

Testimony of
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Introduction

Chairman Specter, Ranking Member Leahy, distinguished Members of the Committee, my name is Robert A. Marchman, and I am the Executive Vice President of the Market Surveillance Division of NYSE Regulation, Inc.

I want to thank all the members of the Committee for providing me with this opportunity to address the important regulatory challenges raised by insider trading, an area of the highest priority for NYSE Regulation as our core mission is the protection of the investing public.

NYSE Regulation, Inc.

NYSE Regulation, Inc. is a not-for-profit subsidiary of the New York Stock Exchange Group, Inc. that performs self-regulatory functions for both the NYSE and NYSE Arca. NYSE Regulation is comprised of the following five divisions and a risk assessment unit: Member Firm Regulation, Market Surveillance, Enforcement, Listed Company Compliance, and the Office of the Hearing Board.

Market Surveillance

The Market Surveillance Division of NYSE Regulation plays the lead critical role of monitoring trades in NYSE-listed securities, options, bonds, exchange traded funds, closed-end funds, and other structured products. The Division is charged with monitoring the market for a variety of potentially violative conduct, including insider trading, and determining whether transactions are executed properly and fairly.

At the outset, it is important to underscore that NYSE Regulation has limited jurisdiction in the area of insider trading. We do not enforce insider trading for the general public. Rather, our jurisdiction is limited to NYSE Group, Inc. "members, member organizations, allied members, approved persons, and registered and non-registered employees of member and members" with respect to violations of the Securities Exchange Act of 1934 and our internal rules. By way of example, we do not have the jurisdiction or the ability to compel cooperation or bring disciplinary action against broker dealer customers, attorneys or accountants, nor do we have jurisdiction over hedge funds. Therefore, investigations at NYSE Regulation frequently result in referrals to the Division of Enforcement of the Securities and Exchange Commission, ("SEC") with whom we enjoy a strong working relationship in the investigation of potential insider trading. Our frequent and constructive interaction with the SEC allows us to discuss potentially troubling trading scenarios, trends, and referrals. Important outcomes of this constructive relationship are SEC enforcement actions resulting from Market Surveillance referrals. The history of the securities markets teaches us that insider trading is a serious regulatory

concern, particularly today, where the volume, complexity of trades and products, and cross-border transactions are re-defining capital markets almost on a daily basis. Market Surveillance continues to meet these challenges through the use of extensive and sophisticated surveillances, systems and tools that allow us to timely review and aggressively investigate trading that may constitute insider trading.

Market Surveillance: Surveillances and Alert Generation

On an ongoing basis, Market Surveillance analysts conduct reviews of alerts and investigations. Alerts are typically generated by automated electronic surveillance systems and real-time and exception-based surveillances, but can also be generated as a result of customer complaints. Electronic surveillances that relate to insider trading include, among others, Insider Trading, Frontrunning, Market Manipulation, Trading Ahead of Research, Earnings, Mergers and Acquisitions, and Trading Ahead of Publication. Insider trading is considered a high priority and we review related exceptions and alerts on an expedited basis.

Surveillances generate alerts that can contain one or more exceptions. Exceptions are defined as a particular type of suspicious activity or activity of potential interest because it meets or exceeds surveillance threshold criteria or parameters. Alerts are assigned to an analyst for tracking, management and conclusion. Investigations typically follow from a determination that an alert requires a more in-depth analysis and/or additional regulatory action.

A "Stock Watch" unit in Market Surveillance makes use of sophisticated computer and software systems to search and identify unusual trading patterns on a real-time basis in conjunction with support from the Massachusetts Institute of Technology (MIT). By way of example, Stock Watch uses a variety of services and information to augment its real-time surveillance capability including vendor services and information from sources such as Dow Jones, First Call, S&P Market Scope, real-time information from the consolidated tape, futures indices, major foreign indices, and selected stories from the Wall Street Journal and Barrons.

Stock Watch alerts Market Surveillance analysts on a real-time basis to aberrational price/volume activity in connection with news that may be suggestive of insider trading by generating exceptions that are further investigated by professionals and, where appropriate, by other analysts. On a daily basis, and throughout the day, the statistical outlier methodology used by Stock Watch electronically collects trading data for individual stocks in order to create a stock profile against which each trade on that stock is measured to determine deviations from the norm. An overall market volatility component is applied as an additional filter on a stock-by-stock basis. Stock Watch uses an additional alert system to monitor trading activity, which measures stock trades based on strict price and percentage movements, depending on the price level of the issue. Based on its review of trading activity, Stock Watch generates alerts that are further reviewed by analysts through the use of electronic surveillances.

