Testimony

of

Michael LaBranche

The Specialist Association

of the

New York Stock Exchange

on

Market Structure Issues and the Current Trading Environment

Before the

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

of the

Committee on Financial Services

United States House of Representatives

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I am Michael LaBranche, Chairman and Chief Executive Officer of LaBranche & Co. Inc., the parent of LaBranche & Co. ("LaBranche"), the largest specialist firm on the New York Stock Exchange ("Exchange"). Our firm has over 107 seats on the Exchange and is the specialist for more than 575 common stocks listed there, operating through 107 individual specialists on the floor. I also am a Governor of the Exchange and a member of its Market Performance Committee. I appear before you today on behalf of The Specialist Association of the Exchange, of which LaBranche is a member, as well as on behalf of my firm.

Development of the National Market System and the Problem of "Trade-Throughs"

Many of the witnesses who have appeared before you represent one form or another of the electronic trading markets that have come into being since the advent of the Securities Acts Amendments of 1975 ("1975 Amendments") and establishment of the most basic elements of the national market system contemplated by the 1975 Amendments under rules of the Securities and Exchange Commission ("SEC"). These are: (i) the consolidated last sale information system ("consolidated system"), administered by an association comprised of representatives of the several self-regulatory organizations known as the Consolidated Tape Association; (ii) the

consolidated quotation system ("CQS"), which collects from all markets, consolidates, and disseminates bid and offer information, required to be "firm" by the firm quote rule of the SEC; and (iii) the Intermarket Trading System ("ITS"), created pursuant to another joint self-regulatory organization plan, which enables participants in all of the markets sponsored by a self-regulatory organization to transmit to each other's markets "commitments" to buy or sell at a specified price and size when a better price is available in another market.

A so-called "trade-through" in a listed stock included in the CQS occurs whenever a trade is completed in one market at a price inferior to an apparently available price being published in the CQS by another market. All self-regulatory organizations have adopted a uniform trade-through rule pursuant to the ITS plan which requires their members to "avoid" trade-throughs. This obligation, combined with brokers' duty of "best execution" (namely, to use the broker's best efforts and all available means to obtain for the broker's customer the best execution available under the circumstances), effectively compels brokers seeking to execute customers' orders in one market at a time when a better price than the proposed execution price is shown in CQS to be available in another market to either match or improve upon that better price or to send a "commitment" to that other market by means of the ITS to seek to trade with that better priced bid or offer before effecting the trade – thus avoiding a trade-through.

The Advent of Electronic Markets

It is the advent of electronic markets in the context of CQS, ITS, and the trade-through rule that have caused indigestion in the markets of today. And it is these systems and the trade-through rule that have incurred the wrath of the electronic markets whose representatives have appeared before you in these hearings. Blame for the problems that the CQS, the ITS, and trade-through rule have caused the electronic markets is heaped primarily on the Exchange, although the CQS, ITS, and the trade-through rule were the result of SEC prodding and insistence.[1]

[1] The SEC position on trade-throughs has been clear and consistent over the years. For example, in 1982, the SEC stated that "Trade-throughs undermine the ability of market participants to compete effectively for order flow and should be eliminated to the extent practicable." Release No. 34-19249 (November 1982), 47 FR 53552, 53553 (November 26, [footnote continued]

Why has this caused indigestion? It has resulted from the fact that electronic markets trade in fractions of a second, at least for small orders where the opposite side typically is already resident in their systems. These markets rely primarily or exclusively on priced orders to buy and sell that are collected and displayed within each such market and can be "hit" in effect instantaneously by the entry of an order on the other side of the market at the same price. It should be noted, however, that these electronic markets are purely passive and only offer quick liquidity in stocks listed on the Exchange – if at all – if opposite-side buying or selling interest is resident in their systems when someone wishes to trade in them. Lengthy waits to find an opposite side for larger orders are common in these systems.[2]

1982). The SEC also has indicated that trade-throughs are "unacceptable." Release No. 34-17314 (November 20, 1980), 45 FR 79018, 79019 n. 12 ("the Commission has taken the position that such trade-throughs constitute 'unacceptable behavior'"). Moreover, the SEC consistently has held that nationwide price protection is a "first priority" and should be a "basic characteristic" of a national market system. Release No. 34-15671 (March 22, 1979) at 3, 5 (appropriately displayed public limit orders should be assured of receiving an execution prior to any execution at an inferior price).

Importantly, the SEC recently adopted amendments to the ITS Plan to expand the ITS/CAES system and bring more securities within the protection of the trade-through rule. (ITS/CAES is the computer system linking exchanges and OTC traders trading certain listed securities.) In Release No. 34-42212 (December 9, 1999), 64 FR 70297 (December 16, 1999), the SEC reiterated that it "continues to believe that it is necessary to expand the ITS/CAES linkage to all listed securities in order to fully implement the 1975 Congressional mandate to create a national market system linking the exchanges and the OTC market. . . ." 64 FR 70297, 70303. The SEC went on to observe that "failure to achieve a linkage between exchange and OTC markets in all listed securities inhibits a broker's ability to ensure best execution of customer orders. . . ." Id. Persons commenting on the SEC's ITS/CAES proposal, such as the Investment Company Institute, supported the adoption of a trade-through rule for third market makers displaying orders. 64 FR 70297, 70301.

