In The News

Senate Banking Committee Studies Centralization Of All Stock Quotes While NYSE And NASDAQ Talk Merger

Will our 19th century trading systems make the leap into the 21st century? A meeting of the Senate Banking Committee in New York earlier this month offers insight into how close we are to providing investors with the best price available and in putting firm price and time priority on orders both within the exchanges, between exchanges, and with electronic communications networks. Sounds pretty simple, doesn't it? But it's not. At risk is the survival of the specialists, traders and market makers on the exchanges and perhaps even the exchanges themselves.

Electronic communications networks have become faster, cheaper and better trade execution than the proven but outdated methods used by the exchanges to facilitate the sale and purchase of securities. Across the world, stock exchanges are moving to totally electronic trading, yet here in the U.S., the foremost capital market and the center for free enterprise around the world, there is actually an ongoing high level discussion among legislators, regulators and members of the exchanges on whether the investor's best interests should be put first.

To the investor, there is no question that faster, cheaper, better trade execution can be obtained through electronic communications networks (ECNs), resulting in the best price available. Thus, the best price available on the NYSE is rarely the best price available. But, it is the best price available on the NYSE. Clearly, no investor is well served by slower, more expensive, inefficient trade execution that has been outdated by innovation and technological advances. SEC chairman Arthur Levitt has called on the exchanges to "become more aware of the economic realities and interests of the investor. If not, there is a real chance that within a short period of time, the exchanges will lose substantial marketshare and never regain it." Levitt would like to see a more centralized system where all the exchanges and ECNs are linked together into one system under one regulatory body which would see the NYSE acquire the NASDAQ. From a public policy standpoint, Levitt is intent on serving the public's best interests, which are not necessarily the best interests of the market makers, specialists and traders who own the seats on the NYSE that control the exchange's destiny.

The central premise of the stock exchanges, which is the basis of the public's trust, is that all orders will be executed as quickly and as fairly as possible, and the exchanges will assure both the buyers and the sellers the best price available. With the advent of electronic trading and ECNs, buy-

continued on page 24

Fidelity's On-Line Investors Help Lehman Brothers Become A Major IPO Underwriter

Fidelity has found a strategic partnership that works brilliantly and raises the specter of merger talk. After an unsuccessful alliance with Salomon Brothers in 1997 which gave Salomon Brothers access to Fidelity brokerage services' 15 million retail investors, Fidelity has had spectacular success with Lehman Brothers. Lehman credits the Fidelity strategic alliance with its huge underwriting gains, and Fidelity credits access to Lehman Brothers' IPO business as a huge draw in winning on-line trading clients with $500,000 or more in investable assets. The alliance has been of extraordinary benefit to both firms.

The alliance formed in June of 1999 provides Fidelity's investors with access to Lehman Brothers highly regarded stock research and access to a portion of Lehman Brothers' initial public offering and secondary stock and bond underwriting business offered through it syndicate desk. What has since happened was a pleasant surprise to all. Lehman Brothers has gone from underwriting no IPOs in the fourth quarter of 1998 to handling more IPOs than all but three firms in the fourth quarter of 1999. Lehman was lead underwriter on 13 deals on four continents totaling $1.56 billion in the fourth quarter 1999, which contributed to 306% increase in the firm's earnings for the quarter. What was the difference between the fourth quarter 1998 and the fourth quarter 1999? It was the three million clients of Fidelity's 15 million clients who invested on-line. This was a huge factor in Lehman winning the brutally competitive, global, egocentric investment banking competition for the lucrative lead underwriting position of many significant offerings. Seventy percent of last year's underwritings were with technology and internet companies whose biggest boosters were on-line traders. Fidelity's on-line traders have attracted Net-type investment banking clients to Lehman like a magnet. Fidelity's on-line traders were not only more attuned to technology and internet company offerings, but their enthusiasm often drove the price of these offerings up. Interest by Fidelity's on-line investors was so great in Lehman's underwritings that on many occasions the interest from Fidelity exceeded the total stock offered in the underwriting.

Such high demand by Fidelity's on-line investors is a very persuasive selling point

continued on page 26

Ph 804-795-1642 ■ Fax 804-795-7703

overwhelming and falls short in most cases. It is impossible to be all things to all people at all times. As technology designed to match managers with customers is more widely utilized, the real problem will emerge as the dynamic nature of the manager being selected through the search. Key employee and management personnel turnover ensures that even the best-fit matches will be subject to change, notwithstanding that what you see or hear from a manager is not always what you ultimately receive. All managers are human . . . and most active managers are artists rendering unique images based upon newly emerging market trends. Often they are similar to the last, but the myriad of dynamics unfolding during certain market conditions make conjecture of consistency unreliable at best.

