How to Keep NYSE’s Stock High

Richard Grasso, chairman and chief executive officer of the New York Stock Exchange, recently won his board’s approval to explore the possibility of transforming the 207-year-old institution from a member-owned, not-for-profit club into a for-profit, publicly traded company. Mr. Grasso indicated the deal could go through sometime next year. If it does, other exchanges are sure to follow suit, altering the global financial landscape. Whether these changes will be for the good depends on the sort of regulatory structures the various exchanges establish.

It is important to recognize that the Big Board has little choice but to turn itself into a nimble commercial enterprise. As Mr. Grasso says, the exchange is fundamentally a transaction-processing and data-transmission company. As such it faces potential competition from everyone from Reuters to Microsoft to Merrill Lynch. Yet it is saddled with a fractious organizational structure that includes big institutions like Morgan Stanley, independent brokers and private investors who lease their seats. As a result, it has become very difficult to make timely strategic changes. Equally important, the exchange’s modest financial position—1998 net income of $101 million on $729 million of revenues—makes it nearly impossible to build or acquire new electronic exchanges or other companies.

The biggest policy question surrounding the future of the exchange concerns regulation. The Big Board is a self-regulating body, policing its members and their traders and floor specialists. It also has the power to establish disclosure and corporate-governance standards for companies that list on the exchange. If the exchange goes public, this self-regulating authority would create huge conflicts of interest between the Big Board’s legitimate mandate to enrich its shareholders by attracting new listings, and the requirement to regulate many of those same shareholders as they trade on the exchange’s floor. A second conflict would arise in setting listing requirements for new companies, as there would be a temptation to dilute standards or relax surveillance over them in order to sign up more corporate clients.

One alternative would be to create a holding company housing two subsidiaries, the first a publicly traded company and the second a not-for-profit regulatory body. This in essence is what the National Association of Securities Dealers has done with the Nasdaq and its regulatory arm. But this would only further the trend toward a proliferation of self-regulating bodies, all competing with one another not to impede new listings for their parent companies. The inevitable result would be looser standards. And since many institutions trade on more than one exchange, they would be subject to overlapping regulatory burdens.

A far better option is to strip the exchanges of most of their regulatory authority and create one independent national self-regulating body—call it the NSRB for short. The new board would have functions similar to what the Big Board and the NASD have now. It would not be encumbered by conflicts between commercial and regulatory goals; it could apply uniform standards on all market participants; and it would oversee individual firms more efficiently.

To be sure, an NSRB would raise legitimate concerns about centralizing too much power in one self-regulating body. But we already have a benign model in the Financial Standards Accounting Board, and like the FASB the new body would itself be monitored by the Securities and Exchange Commission. Moreover, a national organization is fast becoming absolutely essential at a time when the markets are increasingly global—when more than $1.5 trillion in foreign exchange changes hands each day, when stock exchanges are linking up across borders, and when combinations like DaimlerChrysler, BP Amoco and Duetsche Bank-Bankers Trust are multiplying.

The exchange itself is a good example of the accelerating pace of globalization and the need for regulation to keep up. There are not enough blue chips in the U.S. to keep the Big Board growing at a rapid pace. The biggest opportunities lie abroad. The number of foreign listings has more than tripled over the past five years and now stands at 379, or 13% of all listings. The exchange forecasts that this figure will reach 25% by 2005 as foreign companies rush to tap U.S. markets and as Americans’ equity portfolios of non-U.S. shares double from 5% to 10%.

While all of tomorrow’s regulatory issues cannot be known today, it’s clear that they will be increasingly global. Foreign companies coming to our market deserve more intense scrutiny. Governance issues such as voting rights, procedures for mergers and the need for independent directors must be considered. U.S. investors ought to be shielded by the highest standards of disclosure and reporting. The time to get ready is now.

Mr. Garten is dean of the Yale School of Management.