# CHAPTER 7: ELECTRONIC AND FLOOR-BASED TRADING: THE NYSE HYBRID MARKET

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LAWRENCE ZICKLIN: This is a propitious time for the securities markets. Having spent 40 years in the industry with Merrill Lynch and Newberger Berman, I am speaking from personal experience. I have become an observer looking at this extraordinary industry from the outside. Indeed, these are times that are parallel to the mid-1970s when we deregulated commissions. We are now at that kind of a turning -point again. There has been a lot of scandal reported in the financial industry, in the trading industry, and at the New York Stock Exchange. In the midst of all that is happening, it is a privilege to listen to Catherine Kinney of the New York Stock Exchange.

Let me give you a minute's worth of background. She has been President and Co-Chief Operating Officer of the New York Stock Exchange since January of 2002. She is also a member of the Office of the Chairman, and she co-chairs the New York Stock Exchange's management and operating committees. Prior to this, Ms. Kinney was group executive vice president, overseeing the exchange's competitive position, relationships with listed companies, member firms, and institutions, as well as the NYSEs new listings in client service, equity marketing, sales, exchange traded funds and fixed income divisions. In short, she has been busy.

Prior to all of this, Catherine Kinney was responsible for managing trading operations and technology. She also worked in several departments of the exchange, including regulation, sales and marketing, and technology planning. It is my pleasure to introduce her. Catherine Kinney, welcome. The microphone is yours.

CATHERINE KINNEY: Thank you. This must be the toughest spot on the program. I am between you and a drink after a long day. I have to say thanks to you, Larry Zicklin and to Bob Schwartz for bringing everyone together today. The last panel was very interesting. I want to use it as a jumping off point for my presentation this evening.

The title of this conference is Electronic vs. Floor Based Trading. It is an intelligent title, but I do not think that we are facing an either/or proposition. It should not be a choice of one or the other. You heard some of the professionals recommend both, if that is possible. I will talk today about how the New York Stock Exchange intends to execute the Exchange's proposed hybrid model. While it is a challenging project, the history of the New York Stock Exchange would suggest that it can be accomplished. Hopefully, it will be successful for the customers who are in this room.

I will get started by recalling what Bill Donaldson said in a speech this past Sunday to the Society of American Business Editors and Writers in Fort Worth. It supports my opinion. Bill said, 'The leadership of our market depends on going to the benefits of technology while maintaining the advantages of the floor auction model for all investors.' I will therefore start with that as my premise. I also wish to note that the SEC is clearly signaling that it thinks the hybrid model can be effective.

I will make three points. First, I want to challenge the proposition of floor-based versus electronic for listed securities. Second, I would like to describe how the exchange will achieve the hybrid model. This certainly is a work in progress, but we have enough of the elements in place to give you a sense of where we are going. I cannot tell you how it warms me to hear our customers talk about a lot of our products. They have a good understanding of those products. Third, I want to discuss the road ahead.

Before I challenge the proposition of electronic versus floor, I would like to review the list of customer needs that we see. First, everybody wants a deep liquidity pool. I believe that most people would favor a centralized market to achieve that deep liquidity. Our customers clearly want speed. Our customers want efficient access to quotes. They want certainty. They want anonymity. They want high levels of transparency, and they want to protect limit orders. They want low-cost executions.

You heard some of the professionals say, and I agree, that with all of the tools that Wayne Wagner and his peers are developing, there will be a more balanced measurement scorecard on execution costs and market impact. Customers want capital, either from the marketplace or from the sell-side. The sell-side obviously has to fulfill its responsibility to achieve best execution. I suggest that the ideal way to respond is the creation of the right market structure and the best technology, to deliver great service at low cost. Before we discuss exactly how the Exchange hopes to achieve this hybrid model, I will examine where we start from at the New York Stock Exchange.

We believe in a centralized model. We have been trying to commingle a model that includes both institutional investors and retail investors. As many people in the room have pointed out, we have overlaid several things onto that – more professional trading, statistical arbitrage, program trading, and all sorts of other customers into the mix. We are trying to commingle all those customers to create that deep liquidity pool.

The market infrastructure at the Exchange has been very successful. What are the elements of that success? You start with quotes and the advertised quotes. The exchange is putting out nine million quotes a day. We are setting the NBBO. We are the best price 93 percent of the time. We have an open limit order book that is refreshed every five seconds.[37] From our perspective, we are setting the market. We are setting the pace. The fact that we are setting the price is an important benchmark relative to the advertisement of what you can do on the floor of the Exchange.

