Written Testimony of
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Hearing on
"The SEC's Market Structure Proposal: Will It Enhance Competition"

February 15, 2005

Testimony of Robert H. McCooey, Jr. Member of the New York Stock Exchange and Chief Executive Officer of The Griswold Company, Incorporated

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Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee:

My name is Robert McCooey. I am a proud Member of the New York Stock Exchange and President and Chief Executive Officer of a New York Stock Exchange member firm, The Griswold Company, Incorporated. Griswold is an agency broker executing orders for institutional clients on the Floor of the NYSE. As an agency broker, we execute trades on behalf of our customers. We do not make markets in securities or engage in proprietary trading. Our clients include some of the largest mutual and pension funds in the United States.

Thank you for inviting me here today to testify concerning the SEC's Regulation NMS market structure proposal. I will focus my comments on the trade-through rule section of the proposal, where the SEC offered two alternatives. The first, called the Market BBO (or best bid and offer) Alternative, would be a modification and a modernization of today's trade-through rule to account for the speed of execution in today's market. The second, called the Voluntary Depth Alternative, is a major expansion of the order routing demands of the current trade through rule. I applaud the SEC's work in coming up with these alternatives and will comment more extensively on each.

When I last had the privilege of testifying before this committee last year at about this time in New York, the debate had just begun about whether or not to have a trade-through rule in the National Market System. Today, with the latest SEC Regulation NMS proposal, the debate seems to have shifted from whether or not to have a trade-through rule to what form a trade-through rule should take. I am pleased that the SEC has recognized the importance of maintaining some form of a trade-through rule in the National Market System. As we comment today on how this trade-through rule should work, we must make sure that it allows for competition between the various market models in the National Market System for the benefit of all investors.

As an agent on the Floor of the NYSE for the past 17 years, I have seen the evolution of Floor brokers from providing outsourced executions for the major broker-dealer firms to establishing themselves as strategic partners for institutional clients. Increasingly, the goal for clients has been to find ways to gain efficiencies in the execution process by getting closer to the point of sale. Independent agents working on behalf of these customers now furnish real-time market information coupled with tremendous cost savings to these institutional customers. The assets that are managed by my institutional customers are owned by the small retail customer: the pensioner, the parent saving for college, the worker funding his or her IRA and all the others who invest in equities traded here in America. Today in the United States, when we talk about doing what is right for the marketplace and the participants in that market, we must realize that the retail customer and the institutional customer are one and the same. Institutional customers simply represent the commingled interests of many retail investors.

Floor brokers play an important role in the price discovery process. The competition between orders represented by brokers at the point of sale on the Floor of the NYSE helps to ensure fair, orderly and liquid markets. It is the Floor broker who will seek out contra side liquidity for an order as well as make decisions based upon rapidly changing market dynamics. The Floor broker serves as a point of accountability and information, with the flexibility to represent large orders over time at the point of sale – not found in dealer markets and ECNs – and employs the most advanced technology to support his or her professional judgment. The interaction between the Floor broker and the specialist provides the flow of information necessary to keep customers informed about changing market conditions. That information flow is more often than not the catalyst that provides incentives for traders to provide liquidity in a way that reduces execution costs. The combination of best price and intelligent information flow is the backbone of the NYSE.

Superior technology will continue to be the NYSE's advantage. During the past decade, the NYSE has invested billions of dollars in technology for our Trading Floor, data centers, and new product and service development. The NYSE Floor has one of the largest deployments of flat screen technology anywhere in the world. Brokers no longer write on little slips of paper and have “pages” transport the information from point-of-sale to a phone clerk for relay to our clients. The agent relies upon a digital handheld communication device, which receives the order, transmits the reports (often directly to the customer) and engages in an ongoing dialogue with the client through the use of digital images. All of this is accomplished without ever leaving the trading crowd. In the future, as the NYSE implements its hybrid market, the technology at the disposal of the floor broker will further increase.

