REVIEWING U.S. CAPITAL MARKET STRUCTURE—PROMOTING COMPETITION IN A CHANGING TRADING ENVIRONMENT

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTEREPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

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REVIEWING U.S. CAPITAL MARKET STRUCTURE—PROMOTING COMPETITION IN A CHANGING TRADING ENVIRONMENT

Thursday, October 30, 2003

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:07 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Ose, Gillmor, Bachus, Royce, Oxley (ex officio), Kelly, Fossella, Biggert, Hart, Tiberi, Brown-Waite, Renzi, Kanjorski, Sherman, Meeks, Inslee, Hinojosa, Lucas of Kentucky, Crowley, Clay, Matheson, Emanuel, Scott and Maloney.

Chairman BAKER. [Presiding.] I would like to call this meeting of the Capital Market Subcommittee to order.

Committee is convened to receive comment and testimony with regard to the adequacy of our current market structure regulatory environment.

The inexorable press of technology combined with the effects of decimalization, have brought about changes in the market that are not entirely clear to be beneficial at the moment.

At this point, artificial rules that constrain where a customer might execute the best trade to their own personal advantage, does not, in itself, lead one to conclude that the current system enables that to occur on every occasion.

Also recent unfortunate events surrounding corporate governance issues at the New York Exchange, have opened the entire debate as to whether the specialist system continues to serve the highest and best purpose of the American investor.

And, at the same time, raises issues as to whether regulation and compliance can be subservient to the same board which has responsibilities for operation of a for-profit, shareholder-owned corporation.

All of these issues raise the whole discussion to an important level. "What do we do and when do we do it?" I do believe that the SEC, over the years, has conducted a number of evaluations and studies, and I think, because of the unique circumstance we now find ourselves in, it is appropriate to consider taking some action.

Whether it is statutory or whether by SEC regulation, I do believe the forces of technology are bringing about the potential for significant market structure changes that will be in the best interest of the individual investor.

With now over 50 percent of American homeowners invested directly in the marketplace, this is no longer an issue which can be relegated to a second-tier importance. It is a principle importance, not only for those individual investors, but for the success and growth of our own economic systems, and the exchanges and the capital markets are at the core of our opportunity for economic growth.

To that end, I am anxious to hear from the Chairman this morning as to their observations and recommendations and hope that we can come to relatively quick closure on an action plan, not only from the commission's perspective, but for this Committee to consider as well.

With that, I recognize Mr. Kanjorski.

Mr. KANJORSKI. Mr. Chairman, we meet today for the second time in the 108th Congress to review the structure of our capital markets and evaluate reforms that might enhance competition in light of recent technological advances and marketplace developments.

In recent years, a variety of participants in the securities industry have questioned one or more aspects of the regulatory system.

Today's proceedings will, therefore, help us to better understand these issues and their concerns. In my view, we have come to a crossroads in the securities industry, facing a number of decisions that could fundamentally alter its structure for many years to come.

As I did in our last market structure issues hearing, I must caution my colleagues on both sides of the aisle to move carefully and diligently in these matters. Because we have elaborately interlocking systems and relationships in our securities markets, I believe that we should refrain from pursuing change for change's sakes.

Moreover, in pursuing any change to fix those portions of the system experiencing genuine strain, we must also ensure that we do not disrupt these elements of our market that are working well.

In adopting the Securities Act Amendments of 1975, the Congress wisely decided to provide the Securities and Exchange Commission with a broad set of goals and significant flexibility to respond to market structure issues. From my perspective, this system has worked generally well, over the last three decades, in adapting to technological changes and other developments.

This legal framework ought to continue to provide the commission with the flexibility that it needs to consider and adopt further reforms in the future.

In testimony before the Senate earlier this month, SEC Chairman Donaldson indicated that the Commission would be focusing on increased intensity on the structure of our securities markets in the upcoming months.

I, therefore, look forward to learning from the Chairman, later this morning, about his current views on these matters. I want him

to know that it is my hope the Commission will move expeditiously and methodically in its deliberations.

Mr. Chairman, I have made investor protection an important issue of mine in this Congress, and during my opening statement at our last hearing in market structure issues, I outlined some of my thoughts regarding self-regulation in the securities markets.

Today, I would like to focus on another important investor protection issue: transparency.

For our securities markets to work well and advance the interest of investors, I believe, as a general rule, that we should seek to promote transparency to the maximum extent possible.

Transparency helps to ensure that all participants in the marketplace have access to the same information for making decisions. Transparency, therefore, ensures that no participant in a marketplace is either advantaged or disadvantaged because of their access to information.

For these reasons, I have apprehensions about any market structure reform proposal that would limit access to information, including those that would allow for internalization of market orders.

In my view, such proposals have the potential to jeopardize the transparency of our markets and harm investors.

During their tenures, the two most recent former commission chairmen have expressed concerns about the internalization of market orders by broker dealers.

Additionally, the current SEC Chairman has previously observed that internalization can discourage markets from competing on the basis of price and pose a conflict of interest for broker dealers.

As we deliberate on market structure issues this morning, it is my expectation that he will comment further on the importance of further enhancing transparency in the securities industry.

In closing, Mr. Chairman, I believe our Committee must continue to conduct vigorous oversight of the securities industry to determine whether its regulatory structure is working as intended and to examine how we could make it stronger.

The observation of today's witnesses about these complex matters will also help us to discern how we can maintain the efficiency, effectiveness and competitiveness of our nation's capital markets into the foreseeable future.

I look forward to this hearing, Mr. Chairman.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 71 in the appendix.]

Chairman BAKER. Thank you, Mr. Kanjorski.

Chairman Oxley?

Mr. OXLEY. Thank you, Chairman Baker, for holding this important hearing.

There are a few issues that come before this Committee that are as fundamental as how investors buy and sell securities. I want to particularly welcome our distinguished witnesses today; Chairman Donaldson and Annette Nazareth, for appearing.

This Committee's first market structure hearing earlier this month, I think all the members would agree, was quite encouraging. I was pleased with John Reed's candid and forthright testimony.

There is no question that he has volunteered for a difficult job, under trying circumstances, but I believe he is the right leader, at the right time, to right the ship at the New York Stock Exchange.

And even more importantly, I also believe that the recent controversies at the New York Stock Exchange present a real opportunity to enact significant and long overdue reforms to our market structure. An opportunity like this does not come around often, and we must not squander it.

I have long taken the position that investors benefit from multiple market centers that engage in vigorous competition based on speed and certainty of execution, anonymity and price.

The government should not decide which markets prosper. In fact, it is our obligation to ensure that no market have regulatory advantages that inhibit competition and artificially preserve market share.

Accordingly, it is imperative that we revisit the rules and regulations that have governed the markets for more than a quarter of a century.

What Congress did in 1975, may have made sense at the time, but those policy decisions were made prior to the greatest technological advances in human history.

It makes no sense, whatsoever, for these outdated regulations, which preceded, for example, the advent of Netscape by two decades, to be controlling in today's high-tech environment.

With a change in leadership at the NYSEC, I believe we are at a crossroads with an important opportunity to implement changes that will foster competition and make our markets even more efficient.

The Intermarket Trading System is an outdated construct that has outlived its usefulness. It is time to revamp the system that links our markets so that market forces and modern technology can replace bureaucratic, restrictive regulatory systems.

There has been a great deal of talk about the need to reform the ITS's trade-through rule. I expect we will hear from virtually all of our witnesses here today about this issue.

It is clear to me the time for reform is long overdue. Price simply is not the only factor to be considered for the purposes of best execution. The trade-through rule, as it stands, is standing smack in the way of more efficient, competitive markets.

The viability of the SRO model depends on whether it is one that uses regulation to protect investors and promote confidence or to hamper competition. We will examine many of these rules today.

Central to today's discussion, will be the role of the specialist. It has been widely criticized as monopolistic, anachronistic and unnecessary in today's highly-evolved technological environment.

John Vogel, who has appeared before this Committee several times, calls it, "A dinosaur that maintains as much of a monopoly as you can get in this world."

Even more alarming are the allegations of wrongdoing that call into question the integrity of this model and whether it creates an irresistible opportunity to put the specialist's interests ahead of investors.

Critics of decimal pricing argue that decimal pricing has led to front-running and other trading violations.

I would argue that these abuses are symptomatic of a flawed structural system, not the result of decimal pricing which has resulted in what one commentator has called a, "Billion-dollar tax cut for investors."

It is time to review the specialist system. Today's hearing is an important step toward that end.

I have long argued that market data, the fundamental information about securities prices that is the oxygen of our marketplace, needs to be free from ownership interest that could restrict access to that data.

It is essential that we ensure that investors have guaranteed full access to this information.

I am eager to hear from SEC Chairman Donaldson, this morning and, particularly, I look forward to learning how he intends to expedite consideration of all the pending issues before the Division of Market Regulation.

As many petitioners know all too well, the failure to make a regulatory decision is often worse than the adverse decision.

Again, I want to commend you, Chairman Baker, for putting together an excellent and balanced second panel of witnesses and I look forward to hearing their testimony as well.

And I yield back.

[The prepared statement of Hon. Michael G. Oxley can be found on page 64 in the appendix.]

Chairman BAKER. Thank you, Mr. Chairman.

Do members have—further members have opening statements? If not, at this time, I would like—I am sorry, Mr. Emanuel, did you have?

Yes. All members may submit their opening statements in writing for the record, without objection.

If there are no members seeking recognition at this time, I would like to welcome back Chairman William Donaldson, who is no stranger to the hearing room, unfortunately for him, I guess.

But we certainly do appreciate the courtesy of your appearance and we look forward to receiving your testimony this morning, Sir.

STATEMENT OF HON. WILLIAM H. DONALDSON, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. DONALDSON. Thank you very much.

Good morning Chairman Baker, Ranking Member Kanjorski, and members of the Subcommittee. I am very pleased to be here to discuss some of the significant market structure issues that we are facing in the U.S. equities market today.

Our markets are comprised of intricately-interwoven systems and relationships.

While the Commission recognizes the importance of addressing market structure issues expeditiously, the extent to which structural changes are needed, and what those changes should be, are complicated problems to say the least and not subject to quick and easy resolution.

We must take care not to disrupt those areas of our market that are working well in our haste to fix those areas which we think are not.

The Commission staff has made significant progress in analyzing the structure of the securities markets, identifying the sources of the strains to which it is increasingly subject, and formulating a road map for responding to these concerns.

The staff is now in the process of drafting concrete proposals to address the root causes of the stresses on the U.S. market structure. I have asked the staff to produce, in the coming months, a plan that includes proposals to respond to several of the more pressing market structure issues.

As you know, Congress formally directed the Commission to address market structure when it enacted the Securities Act Amendments of 1975.

That legislation instructed the SEC to facilitate the creation of a national market system for securities that would maintain fair and orderly markets and tie together all buying and selling interest so that investors would have the opportunity for the best possible execution of their orders, regardless of where in the system they originate.

Rather than attempt to dictate the specific elements of the U.S. market structure, however, Congress chose to rely on an approach designed to provide maximum flexibility to the Commission and the securities industry in its development.

The 1975 amendments to the Exchange Act created a framework for fostering transparency, interconnectivity and competition in our securities market.

As a result, today, equity market centers compete with one another in an environment where quotes and transaction prices are widely available to all market participants.

Direct and indirect linkages among competing market centers help ensure that brokers can access the best quotes available in the market for their customers.

Market centers, including exchange markets, over-the-counter market-makers and alternative trading systems have an incentive to offer improvement in the execution quality and to reduce trading costs in order to attract order flow away from other market centers.

Taking a step back and looking at the market as a whole, our National Market System has worked remarkably well for the past quarter century and, in recent years, it has become increasingly efficient.

At the same time, we recognize that this very efficiency, arising from the technological and other market developments, has put strains on existing national market structures.

One significant change has been the proliferation of the new electronic markets, such as the ECNs, that offer fast executions and have spurred competition among market centers, but, at the same time, exacerbated concerns about market fragmentation, the feasibility of integrating different market models into the National Market System, and maintaining a level regulatory playing field among the functionally-equivalent market participants.

The implementation of decimal pricing in 2001 and the concurrent move to a minimum tick of one penny in the equity markets have narrowed spreads and enhanced the efficiency of the price discovery process but, at the same time, reduced the liquidity avail-

able at each price point, made it easier to step ahead of limit orders, and placed economic strains on the dealer business.

Decimal pricing has also put a premium on swift access to displayed prices so investors can quickly reach these smaller quotes before they change.

The trend toward demutualization of exchanges and their conversion to for-profit enterprises has heightened concerns about the inherent tensions in the self-regulatory model, in particular the concern that the funding and vigor of the regulatory function might be sacrificed in favor of delivering returns to shareholders.

As noted, over the last several years, the Commission has taken a number of steps to address concerns facing our National Market System.

In the Order Handling Rules and Regulation ATS, for example, the Commission broadened the class of market centers required to make their quotations and orders publicly accessible. In doing so, it sought to redefine the idea of an exchange to include, not just traditional exchanges, but also trading systems where orders interact according to specified trading rules.

The Commission also adopted rules to improve the disclosure by market centers of execution quality data and the disclosure, by broker-dealers, of their order routing practices in order to enable investors to comparison shop among the myriad market centers and to stimulate competition on the basis of execution quality.

There is no doubt that there are issues regarding our National Market System that call for our attention; and, indeed, the Commission and its staff have been increasingly focused on addressing these issues and resolving perceived conflicts in a timely manner.

Commission staff is in the midst of developing proposals that address, in a comprehensive fashion, the various market structure issues.

I would like to focus the remainder of my testimony on the four key areas of the Commission's market structure initiative: access to markets; market data; the self-regulatory model itself; and the nature of a securities exchange.

Fair access: a significant market structure issue on the Commission's agenda is making sure that access between markets is as fair and as efficient as it can be.

If best execution is to be achieved in an environment characterized by multiple competing markets, broker-dealers must be able to identify the location of the best available prices and obtain access to those prices routinely and efficiently.

The Commission's approval, last year, of the NASD's Alternative Display Facility as a pilot program has heightened the issue of intermarket access.

Rather than obtaining access through "hard" linkages directly between markets, in the way that competing markets can access the New York Stock Exchange, in the Alternative Display Facility competing market centers obtain access to each other directly through privately-negotiated access agreements and indirectly through subscribers.

The Commission is evaluating this decentralized access approach to determine whether, as a practical matter, it would be an appro-

priate model for the National Market System, and this could be applied to other market centers.

Access fees: access fees charged to reach a quote create another difficult market structure problem. Some markets charge varied per-share transaction fees for access to their quotes.

Therefore, a displayed price may represent the true price that a customer will pay, or it may represent only a base price to which an undisclosed access fee will later be added.

To ensure real access to public quotes between competing markets, it is important that quotes be accessible to other market participants on clear and fair terms.

Price protection: as a part of our examination of intermarket linkages, we also are actively reevaluating the question of intermarket trade-throughs, which occur when orders are executed in one market at prices inferior to the prices disseminated on another market.

The challenge before the Commission is to devise standards that allow faster markets and slower markets to thrive within a single system of interconnected markets while, at the same time, providing order executions to customers that display prices for those customers who desire the best price on their order.

Market data: an additional market structure challenge facing the Commission involves the collection and reporting of trading information and the influence of the market data revenues on market structure.

Under the current system, distributions of market data revenues to self-regulatory organizations are based primarily on each self-regulatory organization's reported trade volume.

This compensation scheme has created a financial incentive for self-regulatory organizations to report as many trades as possible.

As a result, markets are vying for ECNs and market-makers to report their trades through them, as this allows markets to tap more deeply into the pool of available market data revenue and to rebate substantial portions of the additional revenue to the entity reporting the trade.

All of this calls into question whether the current method of distributing market data revenue creates appropriate economic incentives and whether it furthers the goal of rewarding markets that make valuable contributions to the market data being disseminated.

The self-regulatory model: another matter of great importance is the effectiveness of the self-regulatory system of our securities markets.

The principle of self-regulation is based on the idea that regulation can be best done as close as possible to the regulated activity. However, an SRO that operates a market has a potential conflict of interest between its role as a market and as a regulator.

The advent of for-profit, shareholder-owned exchanges creates additional issues, including ensuring that self-regulatory obligations do not take a back seat to the interests of shareholders.

The challenge for the Commission and the SROs is to ensure that, as the securities markets grow more competitive, the SROs continue to dedicate their energies and resources to surveillance and enforcement.

We also must prevent fragmentation of trading from creating gaps in the SRO oversight of the markets.

As a part of our review of the self-regulatory structure, I believe the Commission must thoroughly review the SROs governance. Recent events at the New York Stock Exchange point to the need for this review.

SROs play a critical role as the standard setters for sound government practices. Just as SROs have demanded that their listed companies strengthen their governance practices, we must demand that, at a minimum, SROs match the standards they set for listed companies.

There are several topics that merit our consideration, including board composition and the independence of directors; the independence and function of key board committees; the transparency of the SRO's decision-making process; and the diligence and competence required of board and committee members and ensuring their focus on the adequacy of regulation.

The last topic I would like to touch upon is what it means to be registered as a national securities exchange.

All currently-registered exchanges have a limit order book in which better-priced orders take precedence. But a mandatory order book system is not easily reconciled with a dealer model, such as the NASDAQ stock market, in which there is no central limit order book.

I spoke earlier about the merits of price protection across markets. NASDAQ's application to register as an exchange places squarely before the Commission, the issue of whether price protection, within a market, is a requirement of an exchange registration.

One issue is customer expectations. I suspect that customers generally expect their better-priced orders to be protected within an exchange.

We do not expect all exchanges to be identical, much less to replicate any market's faults. Yet, until now, all exchanges have given their limit orders priority throughout their marketplace.

If the Commission were to approve NASDAQ's application, other exchanges would likely seek to eliminate intra-market price priority from their rules. As a result, the protection of limit orders within markets would decrease. For this reason, NASDAQ's exchange application raises overall market structure issues that transcend the particular question of whether NASDAQ, or any other particular market, should be registered as an exchange.

In conclusion, I would like to reiterate that the market structure challenges that I have discussed today may shape the National Market System for years to come. The Commission recognizes the importance of addressing these challenges in an effective and timely manner.

At the same time, however, we have got to be mindful not to rush to judgment but, instead, take a deliberate and reasoned approach to reach the right result.

That said, we fully acknowledge the need to resolve the conflicts, and it is my expectation to be able to review proposals from Commission staff, in the coming months, with an eye towards publishing proposals soon thereafter.

I look forward to continued input from this Subcommittee on those important matters throughout this process. Thank you again for inviting me to speak on behalf of the Commission.

I would, obviously, be happy to answer any questions that you may have. Thank you.

[The prepared statement of Hon. William H. Donaldson can be found on page 73 in the appendix.]

Chairman BAKER. Thank you, Mr. Chairman.

We do have announced a series of votes; there are three now pending.

First is a 15-minute vote. It would be my intention to proceed with my questions, perhaps those of Mr. Kanjorski, if—well, at least I will go through mine, if that is the case.

And then the Committee would stand in recess for about 15 minutes to complete the remaining part of the first 15-minute vote and the other two fives.

Mr. Chairman, it is my understanding the SEC is in preparation of a concept release on the trade-through rule.

When do you anticipate some product being ready to release for public consideration?

Mr. DONALDSON. Well, it is implied in my comments. We are looking at a number of issues that we believe are inter-related.

We believe the trade-through rule is a very critical rule now, in terms of any modifications, eliminations or, whatever, that we might make on that rule.

I believe we want to consider that within the context of a couple of other issues that I have mentioned.

As I say, I hope that—we are working on it right now; we have taken testimony; we have talked, and now is the time for action. I think it is a matter of months, not years, but not weeks, either.

Chairman BAKER. I posed that question in light of what, I understand, was the pilot in August of last year, which looked at relief from the trade-through rule.

And the reported observations about the success or failure of the pilot indicated that it seemed to work very, very well and that there were efficiencies, other than best price, that were of material importance to investors.

And it just seems, from my perspective, that it is a very significant first step in providing more efficient functioning of markets to either expand the pilot or to take some further definitive action as quickly as possible, given the benefits of, at least reported benefits of, that pilot effort.

What is your opinion with regard to the specialist system? And I make the observation, perhaps not in a sophisticated way but, in Louisiana, as a former realtor, if I were to represent a buyer and a seller and I knew that the seller would take $100 thousand for the house, and I knew the buyer would pay $125,000; if I exercised an option or bought the property for my own account and then turned around and sold it to the buyer I knew of, by virtue of my fiduciary position, for $125 thousand, it is not only unethical; it is illegal, and I would go to jail.

How is that illustration different from what the specialist may do when he trades for his own account, given that market knowledge?

Mr. DONALDSON. The specialist system, as practiced on the New York Stock Exchange, has, in the structure and the rules, a negative and a positive obligation, if you will.

Specialists have a positive obligation to make a market in the stock and to provide liquidity when there is not a ready buyer or seller for the other half of a trade——

Chairman BAKER. And I think that is very valuable, and I don't want to lose that in the mix but, often, there is not concurrent disclosure and the time—if there is a liquidity reason to act, that is a great thing.

And I could buy that house and sell that house as long as I made concurrent simultaneous disclosure to both parties, and if they both agreed it was okay for me to make the $25,000, fine. But I couldn't do it without providing that notice.

Mr. DONALDSON. Right. Well, the other part of the specialist obligation is not only to the positive obligation to step in and provide liquidity but also the negative obligations to not step ahead of the customer account, and this is the very essence of the auction system.

And I believe that there are issues associated with that which have to do with what I referred to before, which is the advent of technology and the ECNs, which are able to transact instantaneously.

And, I might add that, in many of the ECNs, they are not that instantaneous unless there happens to be a matching order on their books. I mean, an order can sit there for minutes or hours.

That does not happen on the New York Stock Exchange because of the liquidity provided by the specialist.

Chairman BAKER. Understood, and there is value to the system. I just think there are some areas of concern that, perhaps, need to be thoughtfully examined by the commission——

Mr. DONALDSON. Absolutely. That is exactly what we are doing——

Chairman BAKER. If the trade-through rule, recommendations, analysis of the specialists concerns or modifications of rules governing practice, all of this, as you indicate, is part of a larger market structure recommendation.

Would that go to the point of the regulatory model of the New York Exchange? Is that viewed as being essential in this package of recommendations that might be later forwarded?

And I make that observation in light of this thought: what if someone were to come to the Congress and say, "The SEC ought to own a securities firm or the Federal Reserve ought to own a large national bank?"

You probably wouldn't get many co-sponsors, and the hearing date would probably be a long time in the future.

But, at the same time, we have the CEO of the for-profit enterprise often as the Chairman of the regulatory body, investment bank analyst—you know the litany of subjects we have dealt with in the Committee over past years has always generally resulted in very clear-cut separations of authorities between regulation and for-profit decisions.

Do you have a view today as to the appropriateness of maintenance of the current structure or should we really be thinking through perhaps a more radical modification?

And what will the SEC actions likely—will that be a consideration in the package of issues that the SEC is now considering?

Mr. DONALDSON. Critical consideration; bottom line. Clearly, the responsibility of an SRO for running a marketplace, as well as the responsibility for the regulation of that marketplace, brings into the forefront a potential conflict of interest.

And we are concerned about that conflict of interest.

There are a number of different ways of addressing that, ranging all the way from a total separation of the regulatory function to a partial separation to an internal structure that separates the reporting function and financing of the regulation inside an SRO.

I think this is what John Reed, the Acting Chairman of the New York Stock Exchange, is wrestling with right now, in terms of coming up with a corporate governance structure that addresses those issues.

But I think the point you are making is right on, which is, we must pay attention to the independence of the regulatory function.

And we must pay attention to the financing of the regulatory function, the adequacy of its financing. And we must separate, either by the way it is organized internally or totally externally, we must separate that potential conflict.

Chairman BAKER. Mr. Chairman, we are down to about three minutes on the vote. We are going to have to excuse ourselves.

Just one final, sort of, comment from my perspective.

Your observation was that we don't expect a recommendation or a package from the SEC within days or weeks; we don't expect it to take years; we are kind of in the months range.

So this might well be something pursuant to the Exchange action early next year, early spring; we might have some recommendations that would give us a global picture of where you think we should go.

Mr. DONALDSON. Right. I think the first indication of an approach and whether it is an acceptable approach will be the governance structure proposed by the New York Stock Exchange.

Chairman BAKER. We are in recess. Thank you.

[Recess.]

Chairman BAKER. I would like to reconvene our meeting.

Mr. Chairman, I just have one more, sort of, follow up from our earlier line of questions, not on the principle subject of the hearing today, but on the related matter of mutual fund governance.

I read, with interest, some comments by Mr. Spitzer in the morning news about his perspective of SEC actions in relation to his findings, which were troubling to me, a bit.

But, more importantly, in our last hearing in which you appeared, I had expressed interest in having Agency comment with regard to H.R. 2420, which is still pending, on any modifications or improvements that might be considered to that act, with regard to mutual fund governance.

And in light of the developments reported in the media by actions of the Attorneys General, your own agency, I just renew that

request in light of current market circumstances if the Agency could review and forward any comment that might be appropriate.

Certainly, we don't expect immediate action on H.R. 2420, but it is within that weeks range; not days, but not years, kind of, category.

And whenever you could get us something, it would be very helpful.

Mr. DONALDSON. We would be glad to do that.

Chairman BAKER. Thank you, Mr. Chairman.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman. Welcome back, Mr. Chairman. We look forward to having you here, particularly in these trying times.

I think one of the things I am trying to organize, in my mind, is recognizing some of the threats of investor confidence that exists as a result of the continuum of things that have happened over the last year, year and a half.

Is there any method or methodology that should be employed by the regulator, by the Commission, to get all of this out on the table, once and for all, instead of the slow bleeds and the information coming forth, whether it is the mutual fund industry, or whether it was the governance at the New York Stock Exchange, or whether it was the inappropriate activities of some of the huge corporations?

Can't we find some method to bring this to an end?

And, in light of that, what I am thinking of is, in the past, the Chairman of the SEC has always said he really doesn't need a larger budget. We tried to give him one a couple of years ago, and there was always some hesitation of taking it.

Do you think you are sufficiently staffed now?

And the one reason that brings that to my mind—and I know we will have another hearing on this subject—but I am really disappointed with the whistleblower that brought, apparently, timing evidence in the mutual fund industry to the Enforcement Office of the Commission back in March and had an attorney follow up on a monthly-weekly basis.

And it wasn't until the State Attorney Generals took action that anything happened.

On the face of that, it certainly makes it appear that perhaps the federal regulator is not ahead of the game. I know the pressures that the Commission has been under and the wide range of activity they have to do.

But while you are reviewing all these governance issues and other issues involved in the exchanges, are you going to also look at your enforcement regulation budget and what you need so that we can make sure that we can, once and for all, say to the American people that this is the bottom line and draw our two lines and close this out?

Or, other than that, we are just going to go on and on, internally bleeding and, every time we seem to have an uptake in the market or in the economy, we get hit with another investor confidence question.

Mr. DONALDSON. Let me confine my remarks, I think, to the central thrust of your question which is the issues with the mutual fund industry right now.

You are talking about other issues, too, that are on our docket but, most recently, the issues that have come to the fore on market timing and late trading, and so forth.

I could give you a number of answers but first and foremost, there is no doubt about the fact that we can improve our methodology.

We have a huge universe of funds, some 5,000 mutual funds with over 8,000 portfolios of securities, and over 7,000 advisers in which we are expected to conduct inspections.

We have to have a set of priorities, if you will, in terms of what we are looking for, and I believe that the issue of risk assessment, if you will, is one that we are addressing right now, in the Commission, in terms of how we determine exactly what we are looking for. And I think that can be improved, and we are working toward that end.

We are working toward a better synergy, if you will, between our divisions of investment management, our divisions of inspections and so forth.

But we do have new troops coming in: a substantial increase from, I think, 350 people in our inspection group to almost increasing that by 50 percent so we will have more bodies.

But the real issue is how we determine where the risks are, and we, I think, probably have not had the issues of market timing as high in our priority as we should have.

We are taking steps now, I might add, to do something about that and do something about it quickly.

The other thing is that, in the case of some of these issues that have come to the fore, you had, basically, an alleged collusion between two entities; the Canary Hedge Fund and the mutual fund that they were doing business with.

And unless you have a direct tip, unless you have a direct insight, it is very hard to find collusion, particularly in the case of Canary when we didn't have the authority to go in and examine them.

Mr. KANJORSKI. If that is the case, I can understand that being the case, then part of this argument on a totally electronic market raises a lot of questions in terms of how are we going to pick these transactions up.

Those of us that aren't informed on the technology assume that, with computers today, everything is seen. And when there is improper activity it would set off some sort of a tilt so that regulators would look at it.

And you have layers of regulation, as you pointed out. The SRO is the first responsible party to know what is going on but then you, over them, have some idea.

Now, this last weekend—and Monday I was in Chicago looking at the markets and trying to understand what they are doing—and they brought me aware of the fact of what internalization may or may not do, and some of the advantages of it, and some of the deference of it.

But one of the things that we talked about with quite seriousness, that you referred to in your testimony, is this idea of the penny market and how that can interfere with another market that deals in more than pennies and 10 cents, as the Chicago markets do.

And how that delays a transaction until someone filters through that 10-cent spread.

And that goes to the question of that unique characteristic on the New York Stock Exchange of the specialist. They drive and create that market and it doesn't get as delayed.

But I was most impressed about a meeting I recently had with John Reed, in terms of what the specialists did during the 1987 crash and that, without their existence there—and if we had a totally electronic market—we potentially would have no buyers when the market was falling as rapidly as it was.

Could you tell us whether or not their—because we hear of all the negatives, everything from extraordinary income, which all of us know is impossibly true, or General Electric; own all the specialist positions on the market—a lot of misinformation is out there but it is having an effect on people because it is misinformation. But a lot of us aren't sufficiently knowledgeable about these exchanges and how they work.

What is your impression, really, of whether, one: we have a problem in the specialist field in the New York Stock Exchange particularly?

And, two: do they, in your estimation, fulfill a necessary function?

Mr. DONALDSON. Clearly, I think that you have to draw a distinction between the rules and regulations under which the specialists operate. And the enforcement of those rules and regulations, which I believe is a separate issue from the function of the specialist system itself.

I think John Reed was absolutely correct when he referred to the effectiveness of the auction market system as, "A deliverer of liquidity in times of stress."

And I think we have seen that time and time again over the course of my business career, where in turbulent markets the liquidity pool is developed on the floor of the New York Stock Exchange.

It is a tremendously valuable national asset.

Now, the game has changed a bit, as you correctly say, with the advent of penny spreads and decimalization and, the fact that, although you have narrower spreads, you have less of the true size of the market displayed.

In other words, there is a bid and an ask that are separated by a penny, but that doesn't really disclose what the real depth of the market is behind that bid and offer. And I think that has been to the detriment of informed trading.

The trick here, as far as I am concerned personally, and I believe as far as the Commission is concerned, is to get an interface between this rapid trading and possible price improvement. In an environment where you only have a penny spread, a case can be made by some, that they, the customer, the client, the broker,

doesn't want to wait for a penny improvement. They want to get a trade done; they are interested in speed.

But I don't think you can apply that across the board to the fundamental concept of price improvement and the customer getting the best price that he or she can possibly get.

And I think we tread on thin ice when we suggest that we are not going to get the best price for somebody. And I think that is the beauty of our market.

Chairman BAKER. Thank you, Mr. Kanjorski.

Chairman Oxley?

Mr. OXLEY. Thank you, Mr. Chairman.

Chairman Donaldson, I ought to call your attention to the lead editorial in today's Wall Street Journal, and it tracks very closely, the views that I expressed earlier in my opening remarks.

And we operate on a separate track; I don't write the editorials for the Wall Street Journal, nor do they write my opening statements.

But I want to quote from that editorial.

"We hope he, that John Reed and especially folks in Washington, don't ignore the largest public policy issue at stake: the rules and regulations governing the national market for stock trading. Specifically, the monopoly created for the New York Stock Exchange by the Intermarket Trading System."

"The heart of this system is a prohibition mandated by the Securities and Exchange Commission against trade-throughs. In theory, this sounds like good market organization and practice; it allows the New York Stock Exchange an artificial market advantage."

Do you disagree or agree with those sentiments? And how does the Commission intend to address those thorny issues?

Mr. DONALDSON. I think, in the testimony upcoming, you are going to see the disagreement that exists out there.

If I have correctly read some of this testimony that you are about to get, you have people arguing violently on the side of what that editorial said; that there ought to be a total elimination. There are equally strong arguments on the other side.

I believe the answer is probably somewhere in between, as it always is in many disputes where there are extremes.

I think we have to be very cognizant of the tradition of the central market structure that says the customer, the client, the small investor, the large investor ought to be able to get at the best price.

And when you get into defining execution as something other than best price, such as speed, or a number of other criteria, you get a little bit on slippery ice. This isn't to say that there aren't certain customers that would sacrifice price improvement for speed. We have to come up with a system whereby in a unified market, we can satisfy both kinds of customers. And that is our challenge.

Mr. OXLEY. Has the SEC looked at the—I guess, for want of a better term—the European model? Virtually all of the bourses in Europe have gone to all-electronic trading.

Is there any evidence over there that there is a lack of liquidity or failure of folks to make a market? It appears that they have totally abandoned the auction system there. Does that give the SEC any guidance one way or the other?

Mr. DONALDSON. I don't want to comment generally on the quality of pan-European markets, except to say that I think I could make the generality that our markets are still the envy of the free world; that there is no market system that operates as efficiently and effectively in the interest of individual customers, as well as institutions, as the U.S. markets do.

Now, that is the basic premise from which we start, which is, we are still the best. And I think all evidence indicates that. Can we improve it? Can we adjust the technology? Yes. I believe we can, and that is what we are working on right now.

The system—if you want to go into the history of the formation of the auction market system long before technology was designed to create a market that, as much as possible, eliminated dealer interface and allowed natural customers to meet each either directly with no intermediary. And that system was developed over a number of years and has worked pretty well.

However, if you are starting up new systems, which are characteristic of many of the European markets, they are basically started by dealers who want to get a dealer spread and want to interpose themselves in between natural buyers and sellers.

Now, that is the fundamental clash, if you will, between those systems and our systems. And now you add onto that the new technology that has come in.

And, again, I would say that we do not want to lose the benefits of the auction market of which the specialist is a primary part, but we also do not want to deny the speed that is available in some of our electronics markets.

So the trick is bringing them both together and having an option for customers.

Mr. OXLEY. But is there evidence, that you know of, that there is a severe lack of liquidity in the European markets as a result of having an all-electronic system of trading?

Mr. DONALDSON. Well, I will give you one man's view, and that is I think our markets are much deeper, much more liquid and particularly so in times of stress.

It is easy to have functioning markets when you are in a relatively calm period. It is a little more difficult to assemble liquidity to offset imbalances when markets are turbulent. And I think that is when the auction market really works the best.

Mr. OXLEY. If I may, just one more, Mr. Chairman.

In regard to SROs, do you think that there is an essential function—I am not talking now about structure or design, but just in a general sense—do you agree that there is a need for SROs to exist?

Mr. DONALDSON. Yes, I do.

Mr. OXLEY. Okay.

Mr. DONALDSON. I believe that the original decision that was made back in the 1930s, to create an SRO structure, was a very sound decision.

And that, fundamentally, was based on the idea that, if you set up a government agency, such as the SEC, and gave it the responsibility for totally regulating the markets, you would create a bureaucracy, you would create a federal expense, and you would cre-

ate a lack of being in touch with the marketplace that would impede our markets.

So, I think that the concept of a self-regulatory organization, which gets the regulation down to people who are familiar with the marketplace, is a very sound concept.

It also gets the expense of regulation down where it should be, on our participants in a marketplace.

Then, the question is, "Can you structure that self-regulation so it is totally unbiased?" So that it is uninfluenced by the responsibility for running a market as a business. And, that is the trick.

How do you get that self-regulation independent so that it is not being influenced in any way by those who are trying to build the marketplace?

Mr. OXLEY. Do you think the NASD model fits that description?

Mr. DONALDSON. I think the NASD model is an interesting model.

I think that it still has the need to regulate the NASDAQ market, itself. It is being done by NASDR, I think is one approach. I think there are other approaches.

Mr. OXLEY. Thank you. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Chairman.

Mr. Emanuel?

Mr. EMANUEL. Thank you, Mr. Chairman.

I was intrigued by what you said earlier to the Chairman. I think the way you said it is that the SEC was caught a bit flat-footed by the market timing and late-trading scandal. And this is part question as well as part statement—my hope here is that the mutual fund industry investigation doesn't become a turf battle between the New York Attorney General and the SEC.

Although the Attorney General has been leading the effort, I would like to see a coordinated strategy without any dispute over "real estate."

Because given how many Americans are invested in mutual funds, the integrity of that industry and its managers is essential. As much as we discuss market regulation, with 96 million Americans investing in mutual funds, it is essential that that investigation be done without any squabbling between the States and the SEC.

With that said, how widespread do you think this market timing issue is in the mutual fund industry and among its managers?

Mr. DONALDSON. Let me address the first part of your observation there.

Mr. EMANUEL. Sure.

Mr. DONALDSON. Which is this should not be a competitive situation between regulators.

Mr. EMANUEL. Good.

Mr. DONALDSON. This should not be a competitive situation between the federal regulators or any of the State regulators. We have worked with the State regulators for years.

We have recently formed a joint committee between the State regulators and ourselves to try and iron out cooperative attitudes; how we can help each other; how we can improve that cooperation.

I think that the spectacle of one regulatory agency criticizing another is not healthy. We look to cooperate, the New York Attorney

General, we have tried to cooperate with him, we are cooperating with him right now on a number of issues.

We have a much broader responsibility, a much larger staff. The whole investigative thing is going on now as we enable it not to be a rifle shot but to be a broad-gauged investigation.

To answer the second part of your question, we believe, as a result of a net that we have cast, that the market timing and late-trading issues are quite widespread.

We are still gathering data on this. But we think it is more widespread than we originally anticipated.

Mr. EMANUEL. Mr. Chairman, we have worked on an agreement that we are going to be holding hearings on the mutual fund industry in the not-too-distant future. Correct?

Chairman BAKER. That is our intention.

Mr. EMANUEL. Okay.

To me, what is critical here is the integrity of the financial markets in the United States, and the trust investors have in the markets. I feel strongly that these scandals have become for mutual funds what Enron, Tyco, and WorldCom were to corporate America.

And I think we are all vested in making sure that everybody's level of confidence is restored to the highest level, as quickly as possible.

So, I applaud you for creating this joint task force. Please let this Committee know if there is anything we can do to help you on the funding level, because I think what is happening, as evidenced by today's news about the Strong funds, is an unparalleled threat to the public's confidence in this sector of the financial markets.

Thank you for you leadership on these issues. I look forward to continuing to work with you on meaningful reform.

Mr. DONALDSON. Thank you.

Mr. EMANUEL. No further questions.

Chairman BAKER. Thank you, Mr. Emanuel.

Mr. Bachus?

Mr. BACHUS. Thank you. Does someone need to put something in the record?

Chairman Baker, I understand.

Chairman BAKER. Thank you, Mr. Bachus. I didn't realize Mr. Fossella wanted to put a statement in the record.

Mr. FOSSELLA. Yes, Mr. Chairman, I have been asked by the Organization of Independent Floor Brokers to have their statement submitted for the record.

Chairman BAKER. Without objection. Thank you, Sir.

[The following information can be found on page 196 in the appendix.]

Mr. Bachus?

Mr. BACHUS. Thank you, Mr. Chairman. Chairman Donaldson, Chairman Oxley asked you about the trade-through rule and you indicated that there is consideration for reforming that rule. Is that correct?

Mr. DONALDSON. Yes.

Mr. BACHUS. That would go from anything from abolishing the rule to maybe establishing the same practices we have for the queues and the spiders today, is that correct?

Mr. DONALDSON. Yes. Let me just make a couple of comments on the trade-through rule.

The trade-through rule was designed to force executions to be done at the best available bid or ask. And it was a rule that was put in to make sure that, no matter where listed stocks were traded, the customer would be afforded the opportunity of the best bid or the best offer.

What has changed the scene now is two things.

The first is the speed of electronics with some of the ECN markets, and the second is decimalization.

The speed is so fast that it is hard to monitor the trade-through rules, and you have trade-throughs going on where, in the name of speed, the customer may be getting a worse price.

It may well be that because the worst price is only a penny, as opposed to an eighth, or a quarter, or a half, that some class of customers say that, "I don't care. I would rather have the speed."

But to design a market that just throws out the ability to match at the best bid or offer is quite a move.

So as we look at this rule and try to contend with it, in terms of the modern clash that we are having, I think we have to be very careful what we do with that rule. And that is just what we are looking at right now.

Mr. BACHUS. Thank you.

Do you know when you will maybe disclose the results of, at least, your preliminary findings?

Mr. DONALDSON. The timing of this and several other market structure issues, as I intimated earlier, is——

Mr. BACHUS. Months; not days.

Mr. DONALDSON.——in months now, not days or weeks. And not years.

Mr. BACHUS. Thank you.

Earlier, in response to a question from the other side, you mentioned the orderly markets and the fact that one thing specialists do is they stabilize the market and supply liquidity.

There was an article in the Wall Street Journal yesterday that actually said—I am sure you probably read it—that actually said that, "The NYSE apparently does not have any data demonstrating that their specialists actually step in and provide capital to stabilize the trading on a particular security during times of market stress." That was the Wall Street Journal, yesterday.

Do you know if those press reports are accurate? I have also heard that Mr. Reed had requested that information and it wasn't available.

Mr. DONALDSON. I don't know that study. Did you?

Ms. NAZARETH. Yes. I take it they know how much they bought or sold in times of stress, but they are having difficulty retracing how much capital they committed at the time.

Mr. BACHUS. When they determine that, will they determine their profits? Are you seeking that information? Is that an area that you are inquiring or examining?

Mr. DONALDSON. Yes. Sure. Yes.

Ms. NAZARETH. Yes.

Mr. DONALDSON. Yes.

Mr. BACHUS. Do you know what the status of that inquiry is?

Mr. DONALDSON. I don't want to give you a direct answer on that because I don't know the exact status. It is under way.

I will come back to you with just how far we are into it.

Mr. BACHUS. But you are also trying to gain that same information?

Mr. DONALDSON. Yes.

Mr. BACHUS. Yes, Okay.

In Trader magazine—I guess it is a magazine—I want to just read to you a quote.

They said that, "The NYSE's recent release of SEC-mandated order execution qualities statistics actually suggest that investors don't get the best possible execution on the floor of the NYSE, despite the NYSE's claims."

And this is really of particular concern, "The NYSE's public claim is consistent with complaints by large NYSE members that when such members have considered routing investor order flow to alternative market centers away from the NYSE, the NYSE regulatory arm has threatened the members with best execution investigations."

You have probably heard some of those allegations? And let me put another question on top of that.

What disturbs me about that is that the regulatory arm of the NYSE could be used to stifle competition, if that is true. And I would just like your comment on that.

Chairman BAKER. And that will have to be the gentleman's last question. His time has expired, but please respond, Mr. Chairman.

Mr. DONALDSON. Let me just put newspaper articles and studies in context. What we are dealing with here is a competitive situation.

As a former academic myself, there are studies, and there are studies, and there are studies that are sponsored by groups—I am not referring to any particular study——

Mr. BACHUS. Absolutely.

Mr. DONALDSON.——but I think that you have a right to believe that the studies being done by the SEC are non-biased, straight down the middle, with one purpose in mind: the effective structure of the marketplace.

And I think it is very hard for people to separate out the competitive markets that are out there today and the prejudices associated with that, including, but not limited to, the New York Stock Exchange, the American Stock Exchange, the ECNs, et cetera.

They are trying to promote a marketplace. And so, I take some of these studies with a grain of salt.

Mr. BACHUS. I guess I would just say, would you agree that if they were using the regulatory arm to stifle competition that would be improper?

Mr. DONALDSON. Well, I think that this gets to the issue of where the locus of the regulation is, and I am sure that there are accusations on all sides about the regulation being biased or not being biased, or being used for other purposes.

I think the solution to that is to have the regulation independent of those that are trying to build the market itself and to have it be a truly independent entity.

And that goes to, as I said before, a number of different ways of doing it: internally structured or externally and totally separated, or a mixed mode, such as NASDAQ has.

Mr. BACHUS. I thank you.

Chairman BAKER. Gentleman's time is expired.

Mr. Hinojosa?

Mr. HINOJOSA. Thank you, Chairman Baker and Ranking Member Kanjorski.

I want to thank you for holding this second hearing on market structure. I recall that the first hearing on this series was on governance issues at the New York Stock Exchange, including the potential conflicts of interest created by regulators.

This leads me to my question. Chairman Donaldson, what role can the public equity markets, specifically, real estate investment trust equity funds, play in providing capital to invest in affordable multi-family and home ownership efforts?

For example, can the public equity markets play a role in providing capital the same way Citigroup and Fannie Mae announced yesterday that $100 billion of financing through the end of the decade to help lower-income families obtain mortgages to buy homes?

Is that something you would support?

Mr. DONALDSON. My answer to your statement or question is that the equity markets, in this country in particular, are highly liquid. And they are highly transparent. And, because of the liquidity and the transparency, they give people an opportunity to set the cost of capital, if you will, by the multiples of earnings, or whatever, that stocks sell at.

So it is a great capital-generating machine. The equity ownership has, inherent in it, the raising of new equity and the raising of new capital.

As far as what vehicles are better for distributing it to one industry: housing or whatever, we could sit here and talk about that for a long time.

Mr. HINOJOSA. Well, that answer is a little bit unclear.

It seems to me that you and I and many in this room, understand that the housing industry is the one that is helping keep unemployment rates down to the point that they are.

Otherwise, it would probably be one or two points higher.

So it seems to me that there needs to be a boost in terms of monies available, particularly for working families who want an opportunity to have their first home.

Are you saying that you don't favor one industry over another?

Mr. DONALDSON. No.

There are many mortgage security mutual funds to begin with, but I think the political issue of how money is directed to different parts of the economy is not really my function or the SEC's.

I may have personal views on it, but I think it really is not in our mission.

Mr. HINOJOSA. Okay.

Chairman Baker, I look forward to learning more about our capital markets from today's and, hopefully, future witnesses.

I also look forward to working with you and with Ranking Member Kanjorski should this Subcommittee conclude that it needs to

formulate legislation to change corporate governance, or possibly encourage the exchanges to adopt certain best practices.

With that I yield back.

Chairman BAKER. I thank the gentleman for his good statement.

Ms. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman.

Just to follow up on Mr. Bachus's question for a moment. You were saying that you are moving expeditiously on the market structure issues and that would be within months.

Do you have a list of how you are going to proceed and what issues will the Commission tackle first?

Mr. DONALDSON. Yes. There are a number of issues that are on our agenda.

Obviously, the issues we have been discussing this morning: trade-throughs; trade-through rules and other rules; access; market access; the openness or lack, thereof, of access. And we have a number of concerns about the way the market data tape revenues are determined and distributed. Those are a few of the categories that are on our agenda right now.

Clearly, governance is a part of that and regulation.

Mrs. BIGGERT. One of the issues that I am particularly interested in is internalization.

And it just seems like, with all of the recent conflict of interest scandals, that little has been said about the internalization which, obviously, involves the brokerage firms trading against their own customers' orders.

And I have concerns that this practice in the listed options markets may soon be systematic and taken to a new level if the SEC approves the pending proposal from the Boston Stock Exchange, called BOX.

Could you comment on the timeframe for completing that proposal? And could you also comment on what the SEC is currently doing to study the beneficial, or the adverse, effects of internalization?

Mr. DONALDSON. As you intimate, the proposed BOX system was proposed to the SEC. We had a number of questions about various aspects of that proposal.

We received answers from not only the BOX promoters but also answers from the public. We are in the process now.

I think our cut-off date was less than a month ago?

Ms. NAZARETH. Yes.

Mr. DONALDSON. Yes, less than a month ago.

And so we are now examining the comments. Clearly the internalization aspect of that proposed system is one that concerns us, as does internalization generally, not just in the option markets, but the potential for internalization in the equity markets.

Again, the negative potential of capturing buy and sell interests inside an entity—as opposed to exposing them to buy and sell interests across the country, and the world for that matter.

Mrs. BIGGERT. Would the impact of the one-cent trading have any effect on that issue as well? On the BOX?

Mr. DONALDSON. I am sorry, I didn't hear that.

Mrs. BIGGERT. Would the one-cent trading have any effect in the listed options industry?

Mr. DONALDSON. Well, as you know, options are traded at nickel increments and that spread has a lot to do with the dangers of internalization. Yes.

Mrs. BIGGERT. Okay.

Thank you. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Biggert.

Mr. Scott?

Mr. SCOTT. Thank you very much, Chairman Baker.

Chairman Donaldson, I would like to ask you a couple of questions about the National Security Clearing Corporation. There is a proposed rule change.

This rule change will allow the National Security Clearing Corporation to enter into services that are already being given and serviced very effectively and efficiently by the private sector.

It would, basically, if you are not familiar with it, it would create a new service for the NSCC that would provide its current members with other data services, only for members, would specifically propose to provide a service for its members that would enable the NSCC to provide a messaging hub for the communication of information among sponsors of Separately Managed Accounts, or SMAs, and the investment managers participating in this program.

If that rule goes into effect, it would historically change the basic statutory purpose of the NCA.

And it seems to me that given the current level of private competition present in a marketplace, it could very well be a violation of the NSCC's mandate and would be inappropriate from a policy perspective, for any SOR, including NSCC, to become an active participant in an existing competitive market.

So it seems, to me, Mr. Chairman, as a matter of policy, that the fundamental role of self-regulatory organizations, or SROs, subject to SEC supervision, should be to facilitate the efficient operation of the markets, as an extension, if you will, of the Commission itself.

I am very concerned, though, that the National Securities Clearing Corporation, long an essential link in the securities payment process, may be trying to meddle in the kind of function that has been exclusively reserved for the private sector alone.

What do you know specifically about this rule change that the NSCC is in the process of proposing to the SEC?

And what assurances can you give to this Committee, and the nation, and to the private sector, that SROs, because of their inherent competitive advantages that accompany their status as quasi-government entities, ought not to be in the business of competing in the private sector with established businesses?

Mr. DONALDSON. Congressman, I will begin by saying that I am not familiar with the issues that you have just brought up. I just checked with Ms. Nazareth, who, likewise, is not familiar with the particular issues you have brought up.

But I would like to come back to you with answers to your statement and will do so.

Mr. SCOTT. That is very good. Thank you, Sir. And I will look forward to getting that information.

There are a lot of companies who are involved in this area that are very much impacted and would like to get some answers to that. So I look to get that from you.

Thank you.

Chairman BAKER. Thank you, Mr. Scott.

Mr. Chairman, I don't know if you have previously announced time constraints, but we have several members who are still indicating an interest in asking questions, and we would return right after a brief break with Ms. Kelly on our side.

And there are several other members on the Democrat side who would like to have the ability to ask questions.

We have two votes, we think. One for sure that is down now to about six, seven minutes, and possibly a procedural motion would keep us over there another 10, 15 minutes, and we would be right back.

Mr. DONALDSON. That is fine.

Chairman BAKER. If that doesn't present a problem, then we will stand in recess for about another 15 minutes.

Thank you, Sir.

[Recess.]

Chairman BAKER. I would like to reconvene our meeting of the Capital Market Subcommittee.

And at this time, I would recognize Ms. Kelly for her questions.

Mrs. KELLY. Thank you very much, Mr. Chairman.

Mr. Donaldson, my neighbor, I am delighted to have you here today. Thank you very much for coming and for your patience and answering our questions.

A couple of things that I was interested in: one of the things we have been talking about—I, also, don't know if anybody has noted the fact that we are pretty close to October 29th, Black Tuesday, and this is the 75th anniversary of the market, so I am glad you are here and we have a strong market and I hope it stays that way, but—you were talking about the buyer of last resort.

And I would like your thoughts on the practice of the buyer of last resort has played in providing liquidity and in preventing disturbances and how the market structure reforms might have an impact on that principle.

Mr. DONALDSON. Well, I think if I understand your question, I did make comments earlier about the liquidity that is available in the concept of the auction market and the "crowd" and so forth; liquidity that seems to appear at times of stress.

There is a mechanism there for drawing out that liquidity and putting it together; that I think has served the country well.

Mrs. KELLY. I am sorry, sir, I wasn't able to be here earlier, I had to go out to the Pentagon, so I didn't hear that at that prior discussion. But thank you for answering that question. I am sorry it was redundant.

Have you also discussed naked short-selling?

Mr. DONALDSON. I am sorry, did we——

Ms. NAZARETH. No. Naked short-selling, we did not discuss that.

Mr. DONALDSON. No, we did not discuss naked short-selling.

Mrs. KELLY. I would be very interested in what you plan to do in that area.

Mr. DONALDSON. Yes.

We have just put out a new proposed rule that deals with naked short-selling. It deals with short-selling, in general, but as a part of that, naked short-selling.

And, in the proposed rule, we have proposed that there be new restrictions on naked short-selling.

I will give you, in general terms, the concept. It would be the obligation of the short seller's agent to identify where the certificates were for the short sale.

In other words, it would not prohibit short-selling, but it would severely restrict the short-selling where the short seller can't deliver the certificates. And there are certain leverage advantages to doing that, but it is something we think should be eliminated.

Mrs. KELLY. And you have a plan to do that is that what I understand?

Mr. DONALDSON. Yes we have. We have put out a rule on that.

Mrs. KELLY. Good. Thank you very much for doing that.

Mr. DONALDSON. Right.

Mrs. KELLY. I think that will help market stability and trust for the public.

I am going to ask one other question and that is when the market went to decimalization it went to a penny on the spread.

I am wondering if we have the opportunity now to take a look, if we are going to standardize, across the board, a certain number of things, whether or not it would behoove us to maybe not take action, but at least evaluate the effect on that regarding the depth of the market.

And whether or not it might be prudent for us to move to a five-cent, rather than a penny spread. I will give you some leeway to answer that, but I would like to hear.

Mr. DONALDSON. Yes. Well, I think there has been a lot of examination of just exactly what the effect of the decimalization has been.

Clearly, part of what you imply is true, in my view, which is that the liquidity or the displayed liquidity is hidden, if you will. There can be a penny spread, but that can be for a hundred shares.

And you really don't know what liquidity is there,I think that is a disadvantage.

In terms of the monies either saved or not saved by the reduction—going to decimalization and all the way down to penny spreads—I think that is a debatable item.

There are studies that have been done that say this has been to the advantage of the individual investor and to the disadvantage of institutional investors.

Again, I think that the more light we can shed on just exactly what the implications of decimalization have been, the better.

In terms of increasing the spread, I think it is probably premature to do that unless and until we have evidence that negative aspects of penny spreads are hurting the liquidity in a marketplace.

Mrs. KELLY. Are you examining that? Is anyone tasked with an examination of what that effect was on the market and continues to be?

Mr. DONALDSON. Yes.

A lot of it is hard to identify in the sense that you have, with the reduced spread, reduced profitability.

It is quite possible that we have had a reduced liquidity in lesser-traded stocks that market-makers are less inclined to commit their capital with less of a profit margin available to them.

There are other issues on the other end of the scale: the sub-penny spread issue, which is, "How far does this go? Do we now get down into not just pennies, but fractions of pennies?"

You didn't ask me that question, but I will give an answer to it. I think it would be counter to the public interest to get into sub-penny spreads, and that is one of the things we have to address in our market study.

Mrs. KELLY. Would you also be including commodities markets in that?

Mr. DONALDSON. Right.

Mrs. KELLY. In that study?

Mr. DONALDSON. Yes. Right.

Mrs. KELLY. Thank you very much. I yield back.

Chairman BAKER. I thank the gentle lady.

Mr. Inslee?

Mr. INSLEE. Thank you, Mr. Chair.

Two questions. I have a quote, Mr. Chair, I believe is yours.

You said, at one point, to the Senate Banking Committee, you said, "Like payment for order flow, internalization can discourage markets from competing on the basis of price and pose a conflict of interest for broker dealers," which, I think, evinces a concern that many of us have.

But, we are told that you are actively considering this proposal by the BOX, which would, in its essence, increase, as I understand it, the practice of internalization from a structural standpoint.

Given your apparent concern about internalization, why are you actively considering this? And in what circumstances would you consider approval to try to reduce or eliminate those concerns about internalization?

Mr. DONALDSON. Well, we, as I said, we have the BOX proposal. We put it out for comment. We got a lot of comments back.

The most negative comments had to do with the internalization aspect of the BOX procedure. We have asked additional questions based on the earlier responses. We now have this new wave of responses back, and we are looking at the situation.

We are concerned about internalization, and we are concerned about the spread of internalization, not just from that market, if it were allowed to exist, but the spreading into other markets.

Mr. INSLEE. Well, just by way of editorial comment, on our main street on the hustings of the small towns we represent, credibility really is an issue and we hope that you will focus on that and give this very exquisite care.

Second question. I have spoken recently to some leading managers of leading hedge funds and they have expressed real frustration at timeliness of execution of their orders.

Sometimes they believe that the exchanges have ignored orders, sometimes they have cited inefficiencies. And so I, kind of, have two questions.

Is it time for some changes to the pass-through rule?

And secondly, why has the SEC not responded to, what I understand—I haven't seen the paper on this, but I have been told—

there are hundreds of complaints regarding unfulfilled orders, particularly with Amex?

If that is not correct, perhaps you can tell me. And if so, tell us how we get those complaints responded to.

Mr. DONALDSON. Yes.

Well, again, this gets to the heart of the analysis that we are doing now, in terms of the viability of that rule and the negative aspects of the rule given the trade-throughs that are occurring.

Also, the positive aspects of that rule that ensure that the best price is available no matter what the market is; and I think you are right at the heart of the debate, if you will, and we are aware of some orders that don't get executed.

We are also aware of orders that, because of the system, have gotten the best price that they otherwise probably might not have gotten.

So, we have to work at that interface and figure out how it should be adopted, given the circumstances we are in right now.

Mr. INSLEE. How can such a basic situation not get remedied?

Just getting an order executed, if there are hundreds of these, how can the SEC not solve problem in a timely fashion?

It is an honest question, because what I am told is that there are hundreds of these without a resolution of this. Maybe you could help me understand why that can't get resolved, number one.

And number two: why don't you attempt to resolve these complaints and get to the heart of what has happened here before you go forward on the BOX situation?

Mr. DONALDSON. Again, I think you have to put the whole situation within the context of our overall marketplace and how it is functioning.

With all the hundreds that may not get executed, there are millions that do get executed in the best interests of the public.

I think it is not that we were not looking at this, it is not that we were not paying attention to it; it is just that it is a very tough question.

And we have got the best brains that we can assemble, not just at the SEC, but elsewhere, in terms of trying to figure out what is the right answer.

Mr. INSLEE. Clearly, we are hoping now we do see aggressive action. I come from Washington State where William O. Douglass got the bowl rolling on the SEC and we would like to see that tradition followed. And we hope that you move in that direction.

Thank you, Mr. Chair.

Chairman BAKER. Thank you, Mr. Inslee.

Mr. Crowley?

Mr. CROWLEY. Thank you, Mr. Chairman for the hearing today. Thank you, Chairman, for coming before us and spending the better part of the morning with us.

I would like to redirect the focus, just a bit, of the hearing away from the issues like speed and intermediaries and refocus back to the special interests of the investor.

I am not speaking of the professional investor, something I think the New York Stock Exchange has done remarkably well and demonstrated throughout its prestigious history of 211 years.

As you can tell, I am from New York City, and I am a little jealous about the Exchange and concerned about the image that has been portrayed of it most recently. What basically the tenet behind the trade-through rule, as I understand it, was to produce the best price.

Do you, Mr. Chairman, believe that that has been successful, as far as the public interests are concerned? And, has it worked? I would like to have your personal, maybe, your opinion about this.

