SPECIALIST MAN
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Well-deserved attention has been focused on the $140 million compensation package received by Richard Grasso, the recently departed chairman of the New York Stock Exchange. Undoubtedly there will now be significant changes at the NYSE Board. But the real question is why that Board, with representatives from the most sophisticated firms on Wall Street, agreed to pay its chairman such a rich compensation package. There is only one conclusion: He was worth the money.

While the NYSE bills itself as "a private company with a public purpose," there is no doubt that its chairman's most important role is to protect the interests of its members. And no interest is more important than the protection of the trading profits derived by the NYSE's floor-based specialists. Thanks in large part to Mr. Grasso's efforts, the NYSE has, until recently, enjoyed a remarkable level of prestige, providing the cover necessary to protect its inherently unfair and inefficient trading system.

Every security traded on the NYSE is assigned exclusively to a specialist firm. The specialist ultimately sees every order in its assigned stocks submitted to the exchange either electronically or through brokers on the floor. But while the NYSE grants specialists a privileged position in order to maintain a "fair and orderly market" (which, curiously, is nowhere defined), the specialist is also permitted to simultaneously trade for his own account — an obvious conflict of interest.

NYSE rules attempt to limit the specialist's ability to improperly use inside information by limiting specialists to trading only when there is a temporary disparity between supply and demand, buying when there are no other buyers and selling when there are no other sellers. Yet if specialists really traded only when there is an absence of buyers or sellers, one would think they would lose money.

The fact is that specialists are profitable, in Samuel Johnson's words, "beyond the dreams of avarice." A forthcoming study by Precision Economics will reveal that publicly traded firms with specialist units last year enjoyed pre-tax profit margins ranging from 35% to 60%. Labranche, the largest NYSE specialist, generated more than a quarter of a billion dollars in revenues, almost entirely from trading for its own account on the floor. Pretty profitable for trading only when nobody else wants to!

Since trading is a zero-sum game, these profits come at the direct expense of investors such as large institutions, which desperately want competitive alternatives to the NYSE but are reluctant to publicly complain about the fundamental unfairness of the NYSE model. After all, institutions have to do business with the NYSE because there are no real competitive alternatives.

The NYSE has perpetuated myths that mislead regulators and the investing public into believing that specialists serve the public. For instance, the NYSE asserts that investors need specialists because without them, "who is going to be there to buy or sell when nobody else wants to?" The NYSE claims that the specialist reduces market volatility by acting as the buyer or seller of last resort.

Think about that: Envision SpecialistMan, emerging amongst the bedlam of a fast falling stock with a giant "S" on his chest. Quickly calming the crowd, he exclaims "I will buy from every one of you because it is my duty, even though I will lose money." They sell their shares to SpecialistMan, praising him for his willingness to selflessly provide liquidity, regardless of the impact on his profits.

While this notion is ridiculous on its face, it is still put forward to defend the NYSE specialist when nearly every other major instrument is traded completely electronically without anyone being given an informational advantage. The truth is that when a stock like Enron starts falling, just like everyone else, SpecialistMan gets out of the way.

We ought to ask ourselves why we even want a specialist to manage the decline of a stock. In an efficient market, that is the last thing we should want. The market should be permitted to clear — move to its equilibrium point — as quickly as possible, without somebody trying to manage the process. A slowly declining stock only hurts buyers at the expense of sellers, and vice versa.

We need not worry about the specialist abusing his privileged position, we are assured, because the NYSE's cardinal principle is that the investor's interest is always served first. But it's easy to get around this tenet. Even though there is no imbalance between supply and demand, the specialist simply trumps the price of investor orders. If a specialist is holding investor orders to buy IBM for $10.00, he cannot buy at $10 until all investor orders at $10.00 are executed. But he can buy at $10.01. With his informational advantage over everybody else concerning the likely direction of a stock's price, the specialist will outbid investors only at the most advantageous moments.

Ironically, the specialist is rewarded for this exclusive opportunity. The NYSE calls this "price improvement" because the investor trading with the specialist receives a better price. The NYSE actually brags about the frequency of price improvement, which really represents how often the specialist uses his informational advantage (what most of us would otherwise call insider information) to make a trading profit and disadvantage investors.

These points should not be a revelation. Why would NYSE members pay approximately $2 million for the privilege of standing on an old, crowded floor all day unless they gained some sort of advantage? Membership has its privileges. But does the public benefit from a structure that grants privileges to a select few even though, thanks to technology, we now have more efficient ways to trade securities?

SEC rules ban floor brokers from trading for their own accounts. Specialists, however, are exempted from this prohibition because they are assumed to be performing a public service, an assumption belied by the facts. So let's be clear. While the NYSE Board structure needs to be fixed, and fixed promptly, we investors ought to focus most of our attention on the profit center of the NYSE, its specialist system.

1 COMMENT

COMMENTS

dlmrgnk - Jul 01, 2006

Even the NYSE has no clothes? What could the next problem be? (I feel as tho I'm in a Cathedral of the Immaculate Investment!!!)