Evolution of the Trade-Through Rule Debate

De-Miminis Exception

The debate over the trade-through rule has evolved greatly over the last couple of years. At first, there was discussion of expanding to listed securities the de minimis exception currently in place for ETFs. However, such an exception runs contrary to the whole principle of decimalization and moving to a minimum price variation of a penny. If Congress and the SEC were trying to save investors money by going to penny pricing, why would they turn around and say that pennies do not matter by issuing a de minimis exception?

Arguments were made at that time about the tremendous savings to investors from the shift to decimal pricing of securities. If a fund foregoes better available and accessible prices for the sake of speed, the negative cost impact to the fund’s shareholders is in the millions of dollars. For a fund trading an average of ten million shares a day (not unusual today), to receive that incremental penny of price improvement on all those shares and multiplied by 250 trading days in a year, the savings are twenty-five million dollars ($25,000,000), which rightfully belongs to your constituents, the investors in that fund. Furthermore, I am only giving you one example of just one fund manager. Across thousands of funds and billions of shares traded, the potential negative impact to investors makes the term “de minimis” a real misnomer.

Fortunately for investors, no such exception has been created.

Fast Quote / Slow Quote Exception

Then there was discussion of providing an exception from the trade-through rule for slow quotes or quotes that were not accessible electronically. The main premise for this debate was centered around the fact that the even though the NYSE had the best price 93% of the time and price improvement 29% of the time, other markets could not access those prices because of the 10-15 seconds on average that it took for an order to be executed on the Floor of the NYSE. Opponents of the trade-through rule argued that the NYSE's "best prices" were only "advertised" prices because in the 10-15 seconds that it took for an order to get executed the market could have moved 2-3 cents or more.

To his credit, NYSE CEO John Thain recognized the validity of this argument not only from a public policy perspective but also from a business perspective. Collectively the members of the NYSE agreed that if the NYSE did not provide its customers with the speed of execution that they desired, they would consider taking their business to another market. So, Mr. Thain proposed to expand the automatic execution offering at the Exchange without sacrificing the advantages of best prices and low volatility associated with the manual auction market. The NYSE's Hybrid Market proposal, which is still at the SEC awaiting approval, will offer customers the best of both worlds. The auction market will remain, but customers who want the speed and certainty of execution associated with automatic execution will now have that option as well. Many longtime critics of the NYSE have applauded the goals of the Hybrid Market and are looking forward to its implementation.

At the same time, the SEC also recognized that forcing electronic markets to chase after better "advertised" prices on manual markets was neither practical nor advantageous to the investor, especially since the price could change for the worse in the time it took to get a execution on the manual market. As a result, the SEC proposed a fast quote/slow quote exception from the trade through rule. Essentially, the reproposed rule states that if a superior quote on a market is not accessible electronically, another market with an inferior quote can trade through the superior quote. This exception recognizes the fact that speed should be a factor in determining the best execution for the investor.

The fast quote/slow quote exception is a significant and sensible change to the trade-through rule, and is the basis for the SEC's Market BBO Alternative, which I will discuss further.

Opt-Out

The SEC also initially proposed an opt-out provision for "informed investors." Opponents of the trade through rule argued strongly for this option. They said that speed and other factors could be just as important if not more important than price and that an "informed investor" (i.e., institutional investors) would know when this was the case.

I opposed the opt out because it ran contrary to the principle of best price for the investor and rewarding the best displayed price with an execution. I supported, and continue to support, a fast quote/slow quote exception because while it recognizes speed as an important factor, it is only important in so far as it affects best price or one's ability to access the best price. Speed of execution is not more important than price; rather it is a factor in determining price. However, the opt-out would have allowed speed, regardless of its effect on price, to be the sole reason for executing on a particular market. There is no sound public policy rationale for this. Also, there were practical issues concerning who could opt out for whom and how often. For example, did a mutual fund manager have the right to opt out on behalf of his millions of investors, or would he have to get affirmative approval from each investor? I, for one, would certainly want to know if my fund manager was opting out of the best price for a faster trade with my money.

