Testimony of Robert B. Fagenson

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

concerning

Regulation NMS and Market Structure Developments

(July 22, 2004)

I am Robert B. Fagenson, Vice Chairman of Van der Moolen Specialists, the fourth largest specialist firm on the New York Stock Exchange ("NYSE"). I also served as a Floor Official and later Floor Governor of the NYSE from 1985 through 1993, on the Board of Directors of the NYSE from 1993 through 1999, and as the Board's Chairman in 1998 and 1999. After a four-year absence, I was reelected to the NYSE Board in 2003, but resigned upon reconstitution of that Board to consist solely of public Directors. I currently serve on the NYSE's Technology Planning and Oversight Committee.

I appear today on behalf of my firm and on behalf of The Specialist Association ("Association"), of which my firm is a member and which I have served for over a decade, currently as Chairman.

The Securities and Exchange Commission, in its proposed Regulation NMS release ("Release") and supplemental release ("Supplemental Release"), attempts to address and solve a number of complex, inter-related problems affecting our markets – problems, that, in my view, stem primarily from technological change in a regulatory environment that was created for a slower world. The Release attempts to provide solutions to virtually all of these problems in an integrated way. The SEC and its staff are to be congratulated for this timely and important effort.

As I see it, at the heart of the regulatory proposals advanced in the Release and Supplemental Release are three issues. First, now that technology has advanced to the point where it is truly possible to ensure that no investor's displayed order to buy or sell at a price better than any other price shown in our markets can be ignored, are we nevertheless going to permit transactions at a worse prices to occur without filling or at least matching that better price? Second, is there something about the speed with which transactions, as a technological matter, can occur that matters enough to override the basic principle in our markets that trades always should occur at the best available price? Third, are we going to compel each market that wishes to have its own buying and selling interest be protected by an anti- trade-through rule to trade exclusively on the basis of bids and offers displayed in the consolidated quotation system ("CQS") that can be filled or taken instantaneously by electronic means? Or will investors who wish to seek a better price, as an alternative to buying or selling at displayed prices, still be permitted, as they are today, to participate in an auction process like that on the NYSE that discovers and provides a better price much of the time?

What has brought these issues to the forefront? Primarily, in my view, three factors:

- The growth of electronic markets -- so-called alternative trading systems or ATSs, electronic communications networks or ECNs, and in-house electronic order crossing systems of large brokerage firms. These electronic markets insist, for purely competitive reasons, that there are customer constituencies who value speed of execution over best price and that those constituencies should be permitted to trade without regard to other markets and other market participants that offer, at the time of trade, better prices.

- The failure to ensure, before now, that each market affords fair access by all market participants to the best bid and offer prices available in that market and to do so on a basis that is as efficient as today's technology permits.

• The need to reaffirm and adapt anti-trade-through principles to the faster markets of today in a way that makes it feasible to insist, unequivocally, that all markets and all market participants must trade at all times in a manner consistent with those principles. .

The most important proposal in the Release and Supplemental Release, in my view, is a rule that would require all markets, including electronic trading markets, to adopt and enforce their own anti-trade-through rules. Each market's anti-trade-through rule would have to prevent trade-throughs from occurring in that market at prices inferior to any price displayed in the CQS and made available by another market on an immediately accessible basis (which I shall refer to as a "fast quoting" market), with very limited exceptions. In this regard, the SEC is to be especially commended for modifying its original proposal to recognize that within each market some quotes will be "fast" while others may not be, and that quotes in the same stock may be "fast" much of the time, but at others "slow." The SEC has proposed that all "fast quoting" markets should receive the full protection provided by anti-trade-through rules for all of its "fast" quotes. (Originally the SEC had proposed that each market as a whole would be categorized as either "fast" or "slow," with only the former being entitled to absolute trade-through protection.) A companion rule proposal would ensure fair access by all markets and market participants to all quotations displayed in the CQS. The SEC also proposes an "opt-out" exemption from its anti-trade-through rule that would permit any broker-dealer and any consenting customer to decide, ostensibly on a trade-by-trade basis, to forego the protections of the trade-through rule – that is, to trade without regard to better priced bids or offers displayed from any market.

The NYSE and the Association have submitted comment letters responding to most of the issues and proposals discussed in the Release and the Supplemental Release, including those that I have described. I agree with the positions articulated in those letters and commend them to your attention. Today, I will limit my testimony to what I regard as the three primary issues described above.

