ECNs AND MARKET STRUCTURE: ENSURING BEST PRICES FOR CONSUMERS

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCE, TRADE, AND CONSUMER PROTECTION

OF THE

COMMITTEE ON ENERGY AND COMMERCE
HOUSE OF REPRESENTATIVES

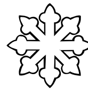
ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

OCTOBER 17, 2002

Serial No. 107–134

Printed for the use of the Committee on Energy and Commerce



Available via the World Wide Web: http://www.access.gpo.gov/congress/house

U.S. GOVERNMENT PRINTING OFFICE
82–451CC WASHINGTON : 2002

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON ENERGY AND COMMERCE

W.J. "BILLY" TAUZIN, Louisiana, *Chairman*

MICHAEL BILIRAKIS, Florida
JOE BARTON, Texas
FRED UPTON, Michigan
CLIFF STEARNS, Florida
PAUL E. GILLMOR, Ohio
JAMES C. GREENWOOD, Pennsylvania
CHRISTOPHER COX, California
NATHAN DEAL, Georgia
RICHARD BURR, North Carolina
ED WHITFIELD, Kentucky
GREG GANSKE, Iowa
CHARLIE NORWOOD, Georgia
BARBARA CUBIN, Wyoming
JOHN SHIMKUS, Illinois
HEATHER WILSON, New Mexico
JOHN B. SHADEGG, Arizona
CHARLES "CHIP" PICKERING, Mississippi
VITO FOSSELLA, New York
ROY BLUNT, Missouri
TOM DAVIS, Virginia
ED BRYANT, Tennessee
ROBERT L. EHRLICH, Jr., Maryland
STEVE BUYER, Indiana
GEORGE RADANOVICH, California
CHARLES F. BASS, New Hampshire
JOSEPH R. PITTS, Pennsylvania
MARY BONO, California
GREG WALDEN, Oregon
LEE TERRY, Nebraska
ERNIE FLETCHER, Kentucky

JOHN D. DINGELL, Michigan
HENRY A. WAXMAN, California
EDWARD J. MARKEY, Massachusetts
RALPH M. HALL, Texas
RICK BOUCHER, Virginia
EDOLPHUS TOWNS, New York
FRANK PALLONE, Jr., New Jersey
SHERROD BROWN, Ohio
BART GORDON, Tennessee
PETER DEUTSCH, Florida
BOBBY L. RUSH, Illinois
ANNA G. ESHOO, California
BART STUPAK, Michigan
ELIOT L. ENGEL, New York
TOM SAWYER, Ohio
ALBERT R. WYNN, Maryland
GENE GREEN, Texas
KAREN MCCARTHY, Missouri
TED STRICKLAND, Ohio
DIANA DEGETTE, Colorado
THOMAS M. BARRETT, Wisconsin
BILL LUTHER, Minnesota
LOIS CAPPS, California
MICHAEL F. DOYLE, Pennsylvania
CHRISTOPHER JOHN, Louisiana
JANE HARMAN, California

DAVID V. MARVENTANO, *Staff Director*
JAMES D. BARNETTE, *General Counsel*
REID P.F. STUNTZ, *Minority Staff Director and Chief Counsel*

SUBCOMMITTEE ON COMMERCE, TRADE, AND CONSUMER PROTECTION

CLIFF STEARNS, Florida, *Chairman*

FRED UPTON, Michigan
NATHAN DEAL, Georgia
Vice Chairman
ED WHITFIELD, Kentucky
BARBARA CUBIN, Wyoming
JOHN SHIMKUS, Illinois
JOHN B. SHADEGG, Arizona
ED BRYANT, Tennessee
GEORGE RADANOVICH, California
CHARLES F. BASS, New Hampshire
JOSEPH R. PITTS, Pennsylvania
MARY BONO, California
GREG WALDEN, Oregon
LEE TERRY, Nebraska
ERNIE FLETCHER, Kentucky
W.J. "BILLY" TAUZIN, Louisiana
(Ex Officio)

EDOLPHUS TOWNS, New York
DIANA DEGETTE, Colorado
LOIS CAPPS, California
MICHAEL F. DOYLE, Pennsylvania
CHRISTOPHER JOHN, Louisiana
JANE HARMAN, California
HENRY A. WAXMAN, California
EDWARD J. MARKEY, Massachusetts
BART GORDON, Tennessee
PETER DEUTSCH, Florida
BOBBY L. RUSH, Illinois
ANNA G. ESHOO, California
JOHN D. DINGELL, Michigan,
(Ex Officio)

CONTENTS

Page

Testimony of:

Foley, Kevin M., Chief Executive Officer, Bloomberg Tradebook, LLC 6

Gasser, Robert C., Chief Executive Officer, Nyfix Millennium, LLC 25

O'Brien, William, Senior Vice President and General Counsel, Brut, LLC 19

O'Hara, Kevin J.P., General Counsel, Archipelago 14

Ryan, Michael J., Jr., General Counsel, American Stock Exchange LLC ... 29

Additional material submitted for the record:

Foley, Kevin M., Chief Executive Officer, Bloomberg Tradebook, LLC, response for the record 56

O'Brien, William, Senior Vice President and General Counsel, Brut, LLC, response for the record 63

Ryan, Michael J., Jr., General Counsel, American Stock Exchange LLC, letter dated November 22, 2002, enclosing response for the record 66

ECNs AND MARKET STRUCTURE: ENSURING BEST PRICES FOR CONSUMERS

THURSDAY, OCTOBER 17, 2002

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON COMMERCE, TRADE AND
CONSUMER PROTECTION,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:35 a.m., in room 2123, Rayburn House Office Building, Hon. Cliff Stearns (chairman) presiding.

Members present: Representatives Stearns and Towns.

Staff present: David Cavicke, majority counsel; Shannon Vildostegui, majority counsel; Brian McCullough, majority counsel; Will Carty, legislative clerk; and Consuela Washington, minority counsel.

Mr. STEARNS. Good morning, everybody. The subcommittee will come to order.

Let me welcome our witnesses. In the securities area, there has been an intense focus today on corporate governance, and of course, with that, accounting governance over the past year. And, of course, rightly so. There has been a tremendous need for oversight and correction in these areas. And these areas, these issues, will continue to be of heightened concern as corporate America works to regain investors' confidence.

But today we will take a look at another set of very important issues. These issues are less sensational than the scandals of the last year, so we are not likely to see extensive media coverage of this hearing today. Yet these issues are no less important to the functioning of the capital markets and, of course, to the protection of investors.

Today we will focus on market structure issues. There have been significant market structure changes in the past year that have important implications for all investors. These are ECNs. And ECNs are basically electronic communication networks. They are basically technologically advanced communication systems for simply trading securities. As a result of advances in computing power and telecommunication technology as well as certain changes in security rules, ECNs have emerged as competitive alternatives to traditional stock markets.

ECNs are basically order matching services, matching buy and sell orders entered into their systems by their subscribers, and through this simple procedure, buyers and sellers are able to come together. But they are relatively new market participants that pro-

vide trading platforms that are distinct from traditional floor and specialist models of the New York Stock Exchange and the quotation montage and market-maker model of the Nasdaq. So basically ECNs models vary. Some are order matching systems, others are order routing systems. They have different fee structures as well as different customer bases.

