REGULATION NMS: THE SEC'S VIEW

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES

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CONTENTS

	Page
Hearing held on:	
March 15, 2005	1
Appendix:	
March 15, 2005	31

WITNESS

TUESDAY, MARCH 15, 2005

Donaldson, Hon. William H., Chairman, U.S. Securities and Exchange Commission	14

APPENDIX

Prepared statements:	
Oxley, Hon. Michael G.	32
Brown-Waite, Hon. Ginny	34
Fosella, Hon. Vito	35
Gillmor, Hon. Paul E.	37
Hinojosa, Hon. Rubén	38
Kanjorski, Hon. Paul E.	40
King, Hon. Peter T.	41
Donaldson, Hon. William H.	42

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Donaldson, Hon. William H.:	
Written response to questions from Hon. Judy Biggert	80
Written response to questions from Hon. Ginny Brown-Waite	82

REGULATION NMS: THE SEC'S VIEW

Tuesday, March 15, 2005

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 10:13 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Ryun, Shays, Manzullo, Royce, Oxley, Fossella, Biggert, Kennedy, Tiberi, Barrett, Feeney, Hensarling, Davis of Kentucky, Fitzpatrick, Kanjorski, Ackerman, Sherman, Moore, Ford, Crowley, Israel, Baca, Lynch, Scott, Velazquez, Wasserman Schultz, and Maloney.

Mr. BAKER. [Presiding.] Good morning. I would like to call the meeting of the Subcommittee on Capital Markets to order.

Today, the committee meets to receive comments from the chairman of the SEC on a proposed initiative now under review known as Reg NMS.

I must confess to the committee that I do not come to this issue with my usual passionate neutrality. I have a predetermined perspective, and my testimony this morning will reflect that.

This is the committee's sixth market structure hearing over the past 18 months. Needless to say, we all understand that this is a vitally important subject for U.S. investors and the capital markets generally. Philosophically, I have always been a very market-based person and to support new regulatory intervention is something that should be viewed as a last resort in my opinion. This fundamental approach is particularly relevant when considering the issue before us today.

Reg NMS addresses four principal areas. Understandably, most of the discussion has centered on its one most controversial aspect, the trade-through rule. I have opposed the trade-through rule based on free market principles and have been an advocate for its repeal. It may have made sense at times in the past, but today it is a relic of a bygone era. I believe it to be basic protectionism, and in the 21st century, investors should be able to choose speed, anonymity and certainty over what is generally seen as an advertised, but not a guaranteed best price. I do not believe that choice should be taken away from the investors.

Moreover, the trade-through rule has not been enforced on a consistent basis. Indeed, the New York Exchange, the rule's most ardent supporter, is also one of the more frequent violators. The com-

mission has been presented with what I believe to be clear data supporting this claim, but is poised to act in the face of the clear facts to the contrary. The trade-through rule has certainly accomplished at least one thing. It has helped the New York Exchange maintain about 80 percent market share in listed securities. By contrast, the Nasdaq, which operates without such a rule, has about 20 percent market share in Nasdaq securities, with the rest divided up among INET, ARCA and others.

From this fact alone, it is clear who is subject to competitive forces and which market is protected. The bottom line is the trade-through rule is anticompetitive, anti-investor, and antiquated. So what is being proposed in the face of the evidence? Not to repeal it, but amazingly to extend it to other market participants as well. I cannot come to a conclusion that makes this suggestion make sense. In a very similar or basic observation, it is like selling your car and buying two horses, based on the view you will save money on parking fees. I would not think that a well-advised strategy.

The Nasdaq market has never been part of the inter-market trading system and therefore does not have a trade-through rule. According to some independent observers, it has developed into the most competitive marketplace for trading stocks. The Nasdaq has thrived since the adoption of the over-handling rules and the advent of ECNs in the late 1990s. Three major markets, INET, ARCA and Nasdaq all compete to trade the same securities without a trade-through rule. There are more limit orders with Nasdaq and roughly the same number of trade-throughs as compared to the listed markets.

Two arguments are offered by the SEC in support of the trade-through expansion: that the rule is needed to increase limit orders and to reduce trade-throughs, both laudable goals which I support. There is only one problem I find with the analysis: This plan will not achieve that end. It is as if 30 years of trading history mean nothing and 3 months of rulemaking is everything. Competition in Nasdaq stocks is intense. No market has more than 30 percent share, and the competition has been proven worthwhile for investors. As Matt Andresen stated before the committee last month, based on our own experience trading large volumes of both Nasdaq and listed equity securities, we believe strongly that execution quality of the Nasdaq is significantly better than that of the listed marketplace.

The commission justifies the re-proposed Regulation NMS with various studies conducted by the Office of Economic Analysis, known as the OEA. Several commenters have clearly outlined the basics which are flaws of these studies. That is, the analysis had a predetermined outcome to make the Nasdaq appear inferior in operations to the NYSE. As to the trade-through study, with the acquisition of brute technologies and the smart-order routing capabilities, Nasdaq has been able to lower trade-through rates in Nasdaq stocks from 2.5 percent in 2003 to the figure of 1.5 percent today.

In addition to many trade-throughs that were incorrectly accounted for as trade-throughs, actually involved lock and cross-market or block trades, according to one commenter, excluding large trades during cross-markets, the trade-through rate would

drop to .08 percent. Additionally, studies rely on stale quotes, which traders rightly trade through. If accessible quotes had been utilized and excluded stale quotes, the trade-through rate would have been even lower. Also, the OEA overestimated the shares traded-through by, including the entire size of the order that traded through when calculating the size of the trade-through, rather than the size of the displayed quote, which was actually traded through.

The OEA used a statistically biased example of 4 uncommonly volatile days. Even if 4 days were studied, the scope of the study is very limited. With regard to the match pair study, the study actually shows Nasdaq market quality is on par with the NYSE. Over one-quarter of the stocks in the sample are not eligible for NYSE listing, and only 10 percent are from the Nasdaq 100. The S&P Index study overstates the effective spreads of Nasdaq stocks and thus concludes that the Nasdaq has inferior execution, but the OEA employs a methodology that favors high-priced NYSE stocks and also uses statistics from a single month.

The volatility study includes results that at least one commenter has attempted and failed to be able to reproduce. The SEC's short-term volatility estimates are more than three-times higher than that of the Nasdaq, and even higher than those in an NYSE study upon which the SEC findings are based.

These are the four studies cited by the SEC to support the trade-through. For all the reasons I have outlined, I will follow our hearing today with a letter to Chairman Donaldson requesting information pertinent to these documents, and respectfully request the committee be granted sufficient time to review the information before the Commission moves to final promulgation.

In addition to the flawed studies, there is nothing even approaching an industry consensus on the advisability of expansion of the trade-through. Market participants including, but not limited to, Nasdaq, Instinet, ARCA, TIAA-CREF, Bloomberg, Fidelity, Schwab, Ameritrade, UBS, Morgan Stanley, J.P. Morgan Chase, I-Trading and Securities Traders Association have all openly opposed extending the flawed regulation to the Nasdaq marketplace. We should not be imposing new regulatory regimes under these circumstances.

Along with substantive concerns, the process itself has troubled me. When the original NMS was issued, the Commission requested public comment, whether there even ought to be a trade-through. The comments ran, from reports, about three to one against the trade-through in any form. So how does it make sense to not only keep it, but now extend it? Further, the re-proposal was issued 90 days ago, and appears to be on the verge of adoption. As you contrast this with the process for the Nasdaq to have its exchange application considered, it was filed in March 2001 and yet there is no action to move forward on that application.

There are recommendations now pending that the Commission adopt which equate to the most sweeping reforms our markets have experienced in 30 years, resulting from only a 3-month public comment period. I do not understand why the SEC has disregarded the results of its own ETF pilot fashioning Regulation NMS. Under the pilot, the SEC granted a deminimus exemption to current

trade-through rules for three ETFs. Never has the trading been more liquid and efficient. It has been an overwhelming success by any measure. Indeed, it accomplished everything trade-through opponents predicted it would, but the Commission has ignored this result.

Paradoxically, less than 2 weeks before the SEC proposed Regulation NMS where it extends the trade-through to Nasdaq, it extended for a third time the terms of this pilot that technically removes the trade-through. I am not aware of any public adverse comment concerning the success of these pilots or their continuing extension. It appears the Commission is having it both ways: on the one hand saying that a trade-through is needed throughout the market; and on the other, removing it from the trading of certain securities. This needs to be made clear.

When Congress created the National Market System in 1975, the stated congressional intent was to ensure economically efficient execution of securities transactions and fair competition among brokers and dealers, and between exchange markets and markets other than exchange markets. Any fair reading would suggest that Reg NMS with its preservation and expansion of the trade-through rule is inconsistent with these underlying principles.

Regrettably, I feel I must say it. Regulation NMS ranks up there with the worst public policy I have seen proposed for the securities markets in my tenure in Congress. I would hope that there would be serious consideration, at least to some of the concerns I have recited, before the Commission acts in this matter. I sincerely do appreciate the Chairman's willingness to appear here today to listen to our concerns and make comments as to the direction the Commission may take. I hope we are able to work together going forward to address the concerns raised.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Chairman, we meet once again to discuss the important issue of the regulation of our capital markets generally, and the trade-through rule specifically. This time we will hear again from the chairman of the Securities and Exchange Commission.

The ongoing deliberations over our national market system have engendered strong emotions and considerable debate. As my colleagues already know from our extensive investigations into these matters, market structure is also an extremely complex subject.

We are, Mr. Chairman, at a crossroads. A variety of agents in our equity markets have questioned one or more aspects of the regulatory system governing our national markets during the last several years. Technological advances and competitive developments are also forcing us to confront a number of important decisions.

During his previous testimony before our panel concerning these matters, SEC Chairman Donaldson noted that in pursuing any plan to fix those portions of the national market system experiencing genuine strains, we must ensure that we do not disrupt those elements of our markets that are working well. Chairman Donaldson knows that I share his views in these matters. We should not pursue change for change's sake.

In his recent testimony before the Senate Banking Committee, Chairman Donaldson also offered some insights into the Commis-

sion's deliberations regarding its broad set of proposals to update the regulatory structure of our stock markets. He focused his comments last week on the trade-through rule. In particular, he noted that the regulation advances three important policy goals: it ensures best execution; it promotes fair and orderly markets to get the best price; and it advances market depth and liquidity.

Chairman Donaldson will, as I understand, expand on those views today by providing us with more analysis and detail about his thinking regarding these matters. In his comments today, I hope that Chairman Donaldson will once again express his support for the trade-through rule. From my perspective, this standard is one area of our regulatory structure that has worked well for nearly three decades. As one of the foundations of our national market system, this rule has ensured that all investors get the best price that our securities markets have to offer regardless of the location of a trading transaction.

Today, I also suspect that many of my colleagues will focus on the Commission's newest proposal to alter the trade-through rule when asking questions of Chairman Donaldson. In addition to applying the trade-through rule to all securities marketplaces, the Commission's latest plan for updating the national market system includes two alternatives for implementation: the market best bid or offer alternative and the voluntary depth alternative.

The voluntary depth alternative would almost certainly result in only one way for markets to differentiate themselves, namely, how much they are willing to pay other market participants for their order flow. In my view, promoting competition based on payment for order flow will prove detrimental in the long term to average retail investors because of the conflicts of interest it creates. This issue is one that the Commission should carefully study.

The incremental approach contained in the market best bid or offer alternative is therefore the preferable option going forward. The adoption of this alternative will also help to ensure that the United States maintains its global leadership in our financial markets.

In closing, Mr. Chairman, it is my very strong hope that the Commission in working to finalize any changes in the market structure rules will make certain that any regulation it promulgates will provide an improvement over the existing regulatory regime and protect the interests of retail investors.

I look forward to receiving the testimony of Chairman Donaldson.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 40 in the appendix.]

Mr. BAKER. I thank the gentleman for his statement.

Chairman Oxley?

Mr. OXLEY. Thank you, Mr. Chairman.

Chairman Donaldson, welcome back to the committee. In case you do not get enough of us today, you will be coming back for more when you return in April to talk to us about Sarbanes-Oxley. We look forward to having you there again.

Today, our topic is Reg NMS, and I want to begin by commending Chairman Baker's outstanding leadership on the important and difficult issues raised by the proposal before us today,

Regulation NMS. I have found the Financial Services Committee's five previous hearings on this Securities and Exchange Commission initiative to be extremely informative. I am only sorry that I missed the famous hearing in New York. Perhaps we could have an instant replay of that at some point.

The threshold questions for me are, what kind of marketplace do we want to create for the 21st century? And in what direction do we want the markets to go as they evolve and adapt to technology?

My approach to these complex issues is governed by the belief that Congress should work to reduce or eliminate any regulatory advantages that inhibit competition and artificially preserve market share. As an advocate of free markets, I believe that we should move the National Market System toward more robust competition, more investor choice, and greater investor protection. Of course, we must be guided by best execution for the investor. If an investor misses the best price, that is not best execution. If a trade cannot be completed, that is not best execution.

At the subcommittee's spirited hearing last month, six major market participants, Nasdaq, Instinet, Bloomberg, Knight, Schwab, and Citadel, all expressed opposition to the portion of the Reg NMS proposal that would preserve and expand the trade-through rule. As a matter of applying free-market policy, I share that view. While the trade-through rule had its purpose in an earlier era, today's technology has rendered it regulatory and anti-competitive. As I discussed at the last hearing, let's remember the broker's fiduciary duty to obtain best execution of his clients' orders is a more efficient way of ensuring investor protection.

Therefore, it does not make sense, it seems to me, to extend the trade-through rule to the Nasdaq market, which has operated efficiently and competitively without it. I can think of no compelling reason to expand the rule, with its associated and quite significant compliance costs, to the vibrant Nasdaq marketplace.

If the SEC were to modify the proposal so that the trade-through rule is not expanded, that is an outcome that I think most interested parties could support. It strikes me as a sensible compromise that would improve the status quo. A final rulemaking that resists the urge to over-regulate the Nasdaq market would include significant improvements over the existing regulatory structure. The Reg NMS trade-through provision as applied to only exchange-listed stocks would be more enforceable than the current rule and would recognize the difference between automated and manual markets.

Reg NMS, as modified, would encourage the New York Stock Exchange to continue to modernize its market. The hybrid proposal crafted by the exchange is an important step in this direction. I want to commend John Thain for his leadership and vision. I know he is committed to serving investors in this age of rapidly changing technology.

We are nearing the end of a long process. I would like to commend the Commission and its staff for their hard work over the past several years. This is a difficult and complex area, and I certainly recognize the good intentions and good will of people on all sides of this important issue.

Mr. Chairman, I thank you again for your leadership and I yield back.

Mr. BAKER. I thank the Chairman.

Mr. Ackerman?

Mr. ACKERMAN. No, thank you.

Mr. BAKER. Mr. Ford?

Mr. Crowley?

Mr. CROWLEY. Thank you, Mr. Chairman.

I would like to thank Chairman Baker and ranking member Kanjorski for holding this hearing today on Reg NMS. I also want to welcome Chairman Donaldson here today who will discuss with us where the SEC is in their process of completing Reg NMS and how they plan to modernize and strengthen the regulatory structure of the U.S. equity markets.

The Chairman and I were able to speak briefly privately a few weeks back where I expressed to him my concerns about the SEC's proposed voluntary depth alternative. Without getting into depth here on the subject, I do hope that in the final rule this voluntary depth alternative will be rejected.

Additionally, I welcome the discussion of applying the market BBO alternative across all markets and to all NMS stocks, under the guise of ensuring that investors will be treated the same regardless of the stocks they are trading. While I know some argue that the trade-through rule is antiquated and impedes competition by forcing their businesses to operate at the speed of the slowest market, I disagree.

I agree with your comments before the Senate Banking Committee on the 9th of this month where you stated, "The trade-through rule is designed to promote fair and orderly markets and investor confidence by providing greater assurance that limit orders displaying the best prices are not bypassed by trades at inferior prices."

Additionally, I was concerned with the comments in your prepared testimony for this morning whereby you reference an SEC staff study found that trade-through rates are significant for Nasdaq stocks; that approximately 98,000 Nasdaq trades per day receive a price that is inferior to a displayed and accessible quotation. I share your concerns that thousands of retail investors each day may unwittingly be receiving an inferior execution of their orders in the Nasdaq stocks.

I also agree with your testimony whereby you stated, "The relevant data does not support any sweeping claim that trading in Nasdaq stocks now is generally more efficient than trading in the New York Stock Exchange stocks."

Finally, I believe that if the SEC does not apply the trade-through rule across all markets, regulatory arbitrage will be the result. While professional traders will profit in a market with no prohibitions, those profits will not be passed on to our consumers. This issue is about the uniformity of markets. If price protection is good for investors trading General Motors on the New York Stock Exchange as a New York Stock Exchange-listed stock, then it should also be extended to investors trading Microsoft, a Nasdaq-listed stock. Again, this highlights the need for the extension of the trade-through protections to all U.S. equity markets. The trade-through rule has helped smaller investors smooth the path from Main Street to Wall Street.

