the past 19 months, we have committed an additional, significant amount toward systems improvements for the next five years.

In fact, during this 19-month period, we have averaged at least one major systems improvement per month. These upgrades cover everything from the NYSE Consolidated Tape to behind-the-scenes processing systems.

SuperDot, itself, has undergone a major enhancement. It now enables member firms to send orders directly from brokerage offices around the United States to trading posts on our trading floor and have reported confirmations returned to the branch office much more efficiently.

To make SuperDot even more efficient, we've expanded the capacity of our limit order system -- which routes orders to the specialist for execution at a prescribed price -- by 50 percent since October 1987.

In addition, we've integrated into SuperDot our odd-lot order system, which handles orders in amounts of stock less than the established 100-share unit, providing substantially more capacity and faster response for odd-lot orders.

The ability of other markets to reach the NYSE through the Intermarket Trading System, or ITS, also has been significantly upgraded by the diversion of other message traffic from printers to the display books. The ITS network will be further enhanced soon, when incoming ITS commitments to trade will bypass printers and go to the display books.

As an additional means of assuring that ITS in the future is positioned to operate optimally in very active markets, the NYSE will be conducting a nationwide test of the system later this year. The test will encompass all the markets participating in the system, and will be geared to insure that the system and each market have the capability to process ITS traffic under growing and changing demands.

Among the many technological advances enhancing operations on the NYSE trading floor is the more-than-doubling of the number of electronic display books used by specialists to facilitate the recording, execution and reporting of orders. As a result, more than three times as many stocks are now displayed -- over 1,750 compared with 476 in October 1987.

There have been many more technological advancements instituted throughout the NYSE system, and we continually strive to be on the leading edge. That's why, for example, if there were interest in off-hours trading, the NYSE would mobilize its technological resources and launch an off-hours trading pilot.

But as yet, there has been little interest among our market participants to extend our trading hours. We've surveyed our member firms and institutional investors, and a majority expressed little or no interest in off-hours trading. Should that interest change, we will respond.

In the area of capacity, the NYSE in January 1988 expanded the capacity of our trading floor by one-fourth, with the addition of a new 7,000 square foot area equipped with state-of-the-art technology.

Capacity has been uppermost in our minds these past 19 months -- as it always has been.

NYSE policy historically includes contingency planning that calls for the continual buildup of our capacity to handle sudden spurts of trading volume far in excess of normal.

Such planning enabled us to handle on emergency basis the 600-million share days of October 19th and 20th in 1987 -- volume that was more than three times the norm.

We continue to aim at managing volume of 600 million shares a day as efficiently as we already process daily volume of 200 million shares. And it is our goal to be able to handle peak, one-day demand of one billion shares in the early 1990s.

Toward those ends, we have completed three of a planned series of Saturday systems tests since October 1987, the most recent one just five days ago.

The purpose of these tests is to simulate October 19th, address a variety of other factors and determine what needs to be done to build our capacity for the future.

The first test, in April 1988 -- simulating as best as possible the circumstances of October 1987 -- tested our internal systems. The second test, seven months later, included our member firms, and the last test included financial services vendors.

Currently, we have two additional tests planned. The next one, as I mentioned a little earlier, is scheduled for later this year involving the Intermarket Trading System. This test also will involve the Consolidated Tape and Consolidated Quotation. Next year we plan to run another test with our member firms, but at a higher capacity.

We have used outside consultants to help us develop our tests and to monitor them. Arthur D. Little has been an integral part of the process from the beginning, helping us plan and monitor the tests and conduct an independent assessment of our capability.

In addition, Peat Marwick has reviewed our model and simulations, monitored tests and conducted an independent review of our systems and processes. The firm completed its evaluation last September, and we plan to have it conduct additional studies approximately every 18 months.

The tests are run by a combination of NYSE staff and the Securities Industry Automation Corporation, or SIAC. The SEC, the GAO and the CFTC also are invited to witness the testing process.

We also are taking another major step in contingency planning in connection with SIAC. We are establishing a second SIAC facility that will split SIAC's data processing capabilities, so as to provide backup protection against a disaster that otherwise could seriously affect the trading or post-trading processes.

