

1 I have a question that arises at this point.

2 The use of the term "best execution" in
3 conjunction with the practice of payment for order flow and
4 the use of the adjective "best" raises a question just on a
5 simple arithmetic basis.

6 It appears that the implicit assumption is that
7 the inside bid and offer is taken as the definition of
8 "best," that that is the best market. But if that really is
9 the best market that is available, then as somebody paying
10 up for order flow, I cannot make money by paying for the
11 order flow and then having to transact at that, because then
12 I am a penny away from the best.

13 So, in other words, on average and over time, I
14 have to do a penny better than the best, which means that
15 the best is no longer the best, and my guess is if I am in
16 business to make money -- and I hope these guys are; there
17 is no other reason to do it -- the best, such as it is, has
18 got to be at least a penny better than the inside bid and
19 ask, otherwise you are not going to generate the revenue
20 within your firm as a firm that is paying up for order flow
21 in order to cover the expense of trading in the market, plus
22 paying the penny for the share.

23 MR. KETCHUM: Perhaps that goes to the more
24 general question of profitability of this business.

25 With respect to Madoff and Herzog, you have been

1 involved in paying for order flow for some time. What has
2 the impact of payments for order flow on your profitability
3 and your market share?

4 MR. GEDULD: In reference to your first question
5 about what is best execution, the best execution on small
6 orders would be the inside market.

7 So clearly, on these private systems, where the
8 firms are guaranteed best execution, i.e., the inside
9 market, and these are primarily small orders. The firm,
10 such as my own, then makes a determination. For the purpose
11 of capturing large scale order flow, in other words, from a
12 market makers point of view, we need order flow to make
13 money. It is volume when you are working for literally
14 pennies, and you make a determination: Is it worth one or
15 two cents a share to capture "X" percent of the market out
16 there and then determine the profit on that, and of course
17 the profit is minute.

18 COMMISSIONER GRUNDFEST: But if the inside bid is
19 42-1/4, you cannot do all your business at 42-1/4 and pay
20 for the privilege of doing that. You have got to get a
21 better price from being able to accumulate your volume.

22 MR. GEDULD: The mere nature of the
23 over-the-counter marketplace is you do make your money
24 between the spread. You do not buy at 45-1/4 and sell at
25 45-1/4. Hopefully, you buy at 45-1/4 and sell at 45-3/8,

1 generating an eighth, theoretically, which is very rare
2 these days.

3 Let us assume you generated an eighth, if you
4 were paying someone 2 cents a share, that would leave you a
5 profit of 10-1/2 cents.

6 COMMISSIONER GRUNDFEST: Mr. Madoff does not do
7 his business over-the-counter.

8 MR. MADOFF: I do not do my business
9 over-the-counter, but the nature of the trade is identical
10 to an over-the-counter trade, so there really is no
11 difference.

12 I think it is important to state, number one,
13 which I guess most of you are already aware of, that we are
14 in business to make a profit. To the best of my knowledge,
15 no one is going to admit that is wrong.

16 COMMISSIONER GRUNDFEST: We are the only people
17 in the room who were.

18 MR. MADOFF: I think there are some similarities
19 to the soft dollar area between hard dollars and soft
20 dollars, and there are also some areas that are totally
21 dissimilar.

22 One of the things you have to understand that
23 when an over-the-counter market maker, whether he is buying
24 over-the-counter securities or whether it be us buying
25 listed securities, is not guaranteed a profit after he makes

1 that purchase or that sell.

2 Unlike soft dollar order flow where the -- or
3 even if you want to take block firm that make a discount bid
4 or make a bid, let's say, higher than they normally would
5 make because they know they are going to lose money on this
6 fray or assume they are going to lose money on the trade,
7 knowing, or with the full understanding, that they will be
8 getting commission dollars back, which are riskless dollars,
9 to compensate them for the risk they take, we are not in
10 that position.

11 We have no guarantee that when we make this bid -
12 - I mean, we guarantee a 3,000-share execution on the inside
13 quote. That appears -- and it is done in our firm by a
14 totally neutral pricing mechanism, a standard employee's
15 mechanism. By the time my trader receives the order or the
16 execution, it is the same time that a Charles Schwab or
17 Quick and Reilly or Fidelity, or whatever, is getting that
18 order. He then has to react to that purchase or sale, and
19 he is at a risk at that time.

20 There is no commission business that is coming
21 back to us. Whether someone is receiving payment because he
22 is making a block bid and then turning around and getting
23 commission business back, whether it is for research or
24 whatever, all of those things are the same.

25 I agree, there is almost no difference between

1 hard and soft dollars.

2 COMMISSIONER GRUNDFEST: I think the thing to
3 point out also is that it is not necessarily the case, that
4 any of this harms the small investor or the customers of the
5 firms that are getting paid for the order flow, because if
6 the brokerage firms then say, look, we are getting paid a
7 penny a share for directing order flow to one of these
8 firms, it is possible that they reduce their commissions by
9 penny a share or a fraction of a penny a share.

10 So it does not necessarily follow that the fact
11 of this payment for order flow is anything that harms
12 investors. It does raise some questions
13 about when and how you use adjective like "best."

14 MR. MADOFF: I agree with you.

15 As far as whether or not this business is passed,
16 these savings or this rebate is passed on to the customer, I
17 certainly am of that opinion -- and that would best be
18 addressed by the other people around this table -- but I
19 would say that as far as whether or not the best execution
20 is concerned, we are all satisfied that in fact this is the
21 best execution.

22 As to getting into a theoretical debate as to
23 whether you can get in between the spread or not, I do not
24 know. In our particular situation, 75 percent of the
25 securities that we make markets in have an eighth of a point

1 inside market, which means there is no improvement, unless
2 you went to smaller decimal pricing.