Finally, Mr. Chairman, in the Chairman's opening statement, I would appreciate him, if he could, comment on his thoughts on the New York Stock Exchange's hybrid proposal and if he believes it represents a dramatic and positive change; and is it consistent with the principles behind Reg NMS? The hybrid model demonstrates that once approved, the New York Stock Exchange will marry the best of electronic trading and the auction market. Investors will have choices. If they want speed, certainty and anonymity of execution, they will have it. If they want the opportunity for price improvement, they will have that as well.

I look forward to your testimony, Mr. Chairman, this morning. With that, I yield back the balance of my time.

Mr. BAKER. I thank the gentleman.

Mr. Ryun?

Mr. RYUN. Thank you, Mr. Chairman. I appreciate your scheduling this hearing to discuss the important issue of market structure, and specifically the SEC's proposed Reg NMS.

Chairman Donaldson, thank you for being with us today. We look forward to hearing your expertise on this particular issue. I look forward to your unique perspective on the pending proposal. I am especially interested to hear your thoughts on the merits of expanding the trade-through rule to the Nasdaq.

While I certainly support the careful governance of the securities industry and am mindful of the oversight of Congress and this panel, I am generally inclined to only look for additional government intervention or regulation when something is not functioning properly.

There is an old adage that says if it is not broke, don't fix it. I am afraid that expanding the trade-through rule at this time could be failing to heed that advice. It seems to me the Nasdaq market has functioned quite well without the rule and I am curious about the reasons that the SEC would look to expand that rule now.

I applaud the New York Stock Exchange for the steps it has taken to modernize its marketplace. I am also pleased to see the other items and the Reg NMS that they are widely agreed upon. However, I am afraid that expanding the controversial trade-through rule without allowing the changes that without wide support would be implemented, that could lead to problematic results.

I also feel that it would be prudent to allow the New York Stock Exchange's new hybrid system some time to operate before injecting another dramatic change into the marketplace. I look forward to your thoughts and your expertise on these issues, and I yield back my time.

Mr. BAKER. I thank the gentleman.

Mr. Israel?

Mr. ISRAEL. Thank you, Mr. Chairman.

Obviously, we have already heard quite a diversity of opinion on the trade-through rule, so let me offer my own as briefly as I can.

Let me begin by welcoming Chairman Donaldson and stating that I certainly appreciate the importance and the enormity of the task that the SEC has undertaken. Clearly, our markets must be modernized if they are to maintain their status as the most competitive and most dynamic in the world.

I do, however, have several significant concerns about the regulation as proposed, and also regarding recent movement to change the application of the trade-through rule. In the past in this committee, I have gone on record expressing my reservations about the proposed virtual consolidated limit order book structure, and those reservations still stand.

However, I do want to weigh in on the conversation that we have already had today about the importance of maintaining the integrity of the trade-through rule. I fear that any weakening of the trade-through rule would take away investors' assurances that their representatives are working to execute their trades at the best price. As we are all aware, the difference between the best price and the second-best price can be very significant, more than four cents per share for the S&P 100 stocks listed on the New York Stock Exchange.

These additional expenses would affect all investors large and small. But the brunt of them would be borne by small investors who are less able to monitor closely execution costs and to question their brokers or agents about prices received. Investors deserve and demand the highest quality order executions and the best price on all transactions.

I want to emphasize the word "all," as I am concerned by recent talk of a carve-out for the Nasdaq. Simply put, I believe that the trade-through rule is good for investors and therefore all investors deserve the benefits of it, whether the stocks they seek to purchase are New York Stock Exchange-listed or Nasdaq-listed.

I want to particularly note that I believe that one of the strongest protections available today is the ability for investors to be made whole when a trade-through occurs. Today, this protection is available on the New York Stock Exchange, but not on the Nasdaq where there is no trade-through rule. The SEC's current proposal to extend this protection to investors in Nasdaq-listed securities makes sense, and I would strongly urge us not to yield to recent calls to create a Nasdaq carve-out.

The New York Stock Exchange has been the most prominent symbol of capitalism in the world. I believe that seeking to emulate its reputation for transparency in all transactions and ensuring the best price for all investors, large or small, at all of our markets can only improve our national economy.

I look forward to a continuing discussion of these and other issues. Thank you, Mr. Donaldson, for joining us today, and I yield back the balance of my time.

Mr. BAKER. I thank the gentleman.

Ms. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman, for holding this very important hearing today.

Thank you, Mr. Donaldson, for being here today.

As we all know, the Securities and Exchange Commission is charged with protecting investors and maintaining the integrity of the securities market. Today we will examine whether a proposed rule by the SEC follows the SEC's mission and vision. As we conduct an analysis of the proposed rule, let us keep in mind that the Government is not in the business of innovation. Innovation is

birthed out of the genius of our entrepreneurs and market participants. It is a response to investor demand.

I am pleased that the SEC has moved forward with its work on this regulation, and I would argue that probably 90 percent of the proposal would benefit our markets, market participants and investors. I also believe that the SEC should approve the New York Exchange's hybrid proposal. However, I cannot at this time understand the rationale for the trade-through rule that we have heard so much about.

I understand that the vast majority of the Commission is not in agreement over the rule and the rule has sparked healthy discussions and debate, but it appears that the critics' view of the rule is unnecessary at this point in time. It has been brought to my attention that some of the SEC intends to apply the trade-through to the Nasdaq marketplace which currently has no trade-through rule, as well as the New York Stock Exchange, which currently does have the rule.

As the SEC's statistics show, there are only a small number of trade-throughs in the Nasdaq marketplace, about 2.5 percent of the trades. More than half of these trades, though, are outside the quote for only one penny per share, and the Nasdaq market is already dominated by limit orders. In addition, Mr. Chairman, I am concerned that the trade-through rule would not enhance competition in the marketplace or prove effective in any way. I understand that the SEC has worked on this issue for quite some time, but I also understand that the broader mission of the SEC, this committee and Congress should be first and foremost to uphold free market values: competition, rules that are fair, and effective enforcement of those rules because that is what makes America the most economic leader in the world.

In this vein, I have great concern about the anti-competitive nature of the trade-through rule. The Nasdaq market is exhibit number one on why we do not need the Government-mandated trade-through rule. Operating without trade-through, it is a fiercely competitive marketplace that provides investors with superior trade execution. Equally important, we should ensure that the investors are protected. Market participants are charged with the mission of providing investors the best possible service. Investors should be able to trust the systems and businesses in which they can easily and intelligently invest and move their money.

A modernized U.S. market structure should enhance competition, foster the development of safe and sound business products and practices, allow for innovation, and maintain an efficient and transparent system.

I look forward to hearing from our witness today regarding Reg NMS and how elements of the current proposed regulation will foster or hinder competition in the U.S. equity markets.

Thank you very much. I yield back.

Mr. BAKER. I thank the gentlelady.

Mr. Scott?

Mr. SCOTT. Thank you, Chairman Baker.

Good morning, Chairman Donaldson. It is good to have you before the committee once again to discuss the Securities and Ex-

change Commission's proposal to modernize the national market system.

I understand that the proliferation of electronic computer networks have changed the way that investors trade in the markets, which is the reason the SEC needs to update the current national market system. The witnesses from the hearing held last month provided a wide range of opinions on the best approach for assuring inter-market price protection. The SEC has heard comments on its proposed rule from more constituencies than have appeared before this committee.

So I look forward to your testimony to better understand how the SEC is balancing the often-contradictory comments about the proposed rule. One question that I would like to focus on today is, if the ultimate policy decision is to try to strengthen and expand existing trade-through protection, would not it make sense to do so in an incremental fashion?

Also, I would like to weigh the potential costs to participants in relation to the benefits that these new rules would provide to the markets. As this committee reviews these proposed regulations, we must keep in mind the need to have an efficient national system that provides the best prices for a wide variety of investors. Considering the concerns with inadequate retirement savings of Americans, this rule should certainly protect the interests of long-term investors.

So I look forward to your testimony today and certainly getting involved in some of these important questions and getting your very important answers.

Thank you, Mr. Chairman.

Mr. BAKER. I thank the gentleman.

Mr. Barrett?

Mr. Davis?

Mr. Fitzpatrick?

Does another member have an opening statement? Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman. Mr. Chairman, thank you for holding this hearing. This is an important matter that deserves the attention that you have given it.

I also want to welcome Chairman Donaldson to this committee and take a minute to express some concerns that I have about the SEC's currently proposed Reg NMS. Clearly, this is a controversial matter among many well-established and well-respected parties in the market who represent a wide variety of both small and large individual and institutional investors.

It is my hope that any final rule issued by the SEC might achieve greater consensus among the Commissioners with every commissioner's concerns being properly considered. While I understand that consensus does not come easy, I hope that we are not again looking at another three-to-two vote on a matter of this magnitude.

As I have mentioned before in this committee, I continue to have great concerns about any expansion to other markets of a rule that appears to be antiquated and the potential impact that further regulation might have on private sector innovation. Since an investor

has a 98 percent chance of not being traded through, I hope we are not considering a remedy in search of a problem.

I hope this debate continues to focus on what might strengthen competition, and thus what is best for the American investor.

Thank you, Mr. Chairman. I yield back.

Mr. BAKER. I thank the gentleman for his statement.

Ms. Velazquez?

Ms. VELAZQUEZ. I have no statement.

Mr. BAKER. Thank you.

Mr. Lynch?

Mr. LYNCH. Thank you, Mr. Chairman.

Thank you, Chairman Donaldson, for being here today to help this committee with its work and discuss Reg NMS. I appreciate the efforts that you have put in to restore and maintain the integrity of the financial markets.

I also want to thank the Chairman and the ranking member for holding the hearing today, which is just one in a series of hearings focusing on the potential impact of Reg NMS proposals.

Chairman Donaldson, there are a number of issues that I hope that your testimony will address today. I hope that we come away from this hearing with a clear understanding of the goals of the SEC in moving forward with this proposed change to the national market system. I appreciate the SEC in taking a thoughtful approach in addressing these issues.

When dealing with matters like this that are so complex, I think it is critical that all parties come to the table and talk through the potential impacts of such rule changes, especially ones that will have a broad-based impact on the financial markets. I believe through this series of hearings, the committee will establish an important forum for such discussions to take place.

I hope above all that the SEC will be sensitive to the concerns that are raised in these hearings, and that they will pay attention and will move forward thoughtfully and work toward developing a consensus approach to the controversial issues on the table.

Chairman Donaldson, it is my understanding that the SEC views the current trade-through rule as outdated. I understand that, but I am interested in learning from you today whether you believe that there is value in the SEC moving forward incrementally, rather than in one swell swoop. Just last week, Commissioner Atkins delivered remarks to security traders in my district in Boston expressing his view that the concern about unintended consequences is justified, given that there "has never been a trade-through rule on Nasdaq and the trade-through rule has never been enforce in exchange-listed markets," close quote. He went on to ask if "we are putting at risk the world's best security markets."

Chairman Donaldson, I am very interested in hearing your response to the concerns raised by Commissioner Atkins. Specifically, I am interested in learning more about the deliberation process for the scope of the rule. Did the SEC, for example, consider trying a pilot version that would apply only to the New York Stock Exchange or some subset of the markets? It would seem to make sense for us to determine the potential impacts of these changes on a smaller scale before engaging in a broad-based expansion on all markets.

With that approach, we could minimize the unintended consequences and the potential disruption to the financial markets. If a pilot program has not been previously considered by the SEC, I would like to hear from you in your testimony whether this is something that the SEC is willing to look at.

In a related area, I understand that the New York Stock Exchange is in the process of expanding the New York Stock Exchange direct, to expand the availability of automatic execution of limit orders without human intervention. I would be interested also in learning more about this hybrid market and how it will be impacted in Reg NMS.

Again, Mr. Chairman, I want to thank you for your willingness to come here before this committee to help us with our work. I hope that many of the questions that we raise here today will eventually be answered. Thank you for being here today.

Thank you. I yield back, Mr. Chairman.

Mr. BAKER. I thank the gentleman.

Mr. Tiberi, did you have a statement?

Mr. Fossella?

Mr. FOSSELLA. Thank you, Mr. Chairman.

Since the start of the SEC's proposed Regulation NMS, it was clear that the cornerstone of debate would be centered on the trade-through rule. Although at first glance it would appear obvious that an investor large or small should get his or her order filled at the best price available, we learned that there is a lot more to this debate than just getting the best price. With new technologies, three other variables have become increasingly important: speed, certainty and size of execution. In fact, these three variables have been what have driven debate to the point of SEC action.

The trade-through rule was established, an ITS rule, in an effort to both increase the connectivity between and among markets and to ensure that traders captured the best available execution price for their clients. Thus, if a broker on the floor of the Boston Exchange needs to buy 2,000 shares for a client, if the national best bid or offer is at the Philadelphia Exchange, the rule forces the broker to execute at the Philadelphia Exchange so that the investor is assured the best representation.

The result was a national market system with competition and order competition throughout. While this rule was clearly of good intentions when first implemented, as the Nasdaq and ECN grew, an increased number of market participants found that the internal rules of the four base exchanges, particularly the New York Stock Exchange, prohibited them from obtaining the best price for their clients or investors. The first of the rules allows a specialist to hold an order up for 30 seconds before confirming or denying order execution. The second limits the size of an order that can be sent through the New York Stock Exchange electronic order submission to no more than 1,099 shares.

With these rules in place, I agree that a trader sitting at a trading desk outside the walls of the New York Stock Exchange has every right to be frustrated when they could be executing a trade immediately with certainty of execution in whatever size is available, but instead must either break the order up into lots of 1,099 shares, or hire a representative on the floor of the exchange who

can execute the size their client is looking for. In one simple method, Reg NMS will eliminate the limitations experienced by traders outside the walls of the four base exchanges, allowing them to build and operate a marketplace with speed, certainty and size.

In addition, Reg NMS allows investors not wanting to participate within a slow quote to trade around that quote. With the elimination of these rules, the trade-through rule will once again work in favor of the investor, with increased enforcement from the SEC.

Finally, I believe the trade-through under Reg NMS when properly enforced will be a net plus for both the confidence of the individual investor that has grown skeptical of Wall Street during the past 5 years, and for the confidence of foreign investors who desire to invest money in the United States. The influx of capital from foreign investors has doubled over the past decade, and while likely to continue to increase as foreign countries become wealthier and as foreign companies decide to access U.S. capital by listing on the U.S. exchanges, I believe it is important that the United States provide a vibrant marketplace where all investors in all companies looking to participate in them can do so with confidence that there are regulatory backstops in place to protect them from being unfairly disadvantaged.

In conclusion, I want to thank Mr. Donaldson, and I want to thank the SEC for their efforts. I think the staff has found a good balance in these proposals. It would open up the marketplace to competition, while maintaining principles that ensure the investor remains protected.

Thank you. I yield back.

Mr. BAKER. I thank the gentleman.

Mr. Moore? Mr. Moore stepped out.

Mr. Baca?

If no member seeks recognition for purposes of an opening statement, at this time I would like to turn to our witness today, Mr. William Donaldson, the chairman of the Securities and Exchange Commission.

Your formal statement will be made part of the record. Please proceed at your own leisure, sir.

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

Mr. DONALDSON. Chairman Baker, ranking member Kanjorski and members of the subcommittee, thank you for inviting me to testify today on proposed Regulation NMS.

All of the proposals included in Regulation NMS are designed to benefit and protect investors in the U.S. equity markets and to facilitate efficient capital formation by modernizing and strengthening the national market system. The national market system encompasses the stocks of more than 5,000 listed companies which collectively represent more than $14 trillion in U.S. market capitalization held by investors.

The commission is committed to assuring that investors and public companies have the fairest and most efficient markets possible for the these stocks. I welcome your continuing interest in an issue of such vital importance to investors and the economy.

Given where we are in the process of considering Regulation NMS, my testimony today reflects my own views and not necessarily those of my fellow commissioners. In this regard, I must point out that the Commission and its staff are currently in the final stages of deliberation on the NMS proposals and the individual commissioners continue to weigh the complex policy considerations presented by the proposals. I have not reached a final judgment on how to balance these considerations myself.

Regardless of what the Commission ultimately decides, this subcommittee and the public should have full confidence that the Commission has systematically and responsibly analyzed the relevant data and carefully considered the views of all commentators.

Hopefully, my testimony today will convey some measure of the enormous amount of careful consideration that the Commission has devoted to these issues over the last several years, and indeed continues to devote today. In my written remarks, I have described this intensive and comprehensive process. Prior to formulating the specific Regulation NMS proposals, the Commission's review included multiple public hearings and roundtables, an advisory committee, three concept releases, the issuance of temporary exemptions intended in part to generate useful data on policy alternatives, and a constant dialogue with industry participants and investors.