To help coordinate operational systems within our member-firm community, the NYSE in December 1987 established the Operations Advisory Committee. The committee is headed by Richard A. Grasso, NYSE president and chief operating officer, and is composed of senior operations officers from the NYSE's member firms. Its goal is to insure an integrated planning process between the NYSE and its member firms that will prepare our markets to serve customer demand in the years ahead.

Regulatory Enhancements

Earlier, I discussed the numerous meetings and actions the NYSE has taken in conjunction with regulators and other markets to improve regulation of the securities industry, as well as the steps we have taken to reinforce the position of our assigned dealers.

Now I would like to describe some of the other initiatives we have taken internally since October 1987 to strengthen our regulatory and market surveillance capabilities.

We have had to sharply expand our regulatory capability in the wake of the proliferation and increased complexity of products, innovative strategies, growth in volume, and the increased demand for SRO and member-firm regulatory activity.

In support of our accelerated regulatory efforts, the NYSE has substantially increased its financial commitment to regulation. We have budgeted $76 million for 1989, compared with $44 million in 1986.

Our expenditures include an ongoing automation-upgrade program geared to building a new generation of market surveillance tools based on leading-edge technologies, as well as a planned increase in regulatory staff from 373 in 1986 to 549 in 1989.

A major regulatory effort in 1988 was directed at sales practice abuses in the securities industry. This increased effort has enabled the NYSE to pursue many more cases in the past year, and to establish an enforcement unit dedicated to major sales practice investigations.

In another step forward, we have decided to take our comparison cycle from trading-day-plus-three to T-plus-One, or overnight comparison of all NYSE stock transactions. We hope to have this fully implemented by this time next year.

The new cycle means the period in which members and member firms are exposed to risk of loss due to market fluctuations on uncompared or questioned trades will be reduced considerably.

In my remarks earlier, I discussed the importance of audit-trails and the resulting high visibility of our trade information to investors and trading professionals alike.

The NYSE has been steadily improving its audit trail capability over the past decade, and since 1985 has had an ongoing program designed to maximize that capability. Our ability to capture data on the nine elements of audit trail has increased substantially since 1985, to the point where we now get 97.5 percent of the data we need.

We're now focusing on increasing the quality, or accuracy of our audit trail data. Our ability to capture accurate information will get a major boost from our Overnight Comparison System program. Phase One of that program, known as the Automated Correction Process, has the capability of enabling the NYSE and member firms to quickly correct inaccurate data and provide complete data for the audit trail.

Our goal is to achieve 100 percent capability, both in quantity and in quality. It is important, however, to keep in mind that the audit trail is not a panacea. The audit trail tracks transaction activity. It identifies the people involved in a trade, but it does not tell us their intent.

We continue to work closely on regulation with the SEC, the Congress, all other self-regulatory organizations and member firms to meet the growing need for more oversight and surveillance.

Recently, we completed a review of the full scope of our rules relating to trading processes on the trading floor. Following the review, we asked the SEC to approve numerous rule modifications and amendments which are designed to reinforce the exchange market system.

The final area of regulation I would like to talk about involves program trading, especially index arbitrage, in which investors use computers to hedge positions and profit on temporary disparities between prices of equities and stock futures.

In order to deal with volatile market conditions in early 1988, the NYSE implemented an experimental program trading "collar." This rule prohibited member firms from using our automated order delivery system to execute program index arbitrage trades for the remainder of the day if the the Dow Jones Industrial Average moved up or down 75 points (lowered to 50 points in February 1988) from the previous day's close. This program subsequently was superseded by our circuit breakers last October.

In May of 1988 we started requiring members and member firms to submit daily reports on their program trading activity, including program trading on markets other than the NYSE. And three months later the NYSE began to publicly disseminate a monthly analysis of this data to the public.

We think this kind of disclosure is a better solution than some artificial restraint on the system such as the temporary collar. We believe openness and sunshine about program trading, in which we educates people about program trading and tell them how much of it is in the system, is more effective.

Currently, program trading accounts for about 10 percent of our overall volume. At this time, we don't see it having adverse effects on market stability or volatility.

Constituent Interaction

The last initiative I would like to talk about today are the steps taken to broaden the interaction between the NYSE and our various constituents.

