The New York Times

Market Place; Big Board Is Far From Forefront When It Comes to Policing

By Gretchen Morgenson

Sept. 22, 2003

Investors think first of the New York Stock Exchange as a marketplace for buying and selling shares. But the Big Board is also one of the market's most important regulators. And as John S. Reed, the former Citigroup banker, steps in as the exchange's acting chairman, he will have to wrestle with growing questions about the effectiveness of its regulatory performance.

Securities lawyers and former executives of brokerage firms say that under its ousted chairman, Richard A. Grasso, the Big Board was a weak corporate policeman -- a sense that has grown stronger since the bull market ended and revelations of unsavory Wall Street practices have piled up. Regulators from the exchange, they note, have not played leading roles in the major investigations of the brokerage business.

And it was not the Big Board but another regulator, NASD, that brought a case against Invemed Associates, the brokerage firm run by Kenneth G. Langone, who is a friend of Mr. Grasso's and sat on the exchange's board and on the compensation committee that approved Mr. Grasso's $139.5 million payout.

''The idea that they would have this little handpicked group of regulated firms setting the salary for the regulator is so obviously inappropriate it boggles the mind,'' said Barbara Roper, director of investor protection at the Consumer Federation of America. ''To be so oblivious to how these issues are likely to be perceived by investors should disqualify you from the regulatory function.''

Officials at the exchange contend that its operations are closely scrutinized and point to its relatively scandal-free floor trading operations as proof. ''We're happy that most of our firms are not taking advantage of customers,'' said Edward A. Kwalwasser, who heads the exchange's regulatory unit. ''But when we find that they are, we think we bring aggressive proceedings.''

The New York Stock Exchange polices its 400 member firms -- not just big brokerage firms, but also the specialists that conduct trading on the exchange's floor -- to make sure they are abiding by both federal securities laws and the institution's own rules on trading.

The exchange watches for securities law violations -- like insider trading -- by those trading in its listed companies. Investors also rely on the Big Board to make sure that the companies whose shares it trades maintain the asset, revenue or share-price standards required for listing on the exchange.

And the exchange also oversees arbitrations filed by aggrieved investors, making sure they are fairly adjudicated.

Calls for separating the Big Board's regulatory operations from its stock trading business have increased in recent years, in part because the exchange's major competitor in regulation, NASD, formerly the National Association of Securities Dealers, is seen as more aggressive. Either entity can regulate firms that do business on both the Big Board and Nasdaq markets.

Only after an investigation in the mid-1990's by the Securities and Exchange Commission were trading and regulation separated at NASD. The S.E.C. found that traders at Nasdaq, the stock market owned by NASD, were colluding to make investors pay artificially high prices to buy and sell shares and that NASD regulators looked the other way while the collusion occurred. When NASD settled with the S.E.C., it agreed to spin off its regulatory function.

''It does seem to me that the NASD has been a good deal more aggressive and more effective in its enforcement activities since the split- up and the reorganization,'' said Alan Bromberg, professor of securities law at Southern Methodist University. ''That suggests to me that that may be where the stock exchange is heading.''

The exchange has not headed to the front of the line lately in investigating Wall Street wrongdoing.

For example, the inquiry into tainted research at brokerage firms was initiated by Eliot Spitzer, the New York State attorney general. Later, when the Big Board, the S.E.C. and NASD became involved in the case, it was the NASD's regulatory unit that acted most aggressively. It not only filed cases against institutions, it also took action against individuals.

In April, NASD filed suit against Invemed, run by Mr. Langone, who was also a founder of Home Depot. Mr. Grasso sat on the Home Depot board until recently.

Invemed is fighting the suit, which contends that the firm illegally shared in customers' profits by overcharging them to trade in hot new stock offerings during 1999 and 2000.

Because the Big Board is Invemed's primary regulator, some market professionals wondered at the time why the exchange had not taken the lead in filing the suit. Skeptics' eyebrows arched higher when Mr. Langone's role in Mr. Grasso's pay package was made public.