This process continued after the Commission published the proposal for public comment in February of 2004. We held a public hearing on the proposals in April 2004, following which we published a supplemental request for comment to give the public an opportunity to respond to important developments at the hearing. The public submitted more than 900 comment letters on the original proposals, encompassing a wide range of views. The insights of the commentators on the proposals, as well as those of the NMS hearing panelists, contributed to significant improvements in our initial proposal.

Consequently, rather than immediately adopting rules, the Commission re-proposed Regulation NMS in its entirety in December 2004 to afford the public an additional opportunity to review and comment on the details. In response, the Commission has received more than 1,500 additional comments which we are now in the process of analyzing. I might add that 1,400 of those comments were form letters with the same substance in them.

In my written remarks for the record, I provided a brief overview of the four principal components of the regulation. I have also attempted to place the Commission's efforts in the broader context of fulfilling the mandate that Congress gave us in 1975 when it directed us, "With due regard to the public interest, the protection of investors and the maintenance of fair and orderly markets, to use our authority under the Exchange Act to facilitate the establishment of a national market system for securities."

In particular, I discuss the insightful comment in the accompanying House report that emphasized, "Investors must be assured that they are participants in a system which maximizes the opportunities for the most willing seller to meet the most willing buyer." Because I understand that the subcommittee is interested pri-

marily in the trade-through aspect of our proposal, I will confine my oral remarks to this component.

I would like to make three basic observations on this topic, and then I would be happy to elaborate further on these and the other aspects of Reg NMS if that would be helpful.

First, I would observe that throughout the Commission's deliberations over the trade-through rule we have kept our eye on one overriding objective: the protection of investors, with particular attention to the concerns of small investors who may not have the resources to monitor the behavior of their agents, the brokers. The thrust of the proposed trade-through rule is actually quite simply stated. When an investor sends an order to a market, the market can either execute the order at the best price then being quoted on the national market system, or the market must send the order to the best quoting market.

What does this mean? Two things. It means that a broker executing an order will be required to give that order the best price then available in any electronically accessible market even if the broker internalizes the order or would prefer to trade in another market that may offer the broker itself, if not the customer, an advantage. And second, it means that an investor who is willing to place an aggressively priced limit order on the book will not have his order ignored in favor of a less aggressively priced order. This second point is sometimes overlooked, so let me just expand on it a bit.

The investor who is willing to post a limit order supplies liquidity to the marketplace. The limit order shows the market where trading interest lies and helps to establish the best price for stock trading. This investor provides a public service and the market as a whole benefits. But this investor acts at a cost to himself, for he reveals his trading interest. In effect, he offers an option that any other investor can exercise simply by placing a market order. He risks having that option exercised only when the market is moving against him, and losing the trade when the market is moving away from him. His only compensation is the ability to trade when his quote is the best quote available. If he does not get an execution, then he is not compensated and he will soon question why he posted the limit order.

Worse, if he only gets an execution when the market is moving against him, we can begin to understand why he might choose not to offer the option to the market in the first place. A trade-through rule helps protect that investor for his willingness to supply liquidity to the market. So the trade-through rule is in the most fundamental sense a rule that protects investors.

This simple point can get lost in all of the sound and fury unleashed by vested interests for whom a market-wide trade-through rule will require new ways of doing business. I know that members of this subcommittee have been lobbied just as hard as I have on this issue. I am sure that you have asked yourself, as I have myself, just exactly whose interests are being advocated.

The second broad observation I would like to make is that I think it is useful to note that much of the hue and cry over the trade-through rule is somewhat wide of the mark. The most strident criticism that we hear about the trade-through rule appears

to focus on the existing ITS rule, the intermarket trading system, a 35-year-old anachronism that has plainly outlived its usefulness. Let me be absolutely clear. The commission is not proposing to validate or extend the ITS rule. Quite the contrary, the Commission has proposed a strengthened and modernized trade-through rule, one that will work.

The ITS rule is like a horse and buggy driving down the runway at Reagan Airport. That is because the key weakness of the ITS rule is that it does not distinguish between an electronic quote, one that can be executed immediately, and a manual quote, one that requires human beings to negotiate. The ITS rule has made it difficult for electronic marketplaces to compete with floor-based exchanges. In the process, it has helped floor-based markets maintain their competitive dominance. The commission has proposed to fix that problem.

The only quotes entitled to protection under the proposed trade-through rule are electronic quotes, quotes that are immediately and automatically accessible. As so structured, the proposal addresses the main criticism that one hears about the ITS rule: that when a market is forced to send an order to New York or another floor-based market, it languishes while the specialist decides whether to trade with it. That cannot happen under the rule the Commission has proposed. If the quote is not automatic, then it is not protected.

The proposal addresses other legitimate criticisms of the old ITS rule, such as the block-trade exception that results in the bulk of trade-throughs in listed stocks, and the weak and cumbersome satisfaction remedy that the old rule provides. In effect, the old rule does not prohibit trade-throughs. It merely tells a market that is traded through that it can go and complain to the other market and demand "satisfaction." As you can imagine, such a weak remedy is weakly enforced.

The commission's proposed rule would eliminate the broad block exemption in favor of more tailored benchmark and intermarket sweep exceptions, and we require market centers actually to install policies and procedures to prevent trade-throughs, instead of merely providing for an after-the-fact satisfaction remedy.

To my final observation, I want to emphasize that the trade-through rule that the Commission has proposed is pro-competitive in the best tradition of the market reform initiatives that the Commission has spearheaded over the last number of years. As I explain in more detail in my written remarks, much of the public debate over the trade-through rule has focused on one type of competition: competition between markets. But we must remember that there are two kinds of competition that Congress has directed us to foster. One is competition between markets, like the competition between Nasdaq and Instinet, for instance. The other is competition between investors, or as it is usually called, competition between orders. Both kinds of competition are essential for vibrant and healthy remarks, as Congress recognized in 1975 when it told us to perfect the national market system.

Some of the powerful market centers and professional traders most vocal in this debate seem to downplay order competition. But the Commission has not forgotten that one of the great strengths of the U.S. markets, which do not exist in markets in other places

in the world, is that trading interests of all types and sizes of investors is integrated to the greatest extent possible into a unified market system. Such integration ultimately works to benefit both retail and institutional investors. Retail investors will participate directly in the U.S. equity markets, however, only to the extent they perceive that their orders will be treated fairly and efficiently.

I am concerned about retail investors' perception of unfairness when they display an order representing the best price for a stock, yet see that price bypassed by trading in other markets. A trade-through rule such as the one the Commission has proposed would help maintain the confidence of all types of investors in the U.S. equity markets.

I will conclude by offering a few thoughts on the future of the Regulation NMS rulemaking process. Although I cannot predict the final outcome, I do believe it is extremely important that there be an outcome and that the outcome be reached soon. Many of the issues raised by Regulation NMS proposals have lingered for many years and caused serious discord among market participants.

These issues have been studied and debated and evaluated from nearly every conceivable angle. Few would seriously oppose the notion that the current structure of the national market system is outdated in many respects and needs to be modernized. The commission must move forward and make decisions with regard to final rules if the U.S. equity markets are to continue to meet the needs of investors in public companies.

Although Nasdaq stocks are part of the national market system, some have suggested that the Commission should at this point adopt a trade-through rule only for exchange-listed stocks. Although this approach would preclude the possibility of unintended consequences in the Nasdaq market, no approach would have drawbacks that the Commission would need to consider carefully.

One of the Commission's goals in its year-long review of market structure has been to formulate rules for the national market system that adequately reflect current technologies and trading practices and to promote equal regulation of stocks and markets. This goal does not reflect a simple desire for uniformity, but is identified in the exchange act itself as a vital component of a truly national market system.

The trade-through rule objective of promoting best execution of customer orders would be a particularly difficult benefit to set aside for Nasdaq stocks. I question whether ordinary investors should have to remember that their orders are protected by a commission rule for exchange-listed stocks, but that caveat emptor still prevails in the Nasdaq market. The commission will need to carefully consider whether if a trade-through rule is indeed appropriate for the exchange-listed stocks, its best execution and liquidity-enhancing benefits should not be extended to Nasdaq stocks.

I can assure you that the Commission fully recognizes the far-reaching nature of many of the proposals. If adopted, some would require significant industry efforts to modify systems and otherwise prepare for the new regulatory structure. We are sensitive to those concerns. If the Commission chooses to adopt the rules, we will work closely with the industry on implementing them. As I have

emphasized, the Commission is still considering Regulation NMS proposals, including all of the issues that I have discussed today.

I look forward to hearing your views and answering questions on the market structure issues facing the Commission, with a simple caveat. As I am sure you appreciate, it would be inappropriate for me to attempt to pre-judge where the Commission will arrive in its deliberations on these complex subjects.

Thank you again for inviting me to speak, and I would be very happy to answer any of your questions. Thank you.

[The prepared statement of Hon. William H. Donaldson can be found on page 42 in the appendix.]

Mr. BAKER. Thank you, Mr. Chairman.

I will start with just a question about observations of the performance of the Nasdaq.

Is it your opinion, based on the lack of trade-through provisions for the Nasdaq, that investors have not been appropriately or efficiently treated by Nasdaq performance?

Mr. DONALDSON. Let me try and answer that. The question you ask is complex. I believe there are a number of answers to it. The incidence of trade-throughs in the Nasdaq market is higher than has been advertised by some advocates. The incidence of trade-throughs in the Nasdaq market is concentrated in the small end of the market. It is concentrated in the 500-share end of the market, the individual investor end of the market.

So in that sense, although the Nasdaq market has made tremendous strides in bringing itself to the level that it has brought itself to now, there are large dollars being missed by traded-through best bids and offers on the Nasdaq market.

Mr. BAKER. I read somewhere I believe, I do not think it was in your printed testimony or an SEC document, that the guesstimated inefficiencies as they were making reference to would equate to something in excess of $300 million in lost value, according to some study, I think it was within the Office of Economic Assessment. It seems to me if that is the focus, we ought to be concerned about market data fees. I mean, that is well over $400 million.

I am taking your answer to mean that the Nasdaq is less efficient than the New York, and there are efficiencies to be gained by the application of the trade-through.

Mr. DONALDSON. I would not use the word "efficient," Congressman. I would say that in terms of trade-throughs there are more trade-throughs as a percentage of trading than there are on the New York Stock Exchange.

Mr. BAKER. I understand your position. We will follow up to understand the way in which that position is reached with more detail. Will the trade-through be made applicable to ETFs?

Mr. DONALDSON. I am sorry?

Mr. BAKER. Will the trade-through be made applicable to ETFs?

Mr. DONALDSON. To ETFs?

Mr. BAKER. Yes.

Mr. DONALDSON. We already have a special rule for ETFs, yes.

Mr. BAKER. Well, today there is a pilot which was renewed in December which allows a three cent deminimus trading band, which has been extraordinarily successful by all accounts, I believe. On the one hand, we are setting aside the ETFs not subject to trade-

throughs, and on the other we are going to propose that the trade-through be made applicable to the Nasdaq. Is that sort of the policy outcome?

Mr. DONALDSON. I am hesitating to make a conclusion for the Commission, but I will tell you that the rule will apply to ETFs.

Mr. BAKER. That would seem to be inconsistent with the three pilots that have been previously entered into. I will follow up on that a little bit later.

Going to the particular interests of the Nasdaq, I understand the argument being made is that it really will be a question of better service to consumers who now engage with the Nasdaq in executing a trade. In your discussion of the ITS provision, you indicated that electronically based systems today are at a competitive disadvantage with the auction exchanges, and that application of the trade-through rule as proposed by the Commission will actually equalize competitive opportunities.

Is that a fair summary of your position?

Mr. DONALDSON. Let me try and re-summarize. The Nasdaq market has great strengths and it certainly has improved over the few years. I just ask you to keep in mind that the regulatory action has been an incredibly significant driver for improvement in the Nasdaq market, such as our adoption of the order-handling rules and the Department of Justice's investigation into collusion by Nasdaq market makers, and our mandate that the markets trade in penny increments. I think that basically we have spurred competition through regulation with the order-handling rules that we helped Nasdaq institute. We are doing the same thing here.

Mr. BAKER. I just have one question. My time has expired.

So you are suggesting to me that the application of the trade-through to Nasdaq with the Nasdaq now having more limit orders placed than the New York exchange, the Nasdaq has no trade-through; New York does.

Nasdaq has more limit orders than New York, that the consequence of the application of the trade-through rule as modified in the re-proposal will actually enhance the number of limit orders placed?

Mr. DONALDSON. The comparison must be made with the improvements that we are trying to make in the marketplace. We are comparing New York Stock Exchange postings, if you will, with the old and ineffectual ITS system. We are comparing Nasdaq as it exists today.

You have to make the comparison of what this market will look like with the new rules, when there is a trade-through rule in both markets, and the one market is not depending upon the trading system.

Mr. BAKER. But you feel it will result in an increase in limit orders at the Nasdaq?

Mr. DONALDSON. I think it will result in the increase of posted limit orders, yes.

Mr. BAKER. My time has expired.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

First of all, Mr. Chairman, let me say that I have full appreciation of the pressures you must be under and the other commission

members. We appreciate your holding your position as to what is best for the retail investors.

It is my understanding that the majority of the comment letters received by the SEC concerning Reg NMS from institutional and retail investors such as the Investment Company Institute, T. Rowe Price, Vanguard, Barclays, Global Investors that manages the Federal First Savings Plan, the Bank of New York, the Consumer Federation of America, the National Association of Investors Corporation, favor a trade-through rule. And many, including the ICI, support the rule being applied across all markets in all NMS securities to protect each market's best bid and offer.

Is this accurate? If so, why do you believe that some intermediaries have been so vocal in opposition to the desire of their customers?

Mr. DONALDSON. Well, I think that one would get back to the fundamental principle that we have to keep asking ourselves at the SEC, and that is investor protection. Then comes the efficiency of the intermediaries and the particular platforms that they have.

This whole situation is immensely complicated. There are lots of different views, but when you reduce them down and keep asking yourself what is the effect on individual investors, then that becomes the prevailing mandate, if you will, when there are a lot of compromises available. It becomes the prevailing mandate when a change in the system may change the way some of the intermediaries are organized.

Mr. KANJORSKI. I appreciate your work. I hope you hold a stiff upper lip and we will see you when the rule gets through.

Mr. Chairman, I am going to return my time so that others may have some questions.

Mr. BAKER. I thank the gentleman.

It is the Chair's intention at this point, since we have a vote pending, to recognize Mr. Royce for his full time, and then recess for about 15 minutes so members could vote and come back.

Mr. Royce?

Mr. ROYCE. Thank you, Mr. Chairman.

Chairman Donaldson, I too would like to thank you for being here with us today. It is good to have you back in front of the committee. I want to thank you and I want to thank the entire commission. I think you all are to be commended for taking on the daunting task of reopening Regulation NMS.

It is clear to me that there is a great deal of consensus on many of the issues in this most recent NMS rule. With that said, it is also apparent that there is not a great deal of consensus around the trade-through component of NMS. I wanted to indicate that I appreciate your concern and desire to protect the interests of small investors. One of my concerns which I wrote to you about in January is that the U.S. equity markets remain innovative and dynamic. I have heard many say that the trade-through proposal could hinder the ability of markets and market-makers to innovate.

I would like to get your views about how the trade-through proposal will affect innovation in our markets going forward. In other words, do you think the incentive to create a better trading platform will be diminished in any way?

Mr. DONALDSON. Let me say to begin with that the suggestion of the new trade-through rule is the result of innovation. In other words, the trade-through rule that has existed before in effect was being monitored by the ITS. That was designed 25 years ago and totally inadequate to the speed with which transactions take place today. So the new trade-through rule as proposed is the result of technological innovation.

It is the result that now these markets can be connected with each other and with their customers by a web, a spider web of communications which can transmit orders from anywhere in the country or in the world, for that matter, to the best bid or offer instantaneously. That really could not be done before. When they were transmitted less than instantaneously, the gap that it took, the time that it took to execute the order made a lot of faster trading people miss their markets.

So I would say that this technology that can be used today, which has been developed, and some of it developed only in recent years, is a giant leap forward that will make our markets more competitive.

Mr. ROYCE. Thank you, Chairman Donaldson.

I will yield back the balance of my time.

Mr. SHAYS. [Presiding.] I thank the gentleman.

We are going to have a slight recess. The Chairman has already gone to vote, so he might be back sooner. Thank you.

[Recess.]

Mr. BAKER. [Presiding.] I do not want to inconvenience the Chairman any more than is absolutely necessary. I am convinced that there will be some members returning in a moment.

Mr. Hensarling is here, and he was prepared with his questions.

The gentleman is recognized.

Mr. HENSARLING. Thank you, Mr. Chairman.

Chairman Donaldson, again thank you for appearing before us today. The first question I have, Mr. Chairman, I am curious as opposed to relying on the trade-through rule why the SEC is not relying upon the duty that brokers and investment managers have to their clients, the duty to obtain best execution for their clients' orders.