One way the NYSE makes sure we are attuned to the needs of the people who participate in our marketplace is through our 13 advisory committees to the NYSE board of directors. Over the years, these committees have made substantial contributions to the success and growth of the NYSE market system.

Last year alone, we created four new advisory committees that reflect the most recent areas of change and growth. The new committees are on individual investors, pension managers, regulatory matters and Japan.

The Individual Investors Advisory Committee serves as a liaison between individual investors and the NYSE board and advises our board on policies and programs affecting individual investors in equities, options, futures and fixed-income securities.

The Pension Managers Advisory Committee consists of members representing corporate pension funds, state and local government employee retirement funds, endowments and foundations, and provides counsel on the concerns of pension managers.

The Regulatory Advisory Committee's members have a combination of industry, corporate and legal backgrounds, and advise our board on issues of regulation, self-regulation and the regulatory system as they affect the NYSE, the securities industry and the capital markets.

The Japan Advisory Committee counsels our board on the views and concerns of Japan's business and financial communities. It is chaired by a former foreign minister of Japan and comprises active or former senior officials of Japan's major public companies and financial institutions.

These new committees, along with the previously-created European and International Capital Markets committees, will help position the NYSE for the challenges of the 1990s -- and beyond.

All the initiatives undertaken by the NYSE over the last 19 months contribute to the strengthening of the NYSE market system.

PROPOSED LEGISLATION

Now I would like to turn to a brief discussion of the proposed Market Reform Act of 1989, which was proposed by the Securities and Exchange Commission on June 23, 1988 and was recently introduced as S. 648.

The legislation contains four sections: SEC emergency authority and trading halts, large trader reporting, risk assessment for holding company systems, and coordinated clearing and settlement.

I would like to comment specifically on each of these provisions.

SEC Emergency Authority and Trading Halts

The NYSE supports providing the SEC with authority to halt securities trading under the emergency circumstances spelled out in the legislation. Based on our experience during the week of October 19, 1987, we believe that giving this authority to the SEC is appropriate.

The NYSE hopes that the SEC will consult with us and other SROs before exercising this authority.

Large Trader Reporting

Concerning large trader reporting, the NYSE studied the matter to see if we could do it ourselves. We conducted two surveys on the subject with our member firms. As a result of our study and surveys, we concluded that any large trader reporting should be done through the SEC, and that it should be done across all markets.

Our surveys revealed serious concern about disclosure. We believe the best way to carry out large trader reporting probably is with a member firm file, which would be disclosed upon SRO or regulator request. We also think that the rules for calling up the file should be very narrowly defined, such as for the purpose of reconstructing the market after an October 19th or in connection with possible insider trading.

We should keep in mind, however, that enforcing such a requirement on an international basis may be difficult, because of the inconsistency in disclosure rules and audit-trail practices in U.S. markets and those overseas.

Risk Assessment for Holding Companies

When you get into risk assessment for holding companies, you are getting into an area of potential danger. There is concern about holding companies with broker-dealer affiliates because no one knows what is happening in the entire holding company.

The NYSE does not want to regulate holding companies, but it believes some agency such as the SEC should gather sufficient data to assess the financial soundness of holding companies that are parent companies of broker-dealers. As financial institutions enter non-traditional businesses not subject to SRO oversight, they have the potential to create systemic risks domestically and internationally.

Coordinated Clearing and Settlement

The NYSE agrees with the SEC that the clearance and settlement system for securities should be strengthened, and that clearance and settlement of securities and securities derivative products should be coordinated. But here again, a distinguished international private-sector financial body, The Group of Thirty, has pointed out the threats of national and international systemic risk involving even regulated entities.

We also think that, beyond the involvement of the SEC and the CFTC, it is important that there be coordination with the Treasury Department and the Federal Reserve Board, as far as clearing and settlement is concerned. And we agree with Treasury Undersecretary Robert Glauber that coordinated clearance and settlement should be the number one priority of the Presidential Working Group.

CONCLUSION

That concludes my comments on the NYSE market system, what we've done since October 1987 to strengthen the system, and the four sections of the proposed Market Reform Act of 1989.

Perhaps the theme that runs throughout my testimony today is, as it was once put, "eternal vigilance is the price of survival." This is true, not just for the NYSE market, but for all U.S. markets.

