32

RECEIVED
MAR 29 2004
OFFICE OF THE SECRETARY

Summary of Testimony of Robert B. Fagenson

before the

Securities and Exchange Commission

concerning

Proposed Regulation NMS

(April 1, 2004)

MAR 26 2004

I am Robert B. Fagenson, Vice Chairman of Van der Moolen Specialists, the fourth largest specialist firm on the New York Stock Exchange. 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, of which my firm is a member and which I have served for over a decade, including as Chairman.

Proposed Regulation NMS, Release No. 34-49325 (February 26, 2004) ("Release"), represents an ambitious effort by the Commission to address a number of structural problems that have confronted the markets, listed and over-the-counter ("OTC") for many years, many of which have grown especially urgent in light of changes in our markets over the last two decades. The most important of these include:

(i) the evolution and increasing importance of alternative trading systems and electronic communications networks;

(ii) the movement from trading and quoting in fractions to pennies and sub-pennies, with the attendant problems of "flickering" quotations and the need to "round" sub-penny quotes and sub-penny trades for display, both of which have confused efforts to obtain "best execution" of customers' orders;

(iii) the invention and proliferation of "access fees" imposed by ATSs and ECNs on those who "take" liquidity from their published bids and offers;

(iv) the invention of payments for the provision of liquidity, often constituting a rebate of market information fees leading to, among other things, "tape shredding" and economically meaningless trades entered into for no reasons other than to garner a piece of the rebate;

(v) the enormous increase in the speed with which trades can be effected by electronic means, contrasting and creating tensions with open-outcry, auction markets and their price discovery mechanism;

(vi) the increasing lack of utility of the existing, now inefficient inter-market linkage system connecting the exchanges and OTC market centers for listed securities;

(vii) the increased incidence of "locked" and "crossed" markets; and

(viii) the push by some, including most ATSs and ECNs, to free themselves from the bonds of basic "best execution" and anti-trade-through principles that secure, in addition to "best price" for buyers and sellers, price protection for the highest bids and lowest offers displayed in our markets at the time they buy and sell.

The Release attempts to provide solutions to virtually all of these problems in an integrated way. While I do not believe that all of the ideas advanced in the Release are good ones, many are – and I applaud the Commission and its staff for this timely and important effort.

My time today, obviously, is limited. Consequently, I will confine my remarks to just one of the initiatives proposed in the Release: revision of the existing regulatory scheme controlling "trade-throughs" of bids or offers displayed in one market by a trade effected in another market at an inferior price. Another way of stating what I will talk about today would be to say that I will address the new Commission policy under consideration concerning inter-market price protection and its effects on the market I know best, the Exchange's auction market, and the markets as a whole.

I will not repeat, and assume a familiarity with, the intricacies of the Commission's proposed new trade-through rule, the exceptions from it proposed in the Release, and the definitions of various new terms used in the Release. For convenience, I will refer to "automated order execution facilities" as they are defined in the Release as "fast" markets.

First and foremost, I want to make clear to the Commission and its staff that, no matter what the Commission ultimately decides to require of a "fast" market under its new trade-through rule, the NYSE will be a "fast" market. The Exchange will undertake whatever modifications of its systems and rules are needed to satisfy those requirements. Let there be no doubt about that.

Having said that, I hope to make clear to you today as best I can in this limited time – and we will be supplying more elaborate and detailed comments on the Release later – what would be risked or lost from today's markets if the Commission proceeds rigidly down the trade-through rule path it has set out in the Release.

What Could Be Lost.

1. Opt-Out Exception from the Trade-Through Rule: A Bad Idea. Most importantly, independent of the effects that becoming a "fast" market will have on the Exchange's price discovery and auction processes, which I will come to shortly, the proposed "opt-out" exemption from trade-through rule would swallow that rule. By so doing, the opt-out exception would destroy any notion of inter-market price protection in our markets.

What this would mean is trading by broker-dealers for their own accounts or trading by broker-dealers for or with large institutional clients without regard to the existence at the time of their trades of better bid or offer prices displayed in the CQS. (Such bids or offers, of course, are often posted by brokers for individual investors who will be by-passed by opt-out trades at an inferior price without receiving an execution.) This would occur notwithstanding that those better prices are accessible on fair terms, as contemplated by the Commission's access proposal in the Release, and that any "fast" market that displays those better prices would have to respond to any effort to take the better offer or sell to the better bid *immediately* – not after some substantial delay, as can be the case today in the environment of the Intermarket Trading System, but *immediately*. How can the Commission even suggest such a step backward from where we are today? I am mystified by the notion that doing so would be good public policy.

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 exception would overthrow both principles.

I want to state as plainly and simply as I can that the opt-out exception, in my judgment, would destroy public confidence in the fairness and integrity of our markets. As a result, in addition to the damage it would do to our trading markets, it should be seen as a grave threat to capital raising.

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 importance of the buyer or seller. The rule at all times should be that the best price gets the trade. The opt-out exception would turn this on its head. Instead, the Commission (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 the better prices at which he is

willing to buy or sell. This is not the message that has made our markets the best and the most trusted in the world.

The opt-out exception is a terrible idea and the Commission should disown it.

2. "Fast" Market Status: Effects on the Auction Process and Price Discovery. Today, the Exchange 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 ITS. Some trades, however, take longer.

Sometimes, this is because adverse news affecting the issuer of a particular stock is released. In such a case, 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.

At other times, the specialist is aware of contra-side interest in a stock that a broker seeks to buy or sell and can, by reaching out to such interest, attract it to the post to effect the trade at a price better than any displayed bid or offer price. Through this process orders presented for execution often receive price improvement, but not instantaneously.

In other cases, efforts are made 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 Exchange 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.

It appears that 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 – might be lost when the Exchange becomes a "fast" market. I believe, as many others do, that the virtues of our existing trading system and the benefits that they confer on market participants generally under the circumstances described above are indisputable. We hope that, as the definition of what constitutes a "fast" market evolves in the Commission's rulemaking, these beneficial features of our auction process will be acknowledged, accommodated and preserved.

* * *

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

DC\ 7004175.3