Are we not seeing this take place in the marketplace? Is best execution not happening presently?

Mr. DONALDSON. Well, there are lots of statistics on whether best execution is actually being achieved. I think generally speaking it is, but there is still a large amount that is not consistent with best execution. That depends upon the nature of the stock being traded and the rapidity with which it is traded. You get trade-throughs, as I mentioned earlier, in both markets in rapidly trading stocks. They trade so fast they get trade-throughs. It is hard to track them.

Mr. HENSARLING. Let me ask you this question, Mr. Chairman. You have so many large institutional investors in mutual funds that seemingly are on the other side of this issue and are concerned about the expansion of the rule to Nasdaq. Many firms like Schwab and Fidelity have indicated a preference to trade on Nasdaq over the New York Stock Exchange.

Prior to coming to Congress, what little meager wealth I might have is tied up, for example, in a number of Fidelity mutual funds. I have long since learned that I was not smart enough to trade in individual stocks and bonds. But I guess I would be concerned not so much as a member of Congress, but as an investor when the keeper of my children's college fund indicates a real amount of anxiety over the expansion of this rule.

So why are so many of the mutual fund companies and institutional investors on the other side of the issue?

Mr. DONALDSON. You know, you have to look at the business of these different mutual funds and where it is concentrated. I think the thing that one has to keep in mind is that there is a tradeoff here between attempting to get the best price, the best bid and offer, but at the same time to maintain competition between markets. In effect, there are a very large number of funds, perhaps the largest aggregation of funds is the ICI, the Investment Company Institute, which has written a strong letter supporting us.

But you are asking why do some not support us, some institutional investors not support us? I guess you would have to ask them. If you look at the concentration of trade-throughs in the small 500-share part of the market, I think there is somebody from Schwab here and they can tell me whether I am wrong or not, but that is where a lot of their order business is. At that small end of the market, you have the least, generally speaking, sophisticated investors who have trouble keeping up with knowing exactly at what price their trade is going to be done.

So I suspect you could go down to each one of the people who have written us letters. As the old expression goes, where you stand is where you sit.

Mr. HENSARLING. I think, Mr. Chairman, that you had indicated on a previous occasion that at least one of the reasons we have a trade-through rule is to try to bring institutional orders into the market. There is some concern by others that the institution of this rule could actually have the opposite effect in that traders may take their money in trading activities offshore.

Am I to assume that you do not share those concerns?

Mr. DONALDSON. That is a very good question. I think that to date, we have the best markets in the world. Part of the reason for that is the ability in our market for institutions and individuals to trade in the same marketplace. In other countries around the world, in Germany for instance, the large blocks are not done on the exchange. That has to do with the changing patterns of ownership in Germany.

But the fact of the matter is, I believe that people will continue to pick our markets and to list here and to trade here if we have the most competitive markets in the world. And I think we do, and we are trying to improve that. And if we hold to very high standards, listing standards and accounting standards and so forth, so that people know that when they buy a U.S. security that the numbers are correct. That is what we are striving for in other areas of our responsibility.

So it is not just the trading market, but it is the stamp of approval, if you will, the stamp of reliability that people count on with our accounting systems.

Mr. HENSARLING. I see I am out of time. Thank you for your testimony.

Mr. BAKER. Mr. Chairman, it is my intention to go a little further with my questions, hoping that we will have members come back from the vote, because there were several members indicating they would like to follow up with a question. I was assured that we were only going to have one vote, and unfortunately the price was not as advertised by the time I closed the deal. So I have been misled a little bit.

Let me ask one more question and we will wait and see what happens. I may have to recess again and run over and vote and come back. Do you have constraints on your time today?

Mr. DONALDSON. I am delighted to be here as long as you want me.

Mr. BAKER. You said that with real sincerity, too.

[Laughter.]

Mr. BAKER. One of the other areas that have come to my attention that I do not know what the disposition is in discussions at this point, with regard to fees for market data. It appears from published discussions of the matter that the SROs are collecting about ten times the estimated costs of collection. Under Reg NMS, I am understanding that there is a new methodology being proposed for distribution of the revenues, but there is not a recommendation as to the underlying legitimacy of collecting that much revenue in relation to the actual cost.

It seems that is such an essential component of the trading operation that it is almost like a utility part of the system. Is there contemplating given to any limitation, restructure, any discussion about the fee side?

Mr. DONALDSON. Yes. As you know, we have a release out right now which is, excuse me, a proposed rule is out right now which had been reflected upon, dealing with the structure of the SROs; dealing with how they are to be organized, the independence and so forth; dealing with the clarity of their transparency in terms of how they are spending their money and so forth.

To our way of thinking, a more important long-term decision on just how expensive tape revenues should be will depend upon a better determination of how the independent SROs, particularly as some of them become publicly held, how they are going to pay for their regulatory obligations. The major source of revenue for most of the SROs is tape revenues.

So we have chosen to take this in two steps. Number one, we want to get at a fair distribution of those revenues before we get at the absolute size. There are a number of practices now in terms of determining what those revenues are, so-called "tape shredding," people that break up trades and put many, many trades on in order to get more revenues coming. There are a lot of bad practices out there. Those are the first order we want to address. When we have a better feel for revenue sources for these SROs, then we will have a better feel for how high or low those supporting revenues are. I might also add that the costs of producing those revenues are only one part of the equation.

Mr. BAKER. I understand there is an element of the market data reforms that the Commission's proposal would require market cen-

ters to send protected quotes through some yet to be selected government-recognized distributor of market information. The commission in its oversight role would then establish the price that brokers would pay for this data.

On two levels, just the Government engaged in setting prices for this activity is problematic, but is that the way in which you intend to see the Commission's role in exerting some influence over this pricing schedule?

Mr. DONALDSON. You know, we have a release out right now on SRO structure, as I mentioned, and it raises all these market data issues. I have just tried, in my inarticulate way, to divide this into two parts: the distribution or how the revenues are arrived at; and then as a second part, the absolute size of them.

Is that getting at what your question is?

Mr. BAKER. I can perhaps, for the sake of time, it does not look we are going to have someone to take over. Let me suggest I am going to follow up with more clarity in a written question for you.

I am going to ask your indulgence one more time. I am going to run over there, and I think I can get back in 10 or 15 minutes at the max, find out if we have other members who are going to come back, and answer questions. If we do not have members back by the time I arrive, then we will consider our work done here.

But let me run over to the floor to make sure. We had a number of members on all sides of this issue that expressed interest in having comments. Let me just move cautiously before we adjourn. I will be right back.

Mr. DONALDSON. Okay.

Mr. BAKER. Thank you.

[Recess.]

Mr. BAKER. I would like to reconvene our meeting and proceed with Mr. Fitzpatrick.

Mr. FITZPATRICK. Thank you, Mr. Chairman.

Chairman Donaldson, thank you for your testimony today. I found it very helpful for me.

I understand that the SEC's published studies had some flaws in their calculations in the numbers and the underlying assumptions. You had indicated last week that you had reanalyzed some of the statistics.

I was wondering if you could just give me an update as to what you found, what the statistics were, and whether or not there will be additional reports forthcoming, and if so does it make sense that we wait for the additional reports before we make any major policy changes.

Mr. DONALDSON. Which reports are you referring to?

Mr. FITZPATRICK. The SEC published reports. Did you refer to them last week and indicate that you had thought that there were some statistical problems?

Mr. DONALDSON. There were a number of economic calculations that were made, and when we first put forth NMS and in the reproposing document, some commentators challenged some of those numbers. We have been hard at work verifying those numbers. Basically, we stand by those numbers.

I might add that the effort that the SEC has put forth has been under two different heads of our Office of Economic Analysis, so

that the whole work has been reviewed in a way by two different people at the top, as well as by the organization. And I think that it is comforting to know that there has been agreement there and disagreement with some of the comments that were made by commentators.

Mr. FITZPATRICK. Are you referring to the OEA study, the four studies?

Mr. DONALDSON. I am talking about the OEA studies that were in our original release on NMS, those numbers and figures and judgments which have been re-reviewed as a result of the re-proposal.

Mr. FITZPATRICK. I just have one additional question, Mr. Chairman. Doesn't the SEC believe that using this sort of common-law standard of best trading practices, best execution practices, isn't that sufficient to protect the investors both large and small?

Mr. DONALDSON. I am sorry?

Mr. FITZPATRICK. Best execution practices?

Mr. DONALDSON. Yes.

Mr. FITZPATRICK. Isn't that a better standard going forward?

Mr. DONALDSON. You mean execution standards, the execution based on the size of the transaction?

Mr. FITZPATRICK. There is a standard that exists that brokers and traders should use best execution practices to protect their clients. Isn't that a better standard going forward than a trade-through rule?

Mr. DONALDSON. I see. I do not think so. I think this is an area in which the responsibility that a broker has for best execution is a very important thing. Insofar as that can be monitored, it is very important. But I think that, in terms of the kind of markets that we are operating in and the instantaneous transactions that take place, it is very important that there be a formalized set of rules that guarantee through the trade-through rule that the best bid and offer will be honored. I think it is a combination of those two things that will make for the system being as fool-proof as it can be.

Mr. FITZPATRICK. Do you believe that brokers are living up to their fiduciary obligation?

Mr. DONALDSON. I think that you have to be very careful when you make generalizations. I think that most brokers are attempting to live up to the responsibilities they have. On the other hand, the technology is such and the communication system is such that it is very hard for the broker and most particularly the broker's customer to really feel with confidence that they are getting the best execution.

Mr. FITZPATRICK. Other than generally speaking, let's talk specifics. Is the SEC taking any enforcement action against brokers who are failing to uphold their fiduciary obligation of best execution?

Mr. DONALDSON. We do the best we can. We have a complicated oversight system and we do the best we can to determine that. But it is a complicated subject because there are trade-throughs and there are trade-throughs. There are trade-throughs that are caused by technical conditions in the marketplace, et cetera, et cetera. It is very hard to evaluate that going back, huge amounts of data. So

that we do the best we can. I think we do a pretty good job. I think brokers do a pretty good job, within the context of it being increasingly difficult to know that you are getting the best execution.

Mr. FITZPATRICK. But in the SEC's judgment, are there brokers out there who are not living up to best execution standards and their fiduciary obligation to their clients, such that the SEC has instituted enforcement actions against them?

Mr. DONALDSON. Again, this is a subject of concern for us and we are currently looking at best execution in terms of certain periods of time where we see there may be some question. That would be most particularly at the opening of the markets, at the opening of the markets where we are looking right now intensely at whether best execution is being exercised.

Mr. FITZPATRICK. Okay.

Thank you, Mr. Chairman.

Mr. BAKER. I thank the gentleman.

Mr. Sherman?

Mr. SHERMAN. Thank you, Mr. Chairman.

It would seem like investors might have different objectives, and some would want the top of the book; some the depth book; some might be impressed by the software of this or that brokerage company. I would think that in many of these decisions you are not really retaining a broker, you are retaining a broker's software to execute the transaction.

I would wonder, is the SEC going to in effect prohibit investors from making the choice that they may want to make? In other words, he may want depth of the book. I want a top of the book. Somebody else is impressed with proprietary software that tries top of the book for 3 seconds, and then shifts to depth of the book. Are investors going to be able to retain the software strategy they want for the particular transaction? Or is it all going to be one-size-fits-all?

Mr. DONALDSON. I would answer that in two ways. One is that I think the effect of an effective trade-through regulation will assure that the best prices are available and can be reached by the investor.

Mr. SHERMAN. But sometimes I want the best prices. Sometimes I want the fastest executions. Sometimes I want the most anonymity. Can I pick the strategy I want? Or is the quote "best price," which may end up being the best price available 5 minutes after I make the decision, which may end up being the wrong best price or the worst best price, am I stuck with one-size-fits-all if this regulation goes through?

Mr. DONALDSON. No, I do not think so. I think that basically, to get back to what I said earlier, that this is a compromise, if you will, between two goals. One is the protection of the best bid, and the other is to protect those who want to trade rapidly, for whatever reason.

By putting this together in a system where we are taking basically trade-through controls and so forth off of slow markets and putting it into what is a revolutionary change for the listed markets, the New York Stock Exchange, the dual system that they propose. You now have an interface where you are allowing people to have a best of both worlds, speed of execution and best price.

Mr. SHERMAN. What if I call my broker and I say, "Look, I do not want you to execute this transaction on the New York Stock Exchange for this or that reason—I think they are cruel to bunnies or something; I only want you to execute this on Nasdaq," is that now an illegal transaction? It could be the other way around.

Mr. DONALDSON. Yes. I think what you also have to consider is that there is another side to every transaction. There is a responsibility to the marketplace.

Mr. SHERMAN. Look, my broker represents me. I want my broker to go to the New York Stock Exchange and execute the transaction there. Does that become illegal?

Mr. DONALDSON. No. There is a public good aspect to this.

Mr. SHERMAN. Mr. Chairman, I am not asking you to defend why you are making it illegal. Stripped away of the reasons why it might be a good idea to force me to——

Mr. DONALDSON. Why it would not be a good idea is that you leave out there, if I want to do my own trade and I want to do it in a closet somewhere or I want to do it off the market, you thereby deprive the people who are using the market and——

Mr. SHERMAN. Mr. Chairman, I am not asking for justification. I am asking a yes-no question.

Mr. DONALDSON. What is the yes-no?

Mr. SHERMAN. Under the proposed regulation, if I instruct my broker to execute the transaction on this or that exchange or medium and to ignore all others, am I in violation of the law, or can I have it done the way I want it done?

Mr. DONALDSON. If the market is assessible——

Mr. SHERMAN. Mr. Chairman, I am asking a very simple question. Can I instruct my broker to execute the transaction only on Nasdaq or only on the New York Stock Exchange, or is that an illegal transaction?

Mr. DONALDSON. No is my simple answer.

Mr. SHERMAN. No, I cannot do it?

Mr. DONALDSON. No. No. If you do not like the price that is there, you can ignore it and send your order elsewhere to a market quoting a worse price if you want to. But all market centers must have procedures reasonably designed to avoid trade-throughs, and that could result in the market either matching the best price or your order being sent to another market quoting the best price.

Mr. SHERMAN. So I can call a broker and say, execute this transaction only on Nasdaq and execute this other transaction only on the New York Stock Exchange and that is what he or she will do, and that will not be in violation of the regulation.

Mr. DONALDSON. Yes. Subject to what I just said, you can choose to send your order initially to any specific market center.

Mr. SHERMAN. Okay. So as long as we are preserving the investor choice, I have spent the last 3 minutes satisfying my concerns. Thank you.

Mr. DONALDSON. Okay.

Mr. BAKER. The gentleman yields back.

Mr. Crowley?

Mr. CROWLEY. Thank you, Mr. Chairman.

Thank you again, Chairman Donaldson.

There has been an ongoing discussion about the need to apply the trade-through rule to all U.S. equity markets, including the Nasdaq. Do you believe that if the SEC does not apply the trade-through rule across the board on all markets, regulatory arbitrage will be the result, whereby the professional trader will trade and profit in a market which has no prohibitions, and those profits will not be passed along to small investors?

Mr. DONALDSON. Yes, I do believe that one of the dangers of not extending the new trade-through rule to all NMS stocks is the potential for regulatory arbitrage. As I tried to say earlier, I do not think it is wise public policy to have an individual customer decide that in trading at one market he is being protected, but if he goes to another market the rules are different, and it is caveat emptor.

Mr. CROWLEY. I appreciate that. If you have answered the question before, I am sorry I was not here when you did it. You and I have had a private conversation. I thought it might be appropriate to get some of those comments down on the record.

Mr. DONALDSON. Sure.

Mr. CROWLEY. Since Congress since 2002 and the SEC have tightened the corporate governance rules, tightened rules on mutual funds, hedge funds, expensing stock options, corporate disclosure, I was wondering why then would a new SEC rule apply to half the market and treat investors differently? You have just answered that question, that you do not believe they should be treated differently, depending on where they trade. Correct? For example, on the New York Stock Exchange or the Nasdaq market, is that correct?

Mr. DONALDSON. If I understand your question, I believe that the proposed rule here should be extended to the over-the-counter market, to the Nasdaq market. I believe that if it is not, there is this potential for regulatory arbitrage, but that is of course a decision the Commission has to make.

Mr. CROWLEY. Mr. Chairman, just one final question. It is my understanding that the vast majority of the comment letters you have received on the Reg NMS proposals were in opposition to the mandatory depth book routing due to the practical implications. If that is so, how much weight do you put on those comments?

Mr. DONALDSON. I put a considerable amount of weight on those comments. I think a great preponderance of the comments did not believe that we should go to the depth of book. I think there again is a fear at this stage of the development of the marketplace that that is close to being a CLOB, consolidated limit order book. It is not a CLOB, but it has aspects of a CLOB. I think it has been shown through years and years of debate that that sort of centralization of the system would not be to the advantage of the system.