The NYSE not only has been vigilant in its pursuit of survival. It also has been a leading force in the capital-raising and asset-allocation process that has been the bulwark of the U.S. economy.

All the comprehensive measures we have taken over the past year-and-a-half to strengthen the NYSE market system will help maintain our strong position and our contribution to the U.S. and world economy into the next century.

Thank you.

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ATTACHMENT 1

Memorandum

Date: March 3, 1989

To: All Members on the Floor

From: Market Performance Committee

Subject: New Specialist Job Description

The new Specialist Job Description is attached for your information. This document specifies key expectations with respect to performance of NYSE specialists. We believe the new job description effectively positions Exchange specialists to meet the evolving, competitive demands of the 1990s.

Given the profound changes in the Exchange marketplace since adoption of the original Specialist Job Description (June 1976), the Market Performance Committee initiated a comprehensive review of the job description. Our objective was to determine what revisions were appropriate to more accurately reflect the role of the specialist in today's markets. To this end, the MPC sought input from a diverse group of specialists which developed recommendations. Their input received extensive evaluation and review by the Market Performance and Allocation Committees, the advisory committees of the Board of Directors, the Specialist Critical Issues Organization, and floor broker and operations representatives of member firms. The resultant job description represents a solid, consensus document which was approved by the Quality of Markets Committee and, just recently, the Securities and Exchange Commission.

The new Job Description emphasizes the following responsibilities of specialists:

- Ensure the quality and competitiveness of Exchange markets, in all market segments;

- Stress service to member firms. Provide timely, accurate and complete information on market activity, on an equal and impartial basis, to all inquiring members;

- Ensure adequate, trained staff; efficient administrative procedures; efficient use of financial resources; and use of appropriate Exchange systems;

- Adhere to Exchange performance standards; and

- Attempt to meet annually with listed company executives, as well as appropriate on-floor and off-floor member firm representatives.

The old job description was supplemented by a Code of Acceptable Business Practices. The new document incorporates the code, thereby eliminating duplication and enhancing clarity. It also specifies specialists' responsibilities within the five functions on which the performance of specialist units is evaluated in the SPEQ, and identifies key competitive responsibilities. Among the eligibility requirements, the new job description provides that applicants to become specialists must participate in an orientation session with a panel of market professionals.

We recognize that our individual and aggregate performance is receiving increasing scrutiny by the public, the press, regulators, listed companies and our broker-dealer customers. Each specialist's performance significantly affects the efficiency, competitiveness and overall quality of Exchange markets, and largely determines the Exchange's success as the world's premier securities market. Clearly, it is the responsibility of each specialist to fulfill the performance expectations codified in the new Specialist Job Description. The job description will be the subject of careful, ongoing review and will be revised, as necessary, to ensure that the responsibilities it articulates continue to be consistent with the needs of the marketplace.

The members of the Markets Performance Committee stand ready to assist specialists in fulfilling these expectations.

THE NEW YORK STOCK EXCHANGE, INC.

SPECIALIST JOB DESCRIPTION

I. OBJECTIVE

An Exchange member registered as a specialist is accountable to the Exchange for the quality of the Exchange markets in the securities in which the specialist is registered. The specialist is responsible for fostering and acting to maintain liquid and continuous two-sided agency auction markets by acting as agent and principal in those securities on the Exchange floor. The specialist helps ensure that such markets are fair, orderly, operationally efficient and competitive with all other markets in those securities. A “fair” market is free from manipulative and deceptive practices and affords no undue advantage to any participant. An “orderly” market is characterized by regular, reliable operation, with price continuity and depth, in which price movements are accompanied by appropriate volume, and unreasonable price variations between sales are avoided.

As is true of all Exchange members, the specialist is expected to adhere to all applicable Federal laws and regulations, and Exchange rules and policies, including the provisions that apply to specialists in Section 11(b) of the Securities Exchange Act of 1934, Rule 11b-1 thereunder, Exchange Rule 104 and ITS rules. In this way, the specialist actively contributes to maintaining high quality Exchange markets in the public interest. Because of the specialist’s central position in the Exchange’s continuous two-way agency auction market, the manner in which and the degree to which the specialist performs significantly affects the efficiency, competitiveness and overall quality of Exchange markets, and largely determines the Exchange’s success as a national securities market. Therefore, specialists are expected to enhance their performance in the ways set forth in the Specialist Job Description.