I am mostly concerned about what is at risk in the debate begun by self-interested electronic markets concerning the value of speed of execution compared to the value of price of execution. In particular, I am alarmed by the prospect of what would be lost from today's markets if fascination with what is technologically possible in terms of execution speed were to be permitted to reshape the regulatory landscape, diminishing or even eliminating the idea that best price and order interaction between customers without the intervention of a dealer should continue to be dominant factors in the regulation of our markets. In simple terms, just because we can do something does not necessarily mean we should. My view is that regulation should take into account both developments in technology and the continuing need for the exercise of human judgment in the trading process. That is, regulatory policy should not imagine that technology alone can support the genius and vitality of our trading markets.

The NYSE has made it plain that it intends to provide customers with a choice of a "fast quoting" market. The NYSE even now has begun modifications to its systems and rules to ensure that result, and will continue to do so as the SEC moves to adoption in final form of the Regulation NMS rules. In this regard, my primary concern is that the SEC must make sure that whatever "fast quoting" market standard it ultimately adopts permits the NYSE to continue its traditional auction trading process for those who wish to avail themselves of that process to obtain better prices rather than woodenly accepting whatever prices happen to be displayed in the CQS at the time of the trade.

I also believe that the SEC would make a great mistake if it were to adopt any variation of the "opt-out" exemption. Adoption of that exception, in my view, could undermine or even destroy a trading process that continues to be the envy of the world because it provides enormous liquidity, day after day, in a fair and orderly manner. What adoption of such an exemption would not do is improve the markets in any respect.

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Speed of Execution Is Not a Paramount Value. It is well-known that the NYSE today enjoys a market share of approximately 80% in the trading of its listed stocks. Lately we have heard with regularity that the NYSE's market share is the result of the anti-competitive effects of the trade-through rule. The trade-through rule, we are told, impedes electronic markets from realizing their full potential as markets and stands between at least some investors and their preference as to execution quality (i.e., achievement of an immediate execution rather than one at the best price). In short, the electronic markets seek to persuade us that trade-through rules are old-fashioned and must go. To help them realize their potential, the electronic markets argue, the basic rules of the road in our markets should be changed to acknowledge the special importance of their only real product – speed. If done properly, which means to these electronic markets eliminating the trade-through rule altogether, they then could offer something more – the ability to trade in isolation, free from interaction with other market participants.

While the NYSE does have 80% of the trades in its listed stocks (understandable to me since the NYSE shows the best quotes in its listed issues more than 90% of the time), it should be noted that its competitors have succeeded in attracting the remaining 20% of those trades. Further, they have done so notwithstanding the NYSE's acknowledged quality as a marketplace and the existence of the trade-through rule. This has occurred in an environment where the goal of obtaining the best price governs the conduct of brokers, and the market that provides the best prices is rewarded with trades. That is, the NYSE's competitors know how to offer what securities customers want, and have been rewarded by customers when they do, in terms of efficiency, economical access, and best price. They have not needed regulatory change to do these things. Just because someone's business model is not working does not entitle them to regulatory relief.

Second, I ask you to consider just who is demanding increased speed of execution and why. That is, can any set of investors be identified to whom it matters whether an execution takes place in one second or a nano-second – and to whom it matters enough to sacrifice a penny or more in the price paid or accepted on the trade? I do not believe that there is any such set. There are, however, electronic markets and sponsors of electronic trading who have little else to offer besides their execution speed. They would prefer being spared costs that attend operation in today's markets where order interaction and best price are prized and fostered by current regulatory policy and rules. Finally, they realize that, if they could avoid interacting with other markets and trade for their own accounts without regard to better prices offered by others, new opportunities to profit would present themselves. These markets, I suspect, are the only real advocates of the speed factor.

The SEC's proposed Regulation NMS would do a great deal to modernize the existing regulatory regime by addressing the need for fair and efficient access to displayed quotations and could, if the proposed trade-through rule is adopted in appropriate form without the "opt-out" exemption, go far in realizing the objective of stopping inter-market trade-throughs of better prices. The SEC's new trade-through rule, however, does not and should not be changed to elevate speed of execution over other values now embedded in our regulatory system, the most important of which, in my view, is that no trade should occur at a price inferior to the best price displayed in the CQS.

The "Opt-Out" Exemption. The proposed "opt-out" exemption from the trade-through rule would swallow the rule itself. Adoption of such an exemption would destroy rather than advance inter-market price protection in our markets. To do that would be an incalculable error and inflict more harm on investors than those who support such action seem capable of imagining.