Mr. CROWLEY. Can you give us any indication where the Commission might be heading on depth of book?

Mr. DONALDSON. I am sorry?

Mr. CROWLEY. Can you give us any indication of where the Commission might be heading on the issue of depth of book?

Mr. DONALDSON. Well, there is overwhelming support for the top of the book, and I would say that in our second round of comments, very few proposed that we go to depth of book.

Mr. CROWLEY. I thank the Chairman.

I thank you, Chairman, for the time.

I yield back.

Mr. BAKER. Mr. Chairman, I want to express my appreciation for your generous grant of time today and your willingness to come to the committee and discuss these proposals. I just want to make clear for most members the depth of feeling about this is enhanced because markets have indeed changed dramatically, where hundreds of millions of individual investors are now placing their hard-earned dollars into the markets hoping to grow their personal wealth for the first home, the children's education, whatever it might be.

Because of that greatly expanded number of working families now engaged in active market investing, it has enhanced the sensitivity of members of Congress to better understand and to ensure that those individuals are treated as best as can be practically achieved. No market system is perfect. All will have their flaws.

We also have an obligation in this committee to recognize that this capital market function is very essential to the ongoing economic vitality of this country, and not to take ill-advised steps that may put any of that in the slightest jeopardy.

I only make these comments because there were widely disparate views this morning about which direction we should go. I certainly respect the Commission's work and your leadership. I just have expressed in my own view the concerns about going forward and perhaps a very careful continued evaluation for the short term would be helpful to us all.

To that end, I do intend to follow up today with a letter, and some of the members have indicated a desire with their own questions. We will try to consolidate our limit order here and get it all in one letter, and get it over for your comment. It will be helpful for us in understanding the implications of the next step. I think it would be helpful to the Commission's reception as they go forward as well.

So I appreciate your courtesies extended and we do look forward to working with you as we head down the road. Unless you have further comment, I would like to call our meeting adjourned.

Thank you very much, sir.

[Whereupon, at 12:32 p.m., the subcommittee was adjourned.]

A P P E N D I X

March 15, 2005

Opening Statement

Chairman Michael G. Oxley

House Financial Services Committee

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

"Regulation NMS: The SEC's View"
March 15, 2005

Thank you, Chairman Baker. Chairman Donaldson, welcome back to the Financial Services Committee. In case you don't get enough of us today, you'll be coming back for more when you return in April to talk to us about Sarbanes-Oxley. We look forward to having you here for that occasion as well.

Today, our topic is Reg NMS, and I want to begin by commending Chairman Baker's outstanding leadership on the important and difficult issues raised by the proposal before us today, Regulation NMS. I have found the Financial Services Committee's five previous hearings on this Securities and Exchange Commission initiative to be extremely informative.

The threshold questions for me are, what kind of marketplace do we want to create for the 21st Century? And in what direction do we want the markets to go as they evolve and adapt to technology?

My approach to these complex issues is governed by the belief that Congress should work to reduce or eliminate any regulatory advantages that inhibit competition and artificially preserve market share. As an advocate of free markets, I believe that we should move the National Market System toward more robust competition, more investor choice, and greater investor protection.

Of course we must be guided by best execution for the investor. If an investor misses the best price, that's not best execution. If a trade cannot be completed, that's not best execution.

At the Subcommittee's spirited hearing last month, six major market participants — Nasdaq, Instinet, Bloomberg, Knight, Schwab, and Citadel — all expressed opposition to the portion of the Reg NMS proposal that would preserve and expand the trade-through rule.

As a matter of applying free-market policy, I share that view. While the trade-through rule had its purpose in an earlier era, today's technology has rendered

it regulatory and anti-competitive. As I discussed at the last hearing, let's remember the broker's fiduciary duty to obtain best execution of his clients' orders is a more efficient way of ensuring investor protection.

Therefore it does not make sense, it seems to me, to extend the trade-through rule to the Nasdaq market, which has operated efficiently and competitively without it. I can think of no compelling reason to expand the rule, with its associated and quite significant compliance costs, to the vibrant Nasdaq marketplace.

If the SEC were to modify the proposal so that the trade-through rule is not expanded, that is an outcome that I think most interested parties could support. It strikes me as a sensible compromise that would improve the status quo. A final rulemaking that resists the urge to over-regulate the Nasdaq market would include significant improvements over the existing regulatory structure. The Reg NMS trade-through provision as applied to only exchange-listed stocks would be more enforceable than the current rule and would recognize the difference between automated and manual markets.

Reg NMS, as modified, would encourage the NYSE to continue to modernize its market. The Hybrid Proposal crafted by the Exchange is an important step in this direction. I want to commend John Thain for his leadership and vision. I know he is committed to serving investors in this age of rapidly changing technology.

We are nearing the end of a long process. I would like to commend the Commission and its staff for their hard work over the past several years. This is a difficult and complex area, and I certainly recognize the good intentions and good will of people on all sides of the issues.

I yield back.

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GINNY BROWN-WAITE
5TH DISTRICT, FLORIDA

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March 15, 2005

House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises Hearing, "Regulation NMS: The SEC's View," Tuesday, March 15, 2005.

Statement for the Record:

Thank you Mr. Chairman for holding this hearing.

And thank you Chairman Donaldson for speaking to us today.

For several years, the SEC and this subcommittee have been trying to address U.S. market structure but other, more pressing issues have always seemed to overshadow those efforts. I am glad that this subcommittee is finally getting the opportunity to work with the SEC on modernizing one of the most envied markets in the world.

However Mr. Chairman, my biggest concern with Reg NMS is the Voluntary Depth Alternative. This alternative will create a virtual Consolidated Limit Order Book (or CLOB) that will make large orders of stock difficult to execute. As a recent Wall Street Journal article detailed, "… the large orders of stock will go elsewhere… Small investors are hurt when this happens."

Additionally, I would like to hear from the SEC why it has taken years for both NASDAQ's exchange application and the NYSE's Hybrid Plan to be either approved or denied. It troubles me that the SEC has purposely allowed both of these applications to languish in bureaucratic red tape for over four years.

Lastly, I hope that the SEC provides an answer to us today as to why the U.S. market needs an SEC mandated trade-through rule.

Thank you Mr. Chairman and again, I look forward to hearing your testimony Chairman Donaldson.

Ginny Brown-Waite
Member of Congress

Opening Statement for Congressman Vito J. Fossella
"Regulation NMS: The SEC's View"
Tuesday, March 15th, 2005
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Committee on Financial Services

Since the start of the Securities and Exchange Commission's proposed Regulation NMS, it was clear that the cornerstone of this debate would be centered on the trade-through rule. And although at first glance it would appear obvious that an investor, large or small, should get his or her order filled at the best price available, we have learned there is a lot more to this debate than just getting the best price. With the advent of new technologies, three other variables have become increasingly important: speed, certainty, and size of execution. In fact these three variables have been what has driven this debate to the point of SEC action.

The trade-through rule was established as an ITS rule in an effort to both increase the connectivity between markets, and to ensure that traders captured the best available execution price for their clients. Thus, if a broker on the floor of the Boston Exchange needs to buy 2000 shares for a client, if the national best bid or offer is at the Philadelphia Exchange, the rule forces the broker to execute at the Philadelphia Exchange so that the investor is assured the best representation. The result was a national market system where market competition and order competition thrived.

While this rule was clearly of good intentions when first implemented, as the NASDAQ and electronic communication networks (ECNs) grew, an increased number of market participants found that the internal rules of floor based exchanges, particularly the New York Stock Exchange, prohibited them from obtaining the best price for their clients. The first of the rules allows a specialist to hold an order for up to 30 seconds before confirming or denying order execution; the second limits the size of an order that can be sent through the NYSE's electronic order submission to no more than 1099 shares. With these rules in place, I agree that a trader sitting at a trading desk outside the walls of the NYSE has every right to be frustrated when they could be executing a trade immediately, with certainty of execution, and at whatever size is available, but instead must either break the order up into lots of 1099 shares, or hire a representative on the floor of the exchange who can execute the size their client is looking for.

Once implemented, Reg NMS will eliminate the limitations experienced by traders outside the walls of the floor based exchanges, allowing them the ability to operate in a marketplace with speed, certainty, and size. In addition, Reg NMS allows investors not wanting to participate with a slow quote to trade around that quote.

With the elimination of these rules, the trade-through rule will once again work in the favor of the investor with increased enforcement from the Securities and Exchange Commission.

Finally, I believe the trade-through rule under Reg. NMS, when properly enforced, will be a net plus for both the confidence of the individual investor that has grown skeptical of Wall Street during the past 5 years, and for the confidence of foreign investors who desire to invest their

money in the United States. The influx of capital from foreign investors has doubled over the past decade and will likely continue to increase as foreign countries become wealthier and as foreign companies decide to access U.S. capital by listing on U.S. exchanges. I believe it is important that the United States provide a vibrant marketplace where all investors and all companies looking to participate in them, can do so with confidence that there are regulatory backstops in place to protect them from being unfairly disadvantaged.

In conclusion, I want to thank the SEC again for their efforts. I think the staff has found a good balance of proposals that open the marketplace to competition while maintaining principles that ensure the investor remain protected.

March 15, 2005

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Hearing entitled, "Regulation NMS: The SEC's View"

Thank you, Mr. Chairman, for calling this hearing to discuss the Securities and Exchange Commission's (SEC) Regulation NMS proposal. Furthermore, I welcome you here today Chairman Donaldson and look forward to your comments.

As I mentioned a month ago, I share our Full Committee Chairman's sentiments that our market rules and regulations have not always kept pace with technological advancements and applaud the SEC's efforts to provide greater transparency and investor choice for all Americans.

However, when the SEC re-published its proposed Regulation NMS in December I did send a comment letter expressing my reservations regarding the Voluntary Depth Alternative to Chairman Donaldson.

Again, I am eager to learn more about Regulation NMS and its potential impact on our nation's market structure and competition. I yield back the remainder of my time.

1

OPENING REMARKS OF THE HONORABLE RUBEN HINOJOSA

HOUSE COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON CAPITAL MARKETS

"REGULATION NMS: THE SEC'S VIEW"

Thank you, Mr. Chairman.

Chairman Baker and Ranking Member Kanjorski, I want to express my sincere appreciation for you holding this very important and very timely hearing.

I join you in welcoming the Chairman of the U.S. Securities and Exchange Commission, William Donaldson, this morning and I commend him and his staff for their diligent work in attempting to modernize our national market system.

As you know, the U.S. Securities and Exchange Commission began its review of the rules governing our national market system in February 2004 with the publishing of its first Regulation NMS proposal. In May 2004, the SEC decided to extend the comment period to June 30, 2004, in part likely due to the amazing amounts of interest in the importance of and the controversy surrounding this proposed regulation.

Once all the comments were in, the SEC decided in December 2004 to repropose Regulation NMS with two alternatives – the Market BBO alternative and the Voluntary Depth alternative – for a 30-day comment period, which ended on January 26, 2005. Now that all those comments are in, the SEC is reviewing all of them and I understand that the SEC expects to issue its final rule soon.

I support the Market BBO alternative applied across all markets. This alternative will promote intermarket competition, modernize our capital markets and promote investor protection regardless of the stock they are trading.

I have serious reservations about the Voluntary Depth alternative. The Voluntary Depth alternative could radically change the structure of the U.S. capital markets and damage our internationally competitive, investor-driven markets.

I urge the SEC to consider carefully the adverse consequences of the Voluntary Depth alternative for the investing public. In this instance, I hope that the SEC will complete the path that it set out to do last year and will issue a final regulation soon.

This subcommittee has held five hearings on the Securities and Exchange Commission's proposed national market structure regulation, and we have heard from many witnesses on the proposal. The Subcommittee, as has the SEC, has been extremely thorough in considering many points of view on Reg NMS, and this rule proposal is the result of more than five years of hard work on the part of the SEC staff.

Mr. Chairman and Ranking Member Kanjorski, again, I wish to express my sincere appreciation for you holding this important hearing today.

I yield back the remainder of my time.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

THE NATIONAL MARKET STRUCTURE REGULATION: THE VIEW OF THE SECURITIES AND EXCHANGE COMMISSION

TUESDAY, MARCH 15, 2005

Mr. Chairman, we meet once more to discuss the important issue of the regulation of our capital markets generally, and the trade-through rule specifically. This time we will hear again from the Chairman of the Securities and Exchange Commission.

The ongoing deliberations over our National Market System have engendered strong emotions and considerable debate. As my colleagues already know from our extensive investigations into these matters, market structure is also an extremely complex subject.

We are, Mr. Chairman, at a crossroads. A variety of agents in our equities markets have questioned one or more aspects of the regulatory system governing our national markets during the last several years. Technological advances and competitive developments are also forcing us to confront a number of important decisions.

During his previous testimony before our panel concerning these matters, SEC Chairman Donaldson noted that in pursuing any plan to fix those portions of the National Market System experiencing genuine strain, we must ensure that we do not disrupt those elements of our markets that are working well. Chairman Donaldson knows that I share his views in these matters. We should not pursue change for change's sake.

In his recent testimony before the Senate Banking Committee, Chairman Donaldson also offered some insights into the Commission's deliberations regarding its broad set of proposals to update the regulatory structure of our stock markets. He focused his comments last week on the trade-through rule. In particular he noted that the regulation advances three important policy goals: it ensures best execution, it promotes fair and orderly markets to get the best price, and it advances market depth and liquidity.

Chairman Donaldson will, as I understand, expand on those views today by providing us with more analysis and detail about his thinking regarding these matters. In his comments today, I hope that Chairman Donaldson will once again express his support for the trade-through rule. From my perspective, this standard is one area of our regulatory structure that has worked well for nearly three decades. As one of the foundations of our National Market System, this rule has ensured that all investors get the best price that our securities markets have to offer regardless of the location of a trading transaction.

Today, I also suspect that many of my colleagues will focus on the Commission's newest proposal to alter the trade-through rule when asking questions of Chairman Donaldson. In addition to applying the trade-through rule to all securities marketplaces, the Commission's latest plan for updating the National Market System includes two alternatives for implementation: the Market Best Bid or Offer Alternative and the Voluntary Depth Alternative.

-more-

The Voluntary Depth Alternative would almost certainly result in only one way for markets to differentiate themselves -- namely, how much they are willing to pay other market participants for their order flow. In my view, promoting competition based on payment for order flow will prove detrimental in the long term to average retail investors because of the conflicts of interest it creates. This issue is one that the Commission should carefully study.

The incremental approach contained in the Market Best Bid or Offer Alternative is therefore the preferable option going forward. The adoption of this alternative will also help to ensure that the United States maintains its global leadership in our financial markets.

In closing, Mr. Chairman, it is my very strong hope that the Commission in working to finalize any changes in the market-structure rules will make certain that any regulation it promulgates will provide an improvement over the existing regulatory regime and protect the interests of retail investors. I look forward to receiving the testimony of Chairman Donaldson.

OPENING STATEMENT
CONGRESSMAN PETER T. KING
before the
HOUSE FINANCIAL SERVICES SUBCOMMITTEE ON CAPITAL MARKETS

"Regulation NMS: The SEC's View"

March 15, 2005

Thank you, Chairman Baker. I appreciate the opportunity to comment on the SEC's market structure proposal and I look forward to Chairman Donaldson's insight into these reforms.

Very simply, I support the SEC's proposal to apply the trade-through rule to automated quotes across all markets. Since its inception in 1981, the trade-through rule has ensured that consumers receive the best price available for their trades in the National Market System. The trade-through rule is crucial to investors and I believe that my constituents should receive the same protection regardless of which stock they are trading.

With respect to the two alternatives offered by the proposal, I support the Best Bid and Offer (BBO) alternative, which preserves inter-market competition. I am concerned that the second alternative, the Voluntary Depth Alternative, shares many of the characteristics and problems of a Consolidated Limit Order Book and would turn our market centers into mindless order routers.

Chairman Donaldson, I commend the SEC for its extensive work to craft these proposals. It is my hope that as this process moves forward, the SEC will keep in mind the crucial benefit of the trade-through rule to investors. I look forward to your testimony.

Thank you, Mr. Chairman.

TESTIMONY
OF

WILLIAM H. DONALDSON, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
PROPOSED REGULATION NMS

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT-SPONSORED ENTERPRISES

HOUSE FINANCIAL SERVICES COMMITTEE

UNITED STATES HOUSE OF REPRESENTATIVES

MARCH 15, 2005

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

TESTIMONY CONCERNING PROPOSED REGULATION NMS

William H. Donaldson
Chairman, U.S. Securities and Exchange Commission

Before the U.S. House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

March 15, 2005

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

Thank you for inviting me to testify today on proposed Regulation NMS. All of the proposals included in Regulation NMS are designed to benefit and protect investors in the U.S. equity markets, and to facilitate efficient capital formation, by modernizing and strengthening the national market system. The national market system encompasses the stocks of more than 5,000 listed companies, which collectively represent more than $14 trillion in U.S. market capitalization held by investors. The Commission is committed to assuring that investors have the fairest and most efficient markets possible for these stocks, and I welcome your continuing interest in an issue of such vital importance to investors and the economy.