[2] As reported by an Exchange committee in 2000:

> As to speed, it is true that, if two orders in an ECN's system match, the computer can execute the trade instantaneously. But, because ECNs are passive, order-driven systems in which limit orders wait on the ECN's book until a matching order arrives, the actual time from order entry to order execution can be quite long. In fact, the vast majority of ECN orders never execute on the ECN.

Market Structure Report of the New York Stock Exchange Special Committee on Market Structure, Governance and Ownership (March 23, 2000) at 26.

If an electronic market's share of the aggregate trading volume from all markets for a listed security included on the CQS becomes large enough, as have the shares of several such markets today, that market must publish its best bid and asked quotations in the CQS and, in the case of Exchange-listed stocks, must abide by, among other things, the trade-through rule. Under the ITS plan, a market receiving a "commitment to trade" through ITS must process the commitment on a first-come, first-served, "immediate or cancel" basis along with any other orders or commitments it receives.[3] The Exchange completes transactions against incoming ITS commitments in 12 seconds on average and fills approximately 84% of all such incoming commitments, based on the Exchange's most recent data.

The Need for Improved Inter-Market Protections

Waiting for word of what has happened to a commitment conveyed to another marketplace by the electronic market seems like an eternity to an electronic market.[4] Such a delay is seen by those markets as inconsistent with their business model because they promote themselves largely on claims that they offer virtually instantaneous executions – in the event there is a match.[5] Something no doubt should be done to shorten the time it takes to send buying

[3] The ITS plan permits originators of commitments sent to other markets to provide that such commitments will expire 30 seconds, 1 minute or 2 minutes after the commitment is received – information not available to the receiving market.

[4] Chairman Donaldson of the SEC, however, said recently, "People say they have to wait an intolerable 30 seconds on the NYSE to execute a trade…. I personally can't think 30 seconds is that long if substantial price improvement can be effected as a result." *High Stakes for the Big Board*, The Wall Street Journal, at A1, dated September 19, 2003. A recent Exchange study shows that, on average, the Exchange provides such price improvement over its quoted prices 43.3% of the time. NYSE Execution Quality Study (October 14, 2003) ("NYSE Quality of Markets Study"). The same study shows that execution speed on the Exchange for market orders of 2000 – 10,000 shares (on average, 18.7 seconds) was faster than that of ECNs (on average, 61.7 seconds) and ArcaEx (on average, 119.8 seconds) for Exchange-listed stocks. Id. In fact, the Exchange consummates transactions with ITS commitments faster and to a greater degree than other markets.

[5] See, however, NYSE Quality of Markets Study, supra, at note 4.

and selling interest from one market to another by means of ITS. Perhaps ITS can itself be changed to address this. If not, perhaps "smart order routing" systems, now widely available, can be relied upon instead. Overall, however, there must be some rational compromise between the electronic markets' demand for instantaneity in trading and the needs of open outcry floors like that of the Exchange, where price improvement is always possible, but not always immediately. Both types of markets need to be accommodated, but best price must remain the rule.[6] The electronic markets must sometimes slow down to permit satisfaction of bids and offers displayed by other markets at prices better than those the electronic market otherwise would provide. Similarly, markets like the Exchange must quicken the tempo of responding to off-floor interest transmitted to obtain a better price. We also must address the question of the period of time during which a bid or offer must be continuously displayed to trigger the obligation not to trade through that bid or offer. Clearly, for example, no one should be asked to respond to bids or offers in other markets that are routinely displayed but then removed within a very few seconds. To address the problem of trade-throughs by members of the Exchange, we

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[6] Former SEC Chairman Arthur Levitt observed:

> It is difficult, however, to enable electronic markets to compete fully in the listed market without eroding what many investors have come to expect – price priority. Because of ITS, investors today are ensured that they will get the best price offered on any exchange, regardless of where their order was originally routed. ECNs argue their customers will forgo a better price elsewhere to achieve immediate execution. This may be true for some investors. But trading price for speed must be rooted in the customer's interest, not the ECN's.

Speech by former Chairman Arthur Levitt, *The National Market System: A Vision That Endures*, at 5 (January 8, 2001, delivered at Stanford University).

Former Chairman Levitt offered a darker view as to why firms might argue that their customers favor speed over price. "Sometimes, the invocation of speed rings as a hollow rationalization for selling order flow or capturing the spread on internally executed orders." Speech by former SEC Chairman Arthur Levitt, *Best Execution: Promise of Integrity, Guardian of Competition* at 2 and 6 (November 4, 1999, delivered at Securities Industry Association Conference, Boca Raton, Florida). Former Chairman Levitt also suggested that the firms claiming that their customers favored speed over price did not offer any support for these contentions and that he suspected that most retail investors would willingly sacrifice five or ten seconds for price improvement. See also remarks of Chairman Donaldson, supra, at note 4.

understand that the Exchange is now preparing new tools to enable the Exchange to automatically send ITS commitments to other markets any time a trade-through on the Exchange would otherwise occur. Finally, it may be time for the SEC to adopt a universal trade-through rule rather than rely on self-regulatory organizations to do that – and to enforce it as an SEC rule.

