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Is the Big Board Getting Creaky?

By GRETCHEN MORGENSON

JUST a few months ago, Richard A. Grasso, the chairman of the New York Stock Exchange, was a Wall Street hero. He brokered the peace between securities regulators and big brokerage firms, leading to a settlement in the Wall Street research investigation. He also moved forcefully to improve corporate governance standards among companies whose shares are traded on the Big Board. Quietly, Mr. Grasso became something of a statesman.

That was then. Now, the exchange is investigating its own floor operations for possible anti-investor practices, and Mr. Grasso and his institution are taking a pounding from angry investors who call the Big Board's trading system archaic, inefficient, unfair and arrogant. The statesman is under siege.

On Tuesday, the Big Board disclosed that it was investigating activities by traders in about two dozen stocks and that the traders, known as specialists, might have broken rules by stepping between buyers and sellers, making a slight profit by buying from one and selling to another instead of matching them directly. The stock exchange requires that its traders match customer orders whenever possible, allowing investors who want to buy and sell to meet without an intermediary.

Although it is too early to say what, if any, trading infractions the Big Board's investigation will find, its existence has opened the exchange to criticism from customers, especially the money managers and other institutional investors who send their buy and sell orders to the floor every day. Many customers have grown frustrated by their dealings with the exchange and say that its position as the world's premier marketplace is at risk.

What has happened to put the powerful New York Stock Exchange and its chairman on the defensive? Improvements in systems that trade Nasdaq stocks, investors say, even as the Big Board has pretty much stood still.

"There haven't been a lot of innovations from the New York Stock Exchange," said Peter W. Jenkins, head of North American equity trading at Deutsche Asset Management in New York. "Really nothing has changed. They haven't come up with the tools for the institutions to make their process more efficient. There are still so many steps between us and the specialist's post, that we can't execute

efficiently."

Many investors will complain about the prices they receive on some trades. But the Big Board remains the most prestigious marketplace in the world for investors to trade stocks. Its listing standards are tougher than those of other markets, and its trading costs are lower.

Still, complaints from institutional investors are growing louder, and new trading alternatives are being created by smaller companies every day. As trading volume migrates away from the exchange floor, investors who still choose to trade there face more difficulty buying and selling with ease and at a reasonable cost.

To some degree, the current anger with the exchange is a result of something out of its control. After three years of a down stock market, most institutional investors have lost a lot of money for their clients. During the bull market, when these investors were making buckets of money, questionable executions or rising trading costs were forgiven and ignored. Now, firms are desperate to improve efficiency in their operations, and costly trades or transaction problems pose a bigger problem.

"The game is tougher for everybody, including the specialists," said James Elkins, president of Elkins/McSherry, a company that measures trading costs and efficiency. "What happens when the game gets tougher? Everybody starts to cry; everybody claims foul."

Nevertheless, interviews with a dozen traders and investors indicate that resentment against the Big Board runs deep.

"If we were doing business today the way we were doing it five years ago we'd be out of business," Mr. Grasso said. "If you catalog all the changes we've made in our systems, we are the only model that gives open outcry, highly automated, almost instantaneous execution. We have been enormously flexible and accommodating. Everything is on the table for change except self-annihilation."

As the Big Board is under pressure from customers, newer electronic markets are taking more business from it. Networks that trade Nasdaq stocks are gaining significant ground and getting higher marks from professional investors. The Nasdaq market does not employ specialists and has no centralized floor; it is an electronic system and provides automatic access to big investors.

LFRED ESKANDER is director of marketing at Liquidnet, a new electronic exchange that allows institutional investors to meet without a middleman. He said his firm sponsored a conference last fall and invited 38 head traders from various money management firms.

"We asked them in a survey which market do you feel you get a better execution in," Mr. Eskander said. "Over 85 percent said Nasdaq. If you had asked that question five years ago, it would have been completely the opposite."

Indeed, in the mid-1990's, Nasdaq was a Wild West market that treated investors so unfairly that the Justice Department and the Securities and Exchange Commission investigated its dealers' practices, which led to fines of \$1 billion. Nasdaq was also forced to institute measures designed to reduce trading costs in the market that had been kept artificially high by the dealers and to eliminate other anti-investor tactics.

Although not perfect, networks that trade Nasdaq stocks have now become the favored trading sites for many professionals. They say they prefer Nasdaq's multiple dealers' posting prices on the same stock, versus the one specialist on the New York Stock Exchange.

"I used to detest trading on Nasdaq years ago and always preferred the Big Board," said William Fleckenstein, president of Fleckenstein Capital in Seattle.

But he said he had had so many problems with trades on the Big Board that he had come to believe that the specialist system was flawed. "I don't see how having one guy making a market is better than having 50 guys making a market," he said.

Mr. Jenkins of Deutsche Asset Management agreed. "The liquidity in Nasdaq allows us to execute larger size in the big-name stocks more efficiently and quicker. You hit a button and get things done. With the New York, you have to think of strategies to break up your order. It is complicating rather than simplifying."

To see how hard it is to trade large blocks on the Big Board, consider how its average trade size has declined in recent years. In 2002, its average trade was 666 shares; in 1999, the figure was 1,205. Yet the average size of an institutional order today is 44,660 shares, according to the [Plexus](#) Group, a firm that tracks institutional trading costs.