Given where we are in the process of considering Regulation NMS, my testimony today reflects my own views and not necessarily those of my fellow Commissioners.

I will first give an overview of the process the Commission has followed in developing the NMS proposals and describe the principal components of Regulation NMS. Then I will focus more specifically on one aspect of the proposals that has generated the bulk of the public comments. Specifically, I will review the arguments for

and against the trade-through proposal, including with respect to Nasdaq stocks which are not currently covered by any trade-through requirements.

I must point out that the Commission and its staff are currently in the final stages of deliberation on the NMS proposals, and the individual Commissioners continue to weigh the complex policy considerations presented by the proposals. I have not reached a final judgment on how to balance these considerations myself. Market structure is an extremely complex area of public policy and securities regulation. Regardless of what the Commission ultimately decides, this Subcommittee and the public should have full confidence that the Commission has systematically and responsibly analyzed the relevant data and carefully considered the views of all commenters. Hopefully, my testimony today will convey some measure of the enormous amount of careful consideration that the Commission has devoted to these issues over the last several years and, indeed, continues to devote today.

I. Overview of Regulation NMS

A. Extended and Open Commission Review

The Commission has undertaken its comprehensive review of market structure regulation to respond to the many changes in the equity markets since the national market system was created in 1975. To inform our thinking, we actively have sought out the views of the public and securities industry participants. Even prior to formulating proposals, our review included multiple public hearings and roundtables, an advisory committee, three concept releases, the issuance of temporary exemptions intended in part to generate useful data on policy alternatives, and a constant dialogue with industry participants and investors. This process continued after the proposals were published for

public comment.[1] We held a public hearing on the proposals in April 2004 ("NMS Hearing").[2] To give the public an opportunity to respond to important developments at the hearing, we published a supplemental request for comment and extended the comment period on the proposals.[3] The public submitted more than 900 comment letters on the original proposals that encompassed a wide range of views.

The insights of the commenters on the proposals, as well as those of the NMS Hearing panelists, contributed to significant improvements in the original proposals. Responding appropriately to these comments led to changes in the rule text as originally proposed. Consequently, rather than immediately adopting rules, the Commission reproposed Regulation NMS in its entirety in December 2004 to afford the public an additional opportunity to review and comment on the details of the rules.[4] In response, the Commission received more than 1500 additional comments on the reproposal.

B. Substantive Components of Regulation NMS

The Regulation NMS proposals include four broad substantive initiatives: trade-throughs, access to markets, sub-penny quoting, and market data. The trade-through proposal would require all markets to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs of protected quotations. To qualify for protection, a quotation would have to be automated – one that, among other things, is displayed and immediately accessible through automatic

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1 Securities Exchange Act Release No. 49325 (Feb. 26, 2004), 69 FR 11126 (Mar. 9, 2004) ("Proposing Release").

2 A full transcript of the NMS Hearing ("Hearing Tr."), as well as an archived video and audio webcast, is available on the Commission's Internet Web site (http://www.sec.gov).

3 Securities Exchange Act Release No. 49749 (May 20, 2004), 69 FR 30142 (May 26, 2004) ("Supplemental Release").

Securities Exchange Act Release No. 50870 (Dec. 16, 2004), 69 FR 77424 (Dec. 27, 2004) ("Reproposing Release).

execution. Thus, the trade-through proposal would not require market participants to route orders to access manual quotations, which generally entail a much slower speed of response than automated quotations.

The trade-through proposal also includes a variety of exceptions that would make intermarket price protection as efficient and workable as possible. These would include an intermarket sweep exception, which would allow market participants to access multiple price levels simultaneously at different trading centers – a particularly important function now that trading in penny increments has dispersed liquidity across multiple price levels. The intermarket sweep exception would enable trading centers that receive sweep orders to execute those orders immediately, without waiting for better-priced quotations in other markets to be updated. In addition, the trade-through proposal would provide exceptions for the quotations of trading centers experiencing, among other things, a material delay in providing a response to incoming orders and for flickering quotations with prices that have been displayed for less than one second. Both exceptions would serve to limit the application of the trade-through rule to quotations that are truly automated and accessible.

The access proposal would set forth new standards governing access to quotations in NMS stocks. As many commenters on the proposals have emphasized, protecting the best displayed prices against trade-throughs would be futile if broker-dealers and trading centers were unable to access those prices fairly and efficiently. The access proposal is designed to achieve this goal in three ways. First, it would enable the use of private linkages offered by a variety of connectivity providers, rather than mandating a collective linkage facility such as the Intermarket Trading System ("ITS"), to facilitate the

necessary access to quotations. The lower cost and increased flexibility of connectivity in recent years has made private linkages a feasible alternative to mandated public linkages. To facilitate these private linkages, the access proposal would prohibit a trading center from imposing unfairly discriminatory terms that would prevent or inhibit the access of any person through members, subscribers, or customers of such trading center.

Second, the access proposal would limit the fees that any trading center can charge for accessing its protected quotations to no more than three tenths of one cent per share. The purpose of the fee limitation is to ensure the fairness and accuracy of displayed quotations by establishing an outer limit on the cost of accessing such quotations. For example, if the price of a protected offer to sell an NMS stock is displayed at $10.00, the total cost to access the offer and buy the stock will be $10.00, plus a fee of no more than $0.003. The access proposal thereby would assure order routers that displayed prices are, within a limited range, true prices.

Finally, the access proposal would require SROs to establish and enforce rules that, among other things, prohibit their members from engaging in a pattern or practice of displaying quotations that lock or cross the automated quotations of other trading centers. Trading centers would be allowed, however, to display automated quotations that lock or cross the manual quotations of other trading centers. The proposed access rule thereby would reflect the disparity in speed of response between automated and manual quotations, while also promoting fair and orderly markets by establishing that the first automated quotation at a price, whether it be a bid or an offer, is entitled to an execution

at that price instead of being locked or crossed by a quotation on the other side of the market.

The sub-penny proposal generally would prohibit market participants from displaying, ranking, or accepting quotations in NMS stocks that are priced in an increment of less than one cent. A strong consensus of commenters has supported the sub-penny proposal as a means to promote greater price transparency and consistency, as well as to protect displayed limit orders. In particular, the proposal would address the practice of "stepping ahead" of displayed limit orders by trivial amounts. It therefore should further encourage the display of limit orders and improve the depth and liquidity of trading in the national market system.

The market data proposal would promote the wide availability of market data and allocate revenues from market data fees to the SROs that produce the most useful data for investors. It thereby would strengthen the existing market data system, which provides investors in the U.S. equity markets with real-time access to the best quotations and most recent trades in thousands of stocks throughout the trading day. For each stock, quotations and trades are continuously collected from many different trading centers and then disseminated to the public in a consolidated stream of data. As a result, investors of all types have access to a reliable source of information for the best prices. When Congress mandated the creation of the national market system in 1975, it noted that the systems for disseminating consolidated market data would "form the heart of the national market system."[5] Accordingly, one of the Commission's most important responsibilities is to preserve the integrity and affordability of the consolidated data stream.

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[5] H.R. Rep. No. 94-229, 94th Cong., 1st Sess. 93 (1975).

The proposal would promote this objective in several different respects. First, it would update the formulas for allocating revenues generated by market data fees to the various SRO participants in the joint industry plans for the dissemination of market information to the public ("Plans"). The current Plan formulas are seriously flawed by an excessive focus on the number of trades, no matter how small the size, reported by an SRO. They thereby create an incentive for distortive behavior, such as wash sales and trade shredding, and fail to reflect an SRO's contribution to the best displayed and automated quotations in NMS stocks. The formula is designed to promote an allocation of revenues to the various SROs that more closely reflects the usefulness to investors of each SRO's market information.

The proposal also is intended to improve the transparency and effective operation of the Plans that disseminate market data by broadening participation in Plan governance. It would require the creation of advisory committees composed of non-SRO representatives. Such committees would give interested parties an opportunity to be heard on Plan business, prior to any decision by the Plan operating committees. Finally, the market data proposal would promote the wide availability of market data by authorizing markets to distribute their own data independently (while still providing their best quotations and trades for consolidated dissemination through the Plans) and streamlining outdated requirements for the display of market data to investors.

Many commenters on the market data proposal expressed frustration with the current operation of the Plans. These commenters generally fell into two groups. One group, primarily made up of individual markets that receive market data fees, believed that the current model of consolidation should be discarded in favor of a new model, such

as a "multiple consolidator" model under which each SRO would sell its own data separately. The other group, primarily made up of securities industry participants that pay market data fees, believed that the current level of fees is too high. This group asserted that, prior to modifying the allocation of market data revenues, the Commission should address the level of fees that generated those revenues.

As noted in the Reproposing Release, the Commission has considered these concerns at length in the recent past. A drawback of the current market data model, which requires all SROs to participate jointly in disseminating data through a single consolidator, is that it affords little opportunity for market forces to determine the overall level of fees or the allocation of those fees to the individual SROs. Prior to publishing the proposals, therefore, the Commission undertook an extended review of the various alternatives for disseminating market data to the public in an effort to identify a better model. These alternatives were discussed at length in the original Proposing Release, but each has serious weaknesses. The Commission noted that it was particularly concerned that the integrity and reliability of the consolidated data stream must not be compromised by any changes to the market data structure.

For example, although allowing each SRO to sell its data separately to multiple consolidators may appear at first glance to subject the level of fees to competitive forces, this conclusion does not withstand closer scrutiny. If the benefits of a fully consolidated data stream are to be preserved, each consolidator would need to purchase the data of each SRO to assure that the consolidator's data stream in fact included the best quotations and most recent trade report in an NMS stock. Payment of every SRO's fees would

effectively be mandatory, thereby affording little room for competitive forces to influence the level of fees.

The Commission noted in the Proposing Release that it also considered the suggestion of many in the second group of commenters that market data fees should be cut back to encompass only the costs of the Plans to collect and disseminate market data. Under this approach, the individual SROs would no longer be allowed to fund any portion of their operational and regulatory functions through market data fees. Yet nearly the entire burden of collecting and producing market data is borne by the individual markets, not by the Plans. If, for example, an SRO's systems fail on a high-volume trading day and it can no longer provide its data to the Plans, investors will suffer the consequences of a flawed data stream, regardless of whether the Plan is able to continue operating.

If the Commission were to limit market data fees to cover only Plan costs, SRO funding would have been cut by $386 million in 2003.[6] Given the potential harm if vital SRO functions are not adequately funded, I believe that the level of market data fees is most appropriately addressed in a context that looks at SRO funding as a whole. The Commission therefore has requested comment on this issue in its recent concept release on SRO structure.[7] In addition, the recently proposed rules to improve SRO transparency would, if adopted, assist the public in assessing the level and use of market data fees by the various SROs.[8]

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6 See Proposing Release, 69 FR at 11179 (table setting forth revenue allocations for 2003).

7 Securities Exchange Act Release No. 50700 (Nov. 18, 2004), 69 FR 71256 (Dec. 8, 2004) ("SRO Structure Release").

8 Securities Exchange Act Release No. 50699 (Nov. 18, 2004), 69 FR 71126 (Dec. 8, 2004) ("SRO Transparency Release").

In sum, there is inherent tension between assuring price transparency for investors, which is a fundamental objective of the Exchange Act,[9] and expanding the extent to which market forces determine market data fees and SRO revenues. Each alternative model for data dissemination has its particular strengths and weaknesses. The great strength of the current model, however, is that it benefits investors, particularly retail investors, by helping them to assess quoted prices at the time they place an order and to evaluate the best execution of their orders against such prices by obtaining data from a single source that is highly reliable and comprehensive. In the absence of full confidence that this benefit would be retained if a different model were adopted, the market data proposal has been formulated to implement such immediate steps as are necessary to improve the operation of the current model.

II. NMS Principles and Objectives

A. Competition Among Markets and Competition Among Orders

Before getting to the details of the trade-through rule, the proposed rule must be placed in proper context. The Commission's range of policy choices cannot be appreciated without first having a clear understanding of the fundamental principles that underlie the national market system and the ultimate objectives for the U.S. equity markets which were, indeed, given to us by Congress in the 1975 Amendments to the Exchange Act, when it directed us, with "due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets," to use our "authority under [the Exchange Act] to facilitate the establishment of a national market system for securities."[10] I therefore will briefly address these principles and objectives.

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9 Exchange Act Section 11A(a)(1)(C)(iii).

10 Exchange Act Section 11A(a)(2).

The fundamental challenge of the national market system can be expressed in a nutshell as promoting and balancing two essential, yet distinct, types of competition: competition among markets for trading services and competition among the orders of buyers and sellers in individual stocks. Each of these forms of competition is essential to the well-being of investors and listed companies. The importance of competition among markets for trading services is self-evident, yet competition among orders is at least as important, for this competition to be the best price produces narrow spreads and deep liquidity. Over the years, the Commission's often difficult task has been to promote both these forms of competition as technology and trading practices evolve.

With respect to competition among markets, the record of the last thirty years should give pause to those who believe that a national market system is inherently inconsistent with vigorous competition. Other countries with significant equity trading typically have a single, overwhelmingly dominant public market, and separate dealer trading in block size. The U.S., in contrast, is fortunate to have equity markets that integrate retail and block orders, and that are characterized by extremely vigorous competition among a variety of different types of markets, including traditional exchanges, electronic order books, market-making dealers, and automated matching systems for large orders.

The public policy challenge, however, is that competition among multiple markets simultaneously trading the same stocks can interfere with competition among orders in those stocks, thereby detracting from the quality of price discovery and leading to reduced market depth and high volatility. Congress, when it directed the establishment of the national market system in 1975, emphasized that "investors must be assured that they

are participants in a system which maximizes the opportunities for the most willing seller to meet the most willing buyer."[11] If this goal is not achieved and competition among orders is seriously impaired, investors will be harmed. In particular, investors would receive inferior prices for their trades, and our markets would be characterized by reduced depth and liquidity and excessive price volatility. Consequently, the Commission must always seek to promote both competition among markets and competition among orders. A trade-through rule is intended primarily to assure that the most willing buyers meet the most willing sellers in the national market system.

B. Giving Precedence to the Interests of Investors

When the Commission published its December release reproposing Regulation NMS, I believed that one of its more straightforward statements was that the interests of investors are entitled to take precedence over the interests of professional short-term traders and market intermediaries when evaluating conflicting policy choices. The statement was made in the specific context of evaluating the effect of a trade-through rule on the interests of professional traders in profiting from extremely short-term trading strategies that can depend on millisecond differences in order response time from markets. Noting that any protection against trade-throughs could interfere to some extent with such short-term trading strategies, the release framed the Commission's policy choice as follows: "Should the overall efficiency of the NMS defer to the needs of professional traders, many of whom rarely intend to hold a position overnight? Or should the NMS serve the needs of longer-term investors, both large and small, that would benefit substantially from intermarket price protection?"

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[11] H.R. Rep. No. 94-123, 94th Cong., 1st Sess. 50 (1975).

Most of the time, the interests of short-term traders and long-term investors will not conflict. Short-term traders clearly provide valuable liquidity to the market. But when the interests of long-term investors and short-term traders diverge, few issues are more fundamentally important in formulating public policy for the U.S. equity markets than the choice between these interests. While achieving the right balance of competition among markets and competition among orders will always be a difficult task, there will be no possibility of accomplishing it if, in the case of a conflict, the Commission cannot choose whether the U.S. equity markets meet the needs of long-term investors or short-term traders.

I strongly believe that one of the most important goals of the equity markets is to minimize the transaction costs of long-term investors and thereby to reduce the cost of capital for listed companies. These functions are inherently related because the cost of capital of listed companies depends on the transaction costs of those who are willing to accept the risk of holding corporate equity for an extended period. To the extent that the interests of professional short-term traders conflict with those of investors in listed companies, the interests of investors are entitled to take precedence. My view is that any other outcome would be directly contrary to the Exchange Act and its objectives of promoting fair and efficient markets that serve the public interest.

I recognize that it is important to avoid false dichotomies between the interests of traders and investors, and that many difficult line-drawing issues potentially can arise in precisely defining the difference between a "trader" and an "investor." For present purposes, however, these issues can be handled by simply noting that it makes little sense to refer to someone as "investing" in a company for a few seconds, minutes, or hours.

Given my views on this matter, I was quite surprised that several commenters sharply questioned whether the Commission should make any distinction between the interests of investors and those of short-term traders. I realized that much of the dispute over Regulation NMS – and the trade-through proposal in particular – may relate more to a lack of common ground on ultimate objectives than to disagreement on particular data and analytical issues. I therefore want the Subcommittee to know quite clearly where I stand on this issue and why.

Short-term traders and market intermediaries unquestionably provide needed liquidity to the equity markets and are essential to the welfare of investors. Consequently, much, if not most, of the time the interests of investors and professional traders in efficient markets will coincide. But when they conflict, the Commission's clear responsibility under the Exchange Act is to uphold the interests of investors.

