January 27, 2005

IN QUEST OF THE BEST

By James Maguire
Managing Director, LaBranche & Co.

It is noteworthy that while the Securities and Exchange Commission appropriately called for trading equity securities in decimals in June 2000, it did not specify the minimum price variation (MPV), wisely leaving that important detail to the industry, **stipulating only that the choice be no greater than 5 cents nor less than 1 cent.** Unfortunately, the NYSE, on behalf of the group, chose 1 cent as the minimum standard, an incredible 84% reduction from the previously existing 6 ¼ cent MPV.

Implementation of this extreme reduction has precipitated an unmitigated disaster for the quality of United States equity markets. Most notably, it is almost impossible for the NYSE pricing mechanism to show transparency consistent with that which it is capable of providing. The main beneficiaries of this failed initiative appear to be professionals who engage in sophisticated program trading strategies that obscure market transparency, not the ninety million public investors represented by over nine hundred mutual fund companies, for whom it was intended. This result is supported by the online NYSE Fact Book which reports an escalation of program trading from the pre-penny environment of 22% in December 2000 to an all-time high of 50.6% of NYSE volume for the year 2004. Two other NYSE Fact Book statistics give hard evidence of the deplorable decline in the efficiency of NYSE pricing in a 1 cent MPV environment. Namely, reductions in block transactions from 51.7% to 31.9 % and of average trade size from 1187 shares to 393 shares over the same period. Virtually every professional agrees that these unintended consequences of a 1 cent MPV must be addressed.

Over the last two years I have lobbied actively for a test marketing initiative that would set up a pilot program for five months across all markets using a 5 cent MPV in five hundred selected NYSE stocks that represent a cross section of all NYSE listings. I feel such an initiative is an imperative obligation to the faithful discharge of our responsibility to the public trust. To this end, I suggest that a concurrent pilot program be conducted in the unlisted market as well. In furtherance of this objective, I have had numerous discussions with regulators, legislators, academicians, and market professionals and find wide support for this proposition. Virtually all to whom I have spoken aver that "nickels would have been the right choice". There is an important distinction between this approach and the "cold turkey" approach of requesting a 5 cent MPV without supporting data. This "soft approach" I recommend is receiving enthusiastic support. In this regard, Andy Brooks of T. Rowe Price recently stated, "One of the concerns we have is the excessive amount of intraday volatility. A pilot program of 5 cent MPV across all markets would be a worthwhile experiment. It is possible it might reduce transaction costs and improve liquidity for all investors". Be mindful that my proposal is only for a test at virtually no expense to anyone.

While there is no doubt that the NYSE will maintain its preeminent role in pricing equity securities, it will simply be "the best of the worst". We can do better! To this end, the NYSE is on schedule to implement its Hybrid Market plan in the second half of this year. This proposal is well conceived and a giant step in the right direction. As currently structured, however, algorithmic trading and reluctance to show limit orders, both of which are unintended consequences of a 1 cent MPV, may inhibit attainment of its objectives. However, in a 5 cent MPV environment, implementation of this initiative takes on significant importance. It is not only a panacea for the problems that beset us but a platform for proving the efficiency of our twin strengths--best price and meaningful transparency. I believe that with a 5 cent MPV where liquidity naturally manifests itself at 5 cent increments in high volume stocks, the NYSE would provide a preeminent world-class market featuring cost efficiency, speed and simplicity of execution. Investors would have the choice of automatic execution at the published bid and offer or the opportunity for auction price improvement - precisely what the buy side (public investors) wants and deserves.

In recent months I have received expressions of heightened concern regarding the growing European threat to American preeminence in pricing equity securities. When considering our ability to meet this threat effectively, one must focus on the negative impact of the three statistical measures noted above. These measures are compelling evidence of significant erosion in the efficiency of our equity markets since the advent of a 1 cent MPV. Alternatively, the openness of the Hybrid Market on a 5 cent MPV platform assures that United States equity markets will be the best that they can be and successfully meet any foreseeable challenge.

It is instructive to include in this commentary an excerpt from an article in the November 2003 issue of Traders Magazine by Professor William G. Christie of Vanderbilt University. Professor Christie, together with his colleague, Professor Paul Schultz, is renowned for his scholarly paper that provided the fundamental research upon which the Securities and Exchange Commission promulgated the limit order handling rules:

> "Suppose the SEC were to advocate a tick size of $0.05. Who wins and who loses? Let's begin with the winners. Empirical evidence accumulated over the years and across markets suggests that price priority will regain its appropriate role, limit order investors will reveal greater size, and institutions/mutual funds will be able to execute larger trades at lower costs. Who loses? Opportunistic traders who add little liquidity to the markets and the smallest of retail investors who trade in the most active issues. The question then boils down to the balance between the two. My research with Jeffrey Harris (University of Delaware) and Eugene Kandel (Hebrew University) strongly suggests that the marginal benefits of moving to a $0.05 tick size clearly outweigh the marginal costs".

As NYSE Chief Executive Officer John Thain stated, in a recent op-ed commentary concerning Regulation NMS, "We all need to take the time to focus and unite around a public policy that is best for our markets and for investors". In this vein, I submit that logic, common sense and the courage to pursue a course of action that may reduce costs for ninety million investors is the epitome of professional excellence and worthy of our focus and unity.

We have it within our grasp to be the best of the best!

The opinions expressed herein are mine and do not necessarily represent those of LaBranche & Co. LLC or any other entity or individual.

I am the beneficial owner of 50,000 shares of LaBranche & Co. Inc. common stock. One Exchange Plaza, NY, NY. 212-425-1144