What the ECNs do have in common, though, is that they provide much of the impetus for market improvements, those we have seen over the past few years and certainly we will see into the future. ECNs were the first to trade in decimals, the first to show depth of book, the first to offer reserves, and the first to allow anonymity to trades. These are common features now, and the Nasdaq has incorporated these functions into its SuperMontage. But the competitive pressures that ECNs have brought to the marketplace have made trading cheaper, faster, and tailored to fit real market needs, and their presence in the marketplace will continue to push forward cheaper, faster, and, of course, more innovative services.

But it is not only institutional investors that have reaped the benefits of ECN innovation. Small investors have also reaped the benefits. Competition from ECNs have reduced transaction costs marketwide; namely, commissions and spreads have dropped. For example, ECNs lead the push to decimalization, reducing the trade increments in which investors trade from one-sixteenth of $1 to a fraction of a cent.

ECNs also introduced anonymity of trades, allowing my mutual funds to buy or sell securities without moving the market. This, of course, has a direct impact on the value of my mutual fund investment, for example.

Over the past year, there have been some important market structure developments. One ECN was approved to operate as an exchange. Some ECNs merged and the SEC approved the Nasdaq SuperMontage. All have significant implications for the future of the marketplace, and I look forward to hearing the testimony of our panel today to discuss some of these issues raised by these market developments.

In particular, I hope that our panel will discuss market data issues: Are customers still paying too much for market data? Are market data rebates a benefit to investors? Will market data rebates solve the market issues, or is a regulatory fix required?

I also hope to hear some testimony on the status of SuperMontage: Has the Nasdaq addressed the competitive concerns raised by ECNs? What potential benefits or risk does the SuperMontage bring to the marketplace? What is the status of ITS. Are the access rules for listing securities responsible for ECNs' lower trading volumes in listed securities than in the Nasdaq securities?

And finally, my colleagues, inter-ECN access fees: What are the different fee structures in place for access to ECN systems? Are these fees consistent with ECN obligations under the order handling rules to provide access to the best prices in the marketplace?

These are some of the questions we would like to have discussed today and I look forward to discussing these with our panel. So I welcome your comments and I appreciate your appearing before your committee. Even though Congress is out, we wanted to continue the schedule of this hearing. So I thank you for coming.

With that, I offer an opening statement to the distinguished ranking member from New York, Mr. Towns.

[The prepared statement of Hon. Clifford Stearns follows:]

PREPARED STATEMENT OF HON. CLIFF STEARNS, CHAIRMAN, SUBCOMMITTEE ON COMMERCE, TRADE AND CONSUMER PROTECTION

In the securities area, there has been an intense focus on corporate governance and accounting governance over the past year. And rightly so, there was a tremendous need for oversight and correction in these areas. And these issues will continue to be of heightened concern as corporate America works to regain investor confidence.

But today we will take a look at another set of important issues. These issues are less sexy than the scandals of the last year so we are not likely to see extensive media coverage of the hearing here today. Yet these issues are no less important to the functioning of the capital markets and the protection of investors. Today we will focus on market structure issues. There have been significant market structure changes in the past year that have important implications for investors.

ECNs are relatively new market participants that provide trading platforms distinct from the traditional floor and specialist model of the New York Stock Exchange and the Quotation Montage and Market Maker model of the NASDAQ. ECN models vary—some are order-matching systems. Others are order routing systems. They have different fee structures as well as different customer bases.

What the ECNS do have in common is that they provide much of the impetus for market improvements, those we have seen over the past few years and certainly those we will see in the future. ECNs were the first to trade in decimals, the first to show depth of book, the first to offer reserves and the first to allow anonymity to trades. These are common features now—and the NASDAQ has incorporated these functions into its SuperMontage—but the competitive pressure ECNs have brought to the marketplace has made trading cheaper, faster and tailored to fit real market needs. And their presence in the marketplace will continue to push forward cheaper, faster and more innovative service.

It is not only institutional investors that have reaped the benefits of ECN innovation. Small investors have too. Competition from ECNs has reduced transaction costs market-wide—namely commissions and spreads have dropped. For example, ECNs lead the push to decimalization, reducing the trade increments in which investors trade from 1⁄16ths of one dollar to fractions of a cent. ECNs also introduced anonymity of trades—allowing my mutual fund to buy or sell securities without moving the market. This has a direct impact on the value of my mutual fund investment.

Over the past year there have been some important market structure developments. One ECN was approved to operate as an exchange, some ECNs merged and the SEC approved the NASDAQ's SuperMontage. All have significant implications for the future of the marketplace and I look forward to hearing our panel discuss some of the issues raised by these market developments.

In particular, I hope that our panel will discuss market data issues. Are customers still paying too much for market data? Are market data rebates a benefit to investors? Will market data rebates solve the market data issues or is a regulatory fix required?

I also hope to hear some testimony on the status of SuperMontage. Has the NASDAQ addressed the competitive concerns raised by the ECNs? What potential benefits or risks does the SuperMontage bring to the marketplace?

What is the status of ITS? Are the access rules for listed securities responsible for ECN lower trading volume in listed securities than in NASDAQ securities?

And finally, inter-ECN access fees. What are the different fee structures in place for access to ECNs systems? Are these fees consistent with ECN obligations under the order handling rules to provide access to the best prices in the marketplace?

I look forward to discussing these and other issues with our panel today. I welcome you all and thank you for appearing before the Subcommittee.

Mr. TOWNS. Thank you very much, Mr. Chairman. I agree with you that I think that this is a very important hearing, and even though the Congress is out, I really feel we should move forward with this particular hearing, and I want to thank you for holding it. I welcome all of my New York constituents this morning, of course, but I look forward to everybody's testimony.

While the title of this hearing suggests that the focus is solely ECNs, it would be a mistake to overlook or to minimize the contributions and value of the exchanges and all that they contribute to market liquidity, capital formulation, and economic improvement in this country. One of the hallmarks of our system is that we offer users a broad array of competitive alternative trading venues, and I hope that we will always continue to do that.

Let me note that as a result of changes in the House rules adopted by this Congress, most of the committee's historical jurisdiction over securities and exchanges are transferred to the newly created Committee on Financial Services. However, it was agreed that this committee would retain jurisdiction over legislation dealing broadly with electronic commerce, including ECNs, and that none of our jurisdiction over consumer affairs and consumer protection would be limited in any way.

Accordingly, I commend the chairman of the subcommittee for exercising this jurisdiction and looking into these important matters this morning. I salute you for that, Mr. Chairman. A great deal has changed since the subcommittee's December 19, 2001 hearing on ECNs. For starters, two of the witnesses at that hearing, Island and Instinet, have merged. Mr. Chairman, maybe we should not have allowed them to sit next to each other during that day. Also, Nasdaq commenced trading on the SuperMontage system this week with five stocks.

I hope we will revisit the issue raised by these and other events early next year after we have had a chance to measure the effects on electronic commerce and the consumers. With Nasdaq trading below 1300 and the Dow trading only near about 8000 and with the steady beat of corporate and accounting scandals and bad economic news, Wall Street is facing difficult times and so is the economy. Investor confidence has taken a serious beating.

I hope the Congress and this administration will take the necessary steps to adopt responsible economic policies and to finish the job that the Sarbanes and Oxley Act begins. Mr. Chairman, on that note, I yield back and I am anxious to hear from my witnesses.