Indeed, the core concern for the welfare of investors was first expressed in the foundation documents of the Exchange Act itself. In language that remains remarkably relevant today, the 1934 congressional reports noted how the national public interest of the equity markets had grown as more and more Americans had begun to place their savings in equity investments. Given this development, the reports emphasized that "stock exchanges which handle the distribution and trading of a very substantial part of the entire national wealth . . . cannot operate under the same traditions and practices as pre-war stock exchanges which handled substantially only the transactions of professional investors and speculators."[12]

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[12] H.R. Rep. No. 1383, 73rd Cong., 2d Sess. 4 (1934).

In the years since 1934, the priority placed by Congress on the interests of investors has grown more and more significant. Today, more than 84 million individuals representing more than one-half of American households own equity securities.[13] More than 70 million of these individuals participate indirectly in the equity markets through ownership of mutual fund shares. Most of them hold their investments, at least in part, in retirement plans. Indeed, nearly all view their equity investments as savings for the long-term, and their median length of ownership of equity mutual funds, both inside and outside retirement plans, is 10 years.[14]

In assessing the current state of the NMS and formulating its rule proposals, the Commission has focused on the interests of these millions of Americans who depend on the performance of their equity investments for such vital needs as retirement security and their children's college education. Their investment returns are reduced by transaction costs of all types, including the explicit costs of commissions and mutual fund fees. But the largely hidden costs associated with the prices at which trades are executed often can dwarf the explicit costs of trading. For example, the implicit transaction costs associated with price impact of trades by mutual funds and other institutional investors is estimated at more than $30 billion per year.[15] Such hidden costs eat away at the long-term returns of millions of individual mutual fund shareholders and pension plan participants. One of the primary objectives of the NMS is to help reduce such costs by improving market liquidity and depth. The best way to promote market depth and liquidity is to encourage vigorous competition among orders. As a result, the

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13 Investment Company Institute and Securities Industry Association, Equity Ownership in America 17 (2002).

14 Id. at 85, 89, 92, 96.

15 Reproposing Release, 69 FR 77424, 77443-77444.

Commission cannot merely focus on one type of competition – competition among markets to provide trading services – at the expense of impaired competition among orders. The interests of U.S. investors and listed companies require that the national market system continue to promote both types of competition.

III. Benefits of Trade-Through Rule

With that overview, I'd now like to turn to the topic of the proposed trade-through rule, and will begin with three basic observations.

First, I would observe that throughout the Commission's deliberations over the proposed trade-through rule, we have kept our eye on one overriding objective – the protection of investors – with particular attention to the concerns of small investors who may not have the resources to monitor the behavior of their agents, the brokers. The thrust of the proposed trade-through rule is actually quite simply stated: when an investor sends an order to a market, the market can either execute the order at the best price then being quoted in the national market system, or the market must send the order to the best quoting market. What does this mean? Two things. It means that a broker executing an order will be required to give that order the best price then available in any electronically accessible market, even if the broker internalizes the order or would prefer to trade in another market that may offer the broker itself, if not the customer, an advantage. And second, it means that an investor who is willing to place an aggressively priced limit order on the book will not have his order ignored in favor of a less aggressively priced order. This second point is sometimes overlooked, so let me expand on it a bit. The investor who is willing to post a limit order supplies liquidity to the marketplace. The limit order shows the market where trading interest lies and helps to establish the best

prices for stock trading. This investor provides a public service, and the market as a whole benefits.

But this investor acts at a cost to himself, for he reveals his trading interest, and he offers an option that any other investor can exercise simply by placing a market order. He risks having that option exercised only when the market is moving against him, and losing the trade when the market is moving away from him. His only compensation is the ability to trade when his quote is the best quote available. If he does not get an execution, then he is not compensated, and he will soon question why he posted the limit order. Worse, if he only gets an execution when the market is moving against him, we can begin to understand why he might choose not to offer the option to the market in the first place. A trade-through rule helps protect that investor for his willingness to supply liquidity in the market.

So the trade-through rule is, in the most fundamental sense, a rule that protects investors.

This simple point can get lost in all of the sound and fury unleashed by the vested interests for whom a market-wide trade-through rule would require new ways of doing business. I know that the members of this Subcommittee have been lobbied just as hard as I have on this issue, and I am sure that you have asked yourself, as I have, just exactly whose interests are being advocated.

The second broad observation I would make, is that I think it useful to note that much of the hue and cry over the trade-through rule is somewhat wide of the mark. The most strident criticism that we hear about the trade-through rule appears to focus on the existing ITS rule, a 35-year-old anachronism that has plainly outlived its usefulness. Let

me be absolutely clear. The Commission is not proposing to validate or extend the ITS rule. Quite the contrary: the Commission has proposed a different type of trade-through rule – one that would work in today's marketplace.

The ITS rule is like a horse-and-buggy driving down the runway at Reagan National Airport. That is because the key weakness of the ITS rule is that it does not distinguish between an electronic quote – one that can be executed immediately – and a manual quote – one that requires human beings to negotiate. The ITS rule has made it difficult for electronic marketplaces to compete with floor-based exchanges, and in the process has helped floor-based markets maintain their competitive dominance. The Commission has proposed to fix that problem. The only quotes entitled to protection under the proposed trade-through rule are electronic quotes – quotes that are immediately and automatically accessible.

As so structured, the proposal addresses the main criticism that one hears about the ITS rule – that when a market is forced to send an order to New York, it languishes while the specialist decides whether to trade with it. That cannot happen under the rule the Commission has proposed. If the quote is not automatic, then it is not protected.

The proposal addresses other legitimate criticisms of the old ITS rule, such as the block-trade exception that results in the bulk of trade-throughs in listed stocks, and the weak and cumbersome "satisfaction" remedy that the old rule provides. In effect, the old rule does not prohibit trade-throughs – it merely tells a market that is traded-through that it can go and complain to the other market, and demand "satisfaction." As you can imagine, such a weak remedy is weakly enforced.

The Commission's proposed rule would eliminate the broad block exception in favor of more tailored benchmark and intermarket sweep exceptions, and would require market centers actually to implement policies and procedures that are reasonably designed to prevent trade-throughs, instead of merely providing for an after-the-fact "satisfaction" remedy.

To my final observation, I want to emphasize that the trade-through rule that the Commission has proposed is pro-competitive – in the best tradition of the market-reform initiatives that the Commission has spearheaded over the last several years. Much of the public debate over the trade-through rule has focused on one type of competition – competition between markets. But as I alluded to above, we must remember that there are two kinds of competition that Congress directed us to foster. One is competition between markets – like the competition between Nasdaq and Instinet, for example – and the other is competition between investors, or, as it is usually called, competition between orders.

Both kinds of competition are essential for vibrant and healthy markets, as Congress recognized in 1975 when it told us to perfect the national market system. Some of the powerful market centers and professional traders most vocal in this debate seem to downplay order competition. But as noted below, the Commission has not forgotten that one of the great strengths of the U.S. equity markets is that the trading interest of all types and sizes of investors is integrated, to the greatest extent possible, into a unified market system.

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The primary objective of a trade-through rule is to promote competition among orders – to encourage the most willing buyers and sellers of a stock to meet on an order-by-order basis, no matter where their orders are submitted in the national market system. The proposed rule therefore would require all markets to establish, maintain, and enforce policies and procedures that are reasonably designed to prevent "trade-throughs" – the execution of an order at a price that is inferior to the price of a protected quotation, often representing an investor limit order, displayed by another market. In evaluating whether to adopt a trade-through rule, the Commission must consider two broad categories of issues: first, whether there is a need for intermarket protection against trade-throughs and, second, whether the potential benefits would justify the implementation and other costs of a trade-through rule.

Commenters supporting the trade-through proposal have emphasized three important benefits of trade-through protection. First, a trade-through rule would provide an order-by-order backstop to a brokers' duty of best execution for customer market orders. Although all brokers owe a duty of best execution to customers when handling their orders, the interests of agents and their principals often can conflict. Brokers may have strong financial and other interests for routing orders to a particular market, which may or may not be displaying the best price for a stock. I believe that most investors, particularly retail investors, assume that their market orders will be executed at the best available prices. It can be difficult, however, for investors to monitor whether, in fact, their orders have been executed at the best available price in stocks with rapidly changing quotations. Investors generally will know the best quoted price at the time they place their order, but prices can change during the interval between order submission and order

execution. A trade-through rule would protect the interests of retail investors by affirming the principle of best price on an order-by-order basis.

Second, commenters have emphasized that a trade-through rule would promote fair and orderly treatment of investor limit orders. Many of the limit orders in today's equity markets are submitted by retail investors. Indeed, one of the great strengths of the U.S. equity markets is that the trading interest of all types and sizes of investors is integrated, to the greatest extent possible, into a unified market system. Such integration ultimately works to benefit both retail and institutional investors. Retail investors will participate directly in the U.S. equity markets, however, only to the extent they perceive that their orders will be treated fairly and efficiently. I am concerned about retail investors' perception of unfairness when they display an order representing the best price for a stock, yet see that price bypassed by trading in other markets. A trade-through rule such as the one the Commission has proposed would help maintain the confidence of all types of investors in the U.S. equity markets.

Finally, commenters supporting a trade-through rule have emphasized the need to promote greater depth and liquidity in NMS stocks by encouraging the use of limit orders. They noted, for example, that limit orders typically establish the "market" for a stock. In the absence of limit orders setting the current market price and the size available at that price, there would be no benchmark for the submission and execution of market orders. Focusing solely on best execution of market orders – and the interests of orders that take displayed liquidity – would miss a critical part of the equation for promoting the most efficient markets – the best execution of orders that supply displayed

liquidity. The trade-through rule is designed to promote best execution of both market orders and limit orders.

IV. Applying Proposed Trade-Through Rule to Nasdaq Stocks

Commenters disputing the need for a trade-through rule for Nasdaq stocks have focused on two factual contentions. First, they have claimed that few trade-throughs occur in Nasdaq stocks and that a rule therefore simply would impose unnecessary costs. Second, they have claimed that trading in Nasdaq stocks, which currently are not covered by any trade-through rule, is more efficient than trading in NYSE stocks, which are covered by the ITS trade-through provisions.

The Commission staff has evaluated the first factual contention by measuring the rate of trade-throughs for Nasdaq and NYSE stocks. The staff study found that trade-through rates are significant for Nasdaq stocks. For example, 1 of every 40 trades in Nasdaq stocks, or approximately 98,000 trades per day, receive a price that is inferior to a displayed and accessible quotation. Given that retail investors can have serious difficulty monitoring whether their orders receive the best price, I am greatly concerned that thousands of retail investors each day may unwittingly be receiving an inferior execution of their orders in Nasdaq stocks. Moreover, I do not believe that retail investors would consider the current rate of trade-throughs in Nasdaq stocks to be "insignificant," as it has been characterized by some of the commenters.

The staff also found significant trade-through rates when measured as a percentage of share volume in Nasdaq stocks. The staff used a number of different methods to calculate such rates, but the overall rates generally ranged from a low of 1.9% when considered as the volume of traded-through quotations, to a high of 7.9% when

considered as the total volume of trades that were executed at inferior prices. In hundreds of the most active Nasdaq stocks, this latter figure rises to 9% and higher.

Some commenters have argued that only the relatively low share volume of traded-through quotations is relevant for assessing the need for a trade-through rule. The low figure, however, reflects the current shortage of displayed size in the absence of trade-through protection. It therefore is a symptom of the problem, rather than an indication of the health of the Nasdaq market. For example, many active Nasdaq stocks trade millions of shares per day, yet average less than 2000 shares of displayed size at their best prices. Given this small amount of displayed size, it simply is impossible for traded-through quotations to represent a large percentage of total share volume in these stocks. But lack of displayed depth is evidence of a market problem, not market quality.

Finally, the staff study also found significant trade-through rates for NYSE stocks – 2.5% of trades and 7.1% of share volume. Notably, however, the great majority of such trade-throughs fall within loopholes to the current ITS provisions that would be closed by the Commission's rule. Moreover, the ITS rules are seriously flawed because they merely provide an inefficient "satisfaction" remedy, rather than truly protecting limit orders by giving them a fast and efficient execution. Finally, the ITS rules are flawed by their failure to distinguish between automated and manual quotations. Thus, while trade-through rates in NYSE stocks are significant and need to be addressed, they do not demonstrate the inherent ineffectiveness of trade-through rules, but rather the severe weaknesses of the ITS approach.

Commenters on the reproposal offered a variety of reasons why they believed the staff study of trade-through rates might be flawed. Commission staff currently is

evaluating their comments. One claim, for example, was that the sample dates chosen for the study involved unusual trading activity. In fact, our economists chose dates that were well within the norms for trading volume and volatility.

Another claim was that the staff study failed to consider the use of reserve size for Nasdaq stocks and therefore greatly overestimated current trade-through rates. The basic flaw in the commenters' claim is that its validity would depend on the failure of sophisticated order routers to consider reserve size when they route orders to multiple markets to sweep available liquidity. Reserve size, however, is a quite well known characteristic of the market for Nasdaq stocks. Indeed, the evidence indicates that order routers are quite accustomed to sweeping both displayed and reserve size when they truly intend to obtain the best prices for their customers. It is most unlikely, therefore, that the existence of reserve size caused the staff study to overestimate trade-through rates for Nasdaq stocks.

The second principal factual contention of commenters opposed to a trade-through rule was that trading in Nasdaq stocks currently is more efficient than trading in NYSE stocks. The Nasdaq market unquestionably has improved significantly for investors over the years. Notably, the most significant steps forward have followed Commission action to extend national market system principles to Nasdaq stocks. These initiatives have included trade reporting, limit order display, inclusion of ECNs in the consolidated data systems, and disclosure of order execution quality.

Nevertheless, the relevant data does <u>not</u> support any sweeping claim that trading in Nasdaq stocks now is generally more efficient than trading in NYSE stocks. As was discussed at length in the Commission's December release, the data submitted by

commenters, which purported to demonstrate the superiority of order execution quality for Nasdaq stocks, was flawed in many different respects. An appropriate analysis reveals that the markets for Nasdaq and NYSE stocks each have their particular strengths and weaknesses.

Moreover, in assessing the need for a trade-through rule, I do not believe it is necessary for the Commission to make any final judgments regarding the relative efficiency of trading in Nasdaq and NYSE stocks. Rather, the critical issue is whether effective protection against trade-throughs would benefit each market, given its specific trading characteristics. On this point, the data indicates that the market for Nasdaq stocks has weaknesses that the implementation of an effective trade-through rule would be designed to address. Although many commenters have been willing to sharply criticize the quality of the exchange-listed markets, they have been much less willing to closely scrutinize weaknesses in the market for Nasdaq stocks.

For example, the fill rates for marketable limit orders in Nasdaq stocks are low, generally falling below 50% for larger order sizes. Many of these unfilled orders may have been probing unsuccessfully for undisplayed "reserve" liquidity and consequently have limit prices that preclude any execution outside the best quotations. Such orders have been called "pinging" orders, but they could just as aptly be named "liquidity search" orders because they are searching for both displayed and reserve liquidity. Consequently, although the effective spreads obtained for orders that actually receive an execution may be relatively narrow, these spreads give only a partial view of total investor transaction costs because they do not encompass costs associated with the more

than 50% of orders that did not receive a fill. The evidence indicates that such costs likely are substantial for investors

In addition, nearly all studies of Nasdaq trading, both by Commission staff and academics, have found significant short-term price volatility. Short-term volatility should be distinguished from fundamental volatility – price fluctuations associated with factors independent of market structure, such as earnings changes and other economic determinants of stock prices. Excessive short-term volatility indicates a shortage of liquidity. Such volatility may offer profitable trading opportunities for short-term traders and other market professionals, but this comes at the expense of investors, who buy at higher or sell at lower prices. Retail investors, in particular, tend to be relatively uninformed concerning short-term price movements and are apt to bear the brunt of the trading costs associated with excessive volatility. The trade-through rule, by promoting greater depth and liquidity, is designed to help reduce short-term volatility in Nasdaq stocks.

In its comment on the reproposal, one of the major Nasdaq market centers questioned whether volatility was, in fact, a market weakness that even needed to be addressed.[16] While volatility may encourage greater trading volume on electronic marketplaces, it is widely considered a negative condition indicating an illiquid market. For example, when creating the national market system in 1975, Congress emphasized that one of its "paramount" objectives was "the maintenance of stable and orderly markets with maximum capacity for absorbing trading imbalances without undue price

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16 Instinet Reproposal Letter at 7-8.

movements."[17] This congressional emphasis on minimizing volatility was yet another manifestation of its intent to give precedence to the interests of investors over those of professional traders and market intermediaries.