The next important point about the infrastructure that I will call your attention to are the execution services themselves. We are handling about 12 million orders a day in DOT. We provide lots of choices. You can use DOT, you can use a completely automatic execution system called Direct+, and you can use Institutional Express. You can also use anonymous DOT.[38]

You can be sponsored by a broker dealer and come directly into the markets, without the aid or assistance of that broker, for anything other than

[37] NYSE OpenBook real-time is currently in testing and awaiting SEC approval.

[38] Anonymous SuperDot® (ADot) enables institutional investors sponsored by a member firm to submit orders directly to the NYSE without the Exchange, member firm, specialist or floor brokers knowing their identity.

clearing arrangements and membership. It is important to point out, with all of that order execution, that you are getting a 10.7-second turnaround time today.[39]

You have heard that there is strong need for the hybrid in the openings and closings. It is true that the New York Stock Exchange has the higher fill rate or certainty of execution. Today seven percent of the orders on the floor of the exchange are market orders; all the rest of them are limit orders. There has been a big transition in terms of the kind of order population that we are processing. For marketable limits, the fill rate is at 79 percent through DOT. It is actually slightly above 80 percent in ITS.

Specialists and brokers who really create value are the third part of the infrastructure in place today. They are the professionals who fit in the middle of the auction. We have the order flow and the limit order book, but we also have the brokers and the specialists. The specialists are one of the capital providers in the marketplace. Their participation rate is about 9.3 percent today.[40] It is the floor brokers and the order flow coming through DOT that largely make up the quotations that set the NBBO today. The specialists overlay their capital when necessary. This is a very important point. The brokers are representing their customers' interests in ways that are appropriate between that customer and that broker. The floor brokers are also very valuable in the construction of the auction market model.

We start with a very important, valid, and successful infrastructure. What do we produce as a consequence of that infrastructure? What is the quality of our market today? It is important to make three points about market quality. First, we have the lowest effective spreads for the top 200 stocks. Despite what you have heard on many of these panels, call up the SEC Website and look at a 2001 paper that has recreated the SEC's own study from 2000.[41] You will see, for the top 200 stocks, that the effective spreads for the New York Stock Exchange are 71 percent lower than they are for the top 200 NASDAQ stocks.

The second point is our lower volatility. I said earlier that we are trying to balance investor interests, both large and small. What is also important is that we are trying to balance the interest of issuers who have listed their shares on the New York Stock Exchange. The listed companies

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[39] The 10.7 second turnaround time was as of the first quarter of 2005.

[40] The 9.3 percent participation rate was as of the first quarter of 2005.

[41] Office of Economic Analysis: Report on the Comparison of Order Executions Across Equity Market Structures, Executive Summary, January 8, 2001, http://www.sec.gov/news/studies/ordrxmkt.htm.

are trying to serve their investors, and one of the things that they care a lot about is volatility. If you look at volatility on the New York, I want to draw your attention to the following. One, on our Website, we have updated a study of 48 companies that moved to the New York Stock Exchange from NASDAQ. You will find that their volatility gets cut in half. We attribute that to our model, and to how we centralize the order flow and the players in our model. That is important to companies and to issuers, because it lowers their cost of capital. By definition, if you have lower volatility, you will have lower execution costs for investors.

The third point is a lower cost of execution. On this, I will simply rely on the third-party experts – Plexus, Able Noser, and Elkins/McSherry – to deliver our message. Execution costs on the New York Stock Exchange are anywhere between 19 and 49 percent lower that other markets.

In short, we have an infrastructure today that, in our view, is successful. It works. It delivers quality for investors and for the issuers who we are trying to serve. That said, everybody in this room has clearly stated that that is not enough. The New York Stock Exchange must try harder. The challenge for the Exchange is to develop the hybrid model.

When we talk about a hybrid model, you should know that we already have one today on some level. In fact, 99.4 percent of the orders, representing about 63 percent of the volume, are going directly to the specialists. The balance of the volume – 37 percent – is going to brokers. That is a little misleading because it is basically a day's volume divided up. Brokers are handling orders that sometimes are multi-day orders that are not necessarily reflected in those numbers. In any event, the customers have said that they want more. What is the 'more' that they want? How will this hybrid evolve? What are we going to focus on?

Let us come back to the three segments I spoke of earlier. The first is information – namely, the quotations. The first important step is to make the limit order book open and real time. We are working on delivering this very shortly – in a matter of weeks or certainly a couple of months, I hope that we will be up and running with a real time book.[42] With respect to execution services, John Thain has established that we are going to be a fast market. Therefore, Direct+ will largely take over in terms of the dimension of execution.

[42] NYSE OpenBook real-time is currently in testing and awaiting SEC approval.