The Big Board said that because the case against Invemed involved shares of initial public offerings that traded on Nasdaq, it was appropriate that NASD take action. But according to NASD's complaint, the improper profit-sharing involved some New York Stock Exchange-listed stocks, as well. So the case against Invemed could have been filed by either the Big Board or NASD.

When the Big Board does act, it can encounter stiff resistance. Earlier this year, the exchange began investigating a number of its specialist firms to determine if they had broken Big Board rules by inserting themselves between customers who were buying and selling stocks and profiting as a result. The investigation fueled the anger that some specialists have harbored against Mr. Grasso and highlighted the Big Board's awkward position as both regulator and marketplace.

Mr. Kwalwasser says that his regulatory unit is run with little input from the stock exchange's board. The directors see all the cases once they are decided, but do not become involved during the investigations.

While the directors approve the regulatory budget, Mr. Kwalwasser dismisses the notion that their handling of Mr. Grasso's pay has anything to do with the exchange's performance as a regulator.

''Whether the compensation committee did the right thing or wrong thing, it has no impact on regulatory function,'' he said. ''We examine every one of our member firms every year. No director has come in and said 'do not examine my firm.' ''

Others are less confident of the Big Board's independence. Ken Morris, a former Wall Street executive who began his career in the brokerage industry in 1979, said that he considered the exchange a toothless watchdog that protects its member firms.

''Actions against specialists are very rare,'' he said. ''We have specialists making millions of dollars who are fined peanuts. The huge majority of cases are against people who have lied on their employment application or against retail brokers who have exercised improper discretion over a client's account.''

He cited an action taken against a specialist firm last February that resulted in a $25,000 fine and a censure. Among other infractions, the specialist had failed to match orders to buy and sell at the same price, as is required by Big Board rules, had in one instance bought more than half the stock offered at a lower price than was proper and executed trades for investors at prices that were inferior to those offered by traders in other regional markets.

When it comes to small players, however, the penalties appear more severe, Mr. Morris said. For example, an employee of a member firm who improperly withdrew $320 from a cash machine in 2001 using another employee's card was censured and permanently barred from working in the securities industry.

Another area of concern is how fair a shake investors get when they file arbitration cases at the exchange. The quality of the Big Board's arbitration system is crucial, because investors are generally required by their brokerage firms to seek redress in arbitration rather than in the courts.

Arbitration panels consist of three people -- two so-called public representatives and one from the securities industry. To qualify as a public arbitrator, individuals are supposed to have no close ties with the securities industry.

But Stuart D. Meissner, a lawyer who represents investors in arbitration cases before both NASD and the New York Stock Exchange, said the Big Board arbitrator fell short of that standard in a case filed by an investor against Banc of America Securities last November.

Mr. Meissner said that one of the panelists selected at random for his case was a director at a bank that has a brokerage subsidiary. The arbitrator was also on the investment committee of the bank's board.

These facts were not disclosed by the arbitrator and came out only when Mr. Meissner sought more information. Mr. Meissner challenged the panelist's inclusion as a public arbitrator but the exchange rejected his challenge with no explanation. Only when the arbitrator agreed to step aside was a new panelist assigned to the case.

''The exchange's arbitration department has become a star chamber where defrauded investors never know what to expect from what is supposed to be a neutral forum,'' Mr. Meissner said. ''The exchange does not fairly apply their own rules and guidelines, and they have enormous power over cases with little oversight by outside authorities.''

Ray Pellechia, a spokesman for the exchange, said: ''Our arbitration officials describe this as an exceptional situation, because we have few bank directors. But since it has come up, we will review it with an eye for strengthening the process.''

But piecemeal reforms may not be enough of a cure, Big Board critics say. The root of the problem, they argue, is that the exchange is trying to serve too many constituents: brokerage firm members, specialists, companies that pay considerable fees to list their shares on the exchange and investors.

Exchange officials say that all are treated equally. But an increasing number of people involved with the market have their doubts.