3 COMMISSIONER GRUNDFEST: I would like to ask
4 permission from my Division Director to expand the
5 discussions in that direction.

6 Is it possible that some of the markets for large
7 securities are sufficiently liquidated that an eighth is too
8 gross a minimum tick?

9 MR. MADOFF: I do not know.

10 I can tell you that if you speak to the
11 individual firms involved, they will tell you that an eighth
12 of a point is a -- first of all, you are assuming that every
13 time you buy stock that you are going to make an eighth. I
14 think that is an incorrect assumption.

15 Quite frankly, even if you made an eighth every
16 time you bought stock, you would probably have a losing
17 operation. I do not think that most firms with the expenses
18 of running automated systems today and the guarantees that
19 are required could profitably operate with an eighth of a
20 point spread.

21 MR. KETCHUM: Mr. Geduld?

22 MR. GEDULD: The subject of spreads sometimes is
23 somewhat misleading.

24 I happen to have called in my office this morning
25 and asked them to do little run down of the past six months

1 of what, in fact, our gross profit is per share of all the
2 stocks we make in market, et cetera, et cetera. I am almost
3 embarrassed to tell you that it is under 3 cents a share,
4 that is with stocks that trade in eighths and quarters and
5 halves and points, 2-point spreads, et cetera.

6 So when you come right down to whether the market
7 making firms really make on average -- I can substantiate
8 this to you -- it was considerably under 3 cents a share for
9 the past six months.

10 I am not sure whether they were much different a
11 year ago; maybe it would have been 3-1/2 cents.

12 MR. KETCHUM: Is this all a pitch to see whether
13 we will pay for your transportation?

14 Since Commissioner Grundfest had raised the
15 question, I think is probably a good time to shift to that.

16 There is one representative from one firm here,
17 Anson Beard from Morgan Stanley, and that firm has
18 suggested, as I understand it, to a number of
19 representatives from the market, that they believe the
20 question of eight-point pricing per quotations and
21 transaction reporting should be reviewed, and that the
22 Exchange market should consider moving to decimal pricing, I
23 guess as well as perhaps the over-the-counter market.

24 Is that a view of Morgan Stanley's and in part is
25 that viewed as a response both payment for order flow and

1 soft dollar practices?

2 MR. BEARD: I think I alluded to that earlier,
3 Mr. Ketchum.

4 We had everybody's attention when we suggested
5 decimalization as the New York Stock Exchange, maybe the
6 only store in America that traded in eighths as opposed to
7 in pennies.

8 I think that the over-the-counter market has
9 adjusted and spreads are -- it was alluded earlier by Mr.
10 Geduld -- I think spreads are closer to a stake in that
11 market more frequently than an eighth.

12 The commission rates being what they are, they
13 are many transactions inside, particularly quarter spreads
14 on the New York Stock Exchange, and that is why we have
15 called for a close examination of Rule 10(b)(10) that would
16 allow firms to print confirmations to large investors like
17 institutions on a net price basis that would be negotiated
18 with those sophisticated traders in the context of the
19 market at that particular time.

20 MR. KETCHUM: You did mention that 10(b)(10)
21 revisions before and -- I guess I would like to follow up
22 this for a second, for my understanding.

23 Why is a net print, or a net price provided on
24 commission viewed as somehow important to the way you
25 operate your business, whether or not you provide a price

1 and separately indicate what markup or commission equivalent
2 you have charged.

3 I guess I am not clear as to what the
4 relationship between that is and the manner in which you
5 trade.

6 MR. BEARD: Our reason for posturing this is
7 clearly to get back to the discussion of the first panel in
8 that the commission is a very measurable instrument, and if
9 you had transactions that were reported on a net basis in
10 the context of the market, that you would eliminate that
11 measure, then you would go a long way toward better defining
12 this elusive term that we have all used this morning called
13 "best execution."

14 COMMISSIONER GRUNDFEST: If the smallest unit of
15 measurement is an eighth in a very liquid market, you can
16 hide a lot of stuff as you get close to an eighth, so you
17 round off to the nearest eighth and you can make a nice
18 living.

19 If I could take just a very brief poll, is there
20 anybody at the table who thinks that moving to decimal
21 pricing would be a bad idea? If so, why?

22 MR. DAPUZZO: Yes. It was stated somewhat by
23 Buzzy Geduld a few moments ago.

24 The fact that we are trading in eighths above a
25 certain price level in the over-the-counter market, and we

1 have these automated systems, our average P&O, also on a
2 per-share basis, is somewhat close to what Buzzy Geduld's
3 is. Simply stated, that if we reduce this spread on
4 higher priced stocks with all this automation through the
5 SOE's, through our own internal system, through other
6 systems in which we participate with the discounting firms,
7 what would happen to that spread? It would bring us down to
8 similar things that are happening in London, and we have
9 seen what has happened, because the industry in London which
10 has gone to the principle type of markets, and with the
11 spreads there being one or two or three "P", and we have had
12 no firm over there showing any signs of health since the big
13 bang.

14 MR. KETCHUM: Mr. Manning?

15 MR. MANNING: Yet, in a very real sense I think
16 that is exactly what we have done with the whole payment for
17 order flow phenomenon, because the way in which perhaps it
18 differs from the traditional soft dollars market is that it
19 comes out of the spread, and you are talking about trading
20 on a net basis and out of that spread paying for the order
21 flow, and that is different from soft dollaring part of the
22 commission on an agency transaction and, in fact, represents
23 exactly what Peter is concerned about, which is in a sense a
24 real narrowing of the spreads, whatever shows on the NASDAQ
25 machine.

1 MR. KETCHUM: That, I guess, gets to the question
2 on, obviously, is there an implication of payment for order
3 flow to provide market share to the wholesale dealers?