Electronic Markets Propose that Price in Execution is Secondary

Rather than attempt to deal with the problem of trade-throughs, missed markets and avoidance of damage to the price discovery system on a rational basis, the electronic markets argue that whatever the customer wants – that is, a notion of best execution being in the eye of the beholder – is what our market system ought to give to that customer. We are told that what many customers want most (as determined by those markets) is the fastest possible execution without regard to small differences in price, or the most anonymous execution, or the execution having the least market impact. That is, electronic markets would have you believe that no one really wants "best execution" in the sense of obtaining a price no worse than the highest bid price when selling or the lowest offer price when buying (or some better price in between the best bid and best offer). If you can accept that, you will accept, as they want you to, that it is perfectly fine for electronic markets to effect executions at whatever prices they happen to come up with within their own closed systems, prices established by their own derivatively priced flow of orders on the buy and sell side.[7] To us, this is a dangerous course. Price is at the center of our trading markets and must remain the center around which everything else is built. Price discovery can never become secondary to some other objective of our markets.

In short, the electronic markets ask you to sweep away the offending ITS and the trade-through rule, replacing them with nothing. They further urge you to forget about the notion that all brokers everywhere ought to be seeking the very best available price when they execute a

[7] I say "derivatively priced" because, as everyone knows, the prices of securities listed on the Exchange, no matter where they are traded (including on electronic markets), are established by reference to the last sale prices and the prices of current bid and asked prices on the Exchange. How could it be otherwise when over 80% of all trade volume in Exchange listed stocks originates on the Exchange? See NYSE Quality of Markets Study, supra, at note 4.

customer's order and that, when they are executing orders for their own accounts for themselves, they ought to be able to do so at any price that appeals to them rather than be required to interact with orders of other investors. The trade-through rule and the basic concept of best execution stand in the way of this. In short, the electronic markets argue that price – that is, the lowest price to a buyer, and the highest price to a seller – ought not to be a determinant of "best execution." They say that "best execution" is whatever the particular customer desires. (In this regard, I join Chairman Donaldson and former Chairman Levitt in doubting that customers are ever asked by the electronic markets what they want or that customers in fact are indifferent to a better price.) They would have you believe that the best market system for the United States is one in which we view those wishes, however well intended or however misguided, as controlling as to what should happen to customers' orders in our markets. In other words, the electronic markets tell us that we ought to look at each such order, not in the context of overall order interaction of all buyers and sellers in our markets, where each seller competes for an execution at the highest price and each buyer competes for a trade at the lowest price, but as if each order was entitled to be treated separately, in splendid isolation from the others, detached and somehow apart and entitled to whatever special treatment the electronic markets have in store for them.

Price Must Remain Central and Paramount In Our Markets

I view the electronic markets' ideas with respect to "best execution" and order interaction as wrong. In those ideas are threats to the price discovery process, which depends every day and at all times on the interplay between the supply and demand provided by innumerable buyers and sellers in our markets, and to public confidence in the fairness and basic integrity of our markets.[8] The genius of the American stock market is that it collects and causes to interact in a competitive auction, driven first by price, and only after that by other factors, all buying and selling interest present in the market at a particular time. It is this process that produces what we

[8] True, an inactive stock may not see very many buyers or very many sellers on a given day, but the price of every stock is, in a sense, affected by the prices being established daily for other stocks that are viewed as of the same type -- *e.g.*, similarly capitalized, in a similar industry sector, etc.

all know as *the* price – that is, the dollar level at which willing buyers and sellers agreed to transact in open competition with other would-be buyers and sellers, others of whom were not willing to buy except at a lower price and sellers who would not sell except at a higher price. Every order that is stripped out of such an interactive system, that is handled as if price was of only tangential concern so that it need not participate in this great, ongoing auction based on price, does damage to the pricing mechanism, rendering it less perfect. If too many orders were to be permitted to do this, the pricing system would become increasingly inexact and unreliable. Indeed, I believe it is the fragmented state of the over-the-counter market, as much as anything else, that has lead to that market's higher volatility and unpredictability as a whole.[9]

In sum, I believe that the attacks on the need for inter-market price protection through adherence to the trade-through rule by electronic markets are grounded in their own self-interest. In pursuing that self-interest to the exclusion of all else, they seem to have forgotten the need to preserve the soundness and fairness of our markets as a whole and to protect the welfare of all investors. In short, they have lost sight of the public interest.

I would be pleased to respond to any questions you may have.

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[9] See NYSE Quality of Markets Study, comparing 249 listed and NASDAQ stocks, matched on trading activity, price and market capitalization and showing that NASDAQ stocks exhibit far greater volatility than stocks listed on the Exchange.