[The prepared statement of Hon. Edolphus Towns follows:]

PREPARED STATEMENT OF HON. EDOLPHUS TOWNS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

I welcome all of our witnesses this morning, especially my New York constituents, but I look forward to hearing the testimony of all of our witnesses.

While the title of this hearing suggests that the focus is solely ECNs, it would be a mistake to overlook or minimize the contributions and value of the exchanges and all that they contribute to market liquidity, capital formation, and economic improvement in this country. One of the hallmarks of our system is that we offer users a broad array of competitive alternative trading venues, and I hope that we will always continue to do that.

Let me note that, as a result of changes in the House Rules adopted at the beginning of this Congress, most of this Committee's historical jurisdiction over securities and exchanges was transferred to the newly created Committee on Financial Services. However, it was agreed that this committee would retain jurisdiction over legislation dealing broadly with electronic commerce, including ECNs, and that none of our jurisdiction over consumer affairs and consumer protection would be limited in any way. Accordingly, I commend the chairman of the subcommittee for exercising this jurisdiction and looking into these important matters this morning.

A great deal has changed since the subcommittee's December 19, 2001 hearing on ECNs. For starters, two of the witnesses at that hearing, Island and Instinet, have merged. Maybe we shouldn't have let them sit next to each other that day. Also,

NASDAQ commenced trading on its SuperMontage system this week with five stocks. I hope that we will revisit the issues raised by these and other events early next year after we have had a chance to measure their effects on electronic commerce and on consumers.

With NASDAQ trading below 1300 and the Dow trading only narrowly above 8000, and with the steady beat of corporate and accounting scandals and bad economic news, Wall Street is facing difficult times and so is the economy. Investor confidence has taken a serious beating. I hope that Congress and the Administration will take the necessary steps to adopt responsible economic policies, and to finish the job that the Sarbanes-Oxley Act begins.

Mr. STEARNS. I thank my colleague.

[Additional statement submitted for the record follows:]

PREPARED STATEMENT OF HON. W.J. "BILLY" TAUZIN, CHAIRMAN, COMMITTEE ON ENERGY AND COMMERCE

This hearing on ECNs and the benefits they provide to consumers is timely and I want to commend Chairman Cliff Stearns and Ranking Member Towns for convening it. ECNs are a relatively new way of trading stock; most are less than five years old. In that time, ECN's speed, agility and the favorable prices and market access they provide to consumers have been an important addition to our financial markets. ECNs are the venue for over 40% of the trading in NASDAQ Stock. Last December Chairman Stearns held a hearing on the role ECNs played in restoring trading activity after the terrorist attacks on September 11th. These hearings demonstrate our continuing interest in and enthusiasm for the development of ECNs in the market place.

There are a number of important issues facing ECNs that have significant effects on consumers. These issues include the creation of an ECN within NASDAQ called the Supermontage. I understand that today is the forth day of operation of the Supermontage, and NASDAQ couldn't be with us today. I think we will have a hearing next spring to see the effects Supermontage is having on competition within the NASDAQ market. We learned after 9-11 that we do not want to have a single point of failure that would render the markets unable to function and we will want to be sure that Supermontage does not inadvertently become such a single point of failure.

Additionally, there are important issues affecting ECNs that have been repeatedly studied and have been awaiting resolution at the SEC for too long. These issues include:

- Market access fees charged by both NASDAQ and some ECNs;
- The continued viability of the intermarket trading system, which all participants say is broken but no one wants to fix; And
- The costs that investors are forced to pay for market data, that everyone agrees greatly exceeds the cost of collection and dissemination of that market data.

Prior to the discovery of serious accounting fraud at Enron, WorldCom, Tyco and Global Crossings, ECNs and market structure issues were front and center both in the Committee and at the SEC. I would not want to see resolution of market structure issues and the important benefits they present for consumers to be neglected or put on the back burner at the SEC because of the egregious conduct corporate officers elsewhere. Just because these issues are not on the front pages of the business section does not mean that there are not important consumer and competitive concerns that need to be addressed.

Times have changes dramatically in the past year, and the ECNs are no exception. There has been consolidation among the ECNs, an ECN has been granted "exchange" status, and the SEC recently approved the NASDAQ's Supermontage.

This Committee has tackled and uncovered some egregious practices by market participants that have rattled the markets and investors in the last year. As investors become increasingly disenchanted with the integrity of the securities markets and its participants, it is vitally important that we continue to examine all aspects of our economy and make necessary changes as appropriate. Restoring "transparency" has been the buzzword this year, but regulators have more to do than that. Investors need to know that the system is not stacked against them, and market participants must be free to compete. Regulatory barriers should not determine winners and losers; innovation and competition should determine the winners.

I look forward to hearing from our witnesses on these issues and yield back the balance of my time.

Mr. STEARNS. And of course as you pointed out, these are constituents of yours, so we welcome all of you: Kevin Foley, the Chief Executive Officer, Bloomberg Tradebook; Kevin O'Hara, General Counsel of Archipelago; William O'Brien, Senior Vice President and General Counsel of Brut; Robert Gasser, Chief Executive Officer of NYFIX Millennium; and Michael Ryan, General Counsel for the American Stock Exchange. We welcome you and look forward to your opening statement.

And, Mr. Foley, we will start with you.

STATEMENTS OF KEVIN M. FOLEY, CHIEF EXECUTIVE OFFICER, BLOOMBERG TRADEBOOK, LLC; KEVIN J.P. O'HARA, GENERAL COUNSEL, ARCHIPELAGO; WILLIAM O'BRIEN, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, BRUT, LLC; ROBERT C. GASSER, CHIEF EXECUTIVE OFFICER, NYFIX MILLENNIUM, LLC; AND MICHAEL J. RYAN, JR., GENERAL COUNSEL, AMERICAN STOCK EXCHANGE LLC

Mr. FOLEY. Thank you, Mr. Chairman and members of the committee. Thank you for your insightful comments. My name is Kevin Foley and I am pleased to testify on behalf of Bloomberg Tradebook regarding "ECNs and Market Structure: Ensuring the Best Prices for Consumers." The topic is both important and timely.

Bloomberg Tradebook is owned by Bloomberg L.P. And is located in New York City. Bloomberg L.P. Provides multimedia, analytical, and news services to more than 170,000 terminals used by 350,000 financial professionals in 100 countries worldwide. Bloomberg News is syndicated in over 350 newspapers and on 550 radio and television stations worldwide. Bloomberg publishes 7 magazines as well as books on financial subjects for the investment professional and nonprofessional reader.

Bloomberg Tradebook is an electronic agency broker serving institutions and other broker-dealers. We count among our clients many of the Nation's largest institutional investors representing through pension funds, mutual funds and other vehicles, the savings of millions of ordinary Americans. Bloomberg Tradebook specializes in providing innovative tools that make large orders small and eliminate the traditional barrier between the upstairs market for large orders and the trading floor. We bring upstairs liquidity directly into contact with small retail trading and other small order flows and, in the process we consolidate what has been a fragmented market. Our clients have rewarded our creativity and service by trusting us with their business, allowing us to regularly trade more than 150 million shares a day in the U.S. And a quarter again as much in international securities.

Electronic communications networks, ECNs, are electronic systems that facilitate trading and securities. Market structure decisions, specifically the SEC's 1996 issuance of the order handling rules in the wake of collusion on the Nasdaq market, have permitted ECNs to flourish over the past 6 years benefiting consumers and the markets generally. These rules were designed to promote market transparency in the Nasdaq market. In the words of then SEC Chairman Arthur Levitt: Electronic communication networks have been one of the most important developments in our markets in years, perhaps decades.