And additionally, in light of the emerging ECNs and the speed, again, would you favor amending or discarding the trade-through rules so that speed could take precedence over price?

And do you believe that such an action, again, would be in the interest of the investing public?

Mr. DONALDSON. As I said before, the trade-through rule is one that we are looking at right now. What the trade-through rule does do is to encourage the display of limit orders.

And the display of limit orders is what makes for depth in the market. So that the trade-through rule also assures, or helps to assure, that the best price is being received.

Now, when you get to the definition of some other definition of best price, such as best execution, then you bring into play a more complex attitude as to what is the best execution.

And that kind of attitude might have with it somebody that is willing to have a fast execution and sacrifice price. And that is the issue we are talking about. That is the issue of the goals and desires of different types of investors.

I would be very hesitant to sacrifice the opportunities to getting the best price entirely in order to have fast execution. But it is a trade-off. It is a compromise. And that is what we are working towards.

Mr. CROWLEY. That is a fair answer. I appreciate that.

At the last market structure hearing we had, you mentioned that the floor-based market, such as the NYSE, often enjoy greater liquidity than non-floor-based markets. Could you expand on that and just give some examples and cite some examples of that?

Mr. DONALDSON. Yes, I can expand on it colloquially, if I may, in the sense that, if we were in a market where there are large amounts of stock for sale, let's say, and there are not enough bids around, I think the floor has a mechanism for creating liquidity to offset the temporary imbalance between sell pressure and buy pressure there.

And I think that that liquidity is, in many instances, the liquidity that is created by human beings, if you will, whether it be the specialists, their floor brokers or whatever, who bring that liquidity in the marketplace to offset an imbalance.

And I think that creates a market that has less fluctuation to it and that is in the interests of the investors. So I think that that is really what I am talking about.

And, again, not to repeat myself, I think that the trick here is to create a New York Stock Exchange, if you will, or a marketplace, that is able to have the speed associated with, let us say, an ECN, but yet has this liquidity aggregating capability that the auction market has.

Mr. CROWLEY. You would also take by this sort of the discussion that has gone on that the stock exchange has not invested in technology, none by the huge—you are stating that—but it is almost—and they have invested billions of dollars in upgrading technology at the stock exchange.

Mr. DONALDSON. There is a lot of rhetoric about technology, and I think there have been—in the competitive juices flowing out there—characterizations of an antiquated system with people running around and no technology. And, of course, that is not so.

Mr. CROWLEY. And it isn't that you all are very competitive.

Mr. DONALDSON. There is tremendous technology at the New York Stock Exchange. And it happens to be blended with human judgment. And I think that characterization of the stock exchange is pretty unfair in this day and age.

Mr. CROWLEY. Thank you.

Chairman BAKER. Gentleman's time has expired.

Mr. Meeks?

Mr. MEEKS. Thank you, Mr. Chair. And being last and knowing that I am in the way between letting the Chairman go about his busy day, or keeping him here with us, I will be very brief, so that we can get to the next panel.

I have, basically, two quick questions.

And like Mr. Crowley indicated, I am from New York and both the New York Stock Exchange and NASDAQ are very important to me and to the city, and I do believe the station.

But as we move on, the key to a lot of this is transparency and credibility and to make sure that there is confidence from the investors, et cetera.

And I know that the New York Stock Exchange is currently investigating several specialists for getting in between trades for their own profit.

My question basically is, "Do you see this as just an isolated incident, something that will be a rarity? Or something that is occurring on a frequent basis?"

Mr. DONALDSON. I think you bring up an important point. I am being reminded that there is a pending investigation on this issue that I will be directly involved in as a member of the Commission.

But let me just say that I think there is a difference between an attack on the specialist system as a system versus the specialist system when some of their rules have been violated.

In other words, if the allegations in the investigation are true and there has been a breaking of the rules, that is one thing. That goes to enforcement of the rules and perhaps it goes to changing the rules.

But in terms of throwing out the whole system because the rule has been broken, that is something that, I think, one has to examine very, very carefully.

Mr. MEEKS. In essence, throw the baby out with the bath water.

My other question is that we know that recently John Reed announced that he is reforming the Board of the Directors of the New York Stock Exchange.

And he is reforming it so that no members will be on the board of directors and securities industry's representatives will be only on

an advisory panel with no jurisdiction over regulatory or compensation issues.

To what extent will you; will the SEC be weighing in at all on the restructuring of the New York Stock Exchange board? What role would you play in that, if any? Will you oversee it? Have any comments in that regard?

Mr. DONALDSON. Yes. The bottom line is that the SEC has to approve the rules that will come from the reorganization of the stock exchange. Net, net, that is what has to happen.

Now we have tried to be of what help we can be in helping John Reed contend with, what are, I believe, necessary changes in the governance system of the stock exchange, that is to attempt to address this issue of separating out by virtue of reporting mechanisms: the regulatory side of the house with the market side of the house.

And I think that John Reed and his advisers are moving in a direction that seems to make sense, I haven't seen the final proposal yet, but the direction that they are moving in is to, in essence, have a totally independent board without any attachments or alliances or to listed companies or floor members or floor brokers or seat holders and have the reporting mechanism of the regulatory side of the house, plus some other reporting mechanisms: compensation, director selection and so forth, report into that entity.

And then to have an entity on the side that would have representation from all the constituencies that would serve as an advisory board to the independent board.

That is a general thrust of what is being proposed, I believe. But we will have to see the details of that because we, in the final analysis, have to approve the implementing rules that will come from these suggestions.

Mr. MEEKS. But will you be involved and how then will you, Mr. Chairman? Will you be involved?

Are you going to just wait until you see what the proposal is before you either approve or not approve it? Will there be conversations in between, which I think that I am hearing is taking place?

And you will be giving some guidance as to what you think is acceptable or not acceptable, while they are trying to develop the plan?

Mr. DONALDSON. We are anxious to get involved, we are anxious to be of what help we can be in looking at proposals before they go out for votes.

And I think that has been the tradition of the SEC: to try and anticipate objections, if you will, that we might have before they are out to be objected to in a general publishing of the rules. So that is the route that we hope we are on.

Mr. MEEKS. Thank you, Mr. Chairman.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Meeks.

Mrs. Maloney?

Mrs. MALONEY. Thank you, Mr. Chairman. It is always an honor to welcome an outstanding New Yorker to the committee and to congratulate you on your public service. It has been an outstanding one throughout your life, and private service.

I would like to touch on a part of market structure that I don't believe has been talked about in this hearing.

And that is the recently issued report from the SEC on the hedge fund industry. And it was reported that they are now roughly 6,000 to 7,000 of these unregulated investment tools and some have suggested that there should be a register at the SEC.

And I agree with the commentators that these funds do make a positive contribution in greatly increasing the liquidity in the markets.

But at the same time, I am concerned about the increasing trend towards hedge funds which lower the financial resources needed to get into the hedge funds and the movement into retail of the hedge funds.

I want to know, do you support making hedge funds available to retail investors?

Mr. DONALDSON. As you may know, we have had the hedge fund industry under review for over a year. We have done as much research as we could accomplish.

We have had groups of hedge fund people brought together on all sides of the issue: advisers, hedge fund managers and so forth.

And as a result of all of that, the staff has presented the commission with a report and with a series of recommendations, perhaps the most prominent of which is that we register the advisers to these funds under the Investment Advisers Act.

And I think that that recommendation is based on several considerations.

Number one is, what you say, which is that there are upwards of 6,000 to 7,000 of these funds out there right now. They account for somewhere around $600 billion to $700 billion; they are growing like a weed.

And we have no right in most of these funds to go in and find out what is going on. Why do we want to go in and find out what is going on?

Two reasons: one is we want to understand the accounting that is being used, we want to understand the pricing that is being used. We don't want to interfere with investment techniques or disclose those to other people; proprietary techniques, but we need to have the right to go in.

Perhaps more important than that, in my view, is we need to understand what impact these funds are having on the marketplace itself.

It has been said that hedge fund investors are wealthy investors and they can take care of themselves.

That may or may not be so, but what we can't afford to have is a hidden impact, if you will, in terms of some of these techniques that act against the best interests of our functioning markets. And that is why that proposition was put forward.

We have put it out for further comment to address the issue of small investors without a means test investing in hedge funds.

I think a good case can be made for that, if there is complete transparency within the hedge fund itself.

And, as we move toward these so-called funds of funds, funds of hedge funds, where you have weekly or monthly pricing, it is all the more important to assure that the small investor knows what

he is or she is buying. And knows how the internal holdings are being priced, et cetera.

Mrs. MALONEY. But that is pretty much important that transparency. And I truly do believe that our capital markets run on trust as much as they do on money.

And therefore, your position is incredibly important to the country and the trust the country will have in financial markets.

So, as one who represents the New York Stock Exchange, I have been there many times and I have met with some incredibly impressive people and the technology and oversight into the building, I would say, is State of the art.

And you have touched on this earlier, but I would like to have it clarified; given the controversies at the exchange, you stated earlier, I believe, that you support this self-regulation model in general.

But my question is, "Should the job of regulating the Exchange be separate from the job of running the Exchange's business?"

I know that the NASDAQ is split from the NASD, possibly these are different models, but you, I believe said you support self-regulation, but do you believe the head of the exchange should also be the head regulator?

Mr. DONALDSON. Well, again, I think that the issue is the definition of separation. And to me, separation can run a gamut. It can be a physical; an ownership separation with a regulator out there, somewhere.

Or it can be an internal structure that separates the reporting function such that the regulators are reporting to an independent board and reporting not to the same people that are running the exchange market, as a business.

And, I think, the stock exchange is now wrestling with where they come down on that.

And I think we have an open mind toward a solution that solves the issue of potential conflict of interest between the business side and the regulatory side.

Mrs. MALONEY. Well, my time is up and I thank you, Mr. Chairman.

Thank you, Mr. Donaldson.

Chairman BAKER. I thank the gentle lady.

Mr. Chairman, we express our appreciation for your courtesy of your time today. It has been very helpful for the Committee's considerations.

I am advised that a number of members, who could not come back, that wish to ask additional questions requested that the record remain open so their submission of questions to you could be, perhaps, responded to by correspondence at a later time, but would be made part of the official committee record.

With that one caveat, and I also will forward my own correspondence relative to a question concerning the window during which some of these ongoing analyses may be completed for the Committee's planning for next year.

Understanding that we would very much like to have the Commission's recommendations finalized, in order, for the Committee to act upon where it is needed to be acted upon within a reasonable time constraint, next congressional year.

So, we do appreciate your courtesies and your willingness to participate. Thank you very much, Sir.

Mr. DONALDSON. All right. Thank you.

Chairman BAKER. Thank you.

And I would ask that the participants in our second panel, please, come on down.

I welcome each of you to the Committee's hearing today. All of your formal statements will be incorporated into the official record. We would request that your oral testimony be limited as best possible to five minutes.

And I do expect members in and out as the course of the hearing proceeds, but all of your recommendations will be reviewed by members of the Committee as we go forward.

At this time, I would like to recognize Mr. Robert H. McCooey, Jr., President and Chief Executive Officer of the Griswold Company. Welcome, sir.

Please proceed at your leisure.

STATEMENT OF ROBERT H. MCCOOEY, JR., PRESIDENT AND CEO, THE GRISWOLD COMPANY

Mr. MCCOOEY. Thank you, Chairman Baker.

Chairman Baker, Ranking Member Kanjorski and members of the Subcommittee. My name is Robert McCooey.

I am a proud member of the New York Stock Exchange and President and Chief Executive Officer of the New York Stock Exchange member firm The Griswold Company.

Griswold is an agency broker executing orders for some of the largest mutual and pension funds in the United States.

Thank you for inviting me here today to testify in connection with your review of the capital market structure here in the U.S. I would like to highlight some aspects of my previously submitted written testimony.

As a floor broker, I know the important role that we play in the price discovery process. The competition between orders represented by brokers at the point of sale on the floor helps to ensure fair, orderly and liquid markets.

The floor broker serves as a single point of accountability and information not found in dealer markets and ECNs, and who employs the most advanced technology to support his or her professional judgment.

The floor broker relies upon a digital hand-held communication device which receives the orders, transmits the reports, and engages in an ongoing dialogue with the client through the use of digital images.

All this is done without ever leaving the trading crowd.

With regard to the trade-through rule, when trading is allowed to occur outside of the National Best Bid and Offer, the NBBO, two investors are being disadvantaged. The bid, or offer, that has been posted, as well as the buyer or seller who receive the inferior price to the NBBO.

To amplify this, I would like to offer the following example. A buyer posts a bid of $49.05 to buy 5,000 shares of XYZ.

In the absence of a trade-through rule, a 5,000 share trade might occur at $49. In this instance, two investors are not being afforded the full protection that they deserve in the marketplace.

The seller who sold the stock at $49 did not receive the highest price that was bid for those shares in the market. Further, the buyer with the $49.05 bid was left unfilled.

This investor posted the best bid in the marketplace and was ignored.

I do not believe that this is the message that we want to disseminate to the investing public. Unfortunately, this is a message that is being promoted by some of our competitors.

In my opinion, some of those who have sat here before you prior to today, have engaged in competitive positioning rather than factual presentation. Simply stated, the facts do not support their contention of the unfair system that stifles competition.

At the New York Stock Exchange, we welcome competition. However, that competition must be one that ends with the customer's order being executed at the best available price.

The reality is that the NYSE posts the best price nearly 94 percent of the time in all listed securities. That is the single reason why we have been successful.

With 30 co-sponsors, Chairman Mike Oxley sponsored H.R. 1053 to eliminate legal impediments to the quotation in decimals for securities transactions in order to protect investors and to promote efficiency, competition and capital formation.

So what happened along the way to the penny? Has something changed in these few short years? Do investors no longer deserve to save money?

Is it acceptable for fiduciaries to accept a worse, though speedier, price for stocks that they are buying and selling on behalf of the millions of shareholders who have entrusted them with their hard-earned money.

There is, however, an answer to these questions about the penny.

I think that somewhere between common sense and today client interests have been abandoned and replaced with those that are self-interested.

During our difficult period for both the financial markets and broker dealers, client interests have been secondary to the economic interests of firms and market centers.

It is not time to encourage or reward this type of behavior. Quite the contrary, the message of the investor first should be quickly and firmly reinforced.

And pennies add up. If fiduciaries are advocating their responsibility to achieve the best price available, the impact to their shareholders is very significant.

If an investment manager decides to forego better, available and accessible prices for the sake of speed, the negative cost impact to the fund shareholders is in the millions of dollars.

For a fund trading average of 10 million shares a day, to receive that incremental penny of price improvement on all those shares, multiplied by 250 trading days in a year, the savings are $25 million.

This is the shareholder's money, the investor's money. Furthermore, I am giving you only one example, from one fund manager.

Across thousands of funds and billions of shares traded, the negative impact to investors cannot be ignored.

Finally, how do we ensure that the national market system benefits all investors? We begin with what has worked for years and continues to work today.

At the NYSE, we provide investors with the best price, liquidity, transparency, accessibility, the highest certainty of an execution, protection of customers' orders and their interests.

At the NYSE, we will continue to change, adapt and innovate to best serve our customers and to fulfill our commitment to producing the highest levels of market quality.

In all that we do, we take pride in the fact that we always place the investor first.

Thank you.

[The prepared statement of Robert H. McCooey can be found on page 155 in the appendix.]

Chairman BAKER. Thank you very much, sir.

Our next witness is the President and Chief Executive Officer, Security Traders Association, Mr. John Giesea.

Welcome, sir.

STATEMENT OF JOHN GIESEA, PRESIDENT AND CEO, SECURITY TRADERS' ASSOCIATION

Mr. GIESEA. Thank you, Chairman Baker and members of the Subcommittee.

I would like to take opportunity to introduce the Security Traders Association to you, which we refer to, and I will refer to, as STA, which is a 70-year-old organization comprising 6,000 individual professionals involved in the purchase and sell of equities securities.

Representatives of our organization are on the buy side and the sell side and participation is included amongst members of ECNs and exchanges.

Myself: my background is simply 23 years at Kidder, Peabody, 10 years with Advest in senior trading and management positions and two years in the current position as President and CEO of STA.

Our sole focus as an organization is market structure.

And the imposition, or the hosting, of the market structure hearings held by the SEC in November and December of last year, formed the basis for a desire on our part to comment on issues that we felt we could add value through our experience and expertise.

The outcome of that process was this report, "Fulfilling the Promise of the National Market System," which I have asked to be submitted along with my written testimony.

In preparation for this report, we examined the origin of the National Market System in 1975 and discovered the five principles that this National Market System was built upon are as valuable today as they were at its inception.

And the Congress got it right: those include transparency, economic efficiency, ease of the best execution, fair competition and the opportunity to transact without need of an intermediary.

The fact is, 28 years later, we need to update, but we need to retain those principles, but update market structure.

Three areas I would like to touch on quickly and that are included in our testimony include fragmentation, regulation and access fees.

We have heard mention of fragmentation a couple of times today, and in and of itself, we would represent that fragmentation is not positive. On the other hand, competition is the foundation upon which our business has been built.

We have succeeded in encouraging and thriving on competition. And competition in the area, particularly NASDAQ stocks, through use of the UTP, Unlisted Trading Privileges, has created fragmentation in the marketplace.

Excuse me.

Alone, fragmentation represents a hurdle to overcome. The hurdle is overcome through linkage and connectivity. We believe that there should be linkage to all markets, that includes automatic and immediate execution.

In the area of regulation, we are pleased with the SEC's SHO short sell regulation, which promotes and suggests the rule that crosses markets.

This is the principle that STA recommends for basic customer protection rules, as well as basic trading rules, such as short sell and sub-penny quotations. Market share gains by a market center should not have root in less regulation.

Thirdly: access fees. We have long opposed, our association has long opposed, the imposition of access fees which was done as part of the 1996 Order Handling Rules by way of a footnote.

This footnote allowed one segment of the market to charge a fee for accessing its quotes. We think this is unfair and represents a hidden cost to investors and should be eliminated.

We praise the NASD, on behalf of NASDAQ, for putting a cap of three mils, a suggested cap of 3 mils, 0.003, on an access fee; though we believe we are still three mils away from where it should be in order to be transparent and fair.

Next, I would just like to make a quick mention of the area of liquidity. Through my conversations and my work, we need to be sure that when we talk about liquidity we make no assumptions.

And another thing the SEC did in their short-sell rule is they allowed for a provision for the most liquid, 300 stocks, to be exempt from the bid test. It recognizes there is a difference in the trading of stocks.

G.E. on the New York, Intel on the NASDAQ seldom, if ever, need an intermediary. They trade efficiently and transparently.

But those other stocks that are less active benefit greatly through the activity of the liquidity provider, called a specialist or a marketmaker. And I think that this is something that the SEC needs to be careful of in putting regulation in place, not to assume that all stocks trade alike.

Then, lastly, in terms of the ability for young, worthy companies to raise capital, we believe liquidity is an important part of that.

And we believe that with issues involving investment banking and research over the past year, together with liquidity, issues and lessons, liquidity, date of market structure, that the underwriting and the ability to raise equity capital is challenged and we don't

want that to happen for the U.S. economy or for job growth within the United States.

STA is honored to be present today and is proud of its tradition of representing the principle, "What is good for investors of all kinds, is good for our market and good for our members."

Thank you, to the Committee for the important work that you do and, in particular, Chairman Oxley, Chairman Baker, Ranking Member Frank and Congressman Fossella for having joined STA in its spring conference earlier in this year.

And we appreciate the opportunity to be before you today.

[The prepared statement of John Giesea can be found on page 111 in the appendix.]

Chairman BAKER. Thank you, sir.

Our next to be heard is Mr. Thomas M. Joyce, President and Chief Executive Officer, Knight Trading Group.

Welcome.

STATEMENT OF THOMAS M. JOYCE, PRESIDENT AND CEO, KNIGHT TRADING GROUP, INC.

Mr. JOYCE. Chairman Baker, Ranking Member Kanjorski, members of the Subcommittee, thank you for inviting me to participate in this hearing regarding the structure of the U.S. equity markets.

My name is Tom Joyce. I am the CEO and President of the Knight Trading Group, the largest, independent market maker in the industry. To give you some sense of context, on a typical day, we do over a million trades and well over a billion shares of equity trading.

I have been a member of the securities industry for the past 25 years, including 15 years at Merrill Lynch. I have been both a student of and an active participant in the debate over market structure for over a decade.

In fact, many of the issues you are hearing about today were examined back when I was the Chair of the Quality of Markets Committee of NASDAQ, and when I served as a member of the New York Stock Exchange's Market Performance Committee.

Having worked both in the option model and the electronic model, I believe I can bring to you a unique perspective on market structure.

Although U.S. equity markets remain the most vibrant and liquid markets in the world today, they are facing severe problems.

The conversion to decimals has successfully narrowed spreads, but it has also sparked a series of unintended consequences that have resulted in new trading challenges for investors.

It is our hope that these hearings will lead to a fair market structure in an even-handed application of rules that we all seek.

There are three main points I would like to convey to the Committee today. The first is on the issue of best execution.

We at Knight strongly believe that the definition of best execution resides with our clients. To attempt to define a single standard of best execution is simply wrong footed. Each client has different needs at different moments. It is our job to know our clients and to perform accordingly.

Thus, the standard of best execution should be defined by competition on a level playing field with the proper transparency associated with it.

As for transparency, each month we publish on the web data regarding the quality of our executions, scored against statistics such as speed and price improvement. They are located in the 1-5 and 1-6 statistics.

This public disclosure, linked to our competitive efforts, is the right approach. Ultimately, if we fail to give our clients what they want, they will vote with their feet. And conversely, as we do a good job for our clients, they will reward us with more business.

The second main point I would like to make is that there needs to be certain high standards established across the various trading venues.

Again, decimal trading has been a success on many fronts, but many of the trading rules that are being applied to our markets today date from the era of eighths.

I would suggest action on the following issues: sub-penny trading; flatly, it should be banned.

Virtually no other retail product in the United States trades in units below a penny. The only beneficiaries of sub-penny trading are professional traders who can use it to game the system.

I would submit to you, you couldn't find a single traditional retail investor who would ask for sub-penny trading.

If people complain about so-called penny jumping that supposedly takes place in the New York Stock Exchange, think about how divisive mil-jumping, tenth of a penny, jumping is in NASDAQ.

To me, this is a race to the bottom. Therefore, I strongly suggest we go back to penny spreads and establish it as a standard of our markets.

The trade-through rule: it exists today to protect price priority across markets. The time has come to adapt the rule to the common market dynamics. When volume aggregated at an eighth or a sixteenth, it made sense.

Now, however, in an era of decimal trading, we see volume dispersed over 100 price points, thus, aggregating it is more difficult.

More importantly, the speed at which many markets trade today make the quote literally flicker. It is not uncommon in highly liquid stocks, like Microsoft, for example, to see 50 quote changes in a second.

In an environment like this, we firmly believe that a de minimis exception of three cents around the quote should be the core component of a new trade-through rule.

Third, we also believe that it is time to establish standards for intermarket access.

The best examples of the need to introduce change here are the unlisted trading privileges NASDAQ and the Intermarket Trading System in the listed market. In each case, you often see the conflict between electronic trading and the old, open-outcry manual systems.

We believe, if markets are expected to interact, then certain minimum standards of connectivity must exist which would allow for electronic access up to some practical trade size.

And the third, and last, point I would like to make is that market-makers matter.

For too long now, ECNs and other ATSs have been receiving most favored nation status in certain regulatory circles, highlighted by the abilities of ECNs to charge fees, while we as market-makers cannot.

We would like to see changes to the current status quo that favors this class of execution providers. A privileged class protected not by competitive superiority, but by regulatory authority.

Now many stocks, particularly the largest stocks, do benefit when trading on ECNs. Admittedly, they do a fine job there.

But as one gets further down the liquidity spectrum without capital committed by market-makers, many nit cap and small cap stocks would trade with much greater volatility and much less liquidity.

This in turn, diminishes the ability of these companies to see additional, or initial, capital through the U.S. Capital Market System.

Marketmakers supply an enormous amount of liquidity in this segment of the market. We believe that if they continue to walk away from this segment of the market, it is a long term negative for the market, for issuer companies and investors.

If it continues unabated, I would argue that ultimately, the capital formation process of the economy could be negatively affected.

In conclusion, give us a level playing field in which to compete in different market centers and a regulator who will establish the appropriate rules set and apply it evenly.

In any market we believe we can compete with any model any time. And ultimately, it is the investor, our end user, who will dictate which service provider succeeds and hopefully, in our case, flourishes.

So on behalf of Knight, I would like to thank you for the consideration of our testimony. And, of course, we would welcome any comments and questions at the appropriate time.

[The prepared statement of Thomas M. Joyce can be found on page 119 in the appendix.]

Chairman BAKER. Thank you, Mr. Joyce.

Our next witness is Mr. Michael LaBranche, Chairman, Chief Executive Officer and President of LaBranche and Company, Incorporated.

Welcome, Sir.

STATEMENT OF MICHAEL LABRANCHE, CHAIRMAN, CEO AND PRESIDENT, LABRANCHE & CO., INC.

Mr. LABRANCHE. I would like to make some general observations about the New York Stock Exchange; what it means to the American economy and especially in light of all the press that is being given to it.

One of the things about the New York Stock Exchange that many people do not understand that it is the world's largest electronic stock exchange.

People don't realize how much technology goes into a trade on the New York Stock Exchange. More than 90 percent of the orders that are delivered to the New York Stock Exchange are delivered on our Super DOT system.

We also have a specialist system which is coupled with that which adds capital to the system, which has human capital as well as financial.

We have a market that has the most liquidity of any market in the world. You can see statistics about how many orders get executed in certain markets.

I can tell you that 100 percent of the market orders that are transmitted to the New York Stock Exchange are executed. That is unparalleled liquidity that has not been equaled in any other marketplace.

The United States Capital Markets are by far the best capital markets in the world and the New York Stock Exchange has played a very large part in the development of the Capital Markets.

It has a direct effect on everybody in this country, in terms of the development of the economy and the standard of living.

One of the things that we hear about very often, especially in the press today, is about the importance of speed versus price. And that is a very important concept to us, and I think it is a lot more complex than simply the trade-through rule.

Remember that speed is really access to the market, but the price is by far the most important thing.

Even for large institutions they are ultimately representing individuals and they are representing individuals that go about their work, or go about go on vacations, or do things in their daily routine.

They don't know if their orders are being executed in two seconds or 12 seconds or 20 seconds. What they care about is what their returns are at the end of the year. And so, to them, the most important thing is to have a mechanism that gives them the best price.

So, when we talk about the trade-through rule, I think it really goes beyond simply talking about a trade-through rule.

I think the most important thing that we have to talk about here today is the fact that we have to be able to send the message to the investment community and investors that their interests are being looked after.

That broker's primary responsibility is to always find the best price for the people they represent.

I think if we go down the road where people believe that their brokers are not necessarily looking for the best price, but more broker-convenient, then I think we are going down a path that might lessen investor confidence.

So, whether the trade-through rule gets reformed, I think it is very important that the message remains that brokers are looking after the interests of their clients.

When we talk about speed, one of the things about the New York Stock Exchange that people tend not to realize is that it really is a much more efficient and quick execution platform.

It is, to me, irrational to think that anybody would want to give up a better price for five or 10 seconds, but the fact is that 50 percent of all orders 500 shares or less that are executed on the New York Stock Exchange are executed within five seconds.

Beyond that, institutional orders that run between 2,000 and 10,000 shares on the New York Stock Exchange are executed on an average of 18.7 seconds. Now, that would compare to the same execution and time span on an ECN of 61 seconds.

So we are a very efficient market, we are a quick market. And we are always looking for the best possible price.

The other important thing that I think we should talk about here—the point I would like to make—is the talk about what does the auction mean. Now the auction is very often confused with a busy trading crowd. But the auction is not an anachronism.

The auction is what allows investors of all kinds, whether or not they have a 100 shares to buy or sell, or a million shares to buy or sell, the auction is what allows them to interact in the market in a fair way.

It means that if you are willing to pay the highest price for a stock, if you have one share to buy or a million shares to buy, you get the first chance to buy it. If you have one share to sell, or a million shares to sell, you get the first chance to sell it.

That is the basic benefit that the public derives from the auction.

And I think that if you think about it that way, people take that basic right for granted, but the auction, in essence, represents the Bill of Rights for investors.

I think the New York Stock Exchange works very hard to make sure that that auction is adhered to in a way that protects investors in all circumstances, whenever possible.

The specialist, we are a very important part of that auction, but we are one piece of the puzzle. We represent one constituency on the New York Stock Exchange.

We are an important part of it, but we function within that community working to make sure that people get the best possible price.

So, thank you.

[The prepared statement of Michael LaBranche can be found on page 145 in the appendix.]

Chairman BAKER. Thank you very much, sir.

Our next participant is Mr. Kevin Foley, Chief Executive Officer, Bloomberg Tradebook.

Welcome.

STATEMENT OF KEVIN FOLEY, CEO, BLOOMBERG TRADEBOOK

Mr. FOLEY. Thank you, Mr. Chairman, members of the Subcommittee.

My name is Kevin Foley, and I am pleased to testify on behalf of Bloomberg Tradebook.

Bloomberg Tradebook is owned by Bloomberg L.P. Bloomberg L.P. provides multimedia, analytical and news services to more than 175,000 terminals used by a quarter of a million financial professionals in 100 countries worldwide. Bloomberg News is syndicated over 350 newspapers and on 550 radio and television stations around the world.

Bloomberg Tradebook is an electronic agency broker serving institutions and other broker-dealers.

We count among our clients many of the nation's largest institutional investors representing, through pension funds, mutual funds and other vehicles, the savings of millions of ordinary Americans.

Bloomberg Tradebook specializes in providing innovative tools that subdivide large orders into small orders and eliminate the traditional barrier between the upstairs market and the trading floor market.

Through that technique we bring upstairs liquidity directly into contact with small retail orders, with the options market-makers and with program trading order flow.

In the process, we consolidate what has been a fragmented market and we increase the efficiency of the market.

Our clients have rewarded our creativity and our service by trusting us with their business, allowing us regularly to trade more than 180 million U.S. shares a day, about 20 percent of that in listed shares; and a third again as much business in international shares.

We have consistently been among the top five providers of liquidity to NASDAQ's supermontage.

And a large percentage of our listed order flow is executed using our technology and through New York Stock Exchange members on the floor of the New York Stock Exchange.

The House Financial Services Committee has long been concerned with potential conflicts that might lessen market efficiency or compromise investor protections.

The Committee has devoted significant time and effort to addressing some of these conflicts in the context of analysts, accountants and others.

Recent conflicts relating to the New York Stock Exchange provide an opportunity to make the U.S. equity markets more competitive.

New York, in 2003, looks strikingly like NASDAQ in 1995. The SEC made decisions on market structure in the mid-1990s intended to combat conflicts of interest in the NASDAQ market by enhancing transparency and competition.

Specifically, the SEC's 1996 issuance of the Order Handling Rules permitted electronic communications networks to flourish, benefiting consumers and the markets generally.

Indeed, the increased transparency promoted by the SEC's Order Handling Rules and the subsequent integration of ECNs into the National Quotation Montage contributed to NASDAQ spreads narrowing by nearly 30 percent.

These, and subsequent reductions in transaction costs, constitute significant savings that are now available for investment that fuels business expansion and job creation.

Chairman Oxley has asked, "Why does New York control 80 percent of the trading volume in its listed companies when NASDAQ controls only about 20 percent of the volume in its listed companies?" And we think the answer is simple.

There have historically been a series of barriers to competition in the New York listed markets that have the effect of centralizing order flow and impairing intermarket competition, and depriving the market of the opportunity to test whether competitors could

bring the same benefits to the New York Stock Exchange investor as they have to the NASDAQ investor.

To unleash competition and promote an efficient market, we believe Congress and the Commission should consider the following: repeal the trade-through rule.

This 20-year-old rule protects inefficient markets while depriving investors of choice. Today's lead editorial in the Wall Street Journal, we believe, is on target.

Facilitate display of New York listed stocks in the Alternative Display Facility. The ADF has been providing a competitive spur to the NASDAQ's supermontage and serving as a check on anticompetitive behavior.

We believe the ADF could provide a similar tonic for the New York Stock Exchange listed market.

Ensure the oxygen supply. The Financial Services Committee has long accurately held that market data is the oxygen of the markets, but the oxygen supply has been imperiled in the past and is imperiled today.

Before the 1970s, no statute or rule required self-regulatory organizations to disseminate market information to the public or to consolidate information with information from other market centers.

Indeed, New York claimed an ownership in market data and severely restricted access to that market information. Congress responded by enacting Securities Act Amendments of 1975.

These amendments empowered the SEC to facilitate the creation of a National Market System for securities, with market participants required to provide, immediately and without compensation, information for each security that would then be consolidated into a single stream of information.

Bloomberg, in consultation with two distinguished economists, has submitted to the SEC a discussion paper entitled, "Competition, Transparency and Equal Access to Financial Market Data."

The paper delineates the ways in which exchanges, in the absence of structural protections, may abuse their monopoly power over the collection of market information to the detriment of consumers.

Those concerns were borne out this year when the New York and its liquidity quote "proposal" sought to make available data that had inadvertently been made less transparent by decimalization, but only under contractual terms that would have required vendors to display it in a way that disadvantaged other market centers, as well as prohibiting data vendors from integrating it with data from other markets.

The promise of enhanced transparency at the heart of decimalization would have been thwarted.

Under Chairman Oxley's leadership, the Congress has pushed hard for decimals, and that additional transparency has indeed, benefited investors. We applaud the SEC for striking down New York's restrictive contracts and liquidity quote.

The controversy underscores, however, that policymakers should give strong consideration to updating the vendor display rule. Otherwise, investors will actually have less useful information than existed prior to decimalization.

Ensuring the oxygen supply also entails greeting efforts to create new property rights in data, with a measure of skepticism.

As this Committee well knows, in past Congresses, both New York and NASDAQ have supported legislation which would create a new and unprecedented property right in factual data, including even government-sponsored monopoly market data.

In hearings in the last Congress, the Financial Services Committee heard a number of market participants express strong opposition to this proposal.

A few weeks ago, H.R. 3261, the Database and Collections of Information Misappropriation Act, was introduced and referred to the House Judiciary Committee.

The legislation is sufficiently contentious that an incredibly diverse array of public and private entities; ranging from the U.S. Chamber of Commerce to the American Civil Liberties Union, the Eagle Forum to the Consumers Union, have already voiced strong opposition.

While some market data has been exempted out of the proposed legislation, the bill continues to potentially bar access to much other information critical to market participants, hence, may well have important ramifications for market transparency.

Finally, in the NASDAQ market: access fees. Bloomberg has long believed that ECN and NASDAQ access fees should be abolished for all securities and all markets. And we have urged the SEC to take this important step.

In conclusion, this Committee has been in the forefront of the market structure debate. I appreciate the opportunity to discuss how these seemingly abstract issues have real-world impact on investors.

Policymakers should set rules, but encourage competition and let the market do the rest. And the New York Stock Exchange will successfully adapt, as it has for more than 200 years, and investors will benefit.

Thank you.

[The prepared statement of Kevin Foley can be found on page 88 in the appendix.]

Chairman BAKER. Thank you, Mr. Foley.

And our next witness is Mr. Edward J. Nicoll, Chief Executive Officer, Instinet Group, Incorporated.

Welcome.

STATEMENT OF EDWARD NICOLL, CEO, INSTINET GROUP INCORPORATED

Mr. NICOLL. Thank you, Mr. Chairman. I will be mercifully brief.

Mr. Chairman, Ranking Member, members of the Subcommittee; thank you for inviting me to testify today on the issue of how to reform our market structure and promote competition in a changing market environment.

Americans have long known the value of competition and that without it, a monopoly can strangle innovation and lead to higher prices. This is, after all, why we have anti-trust laws.

But when it comes to securities markets and trading in New York Stock Exchange-listed securities in particular, we have a reg-

ulatory regime that stifles competition and undermines investor choice.

Let me be clear, I am not here to tell you how the New York Stock Exchange should change. Rather, I am here to tell you that we must modernize the regulations that govern listed trading, so that there are finally robust and competitive alternatives to the NYSE.

If investors want to use a system of floor-based trading, conducted through specialists, they should have that option. If they would prefer to take advantage of modern technology that has led to more efficient electronic marketplaces, they should have that choice as well.

So what impact would real competition have on our capital markets? Fortunately, we have two real-world examples to use as our guides.

First, when NASDAQ dealers effectively wielded exclusive control of the NASDAQ market, it ultimately resulted in the Justice Department's allegations of fraud, price fixing and collusion by these dealers.

To address the situation, the SEC wisely avoided micromanaging the existing NASDAQ structure and, instead, in 1997, opened the NASDAQ and its dealer system to competition.

The defenders of the old system argued that the dealers provided a valuable public service by providing liquidity and they questioned how investors would benefit from increased competition.

But the impact of the new competitive marketplace imposed upon them by the new SEC rules is lower spreads in the NASDAQ stocks, as well as lower overall transaction costs that have saved investors hundreds of millions of dollars in just a few short years.

Here is the second example. Up until 1999, each options exchange exclusively controlled trading in a given option.

For example, Dell options were traded on the Philadelphia Stock Exchange and nowhere else, while IBM options were traded exclusively on the floor of the CBOE.

While there was competition on each floor, there was no competition between markets. These monopolistic practices led the Justice Department to seek to enjoin the options markets from colluding to restrict competition.

Again, the defenders of the status quo said that the so-called fragmentation that would result from competition between exchanges would ultimately hurt consumers.

But independent studies conducted after competition between exchange was imposed showed that spreads in the options market decreased by between 30 and 40 percent practically overnight, while transaction costs also dropped; both to the benefit of consumers.

Today we find ourselves facing a similar situation: the NYSE enjoys a monopoly on trading NYSE-listed securities. But as recent events indicate, this monopoly may harm investors.

Past experience shows us how to solve this problem: we must identify and eliminate barriers to competition.

In the case of the NYSE, the single, greatest barrier to competition is the trade-through rule. The overall effect of the trade-through rule is to undermine the competitive advantages of an electronic marketplace: speed and certainty of execution.

Those who would preserve this regulatory advantage for the NYSE make two basic arguments in defense of the trade-through rule.

First, consumer protection: defenders of the status quo argue that the trade-through rule ensures that investors will receive the "best price." But then how do you explain the superior execution quality in NASDAQ market where there is no trade-through rule?

Indeed, SEC-mandated statistics indicate that overall execution quality for investors is higher in NASDAQ-listed stocks like Microsoft, where there is no trade-through rule, than it is for IBM in other New York Stock Exchange-listed securities where the rule is in place.

One other reason that investors still receive quality executions in NASDAQ stocks is that brokers have a duty to get their customers best execution. In fact, due to the existing broker duty of best execution, the trade-through rule is unnecessary.

And ironically, actually contributes to investors seeing the inferior prices and inhibiting beneficial competition.

The second defense of trade-through is that there is nothing wrong with the short delay that it engenders if investors receive a better price.

But the supposed trade-off between speed and price is based on a faulty premise. And that is, that the best advertised price is the best price. Often, it is not.

As I discuss in my written testimony and in the attached documents, it is often the case that investors will end up with a worse price if they delay their execution attempting to chase the best-advertised price.

Sure, if investors know with certainty that they are going to get a better price in 30 seconds, they would always accept the delay.

The problem is that there is only the possibility of receiving a better price. If there is only a possibility, what should an investor do? The answer is it depends on the investor.

Once again, investor choice and competition should be our guiding principles. Moreover, the SEC has already provided us with a glimpse of what a more competitive future in listed trading would look like.

Specifically, we have, in effect, been without the trade-through rule on three Exchange-Traded Funds, or ETFs, for over a year, including the most widely traded security in the country: the QQQs.

The SEC's 2002 decision to ease the trade-through rule on ETFs has been an unqualified success. It has fostered competition without producing any of the harmful effects that defenders of the trade-through rule so often complain.

As this Committee knows, Congress set out two clear principles in 1975 market reform legislation that are as important today as they were nearly three decades ago.

The National Market System must not favor any particular market, or market structure, and it should foster competition between markets. Through such competition and the innovation it drives, investors receive the best value.

As we have seen with NASDAQ and the options market, allowing any one market to exercise monopoly control, ultimately leads to abuse and increases transactions costs for investors.

Competition on the other hand, leads to narrower spreads, lower transaction costs and investor choice. That is why we urge the repeal of the trade-through rule.

Thanks again for the opportunity to testify and I would be happy to answer any questions.

[The prepared statement of Edward J. Nicoll can be found on page 163 in the appendix.]

Chairman BAKER. Thank you, Mr. Nicoll.

Mr. LaBranche, I understand your statement in defense of the trading practices at the New York exchange is centered primarily on assuring investors in 96 percent of the cases, that they are actually executing the sale at the best price available in the market at the time.

Rarely do I rely on newspaper accounts to ask a question but, the Journal, in its editorial, raises a point that I would like your opinion on because it goes to the heart of that defense of the Exchange.

Specifically, in referencing the New York exchange and, "The frustrating opportunity for mischief occurs when the best price appears on another exchange," meaning not the New York.

"Instead of routing the order to that exchange, specialists on the NYSE have been known to ignore it. The number of NYSE trade-through violations is huge."

Again, this is the paper.

"ArcaEx, an electronic exchange that competes with the big board has found the NYSE has ignored better prices on ArcaEx up to 7,500 times in a single week."

Is there any legitimacy to that claim? Or how do you respond to that accusation?

Mr. LABRANCHE. I would——

Chairman BAKER. Hey, Mick, get your mike on.

Mr. LABRANCHE. Thank you.

Well, I think that that editorial brings up some very important, interesting points.

One of the things about the trade-throughs that exist is that ITS was designed 25 years ago. It has really outlived its usefulness.

And what I think we have today is much better technologies available to us that would allow, say, smart order routing systems to take the place of ITS. But, still it would be kept in mind that you are still trying to get the best price.

On ITS, we have to wait up to 30 seconds to execute a trade. Now, in the investment world when we are trading in pennies, that makes it almost impossible to keep the market going; to wait 30 seconds for someone to give you an answer.

Chairman BAKER. So, you are now saying speed is the most important asset?

Mr. LABRANCHE. No, I am saying that I think that speed, when it is possible, is important, but obviously, most important price is there.

But what happens is that during that 30 second interval, the market moves and the other market cancels. The cancel rate on these trade-throughs, or what you are referring to, is very high and other markets tend to cancel because the markets move during that 30 seconds.

Chairman BAKER. But as to the principle-based statement of this section in the article—and I am just trying to get at the core—that I agree, I am defensive of the individual shareholder's right to buy or sell in the most advantageous, transparent opportunity we can construct and whether the current body of regulation enhances or inhibits that capability.

I see a value in the specialist system, I truly do. I don't know that the value occurs in every transactional relationship, however. I do believe speed is important.

But at the very core of it all, if I know of another opportunity to sell someone shares at a higher price and I am on the New York exchange and I don't exercise that fiduciary responsibility, is that occurring? Is it a rarity? Or is it commonplace?

What is your view of that world?

Mr. LABRANCHE. Well, specialists make every effort to get to another marketplace if there is a better price. And that is a fact and that is a rule.

Chairman BAKER. And, if that is the case, then this editorial, or article, must be——

Mr. LABRANCHE. Because markets change very quickly. And I think that Mr. Joyce referred to how quotes blur in decimals, and that happens.

And we are talking about pennies and it makes—remember, we have moved from trading in eighths to sixteenths to decimals fairly quickly.

We moved from eighths to sixteenths, which lowered the spreads by 50 percent and then in one day we made a transformation to decimals. So, instead of having 16 points of price entry for every dollar, there are 100.

And we are, largely, using some of the same systems. The ITS system was put in place 25 years ago when we traded in eighths. And, in my opinion, it has really not kept up with the times.

In some ways, I think that the Journal makes a very good point. I think they should probably scrap it.

It is not up to me to do it, but I think that we need a better technology.

I think smart order routing systems would be much better for investors, much better for the marketplace. Then you just choose what is the best market from on top of the markets.

Chairman BAKER. Thank you.

Mr. McCooey, again, your general disposition to view the exchange, obviously and understandably, is the best place to do business as an individual investor, within the NASDAQ where there isn't a trade-through rule effective.

How do those two worlds sit side by side?

Does that mean—in a careful reading of your statement—that the NASDAQ, therefore, is inefficient and those who trade through its avenues are not getting their best price on trades?

Mr. MCCOOEY. Well, Chairman, I want to preface it by saying that we are not here to say that one market is better than the other. We support the NASDAQ market and obviously, support the New York Stock Exchange market.

We think that for the equity markets to be as strong as they are in the United States, we need both markets to be as strong as they

can be and to try to enhance them through the use of technology, through the use of regulation, where necessary, and to be able to make those markets as transparent and as investor-friendly as they possibly can be.

The NASDAQ market, I believe, grew up in an age and a time that allowed certain regulatory changes, regulatory—it allowed things to happen on the NASDAQ market that would never have been permitted on the New York Stock Exchange.

NASDAQ also has a lot of stocks that we like to talk about: the Microsofts and Intels and Oracles of the world.

But as Mr. Joyce alluded to, there are plenty of other stocks that are secondary and tertiary stocks where market-makers are necessary, and best price is what the investor is looking for. And market-makers compete based upon best price.

So when you begin to compare apples to apples, if we want to compare the highest, most liquid stocks on New York versus ones on NASDAQ, we may have an argument and a comparison there.

But I think we need to make sure that we are serving the investor across all markets, across all stocks the best we possibly can.

And I know that we do that on the New York Stock Exchange, since I don't trade on NASDAQ, I can't, necessarily, comment as to how they do or do not function, in terms of making sure that they are getting the best price for their customers.

But I still think they should be.

Chairman BAKER. Well, and even with that explanation, I don't understand how elimination of the trade-through rule, if you had an order flow requirement to the best price, wherever that occurs, would operate to the detriment of the individual investor nor represent any significant challenge to the New York exchange, because of the breadth and liquidity of that market.

You are a winner now; you would still be a winner no matter what the rules are.

Mr. MCCOOEY. Oh, I don't think that that is the case at all. I respectfully disagree.

In the example that I gave you in my oral testimony, we will begin to have things such as court d'arbitrage; people that know that there is a nickel bid and buy it from a customer for $49, while at the same time, using electronic systems to hit the $49.05 bid.

We will have more internalization, we will have more fragmentation. We will have broker dealers using this as an opportunity to use customer orders for their benefit, not for the investor's benefit.

I think that one of the things we are missing here is that we are giving the intermediary the choice in this case; where that order goes to, how it gets executed, not the customer.

And I have also heard about things such as, opt-out, so that customers in their opening documents for accounts can decide that the broker decides where the order goes to, whether they want speed, or they can opt-out of price.

The other side of that argument is the contra-side. In my argument: $49.05 bid. That person didn't sign an opt-out document. That person had the best price in the marketplace, that person was ignored. Is that the message that we want to send?

Chairman BAKER. I am going to come back to this, but I don't want to go far beyond my time.

Mr. Kanjorski?

Mr. KANJORSKI. I don't disagree with you very often, Mr. Chairman, but I can think of examples, exactly as he put it there.

Part of our problem we are all talking about it and not getting down to it. For instance, we are all wanting to do the best things for the investor, and we think we can define the investor as one singular entity making up investments.

We know that is not true. You have institutional investors, you have smart investors, you have dumb investors, you have rich investors, poor investors. You have got investors that may be fragments of people's imagination for all we know.

We can't sit with that simpleton.

But the thing that disturbs me most: it seems to me the reason we are into this issue is that we have had some significant, substantial problems.

Everything from Enron on through to Mr. Glasso's problem recently that have shaken up—and the mutual fund industry—they have shaken up confidence in the market, and the investors is a large class in the market. I am interested in that.

On the other hand, I am starting to see some problems here that everybody who has a pet peeve or a pet advantage that they can thrust into this has now gotten the attention of the Congress.

And it is all nice and good and I am interested in all your competitiveness problems, but quite frankly, that is not what this Committee has been addressing itself to.

What we are trying to do is make sure that the end of the day we can clean all the laundry of all the markets, all the exchanges, to have it reflect its excellence as the best commercial and capital market in the world. And I think it does that.

And when we have this interplay suggesting that you are not getting the best price here, you are not getting the best price there, unless we do this or that, it confuses respect for the marketplace.

Now my question is—toward anybody that wants to take it—do we have a technology problem here that can be handled within the institutions themselves? Or do we have a substantive value problem here?

Have we had a breakdown of morality, of ethics, in the system? And that would go a long way to just how much time and how it has evolved.

And the reason I am asking this is, look, I keep referring back to this: you fellows are all capitalists and free marketeers. And maybe with the exception of one or two of you, you are all asking the government to come in and be the big brother here and regulate the capital markets of this country. You may get your wish and be damned for it.

I mean, be very careful what you are asking for here.

You are giving us a tremendous opening here to rush in and start to decide some, I think, competitive issues; that there are going to be winners and losers simply because one person relies on one technology over customer tradition in another technology.

And I want to use—I am not much at football or sports, but I do, while I was thinking here—if I have got a good passing team and speedy ends, I am going to want five plays on my side of the team.

If I have got a heavy, chunky line and a damned good heavy runner, I am going to want three downs. And we are going to argue that all night.

The rules are drawn. That is not up to the Congress to constantly change the rules because of some—unless it is substantial electronic change, which, if you don't address the rules—and then, we shouldn't be changing the rules—unless you want us to take over the exchanges, unless you want government in your boardrooms, then reexamine what you are doing.

So I say again, take it easy on this. Take getting any comparative advantage because it will service your industry or what you can do.

I am interested—any of you want to say—do we have a substantive ethics or moral question in our markets today that we haven't had before?

Or is just this the squeeze of the bubble, and everybody wants to find fault and try and get themselves in a reorganized position? And that the market is still fairly good or very good and it will work itself out.

And the institutions themselves and the existing authority, the SEC, will be able to handle all these things.

Anybody want to take that question?

Mr. JOYCE. Yes, I will.

Mr. KANJORSKI. Yes, Mr. Joyce you were—and I was going to say when you were speaking, you introduced yourselves and said 15 years ago you were sitting on all these committees and everything—boy you must have really done a hell of a poor job, because, you know.

Mr. JOYCE. That is why my hair is gray. Jet black 10 years ago.

Mr. Kanjorski, thank you for introducing those topics. I would like to briefly address both of them.

First of all, I don't know—clearly, technology has changed. As Mr. LaBranche referenced, the ITS system literally hasn't changed that much. Clearly technology is leaps and bounds ahead of where it was 10 to 20 years ago.

The issue isn't so much around what kind of technology is being or isn't being utilized. Clearly, depending upon the rule set that is engaged, you can find the technology to cure your problems.

So the issue, I would suggest, is that in the past few years, we have changed the way we trade equities in the United States: from eighths to sixteenths to decimals.

And when I say that the quote flickers, I literally mean the quote flickers. If you tried to get that nickel bid that Mr. McCooey referenced, by the time you go for it, it is gone. And then it is back and then it is gone.

So the issues around the market that, I think, in the rule set that we are addressing today and would like to see the SEC get engaged on it, is the fact that fundamentally, the way equities trade have changed, and most due to the fact that decimals have been introduced into the process.

Decimals have provided an enormous amount of benefits, but they simply change the way you trade. So, rule sets should, I think, be adapted to take that into account.

As for your second question about ethics, I would strongly, strongly emphasize that I have not seen, in any dealings, any kind of change or diminished ethics that are applied to this industry.

When you look at what happened with the corporate world a year or so ago—was it 10 or 15 institutions; I would bet it wasn't a whole lot more than that—and yet, there are 3,000 companies listed on New York, there are 3,000 more listed on NASDAQ.

I think the statistical selection you are looking at is very small compared to the thousands and thousands of companies that are run extraordinarily ethically.

And when it comes to members of this industry and how they run their business, once again, you are looking at, so far, I have seen a handful of mutual funding complexes that have done things they regret, no doubt.

There are more mutual funds available to the investor than I think there are equities available. I think there are at least 3,000 mutual funds available.

So once again, we have a case where there is a small, small subset of people behaving improperly.

And to me, where I sit, and having watched this industry over the past several years, the amount of ethical behavior that is evident everyday is one that you would be very proud of.

Mr. KANJORSKI. Very good. Congratulations.

I think we need more of that. We are scaring the hell out of that public out there. They are starting to look at Wall Street like nothing but a bunch of gangsters.

"You belong in Lewisburg, not in New York." And that is not true, that is not my impression. I have been looking at this part.

The one thing is that—maybe the third part of my question—I have a hard time figuring out what my question was too, so I don't doubt that anyone up there on the panel would—but, what I am asking is—I recognize the technological changes and the conflicts that that causes, potentially in deciding, particularly in the competitive range—but would you rather the Congress of the United States take it upon itself to decide things like whether we are going to replace the ITS lines or whether we are going to let the exchange make that decision?

Do you really want us in your bedroom?

Mr. JOYCE. Sir, to be completely honest with you, I think it is the SEC's responsibility to do that.

I was very encouraged to see Chairman Donaldson here today discussing his thoughts and some of the issues they are willing to address. I think it has long been the mandate of the SEC to deal with this.

Having said that, I think some congressional oversight is often a good thing. It can often move issues forward.

And I think for that, I applaud you in getting involved.

Mr. KANJORSKI. Mr. Foley?

Mr. FOLEY. Yes, thank you.

I agree with what Tom said that we heard—I thought a tremendous amount of wisdom from the Chairman earlier today and it, I think, gives one great confidence that the SEC is taking its time, but not taking too much time, to address a number of complicated issues, that sort of weave together and are best addressed together.

So, I think, we are not here before you today to ask the Congress to ask, but I had noted some people jotting things down when members of this Committee said, "Weeks, not months" or "Months, not years" and so forth.

And the very fact that we are holding hearings today focuses attention on some of these issues.

I don't think you see people here debating whether the offense should receive three downs or five downs, based on——

Mr. KANJORSKI. Yes we are. You would be one of them, Mr. Foley.

Mr. FOLEY. No.

Mr. KANJORSKI. You talked about the policy rule.

The policy rule is important because you are primarily in the electronic business in an electronic market. And I understand that, and there is nothing wrong with that.

But if you are on the other side of a more conventional market, traditional market, that seems to be fair to have a pass-through rule. It protects, quote, the investor, whoever that six-pack carrying guy is out there.

But the reality is why shouldn't we make it a principle that all equity trades on all markets are considered before a buy or a sell is made, if it is technologically possible?

Mr. FOLEY. Well, if it is technologically possible to do it in a way that does promote finding the best execution.

Here is the thing: yes, everyone responded to an incoming message from another market center, immediately. I don't think there would be anyone against a trade-through rule and against the obligation to find the best price.

I know of no market-makers, ECNs, exchange system that doesn't seek the best price in its own system. And it doesn't, for those of us whose systems go out to each other, doesn't seek the best price that is available in a reasonable timeframe.

Mr. KANJORSKI. But——

Mr. FOLEY. Technology has evolved. It appears to benefit, not investors, but to some players in the market, for the rules which existed for one purpose that is not relevant anymore.

Mr. KANJORSKI. Okay. And I tend to agree with that.

And what I am asking you under self-regulatory authority, do you guys have the capability of being mature enough to regulate yourself, or do you need a cop, or do you need the federal government there to do it?

I would like to think, as a lawyer, that the bar association can throw out the rascals. I would hope that in the exchanges and in the broker trading business you can identify the rascals.

And you, incidentally, have a great tool in a new electronic revolution to find out who they are, either before or after the act occurs and the evidence is not destroyable. Why can't you self-regulate and get the people out?

But there are a lot of good people. Hard, honest working people are doing their best in all these markets and throughout this country that are getting injured now by this over-tow that there is something evil. "There are evildoers."

Gee, I heard that expression somewhere. But there are evildoers on Wall Street.

And that doesn't play to my side of the aisle here, but I am just saying I am not a big person that likes to identify capitalism as the enemy of the people. I don't think it is. And on the other hand, I don't think regulation should always be the mantel of the Democratic Party.

I think there is a good reason to believe that in mature people, regardless of what business or what profession they are in, they can generally police themselves.

And we should only come into play when there is a breakdown of that reality and that we have to get involved, then we have to be heavy cop. Other than that, get the hell out of the way and let the place handle itself.

Mr. FOLEY. I couldn't agree more.

And we believe strongly in self-regulations and believe that the level of ethics and integrity in our industry is very high.

You are going to need a light touch but, nevertheless, a role to play from the SEC for addressing issues that fall between the different markets.

And I think one of the things that has gone on over the past couple of years is that a number of the issues regarding market structure, that is, rules that say you can't do certain things, that many of us don't think are necessary anymore.

Those issues have, sort of, taken a back seat, while other issues that have gained more attention in the newspapers have occupied the policymakers and the lawmakers and the press.

And many of the issues that we are raising here today are issues that have been sitting on the back burner and come forward now that the Commission appears to have the time and the focus to devote to them.

And we are all very happy—I think I speak for all the panelists—we are going to be very happy to see a resolution, one way or another, on a number of these issues that have been outstanding for the past couple of years.

Mr. KANJORSKI. Good enough.

Chairman BAKER. Ms. Hart?

Ms. HART. Thank you, Mr. Chairman.

I want to let Mr. Kanjorski go on, I liked some of his comments. This is good.

Thank you for your patience, I know today's hearing has been going on for a while. I just have one question I want to ask of two of you: Mr. Joyce and Mr. LaBranche.

If the New York Stock Exchange were allowed, or were forced, excuse me, to require multiple specialists for each security, can you tell me your thoughts about that? Do you think it would be harmful?

Do you think it might bring more competition to the market and alleviate some of the concerns that Mr. Joyce raised in his testimony?

We can start with Mr. Joyce.

Mr. JOYCE. Thank you, Ms. Hart.

In point of fact, as you can imagine, as the largest dealer in the NASDAQ market, and frankly, one of the larger dealers in the New York Stock Exchange-listed arena, we clearly believe that com-

peting specialists, competing dealers—specialist is a dealer as a marketmaker fundamentally—provide a lot of benefit.

They particularly provide an enormous amount of benefit as you get into the secondary and tertiary stocks. That liquidity segment needs more, not less, sponsorship.

So we do believe that the competing specialist model is a successful one, as is evidenced by the success of NASDAQ. As an old, listed block trader, incredibly enough—the back of my hair was black, I actually traded listed equities with Mike on a regular basis—I think the specialist system itself, is fine too.

To introduce competing specialists: I wouldn't necessarily leap to do that, unless there was a better body of knowledge on it. But speaking from the NASDAQ model, clearly the NASDAQ competitive model works well, and I would suggest it would work equally well in the New York Stock Exchange system.

Ms. HART. Okay. Mr. LaBranche?

Mr. LABRANCHE. Yes, well, it gets clearer that markets are going to be competing against each other. And I think one of the things we heard today was that technology should be allowed to access pools of liquidity.

It should be allowed to compete. And I certainly embrace that concept.

When it comes to the New York Stock Exchange as a model, we do use a specialist model, but the most important thing about the Stock Exchange is that orders compete with each other and they are centralized to one point of sale.

So they interact with each other and that is a very important concept. It is the one market that has orders competing with each other.

Now the specialist is charged with the responsibility to make sure that those orders compete with each other in a fair way; that they aren't being ignored or anything else. So, that is our charge.

That is what the New York Stock Exchange has designated a specialist to do. He has to buy when no one else wants to and sell when no one else wants to.

So if you had competing specialists, who are you going to pick? You buy it, or you buy it or something like that. And that might be something to consider.

But what we really don't want to do is fragment the order flow. Because when you fragment order flow, you lose sight of what the best price is currently. And I think that is important.

In terms of ECNs, for example, we hear a lot about ECNs. We are not anti-ECN, we are pro-ECN. We receive a lot of order flow from ECNs. ECNs look to us as a resource.

It is our job to be price competitive so they can access our markets in a very cheap way.