4 What has been the impact of payment for order
5 flow to other firms, if you believe there are any
6 deleterious effects to that?

7 Either Mr. Manning, DaPuzzo, or Beard?

8 MR. DAPUZZO: Payment for order flow in different
9 forms goes back many years. When I broke into the business
10 in the late '50s, early '60s, Loeb Rhodes had corresponding
11 relationships with many regional firms who did not have a
12 New York Office.

13 We executed our orders in New York via a teletype
14 and charged them a fee. Later on, the SEC said that this
15 was perhaps called interpositioning because we did it in a
16 simple way of just taking a fraction off of the price. That
17 obviously was changed and different corresponding
18 relationships occurred.

19 That was more where a New York broker wanted to
20 have a presence in a regional city and did not want to have
21 the physical expense of an individual working for him or an
22 office. So by working with a correspondent, he would pay
23 that correspondent so much a share for bringing in business
24 for surrounding firms. That was how, I think, the origin of
25 this took place.

1 the order -- it is a changing complexion.

2 MR. KETCHUM: Mr. Devin, your firm is a firm that
3 I guess was notable in recent months for indicating a
4 concern over payment for order flow practices, and I
5 believe, and not partaking in the processes.

6 I understand Fidelity has reviewed that process
7 and now does receive payment for order flow to some degree.

8 Could you possibly provide an indication of your
9 review of that subject and your present views of the impact
10 payment for order flow?

11 MR. DEVIN: I think that statement you are
12 referring to was part or the end or the tail end of a speech
13 I gave in 1985.

14 At that time we had clearly made a decision that
15 we were not going to accept payment for order flow. I must
16 say that had the crash not occurred, we may be still in that
17 mode.

18 But in about the second
19 quarter of 1988, in searching for revenues and clearly not
20 getting any clear cut direction from the regulatory bodies
21 as to whether payment for order flow was good or evil, we
22 decided in the interest of getting some revenue why not get
23 this while it is still available and clearly having left
24 millions of dollars on the table prior to that, we decided
25 to accept payment for order flow.

I might add this point that the firms that we do

1 business with and do get payment for order flow are clearly
2 the -- from the automation point of view -- in our opinion,
3 the best wholesalers in the business.

4 I might also add that if payment for order flow
5 was not around, we probably would still be doing the vast
6 majority of our retail business with those firms.

7 The public's view of best execution is not just
8 in price but also in speed of execution. The public, when
9 calling into a branch, would like to get that report as
10 quickly as possible.

11 The firms that we are dealing with and receiving
12 payment from are not only sending us the payment, but also
13 sending us that execution in around five seconds. We are
14 clearly able to hold a customer on the phone and give him
15 that report, and it makes him very happy, the fact that he
16 has gotten that report.

17 So the ironic twist is that if it were to go
18 away, we would be still be doing business.

19 MR. KETCHUM: I think the question of exchange
20 listed business is as perhaps at least discrete with regard
21 to payment for order flow and Mr. Madoff touched that
22 briefly in connection with describing his business.

23 By at least recent statistics, 35 percent of New
24 York Stock Exchange executions occur between the quoted
25 spread in stocks with a quarter point or greater spread.

1 Approximately 64.5 percent of stocks have on average a
2 quarter point or greater spread.

3 Are there different issues involved in payment
4 for order flow for exchange listed securities, and I wonder
5 if first we could start by hearing from Mr. Falk,
6 representing, I assume, his firm as well as his position as
7 the chairman of the UTAC committee of the New York Stock
8 Exchange.

9 MR. FALK: I think you have hit the nail on the
10 head from the standpoint of the listed securities that if,
11 in fact, you send order flow, a 50 percent order out of --
12 because of some sort of prearrangement, do you, in fact,
13 preclude the client, the ultimate customer from getting a
14 better price than just what is quoted on the screen?

15 As you indicated, a lot of securities do trade,
16 at least on the New York Stock Exchange, in a fairly wide
17 spread.

18 MR. KETCHUM: Mr. Weithers, would you like to add
19 anything to that with respect to the regional exchange?

20 MR. WEITHERS: I do not think it is just a
21 regional exchange perspective. I think that one of the
22 things that will affect any of the market makers will be the
23 accuracy of the quotations of all their competitors, and I
24 think that is something that still can be improved on.

25 When 35 percent of the transactions take place

1 between the bid and the ask, it may mean that those orders
2 just arrived, or it may mean that the quotations have not
3 been displayed as readily as present technology would allow
4 for it.

5 I do not think that this issue of soft dollars or
6 hard dollars is just an over-the-counter or just an exchange
7 issue. I think it relates to the basic philosophy of our
8 markets as public marketplaces, that we want to make
9 efficient in a way that the customer will understand and
10 will appreciate.

11 I go back to the question about the decimal
12 trading. I do not think anybody was talking disparagingly
13 about the need to make profits or the fact that profits in
14 the over-the-counter market or in the third market or in the
15 exchange markets are a bad thing.

16 But if we do have public markets in which we want
17 the public to participate through agents, then I think we
18 have to come down on the side of vigorous agency
19 participation and things that would support that. I think
20 one of the things that would support would be that we had
21 accurate quotations in every given stock in every given
22 circumstance.

23 I think it is quite clear that if you have an
24 A-spread stock on which you are willing to give back 1 cent
25 or 2 cents, the accurate quotation means that it is an 11

1 cent or 11-1/2 cent, or 10-1/2 cent market.

2 I do not think that speaks to the need to require
3 that all trades should be at decimals or at reduced prices,
4 but each individual stock circumstances might be more
5 accurately quoted, more accurately executed, more readily
6 understood, and the agency principles of the brokers who are
7 now in the position to receive this rebate of practice might
8 be eliminated to the extent that they could more vigorously
9 be on the side of agency.