But exactly what are ECNs and what are we to make of their impact on our markets? In simplest terms, ECNs bring buyers and sellers together for electronic execution of trades. They have provided investors with greater choices and have driven execution costs down to a fraction of a penny. As a result, these networks present serious competitive challenges to the established market centers. More fundamentally, they illustrate the breathtaking pace of change that results when technology and competition coalesce.

As has often been observed, sunlight is the best disinfectant. Indeed, the increase promoted by the SEC's order handling rules and the subsequent integration of ECNs into the national quotation montage narrowed Nasdaq's spreads by nearly 30 percent in the first year following adoption of the order handling rules. These and subsequent reductions in transactional costs constitute significant savings that are now available for investment that fuels business expansion and job creation. The resolution of questions regarding the Nasdaq exchange application and the manner in which SuperMontage is phased in will go a long way toward determining whether the securities markets of the future will be shaped by competition or dominated by government-sponsored monopolies. That will have much to do with whether our markets remain competitive, robust and open to innovation. For-profit exchanges will have powerful incentives to leverage their existing government-sponsored monopolies to gain an unfair advantage in currently competitive markets. They will have incentives to keep pace with market innovators not by moving forward themselves, but by slowing down all market participants and centralizing order flow. If that occurs, consumers, investors in the markets themselves, will be denied the benefits of competition. Everyone loses if exchanges comfortable as government-sponsored monopolies fail to innovate, leaving American markets vulnerable to offshore competitors.

As the growth of ECNs illustrates, modern technology allows the advantages of maximum order interaction without the downside of centralization. State-of-the-art telecommunication systems like the Internet don't rely on a single monopoly channel; rather they rely on the networked web of multiple competing and redundant linkages.

Why shouldn't the securities markets work the same way and reap those same benefits? Centralized systems are resistant to change. The innovations that ECNs have brought to the market would not have occurred under more centralized systems. A centralized system also provides a significant downside of a central point of failure.

So who has benefited from the existence of ECNs? For one, small retail customers who for the first time have gained direct unfettered access to liquidity of institutional order flow represented directly in the market.

Who else has benefited? Clearly, American business. The President of the United States Chamber of Commerce, Tom Donahue, summed it up succinctly in a letter to SEC Chairman Pitt, stating: American business has benefited mightily in recent years from SEC initiatives like the order handling rules that have enhanced market transparency, fostered competition in our securities markets and reduced transaction costs, significantly reduced spreads

and increased efficiencies, and freed up more capital for launching new businesses and creating new jobs. This sunshine is important to ensure the most efficient capital formation process in the U.S. And to ensure that America's market continues to be the preeminent market in the world.

Who else benefits from ECNs? All investors who have seen the speed and fairness of their executions improve. ECNs have raised the standards for all broker dealers. Even traders now participating in ECNs benefit from our depth liquidity and immediacy each time they hit an ECN bid or take an ECN offer.

Who hasn't benefited from ECNs? Useful linkages have yet to be developed for the exchange listed market. As a result, investors in those markets have yet to reap the full benefits of the competition provided by ECNs. This is why it is imperative that the steps necessary to facilitate the promised display of listed stocks in the NASD's alternative display facility be undertaken as soon as possible.

Clearly, the New York Stock Exchange has historically had no interest in encouraging linkages that would make ECNs players in the listed markets. It is long past time for the benefits ECNs have brought to the market in over-the-counter securities to be extended to markets in listed securities as well.

The neutrality, transparency, fairness, and innovation ECNs collectively bring to the Nasdaq market have dramatically increased competition and efficiency on Wall Street, redounding to the benefit of consumers on Main Street and to the benefit of our economy. Investors in the New York Stock Exchange listed market should be permitted an opportunity to enjoy those same benefits.

Historically, not-for-profit exchanges are contemplating a for-profit future. As market players that have traditionally functioned as public utilities become for-profit entities, their goals, incentives and agendas radically change as well. Consumers and investors will suffer if exchanges succeed in leveraging their existing government-sponsored monopolies into currently competitive arenas. These efforts will suppress competition, discourage innovation, and harm consumers. Thank you, Mr. Chairman.

[The prepared statement of Kevin M. Foley follows:]

PREPARED STATEMENT OF KEVIN M. FOLEY, CHIEF EXECUTIVE OFFICER, BLOOMBERG TRADEBOOK LLC

INTRODUCTION.

Mr. Chairman and Members of the Subcommittee. My name is Kevin foley, and I am pleased to testify on behalf of Bloomberg Tradebook regarding "ECNs and market structure: ensuring the best prices for consumers." the topic is both important and timely.

Bloomberg Tradebook is owned by Bloomberg L.P. and is located in New York City. Bloomberg L.P. provides multimedia, analytical and news services to more than 170,000 terminals used by 350,000 financial professionals in 100 countries worldwide. Bloomberg tracks more than 135,000 equity securities in 85 countries, more than 50,000 companies trading on 82 exchanges and more than 406,000 corporate bonds. Bloomberg News is syndicated in over 350 newspapers, and on 550 radio and television stations worldwide. Bloomberg publishes seven magazines, as well as books on financial subjects for the investment professional and non-professional reader.

Bloomberg Tradebook is an electronic agency broker serving institutions and other broker-dealers. We count among our clients many of the nation's largest institutional investors representing—through pension funds, mutual fund and other vehi-

cles—the savings of millions of ordinary Americans. Bloomberg Tradebook specializes in providing innovative tools that make large orders small and eliminate the traditional barrier between the upstairs market and the trading floor. We bring upstairs liquidity directly into contact with small retail trading, the options marketmakers and program trading flow and in the process we consolidate what has been a fragmented market. Our clients have rewarded our creativity and our service by trusting us with their business, allowing us to regularly trade more than 150 million shares a day.

WHAT ARE ECNS?

electronic communications networks—ECNs—are electronic systems that facilitate trading in securities. Market structure decisions—specifically the SEC's 1996 issuance of the order handling rules—have permitted ECNs to flourish over the past six years, benefiting consumers and the markets generally. These rules—aimed primarily at exchange specialists and Over-the-Counter market makers—were designed to promote market transparency in the Nasdaq market. In the words of then SEC Chairman Arthur Levitt:

> Electronic communication networks have been one of the most important developments in our markets in years—perhaps decades. But exactly what are ECNs, and what are we to make of their impact on our markets? In simplest terms, ECNs bring buyers and sellers together for electronic execution of trades. They have provided investors with greater choices, and have driven execution costs down to a fraction of a penny. As a result, these networks present serious competitive challenges to the established market centers. More fundamentally, they illustrate the breath-taking pace of change that results when technology and competition coalesce.[1]

As has often been observed, sunlight is the best disinfectant. Indeed, the increased transparency promoted by the SEC's Order Handling Rules and the subsequent integration of ECNs into the national quotation montage narrowed Nasdaq spreads by nearly 30% in the first year following adoption of the order handling rules. These, and subsequent reductions in transactional costs, constitute significant savings that are now available for investment that fuels business expansion and job creation.

While the complete list of reforms ordered by the SEC to promote transparency is long and varied, all of these changes, including the promulgation of the Order Handling Rules, were animated by the same underlying principle—namely that sunlight—increased transparency—produces the most honest and efficient markets.