There is one large ECN that is very famous that sends 90 percent of their listed business through us. They send it to us because we do it so cheaply.

So, that is order flow that is competing with each other.

So, in answer to your question, I think that what we really need to focus on is making sure that we have a centralized market where orders compete with each other.

Mr. JOYCE. Ms. Hart, if I could just elaborate a little bit.

Ms. HART. Sure.

Mr. JOYCE. When you asked the question, I was conceptualizing competing specialists on the floor of the New York Stock Exchange.

You should be aware that the third market that NASDAQ sponsors—in which we are actually a very large participant—we do, for example, make markets in IBM and in AOL.

So, we, within the third market realm, under NASDAQ's banner, we do make markets and listed equities that directly compete with the specialist making markets on the floor of the New York Stock Exchange.

So that competing specialist model, you could say, currently does exist.

Ms. HART. Just not on the floor.

Mr. JOYCE. It is not within the floor, it is not intra, it is inter.

Ms. HART. It is inter. Okay.

Thank you.

I yield back.

Chairman BAKER. Thank you, Ms. Hart.

Ranking Member Crowley?

Mr. CROWLEY. Ranking by default, I will accept. There are many ways of obtaining positions of leadership.

Thank you all for your testimony today and for your spending a better part of your day here.

I have been following this issue very closely, as probably many of you know.

I had a couple of questions and I would also, if I can, make some reference to the Wall Street Journal editorial that appeared today.

Mr. McCooey, we have all heard reports questioning the value of the specialist and whether they offer a value or not.

And as an agency broker executing trades on behalf of your clients, do you feel a disadvantage by specialists? And do you believe specialists add a value to you or to your clients or not?

Mr. MCCOOEY. I don't believe specialists disadvantage me at all. In fact, it is the advantages of the specialist at the point of sale, providing liquidity and acting as a catalyst that allows me to get my business done on behalf of my customers.

And let me elaborate a little bit on that.

When I talk about liquidity, what I mean, is when I have a buy order coming in and finding that I have 25,000 shares to buy, and there are only 15,000 shares residing on the specialist book at the offer price, that the specialist will be able to step in there and provide the liquidity: the other 10,000 shares that I need to complete my order; to be able to be satisfy my customer at that price.

That is important when they put their capital up.

But even more important and really undisclosed to the world, because they don't understand what dynamics sometimes happen at the point of sale, is the fact that the specialist acts as the catalyst in disseminating valuable information to every party that comes into that trading crowd: who the buyers and sellers are and have been, but even more than that, is able to find the contra-side to my trade.

And what I mean contra-side, if I am a buyer, the specialist will, instead of having me immediately trade with the offer side of the

market, would inform me that a brokerage firm may have been a seller for the past hour, day, week.

And we can contact that brokerage firm very quickly; allow them the opportunity to sell stock for their customer, a natural seller, where natural buyer and seller are meeting in the marketplace with very little market impact.

And we are able to get that trade consummated.

And I am using my digital and hand-held device at the point of sale, communicating with my customer, telling them exactly what I am doing. I am using my cellular telephone from the point of sale; communicating with my customer.

And we were able to get that done for the benefit of my client, as well as the for the benefit of the seller, who was willing to sell stock at that price, but may have just completed their sell order and may just be getting more stock for sale and doesn't want to be disadvantaged by dislocation in the market that may happen very quickly.

If I go in and the last sell is $49 and the liquidity is at $49.25, I may not want to purchase that right away, but I want to give my buyer the opportunity to do better. And that is what we do each and every day.

And the specialist is an important part of that. And my customers find his information and his liquidity very valuable in the executing of my orders.

Mr. CROWLEY. Thank you.

Mr. LaBranche, in the evolution of the stock market, and there has been a lot of discussion about the ECNs and their, one day potentially, replacing the New York Stock Exchange as we know it today in terms of human touch, in many respects, and a lot of discussion about specialists being dinosaurs in this evolutionary process.

Can you comment on that?

Mr. LABRANCHE. Well, I have been hearing that——

Mr. CROWLEY. You don't look like a dinosaur, but I——

Mr. LABRANCHE. Well, thanks.

But, I have been hearing that comment for a long time.

In fact, there was a very widespread discussion back in the 1970s about how the New York Stock Exchange only had a few months left to go and seats went down to $35,000 back in 1978.

So when you think of it in those terms, you realize there is always going to be challenges.

What the New York Stock Exchange needs to do is listen to its customers, its constituencies. Make sure that the buy side, for example, is getting their say of what they think needs to be done; the sell side as well.

We need to integrate our system, take technology, ECNs, other ATFs and incorporate them so they can access our pool liquidity. And, I think, that is a very important concept.

A lot of people think of ECNs as crossing networks, but they are communication networks, and they allow people to communicate with pools of liquidity. And we are a very large pool of liquidity.

So, to get back to where we were before: if we make those transitions, if we are a resource to everybody that we can be, we will be around for a long time.

If we just dig in and don't change, then that is going to be a different question. But we don't have any intention of not changing or listening to people and we are going to keep changing to make sure that we are able to be a resource for almost everybody.

Mr. CROWLEY. You are adapted to the evolution.

Mr. Chairman, I know my time is up, but can I just make a comment about the editorial that you alluded to?

In the very next paragraph—and again, we are taking out of context, some of these things—the editorial went on to say, "Best price is only one of the many ways of best execution. The issue of speed and best price, et cetera, and what companies may be are looking for, what the professional trader is looking for."

But this experiment that is taking place, I know that Chairman Donaldson, not once in his three hours of testimony mentioned the success story that the Wall Street Journal is alluding to.

And, I think if you ask my constituents and the investors in your markets that are my constituents; I think if you ask them, the bottom line is price to them. At the end of the day, the retiree, the pensioner, wants to know that they are getting the best price for what they are paying. And I think that is the bottom line for our constituency.

I understand we have broader constituencies here in this Committee, as well. And the industry is important to us. But the bottom line is the investors.

And people who are making up more and more, a larger portion, of the investment in your markets are the average mom and pops that we represent.

So, I just wanted to make that point for the record.

And I thank you all for your testimony today.

Chairman BAKER. Thank you, Mr. Crowley.

Just welcome, come back at it one more time, from the perspective, not necessarily of just the editorial or news article, "Reference by Numbers."

Maybe try just a different team this time, Mr. Nicoll. In reading through your written testimony, it is pretty clear, at least to me, that you believe that the current system does not automatically result in the best price for the individual, given the regulatory constraints which within the market must now function.

You referenced the SEC trade-through rule suspension on the three ETFs in 2002 and that the QQQ is now the single most actively traded security in the entire U.S. marketplace as evidence that it must somehow meet the needs of investors.

It seems, to me, that you should view the market, not as a particular exchange or a group of premier exchanges, but the entirety of every trading opportunity is the marketplace.

It also appears to me that there are rules or regulatory constraints that keep information even from flowing but, perhaps where it does flow, it may not be a requirement to act on that information.

Am I reading your testimony correctly that your presentation of the trade-through rule or some of the other constraints, if they were, at least modified, if not entirely eliminated, would facilitate trading at the best price as opposed to what now is the consequence of trading under the current regulatory body of rule?

Mr. NICOLL. I think that is exactly what we are saying.

And, what we are saying is, and we want to push back at everybody that keeps repeating this mantra that the choice is between speed and price.

When you choose not to avail yourself of what appears to be the best price in an advertisement because you wonder whether you will get to the store or you will get to the place where it is advertised, whether or not you will actually get the best price, but you may, perhaps, choose to buy the product at what appears to nominally be a higher price someplace else.

Because of your ability to actually execute the transaction, you are acting in your best interest and buying the product at what you believe is the actual best price.

And what we are saying here is that the trade-through rule requires that people go after the best advertised price and leave behind what they know to be the best price. Our customers are not intentionally trying to execute their orders through our system at a worse price.

They believe that by executing an order for a penny less than an advertised price on the New York Stock Exchange, that they are, in fact, representing their customer's interest, performing their fiduciary duties in accord with their best execution responsibilities and doing their best job.

And, in fact, when they are precluded by regulation from accessing the best price and are forced to chase what appears to be the best price but what is, in fact, often not, they feel that the regulations are out of date and don't serve their needs as fiduciaries in performing their duties to get best execution on behalf of their customers.

There isn't a trade-off between price and speed. Speed is an element in evaluating what the best price is in a trade.

Chairman BAKER. One other piece that I picked up out of your written comment, with regard to definition of fragmentation; as opposed to that being necessarily an adverse market consequence, others might define it as more stringent competition.

And that if we are looking for the free flow of information so that all market participants meet the needs of their customers in the most efficient and timely manner, but yet required to pursue the highest price offered in the broader market.

I think that is what I hear members saying, both sides of the aisle, pro-New York Exchange, pro-ECN, whatever the deal perspective might be, we all want one thing.

We want the market to function efficiently, we also want it to function fairly and we also want to assure, that when Customer X or Customer Y pursues an opportunity in the marketplace, that they get the best terms available at the time of that execution.

Now, if those are the precepts on which we all agree, then we can do the critical analysis if the current system really provides for that. And that, Mr. LaBranche, was the reason why I brought up that article in the first place.

It appeared on the surface of the article. It was going at the heart of the Exchange's line of defense, was that in most cases, 94 percent, the individual gets the best price of execution.

And it seems to me it ought to be a factual determination, whether they do or whether they don't, we ought to be able to get to the bottom of it, dig it out, and then ask the SEC to come up with a plan that is responsive.

And I agree with Mr. Kanjorski, we don't want to put a board, I think, governmental representative on every board in America. I am a strong advocate of a whole lot less government than what we pay for.

But I do believe that this discussion, today, and the Committee's review of this, may help facilitate broader market changes that, otherwise, may be very difficult to achieve.

And let me offer Mr. Crowley, or Ms. Hart, any further comment?

And let me express my deep appreciation to each of you. This has been a long day.

And I appreciate your patience in hanging in there and we certainly will leave the record open for a few days if you have further comments or recommendations to the Committee, we would be most appreciative to receive them.

Thank you.

Our meeting is adjourned.

[Whereupon, at 2:26 p.m., the subcommittee was adjourned.]

A P P E N D I X

October 30, 2003

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"Reviewing U.S. Capital Market Structure: Promoting Competition in a Changing Trading Environment"

October 30, 2003

Thank you, Chairman Baker, for holding this important hearing today. There are few issues that come before this Committee that are as fundamental as how investors buy and sell securities.

This Committee's first market structure hearing earlier this month was quite encouraging. I was pleased with Mr. John Reed's candid and forthright testimony. There is no question that he has volunteered for a difficult job under trying circumstances. But I believe he is the right leader at the right time to right the ship at the New York Stock Exchange.

More importantly, I also believe that the recent controversies at the NYSE present a real opportunity to enact significant and long overdue reforms to the market structure of the U.S. An opportunity like this does not come around often, and we must not squander it.

I have long taken the position that investors benefit from multiple market centers that engage in vigorous competition based on speed and certainty of execution, anonymity, and price. The government should not decide which markets prosper. In fact, it is our obligation to ensure that no markets have regulatory advantages that inhibit competition and artificially preserve market share.

Accordingly, it is imperative that we revisit the rules and regulations that have governed the markets for more than a quarter of a century. What Congress did in 1975 may have made sense at the time, but those policy decisions were made prior to the greatest technological advances in human history.

It makes no sense whatsoever for these outdated regulations – which preceded, for example, the advent of Netscape by two decades – to be controlling in today's high-tech environment.

With the change in leadership at the NYSE, I believe we are at a crossroads with an important opportunity to implement changes that will foster competition and make our markets more efficient. The Intermarket Trading System is an outdated construct that has outlived its usefulness. It is time to revamp the system that links

our markets so that market forces and modern technology can replace bureaucratic, restrictive regulatory systems.

There has been a great deal of talk about the need to reform the ITS's "Trade-through rule." I expect we will hear from virtually all of our witnesses here today about this issue. It is clear to me that the time for reform is long overdue. Price simply is not the only factor to be considered for purposes of best execution. The trade-through rule, as it stands, is standing smack in the way of more efficient, competitive markets.

The viability of the SRO model depends on whether it is one that uses regulation to protect investors and promote confidence, or to hamper competition. We will examine many of those rules today.

Central to today's discussion will be the role of the specialist. It has been widely criticized as monopolistic, anachronistic, and unnecessary in today's highly evolved technological environment. John Bogle, who has appeared before this Committee several times, calls it "a dinosaur that maintains as much of a monopoly as you can get in this world." Even more alarming are the allegations of wrongdoing that call into question the integrity of this model, and whether it creates an irresistible opportunity to put the specialist's interests ahead of investors'. Critics of decimal pricing argue that decimal pricing has led to front-running and other trading violations. I would argue that these abuses are symptomatic of a flawed structural system, not the result of decimal pricing – which has resulted in what one commentator has called a "billion dollar tax cut for investors." It is time to review the specialist system; today's hearing is an important step toward that end.

I have long argued that market data, the fundamental information about securities prices that is the oxygen of our marketplace, needs to be free from ownership interests that could restrict access to that data. It is essential that we ensure that investors have guaranteed full access to this information.

I am eager to hear from SEC Chairman Donaldson this morning. In particular, I look forward to learning how he intends to expedite consideration of all the pending issues before the Division of Market Regulation. As many petitioners know all too well, the failure to make a regulatory decision is often worse than an adverse decision.

I want to commend Chairman Baker for putting together an excellent and balanced second panel of witnesses and look forward to hearing their testimony as well. I yield back.

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STATEMENT OF THE HONORABLE WM. LACY CLAY
Before
The Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

"Reviewing U. S. Capital Market Structure: Promoting Competition in a Changing Trading Environment"

Good morning, Chairman Baker, Ranking Member Kanjorski, Members of the committee and witnesses.

I am encouraged by the reports of the plans to reform the New York Stock Exchange (NYSE). Especially encouraging were the proposals for a smaller, independent board, made up of outsiders. This is needed to eliminate any suspicions of conflicts of interest.

There is a clamor for other changes that go beyond the board. State pension funds and mutual funds are demanding radical changes in the way that business is done. They believe that too much of the profits are lost to consumers through the payment of excessive commissions, too high stock prices, and billions of dollars yearly in costs passed on to investors by those who control the markets.

It cannot bode well for investor confidence in the market when one hears that specialists on the New York Stock Exchange (NYSE) often times sell investors stock from their own inventories at inflated prices when the client could buy it cheaper directly from another seller.

It cannot bode well for investor confidence when investors find that specialist firms, according to a study done by a Washington, DC research boutique, "posted pretax margins of 37% to 61% last year compared to 9.7% for the big Wall Street firms."

According to the most vocal critics, the mechanism called the "trade-through rule prevents funds from choosing less risk over a possible better price on the NYSE. The clamor for the elimination of this rule is louder than all of the rest of the complaints combined. This could give customers a tremendous saving, but also cause firms like Merrill Lynch to suffer enormous financial blows.

Restructuring will have to address all of these problems and more to insure competition in the market is on an even playing field. The trade-through rule does give the specialists on the floor an almost monopolistic grip on prices of stocks. How this is addressed is going to be key to whether structural reforms are cosmetic or real.

Mr. Chairman, I ask unanimous consent to submit my statement to the record.

Statement of the Honorable Rahm Emanuel
U.S. House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
October 30, 2003

"Reviewing U.S. Capital Market Structure: Promoting Competition in a Changing Trading Environment"

Mr. Chairman, thank you for holding this important hearing to assess the changing capital markets trading environment. I appreciate that our distinguished guests, including Securities and Exchange Commission Chairman William Donaldson, have taken the time to share their views with us on these issues. As a former investment banker and member of a public company's board of directors, I am keenly aware of the need for a robust, flexible regulatory system that promotes competition while protecting investors and ensuring efficiency and transparency.

The rise of Electronic Communication Networks (ECNs), decimal pricing and demutualization, while in some cases creating greater efficiency, has strained existing market structures and outpaced regulators. Given the marketplace's evolution, it is prudent for the SEC to closely and deliberately evaluate issues such as fair access, access fees, price protection, market data, and the effectiveness of the current Self-Regulatory Organization (SRO) system. Throughout this process, we should recognize there are some areas that are straining market structures but others that are working well. Our national market system should also be flexible enough to accommodate the differences that exist among the exchanges.

I look forward to working with the SEC and with my colleagues in Congress to resolve structural conflicts that hinder competition and restrict liquidity and transparency in the marketplace. We must all work to ensure fair and efficient capital markets and to create a level playing field in which all parties can compete to the best of their abilities.

Thank you, Mr. Chairman. I yield back.

Opening Statement
Congressman Vito J. Fossella
"Reviewing U.S. Capital Market Structure:
Promoting Competition in a Changing Trading Environment"

Subcommittee on Capital Markets, Insurance and
Government-Sponsored Enterprises

Committee on Financial Services
U.S. House of Representatives

October 30, 2003

Mr. Chairman: I'd like to request that on behalf of the 450 independent floor brokers working or the floor of the New York Stock Exchange you accept for the record, the written testimony from the Organization of Independent Floor Brokers.

Whether most of us realize it or not, securities play a major role in our everyday life. Have it be Wal-Mart or John Deere, it's been securities that have given these companies the ability to grow to the size they are today. Small and medium sized businesses can issue stock to raise capital which in turn is used to purchase new equipment, build larger facilities or hire additional employees. The issued securities are then listed on an exchange where people can buy more stock or sell the stock to other buyers.

Over the years the Congress created the SEC to watch over the securities market and gave them the task of ensuring that the markets are operating as efficiently and fairly as possible. In 1975, Congress decided that the capital market structure, while efficient, needed additional tools in order to become a national market system. Through the efforts of Congress and the SEC, the national market system as we know it today, was created.

As with any action Congress or Regulators make, it is inevitable that new technologies and ideas will make past decisions seem arcane and out of sync with the current times. Today we have the opportunity to listen to what our panels of experts think Congress, the SEC, or industry itself, should do to ensure our markets continue to attract domestic and international investors and remain the premiere markets of the world.

What I think those of us on this dais need to remember is that we need not be looking for opportunities to pass legislation, but rather we should be looking to facilitate a discussion that will lead to industry and regulatory solutions. It's important to remember that what we do, will not only affect how Americans invest in our businesses, but also how foreign investors will.

Over the past few years, this committee, and Congress as a whole, has spent a great deal of time finding ways to ensure the average American has confidence in our marketplace. Much of this work has been done in response to the actions of a few bad actors. While these responses have been helpful to cleansing the old regime, it was no doubt a reactionary response. I hope members and market participants involved in this process will keep in mind that these hearing are not in response to any illegal activity. Rather, Chairman Oxley and Chairman Baker have taken it upon themselves to be proactive in ensuring our capital markets remain a safe and trustworthy place where investors will go to trade their securities, knowing that their interests come before anyone else's.

OPENING REMARKS OF THE HONORABLE RUBÉN HINOJOSA
HOUSE FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON CAPITAL MARKETS
"REVIEWING U.S. CAPITAL MARKET STRUCTURE II"
OCTOBER 30, 2003

Chairman Baker and Ranking Member Kanjorski,

I want to thank you for holding this second hearing on market structure. The focus of the first hearing in this series was on governance issues at the New York Stock Exchange and the regulatory role of exchanges. During that hearing, we also examined what has been referred to as the "potential conflicts of interest that are created by a regulator overseeing itself."

In light of recent developments in the capital markets and the fact that the SEC staff is reviewing what changes, if any, need to be made to the agency's various regulations, I look forward to hearing the testimony of Chairman Donaldson.

I understand that the Senate Banking Securities Subcommittee held another hearing on market structure yesterday at which SEC Chairman William Donaldson testified. Chairman Donaldson, you expressed certain concerns about the current corporate governance at the various exchanges, and after the hearing, you reportedly stated that SEC approval for the new listing standards proposed by the NYSE and NASDAQ is ``imminent". I would like to know the status. I also have an interest in the trade-through rules, but I will save that for the question and answer period.

Again, Chairman Baker, I want to thank you for holding this timely and important hearing. I look forward to learning more about our capital markets from today's and future witnesses and to possibly working with you and Ranking Member Kanjorski should this Subcommittee conclude that it needs to formulate legislation to change corporate governance or encourage the exchanges to adopt certain best practices.

I yield back the balance of my time.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON REVIEWING U.S. CAPITAL MARKET STRUCTURE: PROMOTING COMPETITION IN A CHANGING TRADING ENVIRONMENT

THURSDAY, OCTOBER 30, 2003

Mr. Chairman, we meet today for the second time in the 108th Congress to review the structure of our capital markets and evaluate reforms that might enhance competition in light of recent technological advances and marketplace developments. In recent years a variety of participants in the securities industry have questioned one or more aspects of the regulatory system. Today's proceedings will therefore help us to better understand these issues and their concerns.

In my view, we have come to a crossroads in the securities industry, facing a number of decisions that could fundamentally alter its structure for many years to come. As I did at our last hearing on market-structure issues, I must caution my colleagues on both sides of the aisle to move carefully and diligently in these matters. Because we have elaborately interlocking systems and relationships in our securities markets, I believe that we should refrain from pursuing change for change's sake. Moreover, in pursuing any change to fix those portions of the system experiencing genuine strain, we must also ensure that do not disrupt those elements of our markets that are working well.

In adopting the Securities Acts Amendments of 1975, the Congress wisely decided to provide the Securities and Exchange Commission with a broad set of goals and significant flexibility to respond to market-structure issues. From my perspective, this system has worked generally well over the last three decades in adapting to technological changes and other developments. This legal framework also ought to continue to provide the Commission with the flexibility that it needs to consider and adopt further reforms in the future.

In testimony before the Senate earlier this month, SEC Chairman Donaldson indicated that the Commission would be focusing with increased intensity on the structure of our securities markets in the upcoming months. I therefore look forward to hearing from the Chairman later this morning about his current views on these matters. I want him to know that it is my hope that the Commission will move expeditiously and methodically in its deliberations.

Mr. Chairman, I have made investor protection one of my top priorities for my work on this Committee. During my opening statement at our last hearing on market-structure issues, I outlined some of my thoughts regarding self-regulation in our securities markets. Today, I would like to focus on another important investor protection issue: transparency.

For our securities markets to work well and advance the interests of investors, I believe as a general rule that we should seek to promote transparency to the maximum extent possible. Transparency helps to ensure that all participants in a marketplace have access to the same information for making decisions. Transparency therefore ensures that no participant in a marketplace is either advantaged or disadvantaged because of their access to information.

(more)

For these reasons, I have apprehensions about any market-structure reform proposals that would limit access to information, including those that would allow for the internalization of market orders. In my view, such proposals have the potential to jeopardize the transparency of our markets and harm investors. During their tenures, the two most recent former Commission chairmen have expressed concerns about the internalization of market orders by broker-dealers.

Additionally, the current SEC Chairman has previously observed that "internalization can discourage markets from competing on the basis of price and pose a conflict of interest for broker-dealers." As we deliberate on market-structure issues this morning, it is my expectation that he will comment further on the importance of further enhancing transparency in the securities industry.

In closing, Mr. Chairman, I believe that our committee must continue to conduct vigorous oversight of the securities industry to determine whether its regulatory structure is working as intended and to examine how we could make it stronger. The observations of today's witnesses about these complex matters will also help me to discern how we can maintain the efficiency, effectiveness and competitiveness of our Nation's capital markets into the foreseeable future. I commend you for bringing these matters to our attention and yield back the balance of my time.

TESTIMONY
OF
WILLIAM H. DONALDSON, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
MARKET STRUCTURE ISSUES

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

OCTOBER 30, 2003

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

TESTIMONY OF CHAIRMAN WILLIAM H. DONALDSON
BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES
UNITED STATES HOUSE REPRESENTATIVES
OCTOBER 30, 2003

Good morning Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee. I am very pleased to be here to discuss some of the significant market structure issues that we are facing in the U.S. equities market today.

Our markets are comprised of intricately interwoven systems and relationships. While the Commission recognizes the importance of addressing market structure issues expeditiously, the extent to which structural changes are needed, and what those changes should be, are complicated problems, not subject to quick and easy resolution. We must take care not to disrupt those areas of our markets that are working well, in our haste to "fix" those areas that we think are not.

The Commission's staff has made significant progress in analyzing the structure of the securities markets, identifying the sources of the strains to which it increasingly is subject, and formulating a roadmap for responding to these concerns. The staff is now in the process of drafting concrete proposals to address the root causes of the stresses on the U.S. market structure. I have asked the staff to produce, in the coming months, a plan that includes proposals to respond to several of the more pressing market structure issues.

As you know, Congress formally directed the Commission to address market structure when it enacted the Securities Acts Amendments of 1975. That legislation instructed the SEC to facilitate the creation of a national market system for securities that would maintain fair and orderly markets, and tie together all buying and selling interest

so that investors would have the opportunity for the best possible execution of their orders, regardless of where in the system they originate.

Congress specified five key objectives of the national market system: (1) economically efficient executions of securities transactions; (2) fair competition among markets and securities firms; (3) the availability of market information to investors; (4) execution of orders in the best market; and (5) direct interaction among investor orders. To achieve these objectives, Congress recognized that communication systems, particularly those designed to disseminate market data, would form the heart of the national market system. Rather than attempt to dictate the specific elements of U.S. market structure, however, Congress chose to rely on an approach designed to provide maximum flexibility to the Commission and the securities industry in its development.

The 1975 Amendments to the Exchange Act created a framework for fostering transparency, interconnectivity, and competition in our securities markets. As a result, today, equity market centers compete with one another in an environment where quotes and transaction prices are widely available to all market participants. Direct and indirect linkages among competing market centers help ensure that brokers can access the best quotes available in the market for their customers. Market centers (including exchange markets, over-the-counter market makers, and alternative trading systems) have an incentive to offer improvements in execution quality and to reduce trading costs in order to attract order flow away from other market centers. This competition among market centers encourages ongoing innovation and the use of new technology. Within all existing registered exchanges and a number of other markets, investor orders have the possibility of interacting directly without the intervention of intermediaries. This furthers

Congress's fifth objective – direct interaction of customer orders – allowing investors to obtain executions at better prices than otherwise would be available.

Taking a step back and looking at the market as a whole, our national market system has worked remarkably well for the past quarter century. And in recent years it has become increasingly efficient. At the same time, we recognize that this very efficiency, arising from technological and other market developments, has put strains on existing national market structures. One significant change has been the proliferation of new electronic markets, such as ECNs, that offer fast executions and have spurred competition among market centers, but at the same time exacerbated concerns about market fragmentation, the feasibility of integrating different market models into the national market system, and maintaining a level regulatory playing field among functionally-equivalent market participants. The implementation of decimal pricing in 2001, and the concurrent move to a minimum tick of one penny in the equity markets, has narrowed spreads and enhanced the efficiency of the price discovery process, but at the same time reduced the liquidity available at each price point, made it easier to step ahead of limit orders, and placed economic strains on the dealer business. Decimal pricing has also put a premium on swift access to displayed prices so investors can quickly reach these smaller quotes before they change. The trend toward demutualization of exchanges, and their conversion to for-profit enterprises, has heightened concerns about the inherent tensions in the self-regulatory model, in particular the concern that the funding and vigor of the regulatory function might be sacrificed in favor of delivering returns to shareholders.

The issues surrounding intermarket access provide a good example of some of the strains impacting U.S. market structure in recent years. In a system with many competing market centers and pools of liquidity, participants clearly need to know what the best prices are and where they are available. But this information is of little use in the absence of effective access to the market centers with the best prices. Implementing market access, however, has raised a number of difficult issues. Offering access to one's market to competitors can conflict with the core business strategy and commercial self-interest of a market. Over the years, markets have sought to maintain strict control over access and often have erected barriers to achieve this objective. These barriers historically have taken the form of direct bans, restrictive membership requirements, discriminatory execution priorities, fees, and information restrictions. Finally, even setting aside intentional barriers to access, significant practical difficulties must be overcome to ensure the availability of access in an environment where scores of separate market centers – floor-based and electronic, both fast and slow – may be actively quoting and trading a security. The existing compulsory market-to-market linkage in stocks – the Intermarket Trading System (ITS) – applies only to exchange-listed stocks and, in the view of many, has been less than successful in overcoming these obstacles to providing effective intermarket access.

As noted, over the last several years, the Commission has taken a number of steps to address concerns facing our national market system. In the Order Handling Rules and Regulation ATS, for example, the Commission broadened the class of market centers required to make their quotations and orders publicly accessible. In doing so, it sought to redefine the idea of an exchange to include not just traditional exchanges, but also trading

systems where orders interact according to specified trading rules. The Commission also adopted rules to improve the disclosure by market centers of execution quality data, and the disclosure by broker-dealers of their order routing practices, in order to enable investors to "comparison shop" among the myriad market centers, and to stimulate competition on the basis of execution quality.

In addition, the Commission developed ideas and solicited public comment on some of the more difficult market structure issues, such as the regulation of market data fees and revenues, the fragmentation of the U.S. securities markets, and the regulation of exchanges. A federal advisory committee also was convened to address market data concerns, and last year the Commission held public hearings on the full range of market structure issues.

There is no doubt that there are issues regarding our national market system that call for our attention, and indeed, the Commission and its staff have been focused on addressing these issues and resolving perceived conflicts in a timely manner. In my view, several aspects of equity market structure raise particularly pressing questions. These include: (1) the implications of differences among markets in the means by which their quotes may be accessed by non-members and of access fees that are not included in displayed quotations; (2) the role of trade-through rules in intermarket trading for very different types of markets and systems; (3) the manner in which market data is consolidated and distributed, and the resulting revenues allocated among the markets; (4) whether a mixed dealer and auction market such as Nasdaq should be allowed to register as a for-profit exchange; (5) whether the fragmentation of markets that results from competition is reducing the effectiveness of regulatory processes; and (6) the effectiveness of the current self-regulatory system for the securities markets.

That said, I firmly believe our system of multiple, competing markets – on balance – has worked remarkably well. We have the world's most competitive and efficient markets. Competition among markets has fostered innovation and led to the creation of a variety of trading platforms designed to meet the needs of different types of investors. New entrants, particularly those with fully electronic platforms, keep the pressure on established markets to innovate. However, new entrants also challenge our existing infrastructure, much of which was created in the 1970s before the dramatic advancements in technology.

As has always been the case in our competing markets model, our challenge as regulators is to ensure fair and efficient markets through a balance of competition and regulation. Fair and efficient markets, of course, are the key goals of securities market regulation. But fairness and efficiency are at least superficially different concepts, creating tensions in our regulatory mandate. Fairness suggests the use of regulation to ensure against unfair results. Efficiency, on the other hand, suggests reliance on free markets and competitive forces to achieve an efficient result, which may not necessarily be a "fair" one. Regulation and competition do not necessarily conflict, as regulation often seeks to remove barriers to competition or promote efficiency. In other cases, there will be a tension between regulation and competition. Striking the appropriate balance is the responsibility of the Commission.

The optimal equity market structure, in my view, is based on several fundamental principles. First, I believe we should seek to achieve the benefits of competition while countering the negative effects of fragmentation from trading in multiple markets,

through widely available market data, ready access among markets, price protection principles, and best execution standards.

Second, to the greatest extent possible, I believe we should let market forces determine outcomes by seeking to have the marketplace, rather than the government or its regulators, choose the "winners" and "losers." We must seek to provide a level playing field in which all markets can compete fairly and aggressively. That said, regulation is necessary in certain situations, such as when an exchange exercises market power, or when externalities such as principal/agent conflicts obstruct otherwise competitive outcomes. Regulation is also appropriate when its benefits to the marketplace exceed its costs and reduce market frictions, such as when settlement date standards or quoting conventions are established.

Finally, I believe that market transparency, fairness, and integrity are key to the strength of our marketplace. These fundamental concepts underpin the Commission's approach to regulation, and contribute substantially to investor confidence in our markets.

With these general principles in mind, I would like to focus the remainder of my testimony on four key areas of the Commission's market structure initiative: (1) access to markets; (2) market data; (3) the self-regulatory model; and (4) the nature of a securities exchange.

I. Access to Markets

A. Fair Access

In our modern-day marketplace for securities, the New York Stock Exchange, Nasdaq, the American Stock Exchange, the regional exchanges, and numerous electronic communications networks, all compete with each other to offer the deepest pools of

liquidity to investors at the very best prices. I believe that the Commission must resist the temptation to force these diverse securities markets to mimic each other, but rather to encourage them to compete over their differences within a single, robust, national system. In the end, there is little doubt in my mind that investors benefit from markets that compete, so long as the competition is truly fair.

With that in mind, a significant market structure issue on the Commission's agenda is making sure that access between markets is as fair and as efficient as it can be. If best execution is to be achieved in an environment characterized by multiple competing markets, broker-dealers must be able to identify the location of the best available prices and obtain access to those prices routinely and efficiently. In contrast, a market center that is inaccessible does little to promote efficiency and fairness in the marketplace.

Most brokers send orders directly to the market that they expect will provide their orders best execution most of the time, and most of these orders are executed in the market that receives them. At times, however, the best price at that moment may be in another market. And traders in one market may need to access prices in another market to keep prices in line. For these reasons, markets need easy access to each other, either directly or indirectly through brokers.

The Commission's approval last year of the NASD's Alternative Display Facility pilot program has highlighted this issue. Rather than obtaining access through "hard" linkages directly between markets, in the way that competing markets can access the New York Stock Exchange, in the Alternative Display Facility competing market centers obtain access to each other directly through privately negotiated access agreements and

indirectly through subscribers. The Commission is evaluating this decentralized access approach to determine whether, as a practical matter, it would be an appropriate model for the national market system, and thus could be applied to other market centers.

B. Access Fees

Access fees charged to reach a quote create another difficult market structure problem. Some markets charge varied per-share transaction fees for access to their quotes. Therefore, a displayed price may represent the true price that a customer will pay or it may represent only a base price to which an undisclosed access fee will later be added.

These pricing disparities can impede access between competing markets, raise trading costs, and create confusion about the true quoted prices. The absence of a uniform quoting convention across all markets also raises the incidence of locked and crossed quotations. To ensure real access to public quotes between competing markets, it is important that these quotes be accessible to other market participants on clear and fair terms.

I should also mention that, because access fees have gradually shrunk to less than one cent per share in most markets, the imposition of the fees results in de facto subpenny pricing. Indeed, many market participants have suggested that these access fees have precipitated trading in subpennies, thus magnifying the strains caused by the move to decimal pricing. The Commission intends to continue to work closely with the industry and investors to find appropriate solutions to the challenges raised by access fees and subpenny pricing. Whatever solution the Commission decides to adopt, we must assure

that access fees will not function as a tollbooth that snarls traffic along the national market system.

C. Price Protection

As part of our examination of inter-market linkages, we also are actively re-evaluating the question of intermarket trade-throughs, which occur when orders are executed in one market at prices inferior to the prices disseminated on another market. Today's highly competitive securities markets include fully electronic markets that provide swift automatic execution of customer orders, as well as traditional floor-based markets that execute orders through human interaction. Although a market participant that desires an opportunity for price improvement may prefer that its order be routed to a floor exchange for execution, an investor who values speed and certainty of order execution over a marginally higher price may find such a delay intolerable. Accordingly, the challenge before the Commission is to devise standards that allow faster markets and slower markets to thrive within a single system of interconnected markets, while at the same time providing order executions to customers that display prices and for those customers who desire the best price on their orders.

II. Market Data

Another significant market structure challenge facing the Commission involves the collection and reporting of trading information and influence of the resulting revenues on market structure. Our existing market data system has strengthened the U.S. equity markets and has assured that investors have real-time access to accurate, reliable, and affordable information from all significant U.S. market centers. And yet the increasing number and diversity of U.S. market centers, has fueled demands for modernizing the

current market data structure. Despite the sweeping changes that have taken place in the markets over the past 30 years, the structure for market data, including the collection and dissemination of a market's best bid and offer, the national best bid and offer, trading volume statistics, and last-trade prices, has changed very little.

The Commission recognizes that market data revenue is very important to our markets. Indeed, in recent years, self-regulatory organizations have drawn as much as 45% of their total revenues from market data revenue. In 2001, the Commission convened a panel of experts, chaired by Dean Joel Seligman, that looked into the structure of our market data system, as well as the compensation that markets have been receiving for their market data. The Seligman Committee noted that under the current system, securities information processors distribute market data revenues to self-regulatory organizations based primarily on each self-regulatory organization's reported trade volume. This compensation scheme has created a financial incentive for self-regulatory organizations to report as many trades as possible. As a result, markets are vying for ECNs and market makers to report their trades through them, as this allows markets to tap more deeply into the pool of available market data revenue and to rebate substantial portions of the additional revenue to the entity reporting the trade.

Significantly, in 2002 the Commission determined that programs for rebating market-data fee proceeds to market participants were creating incentives for traders to engage in transactions with no economic purpose other than to increase the amount of the market data revenues that they received. In this regard, the Commission abrogated several more extreme proposals to extend rebates of market data revenues to market participants, to allow more time for consideration of these issues.

It is my belief that market centers should be rewarded for providing better services. The recent developments call into question whether the current method of distributing market data revenue creates appropriate economic incentives, and whether it furthers the goal of rewarding markets that make valuable contributions to the market data being disseminated.

III. The Self-Regulatory Model

Another matter of great importance is the effectiveness of the self-regulatory system of securities markets. Recently, a number of concerns have been raised about the current state of self-regulation, including SRO conflicts of interest, SRO governance, and inefficiencies in self-regulation.

Congress and the Commission have long recognized that self-regulation has both benefits and weaknesses. The principle of self-regulation is based on the idea that regulation can best be done as close as possible to the regulated activity. However, an SRO that operates a market has an inherent conflict of interest between its roles as a market and as a regulator. I believe that the Commission must continue its work in ensuring that SROs vigorously fulfill their obligation to enforce their rules and the federal securities laws and rules. The advent of for-profit, shareholder-owned exchanges creates additional issues, including ensuring that self-regulatory obligations do not take a back seat to the interests of shareholders. The challenge for the Commission and the SROs is to ensure that, as the securities markets grow more competitive, the SROs continue to dedicate their energies and resources to surveillance and enforcement. We also must prevent fragmentation of trading from creating gaps in SRO oversight of the markets.

As part of our review of the self-regulatory structure, I believe the Commission must thoroughly review the SROs' governance practices. Recent events at the New York Stock Exchange point to the need for this review. SROs play a critical role as standard setters for sound governance practices. Just as SROs have demanded that their listed companies strengthen their governance practices, we must demand that, at a minimum, SROs match the standards they set for listed companies. There are several topics that merit our consideration, including board composition and independence of directors; the independence and function of key Board committees; the transparency of the SRO's decision-making process; and the diligence and competence required of Board and committee members and ensuring their focus on the adequacy of regulation.

These are critical issues facing the SROs and the Commission. I am committed to ensuring that our system of self-regulation continues to serve as an effective and efficient means of overseeing our securities markets.

IV. Exchange Criteria

The last topic that I would like to touch upon is what it means to be registered as a national securities exchange. All currently registered exchanges have a limit order book in which better-priced orders take precedence. But a mandatory order book system is not easily reconciled with a dealer model, such as the Nasdaq stock market, in which there is no central limit order book.

I spoke earlier about the merits of price protection across markets. Nasdaq's application to register as an exchange places squarely before the Commission the issue of whether price protection within a market is a requirement of exchange registration. One

concern is customer expectations. I suspect that customers generally expect their better priced orders to be protected within an exchange.

We do not expect all exchanges to be identical, much less to replicate any market's faults. Yet until now all exchanges have given their limit orders priority throughout their marketplace. If the Commission were to approve Nasdaq's application, other exchanges would likely seek to eliminate intra-market price priority from their rules. As a result, the protection of limit orders within markets would decrease. For this reason, Nasdaq's exchange application raises market structure issues that transcend the particular question of whether Nasdaq, or any other particular market, should be registered as an exchange.

* * *

In conclusion, I would like to reiterate that the market structure challenges that I have discussed today may shape the national market system for years to come. The Commission recognizes the importance of addressing these challenges in an effective and timely manner. At the same time, however, we must be mindful not to "rush to judgment," but instead take a deliberate and reasoned approach to reach the right result. That said, we fully acknowledge the need to resolve the conflicts and it is my expectation to be able to review proposals from Commission staff in the coming months, with an eye towards publishing proposals soon thereafter. I look forward to continued input from this subcommittee on these important matters throughout this process.

Thank you again for inviting me to speak on behalf of the Commission. I would be happy to answer any questions that you may have.

TESTIMONY OF MR. KEVIN M. FOLEY

CHIEF EXECUTIVE OFFICER

BLOOMBERG TRADEBOOK LLC

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

HOUSE COMMITTEE ON FINANCIAL SERVICES

REGARDING

"REVIEWING U.S. CAPITAL MARKET STRUCTURE: PROMOTING COMPETITION IN A CHANGING TRADING ENVIRONMENT"

OCTOBER 30TH, 2003

INTRODUCTION. MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE. MY NAME IS KEVIN FOLEY, AND I AM PLEASED TO TESTIFY ON BEHALF OF BLOOMBERG TRADEBOOK REGARDING "REVIEWING U.S. CAPITAL MARKET STRUCTURE: PROMOTING COMPETITION IN A CHANGING TRADING ENVIRONMENT." THE TOPIC IS BOTH IMPORTANT AND TIMELY.

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BLOOMBERG TRADEBOOK SPECIALIZES IN PROVIDING INNOVATIVE TOOLS THAT SUBDIVIDE LARGE ORDERS INTO SMALL ORDERS AND ELIMINATE THE TRADITIONAL BARRIER BETWEEN THE UPSTAIRS MARKET AND THE TRADING FLOOR. THROUGH THAT TECHNIQUE WE BRING UPSTAIRS LIQUIDITY DIRECTLY INTO CONTACT WITH SMALL RETAIL ORDERS, WITH THE OPTIONS MARKET-MAKERS AND WITH PROGRAM TRADING ORDER FLOW. IN THE PROCESS WE CONSOLIDATE WHAT HAS BEEN A FRAGMENTED MARKET AND WE INCREASE THE EFFICIENCY OF

THE MARKET. OUR CLIENTS HAVE REWARDED OUR CREATIVITY AND OUR SERVICE BY TRUSTING US WITH THEIR BUSINESS, ALLOWING US TO REGULARLY TRADE MORE THAN 180 MILLION SHARES A DAY.

AN OPPORTUNITY TO DRAMATICALLY IMPROVE THE CAPITAL MARKETS. THE HOUSE FINANCIAL SERVICES COMMITTEE HAS LONG BEEN CONCERNED WITH POTENTIAL CONFLICTS WITHIN THE FINANCIAL SERVICES INDUSTRY THAT MIGHT LESSEN MARKET EFFICIENCY OR COMPROMISE INVESTOR PROTECTIONS. THE COMMITTEE HAS DEVOTED SIGNIFICANT TIME AND EFFORT TO ADDRESSING SOME OF THESE CONFLICTS IN THE CONTEXT OF ANALYSTS, ACCOUNTANTS AND OTHERS.

RECENT CONFLICTS RELATING TO THE NYSE ARE ALSO WORTHY OF CONGRESSIONAL AND COMMISSION ATTENTION. ADDRESSING THESE CONFLICTS WILL IMPROVE OUR MARKETS AND FURTHER THE GOALS OF THE SECURITIES LAWS. INDEED, THESE ISSUES ARE ALL THE MORE PRESSING GIVEN THE IMPORTANCE OF THE NYSE AS A MARKET CENTER, ITS ROLE AS THE PRIMARY SELF-REGULATORY ORGANIZATION FOR THE NATION'S LARGEST SECURITIES FIRMS AND ITS STATUS AS A GOVERNMENT-SPONSORED MONOPOLY.

THE SCANDALS REVEALED AT THE NYSE IN 2003 LOOK STRIKINGLY LIKE THE SCANDALS THAT RACKED THE NASDAQ MARKETPLACE IN 1995. THE NASDAQ PRICE-FIXING SCANDAL OF THE MID-1990S RESULTED IN SANCTIONS BY THE SEC AND THE DEPARTMENT OF JUSTICE AND

DECISIONS ON MARKET STRUCTURE INTENDED TO COMBAT CONFLICTS OF INTEREST IN THE NASDAQ MARKET BY ENHANCING TRANSPARENCY AND COMPETITION. SPECIFICALLY THE SEC'S 1996 ISSUANCE OF THE ORDER HANDLING RULES PERMITTED ELECTRONIC COMMUNICATIONS NETWORKS — ECNS — TO FLOURISH OVER THE PAST SEVEN YEARS, BENEFITING CONSUMERS AND THE MARKETS GENERALLY. THESE RULES — AIMED PRIMARILY AT EXCHANGE SPECIALISTS AND OVER-THE-COUNTER MARKET MAKERS — WERE DESIGNED TO PROMOTE MARKET TRANSPARENCY IN THE NASDAQ MARKET BY PERMITTING THE DEVELOPMENT OF ELECTRONIC SYSTEMS THAT FACILITATE TRADING IN SECURITIES.

AS HAS OFTEN BEEN OBSERVED, SUNLIGHT IS THE BEST DISINFECTANT. INDEED, THE INCREASED TRANSPARENCY PROMOTED BY THE SEC'S ORDER HANDLING RULES AND THE SUBSEQUENT INTEGRATION OF ECNS INTO THE NATIONAL QUOTATION MONTAGE NARROWED NASDAQ SPREADS BY NEARLY 30% IN THE FIRST YEAR FOLLOWING ADOPTION OF THE ORDER HANDLING RULES. THESE, AND SUBSEQUENT REDUCTIONS IN TRANSACTIONAL COSTS, CONSTITUTE SIGNIFICANT SAVINGS THAT ARE NOW AVAILABLE FOR INVESTMENT THAT FUELS BUSINESS EXPANSION AND JOB CREATION.

WHILE THE COMPLETE LIST OF REFORMS ORDERED BY THE SEC TO PROMOTE TRANSPARENCY IS LONG AND VARIED, ALL OF THESE

CHANGES, INCLUDING THE PROMULGATION OF THE ORDER HANDLING RULES, WERE ANIMATED BY THE SAME UNDERLYING PRINCIPLE—NAMELY THAT SUNLIGHT—INCREASED TRANSPARENCY—PRODUCES THE MOST HONEST AND EFFICIENT MARKETS.

CHAIRMAN OXLEY HAS ASKED "WHY DOES THE NYSE CONTROL 80 PERCENT OF THE TRADING VOLUME OF ITS LISTED COMPANIES WHEN NASDAQ CONTROLS ONLY ABOUT 20 PERCENT OF THE VOLUME OF ITS LISTED COMPANIES?" THE ANSWER IS SIMPLE — THERE HAVE HISTORICALLY BEEN A SERIES OF BARRIERS TO COMPETITION IN THE NYSE MARKET.

FROM THE ONLY RECENTLY DISCARDED RULE 390, WHICH SUBSTANTIALLY RESTRICTED NYSE MEMBER FIRMS FROM TRADING STOCKS OF COMPANIES THAT LISTED BEFORE APRIL 1979 ANYWHERE BUT ON THE EXCHANGES, TO RULE 500, WHICH MAKES IT EXTREMELY DIFFICULT FOR A LISTED COMPANY TO DELIST, THERE HAVE EXISTED A NUMBER OF BARRIERS THAT HAVE THE EFFECT OF CENTRALIZING ORDER FLOW, IMPAIRING INTER-MARKET COMPETITION AND DEPRIVING THE MARKET OF THE OPPORTUNITY TO TEST WHETHER ELECTRONIC COMPETITORS COULD BRING THE SAME BENEFITS TO THE NYSE INVESTOR AS THEY HAVE TO THE NASDAQ INVESTOR.

TO UNLEASH COMPETITION AND PROMOTE AN EFFICIENT MARKET, CONGRESS AND THE COMMISSION SHOULD CONSIDER THE FOLLOWING:

REPEAL THE TRADE-THROUGH RULE. THE TWENTY-YEAR-OLD TRADE-THROUGH PROVISION OF THE INTER-MARKET TRADING SYSTEM (ITS) PLAN STATES THAT WHEN A MARKET MAKER RECEIVES AN ORDER, IT CANNOT EXECUTE IT AT A PRICE INFERIOR TO ANY FOUND ON ANOTHER MARKET WITHOUT GIVING A "FILL" TO THE BETTER-PRICED ORDER. TWENTY YEARS AGO INVESTORS COULDN'T CHOOSE BETWEEN PRICE, LIQUIDITY AND SPEED, BECAUSE SOPHISTICATED ROUTING AND EXECUTION TECHNOLOGY DID NOT EXIST. TODAY, TECHNOLOGY PROVIDES THOSE OPTIONS, BUT THE TRADE THROUGH RULE STYMIES CHOICE — FORCING INVESTORS TO GO THROUGH SLOWER, MANUAL MARKETS. THAT MAY HAVE MADE SOME SENSE BEFORE DECIMALIZATION — WHEN THERE WERE ONLY EIGHT PRICE POINTS PER DOLLAR. TODAY, HOWEVER, SPEED AND CERTAINTY OF EXECUTION IS MORE IMPORTANT TO MANY INVESTORS THAN CAPTURING THE LAST PENNY. CURRENTLY, THE RULE PROTECTS INEFFICIENT MARKETS WHILE DEPRIVING INVESTORS OF THE CHOICE OF ANONYMITY, SPEED OR LIQUIDITY BY MANDATING INSTEAD THAT INVESTORS RECEIVE THE THEORETICAL "BEST PRICE".

WE NEED TO TAKE ANOTHER LOOK AT WHETHER SUCH A RULE IS NECESSARY OR EVEN USEFUL. ULTIMATELY, WE THINK THE RULE SHOULD BE REPEALED. AS AN INTERIM STEP, HOWEVER, THE SEC COULD EXTEND THE EXISTING *DE MINIMIS* EXEMPTION. THE EXEMPTION PERMITS TRANSACTIONS IN EXCHANGE-TRADED FUNDS EFFECTED AT A PRICE NOT MORE THAN THREE CENTS AWAY FROM THE BEST BID AND OFFER QUOTED IN THE NATIONAL MARKET SYSTEM. THE COMMISSION COULD EXTEND THAT EXEMPTION TO TRANSACTIONS IN ALL NYSE-LISTED STOCKS THAT ARE EFFECTED AT A PRICE NOT MORE THAN FIVE CENTS AWAY FROM THE BEST BID AND OFFER QUOTED IN THE NATIONAL MARKET SYSTEM.

FACILITATE DISPLAY OF NYSE LISTED STOCKS IN THE ADF. IN 1999, NASDAQ PETITIONED THE SEC TO EXPAND ITS MONOPOLY BY CENTRALIZING QUOTATION DISPLAY AND ORDER EXECUTION IN A "SUPERMONTAGE" NASDAQ WOULD CONTROL. RECOGNIZING THE POTENTIAL ANTICOMPETITIVE IMPACT OF SUPERMONTAGE, THE SEC WISELY MADE ITS JANUARY 2001 APPROVAL OF SUPERMONTAGE CONTINGENT ON NASD'S MEETING CERTAIN CRITICAL PRECONDITIONS INTENDED TO ENSURE THAT PARTICIPATION IN SUPERMONTAGE WAS TRULY VOLUNTARY.

PREEMINENT AMONG THOSE PRECONDITIONS WAS THE ESTABLISHMENT OF AN "ALTERNATIVE DISPLAY FACILITY" (ADF). THIS FACILITY IS INTENDED TO PERMIT THE DISPLAY OF BOTH NASDAQ AND NYSE LISTED STOCKS. THE ADF HAS BEEN DISPLAYING NASDAQ STOCKS DURING 2003, PROVIDING A COMPETITIVE SPUR TO THE NASDAQ "SUPERMONTAGE" AND SERVING AS A CHECK ON ANTI-COMPETITIVE BEHAVIOR.

THE ADF COULD — AND IS CLEARLY INTENDED TO — PROVIDE A SIMILAR TONIC FOR THE NYSE MARKET. IT IS IMPERATIVE THAT THE SEC UNDERTAKE THE STEPS NECESSARY TO FACILITATE THE PROMISED DISPLAY OF NYSE LISTED STOCKS IN THE ADF AS SOON AS POSSIBLE.

ADDRESS CONFLICTS REGARDING NYSE'S ROLE AS A GOVERNMENT-SPONSORED INFORMATION MONOPOLY. THE FINANCIAL SERVICES COMMITTEE HAS LONG HELD THAT MARKET DATA IS THE "OXYGEN" OF THE MARKETS. ENSURING THAT MARKET DATA IS AVAILABLE IN A FASHION WHERE IT IS BOTH AFFORDABLE TO RETAIL INVESTORS AND WHERE MARKET PARTICIPANTS HAVE THE WIDEST POSSIBLE LATITUDE TO ADD VALUE TO THAT DATA ARE HIGH PRIORITIES.

BEFORE THE 1970S, NO STATUTE OR RULE REQUIRED SELF-REGULATORY ORGANIZATIONS (SROS) TO DISSEMINATE MARKET

INFORMATION TO THE PUBLIC OR TO CONSOLIDATE INFORMATION WITH INFORMATION FROM OTHER MARKET CENTERS. INDEED, THE NYSE, WHICH OPERATED THE LARGEST STOCK MARKET, CLAIMED AN OWNERSHIP INTEREST IN MARKET DATA, SEVERELY RESTRICTING ACCESS TO MARKET INFORMATION. MARKETS AND INVESTORS SUFFERED FROM THIS LACK OF TRANSPARENCY.

AT THE URGING OF THE SEC, CONGRESS RESPONDED BY ENACTING THE SECURITIES ACTS AMENDMENTS OF 1975. THESE AMENDMENTS EMPOWERED THE SEC TO FACILITATE THE CREATION OF A NATIONAL MARKET SYSTEM FOR SECURITIES, WITH MARKET PARTICIPANTS REQUIRED TO PROVIDE — IMMEDIATELY AND WITHOUT COMPENSATION — INFORMATION FOR EACH SECURITY THAT WOULD THEN BE CONSOLIDATED INTO A SINGLE STREAM OF INFORMATION.

AT THE TIME, CONGRESS CLEARLY RECOGNIZED THE DANGERS OF DATA-PROCESSING MONOPOLIES. THE REPORT ACCOMPANYING THE 1975 AMENDMENTS EXPRESSLY WARNS THAT:

> "PROVISION MUST BE MADE TO INSURE THAT THIS CENTRAL PROCESSOR IS NOT UNDER THE CONTROL OR DOMINION OF ANY PARTICULAR MARKET CENTER. ANY EXCLUSIVE PROCESSOR IS, IN EFFECT, A PUBLIC UTILITY, AND THUS IT MUST FUNCTION IN A

MANNER WHICH IS ABSOLUTELY NEUTRAL WITH RESPECT TO ALL MARKET CENTERS, ALL MARKET MAKERS, AND ALL PRIVATE FIRMS." REPORT OF THE SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS TO ACCOMPANY S.249, S. REP. NO. 94-75, 94TH CONG., 1ST SESS. 11 (1975).

EVEN AS NOT-FOR-PROFIT ENTITIES, SROS HISTORICALLY HAVE EXPLOITED THE OPPORTUNITY TO SUBSIDIZE OTHER COSTS (E.G., COST OF MARKET OPERATION, MARKET REGULATION, MARKET SURVEILLANCE, MEMBER REGULATION) THROUGH THEIR GOVERNMENT-SPONSORED MONOPOLY ON MARKET INFORMATION FEES. THE INCENTIVE TO EXPLOIT THIS MONOPOLY POSITION WILL BE EVEN STRONGER AS SROS CONTEMPLATE FOR-PROFIT FUTURES AND NEW LINES OF BUSINESS.

THE SEC HAS RECOGNIZED THIS THREAT, PROPOSING A COST-BASED LIMIT TO MARKET-DATA REVENUES AND FUNDING CERTAIN SRO COSTS, PRINCIPALLY THE COST OF MARKET REGULATION, THROUGH THOSE MARKET-DATA REVENUES. BLOOMBERG STRONGLY SUPPORTS THE COMMISSION'S PROPOSED COST-BASED LIMITS ON MARKET INFORMATION FEES, BUT WE DISAGREE WITH THE COMMISSION'S PROPOSAL TO INCLUDE THE COSTS OF REGULATION IN THE CALCULATION OF THESE COSTS.

RESTRICTING COSTS TO THE DIRECT COSTS OF GATHERING, CONSOLIDATING AND DISSEMINATING INFORMATION WOULD MAKE IT EASIER FOR THE COMMISSION TO SET APPROPRIATE RATES, RATES THAT WOULD PREVENT THE SROS FROM EXPLOITING THEIR GOVERNMENT-CONFERRED MONOPOLY POSITION WITH RESPECT TO THE DATA. OTHER SOURCES OF FUNDING AVAILABLE TO THE SROS FOR REGULATION AND OPERATIONS (I.E., PRINCIPALLY MEMBER FEES AND LISTING FEES) ARE UNRELATED TO THE MONOPOLY THE SROS HAVE OVER DATA SALES AND ARE INSTEAD, TO SOME EXTENT AT LEAST, SUSCEPTIBLE TO THE FORCES OF COMPETITION. THEY MAY THUS OFFER SOME PROTECTION AGAINST THE RISK THAT SROS WILL EXACT MONOPOLY RENTS AND USE THEIR CAPTIVE RATE BASES TO SUBSIDIZE OTHER ACTIVITIES.

A YEAR AGO, BLOOMBERG L.P., IN CONSULTATION WITH TWO DISTINGUISHED ECONOMISTS — DR. GEORGE HAY, THE FORMER DIRECTOR OF ECONOMICS OF THE ECONOMIC POLICY OFFICE OF THE ANTITRUST DIVISION OF THE UNITED STATES DEPARTMENT OF JUSTICE AND DR. ERIK SIRRI, THE FORMER CHIEF ECONOMIST OF THE SEC — SUBMITTED TO THE SEC A DISCUSSION PAPER ENTITLED "COMPETITION, TRANSPARENCY, AND EQUAL ACCESS TO FINANCIAL MARKET DATA". THE PAPER DELINEATED THE WAYS IN WHICH THE EXCHANGES, IN THE ABSENCE OF STRUCTURAL PROTECTIONS, MAY ABUSE THEIR MONOPOLY POWER OVER THE COLLECTION OF MARKET INFORMATION TO THE

DETRIMENT OF CONSUMERS, COMPETITORS AND THE NATIONAL MARKET SYSTEM. THE PAPER PROPOSED STRUCTURAL CHANGES TO ADDRESS THESE POSSIBLE ABUSES. THE CONCERNS EXPRESSED IN THE PAPER HAVE BEEN BORNE OUT BY BLOOMBERG L.P.'S YEAR-LONG DISAGREEMENT WITH THE NYSE OVER PROPOSED RESTRICTIONS ON THE DISSEMINATON OF DECIMILIZED INFORMATION TO INVESTORS.

REALIZE THE PROMISE OF DECIMALIZATION – THE LIQUIDITY QUOTE EXPERIENCE. UNDER CHAIRMAN OXLEY'S LEADERSHIP, THE CONGRESS PUSHED HARD AND SUCCESSFULLY TO ENCOURAGE THE SWITCH TO DECIMALS. THE ADDITIONAL TRANSPARENCY BROUGHT BY DECIMALS HAS, INDEED, REDUCED THE COST OF TRANSACTIONS, BENEFITING INVESTORS AND THE MARKETS.

THUS, BLOOMBERG L.P. WAS ENCOURAGED WHEN, LATE LAST YEAR, THE NYSE FILED WITH THE SEC A PROPOSED RULE CHANGE THAT WOULD PERMIT THE DISPLAY AND USE OF QUOTATIONS IN STOCKS TRADED ON THE NYSE TO SHOW ADDITIONAL DEPTH IN THE MARKET FOR THOSE STOCKS.

