I have a question that arises at this point.

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

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

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

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

With respect to Madoff and Herzog, you have been involved in paying for order flow for some time. What has the impact of payments for order flow on your profitability and your market share?

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

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

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

MR. GEDULD: The mere nature of the over-the-counter marketplace is you do make your money between the spread. You do not buy at 45-1/4 and sell at 45-1/4. Hopefully, you buy at 45-1/4 and sell at 45-3/8, generating an eighth, theoretically, which is very rare these days.

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

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

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

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

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

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

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

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

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

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

I agree, there is almost no difference between hard and soft dollars.

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

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

MR. MADOFF: I agree with you.

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

As to getting into a theoretical debate as to whether you can get in between the spread or not, I do not know. In our particular situation, 75 percent of the securities that we make markets in have an eighth of a point inside market, which means there is no improvement, unless you went to smaller decimal pricing.

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

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

MR. MADOFF: I do not know.

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

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

MR. KETCHUM: Mr. Geduld?

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

I happen to have called in my office this morning and asked them to do little run down of the past six months of what, in fact, our gross profit is per share of all the stocks we make in market, et cetera, et cetera. I am almost embarrassed to tell you that it is under 3 cents a share, that is with stocks that trade in eighths and quarters and halves and points, 2-point spreads, et cetera.

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

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

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

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

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

Is that a view of Morgan Stanley's and in part is that viewed as a response both payment for order flow and soft dollar practices?

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

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

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

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

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

Why is a net print, or a net price provided on commission viewed as somehow important to the way you operate your business, whether or not you provide a price and separately indicate what markup or commission equivalent you have charged.

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

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

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

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

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

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

MR. KETCHUM: Mr. Manning?

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

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

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

Either Mr. Manning, DaPuzzo, or Beard?

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

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

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

The fact that certain brokers have begun to sell their order flow directly to the wholesalers or to firms such as my own is a recent development of four or five years ago. That, I think, is almost a different subject, but it is obviously right in there, and there is one where the disclosure was decided to be put on the back of confirmation, or with other things that are on the back of the confirmation. The fact that we as market makers choose to pay for order flow is simply that to be an effective market maker, you have to have market share. Without market share you obviously cannot be an effective market maker. So it is part of our total arrangement.

On of the things that has changed though, incidentally, is that it used to be that the firm who was paying for order flow to a correspondent was getting an exclusive arrangement, in which case you were getting something called quality of order flow, so you had a consistency, you could get the buys and the sells in the same stock.

Whereas now, as Mr. Hardiman mentioned before, certain firms have arrangements with as many as seven brokers. So therefore, you get a sporadic order flow, and sporadic order flow, basically, sometimes a negative selection and the quality is going down. So I do see it being an increased expense unless quality and receiving of the order -- it is a changing complexion.

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

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

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

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

At that time we had clearly made a decision that we were not going to accept payment for order flow. I must say that had the crash not occurred, we may be still in that mode. But in about the second quarter of 1988, in searching for revenues and clearly not getting any clear cut direction from the regulatory bodies as to whether payment for order flow was good or evil, we decided in the interest of getting some revenue why not get this while it is still available and clearly having left millions of dollars on the table prior to that, we decided to accept payment for order flow.

I might add this point that the firms that we do business with and do get payment for order flow are clearly the -- from the automation point of view -- in our opinion, the best wholesalers in the business.

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

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

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

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

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

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

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

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

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

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

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

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

When 35 percent of the transactions take place between the bid and the ask, it may mean that those orders just arrived, or it may mean that the quotations have not been displayed as readily as present technology would allow for it.

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

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

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

I think it is quite clear that if you have an A-spread stock on which you are willing to give back 1 cent or 2 cents, the accurate quotation means that it is an 11 cent or 11-1/2 cent, or 10-1/2 cent market.

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

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

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

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

MR. KETCHUM: Mr. Geduld?

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

MR. KETCHUM: Mr. Madoff?

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

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

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

Now, we are operating the dealer market, offspread is our profitability. Somebody is going to give me a riskless order, that is one thing. So to try and mix the agency side with the dealer side I think is -- I just do not think that makes any sense.