ECNS—A MARKET SOLUTION TO A MARKET PROBLEM.

A regulatory regime that encourages transparency was a necessary, but not sufficient, precondition to the growth of ECNs. The reason ECNs have long accounted for nearly half of the reported share volume of Nasdaq is simple—ECNs are a market solution to a market problem.

not all ECNs are alike. Agency ecns such as Bloomberg Tradebook, however, share four characteristics—neutrality, transparency, fairness and innovation.

Neutrality? Bloomberg Tradebook is an agency broker. We take no position for our own account. Thus we are neutral in the marketplace and exist only to serve our customers' need to buy or sell shares. In addition, we are an open-architecture ECN, by which we mean that we do not simply internalize our participants' orders. Instead, we route most of the orders we receive to market makers and other ECNs for execution—giving our participants the option to select whatever prices are available in the markets. In that way, we differ from ECNs such as island, a closed-architecture system, which does not route orders to other market centers.

Transparency? Like market makers, we maintain an electronic book of our customers' bids and offers. But unlike market makers we publish our entire book of quoted prices electronically for all our customers to see. Indeed, as noted above, we take advantage of this transparency to allow our customers to route their orders to the best available prices, even if they are outside of Bloomberg Tradebook.

Fairness? ECNs are required by SEC rules to respond immediately—and I mean immediately—to orders at any given price, in the time sequence they are received, whether they come from our best customers or from our competitors. That's probably the highest standard of fairness in the industry.

[1] Speech by SEC Chairman Arthur Levitt, *Dynamic Markets, Timeless Principles,* Columbia Law School, September 23, 1999, available on the Internet at http://www.sec.gov/news/speeches/spch295.htm.

Innovation? Unlike Nasdaq and the NYSE, ECNs do not enjoy the privileged and protected status of a government-sponsored monopoly. Instead, ECNs must earn their keep by innovating. At its inception in 1996, for example, Bloomberg Tradebook introduced the concept of electronic order sizing to the U.S. equity markets. Electronic order sizing is a Bloomberg functionality that permits investors to divide large orders automatically into small, random-sized pieces before being presented to the market. With electronic order sizing, ECNs have given investors the tools to control the market impact of their transactions, reducing the extent to which the market "moves away" from them while they are buying or selling in significant quantities.

Just as the competition from ECNs has reduced explicit transactional costs—commissions and spreads—innovations like reserve, discretion, electronic order sizing and other order handling tools have broken down the barrier between the upstairs market and the trading floor, increasing liquidity and leading to dramatic decreases in the implicit costs of transacting in the public markets for Nasdaq securities.

Any edge we gain from introducing an innovation is a momentary one. To remain competitive, we must continue to innovate. We have done so continuously over the past six years.

Along with neutrality, transparency, fairness and innovation, add lots of enthusiasm and creativity from people passionately devoted to serving their customers and you have a picture of who we are and why we exist.

When the Senate Banking Committee held a hearing in the last Congress exploring the role of ECNs, Frank Zarb, then Chairman of the National Association of Securities Dealers, stated, "I guess I sum up the answer as to why we have ECNs as the fact that the national stock exchanges, and I'm not only talking about ours, but the exchanges around the world haven't been keeping pace with the needs of the market."

Mr. Zarb is a recognized leader in business and public service. Investors are fortunate to have had the benefit of his leadership, but I respectfully submit that the reason ECNs exist is not only because of what national stock exchanges failed to do, but also because of what we innovating broker-dealers have done, in the heat of competition. Mr. Chairman, it's worth pondering why the stock exchanges didn't keep pace, as Mr. Zarb stated.

We would submit that Nasdaq and the other exchanges, because they are government-sponsored monopolies, ultimately cannot provide the innovative ideas and customer service of the best ECNs and other private market participants. To spur future innovation, I'd rather place my faith in NASD's members—the marketplace of competing broker-dealers.

THE CURRENT CHALLENGE.

At present, most SROs are nonprofit organizations. NASD, however, has largely completed its privatization of Nasdaq and it may well be that other privatizations will follow. Historically, Under the cover of a nontransparent bureaucracy, non-profit SROs have exploited the opportunity to subsidize their other costs (for example, costs of market operation, market regulation, market surveillance, member regulation) through market information fees. For all SROs, the incentive will be strong to continue to exploit this government-sponsored monopoly over market data by charging excessive rates for market data and by using the resulting monopoly rents to subsidize their competitive businesses. Indeed, shareholders of the now-for-profit exchanges will effectively demand that market data charges remain excessive.

Along with its market data monopoly, Nasdaq also will have a powerful incentive to leverage its trade execution monopoly to the detriment of consumers, investors and the markets. Currently, there is no real alternative to Nasdaq's monopoly with respect to the execution of market-maker quotations/orders in securities traded via Nasdaq. Through a series of developments, starting with the inauguration of the Small Order Execution System ("SOES") in the 1980's and progressing through the development of SuperSOES and SuperMontage, Nasdaq has evolved from a decentralized, quotation- and telephone-based system into a screen-based, electronic communications network embodying a central, electronic limit order book.

In theory, NASD members can bypass SuperSOES through private wire connections between a market maker and a customer or dealer. In reality, however, that means of avoiding SuperSOES is not on an equal competitive footing with the use of SuperSOES. Orders transmitted through SuperSOES impose obligations on the market maker to execute against its published quotation.

Only Nasdaq has the monopolistic power to deliver mandatory executions to market makers against their quotations. Individual market participants do not have the

market power to replicate that obligation through private contractual arrangements or other private ordering.

SUPERMONTAGE AND THE NASDAQ EXCHANGE APPLICATION.

The resolution of questions regarding the Nasdaq exchange application and the manner in which Supermontage is phased in will go a long way toward determining whether the securities markets of the future will be shaped by competition or dominated by government-sponsored monopolies. That will have much to do with whether our markets remain competitive, robust and open to innovation.

Nasdaq has applied to the SEC to become a for-profit exchange. Unfortunately, Nasdaq would like not only to maintain, but also to expand, its government-sponsored monopoly powers while becoming a for-profit exchange. To that end, Nasdaq petitioned the SEC in 1999, to expand its monopoly by centralizing quotation display and order execution in a "SuperMontage" nasdaq would control.

Recognizing the potential anticompetitive impact of SuperMontage, the SEC made its January 2001 approval of SuperMontage contingent on Nasd's meeting certain critical preconditions which were intended to ensure that particpation in SuperMontage was truly voluntary.

ALTERNATIVE DISPLAY FACILITY.

Preeminent among these preconditions was the establishment of an "alternative display facility" (ADF)—a display facility that would be run by NASD and stand as an alternative to Nasdaq.

The ADF was deemed so critical to the SEC that it was cited as a precondition to both the rollout of SuperMontage and the possible approval of the Nasdaq exchange application.

NASD is not independent of Nasdaq. Unfortunately, a number of obstacles have been placed in the way of creating a commericially viable ADF, some flowing from the fact that NASd—which is charged with organizing and running the ADF—is not independent of Nasdaq.

NASD and Nasdaq have interlocking boards. NASD retains a significant ownership interest in Nasdaq and a commercial interest in Nasdaq's eventual success as a for-profit exchange. The significance of NASD's not being independent of Nasdaq is driven home in Nasdaq's Amendment 2 to its form 10 registration statement. Discussing the ADF and its competitive potential, Nasdaq states:

> If this market becomes a viable alternative to Nasdaq, then Nasdaq faces the risk of reduced market share in transactions and market information services revenues, which would adversely affect Nasdaq's business, financial condition, and operating results.