10 MR. KETCHUM: Mr. Weithers, to some degree
11 analogous to the situation of a major integrated firm, your
12 specialists receive a substantial amount of order flow
13 through their automatic execution system, MAX.

14 Do you have concerns over the impact of decimal
15 pricing for handling those type of guaranteed systems, the
16 impact on profitability to specialists?

17 MR. WEITHERS: I think there will be
18 unquestionably some immediate impact in some stocks on the
19 dealers who participate, and I would hope that would be
20 offset as some of the people on the earlier panel alluded
21 to. In the longer run, the better practices will probably
22 generate liquidity from other sources that will more than
23 offset that.

24 MR. KETCHUM: Mr. Geduld?

25 MR. GEDULD: By over-the-counter market's very

1 nature, we are a negotiated market, we are not an auction
2 market. Therefore, if the market is 16-1/8 or -1/4, and I
3 choose to pay up a penny or up 2 cents for what I consider
4 to be a value order or a valued order flow, once you tell me
5 I have to supply that quote to the world in its entirety, I
6 think you are taking something away from the negotiated
7 market. You just turned me into an auction market.

8 MR. KETCHUM: Mr. Madoff?

9 MR. MADOFF: You know, I have not seen anybody
10 ask the agency firms to have a uniform commission schedule.
11 I thought we went away from that years ago.

12 I mean, if someone is going to say to the
13 wholesale dealer that we have to pay the same to everyone,
14 which is basically what you are saying by going to a decimal
15 pricing mechanism and leaving off quote up there, it would
16 seem to me that agency firms are allowed to charge various
17 commissions to various parties, based upon the value they
18 think the order has.

19 I think that to try and compare an agency market
20 to a dealer market, number one, is incorrect and it is
21 difficult, and I think that both marketplaces are the same
22 during certain circumstances, but they clearly have
23 advantages and they have disadvantages.

24 Now, we are operating the dealer market,
25 offspread is our profitability. Somebody is going to give

1 me a riskless order, that is one thing. So to try and mix
2 the agency side with the dealer side I think is -- I just do
3 not think that makes any sense.

4 Every time I receive an order or Herzog receives
5 an order, there is risk involved with order, or if Morgan
6 makes a block bid, there is risk involved in that.

7 On an agency's transaction, there is not. It is
8 just a matter of how much money I am going to make.

9 We made a decision years ago to not pay for
10 over-the-counter order flow, because we felt that the
11 spreads would not, in the liquidity involved, would not
12 justify, not just by us paying for that business. Because
13 of that, we lost a substantial amount of our
14 over-the-counter order flow.

15 That was a decision we made as a firm; we felt we
16 had the right to make that decision. We feel anybody is
17 free to make that decision, and we aimed our business
18 towards listed, because we had -- there were various other
19 things, like hedging capability and liquidity and so on and
20 so forth.

21 The Commission, it seems to me, as is the
22 investing public, is requiring more liquidity. After the
23 October crash -- as a past member of the Board of Governors
24 of the NASD and as chairman of a number of the their
25 committees -- I can tell you that we are asking our market

1 makers to supply more liquidity. We are asking them to risk
2 more capital.

3 There is sort of a contradiction of terms here.
4 You cannot go to a market maker like ourselves and say, we
5 want you to be there all the time, good markets and bad
6 markets, guarantee an execution, have mandatory SOEs, for us
7 to stand there and guarantee a 3,000 share execution to our
8 clients, when maybe a regional exchange is going to
9 guarantee 100 or 200, or maybe 2,000 or 10,000.

10 But if you are asking us to supply that liquidity
11 on an involuntary basis, which is really what is being
12 thrust upon us, both by the Commission and the NASD and by
13 our own clients, then you cannot tell us that we have to
14 limit our price to such a degree that there is no
15 profitability, because you cannot legislate liquidity, which
16 is what is trying to be done here, I think.

17 MR. KETCHUM: If I could just follow up on that
18 for a second.

19 I am not clear that I heard from the suggestions
20 of Mr. Weithers or Mr. Beard or anyone else that there would
21 be -- tell anyone what their price should be. I thought the
22 question was if indeed the spreads are not representative of
23 the actual best price that can be provided since payments
24 can be made back to the firm, why not allow those spreads to
25 be quoted in decimals to more accurately reflect that best

1 price, having at least one benefit of passing the difference
2 directly back to customers as opposed to indirectly back
3 through payments to the firms representing that customer?

4 MR. MADOFF: I will address that.

5 When we put a spread in, when we put our market
6 into a quotation system, that market is visible to the
7 immediate
8 world, and we have to trade on that market.

9 As you are well aware, when we designed our SOE
10 system, it was very clear to us that there are some
11 professional traders that will take advantage of a totally
12 automated environment, at the disadvantage of the investing
13 public at large. We had to go back and alter our system to
14 preclude professional market makers from interacting in an
15 automated system.

16 The dealer market is very different than the
17 auction market. When an order comes down to the floor of
18 the Exchange, the specialist has the ability to negotiate
19 that order, regardless of how automated any exchange will
20 tell me it is -- as someone who deals in that exchange on a
21 regular basis, I can tell you that orders that come through
22 automated systems to the floor of exchanges, or certain
23 exchanges, certainly the primary exchange being the New York
24 -- that specialist has the right to reject that order or
25 take that order. He can always have some reason, whether it

1 be a bid in the crowd, of working order, whatever, that he
2 will not make his market good. That is not to suggest that
3 there is anything wrong with that. He has a lot of valid
4 reasons for doing that.

