<u>The Price Matters</u>:
Ensuring All Customers The Best Price as We Enhance the Benefits of the Agency-Auction System at the New York Stock Exchange

Written Testimony of
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"Market Structure III: The Role of the Specialist in the Evolving Modern Marketplace"

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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 in connection with your continuing review of the capital markets structure here in the United States. I would like to commend the Chairman on his choice of New York City – the center of global capital markets – as the site for this hearing. New Yorkers take great pride in our city. We have worked hard to achieve this status, one that is clearly the envy of our international competitors.

Chairman Baker, I am also very pleased that you have chosen my new partner at the New York Stock Exchange, John Thain, to address the committee today. Five weeks ago, John joined an organization that was desperate for new leadership to implement previously announced changes and address important customer needs.

What John has accomplished in just this short period of time coupled with the work of interim Chairman John Reed is nothing short of remarkable. I think that it is clear to all that there has been a dramatic change at the NYSE. The membership is hopeful that regulators and legislators will support these new changes for the continued benefit of all users of our institution.

My focus today will be on the major market structure issues that are currently under review by the House Capital Markets Subcommittee, your counterparts on the Senate side and at the Securities and Exchange Commission. The discussions that we engage in today should focus on how to **enhance** the National Market System for the benefit of all investors. In the process of answering that charge, we should also promote the aspects of the current National Market System that provide positive results in the execution of investors' orders. I would contend that the agency-auction market model at the New York Stock Exchange is one of these important competitive aspects of the National Market System. The specialist, the focus of today's hearings, plays a vital role in that system.

As an agent on the Floor of the NYSE for the past 16 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 costs 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 their 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 in the same. They are all our assets; institutional is just a larger commingled pool.

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. 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.

The Specialist in the Agency-Auction Market

The topic of today's hearing is to identify the role that the specialist will play as the market continues to change. As an agent on the Floor of the NYSE, I have seen the role of the specialist evolve over the sixteen years. A fundamental principle is to place the interests of the customer first and provide each customer with the best experience trading at the New York Stock Exchange. The specific value that accrues to investors can be broken down into two major categories: information flow as an important part of a specialist's catalyst function and liquidity provided to the marketplace.

As I speak with my customers about the multiple marketplaces in which they trade, one theme about the NYSE is consistently voiced. Customers appreciate the fact that the floor based NYSE provides the participants in that market with valuable information that aids buyers and sellers in making market entry and exit decisions. Through this information flow, specialists act as catalysts, proactively bringing buyers and sellers together thus creating trades that otherwise would not have occurred. Responding to a buyer for example, a specialist may recall selling interest on the part of a particular agent and call that agent to the crowd to help effect a trade. The buyer can then negotiate directly with the agent representing the seller. This results in natural buyers meeting natural sellers over 80% of the time with minimal market impact. Without the specialist as the catalyst for providing that information, the trade may have occurred at the wrong price or worse, never happened at all. This kind of information flow is impossible in electronic markets. Furthermore, the information gathered from the specialist at the point of sale is available impartially to all who ask.

The second and equally important function to customers is the liquidity that the accountable specialist adds to the marketplace. It is important to remember that specialists do not set the price for stocks. At the NYSE, that pricing function is reserved for the buyers and sellers. The important role of the specialist is to provide the liquidity necessary to the market to assist agents in getting orders executed correctly for their clients. What specialists do is risk their capital – in excess of $11 billion during an average trading day – to add market depth and stabilize prices. They inject liquidity by bridging temporary gaps in supply and demand. Each of these trades for the specialist is a one-sided risk transaction. The best method for me to explain the value that accrues to customers is to give you an example:

The market is $28 bid for 25,000 shares and 18,000 shares offered at $28.05. My customer entrusts me with an order to purchase 25,000 shares – this may be all the customer wants to purchase or the beginning of a much larger order. My goal is always to execute that order at the best possible price with the minimum of market impact. I want to purchase all my stock at $28.05, the whole 25,000 shares. That outcome will be in my client's best interest. The only way for this to happen is if the specialist is there to add the necessary liquidity – the other 7,000 to make 25,000 – to complete my client's order. In the absence of a specialist, my natural buyer customer would have to reach to the next price point where that liquidity was available to purchase those shares. For the sake of the argument, let us assume that the customer would have had to pay $28.10 to purchase those shares. Without the capital that the specialist injected into the market to complete my client's order, the cost to that institution (and the hard working investors in that fund) would have been an additional $350. That may seem like a very small amount but multiply that savings by the thousands of times that it happens daily and the millions of dollars add up very quickly.