Fortunately, neither of the SEC's latest alternatives includes such an opt out. I believe that this is the best decision for investor protection.

SEC's Current Trade Through Rule Alternatives

Market BBO Alternative

Of the two alternatives currently pending before the SEC, I strongly favor the Market BBO Alternative over the Voluntary Depth Alternative. The Market BBO Alternative is the result of thorough debate and comment over the last year at the SEC. It modernizes the trade through rule in a way that recognizes the speed of today's fast moving markets without sacrificing the principle of best price protection for the investor. I am especially pleased that it does not include either a de minimis exception or an opt out provision. As I discussed above, the fast quote/slow quote exception, which is the basis of the Market BBO Alternative, is the right approach, and appropriately resolves the issue of best "advertised" quotes.

Equally important, the Market BBO Alternative provides the proper incentives for both intramarket order competition and intermarket order competition. Within each market, each participant is rewarded for having the BBO for that particular market. There is also sufficient order flow incentive for markets to produce the best prices in the National Market System. This is a delicate balance but it is essential for continued growth and innovation by markets.

Voluntary Depth Alternative

On the other hand, I strongly oppose the Voluntary Depth Alternative as proposed by the SEC. This is a radical proposal that could do irrevocable harm to the National Market System.

Although the SEC calls it voluntary, it is not voluntary at all. The SEC says that for those markets that display their books, those displayed orders, through the entire depth of the book, would be protected. While this is voluntary on the part of the market displaying the order, other markets are compelled to honor those quotes. Also, as a practical matter, if one market displays its book, other markets will need to display their books to ensure that they receive similar quote protection for their depth of book.

Furthermore, the Voluntary Depth Alternative picks winners and losers. A market that is not an all-electronic market would have no role in the Voluntary Depth Alternative world. If a quote is not displayed and electronically accessible, it has no protection. What happens to the liquidity on the reserve book that is not displayed? What happens to the auction side of the NYSE's Hybrid Market? Regulation NMS should not pick winners and losers. Instead, it should lay down principles that will allow different market models to compete within the National Market System.

Many commentators have commented that this alternative would behave like a CLOB, and I agree with them. The Voluntary Depth Alternative would homogenize markets and remove all incentives for intermarket competition. It would also require the mandatory routing of orders between markets. I can support routing orders between markets at the top of the book because it provides incentives for participants to post the best prices within markets while maintaining the incentives for each market to have the best price compared to other markets. However, I cannot support mandatory order routing for the depth of book. The most troubling part of the proposal is the consequence of shifting the best execution obligation from the broker dealers (where it belongs) to market centers. The first market will now determine where, how and when orders are shipped to access liquidity in another market. That is my responsibility as a broker on behalf of the customer who has entrusted me with the order. Furthermore, who will take the blame – economic or otherwise – for a missed market or bad fill because a particular market's order routing algorithm sent an order to the wrong market center?

Also, the Voluntary Depth Alternative would greatly reduce liquidity in the market. In the trading world, everyone wants to know what everyone else is doing without telling anyone what they are doing. The reason institutions hire me to do a trade is so that I can move a large amount of stock in a manner that gets the best execution possible with as much anonymity for them as possible. If we move to a world where only displayed quotes get executed, the institutions are going to execute their trades outside of the National Market System. They may even go to Europe. There is a role for the displayed quote, but there is also a role for the broker in an auction market and the reserve book in an electronic market.

It is my hope that the SEC will act soon to reject the Voluntary Depth Alternative and approve the Market BBO Alternative. It is the result that will best protect the interests of the nation's investors. It is also the result that will preserve the forces of competition and innovation that have thus far kept the U.S. capital markets at the forefront of global competition in the financial services sector.

Thank you. I look forward to answering your questions.