Improving market depth and liquidity also would help minimize transaction costs for large institutional investors. The largest component of institutional trading costs is caused by adverse price movements when attempting to execute large orders. These largely hidden costs annually amount to more than $30 billion for equity mutual funds and other large institutional investors. The proposed trade-through rule is designed to improve incentives for displaying liquidity by guaranteeing effective price priority. More displayed liquidity will *at least* lower the search costs associated with trying to find liquidity. If this displayed liquidity represents new orders, it should also reduce transaction impact cost. Consequently, if trade-through protection produced even a small percentage reduction in these costs, this would generate hundreds of millions of dollars in benefits every year for individual mutual fund investors and pension plan participants.

V. Alternatives to Trade-Through Rule

In addition to raising factual claims concerning the extent of trade-throughs and the efficiency of trading in Nasdaq stocks, some commenters have argued that a trade-through rule is unnecessary because reliance on market access and brokers' duty of best execution would achieve similar results. This argument, however, fails to address the problem of "free-riding" on displayed quotations. Even when market participants act in their own economic self-interest, or brokers act in the best interests of their customers, they may deliberately choose, for various reasons, to bypass limit orders with the best displayed prices. For example, an institution may be willing to accept a dealer's

[17] S. Rep. No. 94-75, 94th Cong., 1st Sess. 7 (1975).

execution of a particular block order at a price outside the best prices, thereby transferring the risk of any further price impact to the dealer. Market participants that execute orders at inferior prices without protecting displayed limit orders are effectively free-riding on the price discovery provided by those limit orders. Displayed limit orders benefit all market participants by establishing the best prices, but, when bypassed, do not themselves receive a benefit, in the form of an execution, for providing this public good. This economic externality, in turn, creates a disincentive for investors to display limit orders, particularly limit orders of any substantial size.

One commenter on the reproposal questioned whether large trades that bypass displayed quotations should be considered as free-riding on the price discovery provided by displayed orders.[18] It emphasized that the price-formation process reflects information stemming from all trading interest and that institutional trading interest is an important part of the process. As evidence, the commenter noted that almost one-third of reported volume on the NYSE in 2004 was of block size, typically representing undisplayed institutional trading interest.

Institutional trading interest, both displayed and undisplayed, undoubtedly is an important part of the price discovery process. Notably, the large volume of block trades currently executed on the NYSE is subject both to the NYSE's order interaction rules and the ITS trade-through rules. Accordingly, NYSE block trades cannot be considered as free-riding on displayed limit orders, in contrast to block trades reported by block positioners in the OTC market that currently do not interact with displayed liquidity and are not covered by the ITS provisions.

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[18] Fidelity Reproposal Letter at 5.

Moreover, the proposed trade-through rule would not require that all institutional trading interest be displayed – a goal that would be both futile and counterproductive. Rather, the proposed trade-through rule would provide a greater incentive for the voluntary display of a greater proportion of latent trading interest by assuring that, when such interest is displayed, it is protected against most trade-throughs. In these circumstances, institutions would choose to display when they determined it was in their own interests, not because they were required by Commission rule. Greater displayed size would improve the quality of price discovery for all market participants.

Another commenter asserted that the reproposal overly emphasized the importance of displayed limit orders in the price discovery process.[19] As the commenter noted, many different factors contribute to the price discovery process, including previous trades and undisplayed trading interest. But displayed limit orders are a critically important element of efficient price discovery, both with respect to establishing the inside prices and the size that can be traded at such prices. In particular, such orders are the most transparent and accessible source of liquidity in the equity markets. There are, of course, other sources of liquidity, including (1) reserve size, (2) "not held" institutional orders that are worked by floor brokers on an exchange, (3) automated matching networks that allow large buyers and sellers to meet directly and anonymously, and (4) securities dealers that are willing to commit capital to facilitate customer orders. Displayed limit orders, however, give anyone the ability to trade when they want to trade on a first-come, first-served basis at the market where they are displayed. They thereby act as a vital reference point for all other sources of liquidity. Specifically, reserve size,

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[19] TIAA-CREF Reproposal Letter, Attachment at 9, 15.

undisplayed floor interest, automated matching, and dealer capital commitments all are facilitated by displayed information concerning the price and size of stock that is available for immediate trading in the public markets.

Commenters opposing the trade-through proposal also questioned whether protection against trade-throughs would in fact lead to any increase in the use of limit orders, particularly given the many reasons militating against display. Clearly, a large investor interested in buying 50,000 shares of a stock will not suddenly decide to show his hand simply because his order is given trade-through protection. Without question, there are a host of reasons that deter market participants from displaying their trading interest in full. Indeed, it is the existence of these disincentives, combined with a shortage of positive incentives for display, that have contributed to the small displayed depth at the best prices that characterizes the market for many stocks today.

The objective of the proposed trade-through rule is more modest. It would simply be to increase the perceived benefits of order display, against which the countervailing factors are balanced. As a result, market participants that currently display only 500 shares of their trading interest might be willing to display 1000 shares. The collective effect of many market participants reaching the same conclusion would perhaps be a material increase in the total displayed depth in the market, thereby improving the quality of public price discovery and reducing investor transaction costs.

Some also have suggested that, if the Commission's goal is to protect limit orders, the most powerful tool to achieve that goal would be to establish strict price/time priority for limit orders across all markets.[20] Such an approach particularly would address the

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[20] See, e.g., Instinet Proposal Letter at 12.

common practice of dealers when they internalize customer orders to match the best displayed prices for a stock. Those raising the possibility of restricting this price-matching practice believed that the Commission's only true choice is either to impose no intermarket priority rules, even price priority, or to impose full price/time priority. But the only means to implement intermarket price/time priority would be to mandate a true central limit order book – a "CLOB." The Commission previously has explored such an alternative, but determined that it had potentially severe drawbacks that offset its promotion of limit orders. Most importantly, a true CLOB would require that nearly all orders be funneled through a single trading facility so that they could be ranked by time. Such a facility would greatly reduce the opportunity for markets to compete by offering different trading services. As I discussed above, the challenge of the national market system is to achieve an appropriate balance of market competition and order competition. I believe that a trade-through rule would not have anywhere near the restrictive effect on market competition as a CLOB. The relevant issue before the Commission is whether the benefits of trade-through protection would justify its more limited costs.

VI. Difficulties and Costs of Implementing Trade-Through Rule

In sum, while I emphasize that the Commission has not reached a final judgment on this issue, there appear to be strong reasons to believe that applying the trade-through rule to Nasdaq stocks could generate significant benefits for investors. Clearly, in reaching a final decision, the Commission also must carefully consider the difficulties and costs of a trade-through rule. In addition to the explicit costs of implementation, I believe there are three primary concerns that the Commission must address: (1) the effect of a trade-through rule on competition among markets and investor choice, (2) the extent

to which trade-through protection may lessen competitive discipline on inefficient markets, and (3) the extent to which a trade-through rule is workable for Nasdaq stocks.

Many commenters were concerned that a trade-through rule might unduly detract from competition among markets, particularly competition based on factors other than price, such as system performance and reliability. I share this concern, but wonder whether the commenters have overstated the risk that such competition would be dampened by adoption of a trade-through rule. Even with a rule, markets likely would have strong incentives to continue to compete and innovate to attract both market orders and limit orders. Market participants and intermediaries responsible for routing market orders, consistent with their desire to achieve the best price and their duty of best execution, would continue to rank trading centers according to the total range of services provided by those markets. Such services include cost, speed of response, sweep functionality, and a wide variety of complex order types. The most competitive trading center would be the first choice for routing market orders, thereby enhancing the likelihood of execution for limit orders routed to that trading center. Because likelihood of execution is of such great importance to limit orders, limit order providers would be attracted to this preferred trading center. More limit orders would enhance the depth and liquidity offered by the preferred trading center, thereby increasing its attractiveness for market orders, and beginning the cycle all over again.

Conversely, trading centers that offer poor services likely would rank near the bottom in order-routing preference of most market participants and intermediaries. Whenever the least-preferred trading center was merely posting the same price as other trading centers, orders would be routed to other trading centers. As a result, limit orders

displayed on the least preferred trading center would be least likely to be executed in general. Moreover, such limit orders would be the least likely to be executed when prices move in favor of the limit orders, and the most likely to be executed only when prices are moving against the limit order, adding the cost of "adverse selection" to the cost of a low likelihood of execution. In sum, the lowest ranked trading center in order-routing preference, with or without intermarket price protection, would suffer the consequences of offering a poor range of services to the routers of marketable orders.

The second major concern with adopting a trade-through rule is that it might lessen the competitive discipline that market participants can impose on inefficient market centers. A trade-through rule requires that market participants either match quoted prices or route orders to any market center quoting the best price. This is good for investors generally, but may not be if the quoting market is inefficient. For example, a market center may have poor systems that do not process orders quickly and reliably. Or a low-volume market may not be nearly as accessible as a high-volume market. The reproposed trade-through rule attempts to address this concern by establishing stringent standards for automated quotes and automated markets. It gives other markets a "self-help" remedy to bypass slow markets. Nevertheless, these remedies may not be as effective or as flexible as unfettered competitive forces in disciplining problem markets. If problem markets are not dealt with effectively, implementation of a trade-through rule could detract from the current level of efficiency of trading for Nasdaq stocks.

The third major concern with adopting a trade-through is that it could be less workable for Nasdaq stocks than for exchange-listed stocks. Many Nasdaq stocks are more actively traded than exchange-listed stocks, and thus often have many trade and

quote updates per second. In addition, a larger number of separate market centers currently trade Nasdaq stocks than trade exchange-listed stocks. The combination of more trades and quote updates with more market centers may make implementation of intermarket trade-through protection more difficult for Nasdaq stocks. More orders will need to be routed to more market centers. Moreover, the listed markets are accustomed to working with a trade-through rule, while the Nasdaq markets have developed without one and would have a greater cultural change.

Some commenters suggested that the Commission should consider an exemption from the proposed trade-through rule for stocks that trade very actively.[21] I believe that the benefit of such an exception could be the exclusion of those stocks for which implementation is likely to be most difficult. The downside, however, may be that these also are the stocks that have the highest level of investor participation. For example, the need for a trade-through rule to backstop a broker's duty of best execution by assuring that retail investors receive the best available price is perhaps most acute with respect to the active stocks. In assessing any active stock exemption, the Commission will need to carefully assess the effect it could have on the investor protection objectives of the trade-through proposal.

Although Nasdaq stocks are part of the national market system, some have suggested that the Commission should at this point adopt a trade-through rule only for exchange-listed stocks. Although this approach would preclude the possibility of unintended consequences in the Nasdaq market, this approach would have drawbacks that the Commission would need to consider carefully. One of the Commission's goals in its

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[21] See, e.g., SIA Reproposal Letter at 12.

years-long review of market structure has been to formulate rules for the national market system that adequately reflect current technologies and trading practices and that promote equal regulation of stocks and markets. This goal does not reflect a simple desire for uniformity, but is identified in the Exchange Act as a vital component of a truly national market system.[22] The trade-through rule objective of promoting best execution of customer orders would be a particularly difficult benefit to set aside for Nasdaq stocks. I question whether ordinary investors should have to remember that their orders are protected by a Commission rule for exchange-listed stocks, but that *caveat emptor* still prevails in the Nasdaq market. As I noted earlier, the relevant data indicates that thousands of investors in Nasdaq stocks each day may unwittingly be receiving an inferior price for their orders. The Commission will need to carefully consider whether, if a trade-through rule is indeed appropriate for exchange-listed stocks, its best execution and liquidity-enhancing benefits should not be extended to Nasdaq stocks.

In sum, the Commission should not extend a trade-through rule to Nasdaq stocks without addressing all potential costs and drawbacks, particularly the serious concerns about competitive discipline and workable implementation. In the coming weeks, I and my fellow commissioners intend to focus closely on these issues in formulating final rules.

VII. Conclusion

I will conclude by offering a few thoughts on the future of the Regulation NMS rulemaking process. Although I cannot predict the final outcome, I do believe it is extremely important that there be an outcome, and that the outcome be reached soon. Many of the issues raised by the Regulation NMS proposals have lingered for many years

[22] Exchange Act Section 11A(c)(1(F).

and caused serious discord among market participants. These issues have been studied and debated and evaluated from nearly every conceivable angle. Few would seriously oppose the notion that the current structure of the national market system is outdated in many respects and needs to be modernized. The Commission must move forward and make decisions with regard to final rules if the U.S. equity markets are to continue to meet the needs of investors and public companies.

I can assure you that the Commission fully recognizes the far-reaching nature of many of the proposals. If adopted, some would require significant industry efforts to modify systems and otherwise prepare for the new regulatory structure. We are sensitive to these concerns and, if the Commission chooses to adopt the rules, we will work closely with the industry on implementing them. This process clearly would include an extended time period for the industry to prepare before the new rules become effective. In addition, the process would include phase-in periods to test systems and compliance on a limited group of stocks prior to full implementation for all stocks. Moreover, if the rules were to be adopted, the Commission and its staff would need to consult with the industry throughout the implementation period to clarify any issues that arise, to seek pragmatic solutions to any potential systems or other compliance difficulties, and in general to promote the most efficient possible process for the industry to respond to the adopted rules.

As I have emphasized, the Commission is still considering the Regulation NMS proposals, including all of the issues that I have discussed today. I look forward to hearing your views and answering your questions on the market structure issues facing the Commission, with the simple caveat that, as I am sure you appreciate, it would be

inappropriate for me to attempt to prejudge where the Commission will arrive in its deliberations on these complex subjects. Thank you again for inviting me to speak. I would be happy to try and answer any of your questions.

Question: Some market participants view rules prohibiting locked and crossed markets, such as those proposed in Reg. NMS, as an action that could negatively impact investors and the markets. However, others indicate that these rules would be a positive development for markets and investors. Please explain how the Commission came to the conclusion to have a locked and crossed market rule.

Response:

The Commission's adopted rule regarding locked and crossed markets - Rule 610(d) of Regulation NMS - provides that SROs must establish, maintain, and enforce written rules: (1) requiring their members reasonably to avoid displaying quotations that lock or cross any protected (i.e., automated) quotation, or displaying manual quotations that lock or cross any quotation in an NMS stock (e.g., a NYSE, Amex, or Nasdaq listed stock); (2) reasonably designed to assure the reconciliation of locked or crossed markets; and (3) prohibiting their members from engaging in a pattern or practice of displaying locking or crossing quotations that are to be avoided pursuant to (1). Notably, consistent with the Commission's approach taken in the adopted Order Protection Rule, the rule allows automated quotations to lock or cross manual quotations, thereby addressing the concern that manual quotations may not be fully accessible and recognizing that allowing automated quotations to lock or cross manual quotations may provide useful market information. The Commission adopted the locked and crossed markets rule after considering comments received in response to the proposal and reproposal of Regulation NMS, as well as discussions held at the public hearings on the NMS proposal.

Most of the commenters who addressed the issue supported the proposed restrictions on locking and crossing quotations, generally agreeing that the practice of displaying quotations that lock or cross previously displayed quotations is inconsistent with fair and orderly markets and detracts from market efficiency. Some commenters asserted that locked markets often occur when a market participant deliberately posts a locking quotation to avoid paying a fee to access

the quotation of another market and to receive a liquidity rebate for an execution against its own displayed quotation. Several commenters specifically supported the modification to allow automated quotations to lock or cross manual quotations. A few commenters opposed restricting the practice of locking or crossing quotations, generally believing that the proposal would impair market transparency and efficiency, such as by prohibiting the display of information as to the true level of trading interest or information that a particular market's quotations may be inaccessible.

In adopting the locked and crossed markets rule, the Commission agrees with commenters supporting the proposal that an automated quotation is entitled to protection from locking or crossing quotations. When two market participants are willing to trade at the same quoted price, giving priority to the first-displayed automated quotation will encourage posting of quotations and contribute to fair and orderly markets. The basic principle underlying the national market system is to promote fair competition among markets, but within a system that also promotes interaction between all of the buyers and sellers in a particular NMS stock. Allowing market participants simply to ignore accessible quotations in other markets and routinely display locking and crossing quotations is inconsistent with this principle. The Rule will, however, not prohibit automated quotations from locking or crossing manual quotations, thereby permitting market participants to reflect information regarding the inaccessibility of a particular trading center's quotations.

Question 2: When does the SEC plan on ruling on NYSE's Hybrid Plan? Is the SEC waiting until the Reg NMS rule is promulgated?

Response:

The New York Stock Exchange has proposed to significantly alter its existing auction market structure by expanding automatic executions on its market and provide a means for its floor members to trade electronically. Among other things, NYSE proposes to automatically execute in Direct+ all marketable limit orders, market orders, and ITS commitments, regardless of size.

The NYSE recently submitted an amendment to its Hybrid proposal, which has been published for public comment and can be found at http://www.sec.gov/rules/sro/nyse/34-51906.pdf. To date the Commission has received 25 comments in response to previous published notices describing the Hybrid proposal. I anticipate that the Commission will consider the Hybrid proposal once the current comment period has ended.

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