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Moving the Market – Tracking the Numbers / Street Sleuth: Street Debates Oversight of New NYSE

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By Aaron Luchetti

NEARLY EVERYONE doing business at or with the New York Stock Exchange backs its plan to become a publicly traded company by acquiring electronic-trading firm Archipelago Holdings Inc., a unity evidenced when nearly every Big Board member voted to approve that transaction.

But that harmony is breaking down over how best to police the emerging company.

Wall Street and others are fighting for seats on the regulatory body that will oversee the exchange, but the Big Board says brokers would bring conflicts with them that would hamper the regulator's independence.

While these discordant notes are unlikely to trip up the Archipelago deal, it could delay its closure, which the merger partners hope to see within a few weeks. More important, industry insiders say the argument, isn't going to end once NYSE Group Inc., as it will be known, gets down to business. And it's still not clear whose regulatory vision will best serve investors.

NYSE management, mindful of image in the wake of the brouhaha over ex-boss Dick Grasso's compensation, has submitted a plan to the Securities and Exchange Commission that calls for a not-for-profit regulatory unit of the NYSE Group that will have a mostly independent board. (An earlier plan called for only a minority of the members of the regulatory board to be independent from the for-profit parent.)

Brokerage firms can nominate two directors to the regulatory board -- but those candidates cannot be affiliated with the brokerage firms.

Last week, groups representing Wall Street firms, mutual-fund companies and others wrote letters to the SEC urging that the exchange add seats at the board table for them.

The nation's largest public pension fund, the California Public Employees' Retirement System, or Calpers, also wrote to the SEC arguing that the federal regulator should appoint all the regulatory board members.

This week, the NYSE sent a letter to the SEC defending its regulatory approach, which started in late 2003 as an effort to boost the board's independence after Mr. Grasso was forced out amid outcries that the old board improperly awarded him a giant pay package.

The SEC is expected to approve the NYSE's merger plan within the next few weeks, but whether the federal agency will require any changes to the Big Board's regulatory plan is less certain.

The regulatory issue drew the most comment when the NYSE recently solicited public comment on its governance plan. Letters from mutual-fund trade group Investment Company Institute and Wall Street firms say the regulatory issue should be settled before the biggest stock exchange in the world goes public.

NYSE officials counter that the debate shouldn't hold up the Archipelago deal, which they say needs to close soon to keep the Big Board competitive with other for-profit exchanges.

Critics fear the NYSE could even use its regulatory arm to harm those the Big Board sees as competitors or foes, including brokerage firms that may seek to establish their own electronic-trading networks or those that send business to the Nasdaq Stock Market or other exchanges.

The Securities Industry Association, a Wall Street trade group, said in a letter that a for-profit NYSE “aggravates the conflict of interest” between the exchange’s business interests and the brokerage firms it regulates. The SIA argues the exchange should allow some brokerage firm officials on its board.

Exchange officials respond that they have no interest in hurting their customers or their investors.

Many other exchange boards include brokerage firm executives. Nasdaq Stock Market Inc., which is taking final steps to become an exchange, has several directors from the brokerage industry, as does the National Association of Securities Dealers, the other major industry-funded Wall Street regulator.

Without brokerage firm representation, “you have a dumbed-down board,” says Meyer “Sandy” Frucher, chief executive of the Philadelphia Stock Exchange, where 10 of 22 board members come from brokerage firms. “Independent directors give you wisdom. Industry representatives give you knowledge.”

– Kara Scannell contributed to this article

OUTSIDE AUDIT: The Bard’s line about protesting too loudly apparently applies to accounting, too.

Firms that lash out against criticisms and questions about their bookkeeping could unwittingly be raising red flags about the quality of their earnings, according to a new study by RateFinancials Inc., an independent risk-research firm that rates and ranks companies’ financial reporting.

Although there is no cause and effect, “there appears to be some anecdotal evidence that there might be an inverse relationship between companies [that] are most aggressive about attacking analysts who question their accounting practices and the actual quality of their earnings,” says Victor Germack, founder and president of RateFinancials, based in New York.

The most famous example, of course, would be Enron, whose executives railed against those who questioned the energy company's accounting, according to RateFinancials. Calpine Corp. in 2004 put out a media release decrying media coverage of its accounting practices; the power generator filed for bankruptcy in December.

Companies that had the poorest earnings quality in 2005 – meaning they generated a significant portion of their earnings from operations or transactions outside their core businesses – underperformed the S&P 500-stock index by 11%, according to the study.
– Karen Richardson