THE GOOD NEWS — THE NYSE'S "LIQUIDITY QUOTE" PROPOSAL COULD RESULT IN THE DISPLAY OF ADDITIONAL DEPTH IN A FORM WHICH WAS ITSELF EXECUTABLE FOR TRADING PURPOSES. THE BAD NEWS —

THE NYSE HAD PROPOSED TO EXPLOIT ITS STATUS AS A GOVERNMENT-SPONSORED MONOPOLY TO REQUIRE SOME VENDORS TO SIGN CONTRACTS THAT WOULD PLACE SEVERE RESTRICTIONS ON THE USE OF LIQUIDITY QUOTE DATA. THOSE RESTRICTIONS WOULD HAVE REQUIRED VENDORS TO ADVANTAGE THE NYSE OVER COMPETING MARKET CENTERS WHEN IT CAME TO THE DISPLAY OF DECIMALIZED DATA WHILE ALSO PRECLUDING BLOOMBERG FROM ADDING VALUE TO THIS DATA IN A WAY THAT BENEFITS INVESTORS AND THE MARKETS. THE NYSE'S ORIGINAL PROPOSAL WOULD HAVE PROHIBITED DATA VENDORS FROM INTEGRATING NYSE LIQUIDITY QUOTE DATA WITH DATA FROM OTHER MARKET CENTERS.

IN SHORT, THE PROMISE OF ENHANCED TRANSPARENCY AT THE HEART OF DECIMALIZATION WOULD HAVE BEEN THWARTED. INSTEAD, THE NYSE PROPOSED TO LEVERAGE ITS GOVERNMENT-SPONSORED MONOPOLY OVER MARKET DATA DOWNSTREAM TO UNFAIRLY DISADVANTAGE NOT ONLY COMPETITORS IN THE INFORMATION MARKET, BUT ALSO COMPETITORS IN THE TRADING MARKET. ALONG WITH OTHER MARKETS, TRADING VENUES AND MARKET DATA VENDORS, MIDDLE MARKET AND SMALLER INVESTORS WHO CAN'T AFFORD TO MAINTAIN THEIR OWN COMPUTER FACILITIES WOULD HAVE BEEN PARTICULARLY DISADVANTAGED.

WHEN FACED WITH COMPARABLE TERMS IN THE CONTEXT OF THE NYSE'S OPENBOOK PROPOSAL, THE SEC STATED THAT "THE NYSE'S PROPOSED RESTRICTIONS ON VENDOR RE-DISSEMINATION OF OPENBOOK DATA, INCLUDING THE PROHIBITION ON PROVIDING THE FULL DATA FEED AND PROVIDING ENHANCED, INTEGRATED, OR CONSOLIDATED DATA FOUND IN THESE AGREEMENTS ARE ON THEIR FACE DISCRIMINATORY, AND MAY RAISE FAIR ACCESS ISSUES UNDER THE ACT." Securities Exchange Act Release 44138 (December 7, 2001).

IN LIGHT OF THIS ADMONITION, IT IS UNFORTUNATE THAT THE NYSE SOUGHT TO IMPOSE IN THE LIQUIDITY QUOTE CONTEXT THE SAME CONDITIONS THAT SO TROUBLED THE SEC IN THE OPENBOOK CONTEXT. THESE RESTRICTIVE LIQUIDITY QUOTE CONTRACTS RAISED THE OPENBOOK ISSUES — AND MORE – IN THE CONTEXT OF FAR MORE CRITICAL DATA. THE FACT THAT THE NYSE CHOICE NOT TO MAKE THE CONTRACTS THEMSELVES PART OF THE FORMAL NYSE LIQUIDITY QUOTE SUBMISSION — DESPITE THE FACT THAT THE CONTRACTS CLEARLY MEET THE DEFINITION OF AN SRO RULE AND SHOULD HAVE BEEN SUBMITTED — LIMITED THE OPPORTUNITIES FOR MEANINGFUL PUBLIC INPUT.

AFTER EXTENSIVE REVIEW AND ANALYSIS, THE SEC ON APRIL 2, 2003, UNANIMOUSLY STRUCK DOWN THE NYSE'S RESTRICTIVE CONTRACTS. ON THE NYSE'S EFFORTS TO ESTABLISH BARRIERS THAT

PREVENT VENDORS FROM INTEGRATING LIQUIDITY QUOTES WITH QUOTATIONS FROM OTHER MARKETS, THE COMMISSION HELD THESE BARRIERS TO BE "A MORE SUBSTANTIAL RESTRICTION ON THE ABILITY OF VENDORS TO PROVIDE USEFUL DATA THAN POSED BY OPENBOOK AND WOULD, UNLIKE OPENBOOK, IMPOSE ON USERS INTEGRATION COSTS WITH RESPECT TO IMMEDIATELY EXECUTABLE, MARKET-WIDE QUOTATIONS IN A MANNER THAT WOULD: (1) BE INCONSISTENT WITH FOSTERING "COOPERATION AND COORDINATION WITH PERSONS ENGAGED IN PROCESSING INFORMATION WITH RESPECT TO SECURITIES"; (2) "BE DESIGNED TO PERMIT UNFAIR DISCRIMINATION BETWEEN CUSTOMERS"; AND (3) IMPEDE, RATHER THAN REMOVE IMPEDIMENTS TO, A "FREE AND OPEN MARKET AND A NATIONAL MARKET SYSTEM." Securities Exchange Act Release No. 47614 (April 2, 2003), SEC File No. SR-NYSE-2002-55.

UNFORTUNATELY, THE NYSE's REVISED DISPLAY REQUIREMENTS -- WHICH ARE AT LEAST IN THEORY INTENDED TO REFLECT THE CHANGES ORDERED BY THE SEC -- DON'T REMEDY THE DEFICIENCIES IDENTIFIED BY THE SEC. INDEED, THE REVISED DISPLAY REQUIREMENTS CONTINUE TO DISADVANTAGE THE MIDDLE MARKET AND SMALL INVESTORS, AS WELL AS MANDATING THE IMPOSITION OF A SERIES OF INTRUSIVE ATTRIBUTION REQUIREMENTS THAT WOULD REDUCE TRANSPARENCY AND SEVERELY DISADVANTAGE COMPETING MARKET CENTERS.

AS A RESULT, BLOOMBERG L.P. HAS COMMENCED A DENIAL OF ACCESS PROCEEDING AT THE SEC. INITIAL COMPLAINTS AND RESPONSES WERE FILED THIS SUMMER. WE BELIEVE THE FINAL RESOLUTION OF THIS CONTROVERSY WILL HAVE AN ENORMOUS IMPACT ON THE ULTIMATE EFFICIENCY OF OUR MARKETS AND THE LEVEL OF PROTECTION PROVIDED INVESTORS IN A DECIMALIZED ENVIRONMENT.

THIS CONTROVERSY UNDERSCORES THAT THE CONGRESS AND THE COMMISSION SHOULD GIVE STRONG CONSIDERATION TO UPDATING THE VENDOR DISPLAY RULE TO REFLECT THE REALITIES OF DECIMALIZED TRADING. THE VENDOR DISPLAY RULE WAS ADOPTED WHEN THERE WERE EIGHT PRICE POINTS TO THE DOLLAR AND IT REQUIRES CONSOLIDATED INFORMATION ONLY WITH RESPECT TO THE BEST BID AND OFFER. UNLESS THE VENDOR DISPLAY RULE IS UPDATED, INVESTORS RISK HAVING LESS USEFUL INFORMATION THAN EXISTED PRIOR TO DECIMALIZATION.

I'D CONCLUDE MY DISCUSSION OF LIQUIDITY QUOTE BY NOTING THAT THIS IS YET ANOTHER EXAMPLE OF THE ONGOING CONTROVERSY REGARDING SROs PROPOSING MARKET DATA FEES WITHOUT COST JUSTIFICATION. THE FEES THE NYSE PROPOSES TO CHARGE FOR ACCESS TO LIQUIDITY QUOTE DATA ON A REAL-TIME BASIS ARE APPROXIMATELY EQUAL TO THE FEES THE NYSE CURRENTLY CHARGES FOR ACCESS TO ALL

OTHER NYSE MARKET DATA ON A REAL-TIME BASIS — ABOUT $50 A MONTH PER USER. THESE FEES WOULD EFFECTIVELY ***DOUBLE*** THE AVERAGE FEES INVESTORS PAY TODAY FOR NYSE REAL-TIME DATA IF THE INVESTORS SUBSCRIBE TO LIQUIDITY QUOTE. SINCE DECIMALIZATION HAS REDUCED THE VALUE OF THE EXISTING BBO DATA, THE INVESTORS WOULD EFFECTIVELY BE PAYING TWICE TO RECEIVE INFORMATION EQUIVALENT IN ECONOMIC VALUE TO WHAT THEY USED TO RECEIVE BEFORE DECIMALIZATION. THE MARKETS AND INVESTORS WOULD BENEFIT FROM GREATER SCRUTINY OF MARKET DATA FEES AND COSTS.

OPPOSE EFFORTS TO CREATE NEW OWNERSHIP RIGHTS IN DATA CRITICAL TO THE FUNCTIONING OF THE MARKET. AS THIS COMMITTEE WELL KNOWS, IN PAST CONGRESSES BOTH THE NYSE AND NASDAQ HAVE SUPPORTED LEGISLATION WHICH WOULD CREATE A NEW AND UNPRECEDENTED PROPERTY RIGHT IN FACTUAL DATA, INCLUDING EVEN MONOPOLY MARKET DATA. IN HEARINGS IN THE LAST CONGRESS, THE FINANCIAL SERVICES COMMITTEE HEARD A NUMBER OF MARKET PARTICIPANTS EXPRESS STRONG OPPOSITION TO THIS PROPOSAL. INDEED, THE RESTRICTIVE CONTRACT THE NYSE ATTEMPTED TO IMPOSE IN THE LIQUIDITY QUOTE CONTEXT IS SIMPLY AN EFFORT BY THE NYSE TO LEVERAGE ITS MONOPOLY POWER TO CREATE AN EFFECTIVE

OWNERSHIP RIGHT IN DATA – A RIGHT THAT THE CONGRESS HAS REFUSED TO GRANT LEGISLATIVELY.

A FEW WEEKS AGO, H.R. 3261, THE "DATABASE AND COLLECTIONS OF INFORMATION MISAPPROPRIATION ACT" WAS INTRODUCED AND REFERRED TO THE HOUSE JUDICIARY COMMITTEE. THE LEGISLATION IS SUFFICIENTLY CONTENTIOUS THAT AN INCREDIBLY DIVERSE ARRAY OF PUBLIC AND PRIVATE ENTITIES — RANGING FROM THE U.S. CHAMBER OF COMMERCE TO THE AMERICAN CIVIL LIBERTIES UNION, THE EAGLE FORUM TO CONSUMERS UNION, THE AMERICAN CONSERVATIVE UNION TO THE NATIONAL ACADEMY OF SCIENCES — HAVE ALREADY VOICED STRONG OPPOSITION.

WHILE MUCH MARKET DATA HAS BEEN EXEMPTED OUT OF THE PROPOSED LEGISLATION, THE BILL CONTINUES TO POTENTIALLY BAR ACCESS TO MUCH OTHER INFORMATION CRITICAL TO MARKET PARTICIPANTS -- INCLUDING INFORMATION ON COMMODITY FUTURES AND GENERAL ECONOMIC DATA -- AND HENCE MAY WELL HAVE IMPORTANT RAMIFICATIONS FOR MARKET TRANSPARENCY.

THE NASDAQ MARKET — ACCESS FEES. I'VE FOCUSED PRIMARILY ON ISSUES RELEVANT TO THE NYSE MARKET TODAY, BUT I'D OBSERVE

THAT AN IMPORTANT DEBATE IS CURRENTLY UNDERWAY IN THE NASDAQ MARKET REGARDING THE FUTURE OF ACCESS FEES.

BLOOMBERG HAS LONG BELIEVED THAT ACCESS FEES SHOULD BE ABOLISHED FOR ALL SECURITIES AND ALL MARKETS AND WE HAVE URGED THE SEC TO TAKE THIS IMPORTANT STEP. THERE IS NO GOOD REASON WHY MARKET PARTICIPANTS ENTERING LIMIT ORDERS SHOULD RECEIVE A SUBSIDY FROM PARTICIPANTS ENTERING MARKETABLE LIMIT OR MARKET ORDERS, AND PLENTY OF GOOD REASONS WHY THEY SHOULD NOT. THERE IS ALSO, OF COURSE, NO DEFENSIBLE ARGUMENT FOR PAYMENT FOR FLOW OF MARKET ORDERS.

THE HARM DONE BY ACCESS FEES TO MARKET STRUCTURE OCCUR IN TWO WAYS, IN THEIR IMPACT ON THE BEHAVIOR OF THOSE TO WHOM THE FEES WOULD BE CHARGED AND IN THEIR IMPACT ON THOSE WHO WOULD RECEIVE THE FEES. FIRST, BY PLACING A TAX UPON MARKET ORDERS AND MARKETABLE LIMIT ORDERS, ACCESS FEES TEND TO DISTORT AND ALTER MARKET BEHAVIOR. SECOND, ACCESS FEES MAKE IT POSSIBLE FOR REBATES TO BE PAID TO LIMIT ORDER PROVIDERS.

THE COMPETITION FOR REBATES EXACERBATES THE PROBLEM OF LOCKED AND CROSSED MARKETS. IT ALSO HAS ENCOURAGED SUB-PENNY JUMPING, WHICH OCCURS WHEN A MARKET PARTICIPANT

IMPROVES A BID OR AN OFFER FOR AN ECONOMICALLY MEANINGLESS INCREMENT SIMPLY IN ORDER TO RECEIVE A REBATE. THERE IS AN ECONOMIC SWING IN THE COST INCURRED BY A PARTY THAT HITS A BID OR TAKES AN OFFER AND THEREBY FOREGOES THE REBATE PAYABLE FOR LIMIT ORDERS. THE HIT-OR-TAKE TRADER INCURS AN EXPLICIT COST, IN THE FORM OF THE ACCESS FEE ITSELF, AND INCURS AN IMPLICIT COST IN NOT RECEIVING THE REBATE. THAT CAN BE SIGNIFICANT AS A PERCENTAGE OF THE OVERALL TRANSACTION COST, PARTICULARLY FOR RETAIL ORDERS. IF THE TYPICAL RETAIL TICKET CHARGE — EVEN ONE BY A "DISCOUNT" BROKER OR AN ON-LINE BROKER — IS BETWEEN $10 AND $25 PER TRADE, THE ACCESS FEE SWING WOULD REPRESENT BETWEEN 20% AND 50% OF THAT COST.

WE BELIEVE THE ABOLITION OF ACCESS FEES WOULD GREATLY REDUCE MANY MARKET STRUCTURE ILLS AND PROVIDE FOR A BETTER NATIONAL MARKET SYSTEM.

CONCLUSION. THIS COMMITTEE HAS BEEN IN THE FOREFRONT OF THE MARKET STRUCTURE DEBATE AND I APPRECIATE THE OPPORTUNITY TO DISCUSS HOW THESE SEEMINGLY ABSTRACT ISSUES HAVE CONCRETE REAL-WORLD IMPACT ON INVESTORS.

THE SCANDALS REVEALED AT THE NYSE IN 2003 LOOK STRIKINGLY LIKE THE PRICE-FIXING SCANDALS THAT RACKED THE NASDAQ MARKET IN THE MID-1990S. THEN AS NOW, ENHANCED TRANSPARENCY AND COMPETITION WILL GO A LONG WAY TOWARD BUILDING INVESTOR CONFIDENCE AND PROMOTING THE EFFICIENT FUNCTIONING OF THE MARKETS.

WHEN CREDIT RATING AGENCIES DOWNGRADED ENRON'S DEBT TO JUNK STATUS ON NOVEMBER 28, 2001, THE NYSE HALTED TRADING BECAUSE OF AN ORDER IMBALANCE. AFTER THE NYSE SPECIALIST SHUT DOWN HIS POST, ECNs TRADED MORE THAN 10 MILLION SHARES IN OTHER MARKETS AS THE STOCK WENT FROM $2.60 TO $1.10 OVER THE NEXT THIRTY MINUTES.

IF ECNs MIGHT ACTUALLY CONTRIBUTE TO THE MAINTENANCE OF ORDERLY MARKETS IN WAYS THAT ARE POTENTIALLY SUPERIOR TO THE ROLE OF THE SPECIALIST, ISN'T THAT FURTHER EVIDENCE THAT THE TRADE-OFF OF FOREGONE EFFICIENCY, TRANSPARENCY AND CHOICE MIGHT BE A VERY BAD DEAL FOR INVESTORS?

THE NEUTRALITY, TRANSPARENCY, FAIRNESS AND INNOVATION ECNs COLLECTIVELY BRING TO THE NASDAQ MARKET HAVE DRAMATICALLY INCREASED COMPETITION AND EFFICIENCY IN THAT

MARKET. NYSE INVESTORS SHOULD NOT BE DEPRIVED OF THE OPPORTUNITY TO TEST WHETHER INCREASED COMPETITION COULD BRING THE SAME BENEFITS TO THEIR MARKET.

* * *

Kevin Foley

Kevin Foley is chief executive of Bloomberg Tradebook LLC. He is also responsible for all electronic trading on the Bloomberg Professional Service. Under his direction Bloomberg Tradebook has established itself as a leading electronic consolidator of global liquidity. Since its inception, the number of shares traded daily has risen to over 180 million in the US alone. Bloomberg Tradebook now offers its global customer base trading on 65 exchanges in 54 countries, with service via seven offices on four continents.

Many leading buy-side institutions and broker-dealers have come to rely on Bloomberg Tradebook's commitment to customer service and unique blend of innovative tools and trading algorithms to help them achieve better executions.

Bloomberg Tradebook now also offers innovative electronic trading solutions in global fixed income, energy, and foreign exchange markets. Electronic road-shows are also offered to help connect primary issue markets with buy-side investors.

Mr. Foley has been with Bloomberg for fourteen years. He began his career at Bloomberg LP as a fixed income specialist. During this time he oversaw the development of many popular Bloomberg Professional Service products for the analysis of fixed income and equity securities. He has also served as a regional sales manager and as manager of Bloomberg LP's team of applications specialists. He helped launch and served as an editor of Bloomberg Magazine. At the present, he is developing Bloomberg LP's Foreign Exchange product with partner EBS.

Before joining Bloomberg LP he traded U.S. government bonds for Drexel Burnham Lambert in New York. Mr. Foley currently serves on the Board of Governors of the Philadelphia Stock Exchange. He is a graduate of Haverford College and Columbia University School of Business.

Testimony of John Giesea
Security Traders Association

Before the
Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises
of the
House Financial Services Committee

Hearing on "Reviewing U.S. Capital Market Structure:
Promoting Competition in a Challenging Trading Environment"

Thursday, October 30, 2003

Good morning, Chairman Baker, Ranking Member Kanjorski, Members of the Subcommittee. I am John Giesea, President and Chief Executive Officer of the Security Traders Association ("STA"). I appreciate this opportunity to discuss the structure of the US equities markets on behalf of the STA members.

Prior to my current position at STA, I served as Senior Executive Vice President and Director of Equity Capital Markets for Advest, Inc., based in Hartford, Connecticut. From 1967 to 1990, I held other senior trading positions with Kidder, Peabody and Co., Inc. in New York and San Francisco, including Senior Vice President and Head of Nasdaq Trading. My years of experience in the trading environment have allowed me to witness some dramatic advances in technology and increases in investor participation.

The STA, as the leading trade organization for industry professionals in the securities industry, is a unique association. Our members are the individuals, rather than the firms, who are engaged in the purchase, sale and trading of securities for individuals and institutions. The STA represents the shared interests of its approximately 6,000 member traders, such as the buy-side, sell-side, and representatives from ECNs and exchanges, that belong to one of 29 national and international affiliate organizations, including those in Canada, London and Paris.[1]

Late last year the STA continued upon our previous efforts to systematically examine the structure of the United States securities markets. This examination resulted in the publication in August of a White Paper, entitled "Fulfilling the Promise of the National Market System," in which the STA analyzed the most pressing issues requiring resolution to obtain the objectives of the National Market System. I request that the White Paper be included as part of the record.

[1] **STA Vision Statement:** "By 2005, become recognized as the representative organization of security traders across all Markets and the leading authority and champion of individual practitioners on issues affecting traders and markets; earn the reputation of being a leading advocate of policies that foster investor trust, professional ethics marketplace integrity; and advance an agenda that supports capital formation, jobs creation and marketplace innovation."

The Securities Act Amendments of 1975

Any discussion of market structure must occur in the context of the goals and objectives Congress articulated in the Securities Acts Amendments of 1975. These amendments to the Securities Exchange Act of 1934 charged the Securities and Exchange Commission ("SEC") with the duty to "facilitate the establishment of a national market system for securities" while safeguarding the public interest and ensuring the "protection of investors, and the maintenance of fair and orderly markets".[2] Specifically, the National Market System would provide efficient execution, fair competition, transparency of quotations, the linkage of markets, and an opportunity for transactions without the participation of a dealer. These goals would help to assure that the US securities markets remain the most efficient and liquid in the world.

Unfortunately, many of the goals of the National Market System are not yet a reality. Congress was correct in understanding that advancements in computing power and other technological innovations in the industry, coupled with the dramatic increase of individual investor participation, would in fact transform the US equities markets. Much of the regulatory scheme, however, has lagged behind market developments

The Need for Liquidity in Markets

As we examine the serious, structural problems arising in our capital markets, it is essential to understand the vital importance of fostering efficient, highly liquid and fair markets. Such markets encourage the capital formation necessary for US economic expansion and growth. Noted economist Larry Kudlow recently described capital formation as "the ultimate tonic for maximizing economic growth, job creation, and the wealth of the nation."[3] In other words, an efficient capital formation function encourages economic and job growth. For example, small businesses need capital to make the investments necessary to grow and innovate, which in turn creates more jobs. In fact, they are often referred to as the engine of the US economy because of their importance to the growth of jobs in the economy. Access to the capital such businesses require to grow and develop is enhanced when the markets are efficient, liquid and fair. Therefore, it is of utmost importance to the US economy that the rules governing our markets encourage the capital formation process. Such rules should be fair to all market participants, encourage liquidity at all market levels, and foster efficient markets.

Providers of liquidity, such as market makers and specialists, continue to play a unique and critical role in this capital formation process through the trading of equity securities when there is no natural counter-party to a trade. As the debate over an electronic market versus a floor-based auction market system continues, the STA is increasingly concerned that issues relating to the trading of less active securities (listed and otherwise) and the significant benefits market makers and specialists provide to investors trading in that market are largely being ignored. The number of market makers has been reduced due to structural changes in the marketplace. Due to the important role that market makers play in the efficient operation of the

[2] Securities Exchange Act of 1934, Section 11A(a)(2); (15 USC 78k-1)
[3] Larry Kudlow, "Capital Code Red," National Review Online, March 20, 2003, http://www.nationalreview.com/kudlow/kudlow032003.asp

markets, we should be mindful that the rules governing the industry do not disadvantage one participant to the benefit of another. I will touch upon some unfair or inconsistent rules later in my testimony. The role of liquidity providers to the efficient functioning of the entire market should not be overlooked.

There would likely be consensus that the stocks of General Electric (GE-NYSE) and Intel (INTC-NASDAQ) do not, under normal market circumstances, require a liquidity provider to facilitate the execution of trades. These stocks are so active, liquid and transparent that, in most instances, efficient trading occurs without the need for intermediaries. Where liquidity providers add significant value is in the trading of less active stocks where natural buyers and sellers are not always immediately available.

Thus, the introduction of the market making function becomes an important asset in providing liquidity that is crucial for the efficient operations of the market.

The function of liquidity providers is in turn a very important aspect of the capital raising process. Young, small, public companies often experience less active trading, and as a result, have less liquid stocks. Investors benefit through market maker and specialist support by being able to access the liquidity they need to buy and sell those stocks. A lack of liquidity for stocks will certainly diminish the ability of some worthy corporations to raise equity capital and issue IPOs, thus causing harm to the economy. In fact, a *USA Today* article on October 19, 2003, points out that small, public companies experience the greatest financial burden in complying with laws, which potentially discourages issuance of public stock.[4] If liquidity is lost and other impediments to the capital raising process are erected, segments of the US economy dependent upon such capital may potentially stall.

Under the 1975 Amendments, one of the principles mentions the opportunity for investors' orders to be executed without an intermediary. Although this is an important goal, we should not overlook the other National Market System principles of efficient execution, fair competition, transparency of quotations, and the linkage of markets. As I mentioned, buyers and sellers are not always immediately available for some stocks, creating the need for liquidity providers to take the other side of certain trades. This means that in some instances, no matter how fast or great the technology may become for the execution of securities, an intermediary such as a market maker or specialist is needed to facilitate trades and provide the liquidity necessary for the efficient operation of the markets.

Current Situation

Advancements in technological innovation as well as the advent of decimalization have served to reduce costs for most investors. However, the US markets are currently facing a number of stresses that negatively effect investors and certain market participants. These structural anomalies impact the ability of investors to see a more accurate view of the depth of

[4] Del Jones, "Sarbanes-Oxley: Dragon or white knight?" *USA Today*, October 19, 2003, http://www.usatoday.com/money/companies/regulation/2003-10-19-sarbanes_x.htm.

the market and to access liquidity, and therefore, ultimately serve to impede the best execution of customers' orders.

Fragmentation

The volume of trading in Nasdaq securities by the Nasdaq Stock Market has significantly decreased over the past two years. Several developments have contributed to this decline in Nasdaq volume, causing fragmentation of the market for trading Nasdaq stocks. While this may not by itself be harmful to the proper functioning of the market, it has created several structural problems.

First, I should explain that one of the factors contributing to fragmentation relates to the recent increase in the number of exchanges granted what is referred to as Unlisted Trading Privileges ("UTPs") for Nasdaq securities. Put simply, if an exchange is granted UTPs for Nasdaq securities, that particular exchange is allowed to trade securities whose primary listing is the Nasdaq Stock Market. Several exchanges have been granted UTPs for Nasdaq stocks, such as the American Stock Exchange ("Amex") and some regional exchanges, including the ARCA Exchange, and the Cincinnati Stock Exchange.

The increased trading of Nasdaq stocks pursuant to UTP result in more competition between markets but also increased fragmentation since there are some inconsistent principles and rules governing these markets. Fragmentation may be a positive force if it encourages aggressive competition and innovation, which then serves to increase competition of price, liquidity and execution capabilities. However, without appropriate linkages to the various market centers and consistent rules across market venues – both issues of which I will address later – fragmentation does not serve to advance these positive characteristics.

These differences create problems in the ability to not only identify the best possible price, but may also limit a broker-dealers ability to efficiently "take" the price in a certain market and fulfill its best execution obligations for the customer. The STA believes that it is in the best interests of investors and the protection of fair and orderly markets that fragmentation be addressed in a way that does not diminish the ability of market centers to innovate, yet encourages consistent rules and efficient and workable linkages between markets.

Lack of Inter-market Linkages and Increase of Locked and Crossed Markets

One example of the impact of fragmentation is the lack of intermarket linkages, particularly for the trading of Nasdaq stocks. For example, let us examine the effects of recently allowing the Amex to begin trading Nasdaq stocks pursuant to UTPs. On August 2, 2002, the SEC approved the Amex's request for unlisted trading privileges of Nasdaq stocks.[5] One of the major problems associated with this situation is that Amex is a floor-based system that does not provide automatic execution of orders. Other markets trading Nasdaq securities provide automatic execution capabilities. The SEC allows a UTP Plan participant, such as Amex, the

[5] Securities and Exchange Commission Release No. 34-46305, File No. SR-AMEX-2001-106, August 2, 2002.

option of having its quotes available through Nasdaq's SuperMontage system.[6] Since the Amex has chosen not to participate in SuperMontage, a UTP market participant must go directly through the Amex floor to access its quote.

Why has this situation created serious problems? Due to the different technological capabilities and inadequate intermarket linkages, it is difficult for a participant to access the quotes on the Amex even if the quote is the national best bid or offer for a Nasdaq security. As a result, market participants face complications when attempting to make order routing and best execution determinations for investors. Best execution is a market participant's fiduciary responsibility to its customer, derived from common law, to seek to obtain the most favorable terms reasonably available under the circumstances.

The listed market (the New York Stock Exchange or the Amex) also has inadequate linkages to other market centers, although a system called the Intermarket Trading System ("ITS") has existed for over 20 years. The ITS was facilitated by the SEC due to the Securities Acts Amendments of 1975 for the purpose of "linking of all markets" to encourage efficiency, increased competition and the best execution of customer orders.[7] The Congress, in 1975, envisioned the power of technology to link market centers for the purpose of promoting a more liquid and efficient market. The ITS, however, has not achieved its full potential since some ITS participants do not provide automatic execution of orders, and a market has up to thirty seconds to respond to a commitment to trade. In today's environment, the market can move considerably in thirty seconds. It could be comparable to the 400-yard dash: if you lose 30 seconds, the race is already over. As a result, the ITS is being used primarily as a messaging center. Another obstacle to updating the ITS is that its rules require unanimous support by its members before anything can be amended, preventing common sense change and advancement of its technology requirements.

Another impact on best execution and the lack of inter-market linkages is the increasing amount of locked and crossed markets. A locked market is one where the bid and ask are the same price. A crossed market occurs when the bid is higher than the ask price. These situations are not normal market conditions but are becoming increasingly common in the Nasdaq and over-the-counter market, especially during the market opening. There is no such intermarket prohibition against locked or crossed markets.[8]

Locked and crossed markets have a significant impact on the execution of investors' trades. Such market occurrences cause delays in getting customer orders filled. They also render automatic execution capabilities useless during these periods, forcing slower execution of transactions. This may actually result in a customer's trade being executed at an unfavorable price due to the market changing within the time period required to unlock or uncross the market.

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[6] Nasdaq Head Trader Alert #2002-114, "Amex Will Begin Trading NASDAQ-Listed Issues on August 12, 2002," - August 7, 2002.
[7] Section 11A(a)(1)(D), Securities Exchange Act of 1934 (15 USC 78k-1)
[8] Nasdaq Head Trader Alert #2003-023, "Archipelago to Begin Quoting and Trading NASDAQ Securities as a UTP Participant on February 14, 2003," February 12, 2003.

Rule Inconsistencies

In the market for listed securities, the same rules and standards apply regardless of which market is trading that security. Unfortunately, this same consistency of rules does not extend to the markets trading Nasdaq securities. As mentioned earlier, Nasdaq securities are increasingly being traded by other exchanges such as the Amex and regional exchanges. The result is a system of varying rules and standards for market participants, depending upon which market the transaction occurs.

The problems of trading Nasdaq stocks pursuant to UTPs are not limited to the Amex's technological deficiencies. They also extend to other regional exchanges because of inconsistent rules, surveillance and enforcement of those rules. For example, the ARCA Exchange does not have a short-sale rule, while the Nasdaq and other markets do. Regardless of the merits of a short-sale rule or the lack thereof, one market should not be permitted to compete with others based upon rules designed for the protection of investors. Investors deserve the same protections whether their trade is executed on the Nasdaq's SuperMontage, the Amex, or the ARCA Exchange. It is very encouraging that the SEC will reportedly require a consistent short-sale rule for all markets, ending the disparity that currently exists for that rule. This action will serve as a very positive first step toward rationalizing the rules of the various markets.

ECN Access Fees

Most Electronic Communication Networks ("ECNs") charge fees, called access fees, to non-subscribers wishing to access orders placed on their systems. SEC rules adopted in August 1996,[9] allowed ECNs to charge these fees; however, market makers and other broker-dealers are not allowed to do this. Note that access fees are not included in the quotes of an ECN's system, making it difficult to know the actual cost associated with the transaction.

To understand why access fees do not result in equal treatment of market participants, it is essential to examine the interactions in the marketplace. Market participants have a fiduciary responsibility to seek to obtain the most favorable terms reasonably available for its customers' orders. This responsibility is often referred to as "best execution obligations." This is important to understand, since broker-dealers that are not subscribers to ECNs may sometimes be required to interact with a quote on an ECN's system if it is the national best bid or best offer for a particular stock. If the broker-dealer interacts with the quote, it is charged an access fee, even if it is not aware that such a fee is assessed. If a broker-dealer would refuse to interact with such a quote, it may be in danger of failing to satisfy its best execution responsibilities. This situation results not only in an unfair treatment of certain market participants but, more importantly, hides the true price of the security.

ECN access fees also provide incentives that encourage other behaviors that cause disarray in the markets. For example, access fees contribute to the increased occurrence of locked and crossed markets. Many ECNs now offer "liquidity rebates," which are payments to market participants placing limit orders, or orders that provide liquidity. ECNs use the rebates to attract liquidity in their systems, which in turn attract liquidity takers who are charged an access

[9] Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996).

fee. The access fees are larger than the liquidity rebates they pay out and result in a "spread" for the ECN, even though the actual market for that security is locked, representing a zero spread.

One encouraging development in this area is a request by the NASD, through Nasdaq, to set a maximum level of access fees that ECNs may charge in Nasdaq's SuperMontage system, which is Nasdaq's order display and execution system.[10] Although this is an imperfect solution since a lack of transparency still remains, it is one way of rationalizing the various levels of access fees that are charged, creating more certainty and predictability of the trading costs incurred.

STA Recommendations

The STA recommends several specific actions to advance the National Market System, which will in turn benefit all investors. The Securities and Exchange Commission has the authority to address each of the issues, as the Congress has given it broad authority over the regulation, oversight and "maintenance of fair and orderly markets."[11]

1. Improve Intermarket Linkages and Trading Rules

The ITS is in dire need of improvements that would provide for more efficient and timely executions of trades for listed securities. Therefore, the STA recommends that the SEC undertake efforts to mandate such improvements to the system, making it more useful and efficient. For Nasdaq securities, the STA recommends that the SEC require the establishment of intermarket linkages to provide automatic execution functionality. The resulting increase in technological capabilities should allow linkages to all participating exchanges, market centers, broker-dealers and ECNs. In addition, we recommend that the SEC promulgate intermarket rules that govern locked and crossed markets to ensure that consistent and fair procedures are used for unlocking these markets.

2. Consistent Rules, Enforcement and Surveillance

The STA encourages the SEC to require adoption of consistent trading rules among markets trading like classes of securities. In other words, we strongly support common rules for markets that trade Nasdaq securities and consistent rules for markets that trade exchange-listed securities. The surveillance and enforcement should also be consistent across markets. Eliminating the inconsistencies inherent in the current SRO model would also address "regulatory arbitrage," where the lack of consistent rules may be used to attract order flow, sometimes to the detriment of investors and other market participants.

3. Eliminate ECN Access Fees

I mentioned earlier that one of the goals of the National Market System is, "The availability to brokers, dealers, and investors of information with respect to quotations for and

[10] Securities Exchange Act Release No. 34-48501, File No. SR-NASD-2003-128, September 17, 2003.
[11] Section 11A(a)(2), Securities Exchange Act of 1934

transactions in securities."[12] ECN access fees do not meet this standard, as they obscure the true price of a security quoted on an ECN's system that charges such a fee. Access fees are not transparent and diminish a broker-dealers ability to provide best execution for its customers. In addition, the fee is patently unfair as some market participants are not permitted to charge a fee to access their liquidity while ECNs are able to do this.

There are several alternatives to dealing with the situation. The SEC could prohibit ECNs from charging access fees, thus creating a level playing field and improving the transparency of prices. A second, although less desirable, alternative could be to require ECNs to incorporate fees into their quotes to reflect the true price of a security. One significant drawback to this is that quoting in sub-pennies would be the likely outcome, complicating the best bid and offer. A third alternative is to prohibit ECN access fees for the limited purpose of unlocking markets, thus decreasing the current incentives for certain market participants to lock or cross the market in order to attract order flow.

Conclusion

Competition, the hallmark of a free market system, drives innovation, creativity and productivity. At the same time, rules that serve to advantage one set of market participants at the expense of others negatively impacts not only the attainment of the goals of the National Market System but also investors of every type and size.

We would do well to heed Commissioner Paul Atkins remarks when he said, "Since competition was the underlying justification for, and the by-product of, the 1975 Amendments, competition should continue to drive our decisions to seek further efficiency in the 21st century."[13] Rules that promote competition and fairness will ultimately benefit investors and the markets in general. A good starting point for solutions to the current market structure problems is to establish more efficient and appropriate connectivity and access between market centers and to institute consistent rules for all market participants trading and quoting the same security. Such rules will help to ensure that US markets remain the most efficient and liquid markets in the world, as envisioned by the goals set forth for the National Market System.

US policymakers and regulators must address the areas that impede the continued advancement of the goals of the National Market System, namely the maintenance of efficient, competitive and fair markets. The Congress, by its oversight of the SEC, plays an important role in ensuring that the SEC focus on market structure issues that harm the integrity of US markets. The SEC has examined market structure issues for several years, so it should be in a position to act. Several Commissioners have correctly commented on the need for the SEC to seriously focus on addressing the market structure problems, and the STA encourages them to act now and address these issues in a systematic manner. Inaction is itself a decision and serves only to exacerbate the existing problems. Failing to act on these matters would only further degrade the capital formation and retention process, negatively impacting the growth of jobs and the US economy.

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[12] Section 11A(a)(1)(C)(iii), Securities Exchange Act of 1934

[13] Commissioner Paul S. Atkins, Remarks before the American Enterprise Institute, Washington, DC, May 7, 2003.

Testimony of Mr. Thomas M. Joyce

CEO and President

Knight Trading Group, Inc.

Before the

Subcommittee on Capital Markets, Insurance and

Government Sponsored Enterprises

of the

House Financial Services Committee

Hearing on "Reviewing U.S. Capital Market Structure:

Promoting Competition in a Challenging Trading Environment"

Thursday, October 30, 2003

Chairman Baker, Ranking Member Kanjorski, Members of the Subcommittee, thank you for inviting me to participate in this hearing regarding the structure of the U.S. equities markets. I commend you for your efforts to examine the rules governing our markets to ensure that such policies and regulations remain relevant and adaptable to market developments. We also commend the SEC for its continued efforts to insure that the proper regulatory framework is in place to preserve the integrity of our capital markets, and make them the most vibrant, competitive and transparent in the entire world.

Knight Trading Group, Inc. is the parent company of Knight Equity Markets, L.P., Knight Capital Markets LLC, Knight Execution Partners LLC, Knight Financial Products LLC, and Knight Securities International Ltd., all of whom are registered broker-dealers. Knight and its affiliates make markets in equity securities listed on Nasdaq, the New York Stock Exchange, the American Stock Exchange, the OTC Bulletin Board and in options on individual equities and equity indices. Knight also owns an asset management business for institutional investors and high net worth individuals through its Deephaven subsidiary.

Knight is a major liquidity center for the Nasdaq and listed markets. As a dealer we make markets in nearly all equity securities and are specialists in option classes that constitute approximately 70% of all equity option volume executed in the United States. On active days, Knight executes in excess of one million trades, with volume exceeding one billion shares. Knight's institutional sales business offers comprehensive yet unbundled trade execution services covering the depth and breadth of the market. As a market maker, we facilitate large and complex trades by committing our capital. We are consistently the number one SuperMontage liquidity provider in the Nasdaq marketplace. Using our connectivity to various market centers, we commit capital to facilitate investor trading. Knight has the expertise to execute institutional orders according to client needs. Knight's clients include more than 850 broker-dealers and 600 institutional clients. Currently, the eight year old, publicly traded company employs nearly 1,000 people.

Importance and Role Market Makers Play in the Securities Markets

Knight and other market makers serve a central role in the securities markets. Knight commits capital. Basically, Knight uses its own money to facilitate executions. If someone wants to sell stock, we stand ready to buy it – using our own money if necessary in many instances. By doing so, Knight, and other marker makers, provide stability in volatile markets, and speed and certainty in less liquid issues; such as, securities below the top one hundred in volume, Nasdaq mid-cap stocks, certain listed stocks, the Small Caps, the Over the Counter Bulletin Board (OTCBB) stocks, and the Pink Sheets securities. We are able to ensure that trades are executed in a manner consistent with articulated preferences, based on the unique trading requirements of individual and institutional investors. We offer superior executions, a majority of which are automatically executed, with enhanced liquidity to other broker dealers including many of the online trading firms that have become household names. There is a fundamental difference between market makers and ECNs; while ECNs simply match buyers and sellers electronically, when there is no natural match between a buyer and seller, an order can sit on the books of an ECN for several seconds, minutes or hours if someone does not come along and is willing to trade with that order. A market maker, however, will many times use their own money to provide an execution to that order. By doing so, market makers provide liquidity by committing capital and taking risk to execute the trade as principal. These are functions, I submit, that are vital to the efficiency and depth of our capital markets.

If not for market makers, many stocks would be far less liquid, with increased transaction costs for the investor in the form of wider spreads. At Knight, we commit substantial capital every day, so that whether the investor wants to trade shares of Cisco or a relatively unknown over-the-

counter stock, buy and sell orders are executed quickly at a low cost and at the best available price. In other words, the market maker's ability to commit its own capital to execute trades allows investors to efficiently get into and out of their investments. If market makers did not exist to add liquidity, the market's slogan might be "trade by appointment only." Importantly, what makes our capital markets so strong is that we continue to embrace different trading mechanisms (from specialists to market makers to ECNs) that provide different benefits for different types of stocks and different types of investors. Competition and transparency are cornerstones of our capital markets. We are not here to find fault with one market model over the other; rather, we believe that all models should be given the opportunity to compete fairly. To do so, the rules across venues need to be reasonably and consistently applied to all market participants, so that competition and innovation can thrive – which ultimately inures to the benefit of the public investor.

Deep, liquid capital markets offer an increased capacity for the growth of the economy. Market makers take on the necessary risk to facilitate the efficient trading of securities. In his book on market microstructure, Larry Harris, now Chief Economist at the SEC provides an excellent discussion of the nature of liquidity in capital markets.[i] He also notes the function of market makers to "primarily supply liquidity in the form of immediacy."[ii] Market makers support the capital formation process by providing capital and liquidity to the markets.[iii] Given recent market conditions including a dearth of initial public offerings, smaller firms are very dependent on these venues to continue to raise capital and attract investors.

In the United States, the small business sector is the key to job growth and innovation. If a business is able to access capital and attract investors, it is able to invest in technology, create jobs, and make the capital improvements necessary for sustained growth. The resultant increase in investment by our large and small business sector not only benefits the U.S. economy and creates additional jobs for Americans, but also helps to provide the capital necessary for development of innovations and new technologies. In other words, by providing investors with liquidity in the market place, market makers serve as an integral part of our nation's economic growth.

State of the Equity Securities Industry

Although the U.S. equity markets remain the most vibrant, efficient and liquid markets in the world, they are currently facing several serious problems. The conversion to decimals has narrowed spreads, and has also created a variety of issues that must be addressed. The interaction between floor based markets and electronic markets is straining our ability to achieve the goals of the National Market System. The existence of certain rules that are applied in unfair or inconsistent ways is hampering effective competition. These problems are acute, systemic and have reached a point that causes harm to the efficient functioning of the markets and ultimately, to investors. I will address what we see as the most significant market structure issues below.

Unfulfilled Goals of the Securities Acts Amendments of 1975

Fortunately, the Congress anticipated many of these issues when it adopted the Securities Act Amendments of 1975, which directed the SEC to facilitate the establishment of a National Market System.[iv] At Knight, we take these goals seriously and want to fulfill our obligations as

established in the 1975 Amendments. Doing so puts the investor first. We reaffirm the goals of the Amendments, which are to provide for the "maintenance of fair and orderly markets to assure:"

1) "economically efficient execution" of transactions;

2) "fair competition" among and between market centers, including exchange markets;

3) availability of quotations;

4) "executing investors' orders in the best market";

5) "an opportunity... for investors' orders to be executed without the participation of a dealer"; and

6) "the linking of all markets... [to] contribute to best execution."

The important thing for us to remember is that these six goals are interdependent. For example, it doesn't make sense to try to link all markets if there are inconsistent rules that do not permit fair competition between markets. Similarly, although the 1975 Amendments talk about finding ways to allow "investors' orders to be executed without the participation of a dealer", this was in no way a mandate to eliminate dealer markets, especially in less liquid stocks where orders typically cannot be executed without dealer participation. And, in a post-decimal, one-penny MPV (minimum price variation) trading environment, this directive does not have the same meaning it did when it was adopted nearly 30 years ago. Throughout my testimony I will expand upon specific examples of rules, or lack thereof, which overlook several of the goals of the 1975 Amendments.

I want to commend Chairman Donaldson and other Commissioners and SEC staff for consistently stating the need to expeditiously address market structure issues. The SEC has already developed a significant body of knowledge and sponsored a number of initiatives that have examined all aspects of market structure in considerable detail, including the Market Data Advisory Commission formed by former Chairman Arthur Levitt, and the market structure hearings conducted by the SEC late last year. Unfortunately, after years of study, given the distractions caused by issues relating to accounting fraud, corporate governance, and now mutual fund investigations, the SEC has yet to formally take action. All of these are very important issues and deserve serious attention, but it is important that market structure issues be promptly acted upon or we risk a continued degradation of the efficient functioning of the American equity markets, and ultimately the capital formation process.

I must admit it is somewhat disconcerting to hear from several commentators that the only way to resolve market structure issues is by acting in a "holistic" fashion. As the saying goes, "perfection is the enemy of the good." Unfortunately a holistic approach, one where the Commission would address every market structure issue at the same time, is a recipe for further delay and inaction. Instead, incremental steps can, and must, be taken to address specific issues that are impacting the efficiency of our markets. If we wait on implementing sensible changes until every issue is ferreted out, then it is very possible that no action will result.

Delay will Only Create Further Inefficiencies in the Market

It is interesting to note that only a year ago 97% of all trading volume in Nasdaq stocks was reflected in the Nasdaq market. Today, just one year later, that number has dropped to

approximately 50%. The reasons for this vary. For example, the failure to deal with the market data issues raised several years ago has contributed to the decision of certain market participants to leave Nasdaq. These market participants have instead chosen to print their volume on regional exchanges who have adopted a "shared economic approach" to revenues generated by those exchanges. Thus, we believe that the consequences of waiting for the perfect solution or taking a holistic approach are immense. Market developments such as the Standard & Poor's recent announcement that it will initiate a pilot program using the American Stock Exchange's ("Amex") closing prices of 12 Nasdaq securities for calculating the S&P 500 Index will continue to challenge the market. For the first time, these 12 securities will have two "official" closing prices. Clearly, this will lead to more dislocation of liquidity (for example, the Amex currently accounts for less than 1% of the volume in these 12 stocks), as well as confusion among public investors as to what closing price they are entitled.

Let me be clear that fragmentation is not harmful so long as there are fair rules that allow for a level playing field between competitors. Fragmentation without these essential characteristics does not fulfill the National Market System goal of linking all markets to achieve the best execution of orders. Knight is linked to virtually every market to ensure that it can serve its clients' best interests. These linkages, however, have come at an increased cost. For instance, an NYSE or Amex "commitment to trade" through the Intermarket Trading System ("ITS")[v] with Knight's system is given instant automatic execution. But the NYSE and Amex do not provide automatic execution for an ITS order coming from Knight, resulting in an ineffective linkage. Thus, true bilateral linkages, equal access and fairly applied rules are needed for markets to effectively and efficiently interact with each other.

Best Execution for Investors

The starting (and ending) point for any discussion on market structure is the concept of best execution. On the surface, it seems to be a simple concept. But what may be best execution for one investor could be very different for another, making it very difficult to define. Thus, we must let the individual investors decide. Today, investors make suitability determinations when opening their securities accounts at brokerage firms. They decide if their investing goals are "long-term growth" or "income" or "speculation" to name a few. They decide whether they want to receive dividends or have them reinvested. They should also be permitted to decide ***how*** they want their orders executed – speed, liquidity (fill-rate), and price. Trade execution requirements are simply an extension of the investor decision. An investor's right to choose should be sacrosanct. To decide otherwise is simply incompatible with a free market society. Commissioner Atkins concisely illustrated this point in a speech he gave earlier this year.[vi] He used the example of a time when his wife was pregnant with their first child. She wanted a particular type of ice cream. The local deli store a few blocks away had the favored brand, but it charged a high price. One of the other options was to go to a supermarket on the other side of town where the ice cream was cheaper. Of course, getting to the supermarket would be inconvenient and could fail to satisfy the cravings in a timely fashion. Consequently, Commissioner Atkins chose the local deli to meet his needs at that particular time. As you can see, he adapted his execution standards to meet his immediate needs.

When it comes to Best Execution, we reiterate -- let the investor decide. Best execution can and should vary by investor and can be different for various trades by the same investor. One investor may place importance on speed of execution to lock in a certain price. A different

investor may place primary importance on price, while yet another may be most concerned with maintaining anonymity and liquidity. The different investor needs reflect varied best execution standards, as defined by the investor. As such, relationships with clients are the most important determinant of their best execution needs. A market participant that "knows the customer" will know the needs and objectives of the investor, thus ensuring best execution. Former Chairman Arthur Levitt affirmed this investor-centered concept of best execution in 1999 by stating, "[T]he quality of execution must always be viewed from the customer's perspective, not the firm's."[vii]

It is significant to note that today investors have many more tools and information available to help them assess the execution quality of a broker-dealer. For example, the SEC adoption of Rule 11Ac1-5 improved the disclosure of broker-dealer order execution quality.[viii] The rule requires market centers to make monthly reports of statistical information regarding their order executions, most notably statistics of price and speed of execution. The SEC also adopted Rule 11Ac1-6, which requires all broker-dealers to make available quarterly reports of their routing practices.[ix] These disclosures help all investors, whether they execute one trade per month or several trades per day, to determine which market centers provide the best execution of orders, and whether their brokers route their orders according to the investor's best interests.

The concept of best execution surrounds other market structure issues, such as consistency of rules across trading venues and sub-penny trading. Consistent rules across markets are needed to ensure a level playing field for all market participants and the best execution of investors' orders. Sub-penny trading dramatically increases the number of quoted price points, meaning liquidity is

further dispersed, thus reducing transparency and liquidity. I will describe these issues more fully below.

The Need for Consistent Rules Across Markets

As baseball fans are well aware, the American League and the National League have different rules relating to the use of a designated hitter. As a result, the first time a team from the National League played a team from the American League, the problem of which rules to use arose. The compromise was that the rules of the home team be applied. Today, different market participants have different rules. A harmonization of rules across market venues is necessary for a level playing field so that the industry can better ensure best execution for investors regardless of where the security is traded. Uniform rules that are transparent and vigorous are necessary to serve the best interests of investors.

Increase of Nasdaq Stocks Traded under the Unlisted Trading Privileges Plan

Several inconsistencies encountered in the market result, in part, from the dramatic increase in the trading of Nasdaq/National Market securities (NNM) on regional exchanges pursuant to the Unlisted Trading Privileges Plan (UTP Plan). When the Congress passed the Securities Act Amendments of 1975, it properly envisioned markets where listed securities could freely be traded over-the-counter and unlisted securities could be freely traded on exchanges.[x] The Nasdaq/UTP Plan was established as one component of the National Market System to provide transparency for NNM securities, thereby enabling members of the regional exchanges to trade securities listed on Nasdaq. Although the Nasdaq/UTP Plan governs the collection, consolidation and dissemination of quotations, its scope is limited to market data and does not

require any meaningful type of market linkage nor does it impose any common set of rules other than for trading halts.

Some markets have evolved and advanced their technologies significantly while others have not kept up with such developments. This has caused a collapse in the ability to efficiently execute trades and provide best execution – each being important goals of the National Market System. For example, there are few requirements for a market to update its rules or technology if it is seeking the right to trade Nasdaq securities under the UTP Plan. One of the requirements to gain UTP status is to allow access to the quote. The problem is that this requirement does not go far enough – it does not indicate how market participants can access the quote (e.g., manually or automatic execution).

When the over-the-counter market for listed stocks (the so-called third market) was integrated with the listed market through a linkage called ITS/CAES, third-market market makers were required to adjust certain of their practices to the practices of exchanges in order to assure some comparability of regulation. For example, third-market market makers were required to change the way they reported trades to the way exchanges reported trades. Similarly, although there were many third-market market makers, their quotes were consolidated into a single quote to mimic the way exchange quotations are presented. Finally, third-market market makers were required to agree to the terms of the ITS Plan which provides a uniform (albeit inefficient) linkage among markets trading listed stocks.

When the UTP Plan was implemented, none of these steps were taken. As a result, inconsistent trading environments and access mechanisms have become more common, which directly hinders the ability to efficiently execute trades. The most glaring example has to do with access. The Nasdaq is a screen based electronic dealer market which provides automatic execution in most instances, while most regional exchanges are floor-based auction markets without automated execution. This difference means that regional exchanges can easily access Nasdaq quotes whereas Nasdaq market makers cannot easily access regional exchange quotes. These consequences cause disruptions and do not further the goals of the National Market System to provide for the maintenance of fair and orderly markets. Thus, depending upon the investors' needs, the inefficient linkages may hinder best execution. As such, we believe the UTP plan needs to be revised to properly address these issues.

Short-Sale Rule

The short-sale rule is another rule with differing treatment across venues, although the SEC is proposing[xi] a "bid test" short-sale rule[xii] that will apply to every U.S. equity market, rather than the current inconsistent application of the rule. We support the SEC's attempt to unify the differing rules by applying one rule across all markets. It has been reported, however, that the SEC may not renew the short-sale exemption for market-making activity. We question why this exemption should be taken away as it has served the markets well. As with any law or rule, isolated abuses of the rule can and should be swiftly dealt with. However, we should not throw the baby out with the bathwater. There are very important reasons why market makers need this exemption (e.g.,, the ability to execute investor buy and sell orders in declining markets). The

proposed rule would eliminate the short-selling behavior that has been of concern to issuing companies, but there is no rationale for eliminating the market-maker exemption.

Trade-Through Rule

Briefly, the trade through rule prohibits ITS participants from trading a stock at an inferior price if there is a better price available in another participating market. On May 30, 2003, the SEC granted an additional temporary nine-month *de minimis* exemption to the ITS trade-through rule for transactions in three exchange-traded funds ("ETFs"), the Nasdaq-100 Index ("QQQ"), the Dow Jones Industrial Average ("DIA") and the Standard and & Poor's 500 Index ("SPY"). The rule exempts such transactions from the trade-through rule if they are executed at or within three cents of the best bid and offer.

While the *de minimis* exemption is a step in the right direction, the exemption should be extended across the market to all other intermarket securities. In the meantime, the utility and relevance of the trade-through rule should be further examined due to the rapid technological advancements in the industry that make price priority less relevant. Because decimalization has significantly lowered spreads, and as mentioned earlier, because investors' execution needs vary with some preferring speed over price, the trade-through rule no longer provides the same safeguards as it did when enacted 20 years ago. The market now provides a number of its own protections, including the one-penny MPV, as well as faster and more complete fills, rendering the trade through rule virtually obsolete. Indeed, the trade-through rule may hinder certain investors from implementing their execution strategies. So, we believe that the SEC should

permit investors to decide what is important to them, as it appears the SEC has already done in granting exemptions for certain ETFs.

Efficient Linkages are Key to a Competitive National Market System

The Securities Act Amendments of 1975 envisioned intermarket linkages for the trading of securities to "foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders."[xiii] The lack of efficient linkages is yet another shortcoming of efforts to achieve the goals of the National Market System.

As mentioned earlier, in the listed markets there has been a linkage in place since the Intermarket Trading System (ITS) was introduced in 1978. Unfortunately, this system still uses the technology developed in 1978 and is out of date. For example, some participants still do not allow for automatic execution, instead they require up to 30 seconds to respond to a quote. In markets where executions are measured in milliseconds, 30 seconds is an eternity. Thus, in an ITS setting, executions are not necessarily defined by the best market price, but can be defined by the slowest link in the chain. The linkages that do not provide access to automatic executions do not fulfill the National Market System goals of "fostering efficiency" and "best execution". Therefore, we call for significant improvements to the ITS to ensure more efficient executions of trades. For this to occur, the technology should be updated to allow for automatic execution capabilities, and it should allow direct access for market makers.

For Nasdaq stocks, the situation is much different. There is no common linkage like ITS and the dispersion of liquidity is far greater than for listed stocks. On one level this is good. Competition fosters better pricing and efficiency. However, on another level, the lack of standard rules which define access and trading practices among the different venues has led to a degradation in execution quality.

With requirements of best execution appropriately falling upon various market participants, it has become extremely difficult (and costly) to efficiently and effectively access simultaneously all points of liquidity. And, with quotes flickering at staggering rates, there is no single way to sequentially access pockets of liquidity at any one point in time. Many times, it is "now you see it, and now you don't." As such, it is imperative for the SEC and other regulators to apply realistic notions of what constitutes best execution, and to use the National Best Bid or Offer (NBBO) as a guide – not an absolute measurement.

Unfortunately, the UTP Plan simply does not deal with these issues. Although the Plan does require each market to make its quotations available by telephone, given the way Nasdaq stocks trade, this type of access is useless. It is essential that the SEC step in and require some form of automatic execution of inbound orders. Currently, some markets such as the Amex do not provide for any type of automated execution of orders. Thus to access their quotations, it is necessary to send an order through the Amex order delivery system and wait, quite often for several seconds or even minutes for an execution. What was true for the over-the-counter markets when they started to trade listed stocks is true for exchanges that wish to trade Nasdaq

stocks – they must conform to the trading conventions of the market. In the case of Nasdaq stocks that means instantaneous execution.

The concept of best execution and price-time priority also goes to a proposal now before the SEC. The Cincinnati Stock Exchange ("CSE") submitted a proposal to the SEC last year that would, if implemented, establish a "Voluntary Book" for orders. The proposal would subject both the CSE and the Nasdaq to similar regulatory treatment by allowing the exchange to move away from the price priority rules to which it is currently subjected. The Voluntary Book would include only Nasdaq securities traded through the Nasdaq/UTP Plan. It would do away with price time priority, thus allowing market participants to provide best execution for investors according to their specific needs or requirements. Again, best execution should be from the investor's perspective, meaning the investors could value speed over price. If implemented, the proposal would allow market makers to execute an order based upon the investor's best execution needs.

As with market participants, we believe that competition should be permitted to flourish among market centers. Adoption of this rule will permit the CSE to complete more fairly with other market centers.

ECN Access Fees[xiv] Inhibit Transparency and Promote an Unlevel Playing Field

The National Market System goals encourage fair competition among and between markets. Vigorous competition between market centers ensure that the best ideas flourish and develop. If rules are fairly applied, healthy competition and the free market system will reward the best ideas. Such competition will further reduce transaction costs and cause firms to offer other

value-added services to the benefit of investors. However, if rules treat some market participants differently than others, distortions in the market and unfairness result.

The privileged ability of ECNs to charge access fees is another case of an unlevel playing field in the securities industry. ECNs are allowed, due to a footnote in the Order Handling Rules,[xv] to charge fees for accessing the liquidity in their systems. In contrast, Knight and other dealers are prohibited from charging such fees. By allowing only one segment of the market to charge a fee, competition is hampered and investors lose out.

The National Market System also encourages best execution of orders. A market maker is faced with best execution obligations, which may require it to take liquidity from an ECN's system to provide the "best" price for the investor. The fees charged by ECNs are priced in sub-pennies and typically range from about $0.0025 to $0.009 per share, resulting in significant costs for market participants that must access the quote. This means that if an investor were to purchase a security quoted at $10.95, the actual price of that security if purchased by a market maker would be $10.95, but if purchased through an ECN's system, the actual price of the security may be anywhere from $10.9525 to $10.959.

There is one positive development in regard to ECN access fees. The Nasdaq recently filed a proposed rule change that would establish a maximum ECN access fee in its SuperMontage system.[xvi] As mentioned earlier, the level of ECN fees can vary significantly, making it difficult for a market maker to know the costs they will incur when interacting with an ECN quote. The Nasdaq proposal is a good first step and would help to reduce the disparity in the level of ECN

access fees; however, this is only a partial solution to the problem. The issues of fairness and transparency of prices still remain. In addition, other market centers have not placed limits on these fees, thus maintaining an inconsistency of rules across markets relating to the fee levels.

