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The House Subcommittee on Capitol Markets, Insurance and Government Sponsored Enterprises

Field Hearing entitled
Market Structure III: The Role of the Specialist in the Evolving Modern Marketplace

New York, New York

Chairman Baker, members of the subcommittee, thank you for holding this hearing and for inviting me to speak before you today.

My name is Ed Nicoll and I am the Chief Executive Officer of Instinet Group. While Instinet Group, through affiliates, exclusively serves financial institutions such as broker-dealers, banks, mutual funds, retirement funds, hedge funds, and the like, I have also had extensive experience serving retail investors as the former CEO of Datek Online, and as the co-founder and President of Waterhouse Investor Services. Both of these companies served millions of retail investors nationwide.

Instinet Group, through affiliates, is the largest global electronic agency securities broker. Through our electronic platforms, our customers can access over 40 securities markets throughout the world. We act solely as an agent for our customers and do not trade securities for our own account or maintain inventories of securities for sale.

As you look into the role of the specialist system and the regulations that keep it in place, I would encourage you to support regulatory changes that allow electronic markets to compete on a level playing field with manual, floor based markets such as the New York Stock Exchange. Specifically, Instinet Group has now spent more than three years calling for the elimination of Intermarket Trading System rules that inhibit electronic markets from competing effectively with the NYSE. The most significant impediment is the trade-through rule.

Media reports and the hard work of many in this room have educated most legislators and regulators on why the trade-through rule in fact hinders

competition and hurts investors, and the chorus calling for the rule's reform continues to grow:

- In October 2003, The *Wall Street Journal* published an editorial calling for the abolition of the rule.

- In January 2004, California State Controller Steve Westly, a Democrat whose office oversees the billions of dollars invested on behalf of California retirees, wrote to SEC Chairman Donaldson in January that "[t]he trade-through provision is obsolete" and "[r]eforming trade-through will improve investor choice."

- Just last week, Florida Attorney General Charlie Crist, a Republican who is one of the three state officials who oversee his state's retirement investments, wrote Chairman Donaldson that "[e]limination of the trade-through rule would abolish this antiquated system. Progressive reform would ensure Florida's investors access to a competitive marketplace, prevent manipulation, and guarantee securities are bought and sold at the true "best price."

I have attached these and other similar letters and articles, including those from *Barron's* and *Fortune*, to my testimony and ask that you include them in the record.

However, there are still opponents to trade-through reform. Some argue that without the trade-through rule investors would not get the best price when buying and selling securities. But as you heard in last fall's testimony from numerous experts, this is simply not the case. Brokers still have a fiduciary duty to secure best execution for their clients – but best execution does not and should not mean attempting to execute against the best-advertised price without considering other factors.

Other opponents to trade-through reform appear to consider the issue to be a referendum on the future of the New York Stock Exchange's manual floor-based specialist model. These opponents assert that the rule does not hinder competition. Yet they tend to spend a considerable amount of time explaining the merits of the NYSE's centralized market structure versus other market structures. If the trade-through rule does not hinder competition, then why all the concern about which market structure is superior?

It is because the debate about regulatory reform is really a debate about whether one market structure fits all or whether investors should be free to choose how and where they trade. It is about competition.

The fact that even the trade-through rule's defenders believe that its elimination would affect the market's competitive balance strongly suggests that the trade-through rule is anti-competitive.

And if it is true that trade-through reform will result in greater competition for the NYSE, why should we be concerned about how the NYSE might have to change or adapt to such competition?

The NYSE's well-deserved prestige may make some reluctant to alter its structure. With respect to the role of the specialist, we are TOLD that the specialist has a duty to "maintain a fair and orderly market." We are TOLD that he provides valuable liquidity and that there would be greater volatility without the specialist there to perform his important functions. This all may be true – but how do we KNOW? What PROOF is there that the specialist is trading only when needed to maintain a fair and orderly market or, according to others, trading only when he can make proprietary trading profits. While the NYSE performs studies that purport to show its market is superior to the NASDAQ marketplace, how do we know if that is "in spite of" or "because of" the specialist?

The stakes are too high to not understand completely what the specialist is or is not doing. The principles behind the adoption of the Sarbanes-Oxley Act – enhanced corporate accountability, disclosure, and openness – need to be applied to the nation's markets as well. **I challenge the NYSE to make its trading data, and in particular all specialist trading activity, publicly available.** We owe investors an open and honest look at the numbers. Not just simple assurances that "All is well."

Trades where specialists participate accompanied by their position at that time should be identified in real time so investors, academics, policy makers, and market participants can better evaluate specialists' trading activity.