The specialist occupies a position of public trust and should act at all times in a manner consistent with that trust. Therefore, it is essential that the specialist adhere to the highest standards of business and ethical conduct in the performance of all aspects of the specialist’s job. This duty is formalized by the Exchange’s Rule 401 which states that members must “at all times adhere to the principles of good business practice”. Failure to do so can be detrimental to the Exchange and constitutes a breach of public trust.

The Specialist Job Description is intended to guide specialists in the performance of their duties. Certain specific areas are enumerated below, and may be modified by the Exchange as circumstances require. This is not to be construed as a complete list of specialist duties and, in circumstances not specifically addressed below, the specialist should be guided by the spirit and intent of the Job Description.

Acts or omissions by the specialist that appear to be inconsistent with the Specialist Job Description are addressed by the Market Performance Committee and via the regulatory process. Exchange Rule 103A provides standards with respect to performance of these duties. It is under that rule that the Market Performance Committee monitors the specialist’s fulfillment of the expectations set forth in the Specialist Job Description, and takes steps to encourage performance improvement. Where circumstances warrant, the Exchange may take disciplinary action under Rule 476.

II. PRIMARY DUTIES

A. AGENCY FUNCTION

In view of the specialist's central position in the Exchange's continuous two-way agency auction market, a specialist should:

Act as agent on behalf of orders entrusted to the specialist, hold the interests of such orders above the specialist's own, and properly represent each order, regardless of its size or source, in the marketplace to ensure the timely and best possible execution in accordance with the terms of the order and the rules and policies of the Exchange.

B. DEALER FUNCTION

In performing as a principal a specialist should:

1. Affirmative Obligation

   Buy and sell securities as principal when such transactions are necessary to minimize an actual or reasonably anticipated short-term imbalance between supply and demand in the auction market and do not upset the natural longer term forces of supply and demand, and effect such transactions when their absence could result in an unreasonable lack of continuity and/or depth.

2. Continuous Market

   a. Make firm and continuous two-sided quotations that are timely and accurately reflect market conditions, and ensure that principal transactions are calculated to contribute to the maintenance of price continuity with reasonable depth, and that such transactions are effected relative to the general market, the market in the particular security and the adequacy of the specialist's total position in the security with respect to the actual or reasonably anticipated needs of the market.

   b. Ensure that the election of a Stop Order results from the fair and orderly price movement of the stock and not from poor performance or inadequate depth.

3. Negative Obligation

   a. Provide an opportunity for public orders to be executed against each other without undue dealer intervention within the context of the current market, and not deal in a manner that is inconsistent with the overall objective of maintaining a fair and orderly market, as defined above.

b. Given a reasonable time frame and lack of substantive change in market conditions, refrain from interfering with a cross when the specialist has previously indicated "no interest".

c. Refrain from interfering with a "clean" agency cross unless the specialist's bid or offer has been previously solicited; or unless the reasonably anticipated needs of the market require the specialist to do so in order to be able to fulfill the market maintenance responsibility of the specialist and a floor official has been consulted in the event of any disagreement.

4. <u>Financial Resources</u>

Effect principal transactions in a manner that is consistent with the specialist's financial resources and that maximizes the efficient use of those resources, and report promptly to the Exchange any actual or imminent financial problems that may affect the specialist's ability to fulfill the responsibilities of the specialist to the market.

C. MAINTAINING THE AUCTION MARKET

In opening and reopening trading in a listed security, a specialist should:

1. <u>Market Openings and Reopenings</u>

a. Initiate trading in each security as soon as market conditions allow, at a price that reflects a thorough, professional assessment of market conditions at the time and appropriate consideration of the balance of supply and demand as reflected by orders represented in the auction market, taking extra care, however, when the opening or reopening price is significantly different from the preceding closing price, and maintain continuous fair and orderly trading in the aftermarket.

b. Seek the advice of floor officials in a timely manner in requesting delays in openings or trading halts when warranted by unusual market conditions.