We believe in competition. Competition among the various liquidity pools has in the past and, we believe, will continue to assure that access fees charged to firms that determine to route orders to them are reasonable. The same cannot be said of ECN access fees charged through Nasdaq's SuperMontage precisely because no competition with respect to access fees is permitted. The only competition permitted within SuperMontage is with the price, time and size of quotations. Access fees do not fit into the equation. An appropriate analogy would be if a broker on an exchange floor who had the best bid in the crowd charged another broker who traded with him an access fee. The exchange auction could not operate effectively in this way, nor can Nasdaq.

Sub-penny Quotations

The implementation of decimals has significantly impacted the market. For example, academic studies have shown that individual investors may have benefited from the narrowing of spreads,[xvii] but some studies have also shown that trading costs for mutual funds – in which the majority of Americans are invested – have actually increased.[xviii] This is the result of liquidity dispersed across 100 price points rather than sixteen or eight, thus making sourcing of liquidity difficult.

I strongly urge the Commission and Congress to hold the line on sub-penny quoting and go back to pennies . Here is what I mean.

We are now seeing a shift from decimals to sub-decimals. Securities, particularly Nasdaq, are currently being traded not in 100 increments, but in 1000 price points per dollar, or sub-pennies. The effect is greater diffusion of quotes, resulting in less liquidity and transparency for investors. This reduces the efficiency of our capital markets and renders some rules, such as the short sale more complicated. As I mentioned earlier, liquidity is absolutely necessary for well-functioning markets. Sub-penny trading quite simply degrades the ability to access liquidity for our investor clients. Additionally, it allows some market participants to "step ahead" of investor orders by fractions of a penny. This clearly serves to erode investor confidence, particularly when their orders remain unexecuted in the face of executions occurring within "mils" of their desired price.

Sub-penny increments have also greatly increased quote traffic, straining the technological systems of the market and its participants. A recent study shows that when compared to a pre-decimal period (March/April 2001), Nasdaq quote traffic in the same post-decimal period (April 2003) jumped about two hundred-sixty (260%) percent, during a period when trade volumes were declining. This means that the number of quotes per trade dramatically increased due to the move to 100 price points, thereby resulting in substantial strain on the technological systems. Sub-penny quoting will further degrade the market and increase quoting activity across a thousand price points.

Let me be very clear – we are not talking about going to nickels. We are instead talking about going back to pennies. In its July 23, 2001, request for comments, the SEC staff acknowledged, "there may be a point at which the incremental costs of reducing the MPV exceed the incremental benefits."[xix] I respectfully submit that the negative effects of sub-penny trading has far exceeded any possible associated benefit. We should not further erode the usefulness of the NBBO by permitting the infestation of sub-penny trading. Rather, the SEC should continue its efforts to insure that we maintain the highest possible standards of execution quality, and that individual investors have complete access to the market.

Locked and Crossed Markets Impact Best Execution and Cause Inefficient Trade Executions

Access fees, a lack of adequate intermarket linkages and the increase in trading of Nasdaq stocks pursuant to UTPs have contributed to a raft of locked and crossed markets, particularly during the open and closing markets. Locked and crossed markets cause substantial confusion in the marketplace because these conditions give the appearance of irrationality. A locked market is one where the bid and ask are equal. In a crossed market, the bid is higher than the offer, making it appear that buyers are willing to pay more for the security than they are willing to sell. In a locked market situation, the best bid and ask are the same; so a trade should occur. But because of ECN access fees or inefficient ITS linkages the trades do not occur, and investors miss out on an opportunity to buy or sell securities.

Locked and crossed markets used to be unusual but are now common occurrences. While lowering spreads for investors is positive, locked or crossed markets result in confusion and slower execution of investor orders. If trade executions are delayed for an investor, the market

may move in an adverse direction for the investor after the market is unlocked. Regardless of market moves, slowing executions hampers best execution.

The SEC does not have rules applying to all markets that would address locked and crossed markets. NASD Rule 4613(e) governs such market events for trades on the Nasdaq Stock Market. However, other markets that quote Nasdaq securities pursuant to UTPs do not have rules that address the situation, resulting in further inconsistencies in the marketplace even when trading the same stock.

Again, we believe that there needs to be consistently applied rules across all exchanges to deal with this market structure issue. For example, the SEC should require all market participants to first attempt to trade with posted quotes and displayed orders before locking the market. By doing so, we believe that the incidents of locked markets will be substantially reduced.

Conclusion

Knight has always believed competition is best for the markets and investors. Competition fosters creativity and innovation. But a lack of clarity for rules can lead to less appetite for innovation and technological development due to regulatory uncertainty. At times we have been caught between inconsistent rules, resulting in confusion, wasted time and energy. At Knight we believe in our team and technologies. We have no doubt in our ability to compete with others in the marketplace. But for us to make proper business decisions, we need certainty and fairness in the rules.

It is important to emphasize that market structure is not merely an esoteric issue that only affects Wall Street firms. These issues impact the costs investors must incur and ultimately the capital formation process critical for the growth and development of large and small companies. Vibrant US equity markets will ensure that successful companies of all sizes are provided with the necessary liquidity and access to capital necessary for their growth. Sub-penny pricing, ECN access fees and inconsistently applied rules and the resultant locked and crossed markets should be addressed to ensure liquidity does not dry up, which would have a particularly negative impact on small- and mid-cap companies.

Chairman Donaldson, Commissioner Atkins, Commissioner Glassman, Commissioner Goldschmid, Commissioner Campos, as well as former Chairmen Levitt and Pitt, have all made statements about the importance of addressing market structure. This demonstrates that market structure issues have been lingering for years, only to now reach a critical point. I applaud Chairman Donaldson for his recent comments before the Senate Subcommittee on Securities and Investment regarding his desire to move the process forward. Spending additional months and years examining the issues would only serve to hinder the capital formation process and the maintenance of fair and orderly markets.

I ask the Congress, in exercising its oversight responsibilities, to ensure that that the Commission acts swiftly to address these critical market structure issues. Inaction is a decision to do nothing. Instead, the SEC must act by beginning a rulemaking process for each issue. Promptly addressing these issues will serve to support the capital formation process and ultimately benefit investors.

Endnotes

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[i] Harris, Larry, Trading & Exchanges: Market Microstructure for Practitioners, Oxford University Press, 2003, pg. 394. He states, "Liquidity is the ability to trade large size quickly, at low cost, when you want to trade. It is the most important characteristic of well-functioning markets. Everyone likes liquidity. Traders like liquidity because it allows them to implement their trading strategies cheaply. Exchanges like liquidity because it attracts traders to their markets. Regulators like liquidity because liquid markets are often less volatile than illiquid ones... impatient traders take liquidity. Dealers, limit order traders, and some speculators offer liquidity. Brokers and exchanges organize liquidity."

[ii] Ibid, pg. 401.

[iii] Ibid, pg. 400. Mr. Harris identifies liquidity-offering traders as market makers, block dealers, buy-side institutions, or individual investors.

[iv] Securities Exchange Act of 1934:

Section 11A(a)(1) The Congress finds that –

(A) The securities markets are an important national asset which must be preserved and strengthened

(B) New data processing and communications techniques create the opportunity for more efficient and effective market operations.

(C) It is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure-

i) Economically efficient execution of securities transactions;

ii) Fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;

iii) The availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;

iv) The practicability of brokers executing investors' orders in the best market; and

v) An opportunity, consistent with the provisions of clauses (i) and (iv) of this subparagraph, for investors' orders to be executed without the participation of a dealer.

(D) The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders.

(2) The Commission is directed, therefore, having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets, to use its authority under this title to facilitate the establishment of a national market system for securities (which may include subsystems for particular types of securities with unique trading characteristics) in accordance with the findings and to carry out the objectives set forth in paragraph (1) of this subsection. The Commission, by rule, shall designate the securities or classes of securities qualified for trading in the national market system from among securities other than exempted securities. (Securities or classes of securities so designated [are] hereinafter in this section referred to as "qualified securities".)"

[v] The Intermarket Trading System ("ITS") was developed pursuant to Section 11A of the Securities Act Amendments of 1975, which mandated the SEC to oversee the development of a national market system. The ITS is an order routing system that links all eight US exchanges and Nasdaq in order to assist in the intermarket trading of exchange-listed securities. One significant problem with ITS operations is the

inability of some participants to allow for automatic execution, diminishing the value of the intermarket linkage system for those with auto-ex capabilities.

[vi] Speech by SEC Commissioner Paul Atkins before the American Enterprise Institute, Washington, DC, May 7, 2003.

[vii] Speech by SEC Chairman Arthur Levitt, "Best Execution: Promise of Integrity, Guardian of Competition," before the Securities Industry Association, Boca Raton, Florida, November 4, 1999.

[viii] Securities Exchange Act Release No. 34-43590 (November 17, 2000), 65 FR 75414 ("Adopting Release).

[ix] Ibid.

[x] Pub.L. 94-29 (Section 11A, Securities Exchange Act of 1934).

[xi] http://www.sec.gov/news/press/2003-140.htm

[xii] The "bid test" prohibits selling a stock short if bid for the stock is lower than the previous inside bid. Currently the Nasdaq has a bid test short-sale rule, while the "tick test" applies to the New York Stock Exchange and the American Stock Exchange, while another exchange does not have rules governing short sales.

[xiii] Securities Exchange Act of 1934, Section 11A(a)(1)(D)

[xiv] Electronic communication network (ECN) access fees are fees paid to the ECN when interacting with orders placed on its system. Other market participants are currently not permitted to impose fees for similar access to orders on their systems. Footnote number 272 of the Order Handling Rules adopted by the SEC on September 12, 1996, allow ECNs (but not broker-dealers) to impose fees to access the liquidity in their systems. The footnote reads in its entirety:

> "For access to be "equivalent", the ECN must enable non-subscribing broker-dealers to execute against the ECN's published best price to the same extent as would be possible had that best price been reflected in the public quote of a specialist or market maker. The ECN, however, may impose charges for access to its system, similar to the communications and systems charges imposed by various markets, if not structured to discourage access by non-subscriber broker-dealers."

[xv] Securities Exchange Commission Release No. 34-37619A (September 6, 1996), Federal Register 48290 (September 12, 1996) ("Order Handling Rules").

[xvi] Securities and Exchange Commission Release No. 34-48501, File No. SR-NASD-2003-128, "Notice of Filing of Proposed Rule Change and Amendment Nos. 1 and 2 Thereto by the National Association of Securities Dealers, Inc. Relating to Establishing a Maximum ECN Access Fees in SuperMontage and Elimination of SuperMontage's Price/Time With Fee Consideration and Price/Size Execution Algorithms," Federal Register 56358 (September 17, 2003).

[xvii] Goldstein, Michael A. and Kavajecz, Kenneth A., "Eighths, Sixteenths and Market Depth: Changes in Tick Size and Liquidity Provision on the NYSE, " September 16, 1998; Jones, Charles M., and Lipson,

Marc L., "Sixteenths: direct evidence on institutional execution costs," February 2000; Sugato Chakravarty, Venkatesh Panchapagesan, and Robert A Wood, " Institutional Trading Patters and Price Impact Around Decimalization," December 2001; Sugato Chakravarty, Robert A Wood, and Stephen P. Harris, "Decimal Trading and Market Impact," January 10, 2002; Bourghelle, David and Declerck, Fany, "Why Markets should not Necessarily Reduce the Tick Size," October 2002.

[xviii] Bollen, Nicolas P.B. and Busse, Jeffrey A., "Common Cents" Tick Size, Trading Costs, and Mutual Fund Performance," May 2003. The study examined mutual fund trading cost changes after reductions in tick sizes in the US equity markets. It compared trading costs before and after the switch to sixteenths and decimals. The authors estimated the change in trading costs of mutual funds by inferring trading activity from changes in quarterly-reported portfolio holdings, adjusting this benchmark to account for the actual cash holdings and expense ratios of the funds. The report focused on individual funds invested predominantly in US stocks with at least 90% of their assets in equities. The findings concluded that the average change in trading costs after the switch to sixteenths was not statistically significant. However, the study finds trading cost increases of 1.367% of fund assets after the switch to decimals. Additionally, it reported no evidence of reduced trading costs after the first half of the period following decimalization.

[xix] Securities Exchange Commission Concept Release No. 34-44568, File No. S7-14-01, "Request for Comment on the Effects of Decimal Trading in Subpennies," July 18, 2001.

Testimony

of

Michael LaBranche

The Specialist Association

of the

New York Stock Exchange

on

Market Structure Issues and the Current Trading Environment

Before the

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

of the

Committee on Financial Services

United States House of Representatives

Testimony of Michael LaBranche

Market Structure Issues and the Current Trading Environment

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

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October 30, 2003

I am Michael LaBranche, Chairman and Chief Executive Officer of LaBranche & Co. Inc., the parent of LaBranche & Co. ("LaBranche"), the largest specialist firm on the New York Stock Exchange ("Exchange"). Our firm has over 107 seats on the Exchange and is the specialist for more than 575 common stocks listed there, operating through 107 individual specialists on the floor. I also am a Governor of the Exchange and a member of its Market Performance Committee. I appear before you today on behalf of The Specialist Association of the Exchange, of which LaBranche is a member, as well as on behalf of my firm.

Development of the National Market System and the Problem of "Trade-Throughs"

Many of the witnesses who have appeared before you represent one form or another of the electronic trading markets that have come into being since the advent of the Securities Acts Amendments of 1975 ("1975 Amendments") and establishment of the most basic elements of the national market system contemplated by the 1975 Amendments under rules of the Securities and Exchange Commission ("SEC"). These are: (i) the consolidated last sale information system ("consolidated system"), administered by an association comprised of representatives of the several self-regulatory organizations known as the Consolidated Tape Association; (ii) the

consolidated quotation system ("CQS"), which collects from all markets, consolidates, and disseminates bid and offer information, required to be "firm" by the firm quote rule of the SEC; and (iii) the Intermarket Trading System ("ITS"), created pursuant to another joint self-regulatory organization plan, which enables participants in all of the markets sponsored by a self-regulatory organization to transmit to each other's markets "commitments" to buy or sell at a specified price and size when a better price is available in another market.

A so-called "trade-through" in a listed stock included in the CQS occurs whenever a trade is completed in one market at a price inferior to an apparently available price being published in the CQS by another market. All self-regulatory organizations have adopted a uniform trade-through rule pursuant to the ITS plan which requires their members to "avoid" trade-throughs. This obligation, combined with brokers' duty of "best execution" (namely, to use the broker's best efforts and all available means to obtain for the broker's customer the best execution available under the circumstances), effectively compels brokers seeking to execute customers' orders in one market at a time when a better price than the proposed execution price is shown in CQS to be available in another market to either match or improve upon that better price or to send a "commitment" to that other market by means of the ITS to seek to trade with that better priced bid or offer before effecting the trade – thus avoiding a trade-through.

The Advent of Electronic Markets

It is the advent of electronic markets in the context of CQS, ITS, and the trade-through rule that have caused indigestion in the markets of today. And it is these systems and the trade-through rule that have incurred the wrath of the electronic markets whose representatives have appeared before you in these hearings. Blame for the problems that the CQS, the ITS, and trade-through rule have caused the electronic markets is heaped primarily on the Exchange, although the CQS, ITS, and the trade-through rule were the result of SEC prodding and insistence.[1]

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[1] The SEC position on trade-throughs has been clear and consistent over the years. For example, in 1982, the SEC stated that "Trade-throughs undermine the ability of market participants to compete effectively for order flow and should be eliminated to the extent practicable." Release No. 34-19249 (November 1982), 47 FR 53552, 53553 (November 26,
[footnote continued]

Why has this caused indigestion? It has resulted from the fact that electronic markets trade in fractions of a second, at least for small orders where the opposite side typically is already resident in their systems. These markets rely primarily or exclusively on priced orders to buy and sell that are collected and displayed within each such market and can be "hit" in effect instantaneously by the entry of an order on the other side of the market at the same price. It should be noted, however, that these electronic markets are purely passive and only offer quick liquidity in stocks listed on the Exchange – if at all – if opposite-side buying or selling interest is resident in their systems when someone wishes to trade in them. Lengthy waits to find an opposite side for larger orders are common in these systems.[2]

1982). The SEC also has indicated that trade-throughs are "unacceptable." Release No. 34-17314 (November 20, 1980), 45 FR 79018, 79019 n. 12 ("the Commission has taken the position that such trade-throughs constitute 'unacceptable behavior'"). Moreover, the SEC consistently has held that nationwide price protection is a "first priority" and should be a "basic characteristic" of a national market system. Release No. 34-15671 (March 22, 1979) at 3, 5 (appropriately displayed public limit orders should be assured of receiving an execution prior to any execution at an inferior price).

Importantly, the SEC recently adopted amendments to the ITS Plan to expand the ITS/CAES system and bring more securities within the protection of the trade-through rule. (ITS/CAES is the computer system linking exchanges and OTC traders trading certain listed securities.) In Release No. 34-42212 (December 9, 1999), 64 FR 70297 (December 16, 1999), the SEC reiterated that it "continues to believe that it is necessary to expand the ITS/CAES linkage to all listed securities in order to fully implement the 1975 Congressional mandate to create a national market system linking the exchanges and the OTC market. . . ." 64 FR 70297, 70303. The SEC went on to observe that "failure to achieve a linkage between exchange and OTC markets in all listed securities inhibits a broker's ability to ensure best execution of customer orders. . . ." Id. Persons commenting on the SEC's ITS/CAES proposal, such as the Investment Company Institute, supported the adoption of a trade-through rule for third market makers displaying orders. 64 FR 70297, 70301.

[2] As reported by an Exchange committee in 2000:

> As to speed, it is true that, if two orders in an ECN's system match, the computer can execute the trade instantaneously. But, because ECNs are passive, order-driven systems in which limit orders wait on the ECN's book until a matching order arrives, the actual time from order entry to order execution can be quite long. In fact, the vast majority of ECN orders never execute on the ECN.

Market Structure Report of the New York Stock Exchange Special Committee on Market Structure, Governance and Ownership (March 23, 2000) at 26.

If an electronic market's share of the aggregate trading volume from all markets for a listed security included on the CQS becomes large enough, as have the shares of several such markets today, that market must publish its best bid and asked quotations in the CQS and, in the case of Exchange-listed stocks, must abide by, among other things, the trade-through rule. Under the ITS plan, a market receiving a "commitment to trade" through ITS must process the commitment on a first-come, first-served, "immediate or cancel" basis along with any other orders or commitments it receives.[3] The Exchange completes transactions against incoming ITS commitments in 12 seconds on average and fills approximately 84% of all such incoming commitments, based on the Exchange's most recent data.

The Need for Improved Inter-Market Protections

Waiting for word of what has happened to a commitment conveyed to another marketplace by the electronic market seems like an eternity to an electronic market.[4] Such a delay is seen by those markets as inconsistent with their business model because they promote themselves largely on claims that they offer virtually instantaneous executions – in the event there is a match.[5] Something no doubt should be done to shorten the time it takes to send buying

[3] The ITS plan permits originators of commitments sent to other markets to provide that such commitments will expire 30 seconds, 1 minute or 2 minutes after the commitment is received – information not available to the receiving market.

[4] Chairman Donaldson of the SEC, however, said recently, "People say they have to wait an intolerable 30 seconds on the NYSE to execute a trade.... I personally can't think 30 seconds is that long if substantial price improvement can be effected as a result." *High Stakes for the Big Board*, The Wall Street Journal, at A1, dated September 19, 2003. A recent Exchange study shows that, on average, the Exchange provides such price improvement over its quoted prices 43.3% of the time. NYSE Execution Quality Study (October 14, 2003) ("NYSE Quality of Markets Study"). The same study shows that execution speed on the Exchange for market orders of 2000 – 10,000 shares (on average, 18.7 seconds) was faster than that of ECNs (on average, 61.7 seconds) and ArcaEx (on average, 119.8 seconds) for Exchange-listed stocks. Id. In fact, the Exchange consummates transactions with ITS commitments faster and to a greater degree than other markets.

[5] See, however, NYSE Quality of Markets Study, supra, at note 4.

and selling interest from one market to another by means of ITS. Perhaps ITS can itself be changed to address this. If not, perhaps "smart order routing" systems, now widely available, can be relied upon instead. Overall, however, there must be some rational compromise between the electronic markets' demand for instantaneity in trading and the needs of open outcry floors like that of the Exchange, where price improvement is always possible, but not always immediately. Both types of markets need to be accommodated, but best price must remain the rule.[6] The electronic markets must sometimes slow down to permit satisfaction of bids and offers displayed by other markets at prices better than those the electronic market otherwise would provide. Similarly, markets like the Exchange must quicken the tempo of responding to off-floor interest transmitted to obtain a better price. We also must address the question of the period of time during which a bid or offer must be continuously displayed to trigger the obligation not to trade through that bid or offer. Clearly, for example, no one should be asked to respond to bids or offers in other markets that are routinely displayed but then removed within a very few seconds. To address the problem of trade-throughs by members of the Exchange, we

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[6] Former SEC Chairman Arthur Levitt observed:

> It is difficult, however, to enable electronic markets to compete fully in the listed market without eroding what many investors have come to expect – price priority. Because of ITS, investors today are ensured that they will get the best price offered on any exchange, regardless of where their order was originally routed. ECNs argue their customers will forgo a better price elsewhere to achieve immediate execution. This may be true for some investors. But trading price for speed must be rooted in the customer's interest, not the ECN's.

Speech by former Chairman Arthur Levitt, *The National Market System: A Vision That Endures*, at 5 (January 8, 2001, delivered at Stanford University).

Former Chairman Levitt offered a darker view as to why firms might argue that their customers favor speed over price. "Sometimes, the invocation of speed rings as a hollow rationalization for selling order flow or capturing the spread on internally executed orders." Speech by former SEC Chairman Arthur Levitt, *Best Execution: Promise of Integrity, Guardian of Competition* at 2 and 6 (November 4, 1999, delivered at Securities Industry Association Conference, Boca Raton, Florida). Former Chairman Levitt also suggested that the firms claiming that their customers favored speed over price did not offer any support for these contentions and that he suspected that most retail investors would willingly sacrifice five or ten seconds for price improvement. See also remarks of Chairman Donaldson, supra, at note 4.

understand that the Exchange is now preparing new tools to enable the Exchange to automatically send ITS commitments to other markets any time a trade-through on the Exchange would otherwise occur. Finally, it may be time for the SEC to adopt a universal trade-through rule rather than rely on self-regulatory organizations to do that – and to enforce it as an SEC rule.

Electronic Markets Propose that Price in Execution is Secondary

Rather than attempt to deal with the problem of trade-throughs, missed markets and avoidance of damage to the price discovery system on a rational basis, the electronic markets argue that whatever the customer wants – that is, a notion of best execution being in the eye of the beholder – is what our market system ought to give to that customer. We are told that what many customers want most (as determined by those markets) is the fastest possible execution without regard to small differences in price, or the most anonymous execution, or the execution having the least market impact. That is, electronic markets would have you believe that no one really wants "best execution" in the sense of obtaining a price no worse than the highest bid price when selling or the lowest offer price when buying (or some better price in between the best bid and best offer). If you can accept that, you will accept, as they want you to, that it is perfectly fine for electronic markets to effect executions at whatever prices they happen to come up with within their own closed systems, prices established by their own derivatively priced flow of orders on the buy and sell side.[7] To us, this is a dangerous course. Price is at the center of our trading markets and must remain the center around which everything else is built. Price discovery can never become secondary to some other objective of our markets.

In short, the electronic markets ask you to sweep away the offending ITS and the trade-through rule, replacing them with nothing. They further urge you to forget about the notion that all brokers everywhere ought to be seeking the very best available price when they execute a

[7] I say "derivatively priced" because, as everyone knows, the prices of securities listed on the Exchange, no matter where they are traded (including on electronic markets), are established by reference to the last sale prices and the prices of current bid and asked prices on the Exchange. How could it be otherwise when over 80% of all trade volume in Exchange listed stocks originates on the Exchange? See NYSE Quality of Markets Study, supra, at note 4.

customer's order and that, when they are executing orders for their own accounts for themselves, they ought to be able to do so at any price that appeals to them rather than be required to interact with orders of other investors. The trade-through rule and the basic concept of best execution stand in the way of this. In short, the electronic markets argue that price – that is, the lowest price to a buyer, and the highest price to a seller – ought not to be a determinant of "best execution." They say that "best execution" is whatever the particular customer desires. (In this regard, I join Chairman Donaldson and former Chairman Levitt in doubting that customers are ever asked by the electronic markets what they want or that customers in fact are indifferent to a better price.) They would have you believe that the best market system for the United States is one in which we view those wishes, however well intended or however misguided, as controlling as to what should happen to customers' orders in our markets. In other words, the electronic markets tell us that we ought to look at each such order, not in the context of overall order interaction of all buyers and sellers in our markets, where each seller competes for an execution at the highest price and each buyer competes for a trade at the lowest price, but as if each order was entitled to be treated separately, in splendid isolation from the others, detached and somehow apart and entitled to whatever special treatment the electronic markets have in store for them.

Price Must Remain Central and Paramount In Our Markets

I view the electronic markets' ideas with respect to "best execution" and order interaction as wrong. In those ideas are threats to the price discovery process, which depends every day and at all times on the interplay between the supply and demand provided by innumerable buyers and sellers in our markets, and to public confidence in the fairness and basic integrity of our markets.[8] The genius of the American stock market is that it collects and causes to interact in a competitive auction, driven first by price, and only after that by other factors, all buying and selling interest present in the market at a particular time. It is this process that produces what we

[8] True, an inactive stock may not see very many buyers or very many sellers on a given day, but the price of every stock is, in a sense, affected by the prices being established daily for other stocks that are viewed as of the same type -- *e.g.*, similarly capitalized, in a similar industry sector, etc.

all know as *the* price – that is, the dollar level at which willing buyers and sellers agreed to transact in open competition with other would-be buyers and sellers, others of whom were not willing to buy except at a lower price and sellers who would not sell except at a higher price. Every order that is stripped out of such an interactive system, that is handled as if price was of only tangential concern so that it need not participate in this great, ongoing auction based on price, does damage to the pricing mechanism, rendering it less perfect. If too many orders were to be permitted to do this, the pricing system would become increasingly inexact and unreliable. Indeed, I believe it is the fragmented state of the over-the-counter market, as much as anything else, that has lead to that market's higher volatility and unpredictability as a whole.[9]

In sum, I believe that the attacks on the need for inter-market price protection through adherence to the trade-through rule by electronic markets are grounded in their own self-interest. In pursuing that self-interest to the exclusion of all else, they seem to have forgotten the need to preserve the soundness and fairness of our markets as a whole and to protect the welfare of all investors. In short, they have lost sight of the public interest.

I would be pleased to respond to any questions you may have.

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[9] See NYSE Quality of Markets Study, comparing 249 listed and NASDAQ stocks, matched on trading activity, price and market capitalization and showing that NASDAQ stocks exhibit far greater volatility than stocks listed on the Exchange.

Michael LaBranche
Chairman, CEO & President
LaBranche & Co Inc.

Michael LaBranche is the Chairman, CEO and President of LaBranche & Co Inc. since its inception as a public corporation in August 1999. LaBranche & Co Inc. is the parent of LaBranche & Co., a New York Stock Exchange Specialist firm since 1924.

A graduate of the University of Vermont, Mr. LaBranche joined the firm in 1977 and became a New York Stock Exchange member as a Specialist in 1978. Mr. LaBranche has served on the Management Committee and Executive Operating Committee of LaBranche & Co. since 1988 and as the Chairman of the Executive Operating Committee since 1996. He is currently Chairman of LaBranche & Co Inc.'s Executive Management Committee.

He serves as a Governor of the New York Stock Exchange and is a member of the New York Stock Exchange's Market Performance Committee. He is a board member of Lava Trading and the Securities Industry Automation Corporation (SIAC).

The Investor First:
Enhancing the Existing Protections and Benefits of the Agency-Auction System at the New York Stock Exchange

Testimony of
Robert H. McCooey, Jr.
President and Chief Executive Officer
The Griswold Company, Incorporated
Member, New York Stock Exchange

Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives

Hearing on
"Reviewing U.S. Capital Market Structure: Promoting Competition in a Changing Trading Environment"

October 30, 2003

Testimony of Robert H. McCooey, Jr. Member of the New York Stock Exchange and Chief Executive Officer of The Griswold Company, Incorporated

October 30, 2003

Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee:

My name is Robert McCooey. I am a proud Member of the New York Stock Exchange and President and Chief Executive Officer of a New York Stock Exchange member firm, The Griswold Company, Incorporated. Griswold is an agency broker executing orders for institutional clients on the Floor of the NYSE. As an agency broker, we execute trades on behalf of our customers. We do not make markets in securities or engage in proprietary trading. Our clients include some of the largest mutual and pension funds in the United States.

Thank you for inviting me here today to testify in connection with your review of the capital markets structure here in the United States. I am not here today to speak about recent events related to our Board of Directors, compensation, or the specialist system that have occurred at the Exchange during the past few months. I am also not here to discuss the new governance initiatives that have been proposed. I believe that our interim Chairman John Reed had laid out his plan for the NYSE during his testimony two weeks ago. He presented a very progressive and ambitious agenda to deal with the governance issues that currently challenge the NYSE. As an owner and leader of a firm that owns several NYSE seats, I support the plan that John has put forward to remedy the structural conflicts inherent in today's system.

My focus today will be on the major market structure issues that are currently under review by the House Capital Markets Subcommittee, your counterparts on the Senate side and at the Securities and Exchange Commission. Others would like to paint this debate as one about the New York Stock Exchange and its future. It is not. And never should be. This is

not to downplay the impact that decisions made in this committee will have on the future of the New York Stock Exchange and the important place that the NYSE currently serves in the capital raising process here in the United States. The discussions that we engage in today must focus on one major thought: How do we enhance the National Market System for the benefit of all investors while ensuring a fair and level playing field on their behalf? In the process of answering that charge, we must also protect the aspects of the current National Market System structure that continue to provide positive results in the execution of investors' orders. I would contend that the agency-auction market model at the New York Stock Exchange is one of these important competitive aspects of the National Market System.

As an agent on the Floor of the NYSE for the past 16 years, I have seen the evolution of Floor Brokers from providing outsourced executions for the major broker-dealer firms to establishing themselves as strategic partners for institutional clients. Increasingly, the goal for clients has been to find ways to gain efficiencies in the execution process by getting closer to the point of sale. Independent agents working on behalf of these customers now furnish real time market information coupled with tremendous costs savings to these institutional customers. I would also remind the committee that the assets that are managed by my customers are owned by the small retail customer, the pensioner, the parent saving for college, the worker funding their IRA and all the others who invest in equities traded here in America. Today in the United States, when we talk about doing what is right for the marketplace and the participants in that market, we must realize that the retail customer and the institutional customers are one in the same. They are all our assets; institutional is just a larger commingled pool.

Floor brokers play an important role in the price discovery process. The competition between orders represented by brokers at the point-of-sale on the Floor of the NYSE helps to ensure fair, orderly and liquid markets. It is the Floor broker who will seek out contra side liquidity for an order as well as make decisions based upon rapidly changing market dynamics. The Floor broker serves as a single point of accountability and information – not found in dealer markets and ECNs – and who employs the most advanced technology to support his or her professional judgment. The interaction between the Floor broker and the upstairs trader provides the flow of information necessary to keep those customers informed about changing market conditions. That information flow is more often than not the catalyst

that provides incentives for traders to trade. The combination of best price and intelligent information flow is the backbone of the NYSE.

NYSE competitors have claimed a supposed technology advantage. The reality is quite the opposite. During the past decade, the NYSE has invested more than two billion dollars in technology for our trading floor, data centers, and new product and service development. The NYSE Floor has one of the largest deployments of flat screen technology anywhere. Brokers no longer write on little slips of paper and have "pages" transport the information from point-of-sale to a phone clerk for relay to our clients. The agent relies upon a digital handheld communication device, which receives the order, transmits the reports (often directly to the customer) and engages in an ongoing dialogue with the client through the use of digital images. All of this is accomplished without ever leaving the trading crowd.

Investor Protection

As a registered broker and fiduciary entrusted with orders from my customers, it is amazing and unsettling to me that so many speak so openly and with such a cavalier attitude about breeching their responsibilities to their clients. Clearly, what I am referring to are the proposals to modify or eliminate the "trade-through" rule. The "trade-through" rule was designed to convert multiple competing markets into a National Market System. The rule turns each market into a gateway to every other market and ensures that investors will not be disadvantaged by virtue of having bids or offers displayed in one market versus another.

When trading is allowed to occur outside of the National Best Bid and Offer (NBBO), two investors are being disadvantaged – the bid or offer that has been posted as well as the buyer or seller who received an inferior price to the NBBO. To amplify this, I would like to offer the following example: A buyer posts a bid of $49.05 to buy 5000 shares of XYZ, the stock is offered at $49.10. In the absence of a "trade-through" rule, a trade of 5000 shares might occur at $49.00. In this instance, two investors are not being afforded the full protection that they deserve in the marketplace. The seller who sold stock at $49.00 did not receive the highest price that was bid for those shares in the market. Further, the buyer with the $49.05 bid is left unfilled. This investor posted the best bid in the marketplace and was ignored. I do not believe that this is the message that we want to

disseminate to the investing public. Unfortunately, this is a message that is being promoted by some competitors.

ITS and the "Trade-Through" Rule

Some competitors would have you believe that the Intermarket Trading System (ITS) was put in place for the sole purpose of allowing the NYSE to retain its place as the world's preeminent market. The New York Stock Exchange did not devise the ITS Plan all those years ago and is a sole voice among all the competing market centers that must belong to ITS. I am not going to argue that the current system is perfect. Far from it. The Intermarket Trading System certainly is in need of reform, or possibly elimination. With the technologies available today, there are certainly market linkages available that would (possibly) be acceptable to all. However, the challenge here is to maintain the integrity of the market and protect the least sophisticated user of it.

The most important starting point for any trade through discussion must be the facts, and how the facts impact every investor. In my opinion, some of those who have sat here before you prior to today have engaged in competitive positioning rather than factual presentation – in the name of self-interest, not with the interests of all investors in mind. Simply stated, the facts do not support their contention of the "unfair" system that stifles competition. At the New York Stock Exchange we welcome competition. However, that competition must be one that ends with the execution of a customer's order at the best price available in the marketplace. The reality is that the NYSE posts the best price nearly 94% of the time in our listed securities. In the 100 most actively traded securities, NYSE prices are on average 12 cents better that our competition.

Additionally, we have the benefit of a feature that no other marketplace offers: Price Improvement. Each day, the NYSE improves the posted price on 44% of the orders that it receives by an average of 3 cents per share. You want speed? We have it. Market orders of 500 shares or less are executed in under 5 seconds 50% of the time. A small order auto-execution product, NYSE Direct+, turns around orders in 1.3 seconds. Order sizes of 500 to 2000 shares are executed in under 5 seconds happen 40% of the time. I use these examples because they are representative of the execution size in the NASDAQ market. In these instances as well as almost

all other orders delivered to the NYSE, price improvement was available and received in 44% of the cases. Even in larger order size category the NYSE sets the standard for all others to compete against. We are tied for fastest market for large orders, those of 10,000 shares or more. In contrast to the information offered by others to the committee the average execution speed for those larger orders is 19 seconds, not the sub-second times that some would have you believe.

The most damaging information to the anti-"trade-through" rule crowd is again undisclosed to the lawmakers and regulators that they are attempting to persuade. The baseless claim is that the ability for them to trade at inferior prices to those available in the marketplace is necessary because when they send a commitment to the NYSE to access those prices they are no longer there. The reality you ask? The fill rate on the NYSE for market and marketable limit orders is 83%. Our rate compares very nicely when you line it up next to the fill rates that customers should expect when they attempt to access the liquidity offered on an ECN or NASDAQ. One of our most vocal critics, ArcaEx, boasts a fill rate of 45% and NASDAQ fills less than half at 47%.

Substantively modifying or eliminating the trade-through rule would produce inferior prices and increased costs, contribute to market fragmentation and market volatility, and reduce accountability and transparency. This is not the way to restore investor trust and confidence.

A Penny Saved is a Penny Earned

With thirty co-sponsors, Chairman Michael Oxley sponsored **H.R. 1053** "to eliminate legal impediments to the quotation in decimals for securities transactions in order to protect investors and to promote efficiency, competition, and capital formation." Recognizing that there are some in the financial community who would like to put forward the concept of trading in nickels rather than pennies, the fact is that currently we trade in pennies. It has now been almost three years since that dramatic shift in the way securities are traded and we have survived.

Arguments were made at that time about the tremendous savings to investors from the shift to decimal pricing of securities. Speaking to support

"The Common Cents Pricing Act of 1997" Herbert L. Dyer, Executive Director of the State Teachers Retirement System of Ohio told this House Committee that decimals "could save our teachers and retirees millions of dollars annually." J. Kenneth Blackwell, Treasurer of the State of Ohio, explained his support for the legislation by saying that "Decimalization will encourage the laws of free trade to regulate our exchanges, thereby alleviating the need we now have for many of the rules governing trading in our markets." Savings to investors and competition to provide the best and most fair markets to investors; these were the goals and results of this groundbreaking legislation.

So, what happened along the way to the penny? Has something changed in the Congressional mind in these few short years? Do investors no longer deserve to save money? Have we decided to encourage investors to ignore the best price available in the marketplace? Should investors be prohibited from the opportunity to garner the highest return for the capital that they have invested? Is it acceptable for major mutual fund to publicly state that they would accept a worse though speedier price for the stocks that they are buying and selling on behalf of the millions of shareholders who have entrusted them with their hard earned money?

There is, however, an answer to these questions about the penny. I think that somewhere between "Common Cents" and today, client interests have been abandoned and replaced with ones that are self-interested. During a difficult period for both the financial markets and broker-dealers, client interests have been secondary to the economic interests of firms and market centers. It is not time to encourage or reward this type of behavior. Quite the contrary, the message of "The Investor First" should be quickly and firmly re-enforced.

Pennies add up. And to be fair to my colleagues at the NYSE, I should probably be using the three cents of price improvement that I referenced earlier and that a significant percentage of orders receive. However, I will continue to use the smallest increment and its value because the dollars still add up quickly. If fiduciaries are abdicating their responsibility to achieve the best price available, the impact to their shareholders (THE PUBLIC) is very significant. If the major mutual fund that I cited earlier does forgo better available and accessible prices for the sake of speed, the negative cost impact to the fund's shareholders is in the millions of dollars. For a fund trading an average of ten million shares a day

(not unusual today), to receive that incremental penny of price improvement on all those shares and multiplied by 250 trading days in a year, the savings are twenty-five million dollars ($25,000,000). This is the shareholders money. This is the investing public's money. Furthermore, I am only giving you one example of just one fund manager. Across thousands of funds and billions of shares traded, the potential negative impact to investors cannot be ignored. Honestly, the dollars lost by this deplorable activity will make the recent market timing and rapid trading of funds look like a misdemeanor.

Finally, we have come to the place where we can answer our question. How do we enhance the National Market System for the benefit of all investors? We begin with what has worked for years and continues to work today. We start with a market that provides liquidity, accessibility, transparency, the highest certainty of an execution, protection for customer's orders and their interests. That market is the agency-auction system at the New York Stock Exchange. At the NYSE, we will continue to change, adapt and innovate to best serve our customers and to fulfill our commitment to producing the highest levels of market quality. We must continue to provide the fair and level playing field that investors want and expect from us. We will compete on the basis of discovering and delivering the best price coupled with the highest levels of transparency. Anything else disadvantages investors and is wholly unacceptable. In all that we do, we take pride in the fact that we always place "The Investor First".

Thank you. I will answer any questions that you may have.

Congressional Testimony
Mr. Edward J. Nicoll
Chief Executive Officer
Instinet Group Incorporated

Before the House Financial Services Committee
Subcommittee on Capital Markets, Insurance and Government Sponsored Entities
October 30, 2003

Mr. Chairman, Ranking Member, Members of the Subcommittee, thank you for inviting me to testify today on the issue of how to reform our market structure.

My name is Ed Nicoll and I am the Chief Executive Officer of Instinet Group. While Instinet exclusively serves financial institutions such as broker dealers, banks, mutual funds, retirement funds, hedge funds, and the like, I have also had extensive experience serving retail investors as the former CEO of Datek Online, and as the co-founder and President of Waterhouse Investor Services. Both of these companies served millions of retail investors nationwide.

Instinet, through its affiliates, is the largest global electronic agency securities broker. Our services enable buyers and sellers worldwide to trade anonymously and efficiently and, whenever possible, directly with each other. This "cutting out of the middle man" or more properly, eliminating unnecessary intermediation, lowers transaction costs by improving the quality of the trades and lowering commission costs.

Through our electronic platforms, our customers can access over 40 securities markets throughout the world, including NASDAQ, the NYSE and stock exchanges in Frankfurt, Hong Kong, London, Paris, Sydney, Tokyo, Toronto and Zurich. We act solely as an agent for our customers and do not trade securities for our own account or maintain inventories of securities for sale.

While we have successfully leveraged these assets and services in the U.S. over-the-counter market (where we have the largest combined OTC liquidity pool), we have not been equally successful competing for listed trading due to regulatory barriers. All investors would greatly benefit from increased competition and openness in the listed marketplace.

Let's examine why we're in this situation and what we can do to strengthen our markets.

We are a nation of investors. A majority of Americans participate in equity markets by purchasing stocks or mutual funds either directly or through a retirement plan. In many ways, our fortunes as a nation rise and fall with the strength and integrity of our equity markets.

But recent controversies have shaken consumer confidence in the listed marketplace. This crisis is party due to individual misjudgment and poor governance, but the heart of the problem is the structure of the market – specifically, the outdated barriers that protect the NYSE from competition. These barriers increase the cost of trading equities and, over time and many millions of transactions, erode the returns on our investments.

What are these barriers?

The SEC approved the Intermarket Trading System's so-called "trade through" rule in the 1970s to protect consumers who did not have access to all market information.

To understand this rule, think of the battle between Macy's and Gimble's in the movie, Miracle on 34th Street. In that famous movie, Macy's sent its customers to its competitors if its book of competitors' advertisements listed better prices. Seems innocuous enough. It won Macy's customer praise.

But what if it turned out that those ads were wrong, or outdated, and in fact the best deal had been at Macy's all along. Customers would hardly be happy that they had spent time, effort or even money shopping for the "better" deal only to find out it did not exist. Worse while they shopped around, the item may even have sold out at Macy's. Suddenly, being told to go look for the rumored bargain seems like a much riskier plan.

This is similar to what the "trade-through" rule does today. It requires an order to be shipped to a lower-priced market even at the cost of certainty of execution or speed of execution. It forces consumers to risk losing the best certain price so that they can seek a "potentially better" price. It is worth noting that there is no "trade-though" requirement for NASDAQ- listed stocks, and I have seen few complaints from those trading in Microsoft or Dell that they are not getting the price they "deserve."

Now some have argued that there is a trade-off here: that investors can get either the lowest price or the fastest transaction but not both. This is simply not true.

This argument ignores hidden costs, such as the possibility that you will not receive an execution at all, or that you will receive the execution at a price inferior to the one the NYSE is currently quoting. If investors knew with certainty that they were definitely going to get a better price in 30 seconds, and that the market would not move away from them in the interim, they would always accept the delay in execution. The problem is that there is only the possibility of receiving a better price. If there is only a possibility, what should an investor do?

The answer is: "It depends on the investor."

There is nothing novel about the concept of opportunity cost, or the trade-off between certainty and risk. It arises in many aspects of our life. For example, imagine you are selling your house and you receive two offers. The first offer is for $100,000 cash. The second offer is for $105,000 but is contingent on the buyer selling his house and obtaining financing. Which offer do you take? It depends. If you are in no hurry to sell, maybe you wait. If, on the other hand, you need to sell your house as fast as possible to purchase another house you have your eye on, perhaps you take the cash now.

Just as there is no "right" answer for every home seller, there is no right answer for every buyer or seller of securities. But the trade-through rule assumes there is one right answer for everyone. If it were applied to our home-selling example, it would force you to accept the $105,000 offer. But if it turned out that the person that offered you $105,000 could not obtain financing, and you ended up selling your house for $90,000 thereafter, you would not be comforted to know that the rule was there for your protection. This is just another situation when you may miss out on the real "best" price while seeking an elusive "better" price.

We should know, almost by definition, that there is something wrong with the trade-through rule by design. Think about it this way – why do we need a rule requiring investors to always try to obtain the best price? If it appears that investors are not consistently attempting to obtain the best price, maybe it is because our conception of "best price" is wrong.

In fact, a recent study by Greenwich Custom Research – and I ask permission to include a copy of the study in the record – asked 103 institutions that collectively manage over $2.5 million in assets what they want when they conduct a trade. Their top answer: low market impact. Anonymity, price improvement and certainty of execution followed. It is interesting to note that the current definition of "best" price was only one of these four factors.

I am also often asked if getting a worse price ever really happens? Do people ever really lose out? We have an answer based on quantitative evidence.

This past spring, Instinet conducted a test to see why investors were ignoring "better" prices advertised by the American Stock Exchange ("AMEX") when trading the three exchange-traded funds ("ETFs") based on the Nasdaq-100 Trust ("QQQ"), the S&P 500 ("SPY"), and the Dow Jones Industrial Average ("DIA") that the SEC has temporarily exempted from the full effect of the "trade through" rule. To answer this question, we put together a relatively simple methodology. Every time a member of the Pacific Exchange ("PCX") elected to display a bid or offer and ignore a better-advertised price on the AMEX, we sent an order to the AMEX to see what would have happened if the PCX member had, instead, sent the order to the AMEX.

What we found was that the PCX member would have received an execution just 54% of the time. Further, it would have taken, on average, approximately 19 seconds to receive an execution. Of those orders that were cancelled after not receiving an execution in 30 seconds, it took an average of another 13 seconds to receive the cancellation. That means that nearly half the time, an investor that sent an order to the AMEX in compliance with the trade-through rule would have had to start the entire process all over again 43 seconds later.

It seems to me that, given this data, it is very rational for an investor to avoid the hidden costs associated with sending an order to the AMEX. And there is no reason to believe these results are unique to the AMEX or these three ETFs. Any time there is market volatility or heavy trading volumes, whether it is for stocks trading on the NYSE or AMEX, I would expect the same results.

I have included a full copy of our study with my testimony as part of my paper titled, "What's The Best Price?" I ask that it also be included in the record.

Now we can see that these old rules are reducing competition, increasing transaction costs and hurting investors.

But how will changing these rules improve the entire system to the benefit of all investors and participants?

Well, we have been here before and have a perfect "case study" to review.

Prior to 1997, investors trading NASDAQ-listed stocks had no choice of trading venue – all orders were sent to a NASDAQ dealer for execution. Dealers effectively had a monopoly for setting the prices of NASDAQ stocks. The result: an investigation by the Justice Department and findings of fraud, price fixing and collusion by NASDAQ dealers. At the time, the SEC wisely refrained from micromanaging a remedy.

Instead, the SEC opened the NASDAQ marketplace to competition and restored the integrity of the regulatory process. Specifically, the SEC created a regulatory opening for a new sort of competitor: a fully electronic market that could compete with dealers in setting the prices at which NASDAQ-listed stocks were bought and sold. Rather than employing dealers to act as middlemen on every transaction, these all-electronic markets allow investor orders to interact directly. Investors may well have saved billions of dollars from the resulting lower transaction costs produced by this competition.

In addition to introducing competition, the SEC also required NASDAQ to separate its regulatory function from its business operations – eventually forcing NASDAQ to outsource its regulatory functions to the NASD, a non-profit organization.

Today, we see the NYSE confronting many of the same issues – largely stemming, once again, from a lack of competition. As was the case with the NASDAQ dealer, the NYSE specialist effectively controls the entire price discovery process for every security traded on the NYSE. Further, due to the current regulatory structure conceived 25 years ago when manual, floor-based exchanges predominated, new electronic marketplaces like Instinet's two ECNs and NASDAQ are effectively prevented from competing with the NYSE specialist.

So how do we modernize our markets and introduce competition?

We must begin with regulatory reform that knocks down the barriers to competition in the listed environment: specifically, the rules and regulations governing the Intermarket Trading System, particularly the trade-through rule. As I've discussed, these rules undermine the trading benefits that electronic markets offer to investors, stifle transparency, widen spreads, increase transaction costs and most importantly, protect the NYSE monopoly.

In today's technologically advanced marketplace, the definition of best price must extend beyond best "advertised" price and include factors such as speed, neutrality, anonymity and the certainty of making the trade. Our goal should be to level the playing field and give investors the benefits of the narrower spreads and lower transaction costs produced through competition.

Moreover, the NYSE should also be required, as NASDAQ was a few years ago, to separate its regulatory function from its business interests. Regulation is a duty owed to the public and must be separate from the profit motive of a market and its members.

In addition to looking at the 1997 changes in the NASDAQ, we can examine the SEC's own recent actions to see what impact modernizing our regulatory structure might have.

As has been previously mentioned, in 2002 the SEC temporarily eased the "trade through" rule on three ETFs, including the QQQ. These can be traded without the "trade through" requirement so long as they are executed within a *de minimis* range of three cents of the best price advertised on an exchange. Investors seem to have appreciated the added flexibility and choice they now have on these three ETFs – the QQQ is now the single most actively traded security in the entire U.S. marketplace. It's time to expand this reform by eliminating the rule on all listed securities.

Chairman Baker indicated at your hearing earlier this month that you would like specific proposals, and I have attached the White Paper that Instinet submitted to the SEC Market Structure Hearings last fall to my testimony, as well.

Some market participants have indicated that they want regulators to take action on other issues such as fragmentation, so-called regulatory arbitrage, access fees, and locked and crossed markets. But are these concerns really that troubling?

These issues are based upon an unstated and unproven theory that there is a trade-off between order competition and market competition – between centralization and fragmentation. This theory holds that, as the number of markets increase, fragmentation increases, undermining the overall quality of the markets. This theory haunts every market structure issue we're debating today. Just this summer, SEC Chairman Donaldson framed the market structure debate by asking this key question: "What are the best models to achieve the proper balance between competition and fragmentation?"

But what if there is no trade-off between competition and fragmentation? To consider this matter, we must carefully examine what fragmentation is, how it is measured, and precisely why we think it undermines our markets and harms investors. I would suggest an alternative theory that embraces competition, and denies that harmful fragmentation must accompany it.

According to the "single market versus multiple markets" trade-off theory, as the number of markets trading the same security increases, interaction between orders decreases, causing harmful fragmentation. The SEC articulated this perspective in commenting on NYSE's Rule 390, observing that:

> "... the existence of multiple market centers competing for order flow in the same security may isolate orders and hence reduce the opportunity for interaction of all buying and selling interest in that security. This may reduce competition *on price*, which is one of the most important benefits of greater interaction of buying and selling interest in an individual security."

The SEC has historically expressed concern that the existence of multiple markets ultimately degrades overall market quality. This logic could lead us to believe that one centralized market is the answer to all our market structure problems. To be sure, if centralization were deemed to best serve the marketplace, the best thing to do would be to close every market except for one.

If the committee and SEC are ready to take that step, I'll be glad to submit Instinet's application for the job.

I don't believe, however, that anyone is comfortable with shutting down all markets save one, or with the notion of eliminating competition between markets. Moreover, there are fundamental problems with the idea of a centralized market. First, one market cannot adequately serve the diverse needs of every type of investor. Second, with a centralized market there would be no competition between markets, raising transaction costs and inhibiting innovation. The costs of such a drastic step would far exceed the benefits. And I do not believe that it would even solve the "problem." It is worth noting that the totality of information available in the electronic markets is easily exchanged among the various market sites, while the ideas and wishes of actual people on the floor are not so easily discerned. I would argue that this actually makes information across the electronic medium less fragmented than the information available on the floor of a manual

exchange. When the government promotes fair access and requires a duty to display information, it eliminates the harmful effects of fragmentation and promotes competition.

For good reasons, then, the policy decisions since the creation of the National Market System reflect a strong preference in favor of competition. Given this preference for multiple markets to compete, there has been a long running and never ending effort to balance fragmentation and competition.

It's time to call off this balancing act. It is impossible for policymakers to objectively measure whether there is too much or too little competition. In the absence of an objective measure of where the appropriate balance is struck, critical market structure issues are resolved based on subjective judgments – which then get enshrined in regulatory regimes – rather than by the marketplace itself.

One of your witnesses put it well during Q & A at your hearing earlier this month: "Fragmentation is just another word for Competition."

In Conclusion

Congress set out two principles in your 1975 market reform legislation that I believe should still be considered when the SEC and others talk about market structure reforms: the National Market System must not favor any particular market or market structure, and it should foster competition between markets.

Over the years, the NYSE has done a remarkable job of building its brand and projecting the image that it sits at the heart of American capitalism. There is no doubt that the NYSE has played a critical role in the development of our markets and our nation's economy. Indeed, I think if you asked most Americans they would tell you that the NYSE is a governmental institution, not a private business, so embedded has it become within our culture.

And that may be the very problem. The decades of protection – some of it due to regulatory barriers and some of it due to cultural insulation – have walled it off from scrutiny and overhaul. Until now.

The current crisis at the NYSE, the ongoing specialist investigation, and the corporate governance issues all highlight the long overdue need to undertake a fundamental examination of whether the NYSE and the regulatory structure erected around the trading of listed securities deliver to investors the fairest, most efficient market possible.

Fairness and efficiency are not mere platitudes. Fair and efficient markets are critical to investors because they foster price discovery, which leads to narrower spreads and lower transaction costs for investors. All of us directly benefit from fair and efficient markets. Efficiency means that stock prices instantaneously reflect all market information, ensuring that investors receive the best, most accurate price. Fairness means no market

participant has any unnecessary advantages, ensuring that investors will participate in the market.

We need to take advantage of this opportunity for needed modernization in our National Market System. The reforms and proposals I have discussed today would not eliminate the NYSE model – or even the specialists. The NYSE will continue to be free to pursue the model of its choice. But for really the first time, that model will be tested by competition.

Competition will bring choice to investors and market participants alike. It will bring greater accountability and transparency as investors are free to move their market activities to marketplaces they trust – and thus transparency and related issues will become competitive issues as well.

But competition cannot exist in a system still relying on outdated rules that do not take modern technology and greater information availability into account. The regulation of U.S. market structure needs to evolve if the U.S. markets are truly going to remain the best in the world.

Thank you again for the opportunity to testify before the Subcommittee and I would be happy to answer any questions.

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This document may be deemed to include forward-looking statements relating to Instinet. Certain important factors that could cause actual results to differ materially from those disclosed in such forward-looking statements are included in the Instinet Annual Report Form 10-K dated for the period ended December 31, 2002 and other documents filed with the SEC and available on the Company's web site at www.InstinetGroup.com.

Additional Materials To Be Included with the Testimony
of
Mr. Edward J. Nicoll
CEO
Instinet Group, Incorporated

1. "What do Institutional Investors Want in a Securities Trading System" Research Report by Greenwich Custom Research, October 21, 2003.

2. "What's the Best Price? Execution quality includes speed and risk." Article in *Security Industry News* by Mr. Edward Nicoll, March 24, 2003.

3. "Modernizing the National Market System" White Paper submitted by Instinet Group at the Securities and Exchange Commission's Market Structure Hearings, October 29 – November 12, 2002.

What do Institutional Investors Want in a Securities Trading System?

American Enterprise Institute

October 21, 2003

GREENWICH℠
CUSTOM RESEARCH

A Research Report
Prepared for: INSTINET

Respondent Profile

- Interviews conducted September 2 – September 19, 2003.
- Respondents include traders at 103 institutions collectively managing over $2.5 trillion in assets (an average of $25 billion).
- Traders represent multiple investment styles, but predominantly active growth and value management.
- On average, two-thirds of volume in exchange-listed stocks.

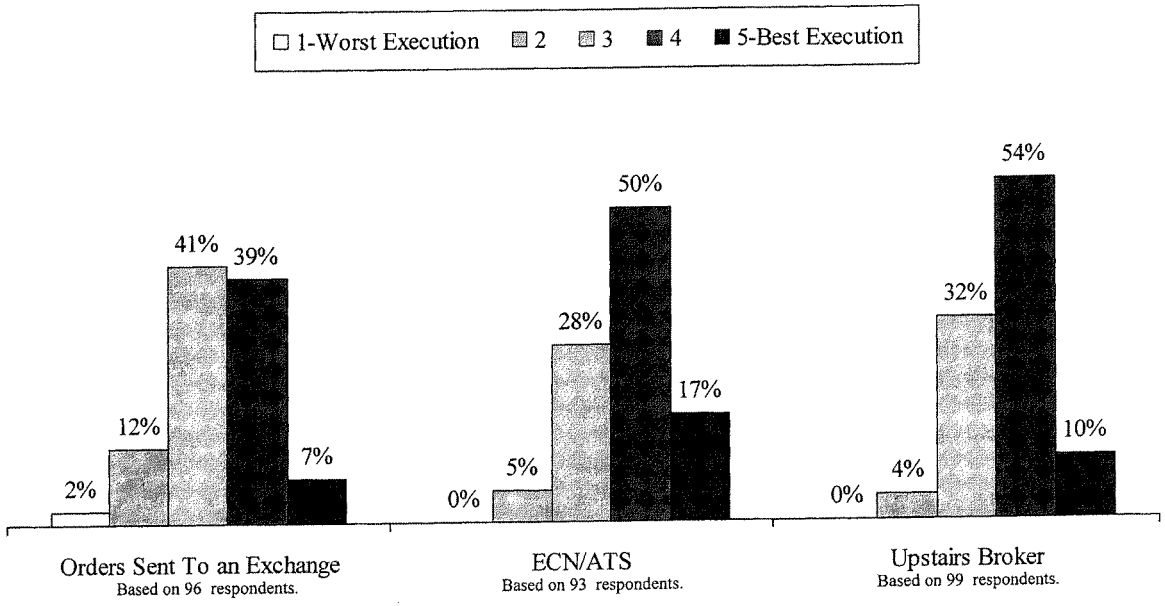
Top-line Findings

- Low market impact, anonymity, price improvement and certainty of execution are all important requirements when executing orders in listed stocks.
- ECNs hold a clear advantage in delivering anonymity and are cited three times more often than an exchange as likely to deliver low market impact (and twice as often as an upstairs broker). Exchanges and brokers hold a modest advantage over ECNs on certainty.
- Over three quarters of traders consider proprietary trading by specialists a conflict of interest. Two-thirds of traders do not think NYSE specialists or NASDAQ market makers add value in trading large liquid stocks.
- Nearly half of respondents would prefer to trade more off the exchange floor. The most common reason: mistrust of the specialists. Other reasons include lack of visible liquidity and order depth, insufficient anonymity, excessive market impact and the need to break up orders.