With Nasdaq viewing the ADF as a potential threat, we believe the SEC and Congress need to remain vigilant to ensure that NASD is wholeheartedly committed to the ADF.

COMMENDING THE SEC.

Signficantly, as NASD and Nasdaq initially designed it, the ADF was to be a hidden market—in essence a "display" facility that few market participants could see. Market participants could have chosen to display their quotations on the ADF, but no provision had been made for the market at large to see those quotations. As proposed by NASD and Nasdaq, the transparency that has been the hallmark of regulation since the promulgation of the order handling rules would have been vitiated for the ADF, to the detriment of consumers and markets. This summer, the SEC rejected Nasdaq's call for a hidden market and issued interpretive guidance that will go a long way toward ensuring that adf quotations will be seen in a meaningful way.

Likewise, while Nasdaq had argued that a viable ADF is not essential, the SEC made clear that a viable ADF is essential to curtail the potential anticompettive impact of SuperMontage. NASD hobbled the launch of the ADF by not releasing the final technical specifications necessary for participation in the ADF until August 2002, placing ECNs and other potential ADF participants in a difficult and disadvantaged position. The SEC this summer, seeking to mitigate the more damaging effects of an ADF that would launch too late to be an effective alternative to SuperMontage, took the important step of ensuring that the ADF and SuperMontage "rollout" simultaneously, a process that is commencing this week.

We would also commend the SEC for recognizing that major superMontage/ADF issues—expressly including discriminatory and anticompetitive fees—will require ongoing SEC engagement.

DISCRIMINATORY AND ANTICOMPETITIVE PRACTICES.

Practices that are discriminatory and anticompetitive stand as good examples of the kinds of issues that merit both SEC and congressional attention. In particular, i want to call your attention to quote decrementation and discriminatory fees.

Quote decrementation has to do with how orders are displayed and adjusted on SuperMontage to the disadvantage of ECNs and their customers. Under SuperMontage rules, if an ECN posts a quotation for a certain price and quantity in a given security, it will be penalized for declining an order from a counterparty with whom the ECN chooses not to do business. Such a counterparty may be an entity that is an unacceptable credit risk, but it is most likely to be one that refuses to pay an ECN's access fees.

Under the SuperMontage rules, when an ECN declines an order, even if only for part of the quantity displayed in its quotation, the ECN's entire quotation will be removed from the SuperMontage quotation display. As a result, the ECN's customers will lose their place in the SuperMontage time-price queue. In addition, ECNs will be at increased risk for incurring costs instead of revenue. What is telling about the quote decrementation feature of SuperMontage is that its adverse effects fall exclusively upon ECNs. It is grossly discriminatory.

SuperMontage fees differentiate between order types in a way that is both unfair and discriminatory. In Nasdaq's nomenclature, a "preferenced order" is an order sent to a specific market participant that has a quotation displayed in SuperMontage at the best bid or offer. A preferenced order is executed through the use of the SuperMontage execution algorithm. A "directed order" is an order sent to a specific ECN that has elected to receive orders rather than executions.

Nasdaq proposes to impose a penalty of 150% on orders directed to ECNs or other participants that are permitted to accept order delivery rather than automatic executions. By charging 150% more for directed orders than for orders executed using the SuperMontage algorithm, the fee structure penalizes ECNs and other market participants that wish to use their own trading algorithms to access liquidity on the SuperMontage screen via directed orders. These deliberately discriminatory fees would force orders into SuperMontage's execution algorithm, thereby restricting market participants from having equal access to all avenues of execution.

Effectively, the proposed fees impose a penalty on NASD members that use alternatives to SuperMontage. By increasing the cost of using facilities other than SuperMontage, the SuperMontage fees compel NASD members to keep their trading volume on SuperMontage and discourage them from using the ADF or other alternatives to SuperMontage.

Other elements of Nasdaq's proposed SuperMontage fee schedule also are intended to suppress competition. Nasdaq has proposed extending the pricing scheme it currently uses for SuperSOES—its current order execution system—to SuperMontage. Under the SuperSOES pricing scheme, NASD members that report to Nasdaq at least 95% of their trades in Nasdaq securities for the preceding month are deemed "Full contribution members". Those reporting fewer than 95% of their trades in Nasdaq securities for the preceding month to Nasdaq are deemed "Partial contribution members". Full contribution members would pay substantially lower Nasdaq access fees than partial contribution members. In short, the access fee differential would punish NASD members for doing more than de minimis business on the ADF, or any trading facility other than Nasdaq's SuperMontage. It's hard to imagine an action more contrary to consumers' interests than extending such an anticompetitive pricing structure to SuperMontage.

As it is, Nasdaq has taken unto itself the enterprise value of its market system, which NASD's members developed over 30 years. Nasdaq embodies both a quotation facility and an execution/clearance facility, which the ADF is not intended to provide. It may be that the ADF will nevertheless be a preferred venue, but that will eventuate only if it is allowed to compete on an equal footing with Nasdaq. Exclusionary and anticompetitive elements in the SuperMontage/SuperSOES combination should be revised to provide that equal footing.

CENTRALIZATION VERSUS DE-CENTRALIZATION.

For-profit exchanges will have powerful incentives to leverage their existing government-sponsored monopolies to gain an unfair advantage in currently competitive markets. They'll have incentives to "keep pace" with market innovators not by moving forward themselves, but by slowing down all market participants and centralizing order flow.

If that occurs, consumers, investors and the markets themselves will be denied the benefits of competition. Everyone loses if exchanges—comfortable as govern-

ment-sponsored monopolies—fail to innovate, leaving American markets vulnerable to offshore competitors.

Technology makes possible a market structure that wouldn't previously have been possible. That has spawned a debate over the past few years over whether public policy should favor a more decentralized market structure, or whether public policy should encourage centralization, as often advocated by the exchanges.

This argument has manifested itself in a number of different ways. A few years ago, proponents of centralization urged support for a time priority Central Limit Order Book (CLOB) to deal with the alleged "problem" of market fragmentation. The notion behind the CLOB was that, by centralizing orders in one place, a single "black box", maximum order interaction and perhaps better prices might be achieved.

While the CLOB was ultimately rejected as unworkable and unwise, the previously described interaction of SuperSOES and SuperMontage within Nasdaq represent the same effort to centralize. The recent Nasdaq pricing proposal, which would clearly discourage execution of trades outside of Nasdaq—even if the best price for a stock were being offered outside of Nasdaq—is simply the latest manifestation of this urge towards centralization. As exchanges contemplate becoming for-profit companies, this urge to centralize order flow and execution will grow more pronounced. This emphasizes the need for a functional, fully competitive ADF as a means to mitigate the anticompetitive effects of Nasdaq's market scheme. It may well be that additional remedial measures will be needed. The continued vigilance of the Congress and the SEC will be essential as these developments unfold.

As the growth of ECNs illustrates, modern technology allows the advantages of maximum order interaction without the downside of centralization. State-of-the-art telecommunications systems like the Internet don't rely on a single monopoly channel—rather, they rely on networked webs of multiple competing and redundant linkages. Why shouldn't the securities markets work the same way and reap the same benefits?

CENTRALIZED SYSTEMS ARE RESISTANT TO CHANGE.