It is important to remember that specialists are not allowed to compete with public orders – they can only buy if they are willing to pay a higher price than anyone else and only sell if they are willing to accept a lower price than anyone else. In fact, the vast majority of trades in which specialists participate are those which most investors would avoid. The specialist obligation to the marketplace requires him or her to be buying when prices are falling and selling when prices are rising, all in an effort to provide liquidity and stabilize prices. In doing so, they reduce overall price volatility. In fact, 98% of all NYSE trades occur at 5 cents or less from the last sale, giving investors confidence that price fluctuations will remain orderly.

Trading technology has allowed people at both the customer and broker-dealer level to work more efficiently as the markets have grown. From the late 1980's, when an average trading day's volume was 100 million shares, today we trade well over 1.5 billion shares on a regular basis. Occasionally, technology can have its' problems. There have been several occasions over the past few months that illustrate the need for professionals working in concert with the technology. A number of months ago, a large NYSE member firm initiated a "program trade" for a customer involving a basket of large cap stocks. Unfortunately, someone added an extra zero to the dollar amount of the trade and what was supposed to be a $40 million basket ballooned to $400 million. On the Floor, those trades were quickly identified as possible errors and the firm was contacted. Realizing the problem, the firm was able to cancel the vast majority of those trades before execution. In another scenario, another member firm entered an order to sell 1 million shares of XRX. While preparing to trade the stock at the appropriate price in the market where demand met this supply, the firm was contacted and an error was again prevented. The order was supposed to be for 1,000 shares only. This process could not occur in an electronic market where there is no one designated to recognized a potential problem such as the ones I described. Only through human intervention and immediate dialogue between market participants were huge losses to investors prevented.

In competing markets, we have recently seen examples of how electronic markets function in the face of stress or incorrect order entry. In early December 2003, the stock of Corinthian Colleges Inc. (COCO) plummeted 19 points in just a matter of minutes. The full details surrounding that event, the halting of the stock, trading in other markets and the canceling of trades made in good faith by investors are still unclear. Recognizing that different market models yield different results, I believe that in this case human participation through an agent or specialist would have prevented such a precipitous decline.

Finally, just last week we observed the trading in the stock of Imclone (IMCL). In three minutes, the stock dropped more than 20% from $42 to $33.50 on no news before being halted. After a 2 hour and 40 minute halt, IMCL finally reopened at 4:20PM – 20 after the NASDAQ closed. During this entire time period, Bristol-Myers Squibb, which owns a stake in IMCL, remained open for trading on the New York Stock Exchange. When it did reopen Imclone immediately rose 35%, back to the levels prior to its' decline and halt, but in after-hours trading, a market which serves only institutions.

The Trade Through Rule

The "trade-through" rule was designed to convert multiple competing markets into a National Market System. The rule turns each market into a gateway to every other market and ensures that investors will not be disadvantaged by virtue of having bids or offers displayed in one market versus another.

When trading is allowed to occur outside of the National Best Bid and Offer (NBBO), two investors are being disadvantaged – the bid or offer that has been posted as well as the buyer or seller who received an inferior price to the NBBO. To amplify this, I would like to offer the following example: A buyer posts a bid of $49.05 to buy 5000 shares of XYZ, the stock is offered at $49.10. In the absence of a "trade-through" rule, a trade of 5000 shares might occur at $49.00. In this instance, two investors are not being afforded the full protection that they deserve in the marketplace. The seller who sold stock at $49.00 did not receive the highest price that was bid for those shares in the market. Further, the buyer with the $49.05 bid is left unfilled. This investor posted the best bid in the marketplace and was ignored. In a time of skepticism and as we try to restore confidence in our markets, I do not believe that this is the message that we want to disseminate to the investing public.