New Control for Consultants, Managers and Clients

As a 20-year market veteran and current technology entrepreneur, I foresee the above list as only the tip of the iceberg relative to the ultimate benefits technology will provide to the money management industry. For instance, in addition to the in-place processes discussed in this article, new applications currently in production include "The Virtual Portfolio Builder" and "The Virtual Analyst." Both projects have been undertaken as a result of customer request for assistance in the initial stock selection process. We estimate testing of these products to be completed by year's end and available to the general market by March of 2001. Meanwhile, we continue to explore the endless possibilities of ideas designed to further our industry in terms of overall growth and profitability through technology.

Conclusion

In closing, keep in mind that as these and other new technologies are brought to market, both managers and end-user clients will enjoy unprecedented control over how their money is being managed. This enhanced ability to monitor current assets will naturally include the capability to better judge relative performance, and as relative performance is more easily ascertained, the tolerance for under-performance will dwindle at an exceedingly rapid pace. The "what-have-you-done-for-me-lately" battle cry will ring loudly and continually as never before. And those who cannot produce satisfactory answers to this question will find their customers aligning themselves with consultants who can. ■

Senate Banking Committee Studies Centralization Of All Stock Quotes While NYSE And NASDAQ Talk Merger

Continued from page 2

and-sell orders can be electronically matched and crossed off the exchange floors, and the buyers and sellers can split the spread of the 1/8 of a point or more (12.5¢ per share or more) between them, thus getting a better price. In fact, assuming a 6¢ per share retail commission, the investor almost gets the trade for free. The cost of the crossed trade is just 1¢ a share, and if the shares are actively traded, the trade is almost immediate in real time. This is, in fact, faster, better and cheaper than the trading floor of the exchanges.

It is with this background that Levitt has been pushing for a resolution which led to Senate Banking Committee hearings in New York last month. The SEC laid out its plan for restructuring the market. The plan proposed a range of six solutions. At the conservative end of the solution spectrum, the SEC could simply require greater disclosure of trade execution and order routing by market centers and brokers. This would require market orders to be exposed to price competition in other markets to assure customers get the best price available. At the aggressive end of the spectrum, all markets would be centralized into one system under one regulatory body.

The specialists, market makers and traders of the NYSE do not like the prospect of matching ECN pricing. Rather than the market maker keeping the spread between the bid-and-asked price as their compensation, ECNs split the spread with the buyer and seller, giving them a better price but eliminating the job of the market maker, specialist and floor trader. The challenge the regulators and legislators face is the exchange's specialists, market makers and traders own the majority seats on the NYSE which governs the exchange, and they are not about to put themselves out of business. Of the six solutions posed by the SEC, at the aggressive end of the scale is the centralization idea. Charles Schwab and the major brokerage firms were opposed to centralization on the basis of it being anti-competitive as it would impede, if not eliminate, the prospect of innovation. Senator Phil Gramm, chairman of the Senate Banking Committee, said, "Total centralization would stifle competition, precluding small or start-up firms from markets that should be freely accessible. The tenor of the meeting centered on not limiting competition. Schwab's general counsel, Hardy Callcott, made a particularly well-reasoned plea for the SEC to make real-time stock quotes free to the public. Exchange fees of $1.8 billion exceed the SEC budget by more than five times, and like genome research, real-time price quotes should be in the public domain.

> THE CHALLENGE THE REGULATORS AND LEGISLATORS FACE IS THE EXCHANGE'S SPECIALISTS, MARKET MAKERS AND TRADERS OWN THE MAJORITY SEATS ON THE NYSE WHICH GOVERNS THE EXCHANGE, AND THEY'RE NOT ABOUT TO PUT THEMSELVES OUT OF BUSINESS

Arthur Levitt expressed fears that markets are being fragmented by orders being directed to other exchanges and