The innovations that ECNs have brought to the market would not have occurred under more centralized systems. A centralized system also provides the significant downside of a central point of failure.

Nasdaq and the nyse argue that the absence of centralization is "fragmentation". Properly understood, market fragmentation is the failure of supply to interact with demand and vice versa. The cure for fragmentation is a combination of transparency and interlinkage of multiple market venues and liquidity pools, a combination that takes place on investors' desk tops. The cure for fragmentation need not involve a single, monopolistic market—indeed Nasdaq proposes to trade NYSE stocks on its exchange and that competition is beneficial. To ignore these basic realities and to argue that fragmentation somehow justifies centralizing and monopolistic market models is fundamentally misleading.

ECNS—CONSUMERS AND INVESTORS BENEFIT.

So who has benefited from the existence of ECNs? For one, small retail customers who, for the first time, have gained direct unfettered access to the liquidity of institutional order flow represented directly in the market. Through electronic order sizing, Bloomberg Tradebook's system permits direct interaction between institutional orders and retail orders since the institution can cut its order into pieces that will interact effectively with the much smaller retail orders. Institutional investors—which pool the savings of many, many small investors—are able for the first time to find liquidity for their orders by interacting directly with small order flow, thereby consolidating what had been a fragmented market.

WHO ELSE BENEFITS FROM ECNS?

All investors who have seen the speed and fairness of their executions improve, as ECNs have raised the standard for all broker-dealers. Even traders not participating in ECNs benefit from our depth, liquidity and immediacy each time they hit an ECN bid or take an ECN offer.

WHO HASN'T BENEFITED FROM ECNS?

Useful linkages have yet to be developed for the New York Stock Exchange listed market. As a result, investors in that market have yet to reap the full benefits of the competition provided by ECNs. While the SEC has allowed ECNs access to the Intermarket Trading System through Nasdaq, this is not sufficient. The Inter-

market Trading System remains crippled both by its technological ineffectiveness and an unworkable governance structure that makes any movement nearly impossible. This is why it is imperative that the steps necessary to facilitate the promised display of NYSE listed stocks in the ADF be undertaken as soon as possible.

Government-sponsored market centers like the Nasdaq Stock Market and the New York Stock Exchange can either make ECN transparency available to the entire national market system or reduce transparency by seeking to block ECN display linkages. Clearly the NYSE has historically had no interest in encouraging linkages that would make ECNs players in the listed market. It is long past time for the benefits ECNs have brought to the market in over-the-counter securities to be extended to markets in listed securities.

CONCLUSION.

The neutrality, transparency, fairness and innovation ECNs collectively bring to the Nasdaq market have dramatically increased competition and efficiency on Wall Street, redounding to the benefit of consumers on Main Street and the economy. Investors in the New York Stock Exchange listed market should be permitted an opportunity to enjoy the same benefits.

Historically not-for-profit exchanges are contemplating a for-profit future. As market players that have traditionally functioned as public utilities become for-profit entities, their goals, incentives and agendas radically change as well. Consumers and investors will suffer if exchanges succeed in leveraging their existing government-sponsored monopolies into currently competitive arenas. These efforts will suppress competition, discourage innovation and harm consumers.

Mr. STEARNS. Thank the gentleman.

Mr. O'Hara, welcome.

STATEMENT OF KEVIN J.P. O'HARA

Mr. O'HARA. Good morning, Chairman Stearns, Congressman Towns, and other distinguished members of the subcommittee. On behalf of Archipelago, I am pleased and honored to be with you this morning and commend the subcommittee for holding this hearing.

And to your earlier point, Congressman Towns, to your earlier point regarding Instinet and Island, let the record reflect that I am sitting next to representatives of Brut and Bloomberg Tradebook. We will come back and test your hypothesis several months from now.

Let me begin by saying that were this a State of the Union on market structure and best execution, I would declare that the State of the Union is good. Though unfinished business still remains, significant progress has been made in recent years. And this subcommittee should be commended for supporting this progress,such as your hard work on decimalization.

Without question, the prime benefactor of this progress is the consumer, or the investor in capital markets' parlance. At no other time has the investor enjoyed greater transparency, better technology, and more innovation than now in the execution business. Importantly, tired bogeymen, thrown up to retard progress by reactionaries-like market fragmentation, ECNs unwilling to "catch the falling knife" in times of stress—have been run out of town on a rail by a Joe Friday-like analysis: Just the facts, ma'am, and only the facts.

At Archipelago, we are proud of our contribution to this progress. And in connection with that, I am happy to report that the Archipelago Exchange is open for business. Not long ago, the Archipelago Exchange was but a dream of its cofounders Jerry Putnam and MarrGwen and Stuart Townsend. In March 2002, after much

inspiration and even more perspiration, the dream culminated in a launch of the first fully open electronic national exchange.

Armed with a "best execution" business model in which we reach out electronically to other markets to obtain the best price for customers, the Archipelago Exchange delivers transparency, speed, innovation and efficiency.

Beginning in January 1997, the day the Archipelago ECN—our exchange's younger brother, if you will—executed its first order, our current Nasdaq business has grown to an almost daily average of 400 million shares or roughly 20 percent of overall volume. In terms of New York Stock Exchange and Amex-listed securities, the Archipelago Exchange executes almost 50 million shares per day.

The model for an exchange is its—the business model for an exchange is its market structure as set out in its trading rules. Archipelago's market structure can be best characterized as fully open and transparent. Everyone, institutional investors, broker-dealers, and retail customers has access to the same information such as limited order book at the core of our exchange. Everyone can see the same information at the same time. Everyone's orders are matched consistently using strict price and time priority. No order can jump ahead of another unless it is at a superior price. The end result: Our customers operate on a level playing field.

Two tenets of best execution—two central tenets of best execution are transparency and access. The two work cheek by jowl to produce a quality market. Transparency is the ability to see information such as a limit order book, while access is the ability to interact with such information. Historically, the market for New York Stock Exchange and Amex-listed trading was not driven by technological solutions to provide transparency and access. Instead, floor-based systems of frenetic brokers and ever-present and very profitable specialists were charged with providing transparency and access. Consequently, technology-based marketplaces had problems gaining traction in listed trading. While Archipelago has found a way to bridge this cultural gap by integrating our prices into the international market system, friction still exists.

Until recently, two of the largest ECNs' merger partners, Island and Instinet, were permitted to hide their prices for exchange-listed securities from the public. Citing insurmountable technology, these ECNs refused to display their quotes in the national market system. As a result, better prices in their marketplaces were not available to customers who were not part of the club. Membership had its privileges.

The SEC has quietly begun to tackle the sticky issue of public display of security prices for listed securities, however. Two months ago, the SEC enforced the provisions of Federal regulation ATS and took appropriate remedial steps against these hermit markets. Curiously, instead of choosing transparency and showing its quote to the public, Island defiantly went dark and ceased displaying a private market in five popularly traded ETFs: QQQ, DIA and SPY, SMH and MKH. Instinet similarly shut down its private market altogether in certain listed securities during regular trading hours. Nevertheless, the resiliency of the marketplace is such that these listed shares continue to trade efficiently on platforms despite the Island and Instinet rolling blackouts.

As many can attest the Inner Market Trading System, or ITS, is the crotchety old man of electronic linkages. But while in need of an overhaul, to refuse ITS linkage is to make mischief with public investors, depriving them of both transparency and access.