There are other parts of the trade through equation that are overlooked by many. Trade throughs cause the mis-pricing of equity securities in the marketplace. When a trade is allowed or sanctioned to occur outside of the

NBBO, the rest of the market is now unsure as to the true price at that moment in time. Investors are now worried about what might be “going on” as a trade takes place away from the best bids and offers. That broker-dealer may now engage in a riskless principal transaction, through the use of sophisticated technology and market intelligence undisclosed to that fiduciary’s ultimate customer, to not only accrue a commission but to profit in the firm’s principal trading account. The firm will buy outside of the NBBO and then hit the bid or take the offer at the NBBO on the NYSE or another market to offset their position. This activity denies customer the opportunity to engage in the full price discovery process. Moreover, the riskless trading by broker-dealers disrupts the markets and damages the overall pricing mechanism. Why not mandate that customer orders should interact rather than unnecessary dealer interpositioning?

One of the major factors that draw companies to the NYSE is the incontrovertible fact of reduced volatility after a stock moves from being listed on NASDAQ to the NYSE. Management and Boards of Directors realize that a tightening of spreads and minimizing trade-to-trade volatility are serving their shareholders’ best interests. A key factor in why this occurs is the accountable specialist. The liquidity that the specialist adds to the market on a moment-to-moment basis prevents stocks from declining or advancing too quickly. Volatility scares investors and therefore, has an impact on the capital raising process for many firms. The dampening of that volatility by a specialist gives confidence to the investor that there will always be a continuous two-sided market in that security. Trading that occurs outside of the NBBO will increase volatility in these issues and adversely affect investment decisions.

The most important starting point for any trade through discussion must be the facts, and how the facts impact every investor. Some proponents of weakening or eliminating the trade through rule do so out of self-interest, not with the interests of all investors in mind. Simply stated, the facts do not support their contention that investor protection provided by the rule stifles competition. At the New York Stock Exchange we welcome competition. However, that competition must be one that ends with the execution of a customer’s order at the best price available in the marketplace. The reality is that the NYSE posts the best price nearly 93% of the time in our listed securities. We think that competition should be based upon price. This is not an artificial barrier to competition. Other markets can compete by simply matching or bettering our prices. Certainly, our customers agree with that value proposition every day as we receive approximately 80% of the volume in NYSE listed securities. We do not think that any marketplace should receive regulatory relief from a rule that benefits investors. By ensuring that best price is paramount to markets, customers as well as the competitiveness of the U.S. securities markets will be well served. Tremendous competition exists today and order competition, as the critical factor in price discovery, based upon protecting those who display best prices promotes the entry of limit orders that narrow quote spreads and reduce execution costs.

Modifying or eliminating the trade-through rule would produce inferior prices and increased costs, increase market volatility, and reduce accountability and transparency. This is not the way to promote investor trust and confidence.

A Penny Saved is a Penny Earned

With thirty co-sponsors, Chairman Michael Oxley sponsored **H.R. 1053** "to eliminate legal impediments to the quotation in decimals for securities transactions in order to protect investors and to promote efficiency, competition, and capital formation."   It has now been over three years since that dramatic shift in the way securities are traded.

Arguments were made at that time about the tremendous savings to investors from the shift to decimal pricing of securities. Speaking to support "The Common Cents Pricing Act of 1997" Herbert L. Dyer, Executive Director of the State Teachers Retirement System of Ohio told this House Committee that decimals "could save our teachers and retirees millions of dollars annually." J. Kenneth Blackwell, Treasurer of the State of Ohio, explained his support for the legislation by saying that "Decimalization will encourage the laws of free trade to regulate our exchanges, thereby alleviating the need we now have for many of the rules governing trading in our markets." Savings to investors and competition to provide the best and most fair markets to investors; these were the goals and results of this groundbreaking legislation.