5 In the over-the-counter environment that is not
6 the case. When we trade in an automated system, once we put
7 our market in, that order is interacted without any dealer
8 interaction on the systems.

9 Now, for us to turn around and now have a decimal
10 pricing system that would show that bid to everyone, that
11 would put market makers at a major disadvantage, which the
12 exchanges do not have.

13 It seems to me that is what is being asked when
14 you are talked about decimal pricing.

15 MR. KETCHUM: Why could you not just simply make
16 that decimal price 12.5 cents and have precisely the same
17 spread, if that is what you feel is necessary in order --

18 MR. MADOFF: To who?

19 MR. KETCHUM: As your proper price.

20 MR. MADOFF: The wholesalers make that price,
21 that payment, not to all firms. It is made to certain
22 firms.

23 MR. KETCHUM: I was assuming, Bernie, that your
24 quote was an eighth spread wide.

25 Why does decimal pricing require you to reduce

1 your spread?

2 MR. MADOFF: From what I understand you are
3 saying is that, rather than pay Charles Schwab 20-1/8, or
4 \$20 for a transaction, I would now raise my bid to 20.01 in
5 his case, so that he gets 20.01 net rather than \$20, and I
6 pay him back a cent. Is that correct?

7 MR. WEITHERS: I do not know why you just do not
8 quote it as 20.02?

9 MR. MADOFF: I am trying to tell you why, because
10 that --

11 MR. WEITHERS: Well, if you are going to give him
12 one cent back later anyway, why would you not give it both
13 to him up front and he could put on the customer
14 confirmation.

15 COMMISSIONER GRUNDFEST: Bernie, 20.01 is fine.

16 MR. MADOFF: It makes no difference to me whether
17 I give him a net price, quite frankly, of 20.01 or 20, and
18 give him a penny back. I have no concern about that.

19 The difference is that I have the right to choose
20 whether or not that 20.01 bid is going directly to him or
21 whether or not that is going to the immediate world.

22 In the same way that other firms decide what
23 commission rates to charge their clients, based upon the
24 value of that order, I as a dealer have the right to decide
25 that I will pay 20.01, whether you call it in a net price,

1 or whether you call it 20, less a 1 cent rebate, to a
2 Charles Schwab, because that order flow is order flow which
3 is valuable to me. Order flow that may come from
4 a competing specialist on an exchange or from a block firm
5 may not be valuable to me. There is a major difference
6 there.

7 CHAIRMAN RUDER: What you just say though, is
8 that you are just providing different quotes?

9 MR. MADOFF: I am providing different quotes to
10 different parties. This is no different to me than a
11 commission firm providing different agency business to
12 different parties.

13 COMMISSIONER GRUNDFEST: I do not think that Mr.
14 Madoff and I are at least disagreeing very much. I think we
15 are saying probably the same thing in two very different
16 ways perhaps, because one of the ways to look it at very
17 simply as he said early on, I agree with you entirely, that
18 nobody should be in the business of telling people exactly
19 what prices to charge.

20 Yet, when the minimum take is an eighth, you are
21 in the business of telling people exactly what price to
22 charge, because if you want to charge a market -- if you
23 want to a run a market at a spread tighter than an eighth,
24 you cannot do it.

25 MR. KETCHUM: Well, put another way, if a

1 competitor of yours chose instead of paying for a particular
2 firm's order flow at the whole plus a penny, if that
3 competitor chose to put out a quote at 20 plus a penny, why
4 is that an inappropriate thing to have in the markets?

5 MR. MADOFF: My own view, I do not think it is
6 inappropriate, if that is what they want to do.

7 In other words, if, in fact, a market maker wants
8 to change his bid to trying to attract order flow at that
9 price, he has the right to do that, whether you do it in
10 decimals or not. That is something that is up to the market
11 place to make that decision and that is not something for
12 us.

13 I think that most market makers would meet
14 whatever the systems or whatever the traffic will bear.

15 MR. KETCHUM: Mr. Hardiman?

16 MR. HARDIMAN: One adjunct to what Commissioner
17 Grundfest said, I think you can quote in less than eighths
18 in our marketplace, if you so choose.

19 I think it is a systems limitations more than it
20 is a regulatory or a regulation or requirement. There is no
21 reason why people could not quote sixteenths if they wanted
22 to.

23 MR. MADOFF: And do regularly.

24 MR. HARDIMAN: Or thirty-seconds, or
25 sixty-fourths.

1 MR. MADOFF: The question is, but I think that
2 people have to understand, because I think it gets a little
3 bit fuzzy here, is that there is a difference between our
4 marketplace or where you have somebody that can access your
5 market automatically without you negotiating that, and I can
6 tell you the over-the-counter market today, certainly the
7 environment that we all deal with, is not the negotiation
8 let's say, that goes on on the floor. We put our bid there,
9 and that bid is going to be taken out by any firm that we
10 guarantee that trade for. There is no discussion about it.

11 On the floor, when I send an order down, whether
12 it be me sending an order or everybody else sending an order
13 down, there is some discussion. The specialist can turn
14 around.

15 Quite frankly, I have been a proponent for many,
16 many years in front of this body and the NASD to require
17 exchange markets to show the real markets, to show the bids,
18 to display the bids that are in the crowd in the quote.

19 If you want to tighten up my marketplace for me,
20 all you have to do is put all the books that are around
21 there on the book -- put the orders, I mean, on the book.
22 Then my mechanism has to trigger off of that.

23 It is the same thing in the over-the-counter
24 market, with a limited order book and so on, our mechanism
25 that we trade through is triggered off of that quote.

1 Now, we cannot -- I cannot know what better
2 bidder offer might or might not exist in a floor
3 environment. That is not up to me.