In relation to this, think about the following: If today we are executing 63 percent of the volume that is going to the specialists through DOT, we will be doing that in one or two seconds. What has been your DOT order is now going to become your Direct+ order in terms of execution. We are going to sweep everything through, and see if it is eligible for an execution in real time. We will incorporate marker orders into Direct+, and we will raise the order sizes and eliminate any barriers to a continuous flow of orders through Direct+.

I think that all of this sounds great. We probably can take many of the DOT orders that we have been getting – those 12 million orders that we are getting through DOT today. I suspect that the lion's share of those orders (given that we get a lot of marketable limits today), will be turned into automatic executions. No one will see that, not even the specialists. Those orders will be paired off and reported back to the customers anonymously.

It is important, in creating this hybrid model, that we also create opportunities for the auction to take place. Back at the Exchange, right now, we are trying to figure out the triggers that suggest that it is time for an auction. Is it a price dislocation, a premium, or a discount? Is it the number of shares? What exactly is it that creates this moment when customers and investors would be better served, not by automatic executions, but by taking advantage of discounts or premiums that they think are important in terms of execution.

That is the challenge – to superimpose the auction in places where we need it at any moment. While I think that everybody can agree that the hybrid model has a lot of benefits, its greatest benefit is that it sits there waiting for its opportunity to be effective. You do not know when you are going to need it. You do not know whether there is going to be news. You do not know whether someone is going to restate earnings. You do not know whether there will be an earnings report. You do not have any idea what is going to affect any stock at any moment. It certainly seems to me that you would want an infrastructure that gives protection when you need it.

Institutional Express and Liquidity Quote ought to be reevaluated and examined closely. That brings me back to the question that was asked in the last panel about whether we are going back to block trading. I think that everybody reminisces about the time when they could do a large block trade on the Exchange. There may be a chance to recreate that, but we have to get the fast market Direct+ done first. We have to figure out how to superimpose the auction. And then, to the degree that we can refocus on the specialist and on the marketplace to commit capital again in large size, we may be able to recreate some of those block executions that we have known in the past.

We have to create even more efficient closings. We will start with more electronic adaptation at the close. But we are very efficient today. That is one of our great strengths right now – the opening and closing. Nevertheless, we have to do it even more efficiently. Technology can play a role.

We have also seen and heard from our customers that they would like to have more choices about where they can print their stops and VWAP trades after the market's 4:00 pm markets close. You will see the Exchange introducing something called Crossing III and IV.[43]

Creating that hybrid model also has other important dimensions. We need more transparency around the book. We need better and faster execution capability. We must have the ability to superimpose the auction as we need it, where the brokers and the specialists can add value. We can make the openings and closings more transparent and more efficient. And there is something else as well – with regard to price improvement, how do we reach for better bids and offers, and how do other customers reach our better bids and offers, since we are creating the NBBO 93 percent of the time?

There is unanimity in the view that ITS needs to be either scrapped or changed. We will have to integrate ITS with Direct+, and give automatic executions to those orders that are coming through ITS. But I do not think that it will be free. It is not a sensible business strategy to give our nonmembers better access at lower costs than what we give our members.

As we move forward, you can expect to see the intermarket linkages tightened and becoming more efficient. But they will not be free. They probably will have a fee associated with them that they do not have today. The important point is that the linkages work very efficiently. Ultimately, most of our competitors either are members or have access through a member. Over the next 12 months you will probably see most people coming in the front door as opposed to the side door. Nevertheless, we can make the side door very efficient and effective, both for our competitors and for our customers.

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[43] Crossing Sessions III and IV debuted on June 15, 2004.

The specialist's responsibilities will be tightened up. We will probably make information about their performance more transparent, not only for specialist units, but for individual specialists. Last but not least, you will see advanced techniques and technology being used to support the specialists' ability to make quotes and to execute trades. Equally important, the other floor brokers will have equivalent technology. They will be making the decisions about when, where, and how to use that technology to compete effectively in a marketplace that includes both floor auctions and execution models like Direct+ and Institutional Express.

There will still be a role for that trusted broker who will provide execution quality to the institution in whatever names the broker thinks are appropriate for his services. You will see specialists doing far less reporting of current market conditions than they are doing today, but much more quoting, committing capital, and taking risks. The whole pace of the market, both at the quote level and at the execution level, will extend to those coming in the front door as well as those coming in the side door.

In a nutshell, we are starting from a very solid platform of success. We can layer on that platform exactly what our customers would like. We can create the hybrid model. That is what the markets expect the New York Stock Exchange to do. We have been very successful in the listed space. We have competed effectively with all types of competitors who have come along, and we will continue to do so. As I said earlier, the Exchange will continue to enhance its trading systems. A more transparent limit order book will be important. The combination of better information about available trading interests and tighter spreads, will all be effective.