Today, when NYSE members complain about an execution, they cannot obtain sufficient data to evaluate the propriety of the specialist's activities.

This lack of information hinders market participants' ability to address their concerns with orders submitted to the NYSE for execution.

For example, in October 2003, Fidelity Investments' head of global trading, Scott DeSano, told the *Wall Street Journal*, "You never get any satisfaction, so you stop complaining."

Among our own customers, the most common complaint I hear is that orders sent to the floor are delayed or not executed at the NYSE's then-quoted market. Without a real-time audit trail, they have little insight into the NYSE's trading process, and less confidence that their orders receive fair treatment on the NYSE.

To its credit, the NYSE has taken some initial, albeit small, steps to respond to market participants' concerns by introducing NYSE Direct+. Direct+ is designed to address execution delays by providing market participants with some ability to obtain automatic executions at the NYSE's quoted market. With great fanfare, the NYSE recently submitted rule changes to the SEC that would, at least in theory, make it significantly easier to obtain automatic executions via Direct+.

Many have expressed their support for these new rule changes and the NYSE itself has proclaimed that Direct+ provides "ECN-like" features to investors. However, the proposed changes simply would expand the range of orders eligible to use Direct+ to include all orders, instead of limiting access to smaller orders and eliminating restrictions on the frequency of its use.

I am surprised that anyone would think that these relatively minor changes eliminate the competitive concerns raised in the trade-through debate. I am also surprised that the NYSE would boast that Direct+ offers ECN-like features.

First, with respect to whether the availability of so-called automatic executions on the NYSE eliminates the need to eliminate the trade-through rule, the short answer is "no." Even if the NYSE did provide additional opportunities for automatic executions, there is still no reason to retain a rule that inhibits competition between the NYSE and electronic markets.

But let's look at how Direct+ really operates. While it provides automatic executions there are some pretty substantial exceptions.

One exception is that there is no obligation to automatically execute an order if the NYSE's quote is in "non-firm" mode. How often does the NYSE publish quotes that are non-firm? Again, there is not much transparency into how the specialist operates its book. Without data from the NYSE on these practices, the "guarantee" seems illusory.

Another exception is that automatic execution is not available when the market is only for 100 shares. I am told this is frequently around 10-20% of the trading day. While this does not sound like much, it is likely that this 10-20% of the trading day occurs at moments when the market is volatile and receiving an automated execution is most valuable. Instead, the "automatically" executed order can take minutes.

A further exception is that automatic execution is only available against the orders comprising the NYSE's quoted market, and not the usually substantial amount of trading interest available at a penny and more behind it. And once the interest at the NYSE's quote is exhausted, Direct+ is unavailable until the specialist displays a new quote.

In sum, it seems the NYSE is guaranteeing an automatic execution except when it is not, which may be often. Not much of a guarantee.

In contrast to the NYSE, every order on an ECN is real and immediately accessible. It is not possible to display an order that is non-firm. There are no delays and no turning off the automated nature of ECNs. Further, every order sent to an ECN for display is immediately displayed. No delays, no freezing and no manual keystrokes from a clerk. That is why I am surprised that the NYSE would even try to compare itself to an ECN.

If the NYSE truly wants to offer an automated execution system that competes with ECNs, **I challenge the NYSE to make two additional changes**:

1) Immediately display all limit orders received electronically for display - no delays, no human intervention, and no exceptions.

2) Immediately execute all matching orders that received electronically - no delays, no human intervention, and no exceptions.

It is these delays in displaying and executing orders that many suspect the specialists use to disadvantage investor orders.

Those two changes would be a start in making the NYSE into a fairer "ECN-like" marketplace.

In conclusion, Instinet Group and operators of other electronic markets are only seeking the ability to fairly compete with floor-based exchanges. It appears, however, that the trade-through debate has become a referendum on the NYSE. Over the past months the NYSE has tried to perpetuate the current regulatory structure by asserting that its market is superior to the NASDAQ market. I do not believe that the NYSE provides sufficient data to adequately evaluate its market. I also believe that the changes that the NYSE is making to Direct+ will have little, if any, impact on investors. Regardless of these changes, there is still a need for unleashing competition between markets. Certainly, if the NYSE is stirred to propose these changes to simply stave off the threat of competition, actual competition will produce even greater benefits for investors.

Clearly, Mr. Chairman, the time for reform is now.

Thank you for your time, interest and leadership on these issues, Mr. Chairman. I would welcome the opportunity to answer any questions.