4 MR. KETCHUM: To follow up on that question that
5 Mr. Madoff really raises, I think it is useful to perhaps
6 raise a question to the retail firms.

7 Clearly there are trades between the spreads and
8 clearly not always do quotations in an exchange environment
9 reflect all interest. Yet, you have chosen, whether they be
10 for payment for order flow deals or otherwise to route, I
11 gather, a large percentage of your order flow for a
12 guaranteed quotation execution. You are certainly not in a
13 minority in that choice.

14 I think it is fair to say that there are a very
15 large number of firms that whether because of payment for
16 order flow reasons or because of arrangements with various
17 regional exchanges that provide similar quote based
18 executions, do precisely the same thing.

19 Why? What are the benefits you see?

20 Is it speed and assurance of price overriding the
21 potential getting a better price?

22 What is the thinking behind that decision?

23 MR. STUPSKI: There is an ongoing effort to
24 manage and monitor this, and we send a substantial part of
25 our listed order flow to the floor of the New York Stock

1 Exchange as well as to regionals and to Mr. Madoff's firm.

2 The total commission to our customers is
3 comprised of our cost in doing business.

4 Speed is very important to a retail customer.
5 Certainty of price is very important. The perception of a
6 large group of retail customers is that the delay would
7 indicate some problem in the execution. Our total automated
8 -- the nature of automation, our total costs in doing
9 business, the quality of the back office and clearing all
10 enter into the total cost of that.

11 We at our firm continue to monitor this and can
12 route, as someone else here on the panel this morning said,
13 different size orders to different market makers and
14 different markets, different sides of orders, different
15 securities, so we continually engage in that effort.

16 The question here that we sent to NASD indicated
17 that we do business with a lot more than seven market
18 makers, certainly.

19 MR. KETCHUM: How do you decide what business
20 goes to the New York Stock Exchange and what business you
21 will contract to pay, to receive payments for order flow?

22 MR. STUPSKI: Well, the payment for order flow,
23 Mr. Ketchum, in the listed arena, is not that prevalent. It
24 is in the minority of transactions. It is much more
25 prevalent in the over-the-counter market. So there is

1 really a difference there.

2 But New York Stock Exchange, sometimes larger
3 trades, certain securities, we feel we get better service
4 out of the specialists that we do with regional specialists.
5 It is done on the basis of trying to achieve the best
6 overall result for the customer as well as ourselves.

7 MR. KETCHUM: Mr. Quick and Mr. Devin?

8 MR. QUICK: To follow up on that, I would say
9 that it is -- we talk to a specialist from the various
10 regional stock exchanges, and those we feel that are doing a
11 good job, we will place the business out there. With us, it
12 is a cost factor, too, though.

13 You know, taking order flow off the New York
14 Stock Exchange and putting it on the Midwest Stock Exchange,
15 or some of the other exchanges, has helped us to eliminate
16 floor brokerage costs on the New York Stock Exchange.

17 MR. DEVIN: Of our listed business, a very small
18 percentage -- we receive remuneration from a very small
19 percentage of that business.

20 We also spread our order flow throughout the
21 various exchanges, and quite frankly, I think Les is right
22 when he says that the costs are more competitive on some of
23 the other exchanges.

24 Also, speed is a very important factor in all
25 executions, not just listed, but also unlisted.

1 Evidence -- someone in the public sector calling
2 a local branch in California to enter an order to one of our
3 branches, he has a price in mind; even though he wants to
4 sell the stock at the market, he has a price in mind.

5 If we were to go through a manual system to get
6 that order executed, most likely there would be movement in
7 that stock prior to his execution, and assuming it was a
8 market order, chances are he would not get the price.

9 Now, maybe he would get a better price or maybe
10 he would get a worse price. It raises all kinds of
11 questions by that customer when the price is moving against
12 him. If we can ensure him a quick turnaround, namely an
13 on-the-phone execution, which I think all of us strive for,
14 we have served part of his definition of "best execution."

15 So that speed does make up a very important -- is
16 a very important factor in the overall scheme in things.

17 MR. KETCHUM: Mr. Weithers, your Exchange, and I
18 think your specialists as the case would -- the number of
19 regional exchanges have engaged in some activities of note
20 lately that have at least been attributed as being one of
21 the reasons that you have been successful in tracking
22 additional market share, and that is included, among other
23 things, providing reduction or credits in trade for order
24 flow to firms that provide you significant amount of order
25 flow.

1 Do you view those credits for fees and the like
2 as any different than payment for order flow, or should they
3 be looked at in any way different?

4 MR. WEITHERS: I do, and it seems to me that the
5 -- when we do our pricing, we relate it to our costs, we
6 relate it to what we have in terms of the operating costs,
7 the machine costs, the systems cost, developments cost.

8 We do have a fixed-cost operation, as everybody
9 else in the industry knows. We are still prepared to handle
10 a much larger, larger volume on a very volatile day, and we
11 hope that it is only on the upside, but we must have a very
12 large fixed-cost operation. When you price relative to the
13 fixed cost, you do understand that you can grant certain
14 kinds of discounts for volume.

15 On the other hand, I want to make the distinction
16 based on the subject we are talking about, if we went to a
17 decimal system or we went to some system that precluded
18 rebates, our pricing would not change, because it is related
19 to our costs.

20 MR. KETCHUM: Mr. Geduld?

21 MR. GEDULD: If we can go back to decimals for a
22 second, as I demonstrated earlier, and I think any market
23 making firm in the country would be easily demonstrated what
24 that profitability is per share, and that is with eighths,
25 quarters, halves, et cetera.

1 I am just curious, when we continue to come back
2 to the issue of decimals, if the Commission would
3 understand, obviously you do, that the closer we get these
4 spreads, the less profitability there will be.