I will close by saying that it is not an either/or proposition. It is not electronic or floor. It can be both. Thus far, the fully electronic model has not been the panacea many would say it is. What the New York Stock Exchange has to offer has clearly been shown to have value. It has been a success. I would like to make Bill Donaldson's statement come true – the leadership of our market does indeed depend on realizing the benefits of technology while maintaining the advantages of the floor auction model. We will be working very hard to achieve that.

I would be happy to take questions.

LANNY SCHWARTZ (Philadelphia Stock Exchange) [From the Floor]: I have a question about what you said about ITS. I want to ask about raising the cost for access, in effect, by ITS. Recognizing that nobody knows what will happen with Regulation NMS, one would have thought that the access fee caps in the nondiscrimination provisions would constrain your ability to do that. Even if Regulation NMS does not go into effect as proposed, the spirit of it would give an indication of what the Commission's views are about what you are proposing. Do you have a comment on that?

KINNEY: Frankly, I think that the NMS proposal indicates that they would not care if ITS went away from the proposal. We could move to a place immediately and say, okay, we are going to pull it down. We will get rid of the consortium and everybody will walk away and become members of each other's markets. That would work just fine. Then you will pay whatever cost you have to pay in that market.

That said, there may be, as you think about it, some value to maintaining ITS as a network. As long, that is, as you make it as efficient as you possibly can, which includes eliminating the 30-second wait. But I do not think that it is reasonable to do all of that and then let someone use the system for free. My reading of the access proposal says that you could charge a mil or two mils. That might be a reasonable thought. But there are other ways to accomplish the same end. For instance, the New York Stock Exchange could eliminate it and hook every specialist up to Lava, and scrape everybody's liquidity quickly. What you would lose is the central clearing mechanism that exists today in ITS. This mechanism is probably very cost effective. To the degree that we all want to work on our execution models for people who come in the front door, I am not sure that that would not be a sufficient answer for everybody in the short run. Twelve months from now, there will be better answers.

JAMES ANGEL (Georgetown University) [From the Floor]: One of the contentious issues in Reg NMS is the allocation of the data revenue. What are your thoughts on the formula proposed in Reg NMS, and what kind of formula would you like to have for the allocation of the revenue?

KINNEY: I will give you three answers to that. Number one, our view is that, if the SEC was trying to get at abusive practices by putting out that model, it probably would be much better if they took on those practices like sharing market data revenue and those kinds of things. Two, the formula is complex. I have to confess that we are still working our way through it. Third, a couple years ago, the SEC sponsored a debate with Joel Seligman who was the chair of the SEC Advisory Committee on Market

Information, and they hashed this out.[44] They talked about the best way to handle market data and the revenue streams. We ought to go back to the work that was done there. But we are happy that the SEC wants to take on what we think is the problem – namely, abusive practices like market data rebates. I just wish there was a simpler way to do it.

THOMAS DOYLE (Nutmeg Securities) [From the Floor]: Sometime in the recent past there was a bit of an uproar from the floor constituency about the cost. How is that being managed? What have they to look forward to in a hybrid sort of market future that will make the floor a competitive alternative?

KINNEY: You probably know that we have suspended the technology fee that you are referring to for the brokers and the specialists last year. With John Thain's arrival, we are looking at the full financial model of the Exchange, and I expect that more will come out about it later in the year. But it is clear that we provide a lot of value in the technology.

We were trying to find other revenue streams that would help support both the development and the operation of the technology. It is a valid goal to align value with the customers who are using it. Nevertheless, in the context of a full review of how the Exchange makes its money from the revenue side, and our expenses, with John driving that review, I would reserve judgment about where it is headed.

NINA MEHTA (Traders Magazine) [From the Floor]: You just mentioned, regarding the handling of market data and the revenues streams, that we ought to fall back on the work done there. I am referring to Joe Seligman's report last year. He had those three data consolidation models. Are you referring to one of those, or are you referring to some other aspect of...

KINNEY: Our view is that work has been done on this, that the SEC has made a proposal. And while the model is complex, we applaud them for trying to address the issue. But we would hope that there would be a simpler way. I was not calling out any specific thing or model.

ROBERT SCHWARTZ [From the Floor]: Thank you, Cathy, very much. You have given us all a great deal of information and a lot to think about. This concludes our formal program. Now it is time to invite you, along with all of the rest of us, to our cocktail reception.

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[44] Report Of The Advisory Committee On Market Information: A Blueprint For Responsible Change, September 14, 2001, Http://Www.Sec.Gov/Divisions/Marketreg/Marketinfo/Finalreport.Htm.