Forced to squeeze big trades through a small funnel, investors are looking elsewhere for ways to meet those interested in taking the other side of their transactions. One new venue is Liquidnet, which started operations two years ago with 48 institutional clients that executed trades of 159 million shares. But in the first quarter of 2003, Liquidnet counted 144 members and 463.5 million shares traded: small potatoes, compared with the Big Board, but growing fast.

Investors said that executing large trades on the Big Board was becoming harder partly because of decimalization — the trading of stocks in penny increments instead of larger fractions of a dollar. While this shift, which came two years ago by Congressional mandate, has driven down one piece of an investor's trading costs, it has also removed liquidity from the market.

Specialists simply do not make as much money trading stocks in pennies and therefore are less willing to risk their capital to ease the trades of others.

"When spreads were a quarter, specialists were willing to put more money on the line," Mr. Elkins said. Now they make less, so they are less willing to take in large orders from institutional investors. As a result, these investors "have difficulty moving large positions in the market because as soon as they show up to sell, all the bids disappear."

Another unintended consequence of decimalization, according to investors, is the ease with which specialists can now step in between investors to make a profit on trades.

Say a stock is trading at \$20 bid and \$20.05 offered. If an investor is willing to sell stock at \$20 a share and there is a buyer with a market order, a specialist could sell stock to the buyer at \$20.01, giving him a better price than he asked for, but shutting out the seller from the additional penny a share. The specialist would profit, which he would not have done had he allowed the two investors to meet. This practice is called penny-jumping — a practice that is frowned on.

Penny-jumping may explain why specialists are participating more in investors' trades on the Big Board. Even though specialists are supposed to let investors meet whenever possible, they are, in fact, meeting less than they did previously. In 1994, specialists were involved in 8.6 percent of trades; this year, they are participating in 15.1 percent.

R. GRASSO said that increased specialist participation is a result of greater volume on the exchange as well as a desire by specialists to give their customers a single price for their trades rather than multiple prices. With stocks trading in penny increments, this translates into more frequent involvement by specialists. "As markets get faster and there is more demand," he said, "now you have 100 price points for a dollar of movement. There can be gaps in those price points. It's natural for a dealer to step in."

Even though decimalization was intended to reduce investors' costs, many money managers take a dim view of it. In a 2001 survey of money managers by Greenwich Associates, 70 percent had a negative opinion of decimalization.

These managers said they thought decimalization had resulted in less liquidity, less transparency and greater volatility. Overall transaction costs are rising, even though spreads are down, because investors have to break up large trades to get them done and prices often move against them while they are doing so.

The lack of liquidity shows up in rising trading costs, according to data compiled by Elkins/McSherry, even among large, heavily traded stocks. "We have seen a reversal in the trend," Mr. Elkins said. "The biggest names, the most-liquid stocks, are costing more to trade" than the smallest stocks.

Many investors who answered the Greenwich Associates survey also said that they thought penny spreads give specialists more opportunities to front-run trades, or profit by buying or selling ahead of customers whose orders they hold.

Samuel F. Lek is chairman of Lek Securities, a 10-year-old firm that provides its 500 clients with electronic access to all United States stock and option exchanges. He said his clients' biggest complaint involved suspicions of specialists' profiting by jumping in front of their customers' orders.

The exchange said that front-running was not a problem and that anyone caught doing it would be severely punished.

Other complaints come from investors who try to trade Big Board stocks on regional exchanges, like the Philadelphia Stock Exchange.

One trader there said that when he submits a customer bid or offer on a stock to the intermarket trading system that is better than the price then trading on the New York Stock Exchange, it is routinely ignored. "The specialist is still obligated to fill national market system orders with any bids shown on the system, but we are shut out," the trader said. "This problem got to be laughable but there was no recourse whatsoever."

Indeed, investors said that there was an arrogance about the New York Stock Exchange toward its customers, which has done a lot to deepen the unhappiness among many who send their trades there.

Mr. Lek, for example, said that his customers were disturbed by what he called inadequate and imbalanced dispute resolution at the Big Board. When customers have a dispute, they must appeal for a ruling from a floor governor, or a senior member of the exchange. "The governor and the specialist are colleagues," Mr. Lek said. "The judges cannot be the specialist's colleagues. The exchange must have a truly objective on-floor dispute resolution system."

He said that in his experience, about one in 50 disputes is resolved in his customers' favor.

"We have a specific alternative to them talking to governors. There's the institutional hot line, they can talk to the management of the exchange whether it's to Cathy or me directly," Mr. Grasso said, referring to Catherine R. Kinney, the president of the Big Board. "I think we are as responsive an institution as you are going to find in the business."

Most investors or money managers interviewed for this article said that perhaps the biggest problem at the New York Stock Exchange was that its specialists have something close to a monopoly — competition has not forced the Big Board to become more investor-friendly.

HE Nasdaq, by contrast, has improved, investors say.

"The structure of Nasdaq has evolved rapidly because of competition from technology," Mr. Jenkins said. "The proof is there, if you open up and you have technology companies that can compete for the business, you are going to get a better market. There is no competition on the New York, so it's stale."

But Mr. Grasso disagrees. "If you balance speed and best execution, our system is the best of both worlds," he said. "It allows for price discovery at a single point that brings the smallest and the largest together. You combine the technology of open outcry but you don't have the slowness of open outcry, and what you get is a balancing of speed and quality of execution that accrues benefit to the consumer."