ECNs. Without the linking of these market centers, buy and sell orders could be distorted, or worse, manipulated. The major brokerage firms supported a middle ground of linked markets but not a centralized market that would include ECNs determining the best price available. Phil Purcell, chairman and CEO of Morgan Stanley Dean Witter, stopped short of advocating a centralized or unified market but supported linking all trading venues to guard against market fragmentation which would take liquidity away. Purcell believed everyone should have open access to the markets but felt the "competition should be between orders, not handlers," thus putting Morgan Stanley slightly more in the camp of the NYSE than the investor, as the handlers ultimately determine price and thus, best execution. David Komansky, chairman and CEO of Merrill Lynch opposed a centralized or collective market in preference to a series of linked markets. To get on the market, firms would have to qualify as brokers/dealers do today. He felt linking of markets was imperative in order to avoid market fragmentation and to strengthen all markets in case of a downturn. Henry Paulson, chairman of Goldman Sachs, said most orders should be displayed for everyone but made the case that large institutional orders should not be displayed because they could move a stock's price. Paulson also called for "catch up" regulation with the innovation and technological breakthroughs that have occurred that are fast redefining the industry.

The NYSE was not an enthusiastic supporter of a centralized or linked markets, which would preserve the role of its market makers, specialists and traders. Chairman and CEO, Richard Grasso, was concerned that institutions might be exempt from displaying big block orders and felt institutions would not send their orders to a centralized monolith. Yet, to the contrary, Fidelity and other leading institutions are either creating ECNs or taking their order flow permanently off the exchange floor to ECNs for better, fast, cheaper execution. Grasso would like to keep the traditional trade execution system of the NYSE while offering electronic trade execution for those who want it. But without linking and matching the best prices among the exchanges or the ECNs, the NYSE would not be in compliance with its public obligation of providing the best price available. Thus, Levitt's mandate for a public policy would require best-price available within, among and outside the exchanges.

Frank Zarb, chairman and CEO of NASD, urged caution as the regulators and legislators started to get down to the "nitty gritty." Zarb said, "The genius behind stock market innovation is not a centrally prescribed single market but free competition." Zarb's comments captured the consensus of the major brokerage firms and left the NYSE as the only participant in the hearings which was not supportive of linking the exchanges and market centers to ensure the best price available.

Arthur Levitt of the SEC has proposed a solution where the NYSE would become a publicly traded company, thus making its allegiance to the public and its shareholders, not its 1,366 members who own the governing seats on the exchange. The NYSE would then buy NASDAQ, creating one regulatory body that would be spun off separately from the consolidated exchanges. The new regulatory organization would govern the exchanges and ECNs. Though the consolidation of NYSE and NASDAQ would be very close to a central or collective market, if it had links to ECNs and an agreement on "best price available," we could be very close to the compromise position most firms would prefer.

Shortly after the Senate Banking Committee hearing concluded, the NASDAQ board had a conference call with the NYSE to discuss a possible merger. At the urging of Arthur Levitt, these talks are continuing. Independently, NASD is moving forward to make the NASDAQ a for-profit organization through a two-step private placement that would raise $1 billion. The proposal is under review by the SEC and the 5,500 members of the NASD. The NYSE continues to pursue its plans of going public. With both the NYSE and NASDAQ pursuing courses of action that would segregate their regulatory and exchange businesses, Arthur Levitt's vision of a faster, better, cheaper market governed by one regulatory body is not only possible, but totally consistent with the actions of all the participants. Maybe we should pay more attention to what is being done than what is being said because once the NYSE goes public and the NASDAQ becomes a for-profit enterprise, their regulatory arms have to go somewhere, and Arthur Levitt has a great idea of how they might be reconfigured. ■

Citigroup's John Reed Retires, Sandy Weill To Unify Two Disparate Cultures Into A New Business Paradigm

Continued from page 3

hensive advice that will manage a mind-boggling array of financial information (risk, return, income and estate tax efficiency, liquidity, cost structure) in terms specifically meaningful to each investor in helping them achieve their long-term goals and objectives. The delivery platform is no longer a brokerage, insurance or banking delivery platform, it is an on-line, virtual real-time balance sheet and income statement incorporating all the client's assets and liabilities. Products are immaterial as it is process or what one does with the products that adds value. Organizational structures built around products or distribution channels are outdated and largely obsolete.

The new business paradigm will be built around customized investment processes that facilitate the highest level of professional investment counsel to be consistently and routinely offered to each of the eight major market segments (high net worth, foundation and endowment, defined contribution, defined benefit, profit sharing, public funds, Taft Hartley and family office) of the institutional and high net worth markets. The banking, insurance and brokerage platforms disappear at the client and financial consultant level. The core account relationship for everyone will entail a savings account, checking account, credit card, term life insurance and home mortgage – all tied to a virtual real-time balance sheet and income statement with electronic bill payment and credit lines. The core account relationship for all clients can be

Ph 804-795-1642 ■ Fax 804-795-7703