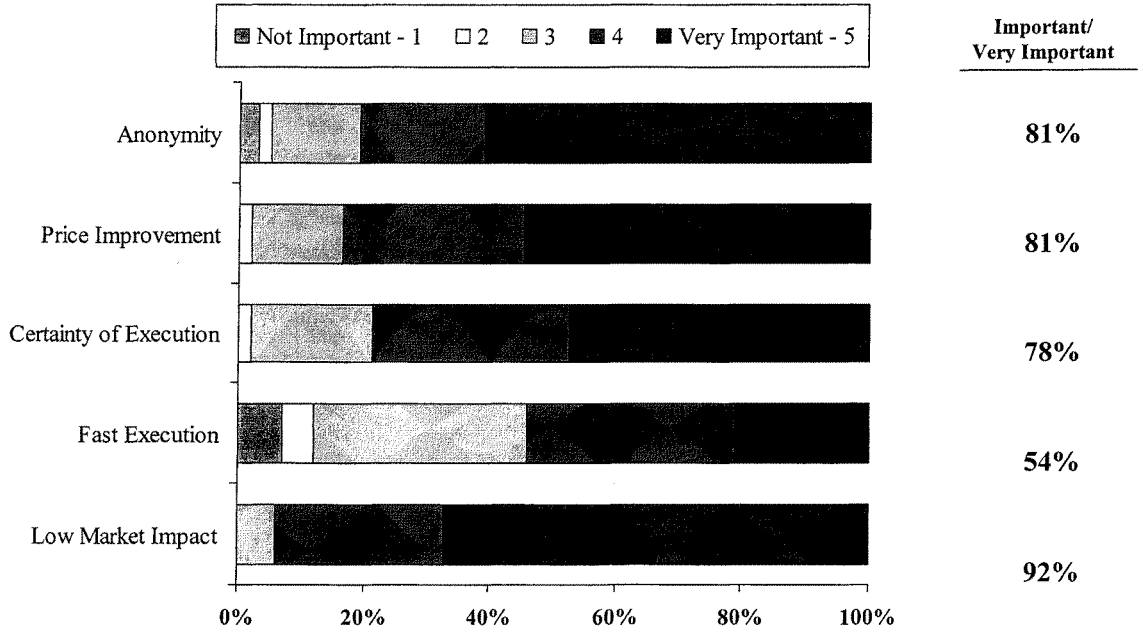
Top-line Findings (continued)

- Among those who would not prefer to move volume off the exchange floor the most frequently cited reasons are the perceived benefits of centralization and the, "human touch".
- A majority of traders do not see multiple competing venues as a negative.
- Institutions would like to see changes in the listed market — in addition to not allowing specialists to compete with customers, support is expressed for a liquid electronic market in listed stocks with a real time order book and an integrated quote display.

Quality of Listed Execution By Venue

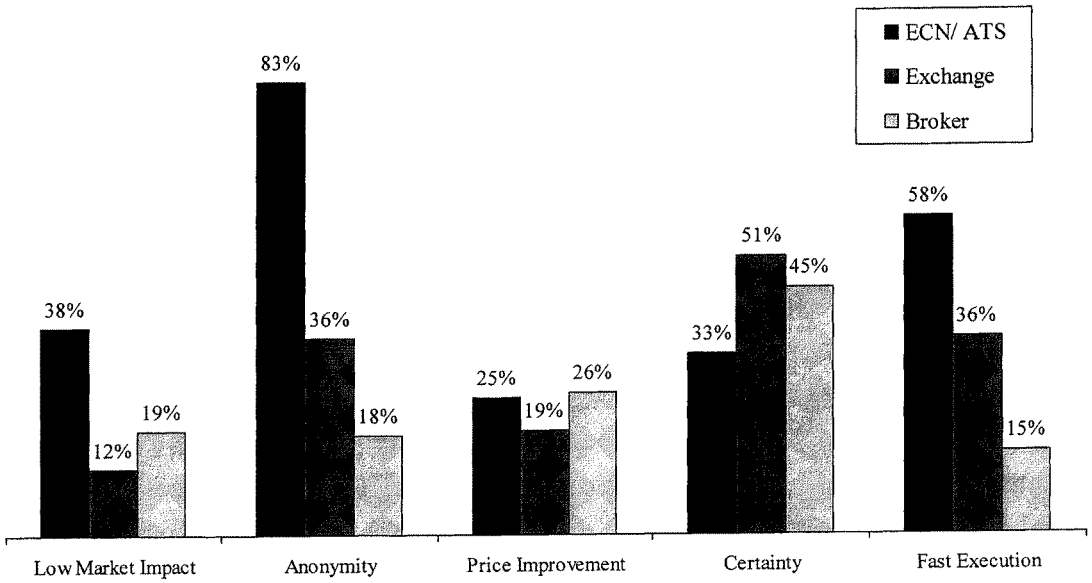


Importance of Attributes When Executing Orders in Listed Stocks



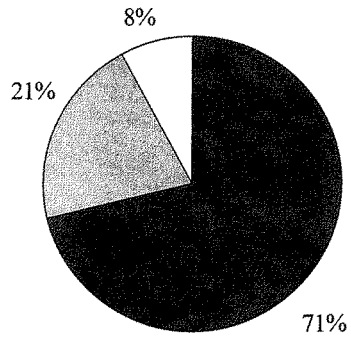
Note: Based on 103 respondents.

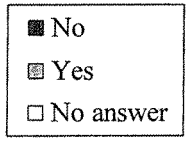
High Probability of Achieving Objectives by Venue



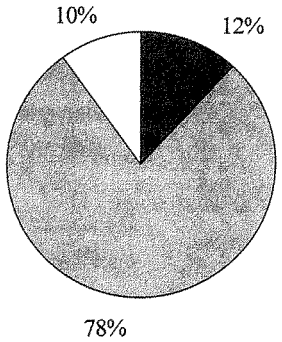
Views On Specialists

Do Specialists and market makers still add value in highly liquid stocks, such as IBM or Intel?



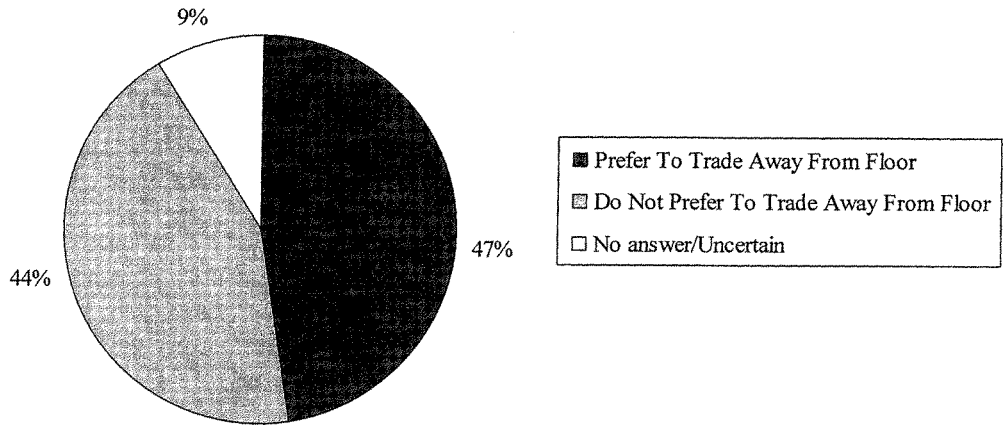


Does the Specialist's ability to trade on a proprietary basis constitute a conflict of interest?



Note: Based on 103 respondents.

Would You Prefer to Trade More Volume Away From an Exchange Floor?



Note: Based on 103 respondents.

Why Traders Prefer to Trade Away From an Exchange Floor

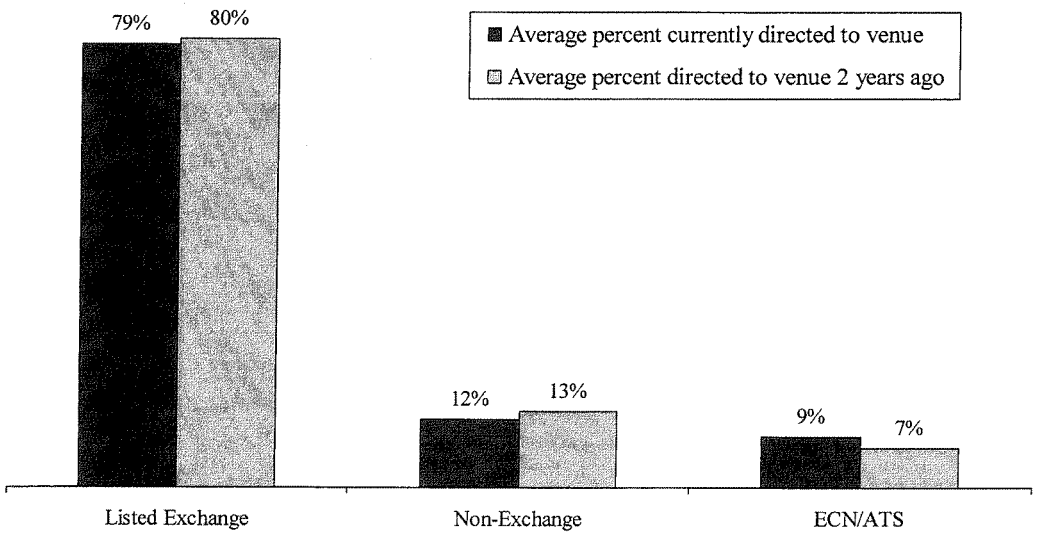
"The specialist is a well funded competitor."

"The primary problem with specialists is pennying and lack of visible liquidity…"

"Liquidity is drying up and I have to go where the liquidity is."

"There are too many intermediaries who don't have my best interest at heart."

Exchange-listed Volume Direction



Why Traders Do Not Prefer to Trade Away From an Exchange Floor

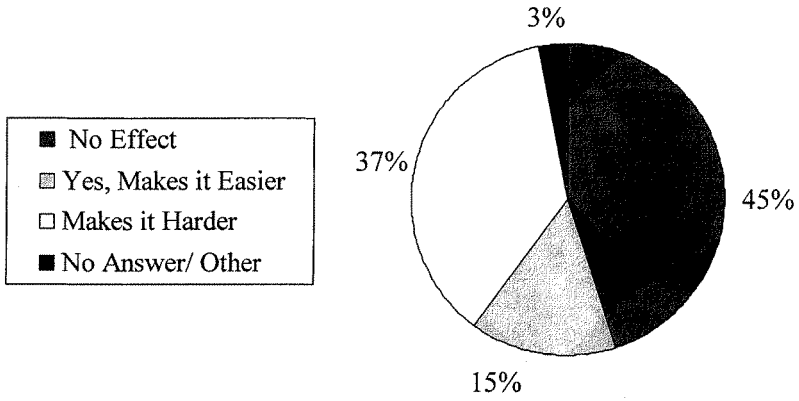
"Central location makes it faster for buyers and sellers to meet."

"On the floor there is more interaction, which provides a better chance for price improvement."

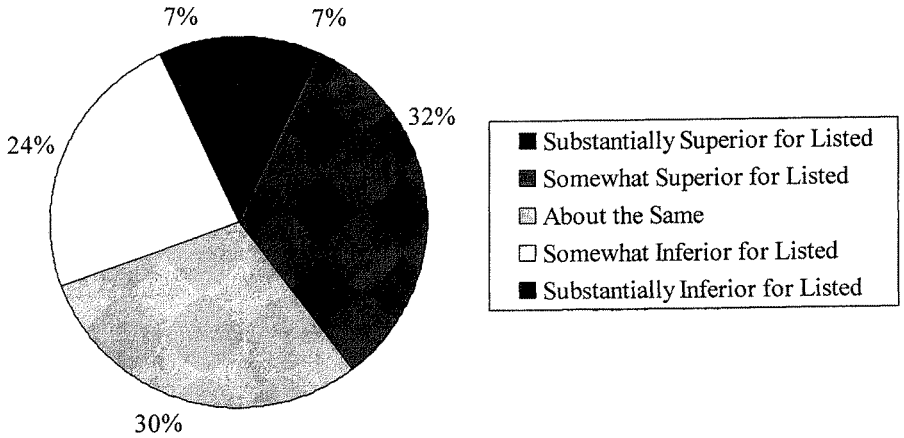
"I don't like fragmentation of the market. I want to see all the players in one place."

"I prefer to deal with people, there is more control."

Do Multiple Competing Venues Affect Traders' Ability to Achieve Best Execution?

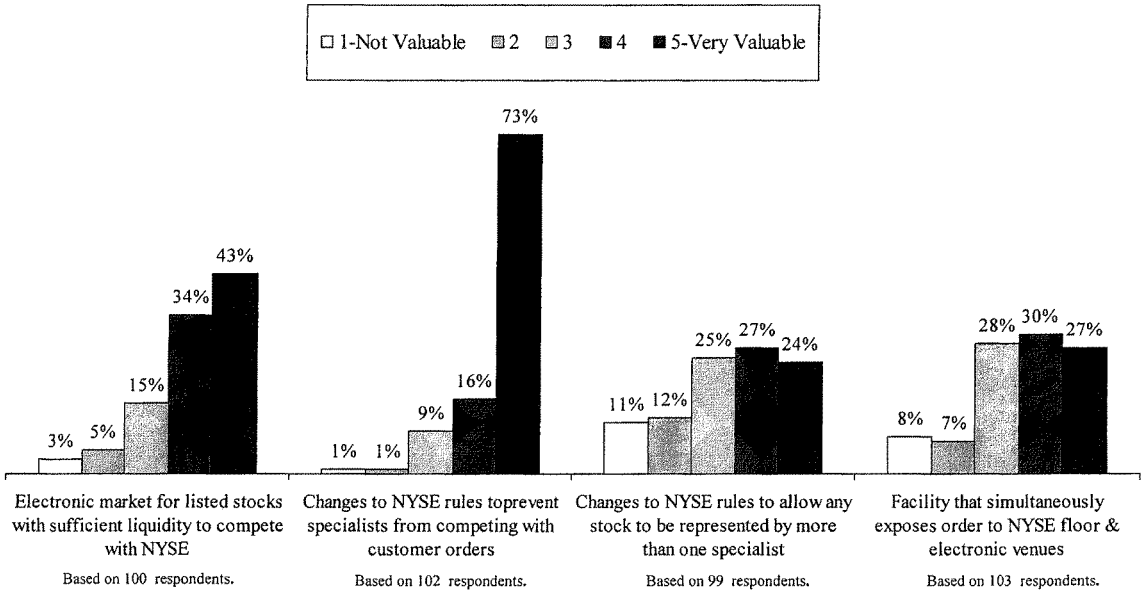


Overall Quality of Execution Between Listed and NASDAQ Stocks

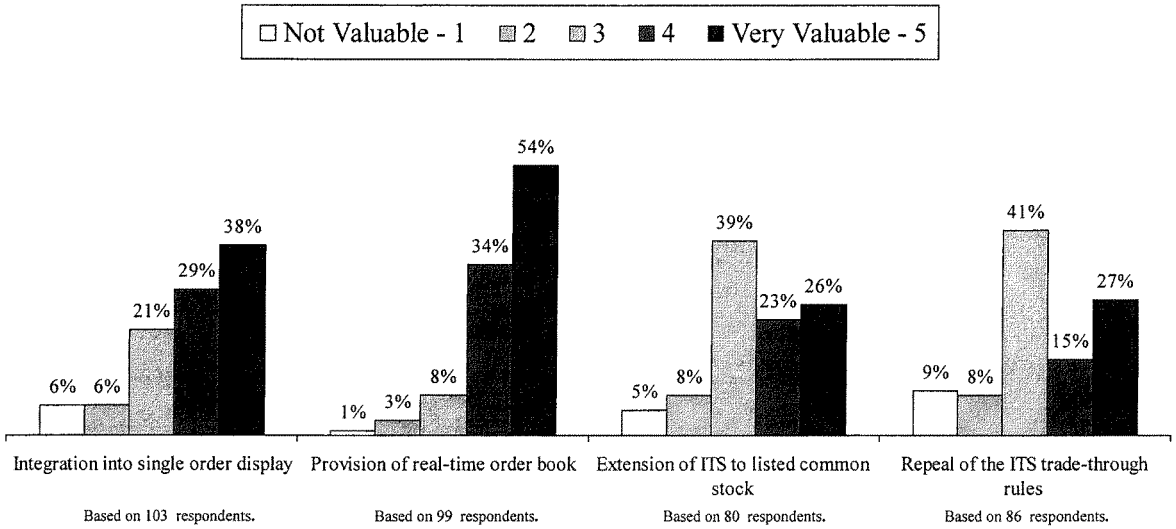


Note: Based on 103 respondents.

Value of Various Trade Execution Changes and Options



Value of Various Trade Execution Changes and Options



What's the Best Price?

Execution quality includes speed and risk.

By Edward Nicoll
CEO, Instinet Group Incorporated

A version of this piece ran in the March 24, 2003 issue of Securities Industry News.

When making a purchase or sale, everyone wants to get the best price available. Yet determining the "best price" is a unique exercise for everyone.

Consider, for instance, a decision to sell your house, and assume that you receive two offers to buy the house. The first offer is for $205,000 but is contingent on the purchaser obtaining a mortgage. As a result, the transaction is not likely to close for 2 months if at all. The second offer is for $200,000 but is all cash and the purchaser can close within two weeks. Which deal is better? It depends in large part on your risk profile. If you just want the highest price possible and are not concerned about time delays or the possibility of the deal not closing, you may prefer to accept the $205,000 offer. On the other hand, if you want to sell the house immediately and want to eliminate the market risk associated with the deal not closing (remember, the house may only be worth $195,000 in 2 months) then you may prefer the $200,000 all cash offer. One thing is clear: there is no "right" answer for every person.

While investors selling a house have a choice as to which offer to accept based on their own risk profile, investors do not have the same choice when buying or selling stocks. Specifically, the regulations governing the trading of stocks listed on the New York Stock Exchange and the American Stock Exchange ("Amex") require every investor to always attempt to obtain the best advertised price regardless of all other considerations. While it seems to make sense that an investor should only receive the best price, the definition of the "best price" is not uniform for all investors. "Best price" is not a one-dimensional concept that only includes the explicit cost of closing the transaction. It also includes factors such as market risk and opportunity cost. In the house analogy above, market risk (i.e. the risk that the price of housing will change in 2 months) and opportunity costs (i.e. the risk that after 2 months your offer is rejected and you will have lost the opportunity to obtain a better price in the interim) are two major considerations in determining the "best price." They simply cannot be ignored.

Instinet recently conducted an internal study to demonstrate the risk associated with always accessing the best-advertised price. The study was of trading in three exchange- traded funds listed on the Amex based on the NASDAQ-100 Index ("QQQ"), the S&P 500 ("SPY") and the Dow Jones Industrial Average ("DIA"). The SEC has temporarily exempted these three funds from the general rule that investors always must access the best-advertised price. Instinet specifically identified situations where an investor elected to trade on the Pacific Exchange ("PCX") (an all-electronic market providing immediate executions) at a price inferior to that displayed by the Amex (a traditional floor-based market that takes many seconds to process an order).

Whenever an investor elected to display an order on the PCX even though a "better" price was advertised on the Amex, Instinet sent the Amex an order to determine what would have happened had the investor which chose the PCX had instead attempted to access the better price advertised on the Amex. Of the 387 orders sent to the

Methodology

ON FEBRUARY 4, 2003, THE FOLLOWING TEST WAS PERFORMED:

At the moment the quotations of the Pacific Stock Exchange (an all-electronic market) and the American Stock Exchange (a traditional floor-based market) were crossed, a limit order was immediately sent to the AMEX at its then quoted price. A crossed market is a market where the bid exceeds the offer.

Example of a Crossed Market

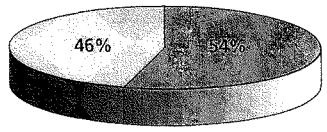
SECURITY: QQQ

HIGHEST BID PRICE: $25.00

LOWEST OFFER PRICE: $24.99

All orders sent to the AMEX were for 100 shares. The orders were cancelled if no execution was received after 30 seconds. Orders were only sent in the following securities: Nasdaq-100 Tracking Stock ("QQQ"), Standard and Poor's Depositary Receipts ("SPY") and DIAMONDS which is based on the Dow Jones Industrial Average ("DIA"). (As of September 2002, these three ETFs were exempted from certain provisions of the Intermarket Trading System Plan by the Securities and Exchange Commission.)

Percentage of Orders Executed



Overall Results for 2/4/03

DIA, QQQ, AND SPY

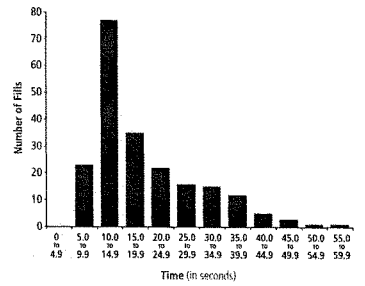
Fill/Execution Data	
Total Number of Sent Orders	387
Total Number of Executions	210
Overall Fill Percentage	54%
Average Fill Time	00:19.2
Cancellation Data	
Average Cancellation Time	00:13.2
Total Cancels Sent	211
Total Successful Cancels	177
Successful Cancellation Percentage	84%

Amex, an execution was received only 54% of the time. If an execution was received, it took an average of 19 seconds. Instinet automatically cancelled the order if no execution was received after 30 seconds. In such cases, it took an average of 13 seconds to receive confirmation that the order was, in fact, cancelled.

These results show that investors who ignored the Amex quote were able to eliminate a significant amount of market risk and opportunity cost by not sending an order to the Amex, even though it had the best advertised price. If the investor had sent the order to the Amex, nearly half the time the investor would have waited 43 seconds (i.e. the 30 seconds plus the 13 second average cancel time) to find out he or she did not receive an execution. At that point, the investor would have had to start his or her search all over again. Given the volatility of these securities, it is very likely that the market would have moved significantly in those 43 seconds. Even for the orders that were executed, the market changed prior to receiving an execution report approximately 70% of the time. Is it really better for all investors, regardless of their trading strategy or risk tolerance, to be required to always attempt to access a market with only a 54% chance of receiving an execution and where market risk and opportunity costs are always incurred?

By preventing traders from efficiently limiting their risk in exchange-listed securities, the present regulatory regime also weakens the important role that those traders play in supplying liquidity and narrowing spreads. This increases trading costs for ALL investors.

Execution Times for Orders Sent to AMEX



Perhaps this explains why spreads in exchange-listed securities are now significantly higher than spreads in Nasdaq-listed securities. In Nasdaq-listed securities, there is no regulation requiring every investor to always access the best-advertised price. Investors are free to determine their own risk tolerance.

Every investor has a unique risk tolerance and, therefore, a different definition of what constitutes the "best price." Though a well-intentioned effort to protect investors, the current regulatory structure that is based on a one-dimensional definition of best price needs to be reconsidered. We must find other ways to ensure that investors get the best price without imposing restrictions that may actually reduce execution quality for all investors.

Individual Stock Data

DIA Fill/Execution Data	
Total Number of New Orders	131
Total Number of Executions	80
DIA Fill Percentage	61%
Average Fill Time	00:18.6
DIA Cancellation Data	
Average Cancellation Time	00:11.3
Total Cancels Sent Out	65
Total Successful Cancels	51
Successful Cancellation Percentage	78.5%
QQQ Fill/Execution Data	
Total Number of New Orders	119
Total Number of Executions	56
QQQ Fill Percentage	47%
Average Fill Time	00:19.5
QQQ Cancellation Data	
Average Cancellation Time	00:14.0
Total Cancels Sent Out	75
Total Successful Cancels	63
Successful Cancellation Percentage	84%
SPY Fill/Execution Data	
Total Number of New Orders	137
Total Number of Executions	74
SPY Fill Percentage	54%
Average Fill Time	00:19.6
SPY Cancellation Data	
Average Cancellation Time	00:14.0
Total Cancels Sent Out	71
Total Successful Cancels	63
Successful Cancellation Percentage	88.7%

For more information about Instinet visit us online at www.instinet.com
or call your Instinet representative at +1 212 310 9500.

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Instinet Corporation • 3 Times Square • New York, NY 10036 • +1 877 INSTINET • www.instinet.com

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BE 0303

MODERNIZING THE NATIONAL MARKET SYSTEM

Market Structure Hearings
October 29 – November 12, 2002

Instinet Group Incorporated, which owns and operates the alternative trading systems Instinet RTTS and The Island ECN, Inc., appreciates the opportunity to participate in the Commission's market structure hearings. For over thirty years, Instinet has served the needs of its customers and investors in an ever-changing marketplace through the application of advanced technology to the trading process and by allowing investors' orders to meet directly without the intervention of a dealer. Instinet's experience brings a unique perspective to many of the issues under discussion at the market structure hearings.

This is an important time period in the evolution of the U.S. equities markets. Spurred by the technological advances of recent years, electronic markets are providing market participants with efficient and innovative trading platforms for Nasdaq-listed securities and are now beginning to provide competition to traditional intermediated markets in exchange-listed securities. The traditional markets are responding to the competitive challenge by incorporating technology to provide their own innovative products and services to market participants.

These developments have taken place in the context of National Market System (NMS) infrastructure and market interaction rules that have remained largely unchanged since their introduction in the late 1970s. The Commission has a tremendous opportunity to modernize the NMS in a manner that ensures that all market types, including electronic agency markets and traditional intermediated markets, are able to compete on a level playing field. This will unleash competition in the listed market, resulting in narrower spreads and improved execution quality for all investors.

Beyond the five NMS principles laid out in Section 11A of the Securities Exchange Act of 1934, the Commission should be guided in its efforts to modernize the NMS by two key principles as set forth by Congress in 1975: the NMS must not favor any particular market or market structure, and it should foster competition between markets.

The National Market System

Competition from electronic markets and changes in the marketplace wrought by technological advances since 1975 have exposed significant stresses in the current NMS. Looking back, it is clear that the two key components of the NMS, the Consolidated Quotation System (CQS) and the Intermarket Trading System (ITS), generally have accomplished their respective missions. The CQS has achieved its goal of ensuring transparency across the equities markets by making available to investors and market participants the best-priced quotations displayed in every participating marketplace. Similarly, ITS has provided a means for addressing concerns regarding fragmented and

unlinked markets by ensuring that every market participant has access to the quotes of every market center displayed in CQS.

A. Modernizing the NMS

It has recently become apparent, however, that these systems must be modernized to accommodate advancements in the marketplace, including the growing importance of electronic agency markets in assisting investors to achieve best execution. In particular, while ITS ensures the availability of a default linkage system between market centers, Instinet believes that the rules governing the operation of markets participating in ITS have unintentionally inhibited competition between various market structures. Certain provisions of the ITS Plan governing trade-throughs and locked and crossed markets were adopted solely with traditional, intermediated markets in mind and are not well-suited to accommodating the participation of fully electronic agency markets. Both rules force market participants to make order routing decisions based on quotations that oftentimes misrepresent the price actually available on the market disseminating the quotation.

Consequently, the effect of the trade through and locked and crossed markets rules has been to add time delays and uncertainty to the marketplace as well as undermine the speed and certainty of execution advantages offered by electronic agency markets. The effectiveness and utility of these rules have been further called into question by the Commission's recent finding of widespread non-compliance with the trade-through rule, particularly in active securities such as Exchange Traded Funds ("ETFs"). Although the Commission recently adopted the *de minimis* exemption for certain ETFs in an attempt to address the concerns associated with the trade-through rule, Instinet believes that there is general agreement among a broad spectrum of market participants that a more comprehensive long-term solution is necessary to resolve the fundamental issues associated with the ITS Plan.

B. Benefits of Competition

Fostering competition and modernizing the NMS is not an obscure concern merely important to a narrow segment of the marketplace. A modernized and efficient NMS is critical to fostering the vibrant intermarket competition that Congress believed would provide the opportunity for best execution to all investors. Investors directly benefit from the narrower spreads and lower transaction costs that result from competition and innovation. For example, in Nasdaq-listed securities, electronic agency markets have emerged as the prime source of quotations that narrow bid and ask spreads. Statistics show that ECNs are at or alone at the inside market approximately 70% of the trading day.[1] Moreover, due in large part to the emergence of electronic agency markets, the Commission's execution quality statistics reveal that the average effective and quoted spreads in the Nasdaq-100 securities are significantly lower than effective spreads in the S&P 100 exchange-listed securities.

[1] See Release No. 34-45957, SR-NASD-2002-23 March 17, 2002.

One key reason that electronic agency markets often display the best prices is that they provide market participants with a more efficient mechanism to rapidly represent their trading interest to the marketplace. Users of electronic agency markets can display or cancel orders within milliseconds as compared to several seconds (*e.g.* specialists have up to 30 seconds to represent their best priced limit orders) in traditional intermediated markets. The impact of these delays on spreads (and therefore, the execution prices investors receive) is perhaps best understood through an analogy. Imagine a buyer of a house could only submit a bid that was irrevocable for one year. Given the time delay, buyers would certainly bid lower to take into account the risk of an adverse market move during that one-year period. Time delays of only a few seconds have a similar impact on trading. As a result, to the extent that electronic agency markets effectively eliminate time delays, they enable market participants to enter the best possible price. Retail investors, whose orders are generally internalized by a dealer at the National Best Bid or Offer, directly benefit from the narrower spreads that result from efficient, electronic agency markets.

The challenge before the Commission is to modernize the NMS in a manner that enables electronic agency markets to bring the benefits of narrower spreads and lower transaction costs to investors in exchange-listed securities that they have brought to investors in Nasdaq-listed securities. In particular, by amending certain ITS rules, investors can directly benefit from the quote competition offered by electronic agency markets. As the Commission is well aware, quote competition among the markets trading exchange-listed securities has been almost non-existent, notwithstanding the Commission's efforts to encourage such competition through the NMS.

The importance of providing an efficient all-electronic alternative marketplace in exchange-listed securities was highlighted by the success of Island's marketplace for trading the Nasdaq-100 Tracking Stock known as the "QQQ." Prior to Island, the primary market specialist effectively controlled the market for trading in QQQ. The sudden availability of an efficient, low-cost electronic alternative to the primary market specialist made possible quote competition and trading strategies that were not available before. As a result, hundreds of firms began trading QQQ and competing with the specialist on price, with the result of narrowing spreads and increasing the liquidity in the QQQ marketplace. Trading volumes in the QQQ rose from approximately 30 million shares per day in 2000 to approximately 90 million shares per day in 2001. In fact, QQQ is now the most actively traded security in the world.

C. An Alternative Approach

The above discussion is not meant to suggest that traditional intermediated markets are inferior to electronic agency markets – just that the emergence of electronic agency markets has brought clear benefits to investors and the marketplace alike. Therefore, in modernizing the NMS, the Commission should ensure that the NMS does not favor any particular market structure, thereby preserving the opportunity for continued competition and innovation. Investors that want exposure to the unique price discovery process of a traditional market should be permitted to route orders accordingly, as should investors

that value the speed and certainty of execution of an electronic agency market. Instinet envisions a NMS where an investor can view the best prices in every market and access those best prices. NMS rules should not dictate where orders are sent but only mandate transparency of order and trade information and access to market centers on non-discriminatory terms. By pursuing a neutral and open architecture market structure, the Commission will more effectively enhance investors' opportunities to receive best execution of their orders.

Despite the benefits of electronic agency markets in Nasdaq-listed securities, some interested parties remain concerned about the consequences of eliminating provisions specifically adopted with the goal of protecting investors, such as the trade-through rule. These parties believe that the trade-through and quote through rules are necessary to ensure the best execution of retail customer orders. As noted above, however, Instinet believes that these provisions actually work to the detriment of investors by inhibiting efficient trading, widening spreads, and increasing transaction costs. Ultimately, Instinet believes that the "costs" (e.g., negatively impacting inter-market competition and innovation) associated with the trade-through rule outweigh the "benefits." Ensuring best execution of investor orders, the most cited purported benefit of the trade-through rule, can be achieved in other ways that do not also negatively impact other important goals of the NMS such as competition and innovation.

In fact, trading in Nasdaq-listed securities provides a blueprint for how best execution can be assured without a trade-through rule. Markets that serve retail orders in Nasdaq-listed securities currently guarantee executions at the National Best Bid or Offer due to business and regulatory necessities. From a business perspective, the Commission's recent adoption of execution quality statistics and strong emphasis on best execution has served to make all market participants aware of the importance of providing customers with best execution. Providing inferior executions in a transparent environment is a clear invitation to competitors to take away business and investors to move their business elsewhere. From a regulatory perspective, regulators are now able to closely monitor the execution quality of market participants executing customer orders through surveillance reports that routinely alert regulators of transactions effected away from the prevailing market. Regulators perform reviews of these transactions to ensure that they were not for the account of a retail customer. The innovation and competition over the past few years in Nasdaq-listed securities that led to the dramatic improvement in execution quality reflects the benefits of ensuring best execution through means other than a trade-through rule.

In summary, the surest way to maximize the opportunity for best execution for all investors is to create the most efficient market possible. Efficiencies are introduced to the marketplace as a result of innovation spurred by competition. All investors benefit from the narrower spreads and lower transaction costs that result from increasingly efficient markets. To the extent that certain provisions of the NMS inhibit competition and innovation (and, therefore, efficiency), the Commission must consider whether the goal of the particular provision can be better achieved in ways that do not distort competition. In particular, Instinet believes that the trade through and locked and crossed

market provisions distort and inhibit competition by dictating how market participants must interact, without regard to the distinct differences between various market types. The goals of the trade-through rule can be achieved with the least amount of market distortion, as is currently the case for Nasdaq-listed securities, by promoting an environment in which competition, regulatory oversight, and disclosure requirements combine to assure that brokers representing retail customer orders (rather than a market center), fulfill their duty of best execution.

What is an Exchange?

Nasdaq's application for registration as a national securities exchange has led the Commission to reconsider the fundamental question of what it means to be an "exchange." Specifically, Nasdaq has proposed to be an exchange without imposing marketwide price-time priority rules on its members, which historically have been considered a central element of "exchange" marketplaces. The Nasdaq exchange application raises serious questions as to whether this historical notion, which is not required by statute, continues to serve the best interests of investors.

Instinet believes that statistical evidence and recent experience suggest that the historical presumption that market centers that require price-time priority between market participants (i.e. traditional *intra*-market price-time priority of exchanges) better serve investors should be revisited. Commission required statistics on execution quality indicate that average effective spreads in the top 100 Nasdaq-listed securities are now lower than those in the top 100 exchange-listed securities, despite the fact that Nasdaq stocks are traded in a decentralized market that does not feature *intra*-market price-time priority. In addition, the decentralized market structure of the over-the-counter marketplace has fostered a variety of business models by giving market participants the flexibility to structure themselves to meet the unique needs of diverse customer groups. Investors trading Nasdaq-listed securities have access to a variety of software packages that allow them to see the entire depth of the market in real-time and electronically route orders to any marketplace within seconds. Electronic agency markets have led the way in providing trading solutions uniquely tailored to the diverse needs of different market participants.

Ironically, such electronic agency markets may never have existed if the NASD were required to enforce price-time priority on the market participants within Nasdaq. Specifically, if an electronic agency market were forced to route orders to the best price displayed within Nasdaq, the speed and certainty of execution advantages of electronic agency markets would have been negated. This is particularly the case since, until recently, Nasdaq market participants had up to 30 seconds to respond to orders. As many investors now strive to save milliseconds, such delays would have had a substantial negative impact on the competitiveness of electronic agency markets and, more importantly, on the quality of the executions available to investors.

Instinet believes that, in the context of the developments of the past few years, the Commission should adopt a policy with respect to registered exchanges that recognizes

that there are merits to both price-time priority markets and decentralized markets. Instinet is concerned that a policy that requires exchanges to operate only with price-time priority marketplaces stifles competition to the detriment of investors. Not only does such a policy unnecessarily inhibit the ability of decentralized markets to compete as they have so effectively over the past few years, but such a policy also could preclude the development of altogether different market models that do not fall neatly into either category.

As a result, Instinet supports a policy that would allow every exchange to determine for itself whether it will operate with price-time priority principles, without such principles, or in some other manner entirely. In each such case, the role of the Commission would be to ensure that certain basic standards are met. All markets, for instance, should be required to meet standards for transparency, access, and regulatory oversight. Moreover, if the Commission is concerned that investors and market participants have certain expectations regarding the market structure provided by a market with an "exchange" label, consistent with its role as a disclosure agency, the Commission could require registered exchanges to provide enhanced disclosure as to the order interaction rules in their markets. A flexible approach will best accommodate innovation and ensure the continued competition within our equity markets that has driven their unparalleled efficiency and fairness among the world's markets.

In summary, given the serious questions concerning which market structure provides greater benefits to investors, Instinet believes that the best policy is not to mandate any basic market structure elements across exchanges or otherwise favor any particular market structure over any other. Instead, every market center that is registered as an exchange, including Nasdaq, should be permitted to determine for itself how it wants to operate vis-à-vis intra-market price-time priority.

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Organization of Independent Floor Brokers

11 Wall Street
New York, NY 10005

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President

Doreen M. Mogavero
Vice President

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Treasurer

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Statement for the Record
"Reviewing U.S. Capital Market Structure:
Promoting Competition in a Changing Trading Environment"

Subcommittee on Capital Markets, Insurance and
Government-Sponsored Enterprises

Committee on Financial Services
U.S. House of Representatives

October 30, 2003

The Organization of Independent Floor Brokers represents the interests of 450 independent brokers working on the New York Stock Exchange trading floor. This statement presents our views on the subject of U.S. capital market structure.

As member broker-dealers of the New York Stock Exchange, we are compelled to answer critics and competitors who question the viability of the auction market model and promote changes that disadvantage the investing public. Respectfully, we seek to add balance and clarity to the debate and offer our views on several important issues.

Obviously, the NYSE is facing many challenges. Interim chairman and CEO John Reed is effectively addressing governance, market oversight and board reform—key issues at the center of the storm. Still, our market is strong and performing exceptionally well. Continuous change and evolution has enabled the Exchange to become the world's most competitively priced, efficient and reliable equities market.

We are confident in the value and capability of the auction market, and in the expertise and professionalism of our colleagues on the trading floor. The NYSE auction market brings investor interests together on a fair and level playing field not found in any other trading venue. It is where investors discover the best price and value when buying and selling stocks of the world's best companies—a distinct competitive advantage and the leading reason for the Exchange's success. Moreover, we realize that our success rests squarely on our commitment and ability to fulfill the needs of our customers, but not at the expense of any single constituent—especially the small investor.

With the investor in mind, we are deeply concerned by proposals to modify the "trade-through rule," a rule that protects investors and—despite the claims of critics and competitors—does not inhibit market competition. This rule promotes competition on the basis of the best-published price posted in all markets and ensures investors of best price when buying and selling stock. Assuredly, the trade-through rule does not inhibit an investor or broker from sending an order to any market or ECN, nor does it preclude any market from executing an order at any price that is agreeable to the customer. It simply requires that investors displaying better-priced quotes in other markets have the right to be satisfied.... nothing more.

Significant alterations to this rule would weaken the National Market System and produce a host of unintended consequences that would disadvantage investors and further diminish their trust and confidence in our capital marketplace.

The absence of the trade-through rule as it exists today would produce inferior prices and increased costs, market fragmentation and market volatility, and reduced accountability and transparency— all byproducts of a market without adequate investor price protection. It would give rise to professional quote arbitrage at the expense of retail investors. Undermining quote competition by trading away from the best bid and offer, in effect, trades away assurances of the best price for investors. Unfortunately, the competition seeks an environment that permits cash inducements to brokers, less sunlight on orders, and speedy executions at inferior prices—practices that have no place at the NYSE and practices that should have no place in our capital market system.

Therefore, we cannot support eliminating or changing the trade-through rule. Are we not working to restore investor trust and confidence in our markets? Disadvantaging investors and diminishing market quality by fostering inferior prices, dislocated and choppy markets, and reduced transparency by no means achieves that end; it sets it back.

Investors would be better served by thoughtful and responsible market structure evolution and market competition that does not advantage a select class of competitors and professional special interests. We must advance the fair and level playing field for investors by ensuring rapid access to the best price in their trading venue of choice. In that spirit, what should be reviewed are the adequacy of the Intermarket Trading System and the elimination of inequitable practices such as preferencing, order rebates, payment for order flow and other "pay-to-play" schemes.

At the NYSE, the benefit of superior pricing is not lost on investors. The Exchange establishes and posts the best price 94% of the time. In the 100 most-actively traded stocks, our prices are on average 12 cents better than the competition. We improve the posted price on 44% of orders by an average of 3 cents per share. In this business, investors naturally gravitate to the best price and to the Exchange, which maintains a dominant—by no means monopolistic—market share of 80% in the trading of listed stocks because we give investors what they most want and value: the best posted price, the lowest all-in cost, narrowest spreads, price stability and least volatility, and highest fill rates. Even in the most difficult market conditions, Exchange market professionals are there, buying and selling, making markets for investors.

In the auction market, all buyers and sellers have equal representation at the point of sale—not so in distributed dealer markets. Specialists and floor brokers play a vital and visible role in the price discovery process and help ensure the most fair, orderly and liquid market. Together, we produce multi-million dollar cost savings annually for large and small investors. We are a single point of accountability

and a valuable source of information for our customers. Most importantly, we apply proven trading strategies and employ the most sophisticated technology tools to secure the best price. Our role in the market is assured as long as we remain cost-effective and provide value to customers.

There are 450 independent agents working diligently to employ their strategic expertise and judgment in representing orders both large and small for both retail and large institutional customers. The larger orders—25,000 shares or more—account for more than 30% of the NYSE's average daily volume of 1.4 billion shares. Most small to mid-size orders are delivered directly to the point of sale for execution via the Exchange's electronic order routing systems, which provide rapid execution speeds of a low as 1.3 seconds depending the order execution route customers choose.

Through the years the NYSE has been viewed as the "gold standard" in markets. This is in great part due to the role of the floor broker. The interaction between the floor broker and upstairs trader provides the flow of information necessary to keep professional traders informed about changing market conditions. That information flow is more often than not the catalyst that provides incentives for traders to trade. The combination of best price and intelligent information flow is the backbone of the NYSE. We will continue to adapt and innovate to retain that standard, to best serve our customers, and to fulfill our commitments to the highest levels of market quality. We will also continue to compete on the basis of discovering the best price. Simply put, we encourage competition on a level playing field—supply the best price to the investor and you will get the order flow. We urge others to follow suit.

MEMORANDUM

TO: Chairman Donaldson

FROM: Annette L. Nazareth

DATE: December 10, 2003

RE: Reviewing U.S. Capital Market Structure Hearing (October 30, 2003)

As you requested, I have prepared responses to the questions submitted by Congressman Doug Ose in relation to the hearing held by the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises on October 30, 2003 entitled "Reviewing U.S. Capital Market Structure: Promoting Competition in a Changing Trading Environment."

Question 1

As you well know, the SEC has been talking about market structure reform for the past four years. I see from your statement that you have linked granting Nasdaq's exchange registration application to the broader issue of market structure reform. What is your time line for achieving market structure reform? I think it is imperative that Nasdaq achieve designation as an official exchange. Can you give this subcommittee a specific time line for when we can expect this to happen?

Response

The concerns raised and the issues relating to market structure reform are a complex and involved subject, one that is not easily resolved. As I have noted, we need to ensure that in attempting to effectively address the concerns, we do not inadvertently damage what is not broken.

Commission staff currently is crafting rulemaking proposals, for consideration by the Commission, that address a number of key market structure issues. My expectation is that in the near future the staff will recommend to the Commission specific steps to respond to several of the more pressing market structure issues. Promptly after achieving consensus on those steps, the Commission will publish its proposals for full notice and comment.

One of the key issues that the Commission must resolve before acting on Nasdaq's application is whether a registered exchange must have market-wide priority rules that promote order interaction. As you know, each of the registered exchanges in the U.S. has priority rules that are designed to promote order interaction, which facilitates the price discovery process. If the Commission were to approve Nasdaq's application as proposed, it would have to likewise permit other exchanges to abandon priority rules. Thus, Nasdaq's application raises profound market structure issues that could have implications for all of our registered exchanges and, ultimately, investors in our markets.

The Commission is dedicated to working with Nasdaq to resolve this and other remaining issues on its exchange application. However, the Commission must be assured that any rules approved for Nasdaq are consistent with the goals of a national market system. Further, we must be assured that, if and when Nasdaq is registered as an exchange, it can fulfill its statutory obligations as a separate self-regulatory organization.

Question 2

In the past, various analysts have raised the prospect of merging the Nasdaq and NYSE. Tradition aside, if we take a rational approach to this issue, given the obvious need for a strengthened regulatory regime, do you think the time has come to create one exchange with one clearly independent regulator? This approach would seem to increase efficiency and significantly reduce regulatory costs while also encouraging the NYSE to adopt some of the newer technology. What is your perspective on merging the two exchanges?

Response

I believe that mergers among markets should be driven, in the first instance, by competitive forces, rather than by regulatory fiat. Congress, in the 1975 Act Amendments to the Securities Exchange Act of 1934, did not dictate or favor one particular market model over another, but instead tasked the Commission with, among other things, assuring fair competition among markets. Under this mandate, the Commission strives to establish an environment in which different types of markets, including traditional auction exchanges and electronic inter-dealer markets, can compete fairly.

While the differences between these types of markets have contributed to some of the market structure issues that we currently face, each has distinct benefits for investors. Rather than choosing which type of market should ultimately prevail, the Commission is attempting to craft market structure proposals that will integrate these different types of markets into the National Market System, while preserving the distinct benefits that these different types of markets offer investors.

Self-regulation has been a fundamental principle of our current system of market regulation, and I believe that it has helped to make markets fair and efficient. The Commission is reviewing our system of self-regulation, including the relationship between the SRO as regulator and market operator, and how to ensure that the regulator function is conducted vigilantly and aggressively. The Commission will be looking to see if our current system needs to be changed to make it more effective. We certainly will take into account the comments and concerns that have been expressed as we explore issues relating to self-regulation in more depth.

MEMORANDUM

TO: Chairman Donaldson

FROM: Annette L. Nazareth

DATE: December 10, 2003

RE: Reviewing U.S. Capital Market Structure Hearing (October 30, 2003)

As you requested, I have prepared responses to the questions submitted by Congressman Ruben Hinojosa in relation to the hearing held by the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises on October 30, 2003 entitled "Reviewing U.S. Capital Market Structure: Promoting Competition in a Changing Trading Environment."

Question 1

In your testimony you note that Congress specified in 1975 five key objectives of the national market system. One of those is "execution of orders in the best market." Without stating that "competition among the various markets" is the best market in 2003 for the execution of orders, what is the "best market" for consumers to use as required by Congress in 1975 in light of all the changes that have occurred since 1975, both technologically and in terms of products?

Response

Congress, in the 1975 Act Amendments to the Securities Exchange Act of 1934, did not choose to dictate or require one particular market model over another, but instead laid out basic principles to help guide and shape the structure of our markets and granted the Commission broad authority to oversee the implementation, operation and regulation of a national market system. As a result, various different market models exist and thrive in the U.S. securities markets today, including inter-dealer markets and auction markets, floor-based markets and all-electronic markets.

Which market is the "best market" for investors will vary depending upon several factors, including the type of investor, the type and size of the order flow and the investment strategy or goal of the investor. The role of the Commission is not to dictate or require any particular trading model but primarily to ensure a level playing field to encourage fair competition and to ensure that no matter what the model, the interests of investors in efficient and fair order executions are upheld.

Question 2

In your testimony, Secretary Donaldson, you also note that you and your staff are also actively re-evaluating the question of intermarket trade-throughs, which occur when orders are executed in one market at prices inferior to the prices disseminated on another market. Do you

intend to change this rule to allow some customers to accept a lesser price in return for speed, certainty or anonymity to bring the NYSE more in line with Nasdaq?

Response

The Commission is cognizant of the concerns that the existing trade-through rules impede the efficient operation of certain markets with "non-traditional" structures and business models that are built upon the speed of execution. We also are aware that sophisticated investors who value speed and certainty of execution over the possibility of a price that is better by a penny or two increasingly want the ability to trade without accessing a slower market.

Commission staff is actively reviewing the viability and continued effectiveness of our existing trade-through rules in today's fragmented markets to determine what, if any, changes should be made to the current structure.

My expectation is that in the near future the staff will recommend to the Commission specific steps to respond to issues raised with respect to operation of the current trade-through rules. Promptly after achieving consensus on that proposal, the Commission will publish it for full notice and comment.

Question 3

It is encouraging that you intend to move forward on addressing market structure issues. Which issues do you anticipate addressing first? What is your time frame for this process?

Response

The Commission staff is developing proposals intended to reconcile the original national market system principles with new issues, including fair and efficient access among different types of market centers, the protection of prices across different types of markets, the sale and distribution of market data revenue, the criteria for registration as a national securities exchange and the issue of pricing and trading in increments of less than a penny.

Commission staff currently is drafting, for consideration by the Commission, rulemaking proposals that address a number of key market structure issues. As noted above, my expectation is that in the near future the staff will recommend to the Commission specific steps to respond to several of the more pressing market structure issues. Promptly after achieving consensus on those steps, the Commission will publish them for full notice and comment.

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

December 8, 2003

The Honorable David Scott
U.S. House of Representatives
417 Cannon House Office Building
Washington, DC 20515

Dear Congressman Scott:

I am writing in response to your November 14th letter in which you presented in writing a question that you asked during the October 30th hearing by the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises concerning market structure. Your question focused on a proposed rule change filed by the National Securities Clearing Corporation and requested my "general assurances that SROs, because of inherent competitive advantages that accompany their status as quasi-government entities, ought not to be in the business of competing in the private sector with established businesses."

The proposed rule change would allow NSCC to establish an information messaging system called the Separately Managed Accounts Service for the communication of information among sponsors of separately managed accounts and the investment managers participating in their programs. It was filed with the Commission on October 16, 2003, and is currently being reviewed by the Commission's Division of Market Regulation. The Division is aware of the issues you raise because it received similar comments on a related proposed rule change that was previously filed and subsequently withdrawn by NSCC. The Division is still reviewing the proposed rule change, and notice of the proposed rule change was only recently published in the Federal Register for comment. Consequently, I am not in a position to comment on the application at this time other than to say that neither the SEC staff nor the Commission has reached any conclusions on the merits of the filing. However, please be assured that, in matters before the Commission, the issue of competition is one that is considered seriously and consistently with our statutory obligation with respect to SRO filings.

Thank you for bringing this matter to my attention. If you have any further questions please do not hesitate to contact me or have your staff call Annette Nazareth, Director of the Division of Market Regulation, at 202-942-0092.

Sincerely,

William H. Donaldson

cc: The Honorable Richard Baker

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Discussion Paper

COMPETITION, TRANSPARENCY, AND EQUAL ACCESS TO FINANCIAL MARKET DATA

Submitted by Bloomberg L.P.

In Consultation With:

Dr. George A. Hay, Edward Cornell Professor of Law and Professor of Economics, Cornell University

and

Dr. Erik R. Sirri, Associate Professor of Finance, Babson College

Willkie Farr & Gallagher
787 Seventh Avenue
New York, New York 10019
(212) 728-8000
Counsel to Bloomberg L.P.

September 24, 2002

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COMPETITION, TRANSPARENCY, AND EQUAL ACCESS TO FINANCIAL MARKET DATA*

Bloomberg L.P. ("Bloomberg")** submits this paper to address the importance of competition in the sale of financial information and the need for equal access to financial market data.

I. OVERVIEW

Competition in the sale of financial information is vital to the broad dissemination of trading data, the development of innovative analytics and indicators, and the transparency and efficiency of the financial markets. This paper demonstrates that exchanges,[1] and the NYSE and Nasdaq in particular, are abusing their government-conferred monopolies over the collection of trading data to restrict competition in the downstream market in which trading data and related products are sold to investors (the "market for financial information"). The NYSE and Nasdaq, for example, have used data relating to proposed or actual transactions on their respective trading facilities to create products (the NYSE Open Book and Nasdaq's Pre-Market and After-Hours Indicators) that they sell in the market for financial information under exclusionary conditions. Neither the products nor the data on which they are based are available to other market-data

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* This paper was prepared with the assistance of, and in consultation with, Dr. George A. Hay and Dr. Erik R. Sirri, who endorse the analysis set forth herein. Dr. Hay is the Edward Cornell Professor of Law and Professor of Economics, Cornell University, and former Director of Economics of the Economic Policy Office of the Antitrust Division of the United States Department of Justice. Dr. Sirri is an Associate Professor of Finance, Babson College, and former Chief Economist of the United States Securities and Exchange Commission.

** Bloomberg is a worldwide, finance-oriented information and media company that provides data, news and analytics (the "BLOOMBERG PROFESSIONAL service") to investment firms and other professionals via more than 180,000 BLOOMBERG PROFESSIONAL terminals worldwide. Bloomberg is a Delaware (U.S.) limited partnership, headquartered in New York.

[1] The term "exchanges" as used herein refers to the New York Stock Exchange, Inc. (the "NYSE"), the American Stock Exchange ("Amex"), the six regional exchanges, and The Nasdaq Stock Market, Inc. ("Nasdaq").

vendors (either from the exchanges or directly from those participating in the proposed or actual transactions) for use in competing products. Those exclusionary practices extend the exchanges' data monopolies downstream into the market for financial information.

The harm to market-data vendors, such as Bloomberg, that are unaffiliated with exchanges is obvious and severe, as such vendors cannot compete in any dimension -- price, quality, innovation -- if their access to necessary raw materials is barred or impeded. As a result, the exchanges' exclusionary conduct directly injures consumers, as the market-data vendors cannot introduce products that compete on either price or quality with the products sold by the exchanges. Higher prices, poorer quality, and less innovation, the hallmarks of harmful monopolistic behavior, will result. In particular:

- By refusing to provide the essential data on reasonable and nondiscriminatory terms, the exchanges eliminate any chance of effective price competition in the downstream market for the sale of financial information. As a result, consumers in the market for financial information will likely pay a price for the exchanges' products that is higher than the price that competition would dictate.
- By refusing to provide the essential data on reasonable and nondiscriminatory terms, the exchanges also eliminate any possibility for meaningful non-price competition, thereby hindering the introduction of alternative products and limiting consumer choice. The exchanges also avoid the need to improve the quality or design of their products, reduce the incentive for investment in the market for financial information, and deprive consumers of the substantial benefits that flow from competition in product innovation.

When exchanges prevent or impede market-data vendors from obtaining access to data relating to proposed or actual transactions on the exchanges' respective facilities, the exchanges thus harm both consumers and competitors and reduce the efficiency of the securities markets.

This paper does not take issue with the monopoly that the current regulatory scheme confers on exchanges over the collection of the raw trading data related to proposed and

actual securities transactions conducted on their facilities.[2] Rather, it takes issue only with the abuse of that monopoly power when the exchanges favor downstream affiliates or prevent access by unaffiliated rivals to crucially important market data, thereby harming both price and non-price competition in the market for financial information.

To prevent the exchanges' abuse of their monopolies over the collection of trading data, we respectfully recommend that any exchange that wishes to compete in the downstream market for financial information be required to do so through a separate corporate entity, much as the SEC required in the Financial Systemware, Inc. ("FSI") exemption order (see Point V below). In addition, we argue that exchanges must distribute all data through a Securities Information Processor (SIP),[3] which already has a statutorily prescribed role in the distribution and consolidation of market data, that is subject to SEC oversight and is owned or administered independently of the exchanges. As such, the SIP would serve as a separate intermediary and firewall between the exchange and its downstream affiliate in the market for financial information.

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[2] The SEC has described its analysis of the financial structures of self-regulatory organizations ("SROs"), the cost of market information, and the relevant statutory standards governing market information and fees in Securities Exchange Act Release No. 42208 (December 9, 1999). While the question of pricing power and how best to address it is an important consideration in the regulation of monopolies, Bloomberg's views on that subject are not within the scope of this paper. As noted in the text, Bloomberg does not take issue in this paper with the exchanges' monopolies over the collection of market data or the manner in which the price of those data is regulated by the SEC. In this context, Bloomberg addresses only the exchanges' abuse of that power by wielding it against competitors and consumers alike in the market for financial information.

[3] 15 U.S.C. § 78c(a)(22)(A).

II. BACKGROUND AND CONTEXT: THE EXCHANGES WILL INCREASINGLY ABUSE THEIR GOVERNMENT-CONFERRED DATA MONOPOLIES AND HARM COMPETITION AND EFFICIENCY.

To make informed and efficient trading decisions, market participants require full access to all relevant trading data, including, but not limited to, the national best bid and offer ("NBBO"), last-sale data, quote data, transaction data, and depth-of-market data possessed by all market centers. The market for financial information also includes value-added analytics and indicators that are based upon trading data as well as software that facilitates the production of tailored analytics and indicators. For competition to thrive, the raw trading data that constitute the core inputs to products in the market for financial information must be equally available to all market-data vendors.

As discussed more fully below, the current regulatory scheme confers monopoly control on the exchanges over the collection of the real-time trading data relating to securities transactions that are proposed or conducted on the exchanges' facilities. The exchanges, however, are now moving forward into the downstream market for financial information to sell trading data (and value-added products based upon such data) that are related to those proposed and actual transactions. The NYSE and Nasdaq in particular are doing so to the exclusion of other market-data vendors, such as Bloomberg L.P., that are unaffiliated with any exchange. The result: the NYSE and Nasdaq are able to restrict the output and raise the price of the financial information products they sell and will increasingly do so unless they are subjected to the type of constraints that are suggested below.

As exchanges move toward becoming private, for-profit entities, their opportunities to market trading data for their own advantages grow, and their incentive to distort

competition and abuse their government-conferred data monopolies will only expand. Nasdaq has pending an application with the SEC for registration as a national securities exchange.[4] If Nasdaq's registration application is approved, Nasdaq will then complete its privatization process. As a for-profit exchange, Nasdaq will enjoy a private treasure trove of the raw materials that are necessary to the construction of data analytics, order-management systems, and other value-added functionalities, all of which are essential tools for market participants. Moreover, as an exchange, Nasdaq will obtain those raw materials from its members by force of law.

To prevent the exchanges from anticompetitively exploiting their monopolies over the collection of trading data, they must be required to make trading data available to all market-data vendors (including the exchanges and their affiliates) at the same time, at the same prices, and on equal terms. This paper suggests a two-part structural remedy to achieve those goals that:

(1) separates the exchanges from downstream affiliates that seek to market value-added financial data, and

(2) provides for independently owned or administered SIPs to consolidate and/or distribute all market data relating to proposed and actual transactions conducted on exchange facilities.

Today, the exclusive SIPs that consolidate and distribute trading data are themselves identical to or affiliated with the exchanges. If an exchange wishes to participate in the downstream market for financial information, Bloomberg believes that the exchange must be structurally and operationally separate from its downstream affiliate that participates in that market and be "independent" of the SIP that consolidates exchange data.

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[4] Securities Exchange Act Release No. 44396 (June 7, 2001) (2001 SEC LEXIS 1097).

More specifically, the SIP either must be owned by an entity other than an exchange, or, if owned by an exchange in whole or in part, must be administered day-to-day by an entity that is entirely independent of the exchange. The exchanges would provide statutorily required trading data, as well as any other trading data they wish to sell or use themselves for value-added products, to the "independent" SIP, which in turn would consolidate and/or sell the data to all market-data vendors (including exchange affiliates) on reasonable and nondiscriminatory terms.[5] Absent such an approach, the monopoly power of the exchanges will continue to grow, damage competition in the sale of financial information, and damage our national market system.

III. THE EXCHANGES HAVE GOVERNMENT-CONFERRED MONOPOLIES OVER THE COLLECTION OF TRADING DATA.

A. The Transaction Reporting Rule, the Quote Rule, and the Vendor Display Rule

The Securities Acts Amendments of 1975 (the "1975 Amendments") directed the SEC to create a national market system for securities.[6] Section 11A of the Securities Exchange Act of 1934 (the "Exchange Act") sets forth the primary objectives of the 1975 Amendments, including the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities. The SEC has promulgated rules in response to the Congress' direction to maintain fair and orderly markets and to facilitate the establishment of a

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5 We recognize that certain of the functions of the "independent" SIP that we discuss in Section III, for example, the negotiation of contracts for the sale of market data to market-data vendors, are not currently performed by the SIP itself, but rather by the Network or Plan administrators. In speaking in this paper about an "independent" SIP, however, we intend to propose a SIP that would have all the functions necessary to make market data obtained from the exchanges available to all market-data vendors on reasonable and nondiscriminatory terms.

6 Pub. L. No. 94-29, 89 Stat. 97 (1975).

national market system for securities. Most prominent are the so-called Transaction Reporting Rule,[7] the Quote Rule,[8] and the Vendor Display Rule.[9]

The Transaction Reporting Rule requires each SRO[10] to file with the SEC a transaction reporting plan for national market system securities traded in its market. The Quote Rule requires an SRO to establish procedures for making available its members' bids, offers, and quotation sizes to information vendors. The Transaction Reporting Rule and the Quote Rule effectively require all exchange members to report quote and transaction data to the exchanges. The Vendor Display Rule governs the distribution, publication, and display of last-sale and quotation data. In general, it requires vendors and broker-dealers that provide broker-dealers and investors with market information regarding a given security[11] to provide a consolidated display of information from all reporting market centers that permit trading in that security. Those rules interact to confer a monopoly on the collection of trading data on the exchanges.