Currently, Market Surveillance is designing the Inter-Case Analysis surveillance -- the next generation surveillance and data tools -- that will allow analysts, investigators and attorneys to delve deeper into trend analyses and pattern recognition of insider trading trends, allowing the analyst to retrieve information in an organized, drilled-down interface. These surveillance and data tools will allow our analysts to view accounts traded in previous investigations and view chronologically participants who were involved in more than one investigation.

Market Surveillance: Investigations and Referrals to the SEC

In a typical insider trading investigation, sophisticated systems compliment analyst requests for

information from member organizations, listed companies and other markets. Information used to ascertain facts surrounding trading under review include, among others (a) names and addresses of those involved in the deals; (b) trading chronologies; (c) firm trades for the period under review; (d) trading strategy descriptions; (e) written descriptions of meetings surrounding the event; and (f) summaries of what transpired at the meetings.

Systems and software tools compare results from our analytical and investigative surveillance systems with electronic bluesheets -- customer and proprietary trading information provided in electronic format by member organizations. This allows staff to run comprehensive surveillance analyses by individual, institution, customer and proprietary trading information, and broker/dealers. Systems have been designed to further assist the analysts in reviewing bluesheet data for volume activity, account open date and other characteristics that may be indicative of potential insider trading, including matching bluesheet data with investigation-specific chronological data, as well as other information culled from sources such as the Central Registration Depository.

"Chronological data" refers to an electronic chronology of events in the given deal or event received from the member organizations. Such electronic data includes the names and addresses of individuals involved in the deal or the event and a narrative of the events leading up to the public announcement, such as dates of meetings, who participated in these meetings and the sum and substance of those meetings. Analysts also make use of our Internet Database or "IDB," which downloads on a daily basis all message traffic on NYSE-listed securities in Internet bulletin boards.

Upon opening an investigation on potential insider trading, Market Surveillance staff sends an electronic communication to the SEC via the Self Regulatory Organization Investigation Referral System. Market Surveillance also notifies other SRO members of the Intermarket Surveillance Group that trade the security, or a derivative such as options, to coordinate investigative activities. At times, Market Surveillance will verbally notify the SEC of the opening of an insider trading investigation prior to sending an electronic notification. Circumstances warranting such immediate verbal notification include, by way of example, a foreign takeover or a surprise announcement where the price of the stock experiences a dramatic reaction. If options are traded on the stock and the options activity suggests possible insider trading, the SEC may contact staff by phone to advise of activity in the options market and to inquire about the underlying stock activity.

Where an investigation indicates possible insider trading by individuals or entities outside the jurisdiction of NYSE Regulation (for example, hedge funds; officers, directors, employees of a listed company; or customers of a member organization), the activity is referred to the SEC both in writing and via the SRO Investigation Referral System. In any given insider trading investigation, staff may make an initial referral, may supplement that referral as the investigation progresses, or may decide that a referral is not warranted. Trading by some accounts may not rise to the level of referral, but may yet merit notification to the SEC through an advisory.

Once a referral is made, the SEC may request from Market Surveillance staff documentation supporting the referral, such as account statements and chronologies. Market Surveillance staff works with staff from the SEC Division of Enforcement, providing background information related to the investigation and referral. Where appropriate, staff may also meet with relevant SEC staff regarding the investigation.

At times, the SEC may open an insider trading investigation related to a corporate development also under review by NYSE Regulation. NYSE Regulation and SEC investigations may proceed in parallel and, as appropriate, documentation may be shared between the SEC and NYSE

Regulation to avoid duplicative requests to the same parties. In that case, the SEC and NYSE Regulation maintain separate investigations, as the SEC is a government entity and NYSE Regulation is a self-regulatory organization.

Separate from an insider trading determination, NYSE Regulation may discipline those under its jurisdiction pursuant to NYSE Regulation Rule 476(a)(6), which prohibits "conduct inconsistent with just and equitable principles of trade" even where the elements of insider trading under SEC Rule 10b-5 may not be met. Occasionally, the SEC requests that NYSE Regulation refrain from pursuing a given insider trading investigation, or a particular individual or entity within that investigation, where our review may compromise a broader SEC investigation, or a related inquiry by the U.S. Attorney's Office.

In addition to our interaction with the SEC on specific insider trading investigations, NYSE Regulation has periodic meetings, normally three times a year, with the SEC staff regarding policies and practice issues, as well as discussions on trends.

Member Firm Regulation

Staff from our Market Surveillance Division often works closely with the staff of the Member Firm Regulation and Enforcement Divisions in conducting and referring insider-trading investigations to the SEC. Our Division of Member Firm Regulation ("MFR") is dedicated to investor protection by means of regular and for-cause on-site examinations of NYSE Group member firms and their branch offices.