For those who propose a "de minimus" or "opt out" exemption to the trade through rule, I would ask: So, what happened along the way to the penny? Has something changed in the Congressional mind in these few short years? Do investors no longer deserve to save money? Have we decided to encourage investors to ignore the best price available in the marketplace? Should investors be prohibited from the opportunity to garner the highest return for the capital that they have invested? Is it acceptable for fiduciaries to accept a worse though speedier price for the stocks that they are buying and selling on behalf of the millions of shareholders who have entrusted them with their hard earned money?

Pennies add up. If fiduciaries are abdicating their responsibility to achieve the best price available, the impact to their shareholders (THE PUBLIC) is very significant. If a fund forgoes 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. 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 minimus" a real misnomer.

The Specialist in the Evolved Marketplace

The role of the specialist (and that of the floor broker, for that matter) will continue to evolve. At the New York Stock Exchange, we embrace change. Providing choices to our customers has been the hallmark of the New York Stock Exchange for as long as I have been a member and we are again addressing the needs of our customers who have asked us to provide more choice. Two weeks ago, our Board passed on a significant structural proposal sent to them by our Market Performance Committee and the Board of Executives, which has been submitted to the Securities and Exchange Commission for final approval. Briefly, the plan calls for an automatic execution of all displayed liquidity in the quotation. Currently, the NYSE offers a product called Direct+, which provides an automatic execution for order up to 1,099 shares with a prohibition of the same customer entering orders in the same stock within 30 seconds. To enhance the product, we have proposed the removal of these restrictions. This will allow the execution choice for 87% of all orders entering our marketplace in less than one second thus disposing of the issue that we are a slower market. We already trade over one hundred million shares a day in this manner. Within our price discovery dynamic, we will preserve the role of the specialist in bringing buyers and sellers together, and committing capital to dampen volatility, as well as the contribution of agency Floor brokers who reduce the market impact and execution costs for institutional-size orders.

Mr. Chairman, your recent description of the New York Stock Exchange in a letter to SEC Chairman William Donaldson, left many feeling that the portrait was incomplete. To those who do not live the market every day, what we do on the NYSE Floor may seem "old-fashioned" but I beg to differ. At the end of the day, it is not just about the technology – and we have plenty of that – it is about the process and the results that accrue great benefits for investors, your constituents.

Let me offer an analogy: Congress meets in Washington DC. Members have offices and staffs. Gavels are banged. Beautiful meeting rooms, antique wooden desks, pictures of dead presidents – all the trappings of a civilized way to execute the business of governing. Almost three hundred million Americans rely on the sound judgment of their agent in Washington to make the right decisions that will affect many aspects of their daily life and future. However, theoretically, it could all be done from your home districts. A bill could appear on a screen. The Member and his or her staff would read it and analyze its impact, most likely focusing on the member's home district and not the United States as a whole. Then, the vote would come. Point and click on the computer in the district without the benefit of face-to-face discussion and negotiation. That potential system is available today. From my background as a political science major and my time spent with many of your colleagues and fine staff, I do not think that just because it is available (and theoretically might save money) that such a "government structure" is one that we should embrace.

In the same way, we at the New York Stock Exchange – 1366 engaged professionals – feel that there is still value in the face to face negotiation that occur in each trading crowd, 250 days a year. Human interaction coupled with the benefits of technology enable elected agents whether in DC or on the Floor of the world's largest marketplace to make the right decisions on behalf of their constituents.

At the NYSE, we will continue to change, adapt and innovate to best serve our customers and to fulfill our commitment to producing the highest levels of market quality. We will continue to provide the fair and level playing field that investors want and expect from us. We will compete on the basis of discovering and delivering the best price coupled with the highest levels of transparency. The interaction of specialists and agency Floor brokers creates a value proposition in which the NYSE delivers to its customers the best prices, the deepest liquidity, the narrowest quote spreads, and the lowest volatility. That results in multi-millions of dollars of savings to your constituents each year. In all that we do, we take pride in the fact that we always place the investor first.

Thank you. I will answer any questions that you may have.