The Quote Rule requires exchange members to promptly report to the applicable exchange or NASD, Inc. ("NASD") their best bids, best offers, and quotation sizes for exchange-

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7 Exchange Act Rule 11Aa3-1.

8 Exchange Act Rule 11Ac1-1.

9 Exchange Act Rule 11Ac1-2.

10 Section 3(a)(26) of the Exchange Act defines an SRO as any national securities exchange, registered securities association, registered clearing agency, or the Municipal Securities Rulemaking Board. 15 U.S.C. § 78c(a)(26). SROs promulgate their own rules, subject to Commission approval, that deal with member regulation, market regulation, and issuer listing standards.

11 Under the Display Rule, if a vendor or broker-dealer provides quote information for any stock that is traded on an exchange or Nasdaq, it must also provide either (a) the NBBO for the stock, or (b) a quotation montage for the stock from all reporting market centers. If a vendor or broker-dealer provides transaction reports or last-sale data for any exchange-traded security or Nasdaq stock, it must also provide the price and volume of the most recent transaction in that stock from any reporting market center, as well as an identification of that market center. See Exchange Act Rule 11Ac1-2(c)(2).

traded and over-the-counter securities.[12] The Transaction Reporting Rule requires all members of exchanges to report their last-sale data exclusively through an approved Transaction Reporting Plan that is created and administered by the exchanges.[13] The Transaction Reporting Rule expressly prohibits members from disseminating transaction reports or last-sale data outside of an effective Transaction Reporting Plan.[14] Similarly, electronic communications networks ("ECNs")[15] are required to provide their trading data to an exchange for inclusion in the quotation data made available by the exchange to quotation vendors.[16] Exchanges thus have a monopoly on the collection of raw trading data, and independent data vendors cannot purchase those data directly from exchange members.

B. The Plans[17]

In accordance with this regulatory framework, the SROs have acted jointly under four national market system plans (the "Plans") in disseminating consolidated market information. The Plans govern the four "networks" of information developed by the SROs to disseminate market information for different categories of securities. Three of the networks

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12 Exchange Act Rule 11Ac1-1(c)(1).

13 Exchange Act Rule 11Aa3-1(c).

14 "No exchange or member thereof shall make available or disseminate, on a current or continuing basis, transaction reports or last sale data with respect to transactions in any reported security executed through the facilities of such exchange except pursuant to an effective transaction reporting plan filed by such exchange...." Exchange Act Rule 11Aa3-1(c)(2). This same rule applies to associations and their members as well. See Exchange Act Rule 11Aa3-1(c)(3).

15 ECNs are automated trading systems that widely disseminate market maker or specialist orders to third parties and permit such orders to be executed through the system. Exchange Act Rule 11Ac1-1(a)(8). Their reporting obligations are governed by Exchange Act Rule 301(b)(3)(ii).

16 Exchange Act Rule 301(b)(3)(ii).

17 The information about the Plans and the Networks they operate is derived from the Report of the Advisory Committee on Market Information, dated September 14, 2001, discussed infra in Section VI.

govern securities listed on the NYSE, the Amex, the regional exchanges and Nasdaq, and the fourth governs exchange-listed options. Each Plan is governed by a committee comprised of a representative of each exchange that participates in the Plan. The three Plans that govern information regarding exchange-traded equities control the collection, consolidation, and distribution of quotation and transaction data for equity securities from all market centers. They also set the fees, subject to SEC oversight, that vendors and subscribers pay for the consolidated financial information.[18] Via the Plans, the SROs have complete monopoly power over consolidated financial information.

Two Plans, the Consolidated Tape Association Plan ("CTA Plan") and Consolidated Quotation Plan ("CQ Plan"), govern all exchange-listed securities (which do not include Nasdaq-listed securities). The participants in the two Plans are the NYSE, NASD, the Amex, Boston Stock Exchange ("BSE"), Chicago Board Options Exchange ("CBOE"), Chicago Stock Exchange ("CHX"), Cincinnati Stock Exchange ("CSE"), Pacific Exchange ("PCX") and Philadelphia Stock Exchange ("PHLX"). The two Plans jointly control two different networks. Market data for securities listed on the NYSE are disseminated via Network A, and information for securities listed on the Amex or the regional exchanges is distributed via Network B.

Network A consolidates all financial information relating to stocks listed on the NYSE, whether traded on the NYSE, a regional exchange, or an ECN. The NYSE is designated as the day-to-day administrator of Network A. As administrator, the NYSE is responsible for negotiating contracts with data vendors. In contract negotiations, vendors must disclose all proposed uses for the data and all uses must be approved by the NYSE. The NYSE thereby

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[18] Exchange Act Rule 11Aa3-2(c)(3).

learns of any new, value-added product that a vendor intends to market while that product is still under development and while the related information is still confidential and competitively sensitive. The NYSE may even deny the vendor the right to use Network A data for a particular product.

A SIP must compile the NBBO and consolidate last-sale data available in accordance with the pertinent Plan.[19] The Securities Industry Automation Corporation ("SIAC") acts as the SIP for Network A. The transaction data collected by the CTA Plan and the quotation data collected by the CQ Plan on Network A are consolidated and processed by SIAC computers. SIAC is currently a joint venture that is two-thirds owned by the NYSE and one-third owned by the Amex. The NYSE (along with the Amex) thus has monopoly power over the collection of raw trading data and the consolidated trading data for trades made by NYSE members. Those monopolies are secured and enhanced by the NYSE's position as administrator of Network A, which allows the NYSE to learn of new products that its competitors are developing.

Network B consolidates market data on securities listed on the Amex or the regional exchanges, but not listed on the NYSE. The Amex, which is a subsidiary of NASD, acts as the administrator of Network B, and, as such, negotiates contracts, including those with market-data vendors. SIAC is the SIP for Network B. The regional exchanges are required to report their trading data to SIAC. So, for data regarding trades by Amex members, NASD -- as the parent of the Amex -- has a monopoly on the collection of the raw data, and the NYSE, together with NASD, as the ultimate owners of SIAC, share a monopoly on the consolidated data.

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[19] Exchange Act Rules 11Aa3-1and 11Aa3-2.

The third Plan for securities, in addition to the CTA Plan and the CQ Plan, is the Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privilege Basis ("Nasdaq/UTP Plan"). This Plan provides for the collection and consolidation of quotation and transaction information relating to securities traded on Nasdaq and on regional exchanges pursuant to Unlisted Trading Privileges under Section 12(f) of the Exchange Act. The participants in the Nasdaq/UTP Plan are NASD, the Amex, BSE, CHX, CSE, PCX, and PHLX.[20] Nasdaq acts as both the administrator of the Plan and the SIP. As administrator, Nasdaq is responsible for day-to-day operations and for negotiating contracts with vendors. As the SIP for the Nasdaq/UTP Plan, Nasdaq collects and consolidates Nasdaq trading data, and controls dissemination of the data.

C. Preventing Abuse of Exclusive SIPs

We have reviewed the Transaction Reporting Rule, the Quote Rule, the Vendor Display Rule, and the Plans to demonstrate that they form a regulatory and operational framework that confers on exchanges monopolies over the collection of data related to potential and actual securities transactions on the exchanges' facilities. As noted above, we do not take issue here with those monopolies, the SEC's regulation of the monopolies in the exchange environment, or the manner in which the SEC oversees data prices as sold through SIPs pursuant to the Plans.[21] Rather, this paper takes issue only with the exchanges' abuse of their data

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[20] Under the Nasdaq/UTP Plan, Nasdaq collects quotation and last-sale information from competing exchanges (currently, the Chicago Stock Exchange and the Cincinnati Stock Exchange) and consolidates such information with its own. Nasdaq then sells this information for a tape fee.

[21] See note 2 above.

monopolies when they favor downstream affiliates in the market for financial information or when they prevent access by unaffiliated rivals to crucially important market data. That abuse harms price and non-price competition (including competition with respect to innovation and design), the interests of consumers, and the efficient operation of the national market system.

The SEC recognized the potential for such abuse in Nasdaq's application for registration as an exchange and its plans to become a for-profit entity. The SEC required alterations to the Nasdaq/UTP Plan if Nasdaq intended to continue to operate as the SIP for that Plan. Those changes, although too limited to address the concerns raised by this paper, illustrate the need to prevent the competitive abuse of exchange-controlled SIPs.

With regard to the Nasdaq/UTP Plan's use of a SIP following the approval of the Nasdaq exchange registration, "a UTP Plan participant -- particularly Nasdaq -- should not operate as the SIP unless (i) the SIP is chosen on the basis of bona fide competitive bidding and the participant submits the successful bid, and (ii) any decision to award a contract to a UTP Plan participant, and any ensuing renewal of such contract, is made without that UTP Plan participant's direct or indirect voting participation."[22] Nasdaq, acknowledging the SEC's concerns, has announced its intention not to participate in the auction process to choose the new SIP for the Nasdaq/UTP Plan.[23]

Although the requirements outlined above illustrate the SEC's current concern with the power the exchanges exert over trading data via exchange-controlled SIPs, the SEC requirements, even if they were expanded to cover all Plans and Networks, do not adequately

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[22] See Amendment No. 2 to Form 10 filed by The Nasdaq Stock Market, Inc., as filed with the Securities and Exchange Commission on June 29, 2001, File No. 000-32651.

[23] Form 10-K filed by The Nasdaq Stock Market, Inc. for the fiscal year ended on December 31, 2001.

protect against competitive abuses. (See Sections V and VII below.) For example, Nasdaq's withdrawal as a candidate for the SIP for the Nasdaq/UTP Plan was entirely voluntary. Even under the SEC's requirements, Nasdaq could have continued to control both raw and consolidated Nasdaq trading data. In addition, the SEC would permit SIAC to win the bidding process to become the new SIP for the Nasdaq/UTP Plan. That would result in the NYSE, through SIAC, having not only monopolies over the consolidated data distributed under the CTA and CQ Plans, but also a significant influence over the consolidated data distributed under the Nasdaq/UTP Plan.

The monopoly power of the exchanges extends beyond the trading data governed by the Quote and Transaction Reporting Rules. All trading activity that occurs on an SRO is within the regulatory control of that SRO. As a practical matter, the infrastructure developed by each exchange to collect the trading data required by the Quote Rule, the Transaction Reporting Rule, and the Plans, as well as the regulatory authority that each SRO has over its members, provide the SRO with monopoly control over the collection of all trading data generated by members of, or participants on, the SRO in connection with proposed or actual transactions on the SRO.

The Congress, in enacting the 1975 Amendments, warned against possible abuses of market power by market centers such as the NYSE and Nasdaq that control or operate as a SIP:[24]

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[24] The NYSE has invoked the privileges and immunities it enjoys as a quasi-governmental body. Indeed, in a recent case in which a floor broker sued the NYSE, the NYSE prevailed by claiming immunity from suit as a regulatory arm of the government. See SEC v. The Street.com, 273 F.3d 222, 225 (2d Cir. 2001) (stating that in earlier, related case, "the District Court concluded that the NYSE and its employees had absolute immunity from claims arising from their performance of regulatory activities.").

> The Committee believes that if economics and sound regulation dictate the establishment of an exclusive central processor for the composite tape or any other element of the national market system, *provision must be made to insure that this central processor is not under the control or domination of any particular market center. Any exclusive processor is, in effect, a public utility,* and thus it must function in a manner which is absolutely neutral with respect to all market centers, all market makers, and all private firms. Although the existence of a monopolistic processing facility does not necessarily raise antitrust problems, *serious antitrust questions would be posed if access to this facility and its services were not available on reasonable and nondiscriminatory terms to all in the trade or if its charges were not reasonable.* Therefore, in order to foster efficient market development and operation and to provide a first line of defense against anti-competitive practices, Sections 11A(b) and (c)(1) would grant the SEC broad powers over any exclusive processor and impose on that agency a responsibility to assure the processor's neutrality and the reasonableness of its charges in practice as well as in concept.

(Emphasis added.)[25] In addition to that clear expression of congressional intent, the language of Section 11A itself seeks to avoid any limitation on the information available through a SIP that "imposes any burden on competition not necessary or appropriate in furtherance of the purposes of this title."[26] Notwithstanding congressional efforts to the contrary, the actual development of the Plans coupled with the centralized ownership and control of the SIPs permit the NYSE and Nasdaq to monopolize and exploit their collection of trading data in the very way that the designers of the national market system sought to avoid.

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[25] Securities Acts Amendments of 1975, Report of the Senate Comm. on Banking, Housing and Urban Affairs to Accompany S.249, S. Rep. No. 94-75, 94th Cong., 1st Sess. 11-12 (1975).

[26] 15 U.S.C. § 78k-1(b)(5)(B). The SEC has adopted rules that also seek to prevent the competitive abuse of a SIP. See, e.g., Exchange Act Rule 11Aa3-1(d).

IV. IN THE ABSENCE OF STRUCTURAL PROTECTION, THE NYSE AND NASDAQ WILL ABUSE THEIR MONOPOLY POWER OVER THE COLLECTION OF TRADING DATA AS THEY INTEGRATE FORWARD INTO THE MARKET FOR FINANCIAL INFORMATION.

As outlined above, Nasdaq and the NYSE have monopoly power over the collection of trading data. They also have the ability and the incentive to exploit that power -- and are now doing so -- by leveraging their monopoly power downstream into the market for financial information by excluding competition, restricting output, and raising price. A crucial component of the market for financial information includes value-added products whose construction typically requires raw data (*e.g.*, transaction prices and quotes) to produce derived information or analytics (*e.g.*, a graphic display of the average price over a period of time, plots of total market depth).

Nasdaq and the NYSE have the unique incentive and ability to construct value-added products from constituent raw data that are unavailable to competitors, including independent market-data vendors. We discuss one example for each of the NYSE (the Open Book Service) and Nasdaq (Pre-Market and After-Hours Indicators) that illustrates the exchanges' ability, incentive, and willingness to engage in such anticompetitive behavior.

A. NYSE's OpenBook

On October 19, 2001, the SEC published for comment rule changes filed by the NYSE in connection with its proposed OpenBook service.[27] OpenBook is a service whereby the NYSE makes available its specialists' limit-order books, a particularly important source of competitive information regarding market depth in a decimalized environment in which the

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[27] Securities Exchange Act Release No. 44962 (October 19, 2001) (2001 SEC LEXIS 2217).

NBBO exposes only the very top layer of quotes. The NYSE does not currently provide the crucially important constituent data -- the limit orders -- to any SIP for redissemination and, therefore, those data are not available, at any price, to independent market-data vendors. Only the formatted and packaged NYSE product, OpenBook, is available to any market participant that wants limit-order data.

Pursuant to the NYSE's proposed subscriber/vendor agreement (the "NYSE OpenBook Agreement"), the NYSE imposes two restrictions on the use of OpenBook.[28] First, the NYSE prohibited any recipient of the OpenBook data feed from redisseminating it (in contrast to displaying the data) in any form. That is, all recipients of the data feed could receive it from only one source -- the NYSE. The NYSE thus exerts monopoly control over the distribution and sale of all data in NYSE specialists' limit-order books and exploits that monopoly control to its financial benefit and to the financial detriment of potentially competing distributors such as Bloomberg.

Second, the NYSE requires recipients of the data feed, such as Bloomberg, that display OpenBook data for their subscribers to view to do so in a window format prescribed by the NYSE. Vendors and broker-dealers are prohibited from making any enhancements to the content or format of the OpenBook display or consolidating the OpenBook data with other market data, including better-priced orders available in other markets, to offer a more useful product for institutional and retail customers. The NYSE thus constrains the competitive latitude of other participants in the market for financial information to preserve its own exclusive control over OpenBook data at the expense of consumer choice. By contrast, institutional investors,

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[28] These restrictions can be found at http://www.nysedata.com.

market professionals, and broker-dealers that use the OpenBook data internally -- and not for display to others -- are allowed to alter it as they wished, including consolidating the display with other data and integrating the information into data analytics, trading models, and order-management systems.

On December 7, 2001, the SEC published an order approving the NYSE's proposed OpenBook fees.[29] The SEC qualified the order, however, by stating that it was "not approving or disapproving" the terms of the proposed NYSE vendor or subscriber agreements. The order expressly added that "[t]he NYSE's proposed restrictions on vendor redissemination of OpenBook data including the prohibition on providing the full data feed and providing enhanced, integrated, or consolidated data found in these agreements are on their face discriminatory, and may raise fair access issues under the Act." Despite the SEC's admonition, the NYSE has yet to change its discriminatory NYSE OpenBook Agreement.

NYSE OpenBook provides a powerful example of the NYSE's monopoly power over the collection of trading data and a bald restraint on effective competition. By virtue of its status as an exchange and an SRO, the NYSE retains exclusive access to and control over the limit-order data that are the raw material of OpenBook. Competing market-data vendors and developers of market-data software do not have access to the limit-order data of the exchange except on the terms imposed by the exchange. In the case of OpenBook, data vendors can obtain

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[29] Securities Exchange Act Release No. 44138 (December 7, 2001) (2001 SEC LEXIS 2563).

OpenBook limit-order data only by entering into adhesion contracts with the NYSE that strictly control the distribution, enhancement, and even the display of the data.[30]

B. Nasdaq's 100 Pre-Market Indicator and Nasdaq 100 After-Hours Indicator

Like the NYSE, Nasdaq sells its own value-added products without providing the underlying data to its SIP for distribution to vendors. For example, Nasdaq developed the Nasdaq 100 Pre-Market Indicator and the Nasdaq 100 After-Hours Indicator in response to increased interest in pre- and after-hours trading. Both indicators provide dynamic data on extended hours trading activity, and according to Nasdaq's Web site, they "use unique editing logic to filter bad trades" and are calculated using other unique parameters, rendering them value-added products.

Whereas the NYSE sold OpenBook to data vendors but restricted its redissemination and display, Nasdaq engaged in even more restrictive conduct. In Bloomberg's experience, in the initial period following the introduction of the Indicators, not only were the underlying data on which the Indicators were based not available, but the Indicators themselves were also not available to data vendors. Nasdaq thus controlled both the type of data that were available and the timing of their availability. Nasdaq eventually made the Indicators available to data vendors, but the underlying data are still not offered for sale. Nasdaq's development, control, and exploitation of the Pre-Market and After Hours Indicators provide another

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30 Consistent with its conduct in the market for financial information, the NYSE has publicly taken the position that the exchanges have intellectual property rights in market data. See NYSE Comments to SEC Release No. 42208, File No. S7-28-99, n. 5; Market Data Hearing at 124-25. Nasdaq has taken the same position. "New Approaches to Market Information," Submission to the SEC Advisory Committee on Market Information, February 19, 2001 at n. 13. Bloomberg disputes those positions but discussion of the details of that debate is beyond the scope of this paper.

illustration of the exchanges' abuse of their monopoly over the collection of trading data in restricting competition in the downstream market for financial information products.

V. NASDAQ'S FSI EXEMPTION AND THE NEED FOR A STRUCTURAL REMEDY TO THE EXCHANGES' MONOPOLY EXPLOITATION.

The NYSE's Open Book service and Nasdaq's Pre-Market and After-Hours Indicators illustrate the abuse of government-conferred monopoly power in the downstream market for financial information. In contrast, the SEC's response to Nasdaq's introduction of "Tools Plus" illustrates a means of anticipating and preventing the anticompetitive consequences of an exchange's abuse of its government-conferred monopoly in adjacent markets.

A. Nasdaq's FSI Exemption

On March 7, 2000, Nasdaq purchased Financial Systemware, Inc., a manufacturer of software products, and formed a wholly owned subsidiary that has been named Nasdaq Tools, Inc. ("Nasdaq Tools"). Nasdaq Tools has introduced "Tools Plus," an order-management system that uses Nasdaq data in the compilation of analytics that compete with those provided by independent market-data vendors. On April 24, 2000, the SEC granted Nasdaq and NASD a one-year, temporary, conditional exemption from various filing and rule-making procedures relating to Nasdaq's acquisition and operation of FSI, subject to a variety of conditions designed to preserve competition, and solicited public comment prior to considering a permanent exemption.[31] At the expiration of that temporary exemption, the SEC granted Nasdaq and

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[31] Securities Exchange Act Release No. 34-42713 (April 24, 2000) (2000 SEC LEXIS 807).

NASD a permanent exemption from the same filing and rule-making procedures, subject to the continued imposition of conditions designed to preserve competition (the "FSI exemption").[32]

In granting the FSI exemption, the SEC recognized the danger of Nasdaq's leveraging its trading monopoly into a competitive adjacent market and imposed conditions to prevent that leveraging. In particular, the SEC conditioned the exemption on the presence of effective competition in the provision of order-management system services and software to market makers, and required that NASD encourage the development of software by NASD members and competing software vendors.[33] To maintain the opportunity for what it called fair competition, the SEC required NASD and Nasdaq to continue to provide open-architecture systems that enable full public access to NASD's facilities.[34] That access is to be provided through an API (Application Programming Interface) that enables firms to have access to the Nasdaq system through their own software or computer system.[35]

The SEC also required that use of the software marketed by FSI not be, currently or in the future, necessary to access Nasdaq or any other NASD market-related facility and that full and fair public access to Nasdaq be available.[36] Thus, brokers and dealers that wish to access Nasdaq are not to be forced to purchase or use FSI products or services.[37] NASD and Nasdaq also agreed to treat FSI like any other third-party vendor with respect to the provision of

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32 Securities Exchange Act Release No. 44201 (April 18, 2001) (2001 SEC LEXIS 738).

33 2001 SEC LEXIS 738 at * 9, * 17, * 29, * 34.

34 2001 SEC LEXIS 738 at * 10, * 30, * 34.

35 2001 SEC LEXIS 738 at * 10, * 19, * 30, * 34.

36 2001 SEC LEXIS 738 at * 9 - * 10, * 16, * 30, * 33.

37 2001 SEC LEXIS 738 at * 9, * 16 - * 17, * 33.

information regarding planned or actual changes to Nasdaq.[38] Specifically, FSI would not be given any advance or private knowledge of such changes.[39] In addition, to enforce and emphasize the separation of Nasdaq and FSI, the SEC required that the two companies have separate and distinct office space and prohibited them from sharing employees.[40] The SEC also specifically noted that NASD and Nasdaq proposed that Nasdaq would operate FSI as a stand-alone business, capitalized separately and not subsidized by NASD members or other revenues of NASD or Nasdaq.[41]

The FSI exemption order stands for the proposition that, when an exchange competes in the market for financial information by selling trading data (or products based on those data) that can be obtained only from that exchange, the exchange must do so through an entity that is separate from the exchange. The separation must be implemented through an independent and separately capitalized corporate structure with strict firewalls providing for independent operation and an arm's-length relationship with the exchange. The affiliated but operationally independent and separately capitalized entity must gain access to data and information, including notice that the exchange will make new data available through the SIP to market-data vendors, at the same time, for the same price, and on the same terms as its competitors. The FSI case thus provides a useful model for structurally separating an exchange

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38 2001 SEC LEXIS 738 at * 11, * 30, * 33 - * 34.

39 2001 SEC LEXIS 738 at * 11, * 33 - * 34.

40 2001 SEC LEXIS 738 at * 11, * 34.

41 2001 SEC LEXIS 738 at * 5.

from a downstream affiliate to prevent the exchange from leveraging its government-conferred monopoly into competitive markets.

In the case of market-data administration, as described more fully below, the separate legal structure and operational independence of the exchange and its downstream affiliate must be supplemented by a SIP that would either be owned or administered independently of the exchanges. The "independent" SIP would receive data from the exchange, consolidate it with data from other exchanges where appropriate, and sell other unconsolidated, raw data (such as limit orders in specialists' books) if the exchange wished to use (through its downstream affiliate) such data in providing value-added products. The independent SIP would offer all such data on reasonable and nondiscriminatory terms to all participants in the market for financial information. Importantly, the independent SIP would eliminate the direct supply relationship between the exchange and its affiliate in the market for financial information that would otherwise render the structural and operational independence of the affiliate difficult, if not impossible, to police and enforce.

B. The Increasing Need for a Structural Solution

The need for the structural and operational independence between exchanges and downstream affiliates -- as well as an independent SIP -- will become more acute as the exchanges pursue for-profit initiatives. As noted above, Nasdaq is pursuing the completion of its plans to privatize. Through two private placements, on June 28, 2000 and January 18, 2001, NASD's holdings in Nasdaq were substantially reduced. On April 25, 2001, the Nasdaq Board

agreed in principle to prepare for an initial public offering of its common stock.[42] Although NASD retains voting control of Nasdaq,[43] it will relinquish that control upon approval of Nasdaq's exchange registration. If Nasdaq becomes an exchange, it will be owned by and operated primarily for the benefit of its shareholders.

As the NYSE and Nasdaq continue to integrate forward into the market for financial information, they will increasingly have the incentive and the ability to favor -- and will in fact favor -- their affiliates competing in that market. As for-profit entities, their market-data affiliates will have a fiduciary obligation to their shareholders to maximize profits. And as monopolists, the NYSE and Nasdaq will have the requisite control over the collection of trading data to manipulate the main input for the market for financial information, harm competition, restrict output, and raise price.

The means at the disposal of the exchanges are numerous and varied.[44] For example:

- As with OpenBook, the exchanges will be able to provide trading data they have acquired in their regulatory capacities and market it as they wish. As the sole sources of those data, they can bargain with information vendors in a way that precludes the introduction of potentially competitive products.
- Under the current system, in which the exchanges control the SIPs, the exchanges can manipulate the format and content of trading data to suit their own proprietary information products and to disfavor rivals' competing information products.

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42 Amendment No. 2 to Form 10 filed by The Nasdaq Stock Market, Inc. as filed with the SEC on June 29, 2001 (File No. 000-32651).

43 Form 10-K filed by The Nasdaq Stock Market, Inc. for the fiscal year ended December 31, 2001.

44 Even if the exchanges do not employ, on every occasion, the means to harm competition that are at their disposal, their ability and incentive to do so may chill investment in the market for financial information.

- The NYSE and Nasdaq, as administrators of the Plans, can manipulate price and discount terms to favor affiliated companies and disfavor their competitors and can misuse competitively sensitive information that they obtain from rivals through the data-contracting process.

As they have in the past, the NYSE and Nasdaq will attempt to justify their anticompetitive conduct by citing the purported need to subsidize the cost of their self-regulatory responsibilities. We believe, however, that those responsibilities must be supported by SRO participants, not by monopoly rents extracted from the market for financial information to the detriment of independent competitors (such as Bloomberg) and consumers.[45] Furthermore, absent the structural separation outlined above (including separate financial accounting systems and capitalization) between the SRO and the affiliated entity competing in the market for financial information, fees collected to support self-regulation could be used to subsidize the research and development of for-profit financial information products. Such cross-subsidization would provide another means by which the NYSE and Nasdaq could leverage government-conferred monopoly power into the market for financial information to the detriment of independent competitors and consumers.

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[45] For the year ended December 31, 2001, market information services accounted for revenue of $250.5 million to Nasdaq, which represented approximately 28.1% of Nasdaq's total revenue. See Note, 1. Business "Overview" of Form 10-K filed by the Nasdaq Stock Market, Inc., as filed with the Securities and Exchange Commission on March 28, 2002. While Nasdaq and, similarly, the NYSE rely heavily on the monopoly revenues they derive from the sale of trading data, they have declined to disclose the costs associated with the consolidation, collection and dissemination of such data. Indeed, the NYSE has claimed in testimony before the House Financial Services Committee that it cannot accurately calculate the cost of consolidating and disseminating market information. See "Public Access to Market Data: Improving Transparency and Competition" Hearing Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services of the U.S House of Representatives, Serial No. 107-5, March 14, 2001 ("Market Data Hearing") at 19-20, 26. Without separately tracking such costs, the NYSE and Nasdaq may well obtain revenues from the sale of market data that far exceed the cost of consolidating and disseminating the data and that subsidize their other ventures, including increasingly NYSE and Nasdaq for-profit ventures.

The NYSE and Nasdaq have other anticompetitive advantages as well. As Plan administrators, they have access to confidential information about the plans of competing market-data vendors. That information is highly sensitive from a competitive standpoint and, in some circumstances, may constitute trade secrets. The NYSE and Nasdaq can abuse their access to such information to the disadvantage of those vendors in the market for financial information.

When market-data vendors purchase trading data from the Networks, for example, they must enter into contracts that require them to disclose their actual and contemplated uses of the data and permit the exchange to veto such uses.[46] The NYSE and Nasdaq thereby have access to competing vendors' research and development and forward-looking competitive strategies. Such one-sided access to competitively sensitive information (indeed, in some cases, trade secrets) is not only inequitable, but also gives the NYSE and Nasdaq a competitive advantage that they can use to harm other market-data vendors, restrict output, and raise prices in the market for financial information. Independent ownership or administration of the SIPs (or independent administration of the Networks and Plans) should deprive the exchanges of those unfair competitive advantages.

* * * *

OpenBook, Nasdaq's 100 Pre-Market Indicators and 100 After-Hours Indicators, and Tools Plus illustrate the NYSE's and Nasdaq's intent and ability to integrate forward into the market for financial information. OpenBook demonstrates that -- in the absence of structural protections -- the NYSE will exploit its data monopoly to the detriment of downstream

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[46] Nasdaq' s standard-form contract with market data vendors can be found at http://www.nasdaqtrader.com/trader/mds/nasdaqagreements/vendoragreement.pdf. The NYSE's standard-form contract with market data vendors can be found at http://www.nyse.com/pdfs/RTIEV.pdf and can also be found at http://www.nysedata.com.

competitors and consumers alike. The Nasdaq Indicators do the same. The FSI exemption provides a template for the structural and operational separation between an exchange and its downstream affiliate that is required to prevent that exploitation. In the case of market-data administration, the SIP must be an independently owned or administered entity if it is to satisfy its legally mandated role of a public utility consolidating and distributing trading information on reasonable and nondiscriminatory terms to all market participants.

VI. THE ADVISORY COMMITTEE REPORT ON MARKET-DATA ADMINISTRATION WOULD PROMOTE THE EXCHANGES' ABILITY TO EXPLOIT THEIR GOVERNMENT-CONFERRED MONOPOLIES.

The SEC has recognized that the interface between the exchanges and the market for financial information may require structural change. In December 1999, the SEC issued a concept release entitled, "Regulation of Market Information Fees and Revenues," that focused on the governance and financial structures of the SROs' market information plans (the "Concept Release").[47] The Concept Release proposed a cost-based approach to setting Plan fees for trading data. In doing so, the SEC confirmed that the comprehensive federal regulation of market information requires that any proprietary interests asserted by an SRO in the information generated on an exchange be subordinated to the Exchange Act's objectives for a national market system.[48]

The Concept Release also acknowledged the competitive dangers implicated by an SRO's pursuit of for-profit objectives:

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[47] SEC Exchange Act Release No. 42208 (1999 SEC LEXIS 2611).

[48] 1999 SEC LEXIS 2611 at * 15.

> The creation of for-profit SROs may require closer monitoring of the SROs' fee and financial structures, including their funding and use of resources.[49]

In the Concept Release, the SEC went on to request comment from the industry on a wide variety of subjects, including the cost-based approach, different methods of allocating Plan revenues from trading data, and increased public disclosure of fees and revenues.

The comments that were filed in response to the concept release expanded the debate and generated industry-wide discussion on a range of issues relating to market-data consolidation and dissemination. The debate led to the SEC's establishing an SEC Advisory Committee on Market Information (the "Advisory Committee") in August 2000. The Advisory Committee was given a broad mandate to explore and evaluate issues relating to the public availability of market information.

The Advisory Committee issued its final report on issues concerning market data on September 14, 2001 (the "Report").[50] The Report describes the status of market-data administration and provides an explanation of the continued value of transparency to the functioning of the securities markets.[51] The Report also recognizes the importance of disseminating market data as broadly as possible through a variety of distribution channels, which apparently prompted a majority of the Advisory Committee to adopt a new, so-called "Competing Consolidators" model.[52]

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49 1999 SEC LEXIS 2611 at * 11.

50 Report of the Advisory Committee on Market Information: A Blueprint for Responsible Change.

51 Report at 68-70.

52 Report at 80.

Although we do not address here in detail the merits of the multiple-consolidator model, we emphasize that the Advisory Committee failed to consider -- much less recommend ways of mitigating -- the anticompetitive impact of that model on the NYSE's and Nasdaq's forward integration into the market for financial information. In fact, the adoption of the multiple-consolidator model would enhance, not limit, the ability of the NYSE and Nasdaq to exploit their government-conferred monopolies.

The Report concedes that "some Advisory Committee members . . . believe that the multiple consolidators model could give both the primary and secondary markets power to seek monopoly rents for their data."[53] Yet the Report does nothing to address that competitive concern. Indeed, although the Report notes that "members pointed out that countervailing forces exist to keep market center pricing in check,"[54] it adds that "some members believe these countervailing forces may be less effective with for-profit SROs, which will have the paramount duty of maximizing shareholder value."[55] The Report devotes only two paragraphs to the evolution of for-profit exchanges and makes only a passing reference to the possibility that "profit motives and competitive pressures" could result in "unreasonable or inequitable fee structures."[56]

The Committee's recommendation, adopted at the instance of the NYSE and Nasdaq representatives, is seriously flawed because it fails to account for the existing

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[53] Report at 86.

[54] Report at 86.

[55] Report at 86.

[56] Report at 54-55.

monopolies of the NYSE and Nasdaq over the collection of data relating to proposed and actual transactions conducted on their respective facilities. The Committee's multiple-consolidator model contemplates that the exchange, the consolidator, and the market vendor may all be one and the same economic entity. The Report thereby sanctions the very structure that will effect the leveraging of monopoly power from the collection of the trading data directly into the market for financial information.[57]

The Report also places the SIP at the disposal of the data monopolist, thereby allowing the exchange to control the interface between the SRO and the competitive market for financial information. In the case of SIAC, the SIP controls an enormously complex and valuable infrastructure that reflects the contributions of public and private entities alike over the last quarter of a century.[58] In short, with essentially no explanation, the Advisory Committee supported recommendations that would seriously exacerbate the anticompetitive forces that now exist in connection with the exchanges' use and sale of market data, instead of trying to grapple with them as the SEC did in considering the FSI exemption.

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In the transmittal letter accompanying the Report, Dean Joel Seligman, the Advisory Committee Chair, properly calls for further study of market structure issues. He observes that "it would be wise for a more comprehensive study of securities market structure

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[57] The Report further assumes that each market center will withdraw from the current joint Plans and disseminate its own data, all the while ignoring the monopoly exploitation issue outlined above. Market center, as used here, includes ECNs. Report at 80.

[58] The Committee Report also does not address whether SIAC and Nasdaq will remain available to other market centers for securities information processing. If the NYSE, the Amex, and Nasdaq foreclosed access to SIAC and Nasdaq by way of their respective ownership of those SIPs, other participants might face substantial barriers to entry in forming competing consolidators.

issues to be initiated . . . [W]hat is important . . . is that there be an informed basis for SEC and Congressional decisions in the near future with respect to significant securities market structure issues."[59] Part of such a structural analysis should include an assessment of the data monopolies that the exchanges already enjoy and the impact that a multiple-consolidator model -- as apparently conceived by the Advisory Committee -- would have on free and fair competition in the market for financial information.

VII. THE MONOPOLY POWER OF THE EXCHANGES CAN BE CONSTRAINED MOST EFFECTIVELY THROUGH A TWO-PART STRUCTURAL SEPARATION: THE FSI MODEL AND AN INDEPENDENT SIP.

As detailed above, increasing the number of SIPs would not by itself restrict sufficiently the data monopolies of the Nasdaq and the NYSE. Instead, two forms of structural protections working in tandem are required. First, as discussed in Part V, the exchange must be structurally and operationally separate from its downstream market-data vendor affiliate. The FSI exemption provides a useful model for that separation. Second, a neutral and independent SIP unaffiliated with an exchange or market-data vendor -- either by virtue of separate ownership or by virtue of an independent administrator of the Plan pursuant to which the SIP consolidates data -- should perform the legally mandated role of data consolidator and distributor.

The independent SIP would be entitled to obtain all of the raw market data that the exchanges are, by statute, required to provide. In addition, any trading data that the exchanges wish to sell, or use in value-added products that they (through their downstream affiliates) wish to sell, would have to be provided to the SIP. That is, if an exchange chooses to construct a derived or value-added product from as-yet "unpublished" data, it should be able to

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[59] Letter from Dean Joel Seligman to Chairman Harvey Pitt, dated Sept. 14, 2001 at p. 4.

do so only upon giving all market-data vendors equal notice of the planned availability of such data and upon making the additional data available to all market-data vendors through a SIP on reasonable and nondiscriminatory terms. The SIP would consolidate such data where appropriate, and then, acting as a separate entity or an independent sales agent of the relevant exchange, sell those data to downstream market participants on reasonable and nondiscriminatory terms.

Such an independent-SIP model will directly address the anticompetitive concerns outlined above through a simple and easily managed structure. As applied to OpenBook, for example, the NYSE would supply to the SIP the raw data from the specialists' limit-order books. The SIP would either consolidate the data into a single display or sell the data in raw form to downstream market participants -- all on equal terms. The downstream vendors may include an NYSE or Nasdaq affiliate, though one governed by the structural and operational protections outlined in the FSI exemption.

The NYSE affiliate could then package those data as OpenBook and sell it, while other market-data vendors could package the same data and sell them as they see fit. Of course, the NYSE could choose not to sell its limit-order data at all, but then it would not be permitted, through the NYSE itself or an affiliate, to sell a product derived from those data, such as OpenBook. The suggested approach would permit the NYSE to participate in the market for financial information, but prohibit the discriminatory use of the NYSE's limit-order information that the SEC has criticized in the context of OpenBook and the discriminatory use of other raw market data that the NYSE might utilize in other, similar products.

In addition, an independent SIP would contract with market-data vendors for the sale of consolidated data in lieu of the current practice in which the NYSE and Nasdaq execute

contracts in their capacity as Network and Plan administrators. Contracting with an independent SIP would relieve independent market-data vendors of the supervision and intrusion by their SRO competitors that is a seriously damaging result of the SROs' current exercise of their Network and Plan administrator functions.

VIII. CONCLUSION

As exchanges increasingly move downstream into the market for financial information, restricting their data monopolies and preserving competition are more important than ever. Bloomberg believes those objectives are most effectively achieved through a two-part structural separation. First, the exchange and any downstream affiliate must be separated as illustrated by the FSI exemption. Second, an independent SIP (as described above) must stand between all SROs and all market-data vendors, providing reasonable and nondiscriminatory terms for access to raw market data at the interface of the two. Absent such a structural approach, the exchanges will remain positioned to exploit their data monopolies in downstream and adjacent markets to the detriment of consumers, independent competitors, and the national market system.

End

SPECIAL REPORT

Fulfilling the Promise of the National Market System

STA'S Perspective on U.S. Market Structure

August 2003

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STA's Perspective on U.S. Market Structure

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Vice President
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Security Traders Association
New York, New York

August 1, 2003

To Those Interested in U.S. Market Structure Issues:

In 1975, the Congress mandated that the Securities and Exchange Commission ("SEC" or "Commission") facilitate the development of a National Market System ("NMS"). Its goal was to assure that securities markets in the United States remain the most efficient and liquid in the world. It was expected that the NMS would foster best execution of customer orders and that broker-dealers would place the interests of their customers first. The Security Traders Association ("STA") shares the goal of achieving the objectives of the NMS, and maintaining efficient and liquid U.S. markets. Fulfilling the promise of the NMS will serve to make the securities markets more efficient and the capital formation process more robust, and in turn benefit the nation's economy and investors in this critical time for the United States.

Much has been accomplished. The heart of the NMS is the integrated delivery of consolidated market information on a real-time basis. Both market professionals and individual investors have more transparent information than was thought possible in 1975. Not only is there reporting of last sale prices and bids and offers for both listed and NASDAQ securities, but also various markets have begun to provide "depth of book" quotes showing liquidity away from the inside market.

Much remains to be done, however. New technologies and the explosion in individual investor participation in the markets, both directly and through institutional money managers, call for continuing analysis of the current market structure and appropriate modification of current rules. The STA does not believe in and does not advocate a complete restructuring of the securities markets in the United States. The NMS has been, and will continue to be, dynamic, constantly evolving to meet current market conditions - conditions driven by investors, industry competitive forces, advances in technology and communications, and the valued and essential work of the Commission and the Congress. To that extent the NMS is simultaneously a market reality and a market goal.

As securities traders, STA members are responsible for executing transactions for and providing liquidity to the American investor. Each day STA members drive the economic engine of the capital in the U.S. markets. The STA represents the shared interests of its approximately 7,000 members, all engaged in the purchase, sale and trading of securities, who belong to one of our 29 national and international affiliate organizations. Our members come from the institutional or "buy side" and the broker-dealer or "sell side" of market participants and from trading venues, including exchanges and Electronic Communication Networks ("ECNs"). STA members facilitate the execution of NASDAQ, bulletin board and exchange listed stocks.

It is from this perspective that STA offers our analyses and recommendations to the Congress, SEC, the securities and investment community, and the investing public.

The STA hopes that our analyses and recommendations will assist the regulatory community to identify and address those areas most likely to impede, rather than further, the maintenance of an efficient and liquid market in which trading venues and trading parties compete with each other on a level regulatory playing field on the basis of execution quality.

John P. Hughes
Chairman

John C. Giesea
President and CEO

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420 Lexington Avenue • Suite 2334 • New York, NY 10170 • tel (212) 867-7002 • fax (212) 867-7030 • traders@securitytraders.org • www.securitytraders.org

Background

The 1990s represented a period of significant change in U.S. market structure. New technology and an unprecedented level of and ability to trade demanded an examination of the market structure and the development of new rules to assure both investor protection and fair, liquid, and orderly markets.

In addition to technological changes in what had previously been a paper-based environment, new market models were appearing worldwide such as for-profit, demutualized stock exchanges and remote memberships. In the United States, technology and competitive forces allowed for entirely new types of market participants, specifically ECNs and other Alternative Trading Systems ("ATSs"). These have been followed by yet newer technology delivery systems such as order management systems, systems integrators and smart order routers. The new environment has led to a number of issues, many of which meet at the fulcrum of transparency and access.

As changes occurred, the SEC's Division of Market Regulation and the Congress examined issues from the perspective of market design, and responded by promulgating and instituting new rules. Among other developments, certain new rules addressed transparency requirements, order handling (and the attendant development of fees to access ECN liquidity) and decimalization. The impact of these rules continues to be felt. STA suggests that the continued effectiveness of these rules in terms of moving towards the goals of the NMS needs to be examined.

While the regulatory environment evolved, the industry wrestled with these same issues from a competitive point of view, consistently providing a greater range of technology to execute orders, with various underlying costs and prices. On the positive side, traders and investors now have available a range of choices in order execution, all of which compete against each other in terms of execution quality to attract order flow. At the same time, the effect of these intense competitive developments on markets and investors continues to be debated, even as the markets themselves are under increasing performance strains.

The STA knows from experience that competitive forces drive innovation. At the same time, rules that advantage one set of participants at the expense of others not only impede movement towards attaining the original objectives of the NMS, but also may adversely impact investors.The problem of the seeming tension between competition and regulation can be resolved.

STA believes the solution is straightforward and rooted in protecting competition on the one hand by establishing adequate, efficient and appropriate connectivity between, and access to, all market centers and their platforms, and by establishing consistent rules, equally binding on, and applied to, all market participants trading and quoting the same security. The net effect will be inclusion of, and continued competition between, all who have innovative ideas to bring to the securities markets without favoring some innovators over others at the expense of the investing public.

To move towards this solution there must be a commitment to ensuring the establishment of efficient linkages between markets coupled with consistent rules. Within that context, STA believes an evaluation of current linkages in markets for both listed and NASDAQ stocks is necessary. This evaluation should be comprehensive and cover the Intermarket Trading System ("ITS") and the propriety of ECN access fees. The benchmark for this evaluation should be whether they impede or promote movement to the NMS.

In addition, to assure compliance, self-regulatory organizations ("SROs") need to apply these consistent rules based on asset class, and according to the practices dictated in the primary listing market for each security. And this needs to be backed by adequate surveillance and enforcement.

To understand the basis for STA's perspective, below is an analysis of the current situation, the keys to moving to a newer more robust environment in the future that achieves the objectives of the NMS, and recommendations on specific actions to move rapidly forward.

The Current Situation

The responses to the rapid changes in technology, trading activity levels, and trading practices have led to certain structural anomalies that impede attaining the objectives of the NMS and which negatively impact both the markets and investors on a daily basis. These anomalies effect the ability to get accurate quotations, the ability to access liquidity, and, therefore, best execution of customer orders.

These negative effects can be seen in four specific areas tied to connectivity and regulation, where recent developments have had a negative impact on market efficiency. Specifically, these issues are fragmentation, connectivity and access to other markets, ECN access fees and regulatory arbitrage.

Each is examined in turn below.

I. Fragmentation

Only two years ago, 98% of all volume in NASDAQ securities was reflected by quotations in NASDAQ. At that time, the only market trading NASDAQ securities other than NASDAQ was the Chicago Stock Exchange ("CHX"), which accounted for less than 2% of the volume and was linked to NASDAQ through the SelectNet System. As a result, traders in NASDAQ and the CHX could easily access each other's markets in the same manner. Today's market for NASDAQ securities looks vastly different. This market has five active venues where NASDAQ securities trade:

1. American Stock Exchange, which recently began to trade NASDAQ stocks. The Amex is the only market trading NASDAQ securities that does not provide automated execution of inbound market and marketable limit orders.
2. ARCA Exchange, an outgrowth of a joint venture between the ECN, Archipelago, and the Pacific Stock Exchange ("PSE") whereby Archipelago operates as a facility of the PSE;
3. Cincinnati Stock Exchange ("CSE"), through which the Island ECN quotes all of its NASDAQ quotations. The CSE now accounts for over 10% of the volume in NASDAQ stocks;
4. NASD Alternative Display Facility ("ADF"), in which market makers and ECNs can display their quotations. The ADF began operations late in 2002 and one of the largest ECNs, Instinet, now displays its quotations there. Another ECN, NexTrade, is beginning to migrate to that facility; and
5. NASDAQ's SuperMontage, which within the next few months, it is likely to reflect less than 50% of all NASDAQ trading volume.

To the extent that the availability of alternative trading venues creates an environment of competition based on price, liquidity and execution capabilities, fragmentation is a positive force. But the positive attributes of market fragmentation, such as robust competition and constant innovation, are lost without active contemporaneous efforts to link trading venues with a consistent set of underlying principles and rules governing access to and behavior in those venues. In effect, market fragmentation alone can result in inefficient markets, which may benefit some market professionals but not the investing public. Recent market structure events for NASDAQ stocks have made market fragmentation a real concern that must be addressed.

II. Lack of Intermarket Linkage and Prevalence of Locked & Crossed Markets

The fragmentation described in the prior section has resulted in severe market dysfunction because of the lack of neutral, efficient intermarket linkages and the lack of a common regulatory structure regarding their use. This has created numerous problems for market participants as they face frequent locked and crossed markets in NASDAQ securities and still seek to fulfill their best execution obligations. Certain private vendors do provide linkages to various markets that make access easier, but at least one exchange does not provide automatic execution of incoming orders, a fundamental feature that should be required. It is clear, however, that these private initiatives do not sufficiently address the problems arising from fragmentation. Without linkages that provide consistent, reliable and efficient execution standards and rules requiring their use where appropriate, investors suffer because broker-dealers face impediments to their efforts to make appropriate order routing and best execution determinations on behalf of their customers.

In 2000, the Securities Industry Association (SIA) identified four central characteristics for effective market linkages:

* State of the art technology;
* Automatic or immediate execution capability;
* Governance representation by all qualified market centers, and
* Access to the linkage for all qualified market centers (including direct access for market makers).[1]

The STA concurs that these characteristics provide a solid framework for effective linkages that also enhance competition.

As a result, STA urges the SEC immediately to oversee the development and maintenance of linkages that meet or exceed the underlying principles described above and to adopt, at a minimum, rules that prohibit intermarket locked and crossed markets.

However, linkages in and of themselves do not completely solve the problem. Without rules that prohibit markets from ignoring existing quotations and either posting quotations that lock those markets or simply trading through quotations, the linkages will be ineffectual. While there may indeed be valid reasons why a market would from time to time chose to ignore quotations from other markets, the fee structures adopted by certain ECNs and markets provide economic incentives to do so. The STA believes the convoluted rate structure used by these markets — whereby users receive rebates adding liquidity and are charged fees for absorbing liquidity — have led to negative behaviors in the marketplace. For example, suppose a customer was interested in selling a stock that was currently quoted at 10.00-10.05. Traditionally, the customer would execute its orders by accessing the 10 bid. In today's rebate scheme, the broker would be better off entering a sell order in an ECN at 10, instead of hitting the existing bid, and creating a locked market (10 best bid - 10 best offer), thereby receiving a rebate and, in the process, possibly depriving the customer of an execution.[2]

[1] See Comments on Securities Exchange Act Release No. 34-42450 from the Market Structure Committee of the Securities Industry Association (May 5, 2000).

[2] Simply stated, a "locked market" is one in which both the inside bid and inside ask for a particular security are identical, resulting in no bid-ask spread. This scenario occurs mainly in volatile and high volume trading. This abnormal market condition occurs primarily in NASDAQ and over-the-counter securities both prior to the market opening and throughout the day. NASDAQ rules require a market maker who locks a market to make reasonable attempts to trade with the market maker(s) it is locking prior to entering the locking quotation.

During the many years that NASDAQ had a virtual 100% market share, this activity was impossible due to the NASDAQ prohibition against locked markets. However, now, where volume is spread between many markets and where there is no intermarket prohibition against locked markets, this activity is commonplace.[3] Locked markets cause havoc in the market place. Customer orders represented by published quotations do not get filled when they should and, more importantly, automated execution systems do not function during periods when there are locked markets.

While the least intrusive way of dealing with locked markets would be to eliminate the economic incentives caused by the rebate structure, as a philosophical matter, we are not in favor of regulating rate structures. As a result, a more acceptable way would be to simply prohibit a market from entering a quotation that will lock the market.

For listed stocks, the STA recognizes that there has been an intermarket linkage in place for over two decades. The Intermarket Trading System ("ITS"), implemented in 1978, links all eight exchanges and NASDAQ and is intended to enable market professionals to interact with their counterparts in other markets whenever the Consolidated Quote System CQS shows a better price in another market. The ITS has not, however, realized its potential. Indeed, a very limited level of trading volume goes through ITS. This is in part due to the fact that some participants in ITS do not provide automated execution.[4] As currently structured, ITS often is used simply as a messaging system whereby a market can send a "commitment to trade" to another market that has up to thirty seconds to respond. Thirty seconds is an eternity in today's active, volatile markets. Without an automated or immediate execution facility, ITS is little more than a way of providing inefficient free access to the primary markets.[5]

Congress envisioned that "linking...all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the off-setting of investors' orders, and contribute to best execution of such orders."[6] Congress understood as far back as 1975 that a variety of linked trading venues competing for orders promotes a liquid and efficient market. Congress also had the vision to anticipate the power of technology to achieve such an integration of trading venues.

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For ITS to be an effective linkage between markets it must have the capacity to match the technological prowess of market participants. ITS has the potential to do so, once it includes an automatic execution component.

[3] For further discussion of STA's views regarding the issues created by locked and crossed markets, see Letter to Jeffrey Brown, Chairman, NASDAQ Unlisted Trading Privileges Committee (March 6, 2003) - see Appenix A.

[4] STA notes that both the Cincinnati Stock Exchange and NASDAQ on their own initiative provide automated execution of inbound ITS orders.

[5] Another obstacle, at present, to realizing the potential for ITS is that its rules can only be amended with 100% assent by its members.

[6] Section 11A(a)(1)(D) of the Securities Exchange Act.

III. ECN Access Fees

It's simple: Investors deserve accurate, not distorted, prices in securities.

In 1996, the Commission adopted amendments to Rule 11Ac1-1 (the "Quote Rule") to require orders entered into ATSs by market makers and specialists to be publicly displayed[7] and, for the first time, gave ATSs the ability to disseminate those quotations through NASDAQ. Those ATSs that chose to display these quotations were referred to as electronic communication networks, or ECNs.

Requiring the display of these quotations meant nothing unless investors who were not subscribers to the ECNs could access these orders. As a way of securing the cooperation of the ECNs, the SEC included in the adopting release a statement that ECNs must provide non-subscriber broker-dealers with a means of accessing these displayed prices that is equivalent to the means of access provided by the exchanges and NASDAQ.[8] Moreover, the SEC said that ECNs could charge fees for access to their systems that were similar to the communications and systems charges imposed by other markets so long as those access fees were not structured to discourage access by non-subscriber broker-dealers. Subsequently, the SEC granted no-action relief to ECNs based, in part, on representations by the ECNs that they would charge non-subscribers fees no greater than the fees charged their active broker-dealers subscribers, and in no event more than $0.015 per share (the most current SEC mandate has revised this to $0.009 per share).[9] Interestingly, only ECNs have been permitted to levy such access fees. The SEC has expressly precluded market makers from doing the same. This creates a regulatory imbalance that not only fails to provide a true price to investors but which also unfairly provides a revenue source for ECNs unavailable to other market participants.

As STA has stated in previous comments provided to the SEC,[10] STA considers ECN access fees a hidden cost to accessing ECN quotations. Because these fees are not included in the published quotations of ECNs, the quotations do not reflect the true price available at an ECN. This distortion and lack of market transparency is inconsistent with the objectives of the National Market System.

Furthermore, because access fees are not reflected in the quotations of ECNs, they also impact the ability of market makers and order routing firms to obtain best execution, especially when these fees are passed on to customers.[11] In addition, the ECN access fees, when combined with the significant reduction in the minimum trading increment and the average spread since conversion to quotation in decimals have the effect of completely eliminating the dealer spread in many stocks. STA believes that the reduction, and at times elimination, of the dealer spread, though reducing costs for some investors, has contributed to a loss of liquidity in the over-the-counter markets.

[7] Securities Exchange Act Rel. No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996).

[8] 61 FR at 48314.

[9] Currently, various ECNs charge anywhere from $0.0025 to $0.009 per share; the resulting amounts paid to ECNs by certain non-subscriber broker-dealers are significant.

[10] Letter to the Honorable William H. Donaldson, Chairman, Securities and Exchange Commission, regarding ECN Access Fees, from John C. Giesea, President, Security Traders Association (April 16, 2003); Letter to the Honorable Harvey Pitt, Chairman, Securities and Exchange Commission from Security Traders Association Trading Issues Committee (March 5, 2002) - see Appendix B.

[11] In order to address this concern, NASDAQ added a feature to SuperMontage that permits market makers and order routing firms to elect to execute against ECNs that charge fees last at any given price level. However, given the fact that access fees can exceed the minimum price increment, the net price available through the ECN would still be worse than the price available at the next pricing level.

IV. Regulatory Arbitrage

In the markets for listed securities, the SEC and the SROs have put in place certain minimum standards that apply regardless of the market in which a security is traded. Examples include the short sale rule and the various ITS rules such as unified opening, trade through and block execution rules. These uniform rules reflect the view of the SEC and industry that a market must meet certain minimum standards to participate in the NMS and the fact the market participants cannot seek "lowest common denominator" regulation through regulatory arbitrage. The market for NASDAQ stocks does not have these uniform rules.

Three years ago, when only two markets traded NASDAQ stocks, this disparate regulation was acceptable. Today it is not. New entrants into the NASDAQ trading arena openly advertise the fact that there is no short sale rule in their markets. While STA does not wish to open a debate on the merits of the short sale rule, the SEC has not abrogated the rule for listed stocks and the fact remains that the NASD adopted a similar rule for NASDAQ stocks at a time when it had 100% market share. With NASDAQ market share now approaching 50% this disparate regulation makes no sense and harms the integrity of the markets.

Similarly, the disparity between the enforcement and surveillance policies of different market centers has provided an incentive for some participants to direct order flow to those market centers that may have lax surveillance and enforcement programs.

The existence of this "regulatory arbitrage" harms the integrity of the entire marketplace, impedes best execution, and does not serve to protect investors. As described below, STA believes that consistent trading rules and integrated surveillance systems would further investor protection, improve execution quality, prevent fraud and manipulation, and reinforce principles of fair trade between members and their customers.[12] As envisioned by the framers of the National Market System, such action would allow market centers to compete for order flow on the basis of the quality of execution provided and the provision of other services and systems, not the ability to trade and quote without regulatory and investor protection concern.[13]

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[12] Indeed, the SEC, in its Request for Comment on NASDAQ Petition relating to Regulation of NASDAQ-listed Securities, Securities Exchange Act Rel. No. 47849 (May 14, 2003), specifically requested comment on the issue of whether trading rules and market surveillance require greater consistency.

[13] See Letter to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission, regarding Commission Request for Comment on NASDAQ Petition relating to Regulation of NASDAQ Listed Securities from the Security Traders Association Trading Issues Committee (June 19, 2003) - see Appendix C.

Recommendations

To address the various problems discussed above and to continue progress towards the goals of the NMS, STA recommends the following:

Recommendation 1: Improve Linkages and Intermarket Trading Rules

As described above, STA concurs that there are four central characteristics for effective market linkages:

* State of the art technology;
* Automatic or immediate execution capability;
* Governance representation by all qualified market centers, and
* Access to the linkage for all qualified market centers (including direct access for market makers).

STA recommends that the SEC mandate that both listed and NASDAQ stocks have linkages that meet or exceed these principles. These linkages should be accompanied by intermarket rules that, at a minimum, prohibit locked and crossed markets.

For Listed Securities

As discussed earlier in this paper, the ITS has been in place for over two decades, but does not, in its current form, provide for efficient executions consistent with the NMS. STA believes that the Commission should mandate improvements to ITS to provide for more efficient and timely executions.

For NASDAQ Securities

STA strongly recommends that the SEC immediately establish and/or oversee the establishment of intermarket linkages and locked and crossed market rules as described above. The linkages must provide automatic execution functionality (assuring the reliability of the market centers' quotations), access to all exchanges and other market centers including broker-dealers and ATSs and technology commensurate with that currently required by the SEC in its approval of other markets.

Recommendation 2: Consistent Rules, Enforcement and Surveillance

Regulatory arbitrage serves to reduce the overall quality of our markets and must be eliminated. STA believes that the SEC must mandate the adoption of consistent, standardized trading rules, such as the short sale rule, among markets trading like classes of securities (i.e. NASDAQ securities and exchange-listed securities). Similarly, surveillance and enforcement functions should be equivalent across markets. Standardization of this type may significantly reduce the need to consider a single SRO by eliminating many, if not most, of the inconsistencies that leave these markets susceptible to manipulation.

All customer-protection related rules applicable to order execution should be uniform to maximize protection of the public investor and to ensure that order flow is not determined by lax, ineffective or nonexistent regulation. In certain cases, markets have imposed rules on their own market maker members that go above and beyond previous standards for providing enhanced guarantees to customer orders. In these cases, rules may rightfully differ and markets should be encouraged to adopt rules to better service the public. Yet, when a disparity surrounding a rule (or lack of a rule) is engineered for the sake of attracting order flow, without any relationship to enhanced

customer protection or service consistent with national market principles, it is possible that the SEC should step in to enforce consistency. Within such a framework, marketplaces can compete with each other on the basis of execution quality, allowing such competition to put the public investor in the best possible position.

The regulatory imbalance generally has contributed to a fragmented regulatory framework that increasingly inhibits the ability of the various SROs to surveil for and enforce against intermarket manipulative and fraudulent activity (in addition to their surveillance for and enforcement against such conduct occurring in their respective marketplaces). STA believes that attempts to enhance the current Intermarket Surveillance Group ("ISG") information-sharing agreement, or mandates directing each market center to establish an order audit trail similar to that implemented by NASDAQ, will not improve the regulatory regime.