The insider trading examination program at MFR is subdivided into several reviews focusing on member firms (institutions) and customers (traders). These reviews include the following examinations. The Written Policies and Procedures Review requires examiners to verify that the firm's written policies and procedures address elements such as safeguarding of confidential information, employee and proprietary trading, employee education and acknowledgement, and the role of Compliance in the monitoring and control of non-public information. The Research Department examination review ensures that firms that engage in research activities have controls to prevent non-public information from being utilized to prepare research reports used by proprietary traders, registered representatives and other employees. The Supervision of Interdepartmental Communication review allows examiners to verify that member organizations segregate departments that normally possess nonpublic information -- such as Investment Banking and Research -- from other departments that could potentially benefit from that information, including Sales and Trading.

MFR also requires production of the firm policies and procedures for the detection and prevention of misuse of material non-public information. Examiners review policies and procedures to ascertain whether they adequately call for (a) review of employee and proprietary trading, (b) supervision of inter-departmental communication by the firm's compliance department, and (c) review of proprietary trading when the firm is in possession of material, non-public information. In addition, examiners determine whether the firm has an adequate education process on the handling of non-public information. Typically, member organizations require employees to confirm in writing that Information Barrier/Insider Trading policies and procedures were reviewed by them when they were initially hired, and annually thereafter. To that end, MFR examiners request a documentation sample to establish that employees have reviewed the firms' policies and procedures.

Enforcement

The Division of Enforcement investigates and disciplines for violations of NYSE Regulation rules and applicable federal securities laws and regulations. Enforcement cases stem from a variety of sources, including Market Surveillance, Member Firm Regulation, investor complaints made directly to NYSE Group companies, and referrals from the SEC.

Enforcement insider trading related cases originate primarily as referrals from the Division of Market Surveillance, but may also be received from the Division of Member Firm Regulation, the investing public, and filings made by member firms.

Interaction with Other Regulators and Market Participants

We are also continuing and strengthening our pro-active engagement with other market regulators. On August 18, 2006, officials of NYSE Regulation, NASD Regulation, the Chicago Board of Options Exchange, and SEC Enforcement met to discuss current developments in the insider trading area. Among other topics, participants discussed the use of spread-betting, Private Investment in Public Equities or "PIPES," IPOs, and secondary offerings. Participants also discussed the continued need for strengthening of cross-border information sharing, and training in cutting edge investigative trade techniques via the Inter-Market Surveillance Group. This follows on the heels of our lead role and open discussion of these issues at the NYSE Regulation Second Annual Securities Conference on June 19 and 20, 2006; and our active participation at the Annual Securities Industry Association Compliance and Legal Division from March 19 through March 22, 2006.

Finally, NYSE Market Surveillance coordinates market surveillance efforts with other SROs and other regulatory bodies through our participation in various industry groups such as the Inter-Market Surveillance Group and the Securities and Commodities Fraud Working Group (a group comprised of various regulatory bodies including representatives from the U.S. Department of Justice). This coordination enables participations to identify trends and discuss best practices as to the effective and efficient utilization of resources devoted to protecting the public interest.

Insider Trading Surveillance Trends

The last two years have seen a significant increase in the number and complexity of our insider trading referrals to the SEC. Referrals to the SEC increased from 68 in 2004 to 111 in 2005, a 63% increase. For 2006, at the current pace, we project 140 referrals to the SEC, an increase of 26% increase from 2005. Combined, insider-trading referrals to the SEC have increased a cumulative 105% over the last two years. The projected 140 referrals in 2006 will handily surpass the 5-year high-water mark of 98 referrals in 2000. We have also seen an increase in the number of insider trading issues related to hedge fund activity referred to the SEC.

It must be underscored, however, that not all matters reviewed by NYSE Regulation result in a referral to the SEC. Only matters that Market Surveillance believes warrant further review are the subject of a referral. Similarly, not all NYSE Regulation referrals to the SEC result in enforcement action by the SEC. We refer matters to the SEC where there is sufficient circumstantial evidence of insider trading. The evidentiary challenge associated with demonstrating that a person engaged in insider trading is substantial.

Penalties and disgorgement stemming from Market Surveillance referrals to the SEC have also increased. In 2004, penalties totaled more than \$2.5 million. In 2005, penalties totaled more than \$3.9 million. For the first half of 2006, total penalties exceeded \$3.2 million, and are well on the way to surpassing 2005 levels.