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

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

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

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

The Commission, it seems to me, as is the investing public, is requiring more liquidity. After the October crash -- as a past member of the Board of Governors of the NASD and as chairman of a number of the their committees -- I can tell you that we are asking our market makers to supply more liquidity. We are asking them to risk more capital.

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

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

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

I am not clear that I heard from the suggestions of Mr. Weithers or Mr. Beard or anyone else that there would be -- tell anyone what their price should be. I thought the question was if indeed the spreads are not representative of the actual best price that can be provided since payments can be made back to the firm, why not allow those spreads to be quoted in decimals to more accurately reflect that best price, having at least one benefit of passing the difference directly back to customers as opposed to indirectly back through payments to the firms representing that customer?

MR. MADOFF: I will address that.

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

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

The dealer market is very different than the auction market. When an order comes down to the floor of the Exchange, the specialist has the ability to negotiate that order, regardless of how automated any exchange will tell me it is -- as someone who deals in that exchange on a regular basis, I can tell you that orders that come through automated systems to the floor of exchanges, or certain exchanges, certainly the primary exchange being the New York -- that specialist has the right to reject that order or take that order. He can always have some reason, whether it be a bid in the crowd, of working order, whatever, that he will not make his market good. That is not to suggest that there is anything wrong with that. He has a lot of valid reasons for doing that.

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

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

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

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

MR. MADOFF: To who?

MR. KETCHUM: As your proper price.

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

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

Why does decimal pricing require you to reduce your spread?

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

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

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

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

COMMISSIONER GRUNDFEST: Bernie, 20.01 is fine.

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

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

In the same way that other firms decide what commission rates to charge their clients, based upon the value of that order, I as a dealer have the right to decide that I will pay 20.01, whether you call it in a net price, or whether you call it 20, less a 1 cent rebate, to a Charles Schwab, because that order flow is order flow which is valuable to me. Order flow that may come from a competing specialist on an exchange or from a block firm may not be valuable to me. There is a major difference there.

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

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

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

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

MR. KETCHUM: Well, put another way, if a competitor of yours chose instead of paying for a particular firm's order flow at the whole plus a penny, if that competitor chose to put out a quote at 20 plus a penny, why is that an inappropriate thing to have in the markets?

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

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

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

MR. KETCHUM: Mr. Hardiman?

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

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

MR. MADOFF: And do regularly.

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

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

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

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

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

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

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

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

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

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

Why? What are the benefits you see?

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

What is the thinking behind that decision?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

MR. KETCHUM: Mr. Geduld?

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

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

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

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

MR. GEDULD: Not the way it works.

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

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

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

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

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

MR. DEVIN: Yes.

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

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

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

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

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

CHAIRMAN RUDER: There seems to be no movement towards providing the customer with the benefits of this rebate in any direct way. Is that right?

MR. STUPSKI: That is correct, Chairman Ruder.

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

MR. KETCHUM: Mr. DaPuzzo?

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

MR. KETCHUM: Mr. Beard?

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

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

I think it is my firm's view that substantially more dollars are involved, and is certainly more rapidly growing in the fixed-income principal business, and while most of your questions have been addressed to the retail public -- and I am sorry Mr. Lerner is no longer here -- but our concern is very much to the ultimate plan sponsor and the owner of that equity capital.

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

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

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

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

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

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

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

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

MR. KETCHUM: Mr. Madoff?

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

I pay the Cincinnati Stock Exchange order flow for the order that they deliver to me, and as far as I know, the specialists are paying for order flow to the exchanges in one from or another for order flow that they get through this exclusive franchise.

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

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

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

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

COMMISSIONER GRUNDFEST: Yes.

MR. HARDIMAN: Even the SEC.

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

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

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

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

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

As we move forward and more and more order flow for various purposes is, use the word "locked up" because of payments, because of relationships, or retail networks or the like, what will be the underlying incentives to quote-type markets, and will there be conflicting incentives to widen spreads because so much of the order flow, whether for payment reasons or otherwise, is receiving a guaranteed quote-based execution?

Mr. DaPuzzo?

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

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

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

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

MR. KETCHUM: Mr. Watson?

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

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

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

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

I would just like to personally thank everyone who participated in the second part of the roundtable.

Again, I thought the conversation was very helpful.

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

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

Thank you, again.

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

REPORTER'S CERTIFICATE

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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.

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