Adoption of the "opt-out" exemption would permit trading by broker-dealers for their own accounts and for customers without regard to the existence at the time of their trades of better bid or offer prices displayed in the CQS. In such an environment, not only would one side of the trade receive a worse price than a better price known to the broker-dealer handling their order or trading with it as principal at the time of the trade – namely, the customer side of the trade – but such trades would leave stranded and unexecuted the better bids or offers made by others. This would be so even though those better prices would have to be accessible "immediately" and on fair terms if the rules contemplated by proposed Regulation NMS were adopted. That the SEC would suggest such an apparent step backward, in light of the formidable reasons mounted in the Release for proposing adoption of a universal trade-through rule for all markets, is confusing.

Two principles tend to force inter-market price protection today: "best execution" in the case of orders of a size that reasonably can be expected to be executed at the best displayed bid or offer price or better; and, in the case of listed securities, self-regulatory organization trade-through rules (even where the size of the trade is such that the prices of displayed bids and offers do not necessarily establish a sound guide to what "best execution" requires under the circumstances). The "opt-out" exemption would overthrow both principles and, in so doing, threaten to capsize fairness and orderly trading in our markets. In our markets to permit the kind of conduct that adoption of the "opt-out" exemption would endorse would, in my judgment, snuff out public confidence in the fairness and integrity of our markets, confidence on which our capital raising process depends.

Public confidence in our markets exists today because those markets operate fairly as to the most basic and important element of a securities transaction – price. This is so without regard to the size or influence of the buyer or seller. The rule at all times should be that the best price gets the trade. The "opt-out" exemption would turn this on its head. Instead, the SEC (and thus our markets) would tell the world that the biggest player gets what he wants regardless of price and regardless of the little guy and any better price at which he is willing to buy or sell. This is the opposite of the message that has made our markets the best and the most trusted in the world.

The "opt-out" exemption is a terrible idea and the SEC should disown it.

<u>"Fast Quoting" Market Status: Effects on the Auction Process and Price Discovery</u>. Today, the NYSE executes virtually all orders submitted within a very few seconds after submission. This includes, most of the time, responding to commitments to trade submitted through the admittedly antiquated Intermarket Trading System. Some trades, however, take longer.

Sometimes, this is because adverse news affecting the issuer of a particular stock is released. In other cases, it is merely the coincidental confluence of a lage number of orders on one side of the market at the same moment. In such cases, after exhaustion of the existing displayed bids, the bid-ask spread is likely to be widened to forestall sequential short sales at successively lower ticks (when the occasional up-tick occurs) and to discover the new price at which buyers and long sellers generally, after absorbing the news, believe is appropriate for that stock.

In certain instances, the specialist may be aware of contra-side interest in a stock that a customer seeks to buy or sell. By quickly reaching out to such interest, and bringing it to the post. The trade then can achieve a price better than any displayed bid or offer price. Through this process of price discovery orders presented for execution often receive price improvement, but not instantaneously.

In other cases, customers may wish to establish or dispose of very large positions – something that will occur at a negotiated price away from the level of the currently displayed bid or offer. Strictly speaking, the interest in assembling such a trade does not take the form of a market or other type of executable order. The conduct and completion of both a search for contra-side interest in a trade of size and negotiations between the prospective parties to such a trade as to price depends on stability of the bid or offer price for a brief period to permit that to occur. The NYSE auction process accommodates such pending transactions today without triggering trading halts and by including rather than excluding all trading interest at the time of the transaction. I believe that doing so performs a valuable service to the markets as a whole.

The ability to perform in the foregoing ways – to adjust to bad news, provide price improvement, and permit the negotiation and smooth execution of very substantial trades – could be lost if, as the price of winning characterization as a "fast quoting" market under the new SEC trade-through rule, the NYSE must give up entirely its existing auction/agency process. The NYSE is addressing this challenge and working toward the objective of assuring that the virtues of our existing trading system and the benefits that they confer on market participants can be preserved side by side with making available to other markets the bid and offer prices on the NYSE displayed in the CQS that are immediately accessible and assuring that no transaction occurs on the NYSE that trades through a better price displayed in the CQS by another 'fast quoting" market. I hope and expect that the definition of what constitutes a "fast quoting" market under the trade-through rule ultimately adopted by the SEC will accommodate the NYSE's effort.

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I appreciate the opportunity to express these views and would be pleased to respond to any questions that you might have.

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