Instead, STA believes that the SEC should mandate standardized rules across markets trading the same securities (i.e., NASDAQ securities or exchange-listed securities) in each case where a disparity of such rules appears to be for the purpose of gaining a competitive edge without adding any real benefit to the protection of investors.[14]

Recommendation 3: Eliminate ECN Access Fees

STA believes that the changes to the marketplace brought about by the conversion to decimalization and the deleterious effects of access fees on market transparency and best execution strongly suggest that ECN fees should be abolished. The difficulties in monitoring the level of fees and the problems created by including access fees in ECN quotations argue in favor of the SEC taking action and abolishing the charging of such fees.

We note that on June 13, 2003 at the Fourth Annual SIA Conference on Market Structure, Annette Nazareth, Director, SEC Division of Market Regulation, stated:

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> The treatment of access fees is another difficult market structure issue that continues to plague the Commission staff. It is remarkable to me that, in such a highly regulated and developed securities market, we find ourselves without a common convention for quoting bids and offers. Without belaboring how we got to this state, let it suffice to say that it is critical we address this unenviable situation in which a price may or may not be a price - it may be a net price, but it may also represent the price with an unstated access fee to be added on top. This disparity - this lack of a uniform convention - causes innumerable difficulties in our national market system, such as a higher incidence of locked and crossed markets, and competitive inequalities between ECNs and market makers. As a result, I believe the Commission will address this issue sooner rather than later.
>
> Obviously, there are a number of potential solutions - from adding the fees to the quote, to permitting fees of a *de minimis* level to, finally, banning access fees outright. The first potential solution, adding the fees to the quote, is the most problematic in my view. For example, the various concerns market participants have raised with the advent of penny spreads would be magnified many times over by the subpenny pricing that would result were access fees simply added to the quote. I take a somewhat simplistic view of subpenny pricing - we don't subscribe to it for virtually any transactions in this country, save for gasoline purchases - but I do believe in this case the burdens would far exceed the benefits. I personally find the other potential solutions to the access fee issue more promising, and I look forward to working with the Commission and the industry to examine them in more depth.[15]

[14] The regulatory community may wish also to consider whether generic surveillance and examination functions should be consolidated into two SROs, one responsible for markets trading NASDAQ securities and the other responsible for markets trading exchange-listed securities. This consolidation might improve examination oversight and policing for manipulative conduct across markets trading and/or quoting specific securities.

[15] STA concurs with Director Nazareth's assessment that quoting in sub-pennies would be deleterious to the markets. See STA letter to the Honorable William H. Donaldson, Chairman, Securities and Exchange Commission, regarding Reexamination of Decimalization (May 14, 2003) - see Appendix D; STA comment letter to the Honorable Laura Unger, Acting Chairman, Securities and Exchange Commission, regarding Trading in Increments of Less than One Penny (June 27, 2001) - see Appendix E.

Conclusion

STA recognizes that the NMS will always be a work in progress. Yet as STA looks at the NMS as a benchmark against which to measure market progress and a goal towards which efforts must be directed, STA questions whether all that can be done is being done. As innovations continue, and as new players, practices, and financial instruments enter the markets, markets and market participants must not lose sight of the NMS as a measure and goal. And it is in that light that we see this as an opportune time to take stock, even as we move forward.

The STA believes, based on experience and analysis, that by following basic principles to drive future market structure, the promise of the NMS on behalf of the investors we represent can be fulfilled sooner, rather than later.

Key to achieving this goal is the connecting of and access to all market centers by all market participants on an equal and level basis. At the same time, rules that are binding on and applicable to all participants will assure consistent practices in this environment as well as guarantee investor protection.

The general strength of any market is its ability to inspire investor confidence. Technologically, the tools are available to deliver on automated execution across market centers. What is required is the will to achieve that connectivity. The requirements for best execution demand nothing less.

Such connectivity will assure that innovation and competition will continue to drive the markets. At the same time, setting rules that protect all market participants and advantage none will assure continued confidence in the market on the part of investors and market professionals.

The securities markets in the United States and those responsible for determining the structure of those markets cannot let this opportunity pass. STA urgently recommends careful consideration of the recommendations in this paper and looks forward to a rigorous conversation with regulators, legislators, and our colleagues and our clients.

Appendix A

March 6, 2003

Jeffrey Brown
Chairman
Nasdaq Unlisted Trading Privileges Committee
440 South LaSalle Street, 26th Floor
Chicago, Illinois 60605

RE: Locked and Crossed Markets

Dear Mr. Brown:

The Security Trader's Association ("STA") is writing to the Nasdaq Unlisted Trading Privileges Committee ("UTP Committee") to express its concern about the currently excessive instances and duration of locked and crossed market conditions for a security across different exchanges and markets. As will be discussed in greater detail below, the existence of such market conditions cause significant confusion to the public investor, has a deleterious effect on the speed of execution, and generally disrupts the marketplace. The STA urges the UTP to amend the Unlisted Trading Privileges Plan ("Nasdaq UTP Plan") and promulgate policies that will operate to significantly reduce or eliminate these market conditions.

The STA is a worldwide professional trade organization that works to improve the ethics, business standards and working environment for its members, who are engaged in the purchase, sale and trading of securities. The STA represents the shared interests of its approximately 7,000 members that belong to one of 29 national and international affiliate organizations. The STA is the largest organization of its kind in the world.

Background

With the creation and implementation of the NASD Alternative Display Facility ("ADF") and the increased trading of Nasdaq securities pursuant to unlisted trading privileges, the STA has recognized a significant increase in locked and/or crossed market conditions between the various exchanges and market participants trading such securities.

Additionally, the extended duration of these conditions exacerbates the harm caused to public investors and other market participants resulting from these deleterious conditions. The increased number of these instances appears to be a direct result of the absence of any rules or policies addressing these conditions,[1] the absence of an electronic linkage and automated execution facility between various exchanges and markets and the apparent desire of some market participants to purposefully lock and/or cross the market in order to attract order flow and, as a result, charge an access fee to the participant that directs a transaction to that party to unlock or uncross the market.[2]

The Effects of Locked and Crossed Market Conditions

Locked and/or crossed market conditions cause substantial confusion to the marketplace, public investors and other market participants. The existence of locked and/or crossed markets add significant confusion to the public investor and provide the appearance of an irrational marketplace where it appears that broker-dealers are willing to pay him more for a security than they would be willing to sell it to him for. With this confusion in place, the investor loses the ability to gauge the marketplace for the security and determine if the price of the security is increasing, decreasing or remaining steady, whether he is obtaining a good price and whether it is an appropriate time to purchase or sell. Moreover, such conditions could provide the investor with a false perception of the price volatility of the security.

During a locked and/or crossed market condition many firms shut off their automated execution functionality and attempt to execute orders on a manual basis. This results in slower executions or limited executions until the market unlocks/uncrosses, further confusing the investor as to the operation of the market place, the speed of execution of his order and the appropriateness of his investment decision. Further complicating the execution of the investor's order is the decision as to what price the order should be executed when the inside market is locked and/or crossed. Depending on what prices are reflected when the market unlocks/uncrosses, if the customer's order is executed at the inside market during a locked/crossed market condition, the customer could receive a very good or very poor execution. A professional market participant is, thus, at a quandary as to how to price the order and such indecision slows down market operations to the detriment of the investor.

The Current Regulatory Environment

Currently, there are no promulgated rules by the Securities and Exchange Commission or the various exchanges and other markets that specifically address this situation. Most markets do, however, maintain rules that operate to deter or eliminate the occurrence of locked and/or crossed markets within its market. For instance, in The Nasdaq Stock Market ("Nasdaq"), NASD Marketplace Rule 4613(e) provides that a market participant shall not, except as provided below, enter or maintain a quotation in Nasdaq during normal market hours if the bid (ask) quotation entered is equal to or greater (less) than the ask (bid) quotation of another market participant entering quotations in the same security. A market participant may lock or cross the market, however, if, prior to entering the quotation that locks or crosses the market, the market participant first makes reasonable efforts to avoid such locked or crossed market by attempting to execute transactions with all market participants whose quo-

tations would be locked or crossed.[3] Additionally, in the event that extraordinary circumstances exist, a market participant may lock or cross the market regardless of whether it has first made reasonable efforts to trade with those market participants whose quotes would be locked or crossed. While the rule does not define "extraordinary circumstances," Nasdaq and NASD Regulation have previously stated that such circumstances generally could exist when there are systemic, market-wide failures in the operation of Nasdaq quotation, execution, or trade reporting and dissemination systems that render Nasdaq quotations virtually inaccessible and/or wholly unrelated to current market activity.

Likewise, NASD Marketplace Rule 5263 requires an ITS/CAES market maker that enters a quote that locks/crosses the market to promptly send a commitment to trade to the other ITS Participant Exchange or ITS/CAES Market Maker it locked/crossed.[4] While these rules provide some effect in controlling the incidents and duration of locked/crossed markets quoted and traded within Nasdaq and for listed securities traded through the ITS, there are currently no rules in effect that operate to prevent such instances between markets quoting Nasdaq securities. In fact, as demonstrated by previous NASD and AMEX pronouncements the quotations of other marketplaces can be ignored for the purposes of locked/crossed market compliance.

STA's Recommendations

The STA believes that the current state of affairs is untenable and needs to be addressed immediately. Further, the STA believes that this issue can be addressed faster and more efficiently by voluntary compliance with policies established by the UTP Operating Committee as opposed to SEC rule promulgation. The STA believes that this issue could be addressed through the following proposals:

1. Prior to entering a quote that would lock/cross another Exchange or Market's quotation, such market participant should be required to first make reasonable efforts to trade with the Exchange and or Market it would lock or cross. The required reasonable effort could be documented by the memorialization of the time of the manual or electronic routing of the order or bid/offer the time the market participant entered the locking/crossing quotation. The STA believes that providing the Exchange or other Market seconds to respond in some manner to its order or bid/offer[5] would demonstrate a reasonable effort to trade.
2. Prohibiting the charge of an access fee by an Exchange or Exchange Member when such Exchange is actively locking/crossing the market.

Conclusion

The STA strongly urges the UTP to take immediate action on this issue to reduce or eliminate these harmful market conditions and increase the efficiency of the marketplace and investor protection and confidence. Please do not hesitate to contact us at 212-867-7002 if you have questions or need further assistance. We would be happy to continue this dialogue with you and help in any way we can to address this unfortunate and troubling situation.

Sincerely,

John C. Giesea
President/CEO

Cc: Richard G. Ketchum
President and Deputy Chairman,
NASDAQ Stock Market, Inc.

Annette L. Nazareth
Director, Securities and Exchange Commission

Robert L. D. Colby
Deputy Director, Securities and Exchange Commission

[1] In fact, as expressed in NASD Head Trader Alert 2002-116 (August 12, 2002), NASDAQ reminded firms that they were permitted to lock-and-cross a non-participating UTP quote and that doing so is not a violation of NASDAQ's locked-and-crossed rule.

[2] See, Gregory Bresiger, SEC Urged to Take Action on Locked Markets, Traders Magazine News Services (January 16, 2003), where it was reported that Nasdaq contended that Island/Instinet is deliberately locking markets to its benefit, earning fees when participants end up in their system.

[3] While the rule does not define what constitutes a reasonable effort to avoid a locked or crossed market, Nasdaq and NASD Regulation staff had, in the past, stated that sending a preferenced SelectNet message for a duration of at least 30 seconds constitutes a reasonable attempt to trade. In determining reasonable efforts to trade between markets and exchanges, the STA believes that a similar minimum time requirement should be imposed

[4] ITS is only used for listed securities. There is no official intermarket linkage system for Nasdaq securities.

[5] In other words, if an Exchange or other market failed to execute the order or bid/offer within seconds, the market participant could enter a locking/crossing quotation.

Appendix B

April 16, 2003

The Honorable William H. Donaldson
Chairman
United States Securities and Exchange Commission
450 Fifth Street. N.W.
Washington D.C. 20549

RE: ECN Access Fees

Dear Mr. Donaldson:

On behalf of the members of the Security Trader's Association ("STA"),[1] the STA again respectfully requests that the Securities and Exchange Commission ("SEC" or "the Commission") reconsider its position regarding the ability of Electronic Communications Networks ("ECN") to charge non-subscribers access fees and abolish the practice.

The STA has previously provided the SEC with its views on this issue through written correspondence and meetings with former Chairman Harvey L. Pitt, a number of Commissioners and Division of Market Regulation senior staff. It is not the intent of this letter to rehash the obvious deleterious effects this practice has had on the marketplace, market participants and public investors. Based on the STA's previous communications with the SEC, and the continuing dialogue between the STA, other market participants and the SEC, we respectfully believe that the SEC fully understands the significant harmful effects this practice has had on market transparency[2] and best execution[3] of customer orders. We also believe the SEC understands that this practice has created an uneven playing field by allowing ECNs, but not market makers, to charge such fees.

Further, since 1999, the SEC has recognized that allowing the imposition of access fees by ECNs on non-subscribers is a controversial issue that needs to be addressed. For instance Annette Nazareth, Director, Division of Market Regulation, recently stated:

I want to touch briefly on a point that I know is important to you, ECN access fees. It has become clear that changing market conditions, such as the narrowing of the spread and the participation of fee charging ECNs in automatic execution systems, may be adversely effecting the profitability of traders and harming the integrity of the public quotation. Indeed, this organization, along with other market participants, has taken the lead in providing thoughtful and helpful analysis on this issue. We have heard your concerns and they are helping us to frame our continuing examination of this issue in our dynamic and ever-changing capital markets.[4]

The STA also applauds the staff of the Division of Market Regulation for publicly stating that this issue should be the first issue the SEC addresses as a result of the Market Structure hearings it held in late 2002.[5]

In light of the fact that the SEC staff is currently developing a resolution to this issue, the STA reiterates its view that ECN access fees be abolished. There is simply no competitive or market structure reason to allow the practice. In addition to its effects on transparency and best execution, there is no justification for allowing one market participant to charge a fee to another market participant when there is no contractual nexus or other agreement between the two parties for the provision of services or the imposition and payment of fees. Moreover, in today's Nasdaq SuperMontage environment, a market maker is forced to pay an ECN access fee, not only where it has never agreed to do so, but also in a situation where it has made no direct effort to route its order to an ECN or attempt to access the ECN's quote.

The STA respectfully believes that it is time to level the playing field and urges the SEC to act quickly and abolish ECN access fees. An ECN should be limited to charging fees to its subscribers just as a market maker may only charge fees to its customers. Any other solution to this controversial issue will only exacerbate the harms previously addressed above by Ms. Nazareth and the STA and cause further harm to the public investor.

Please do not hesitate to contact me if you, or your staff, if you have any questions, need any assistance or wish to discuss this matter further.

Very truly yours,

John P. Hughes
Chairman

John C. Giesea
President & Chief Executive Officer

cc: Hon. Cynthia A. Glassman
Hon. Harvey J. Goldschmid
Hon. Paul S. Atkins
Hon. Roel C. Campos
Annette L. Nazareth
Robert L.D. Colby

[1] The STA is a worldwide professional trade organization that works to improve the ethics, business standards and working environment for its members, who are engaged in the purchase, sale and trading of securities. The STA represents the shared interests of its approximately 7,000 members that belong to one of 29 national and international affiliate organizations. The STA is the largest organization of its kind in the world. (More information about the STA is available on the Internet at : (http://www.securitytraders.com).

[2] Because these fees are not included in the published quotations of ECNs, these quotations do not reflect the true price available at an ECN. In the case of a security with a penny spread this type of distortion is significant and obscures the actual market for the security. This distortion and lack of market transparency is simply inconsistent with the objectives of the National Market System. This problem is exacerbated by the auto-execution system feature of SuperMontage. Because that system will automatically execute market orders and marketable limit orders against the quotations of any market maker or ECN, a market maker or order routing firm may find itself paying access fees that it affirmatively does not want to pay.

[3] If an ECN quotation is executed against in SuperMontage and that ECN charges an access fee, either the customer or its broker will be penalized for attempting to obtain this price.

[4] Nazareth, Annette L., Remarks at Washington Congressional Conference of the STA (May 9, 2002).

[5] Nazareth, Annette L., Colby, Robert L.D., Remarks at SIA Legal and Compliance Seminar (April 7, 2003).

Appendix C

June 19, 2003

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Commission Request for Comment on Nasdaq Petition relating to Regulation of Nasdaq-Listed Securities (File No. S7-11-03) (the "Petition")

Dear Mr. Katz:

The Security Traders Association' Trading Issues Committee ("STA Trading Issues Committee") welcomes the opportunity to provide its views to the Securities and Exchange Commission ("SEC" or "Commission") regarding the SEC's request for comment on the Petition for rulemaking and whether the concerns raised by Nasdaq in its petition exist also for exchange-listed stocks and options.

On April 11, 2003, Nasdaq filed the Petition requesting that the Commission take action to protect investors trading Nasdaq securities. Nasdaq requested that the Commission:

1. Exercise its authority under Section 19(c) of the Securities Exchange Act of 1934 (the "Act") and Rule 192 of the Commission's Rules of Practice to amend the rules of all markets that trade Nasdaq-listed securities to establish uniform trading rules and to ensure equal surveillance and enforcement of those rules;
2. Exercise its authority under Section 11A(a)(3)(B) of the Act, and Rule 11Aa3-2(b)(2) under the Act to order immediately that the exchanges' costs of regulation, including audit trail collection, surveillance, and enforcement, be aggregated and deducted from the market data revenue collected pursuant to the UTP Plan; and
3. identify markets that trade Nasdaq-listed securities without approved rules, order audit trails, surveillance, and examination programs that are sufficient to protect investors that buy and sell Nasdaq-listed securities on those markets and, when a market lacks these functions, exercise its authority under Section 12(f)(2) and (f)(3) of the Act to prohibit the launch or continuation of Nasdaq trading by the market to prevent any failure to protect investors as required under the Act.

To address the issues of uniformity of trading rules, equal surveillance and consistent enforcement, Nasdaq specifically asked the Commission, at a minimum, to add to the rules of all SROs that trade Nasdaq-listed securities, rules requiring an electronic audit trail identical to the NASD's OATS Rules and short-sale restrictions similar to NASD Rule 3350.

Nasdaq also asked that, if the Commission's review of other markets' rules, surveillance, or enforcement revealed inequalities that could be addressed through the adoption of uniform rules, the Commission add those rules as well, to reduce regulatory inconsistencies among markets that trade Nasdaq-listed securities.

Nasdaq believes that the fairest way to allocate the costs of supervising the trading of Nasdaq stocks is to aggregate trading venues' costs of regulation, which include costs associated with surveillance and enforcement, and to deduct that amount from the market data revenue collected pursuant to the Nasdaq UTP Plan. Nasdaq believes that this method of funding aggregate regulatory costs would counter the existing economic incentives that lead markets to reduce their regulatory costs to compete for order flow.

The Commission has asked specific questions concerning the above requested relief. The STA Trading Issues Committee believes that while fairness is important between market centers, the overriding principle of investor protection should guide the SEC's response to the Nasdaq Petition. The STA Trading Issues Committee responds to certain of the SEC's questions as follows:

Request for Comment on the Need for Uniform Trading Rules and Surveillance

Q1. Do commenters agree with Nasdaq that there is unequal regulation of trading in Nasdaq securities?

The STA Trading Issues Committee agrees with the premise that regulatory contributions of individual marketplaces are not in balance with the extent to which they share in the benefits of a strong regulatory environment. While this imbalance is seemingly growing in the eyes of the Nasdaq, it also has become a matter of consternation to all market participants including, but not limited to, investors and broker-dealers, as it is those entities that ultimately shoulder the brunt of regulatory costs.

This regulatory imbalance has contributed to a fragmented regulatory framework that increasingly inhibits the various SROs in their ability to surveil for and enforce against intermarket manipulative and fraudulent activity (in addition to their surveillance for and enforcement against such conduct occurring in their respective marketplaces). The STA Trading Issues Committee believes that attempts to enhance the current ISG information-sharing agreement, or mandates directing each market center to establish an order audit trail similar to that implemented by Nasdaq, will not improve the regulatory regime. Instead, the STA Trading Issues Committee believes that the SEC should mandate standardized rules across markets trading the same securities (i.e., Nasdaq securities or exchange-listed securities) in each case where

a disparity of such rules appears to be for the purpose of gaining a competitive edge without adding any real benefit to the protection of investors. The SEC should consider whether generic surveillance and examination functions should be consolidated into two SROs, once responsible for markets trading Nasdaq securities and the other responsible for markets trading exchange-listed securities. The STA Trading Issues Committee urges the Commission to consider the potential benefits that consolidation of these functions may have in improving examination oversight and policing for manipulative conduct across markets trading and/or quoting specific securities.

The STA Trading Issues Committee encourages the SEC to request and review empirical data from the various market centers that trade Nasdaq securities to determine the accuracy of Nasdaq's contentions concerning Nasdaq's claims of unequal regulation and the allocation of its costs.

The STA Trading Issues Committee encourages the SEC to redouble its substantial efforts to ensure that the rules of all securities exchanges and national securities associations adhere to the statutory directive that they are designed "to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating...processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers brokers, or dealers, ..." Sections 6(b)(5) and 15A(b)(6) of the Act.

Q2. Should all exchanges and associations trading Nasdaq securities have rules requiring detailed audit trail information?

The STA Trading Issues Committee believes that this question can not be answered without an empirical examination of the benefits realized by the NASD in using OATS submitted information compared to the significant costs to member firms to record and report required information to OATS. Moreover, if a determination is made that such an audit trail is needed, the SEC must remain attuned to the costs involved in creating, maintaining and complying with multiple audit trail systems. The SEC might consider expanding OATS to include transactions in Nasdaq securities executed in other markets, rather than requiring separate "OATS-like" systems at other exchanges and associations.

Q3. Should all exchanges and associations trading Nasdaq securities be required to automate their surveillance and examination of Nasdaq trading on their markets?

Fundamentally and practically, the STA Trading Issues Committee believes that each SRO should implement appropriate automation in order to surveil and examine its marketplace for compliance with its rules and the federal securities laws in a thorough and timely manner. That being said, the STA Trading Issues Committee does not believe that a lack of technology should operate as a barrier for any market. If a SRO can demonstrate that its manual systems allow it adequately to surveil and to examine all transactions occurring in its marketplace, the SRO should be allowed to operate. The SEC must make any determination of adequacy of the systems of a specific SRO, however, pursuant to objective standards that focus first and foremost on the protection of investors.

Q4. Should all exchanges and associations trading Nasdaq securities have similar rules to regulate short selling?

The STA Trading Issues Committee believes that the SEC should mandate that all markets trading Nasdaq securities consistently address short selling. Today, short sale activity is regulated differently in different trading venues. SEC Rule 10a-1 generally prohibits short sales in securities listed on an exchange, other than on an uptick. The Nasdaq market short sale rule prohibits, subject to certain exceptions, short selling on a down bid. While these rules operate differently as a result of differing market structure and operation, their effect is the same - both rules prohibit short selling when the market price of a security is falling. The goal of these rules is to prevent manipulative and/or fraudulent activity. The SEC recently issued a Concept Release requesting comment on short sale regulation including, but not limited to, views on whether these rules remain necessary and effective. The SEC has yet to issue its findings in this area. If, however, the SEC concludes that short sale regulation remains warranted for the protection of investors, issuers and the marketplace, the SEC should ensure that such regulation applies in each market center and is consistently enforced.

Presently, within the fragmented market for Nasdaq securities, different market centers address short sale regulation in several different ways, including some market centers that do not regulate short sales of Nasdaq securities. Indeed, some market centers use the absence of a short sale rule to attract Nasdaq order flow. Inconsistent regulation works against protecting investors, however, and provides opportunities for regulatory arbitrage by investors and other market participants.[2]

Q5. What other trading rules should be uniform across all markets?

The STA Trading Issues Committee believes that all customer-protection related rules applicable to order execution

must be uniform to maximize protection of the public investor and to ensure that order flow is not determined by lax, ineffective or nonexistent regulation. In certain cases, markets have imposed rules on their own market maker members that go above and beyond previous standards for providing enhanced guarantees to customer orders. In these cases, rules may rightfully differ and markets should be encouraged to adopt rules to better service the public. Yet, when a disparity surrounding a rule (or lack of a rule) is engineered for the sake of attracting order flow without any relationship to enhanced customer protection or service consistent with national market principles, the SEC should step in and impose corrective action. In addition, markets should set out consistent rules prohibiting quotation in increments below a penny to ensure that the positive benefits of trading in decimals are not lost and the negative attributes of trading in decimals are not magnified.[3] Within such a framework, marketplaces can compete with each other on the basis of execution quality allowing such competition to put the public investor in the best possible position.

Q6. How should the Commission address any regulatory gaps that can arise when trading in the same security is fragmented across different SROs?

The STA Trading Issues Committee believes that regulatory gaps can and do arise when the same security is traded across different SROs. Deficiencies in market structure arising from this fragmentation can be addressed, however, by improving the linkages between market places and by implementing consistent trading rules and surveillance mechanisms.

Unlike the markets for listed securities, there is no intermarket linkage system that even theoretically will permit a firm seamlessly to access liquidity in any of the markets in which Nasdaq securities are traded. For instance, in order to access the markets at the four exchanges trading Nasdaq stocks, an order-routing firm must be a member of each exchange or execute through a clearing firm that is a member of each exchange. Thus, an order-routing firm must maintain its own linkages to the four marketplaces and the two ECNs trading in the NASD's Alternative Display Facility (the "ADF"), as well as to Nasdaq. Furthermore, unlike the market for listed securities, the market for Nasdaq securities lacks an intermarket regulatory structure prohibiting locked and crossed markets or trade throughs, and, as described above, lacks consistent short sale regulation.

The STA Trading Issues Committee cannot over-emphasize the critical importance of accessibility in trading Nasdaq securities where there is active competition between markets with very different market models. Yet currently we lack an adequate linkage between markets that trade Nasdaq securities. This has created numerous problems for the market participants as they face frequent locked and crossed markets in Nasdaq securities and still seek to fulfill their best execution obligations. Certain private vendors do provide linkages to various markets that make access easier, but at very steep prices. It is clear, however, that these private initiatives do not address sufficiently the problems arising from the fragmentation. Without linkages that provide consistent, reliable and efficient execution standards, investors suffer because broker-dealers face impediments to their efforts to make appropriate order-routing and best execution determinations on behalf of their customers.

Previously, the SEC mandated creation of the ADF, but did not mandate linkages between markets using the ADF, and the markets have failed to develop linkages on their own. As a result, we urge the SEC immediately to establish or oversee the establishment of such linkages. The SEC must oversee creation of linkages that provides automatic execution functionality (assuring the reliability of the market centers' quotations), access to all exchanges and other market centers including broker-dealers and ATSs and technology commensurate with that currently required by the SEC in its approval of other markets.

The STA Trading Issues Committee notes that the formal mechanism for linkage between trading venues for listed securities is the ITS. The ITS operational and technological protocols have not, however, kept pace with the markets, and now the antiquity of ITS actually inhibits efficient linkage between the eight exchanges and Nasdaq that are the ITS participants because ITS processes information too slowly to be useful to most sophisticated market participants. Therefore, the STA Trading Issues Committee would recommend establishment of effective linkages in both the Nasdaq securities and exchange-listed markets in order to address regulatory issues or gaps caused by the failure of market participants to access each other.

Additionally, as described above, we believe that the SEC should mandate rule consistency across markets and should continue to consider whether surveillance and examinations should be consolidated in two SROs responsible respectively for the markets for exchange-listed and Nasdaq securities.

Q7. To what extent is ISG a useful mechanism for coordinating intermarket regulatory efforts? Does ISG fully address the regulatory gaps Nasdaq contends exist? Does the fact that the Commission does not have direct oversight of ISG limit the sufficiency of the ISG framework in ensuring adequate regulation of violative conduct in the trading of Nasdaq securities that can occur across markets, such as insider trading or certain market manipulations?

No Comment

Q8. Are there models sufficient to address potential concerns raised by fragmentation of regulation by multiple SROs trading Nasdaq securities?

No Comment

Q9. Are there advantages or disadvantages to a single market regulator with regulatory oversight across all markets trading Nasdaq securities?

As stated above, the STA Trading Issues Committee believes that the SEC's first priority should be to oversee adoption of consistent standardized trading rules among markets trading like classes of securities (i.e. Nasdaq securities and exchange listed securities). Standardization of rules may significantly reduce the need to consider introduction of consolidated SROs by eliminating many, if not most, of the inconsistencies that leave these markets susceptible to manipulation.

The SEC, of course, should continue to evaluate whether the "single" SRO model would be the most effective model. However, the SEC should not assume that the "single" SRO model is preferable to the existing SRO structure until markets have had a reasonable opportunity to compete within a framework of consistent marketplace rules.

Q10. Should a competitive bidding process be required to determine which entity will serve as the single regulator?

If the SEC ultimately determines that a single SRO should oversee markets that trade Nasdaq securities and that another SRO should oversee markets that trade exchange-listed securities, the SEC could conduct a competitive bidding process to determine these regulators. The STA Trading Issues Committee believes that the adequacy of surveillance and regulatory systems should be the deciding factor, however, when the choice of regulator is made, as selection of this entity solely on the basis of cost could place investors in peril.

Request for Comments on Allocation of Regulatory Costs

Q1. Should proceeds from the Nasdaq UTP Plan be withheld to pay for regulatory costs?

Q2. Would Nasdaq's proposal to aggregate and deduct regulatory costs from market data revenue result in adequate regulation? If so, what costs would appropriately be considered regulatory costs and therefore, appropriately deducted from the market data revenue?

Q3. Should other methods of fairly allocating regulatory costs be considered?

Q4. Should the NASD be required, as suggested by the CSE, to alter its systems to include more data from intermarket trading to improve inter-market surveillance?23 If so, who should pay for this enhancement?

Q5. Who would determine what are legitimate regulatory costs? On what basis should such a determination be made?

Overall, the STA Trading Issues Committee believes that the actual number of transactions reported on a marketplace should form the basis for determination of how to allocate regulatory costs. Regulatory costs could be derived from SEC Section 31 fees, the Nasdaq UTP Plan or through the imposition of transaction activity fees. The allocation of regulatory costs, however, raises the same issues the STA Trading Issues Committee addressed in response to the creation of the recently approved NASD TAF fee. In particular, broker-dealers and investors potentially could find that they must pay regulatory fees to more than one market center for the same transaction. If, however, such fees are properly allocated based on market participation, and one regulator operates as described above, this issue should be addressed.

Request for Comments on the Application of Nasdaq's Recommendations to Exchange-listed Securities

Q1. Do commenters believe that there is unequal regulation of exchange-listed securities among the markets trading such securities? If so, do commenters believe that the proposals made by Nasdaq with respect to Nasdaq securities would address such unequal regulation in the listed markets? If not, what other approaches do commenters recommend?

The STA Trading Issues Committee believes that the issues raised in the Petition do not presently exist in the exchange-listed environment in the same magnitude as in the Nasdaq Market, because at present the exchange-listed market is less fragmented. As competition increases, and market structure changes, however, fragmentation in the exchange-listed market will continue to increase. As a result, the issues raised in the Petition should be addressed across all markets to reduce the likelihood that they will arise in the exchange-listed market in the future. This will maximize protection of investors, in particular by minimizing the effects of fragmentation on their trading in exchange-listed securities at the same time that such effects are finally reduced for investors in Nasdaq securities.

Q2. Should the Commission require an intermarket consolidated order audit trial system for Nasdaq-listed and exchange-listed securities, other than options?

The STA Trading Issues Committee respectfully refers the Commission to the response to Question 2 in the first set of queries.

The STA Trading Issues Committee appreciates this opportunity to submit its comments pursuant the Commission's Request for Comment. As a membership organization, the Security Traders Association draws members from a wide spectrum of market participants. Therefore, the Trading Issues Committee membership covers a broad scope and these comments reflect the consensus views of the STA Trading Issues Committee.

Please do not hesitate to contact the undersigned at 212-867-7002 if you have any questions.

Very truly yours,

Mary McDermott-Holland
STA Vice Chairman
Co-Chairman-STA Trading Issues Committee

Mark Madoff
Co-Chairman-STA Trading Issues Committee

John C. Giesea
STA President and Chief Executive Officer

Cc: The Honorable William H. Donaldson
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
Annette L. Nazareth, Director
Robert L.D. Colby, Deputy Director
Division of Market Regulation

[1] The STA is a worldwide professional trade organization that works to improve the ethics, business standards and working environment for its members, who are engaged in the purchase, sale and trading of securities. The STA represents the shared interests of its approximately 7,000 members that belong to one of 29 national and international affiliate organizations. The STA is the largest organization of its kind in the world. (More information about the STA is available on the Internet at: (http://www.securitytraders.com).

[2] The STA Trading Issues Committee recently commented on ECN access fees, which create another unwarranted disparity, this one between marketplaces based on cost of access. Letter to the Honorable William H. Donaldson, Chairman, Securities and Exchange Commission, regarding ECN Access Fees (April 16, 2003).

[3] See STA comment letter to the Honorable Laura Unger, Acting Chairman, Securities and Exchange Commission, regarding Trading in Increments of Less than One Penny (June 27, 2001).

Appendix D

May 14, 2003

William H. Donaldson, Chairman
U. S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20546

Re: Re-examination of Decimalization

Dear Chairman Donaldson:

The Security Traders Association (STA) acknowledges your call yesterday (as reported by Reuters) for a complete re-examination of the impact of trading in decimals. We welcome such an examination and urge that it be undertaken promptly.

We believe that the introduction of decimalization, although well intended, has increased investors' costs, reduced transparency, increased volatility and diminished the visibility of liquidity. Indeed, a recent study by two Vanderbilt professors estimates that trading costs have increased by one to two percent of assets annually for active fund managers.

The goals of moving to decimals from fractions were clearly well intended. These included helping investors understand more easily the pricing of securities. They were also intended to narrow spreads, with the expectation that they would generate a significant saving for investors. While STA argued against the move, we understood the compelling logic for the Commission's action.

With the experience of the last two years, however, we are now finding that decimalization has produced a number of unintended consequences. These include increased costs to investors and economic hardship for specialists, market makers and those risking capital in adding valuable liquidity to the markets.

The confluence of a three-year bear market, market structure changes and decimalization is undermining the economics of the trading community and threatening its future.

The loss of liquidity providers and its potential impact on investors is of major concern to STA. While we would agree that the most active NYSE and Nasdaq stocks could literally trade "by themselves," those less active securities (the overwhelming number of publicly traded securities) and their shareholders do in fact benefit by the presence of market makers and specialists.

The raising of equity capital by corporations is the cornerstone of our economy. However, given the recent regulatory events surrounding research and investment banking and market structure changes affecting trading, the raising of capital has become exceedingly more difficult. That, in turn, is impacting the U.S. economy and its ability to create jobs.

Action must be taken soon to remedy what could soon be a capital formation crisis. A re-examination of decimalization is a good place to start.

In that connection, STA is prepared to be of assistance to the SEC in this undertaking in any way the Commission may find helpful.

Sincerely,

John C. Giesea
President & CEO

Cc: Hon. Cynthia A. Glassman
Hon. Harvey J. Goldschmid
Hon. Paul S. Atkins
Hon. Roel C. Campos
Annette L. Nazareth
Robert L.D. Colby

Appendix E

June 27, 2001

Ms. Laura Unger
Acting Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington D.C. 20549

RE: Trading in Increments of Less Than One Penny

Dear Ms. Unger:

At the request of the Securities and Exchange Commission (the "Commission"), the Security Traders Association (the "STA") is providing the following comments concerning the potential consequences of allowing Nasdaq and the Exchanges to permit quotations and trades in Minimum Price Variations ("MPVs") of less than one penny ("Sub-Penny Trading").

Brief Summary

One of the principal benefits of switching from fractional to decimal pricing is the clarity and simplicity that the new trading increments provide for many public investors. Penny, nickel and dime increments incorporate both the international decimal standard as well as the currency of the United States, and provide a clear standard of reference and comparison for investors in the U.S. and abroad. Allowing quotations and trade increments in MPVs of less than one penny substantially undermines that benefit, and leads to a more obscure and confusing price structure than ever before. Sub-Penny Trading also exacerbates many of the negative consequences to transparency and liquidity that have accompanied the decimal conversion. The STA therefore urges the Commission and the U.S. Congress to act immediately to prohibit Sub-Penny Trading.

Discussion

The Commission has extended until September 2001 the deadline for Nasdaq and the Exchanges to submit reports detailing the impact of decimal pricing on the capital markets, and make recommendations concerning the suitable MPV for various securities. Currently the New York Stock Exchange requires that both quotes and trades take place in MPVs of one penny, while "Average Price" trades may be reported in up to four decimal places. Nasdaq requires that quotes take place in penny MPVs but does not apply this limit to trades. Therefore, on the Nasdaq Stock Market, trades can take place with no limit to the number of decimal places. The conflicting standards have caused a significant degree of confusion among investors and traders, and created a void that should be addressed by legislative and regulatory action.

Clarity and Simplicity

Since the beginning of the legislative effort almost six years ago to convert the U.S. capital markets from fractions to decimals, one of the primary motivating factors was the desire to simplify pricing for investors, and clarify the amount paid or received for the purchase or sale of a security. To the ordinary investor, fractional increments of 1/8 or 1/16 cannot be easily translated into a monetary equivalent. Nor can they be easily compared-while it may be immediately clear to the professional trader that a security offered on Exchange A at 10 13/16 and on Exchange B at 10 3/4 should be purchased on Exchange B, to the average investor who does not deal in fractions in his/her daily life this is not obvious. A price structure that reflects both the U.S. currency of pennies, nickels and dimes as well as the decimal system would, it was rightfully believed, provide a universally acknowledged price reference.

This desire for clarity was repeatedly stated by legislators and regulators alike to be one of the primary reasons for moving away from fractions. The sentiment was reflected in the naming of the "Common Cents Stock Pricing Act of 1997," which was the predecessor House Bill to the one that eventually enacted the decimal conversion. In recent testimony before the Subcommittee on Securities and Investments of the Senate Committee on Banking, Housing and Urban Affairs, most of the comments focused on the clarity that decimal increments have provided.

The STA supports decimal increments insofar as they provide clarity to the United States capital markets, and allow investors to easily compare prices across competing market centers. We urge the Commission to recognize, however, that the primary source of enhanced clarity is the correlation of the new pricing system to the United States currency. Any investor can more easily relate to a purchase price of $10.31 than to one of 10 5/16; or compare puts and calls trading in dime increments on the various options exchanges. The decimal conversion has succeeded in reducing security prices to the same terms used in daily life.

By severing the connection to the U.S. currency, Sub-Penny Trading completely undermines the common sense basis for the decimal conversion, and leads to a more confusing price structure than ever before. Would the

average investor be more likely to understand a price of 10 3/8, or one of 10.369759139? We believe that Sub-Penny Trading would reduce security prices to a series of indecipherable numerical sequences extending out several decimal places to the right of the decimal point. This would deter the maintenance of "stable and orderly markets," which is one of the paramount goals of the National Market System (See S.Rep. 94-75, 94th Cong. 1st Sess. 7 (1975)). It would also change the focus of the trading community from providing fast, accurate and dependable prices to the splitting of incremental differences that have little impact on the average investor. This was most definitely not the intention of the Commission and Congress in enacting the decimal conversion.

We submit that if Sub-Penny trading had even been contemplated at the time of the enacting legislation, it most surely would have been rejected as contrary to the intention and spirit of the entire decimal conversion. We urge the Commission to act now to protect the enhanced clarity provided by decimal increments by prohibiting Sub-Penny Trading.

Transparency and Liquidity

While the public has benefited from simplified decimal prices, it is clear to our members that other elements of the conversion have led to some undesirable consequences. Many trading factors related to decimal quotations and trades are causing a growing number of market participants to conclude, for example, that decimal pricing has so thoroughly clouded transparency and reduced liquidity as to hurt rather than help most investors.

In the months leading up to the conversion, many industry commentators predicted that increasing the number of price points per dollar by over 600%, as occurred in the switch from sixteenths to pennies, would result in fewer shares available at any given quote. It was also predicted that the smaller MPVs would lead to shorter lived quotes spread out over more quotations, with increased "tick" changes. These phenomena have occurred to an even greater degree than anticipated, leaving many experienced traders concerned and frustrated.

According to the Commission's Office of Economic Analysis, The New York Stock Exchange has experienced a 60% decrease in display size, while Nasdaq has seen an even greater 68% decrease. The amount of liquidity available at the National Best Bid or Offer ("NBBO") has decreased not only because of the smaller display size, but also because many firms that used to guarantee executions at the NBBO can no longer do so. The new market features smaller quotes spread out over many price points, which frequently flicker in and out of existence and are therefore effectively inaccessible. In this environment the "true" market often remains hidden, making it difficult to provide the public with accurate price estimates. Traders are less likely to display size for fear of being "picked off," or improperly allocating capital.

The number of executions required to fill even small orders has increased dramatically as the number of shares available at any one price has diminished. In the decimal environment it is much less likely that orders will get filled at the NBBO, and traders are increasingly concerned with the percentage of trades executed outside of the inside market (or "override" trades). The NBBO, which is the primary price indicator broadcast around the world, has diminished in meaning and value. It no longer necessarily serves as an indication of the price at which an order can be filled, or the amount of time it will take for an order to be completed.

The industry has also witnessed an increase in the number of trading strategies designed to enhance profits by taking advantage of the smaller MPV. "Stepping ahead" or "pennying" of orders, for example, has reportedly increased significantly on many of the exchanges. Computer trading programs have proliferated that automatically post penny bids or offers in order to profit from limit orders. Such gaming practices do not further the interests of the public investor, and undermine confidence in the markets.

Sub-Penny Trading would exacerbate these problems by further obscuring the market for publicly traded securities. Liquidity would become hidden in even smaller amounts behind hundreds if not thousands of more infinitesimal trading increments that exist for ever shorter times. The role of the quote itself as a means of price discovery may come under question as display size diminished further. We believe that the type of gaming strategies designed to profit from penny MPVs would inevitably increase as the MPV infinitely decreased. It is even possible that many market participants would pull out of certain securities altogether as it became more and more difficult to manage risk.

Transparency and liquidity are the primary engines behind the historical success of the U.S. capital markets. Thousands of market participants willing to commit unlimited capital to two sided quotations of publicly traded securities is a phenomenon almost unique to this country, and its importance cannot be overestimated. It is the foundation behind the successful underwriting of investments

that has made our markets the envy of the world. Sub-Penny Trading risks interfering with this critical function for little if any potential benefit to the public investor. The STA believes this is clearly a risk not worth taking.

Conclusion

The STA applauds the Commission for enhancing the clarity of the U.S. markets through the introduction of decimal increments. We urge the Commission to act now to protect those benefits by prohibiting Sub-Penny Trading. We are willing to work with the Commission in any way possible on this and other critical industry initiatives.

Very truly yours,

Lee Korins
President and Chief Executive Officer
Security Traders Association

Michael Bird
Chairman, Trading Issues Committee
Security Traders Association

Geoffrey Cloud
Counsel to the Trading Issues Committee

Glossary

Ask - The stated price at which a broker-dealer will sell a stated amount of a security to another market participant; also known as the "offer" price.

Alternative Display Facility ("ADF") - Operated by the NASD for its members to collect and disseminate published bid and ask quotations, compare trades and collect and disseminate trade reports for NASDAQ securities.

Backing Away - When a market maker fails to honor its published bid or ask quotation by not purchasing or selling the stated amount of shares at or better than its published bid or ask price when presented with an order. Backing away is a violation of SEC and SRO rules and is enforced through disciplinary action.

Best Execution - The obligation of a broker to seek to obtain for its customers' orders the most favorable terms reasonably available under the circumstances. This obligation derives from common law agency principles and fiduciary obligations.

Bid - The price at which a broker-dealer will buy a stated amount of a security.

Buy-Side - Investing institutions like mutual funds, pension funds, and insurance firms that tend to buy significant amounts of securities.

Crossed Market - When the inside bid price of a security exceeds the inside ask price. Contrary to normal markets where the bid-ask spread is positive, in a crossed market the spread is negative. This scenario occurs mainly in volatile and high volume trading. This abnormal market condition occurs mainly in markets for NASDAQ and over-the-counter securities both prior to the market opening and throughout the day. NASDAQ rules require a market maker who crosses a market to make reasonable attempts to trade with the market maker(s) it is crossing prior to entering the crossing quotation.

Electronic Communication Network (ECN) - An electronic system that widely disseminates to third parties orders entered by an exchange market maker or an OTC market maker, and permits such orders to be executed either in whole or in part. An ECN networks major brokerage firms and individual traders so that they can trade directly between themselves.

Inside Market - The highest quoted published bid and the lowest published offer price among competing market makers in a security.

Limit Order - An order placed with a broker-dealer to buy or sell a predetermined amount of shares only at a specified price or better. Limit orders also allow an investor to limit the length of time an order can be outstanding before being cancelled.

Locked Market - When both the inside bid and inside ask are identical, resulting in no bid-ask spread. This scenario occurs mainly in volatile and high volume trading. This abnormal market condition occurs mainly in NASDAQ and over-the-counter securities both prior to the market opening and throughout the day. NASDAQ rules require a market maker who locks a market to make reasonable attempts to trade with the market maker(s) it is locking prior to entering the locking quotation.

National Best Bid and Offer (NBBO) - The highest quoted published bid and the lowest published offer price among competing market makers in a security across different markets trading the same security.

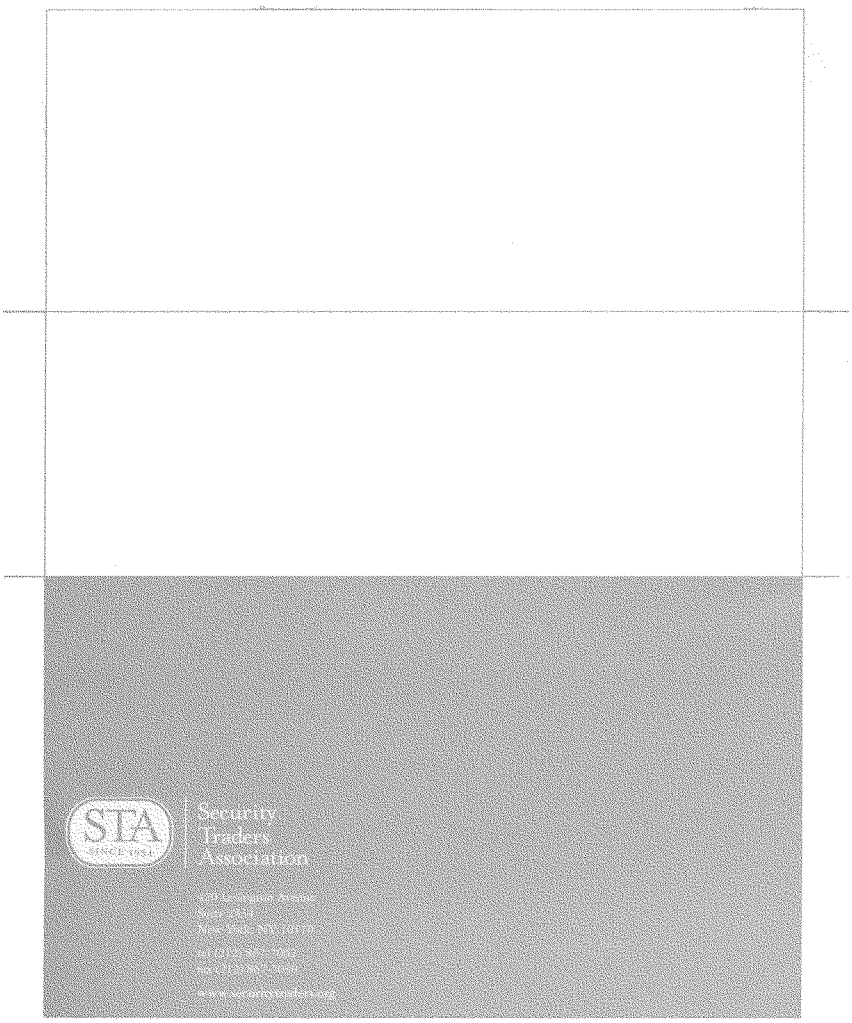
Sell-Side - Traders and the sales and research departments that sell securities and make recommendations to a broker-dealer's customers.

Specialist - A person on the trading floor of certain exchanges who maintains an orderly market for a security by bringing buyers and sellers of the security together and taking a position himself when necessary. There is usually one specialist for each stock traded on the NYSE, except for lower volume stocks.

Spread - The difference between the bid and the ask prices of a security or asset.

SuperMontage - A fully integrated order entry and execution system operated by NASDAQ for its members. The SuperMontage system is designed to be more accurate and efficient than predecessor systems.

Two-Sided Market - A market where both bid and ask prices are quoted.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Association

John Giesea
President and Chief Executive Officer
Security Traders Association
Responses to
Questions by the Honorable Ruben Hinojosa

House Financial Services Committee
Subcommittee on Capital Markets
Oversight hearing on Capital Markets II
October 30, 2003

One of the keys to market structure is modification of the "trade-through" rule, which currently prevents market participants from trading a New York Stock Exchange stock at anything other than the so-called "best price" – thereby denying some customers from accepting a lesser price in return for speed, certainty or anonymity. I would like to ask each panelist if you would recommend that the rule be modified, and if so, how?

The Intermarket Trading System ("ITS") for listed stocks was implemented in 1978, but its rules, such as the trade-through rule, have not been sufficiently modernized to allow market participants to take advantage of technological advancements. For example, the trade-through rule requires an ITS participant to send an order to another market if such market has a better price for that stock. The rule, however, allows an ITS market participant to wait as long as thirty seconds – an eternity in today's active, volatile markets – to respond. Since the trade-through rule focuses only on the best price, it does not allow for other types of trade execution preferences such as those you point out.

Investors should be afforded the right to determine their own standards of best execution for their orders. As you correctly point out, some investors may at times place a higher priority on speed or certainty of execution, rather than focusing only on the best price. Investors are now able to better assess whether they are receiving best execution according to their particular needs. For example, Rules 11Ac1-5 and 11Ac1-6 require broker-dealers to disclose their statistics of price and speed of execution as well as their order routing practices. This information can help investors determine whether a broker-dealer's execution statistics are consistent with their values of best execution.

The SEC recently granted a temporary *de minimis* exemption to the ITS trade-through rule for transactions in certain exchange-traded funds ("ETFs"). The rule exempts transactions of these ETFs from the trade-through rule so long as they are executed at or within three cents of the best bid and offer. The STA, in its White Paper[1], recommended connectivity standards that would include automatic, or immediate, execution capability. We feel that perfect connectivity would mitigate the need for a trade-through rule. Absent such linkage, a change to the current ITS rules would appear in order, resulting in some form of trade-through rule.

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[1] Security Traders Association Special Report, "Fulfilling the Promise of the National Market System: STA's Perspective on U.S. Market Structure," August 2003, pg. 7.

Market makers or specialists play an important role in the capital markets by committing capital to execute investors' trades when there is not a natural buyer or seller. How does this role lead to facilitating the capital formation process? How does this role benefit the US economy in general?

As you correctly note, market makers and specialists play a particularly important role in providing the market with necessary liquidity, especially for the efficient trading of less active stocks which are usually those of smaller companies. It should also be noted that these liquidity providers become even more valuable during a stressed market condition by adding liquidity that otherwise would not exist. In the less active stocks buyers and sellers are not always immediately available, and thus the liquidity provided by market makers and specialists becomes critical. This also has important implications during a stressed market condition, whether it is a stock specific or general market condition.

Liquidity allows an investor to get into and out of an investment quickly with little price impact. As a result, traders and investors are attracted to liquid markets. Market makers and specialists provide the liquidity needed in the market, especially for the smaller issues, by stepping in and risking their own capital to ensure that an investor may trade on demand. As a result, the prices of these stocks are not negatively impacted due to a lack of natural buyers or sellers.

An efficient capital formation process encourages economic and job growth. Market makers and specialists support the capital formation function by providing efficiency and depth of liquidity to the markets. The stability market makers bring to the markets encourage small companies to consider growing their businesses by accessing the equity capital markets.

Small companies are an important and significant part of the US economy. For example, the Small Business Administration indicates that small businesses employ 39 percent of the high tech workforce, account for 60 to 80 percent of net new job growth annually, and produce 13 to 14 times the number of patents per employee than large firms.[2] As more small companies access the capital markets through IPOs or secondary offerings, they are able to make investments in technology and other capital improvements, providing further economic and job growth. But if liquidity is lost and other impediments to the capital raising process are erected, segments of the economy dependent upon such capital may potentially stall. In addition, if only order-matching systems were used to match buyers and sellers, wider spreads would result (particularly for less actively traded stocks) if there were no natural match. This would increase an investor's liquidity risk, and ultimately degrade the capital formation process.

What are your views on the SEC's proposed short-sale rule? What impact would it have on market makers?

The STA specifically recommends in its recent White Paper that the SEC "mandate the adoption of consistent, standardized trading rules, such as the short sale rule, among markets

[2] Office of Advocacy, Small Business Administration, http://www.sba.gov/advo/stats/sbfaq.html#q2

trading like classes of securities".[3] The SEC's proposed new short-sale rule, Regulation SHO,[4] would apply across all markets, thus fulfilling the goal of STA's recommendation. Consistent trading rules are especially important given the increase of Nasdaq stocks being traded on other markets. The proposed regulation would eliminate the possibility that market participants seek different regulatory standards for competitive reasons, rather than for the protection of investors' interests.

STA is pleased by the concept of having a rule that crosses markets, a clear step in allowing investor protection. We also think the Commission makes an important statement in its recommendation of eliminating the bid test for the most active (300) companies. This recognition that all stocks are not alike makes an important distinction, which has other implications in forming market structure initiatives going forward.

Currently, bona fide market making in Nasdaq securities is exempted from the NASD's bid test short sale rule. The proposed rule, however, would eliminate the market maker exception from the uniform bid test. Market makers have important responsibilities to stand ready to buy or sell stock whenever an investor wants to execute a transaction, thus providing valuable liquidity to the markets. They provide immediacy of executions, which help to offer continuity and stability to the markets. The current market maker exception from the bid test allows market makers to fulfill this stabilizing function and facilitate the efficient execution of investors' order.

While STA appreciates the Commission's rule proposal, we have not taken a formal position at this point. As noted previously, our interest in maintaining a market maker exemption is quite high, as we believe it an unfair burden lessening liquidity if it is removed.

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[3] Security Traders Association Special Report, page 7.
[4] Securities Exchange Act Rel. No. 34-48709 (October 28, 2003), 68 FR 62972 (November 6, 2003).

Market Structure and the Trade-Through Rule

At the New York Stock Exchange (NYSE), we firmly believe that the trade-through rule is the cornerstone of our National Market System (NMS). The trade-through rule is all about treating investors fairly. Its objective is to foster competing markets on the one hand, while ensuring that investors will not be disadvantaged by virtue of having their orders displayed in one market versus another.

If you have an order at the NYSE to buy XYZ at $20.00, and it trades in Chicago at $19.90, then your order has been traded through. Under such circumstances, several things have happened: 1) the seller did not get the best price in the market; 2) more relevant to the trade-through rule, the highest bidder did not get to purchase the shares; and 3) the trade-through resulted in the company's shares being mispriced.

The trade-through rule protects investors by providing that a market that executes an order at an inferior price must satisfy investors displaying better prices in other markets. It has the practical (and desirable, effect of directing investors' orders to markets that offer the best prices and, in so doing, incents competition among markets to establish efficient prices.

We believe that the NYSE has a market advantage that has nothing to do with the trade-through rule. It derives from investors embracing the NYSE's value proposition based on: 1) the best price; 2) the highest fill rates; 3) the lowest cost of trading; and 4) the greatest choice of order execution alternatives.

As to price, the NYSE has the best bid and offer 94% of the time and not by a penny or two. In the 100 most-actively-traded stocks, the NYSE's prices are an average of 12 cents per share better than the competition.

As to certainty of execution, the NYSE has by far the highest fill rates through the Inter-Market Trading System, while the electronic markets' rates are among the worst.

In terms of speed, NYSE Direct+ offers an electronic order execution in 1.1 seconds. Interestingly, with regard to investor preference, while 75% of NYSE orders are eligible for Direct+, only 6% actually choose to execute that way. While that makes the NYSE by far the largest Electronic Communications Network in listed stocks, it also demonstrates that raw speed is not terribly high on most investors' wish lists.

Finally, eliminating or diluting the trade-through rule would have several serious consequences. It will uncouple the nation's stock markets, licensing each market to ignore better prices in other markets. Investors whose orders are traded through will quickly perceive that they are not being treated fairly, and will lose confidence in the system's ability to meet their needs. The U.S. securities markets will become less efficient. Indeed, only an inefficient market structure would give rise to a trade-through in the first place. If the U.S. securities markets are to become less efficient, then not only do we fail in our primary mission of efficiently allocating capital, but we also run the risk of failing in the global competition that the U.S. capital markets face on a daily basis.

Instinet Group CEO Edward J. Nicoll
Response to Question submitted by Hon. Ruben Hinojosa

"Would you recommend that the [trade-through] rule be modified, and if so, how?"

Instinet supports the complete repeal of the so-called "trade through rule."

The NYSE enjoys a monopoly on trading NYSE listed securities. But as recent events indicate, this monopoly may have harmed investors.

Past experience shows us how to solve this problem. We must identify and eliminate barriers to competition.

In the case of the NYSE, the single greatest barrier to competition is the trade-through rule. The overall effect of the trade-through rule is to undermine the competitive advantages of an electronic marketplace – speed and certainty of execution.

Those who would preserve this regulatory advantage for the NYSE make two basic arguments in defense of the trade-through rule.

First: consumer protection. Defenders of the status quo argue that the trade-through rule ensures that investors will receive the "best" price.

But then how do you explain the superior execution quality in the NASDAQ market where there is no trade-through rule? Indeed, SEC mandated statistics indicate that overall execution quality for investors is higher in NASDAQ-listed stocks like Microsoft where there is no trade-through rule, than it is for IBM and other NYSE-listed securities, where the rule is in place.

One of the reasons that investors still receive quality executions in NASDAQ stocks is that brokers have a duty to get their customers best execution. In fact, due to the existing broker duty of best execution, the trade-through rule is unnecessary and, ironically, actually contributes to investors receiving inferior prices by inhibiting competition.

The second defense of trade-through is that there is nothing wrong with the short delay that it engenders if investors receive a better price. But this supposed trade off between speed and price is based on a faulty premise.

And that is that the "best-advertised" price is the "best" price. But this is often not the case. As I discuss in my written testimony and in the attached documents, it is often the case that investors will end up with a worse price if they delay their execution attempting to chase the best-advertised price. Sure, if investors knew with certainty that they were going to get a better price in 30 seconds they would always accept the delay. The problem is that there is only the possibility of receiving a better price. If there is only a possibility, what should an investor do? The answer is: "It depends on the investor." Once again, investor choice and competition should be our guiding principles.

Moreover, the U.S. Securities and Exchange Commission has already provided us with a glimpse of what a more competitive future in listed trading would look like. Specifically, we have, in effect, been without the trade-through rule on three Exchange-Traded Funds – or ETFs – for over a year, including the most widely traded security in the country – the QQQ.

The SEC's 2002 decision to ease the trade-through rule on ETFs has been an unqualified success. It has fostered competition without producing any of the harmful effects that defenders of the trade through rule so often warn of.

As we have seen with NASDAQ and the options market, allowing any one market, especially markets with intermediaries that trade for their own account, to exercise monopoly control ultimately leads to abuse and increases transaction costs for investors. Competition, on the other hand, leads to narrower spreads, lower transaction costs, and investor choice. That is why we urge the repeal of the trade through rule.

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