5 If we are down to three cents or below that a
6 share today in the industry, what will that ultimately do to
7 liquidity, if for instance a firm like mine or any other
8 firm that is committing serious capital on a daily basis
9 finds out that their average is a penny or a penny and a
10 half a share, then the determination of how much capital is
11 going to be risked, of course, comes into play.

12 MR. KETCHUM: Just to follow up that for a second
13 without trying to belabor the point, why is it anymore
14 likely that the result of decimals will not move the price
15 for a number of securities from an eight point to 15 cents,
16 as it will be to drop it down to three or four cents?

17 MR. GEDULD: Not the way it works.

18 MR. KETCHUM: Our time is running fairly short.
19 There are two questions I wanted to raise, I think because
20 they do raise some structural issues or issues relating to
21 this. The first is to the retail firms.

22 How do you disclose that you are receiving
23 payments for order flows to your customers?

24 Is that strictly from the confirmation and if so,
25 what level of detail do you provide customers regarding your

1 practices?

2 MR. QUICK: We all have the same language on the
3 back of the confirms. In the four or five years that we
4 have gotten payment for order flow, we had one request about
5 two months from a customer in Baltimore to explain it.

6 MR. KETCHUM: Has that been a similar experience
7 for Schwab and Fidelity?

8 MR. DEVIN: Yes.

9 MR. STUPSKI: We identify it on the back of the
10 confirmation which has the interpretation and that is
11 examined in NASD's examination.

12 MR. KETCHUM: As I recall, those identifications
13 provide a general indication that you may receive payments
14 for order flow and may direct business as a response to
15 that.

16 MR. STUPSKI: That is correct. There is a
17 general 2-cent statement on the back of the confirmation, a
18 list of about eight or nine disclosures.

19 I think most of the firms are moving from
20 language that formerly said, "may or may not," to "may."
21 The next iteration will be "will."

22 MR. KETCHUM: Seems like "will" would be fairly
23 accurate.

24 CHAIRMAN RUDER: There seems to be no movement
25 towards providing the customer with the benefits of this

1 rebate in any direct way. Is that right?

2 MR. STUPSKI: That is correct, Chairman Ruder.

3 The customer, as Mr. Ketchum said, benefits in an
4 indirect way, because it is part of our total cost. But to
5 date, there has not been any movement to directly transmit
6 the money to the consumer.

7 MR. KETCHUM: Mr. DaPuzzo?

8 MR. DAPUZZO: I have seen a direct benefit to the
9 firms that are receiving the payment that they are on the
10 automated systems, because the automated systems carry a
11 larger quantity execution than it does on the SOE system,
12 for instance at the present time, so that their customers
13 are offered either 2-, 3-, 5,000 shares in some cases. In
14 fact, as I am one of the payors, I have offered 5,000-share
15 executions on a large number of stocks through the system.
16 So I think that their clients do benefit from that size
17 execution.

18 MR. KETCHUM: Mr. Beard?

19 MR. BEARD: I would like to add one thing.

20 All the conversation, probably appropriately so,
21 has been relegated to the over-the-counter market for
22 equities, both paying for order flow and perhaps creating
23 third-party payments for other services for that order flow.

24 I think it is my firm's view that substantially
25 more dollars are involved, and is certainly more rapidly

1 growing in the fixed-income principal business, and while
2 most of your questions have been addressed to the retail
3 public -- and I am sorry Mr. Lerner is no longer here -- but
4 our concern is very much to the ultimate plan sponsor and
5 the owner of that equity capital.

6 It is argued that there is no where near the
7 level of disclosure on the confirm or understanding by plan
8 sponsors about what is going on in the soft dollar business
9 or order direction in fixed-income instruments. We would
10 like very much to have that subject on the record.

11 MR. KETCHUM: What type of disclosure do you feel
12 would be appropriate? What level of detail?

13 MR. BEARD: In the full domain, if somebody is
14 either being paid back for a fixed-income order flow, or if
15 dollars are being created to pay for other services, it
16 seems to us that that disclosure should be made to the owner
17 of the capital, as opposed to some fiction that he received
18 best execution because a lot of people were called and all
19 primary dealers would not necessarily make appropriate
20 markets because they did not want to allow someone to
21 interposition themselves between the primary market and the
22 end customer, so that they were not getting best price.
23 That should be part of the disclosure mechanism.

24 MR. FALK: What should it not be the same as the
25 closing commission, part of the affirmation to a client?

1 MR. KETCHUM: What would the view be from the
2 discount brokerage firm to the brokerage firms as to
3 explicitly disclosing whether you received and how much of a
4 payment you received for a particular order?

5 MR. STUPSKI: I suppose we could comply with if
6 that were the rule. Our feeling is that it would probably
7 create an environment of more confusion for the retail
8 customer and would be isolating one circumstance, because we
9 are a non-integrating retailing firm. We receive payment
10 from a wholesaler.

11 The integrated firms may have the payment cross
12 over the barrier, but that may be well within the house. So
13 it starts to -- we would start to feel disadvantaged versus
14 that, and I think that we would probably feel disadvantaged
15 vis-a-vis the soft dollar payments.

16 But if that were the ruling, we could certainly
17 comply and do it.

18 MR. KETCHUM: Mr. Madoff?

19 MR. MADOFF: I just want to bring one point up.
20 Payment for order flow is not only made by wholesalers to
21 people like Charles Schwab, Quick and Reilly, or the like.
22 I pay the NASD, as does every other wholesaler, for all the
23 order flow that they deliver to me through the SOE system.

24 I pay the Cincinnati Stock Exchange order flow
25 for the order that they deliver to me, and as far as I know,

1 the specialists are paying for order flow to the exchanges
2 in one from or another for order flow that they get through
3 this exclusive franchise.