2. <u>Market Coordinator</u>

Serve as the market coordinator for the securities in which the specialist is registered by exercising leadership and managing trading crowd activity, and promptly identifying unusual market conditions that may affect orderly trading in those securities, seeking the advice and assistance of floor officials when appropriate.

3. <u>Market Catalyst</u>

Acts as a catalyst in the markets for the securities in which the specialist is registered, making all reasonable efforts to bring buyers and sellers together to facilitate the public pricing of orders, without acting as principal unless reasonably necessary.

D. COMMUNICATION FUNCTION

In view of the specialist's central position in the Exchange's continuous two-way agency auction market, a specialist should:

1. Equally and impartially provide accurate and timely market information to all inquiring members in a professional and courteous manner.

2. Indicate the depth of the current market, to the extent the specialist's agency responsibility allows, in response to any reasonable inquiry from a member.

3. Equally and impartially provide all inquiring members with accurate, complete and current opening price indications and pre-opening information, such as the amount of stock paired off and the excess to buy or sell.

E. ADMINISTRATIVE FUNCTION

A specialist's administrative and operating practices can have a significant impact on the quality and competitiveness of the market. Therefore, a specialist should:

1. Employ efficient administrative procedures that enable the specialist to maintain accurate and up-to-date records, process trade documents efficiently and accurately, and respond promptly to requests for order or market information.

2. Promptly provide information when necessary to research the status of an order or a questioned trade, and cooperate with other members in resolving and adjusting errors.

3. Accurately report executions of orders entrusted to the specialist in a timely and complete manner and provide information, when requested, on the status of orders and the confirmation of open orders.

4. Maintain a level of trained staff on the Exchange floor at all times sufficient to meet periods of reasonable demand, and provide the supervision necessary to ensure the efficiency and professionalism of the specialist's operation.

5. Ensure that, during an absence from the post, the replacement on the floor is aware of all pertinent information related to the securities in which the specialist specializes.

6. Make arrangements for supplementary staff and financial resources that may be necessary to meet extraordinary market conditions.

7. Utilize Exchange systems and procedures.

F. COMPETITIVE RESPONSIBILITIES

Recognizing the intensely competitive environment in which the specialist operates, the specialist should:

1. Make every effort to be fully competitive in all segments of the market and to maintain and increase market share in the securities in which the specialist acts as the specialist.

2. Establish a positive professional relationship with Exchange listed companies and each year extend an invitation to meet with representatives of the listed companies in which the specialist specializes to acquaint them with the workings and operational aspects of the agency auction market system.

3. Each year extend an invitation to meet with appropriate on-and off-floor representatives of those member firms with which the specialist conducts a significant business and such other member firms as are deemed appropriate to discuss the service, operational and competitive requirements of the member firms.

G. OTHER MARKET RESPONSIBILITIES

In addition to these duties, the specialist is expected to:

1. Assist the Exchange in developing and implementing systems and procedures designed to enhance the efficiency and competitiveness of the Exchange's agency auction market, and to satisfy Federal requirements.

2. Comply with all measures and standards of performance established by the Exchange, understanding that failure to meet these standards could subject the specialist to prescribed performance improvement procedures, which may include the reallocation of a security or securities.

3. Keep records required by Federal and Exchange rules, promptly and accurately report required information to the Exchange and comply with all Exchange rules which govern the financing of specialist operations.

4. In addition to the above, take any actions not prohibited by Federal or Exchange rule or policy or precluded by professional judgment to foster and maintain liquid continuous two-sided agency auction markets on the Exchange floor and to ensure that such markets are fair, orderly and efficient in the public interest and competitive with non-Exchange markets in Exchange listed securities; and avoid any action which would hinder the achievement of these objectives.

III. ELIGIBILITY REQUIREMENTS

An Exchange member who desires to be registered as an Exchange specialist must:

1. Be associated with an existing or newly created specialist unit approved by the Exchange.

2. Complete an adequate training period under the supervision of an experienced specialist.

3. Pass the Exchange-administered specialist examination.

4. Ensure that the specialist unit with which the specialist is to be associated meets the Exchange's specialist capital requirements.

5. Participate in an orientation session with a panel of market professionals, whose membership will be drawn from the Market Performance Committee, to discuss the responsibilities and duties of being an Exchange specialist.

September 3, 1987