Ensuring All Customers The Best Price as We Enhance the Benefits of the Agency-Auction System at the New York Stock Exchange

REGULATION NMS AND DEVELOPMENTS IN THE EQUITIES MARKETS

Written Testimony of
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Chairman Shelby, Ranking Member Sarbanes and Members of the Committee:

Good Morning. Thank you for inviting me here today to testify in connection with your review of the capital markets structure here in the United States. My name is Robert McCooey. I am a proud Member of the New York Stock Exchange (NYSE) and am honored to serve as one of the three agent representatives from the Floor to the NYSE's Board of Executives. In my primary job, I am 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.

Chairman Shelby, I am also very pleased that you chose John Thain, to address the committee yesterday. Six short months ago, John joined an organization that was desperate for new leadership to implement change and address important customer needs. What John has accomplished in just this short period of time coupled with the work of 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 who trade at the New York Stock Exchange.

My focus today will be on the major market structure issues that are currently under review by the Securities and Exchange Commission articulated in Release No. 34-49325, Regulation NMS ("Reg NMS"). 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. I also believe that it would be most helpful for the Committee to focus on the future and not dwell on the miscues of the past. We cannot change what has happened but with new leadership at the NYSE coupled with a dedicated Floor willing to embrace change for the benefit of our clients, the time is ripe for a new beginning.

As an agent on the Floor of the NYSE for the past 16 years, I have seen the evolution of the responsibilities 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 often one in the same.

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. This makes for fair and orderly markets.

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. Over 98% of all orders sent to the NYSE are delivered electronically to the point-of-sale every day. 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 directly to the customer and engages in an ongoing dialogue with the client through the use of digital images. We are electronically connected to our customers all over the world. All of this is accomplished without ever leaving the trading crowd.

Electronic execution options are also not new to us at the NYSE. Direct+, our automatic execution product, was introduced in 2000 and since then has grown from 1% to approximately 10% of the average daily volume.

Allow me to speak briefly about the important role of the other participant in the agency-auction model at the NYSE – the specialist. As an agent on the Floor of the NYSE, I have seen the role of the specialist evolve over my 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 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, 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, like myself, in getting orders executed correctly for their clients. What specialists do is risk their capital 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. These are savings that accrue to investors – your constituents.

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 course of action could not occur in an electronic market where there is no one designated to recognize a potential problem such as the ones I described. More importantly, these trades could have been executed quickly – with the primary focus on speed that some have been asking for – but the outcome to the customer would have been quite negative. Only through human intervention and immediate dialogue between market participants were huge losses to investors prevented.

Alternatively, 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, this past February we observed the trading in the stock of Imclone (IMCL). In three minutes, the stock dropped more than 20% from $42 to $33.50 for no apparent reason before being halted. After a 2 hour and 40 minute halt, IMCL finally reopened electronically at 4:20PM – 20 minutes after the NASDAQ closed. In after hours trading, Imclone immediately rose 35%, back to the levels prior to its' decline and halt. However, this market serves and benefits only institutions – not individual investors.

One of the four major areas for comment contained in Reg NMS was the "trade-through" rule. I believe that customers always deserve the best price. **Price matters to my customers and at the end of the day, they do not ask how long it took me to execute their trade but they do focus on the price that they received**. The "trade-through" rule protects the best prices and rewards the market centers that post them.

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. 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 becomes 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. One of the guiding principles from the SEC is that customer orders should interact without unnecessary dealer interference. I agree.

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 well over 90% 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 between markets exists today. Order competition, as the critical factor in price discovery, is based upon protecting those who display best prices. This process promotes the entry of limit orders that narrow quote spreads and reduce execution costs. 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.

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. If fact, one of the goals of Reg

NMS was to promote competition among marketplaces in order to encourage innovation.

The New York Stock Exchange, in keeping with its pattern of market improvements, committed to being a "fast" market with immediately accessible quotations even before the release of Reg NMS. With that in mind, I support the Commission's suggestion as articulated in the Supplemental Release (No. 34-49749) for a "fast" market to be designated on a security-by-security basis rather than as a whole.

Some customers have asked for the ability to immediately, anonymously access the liquidity that they see displayed in the quotation. Currently, customers can only access Direct+ for 1099 shares or less and are constrained by a rule that prohibits multiple orders within a 30 second window. We have proposed the removal of those restrictions so that customers have the ability to access all of the displayed liquidity. The NYSE will also continue to provide the choice of price improvement for those who avail themselves of that option. We recognize that the market is not a "one size fits all" proposition and we look forward to working with the SEC and Congress to make the New York Stock Exchange the best possible market for all participants.

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 be happy to answer any questions that you may have.