4 So the payment of order flow from market makers
5 or specialists is nothing new. The only thing that has
6 changed is the over-the-counter market does it. For the
7 first time, those hard dollars are right out in the open.
8 They are very visible.

9 We are certain that the money that the wholesaler
10 is paying is going directly to the brokerage firm itself,
11 not to an order clerk on a desk, not to a registered rep,
12 not through dinners or anything else. It is very trackable,
13 the NASD can audit that, and it seems to me that that is a
14 major advantage and a step forward to the way business is
15 done today as the way it was done over the earlier stages
16 the 30 years that I have been in this business.

17 I have a hard time understanding how anybody
18 could find anything wrong with this style of payment for
19 order flow.

20 CHAIRMAN RUDER: That certainly takes us back to
21 Commissioner Grundfest's first question about why we are not
22 paying for anything in hard dollars instead of soft dollars,
23 does it not, Joe?

24 COMMISSIONER GRUNDFEST: Yes.

25 MR. HARDIMAN: Even the SEC.

1 MR. KETCHUM: Our soft dollar budget has not been
2 significant --

3 MR. HARDIMAN: I am talking about the hard
4 dollars that you will soon have to be paying to the SEC that
5 you do not pay now.

6 MR. KETCHUM: Shifting quickly from that subject
7 -- raised only by Congress and the Commission.

8 One last question, as I see that our time has
9 gone by, that is, there are, particularly in the
10 over-the-counter market, a number of ways in which order
11 flow is captured with respect to the retail firms. They
12 have retail networks and that order flow generally is routed
13 to their trading desk where it is internalized on the whole.

14 With respect now to the wholesale dealers, the
15 practice of payment for order flow and determination to
16 routing that order flow from other non-integrated firms is
17 becoming more prevalent. Not only that, the size of
18 guaranteed quote-based executions, both in Exchange listed
19 securities and over-the-counter securities is increasing as
20 was noted by Mr. DaPuzzo.

21 As we move forward and more and more order flow
22 for various purposes is, use the word "locked up" because of
23 payments, because of relationships, or retail networks or
24 the like, what will be the underlying incentives to
25 quote-type markets, and will there be conflicting incentives

1 to widen spreads because so much of the order flow, whether
2 for payment reasons or otherwise, is receiving a guaranteed
3 quote-based execution?

4 Mr. DaPuzzo?

5 MR. DAPUZZO: Well, indirectly, one of the things
6 that we have been fighting for in various places, meaning
7 Shearson Lehman Hutton, is to keep the preference on SOEs,
8 which gives us the ability therefore to prefer to do
9 business with certain firms with our small orders. If that
10 were taken away and it became random, the value of that
11 order would become less valuable, and I might have to join
12 someone's system to direct it somewhere.

13 If we decided to ask the firms who are receiving
14 this compensation to make it a bold statement on the front,
15 where we would draw the line to firms such as ours who
16 directs business to Paine Webber or Merrill Lynch in hopes
17 of getting reciprocal business back, in which case we direct
18 "X" number of stocks to one and "X" number to another -- a
19 flexible number, granted -- but the specific types of
20 stocks, in the hopes of getting business back.

21 I have to put that down somewhere that this order
22 went to Paine Webber in hopes of getting something back, you
23 know, we would really have ourselves -- a very difficult
24 definition to put on that.

25 I think that the spreads will continue to be as

1 narrow as they are and perhaps even more so if we continue
2 to have the competition that we do have out in the industry.
3 I think that basically we have shown that over the years
4 that the spreads have come to a level which has been
5 basically the maximum level we can get down to, and it is
6 one which is keeping the industry somewhat healthy in the
7 trading area, but certainly not overly prosperous.

8 MR. KETCHUM: Mr. Watson?

9 MR. WATSON: The payment for order flow, the hard
10 dollar payment for order flow, in my opinion, is a form of
11 price competition. Consequently, it can be good for the
12 industry rather than bad.

13 The press and other people have made out a number
14 of times that it is a rebate and the customer is not getting
15 best execution, and various other things, but in actuality,
16 I think we are looking at a system that is above board.

17 The payment for order flow, whether it be soft
18 dollar or hard dollar or paid for execution systems or
19 reduction in various other services is certainly easier to
20 understand when it is in cents-per-share than it is in
21 rebates in other ways.

22 MR. KETCHUM: Well, I think because of the
23 interest in the question and the complexity of the question,
24 we have gone past our time.

25 I would just like to personally thank everyone

1 who participated in the second part of the roundtable.

2 Again, I thought the conversation was very
3 helpful.

4 We hope that we will continue to have the benefit
5 of your input and we thank everyone in the audience as well
6 for tolerating some fairly tight spaces and for remaining so
7 attentive throughout it.

8 I would like to repeat the invitation I think you
9 have received from all participants in the panel to join us
10 for lunch if your schedule permits it, and we will move
11 right over to that.

12 Thank you, again.

13 (Whereupon, at 1:07 p.m., the hearing was
14 concluded.)

15

16

17

18

19

20

21

22

23

24

25

REPORTER'S CERTIFICATE

1

2

3

DOCKET NUMBER:

4

CASE TITLE: Roundtable on Commission Dollar and
Payment for Order Flow Practices

5

HEARING DATE: July 24, 1989

6

LOCATION: Washington D.C.

7

8

9

10

11

12

13

14

15

16

17

18

19

20

21

22

23

24

25

I hereby certify that the proceedings and evidence are contained fully and accurately on the tapes and notes reported by me at the hearing in the above case before the United States Securities and Exchange Commission.

Date: 7/24/89


Official Reporter

HERITAGE REPORTING CORPORATION
1220 L Street, N.W.
Washington, D.C. 20005