Set forth below are summaries of significant actions taken by the SEC based on our referrals. These summaries will provide the Committee a better idea of the types of actions that we refer to the SEC.

?Prosecution of an international insider trading scheme orchestrated by a research analyst at the Fixed Income division of the Goldman Sachs Group and a former employee of Goldman Sachs in advance of the August 3, 2005 announcement by Reebok International Ltd. that it had agreed to be acquired by Adidas-Salomon AG. Defendants persuaded mergers and acquisitions analyst at Merrill Lynch to provide tips on upcoming mergers in return for a share of the profits. As part of its investigation of this referral, the SEC conducted additional investigations that led to the prosecution of Defendants for recruiting individuals to obtain jobs at a printing plant in Wisconsin in order to steal advance copies of Business Week and use information on the names of companies discussed favorably in the "Inside Wall Street" column before the information became public. Defendants used accounts in the United States and Europe to trade on the information in return for a share of their trading profits. Disgorgement in this action may exceed \$6.7 million plus penalties, fines and prejudgment interest. SEC v. Sonja Anticevic, et. al., Civil Action 05-CIV-6991 (S.D.N.Y., May 11, 2006).

?Prosecution of an international scheme involving the fraudulent electronic theft of material non-public company information used in the trading ahead of market announcements, which may result in a disgorgement of \$7.8 million and additional penalties, including fines and prejudgment interest. SEC v. Lohmus Haavel & Viisemann, Civil Action 05-CIV-9259 (S.D.N.Y., November 1, 2005); Litigation Release No. 19450 (November 1, 2005).

?Insider trading of stock and put options, and the shorting of stock, based on material nonpublic information involving a nationwide recall of human tissue due to possible contamination, resulting in disgorgement of \$136,334, a penalty of \$136,334, and prejudgment interest of \$19,583. SEC v. Drinen, et. al., Civil Action No. 05-CV-8015 (S.D.N.Y., September 15, 2005); Litigation Release 19378 (September 15, 2005).

?Tipping by a benefits analyst to her husband of confidential information relating to acquisitions or tender offers for publicly traded corporations involving her employers' clients, resulting in disgorgement and penalties of \$1,277,149. SEC v. Welt, et. al., Civil Action No. 05-CV-00783 (JR) (D.D.C., April 19, 2005); Litigation Release 19190 (April 19, 2005).

?Prosecution of managing director of J.P. Morgan Securities who used information obtained from a friend and business associate to purchase stock through his personal brokerage accounts after he was approached to help fund the acquisition of Unisource Energy Corporation. The action resulted in the disgorgement of \$54,693.25, payment of prejudgment interest in the amount of \$7,280.38 and payment of \$54,692 in civil penalties. SEC v. Huscher, Civil Action 06-CIV-3397 (N.D. IL., June 22, 2006) Litigation Release No. 10736 (June 22, 2006).

Recently, some analysts and commentators have stated their belief that the increase in insider trading cases coincides with an increase in merger and acquisitions activity. In fact, what can be fairly be said about M&A activity is that the number of M&A deals is down this year as compared to the same period last year, while the total dollar volume of M&A deals has increased. A year-to-year comparison of M&A deal activity by market analysts shows an increase

in volume from \$467 billion in 2002, to \$871 billion in 2004, and \$1.1 trillion in 2005. During the second half of 2006, global M&A increased to \$1.95 trillion, up from the record level of \$1.89 trillion in the first half of 2000, and up 36% from 2005 levels, topping the \$2 trillion mark on July 10, 2006. During this period, European M&A activity climbed 73%, to \$364.5 billion, while Asian Pacific activity, excluding Japan, followed in lockstep, with volume reaching \$181 billion, exceeding levels reached in the second half 2005.

Cross-Border M&A represented a record volume of \$705 billion or 36% of the total volume, exceeding by more than double last year's volume. Although the total number of deals has dropped to 685 from 763 for the first seven months of 2006, the dollar volume increased 36% during this period. "Merger arbitrage hedge funds" -- the term used to refer to hedge funds that purchase shares of target companies and sell the stock of acquiring firms - and investment banking firms are some of the top performers and revenue generators in the industry as a result of the increase in merger activity.

Conclusion

In sum, NYSE Regulation remains vigilant and cognizant of our responsibility to vigorously and pro-actively pursue the highest excellence in our regulation of the markets. In accomplishing that goal, we remain committed to continue to work with the SEC and with our fellow regulators to improve and strengthen the system of self-regulation that has made the United States the financial center of the world.

Again, I thank you for this opportunity to discuss the efforts of the NYSE Regulation in this important area and invite you, or your staff, to experience first hand our efforts by visiting us in the near future.