

The Extinction of the New York Stock Exchange Specialist

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Last week, the New York Stock Exchange filed with the SEC for rule changes that will alter the way the Exchange has done business for decades. Among other things, the Specialist will go the way of the dinosaur. To many unemployed NASDAQ market makers out there, this has an all too familiar ring.

The institution of Specialist was intended to make sure that at every moment of the day when the Exchange was open for business and for every listed stock, there would always be a buyer and a seller. From a legal point of view, the Specialist is a special type of market maker, since the definition of market maker is a dealer that maintains simultaneous quotations to buy and sell a security. The Specialist is always there to buy or sell when no other buyer or seller is available.

Unlike NASDAQ market makers, Specialist are assigned stocks to make markets by the Exchange, and only one Specialist is assigned in each listed stock. This monopoly position is regulated by “negative” and “positive” obligations. The negative obligations are intended to prevent the Specialist from taking advantage of its position by participating in a market where a willing buyer and seller are already present. The positive obligations are intended to require the market maker to act as the willing buyer or seller when the other side is not present. In each case, the goal is to foster an “orderly market.”

It is worth pointing out that the Specialist’s obligations – negative and positive – reduce profits for the Specialist. The negative obligations require the Specialist to stand aside when an easy profit can be obtained in the middle. The positive obligations require the Specialist to lose money by buying or selling stock at prices where there are no customers. As a result, there have been the occasional scandals where Specialists were accused of not living up to their obligations. In the market collapse of 1987, Specialists were accused of not living up to their positive obligations – hiding when besieged by mobs of desperate sellers. Recently, in the scandal involving “pennyng,” Specialists were accused of not living up to their negative obligations by scalping trades for a penny.

The Exchange’s latest proposal would do away with Specialists, replacing them with “Designated Market Maker Units.” There would still be only one Designated Market Maker Unit (DMMU) per stock, but the informational advantages of being a Specialist would be removed. However, the Unit would not have the informational

advantages of Specialists because it would not be able to see all the orders in the book.

The negative obligations of the Specialist would be abolished. The theory is that since the DMMU can no longer see the book, there is no reason for them to stand aside when there are other willing buyers and sellers. The positive obligations of the DMMU would be enhanced by requiring it to maintain displayed bids or offers at the NBBO at least 5% of the time. And, the DMMU will be committed to provide liquidity at certain price points established by algorithms.

The Exchange states that these rule changes are necessary to accommodate the new electronic market reality and better align the Specialist role in the new world.

The fact is that Specialists are not making any money in the current environment, and the Exchange is rapidly losing market share to NASDAQ. The current proposal is intended to find a way for Specialists, renamed DMMUs, to turn a profit and enable the Exchange to compete for market share.

The difficulty is that the DMMU's profit is based on a privileged position, rather than competition. This will necessarily have two effects. The DMMU will charge "monopoly profits." These profits are essential to compensate it for its positive obligations. But monopoly profits paid to the DMMU will necessarily render the New York Stock Exchange less competitive than other markets, setting aside its need to pay for expensive real estate to house these folks. Accordingly, the positive obligation will be watered down, which has been the case for NASDAQ market makers, or further declines in market share are inevitable.

In either case, the DMMU will have a short lifespan. Without the positive obligation, the DMMU has no function. With the positive obligation and the right to charge monopoly prices, trades will shift to other market centers, rendering the DMMU unemployed. My best guess is that the Exchange will go the way of NASDAQ, eventually instituting a competitive market maker system.

Changes in market structure resulting from improvements in technology have forced many traders into retirement or unemployment. In that respect, our industry is no different than other industries where machines have replaced humans. Unfortunately, we have been no more intelligent than other industries in dealing with the problem.

As a people, we have led the world in innovative technologies. However, the people who hold positions rendered obsolete by technological advances need to be retrained for other jobs. Here, we have fallen down on the job. The human capital displaced by technology has not been put to good use, but is generally wasted.

This is especially lamentable, in my view, with the trading industry, which is renowned for its quick and agile minds. Surely, these wits can be usefully employed in so many enterprises. We would all be better off if these human capital resources could be more usefully employed.

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