Happily, ITS reform is not far off. To address the issue, the SEC summoned the country's exchanges to Washington last week to discuss the trade-through provisions of the ITS plan. With the introduction of decimal pricing and technology changes that have enabled vastly reduced execution times, the trade-through provisions of the ITS plan have limited the ability of automated marketplaces to provide executions when a better price is displayed by a market that provides manual executions. For example, the Archipelago Exchange can offer internal executions at a fraction of a second, whereas New York Stock Exchange or Amex often takes 15 or even 30 seconds to respond to a commitment to trade.

At the SEC's urging, the ITS Operating Committee is working on reform. A consortium of committee members have proposed an approach that would accommodate the differences between floor-based traditionalists and technology-based new entrants. This approach allows for the differences among marketplaces without a time penalty for those markets that have speed and efficiency as their goals. Moreover, it preserves a "best price" principle to protect investors whose orders were represented at a venue willing to make them accessible for instant execution.

Finally, this committee has a record of championing the cause of small investors. Case in point: decimalization of our markets. You were a critical catalyst for this positive change that has narrowed effective spreads in the most liquid stocks on Nasdaq and the New York Stock Exchange. This fundamental change has led to enormous reductions in trading costs and put hundreds of millions of dollars back in the pockets of investors; i.e., your constituents. Thank you for your steadfast perseverance.

Likewise, I know you care about this subject matter we are discussing today. "Best execution" is the heart of our markets. By your continued oversight of our markets on matters of transparency and access, you provide effective stewardship and support of best execution. Archipelago looks forward to continue to work with the subcommittee to enhance our securities markets for the benefits of investors. And I will gladly take your questions at the appropriate time.

[The prepared statement of Kevin J.P. O'Hara follows:]

PREPARED STATEMENT OF KEVIN J.P. O'HARA, GENERAL COUNSEL & CORPORATE SECRETARY, ARCHIPELAGO HOLDINGS, L.L.C.

Good morning Chairman Stearns, Vice-Chairman Deal, Congressman Towns and other distinguished members of the Subcommittee. On behalf of Archipelago, I am pleased and honored to be with you this morning and commend the Subcommittee for holding this hearing on ECN market structure and the quest to ensure best price for consumers.

I. INTRODUCTION

Let me begin by saying that were this a "State of the Union address" on market structure and best execution, I would declare that "the state of the union is good." Though unfinished business still remains, significant progress has been made in recent years. Without question, the prime benefactor of this significant progress is the "consumer," known as the "investor" in the context of capital markets. At no other

time has the investor enjoyed greater transparency, better technology, and more innovation than now in the execution business. Importantly, tired bogeymen thrown up to retard progress by reactionaries—like market fragmentation, ECNs unwilling to "catch the falling knife" in times of market stress, and the Pavlovian definition of best execution as the untimely price improvement by a floor-based traditionalist—have been run out of town on a rail by a Joe Friday-like analysis. "Just the facts, Ma'am, and only the facts."

At Archipelago, we are proud of our contribution to this progress. And in connection with that, I am happy to report that the Archipelago Exchange is open for business!

Not long ago, the Archipelago Exchange was but a dream of its co-founders Jerry Putnam and MarrGwen and Stuart Townsend. In March 2002, after much inspiration and even more perspiration, that dream culminated in the launch of the first fully open electronic national stock exchange. This "next-generation" exchange competes toe-to-toe with the New York Stock Exchange ("NYSE") and American Stock Exchange ("Amex"). Armed with a "best execution" business model—in which we reach out electronically to other markets to obtain the best price for customers—the Archipelago Exchange delivers transparency, speed, innovation, and efficiency.

Beginning in January 1997, the day the Archipelago ECN—our exchange's younger brother, if you will—executed its first order, our current Nasdaq business has grown to an average of almost 400 million shares per day, or roughly 20% of overall volume. In terms of NYSE- and Amex-listed securities, the Archipelago Exchange executes almost 50 million shares per day. Very soon, we will roll our Nasdaq business into the Archipelago Exchange as well, which will afford us the ability to deliver an even "better execution" for consumers by performing executions in a more efficient and cost-effective manner.

From the day we filed our application seeking exchange status with the Securities and Exchange Commission ("SEC") in August 1999, to the forging of our business partnership with the Pacific Exchange in July 2000, to the day in October 2001 when the SEC formally granted Archipelago exchange status, it has been our singular focus to do to the exchange business what innovators such as Dell, Wal*Mart , and Southwest Airlines have done for their respective businesses: that is, deliver a higher quality and cost-effective product to the consumer. And like those agents of change, our mission has been to rework the traditional exchange business model using a one-two combination of cutting-edge technology and a laser-like focus on customer needs.

II. ARCHIPELAGO MARKET STRUCTURE: BEST EXECUTION BUSINESS MODEL

The business model for an exchange is its market structure, as set out in its trading rules. Archipelago's market structure can be best characterized as "fully open and transparent." Everyone—institutional investors, broker-dealers, and retail customers—has access to the same information, such as the limit order book at the core of our exchange. Everyone can see the same information at the same time. Everyone's orders are matched consistently using strict price-time priority. No order can jump ahead of another unless it is at a superior price. The end result: our customers operate on a level playing field.

With our linkages to other markets, we offer an efficient path to the best price, even if it resides at a competing marketplace. Standing orders are anonymously displayed on our book, and marketable orders are either matched internally or electronically routed to a superior price at other marketplaces. Simply put, our exchange is the manifestation of best execution principles put into practice.

III. IMPORTANCE OF THE PUBLIC QUOTE TO CONSUMERS

Two central tenets of best execution are "transparency" and "access." The two-work cheek by jowl to produce a quality market: transparency is the ability to see information, such as a limit order book, while access is the ability to interact with such information. Historically, the market for NYSE- and Amex-listed trading was not driven by technological solutions to provide transparency and access. Instead, floor-based systems of frenetic brokers and ever-present (and very profitable!) specialists were charged with providing transparency and access. Consequently, technology-based marketplaces had trouble gaining traction in listed trading.

While the Archipelago Exchange has found ways to bridge this cultural gap by integrating our prices into the National Market System, frictions still exist. Indeed, many still maintain that any such integration is a "a bridge too far." Until recently, two of the largest ECNs—merger partners Island and Instinet—were permitted to hide their prices for exchange-listed securities from the public. Citing insurmountable technology hurdles, these ECNs refused to display their quotes in the National

Market System. As a result, better prices in their private markets were not available to consumers who were not part of the club. Membership had its privileges.

The SEC has quietly begun to tackle the sticky issue of public display of securities prices for listed securities, however. Two months ago, the SEC enforced the provisions of a federal regulation and took appropriate remedial steps against these "hermit markets." Regulation ATS clearly states that ECNs with more than 5 per cent of the volume in any one security are required to display their quotes to the public. Curiously, instead of choosing transparency and showing its quote to the public, Island defiantly went "dark" and ceased displaying a private market in five popular exchange-traded funds, or ETFs: QQQ, DIA, SPY, SMH and MKH. Instinet, on the other hand, shut down its private market altogether in certain popular listed securities, such as SPY, during regular trading hours. Nevertheless, the resiliency of the marketplace is such that these listed-shares continue to trade efficiently on other platforms despite the Island and Instinet "rolling blackouts."

IV. IMPORTANCE OF LINKAGE: REFORM OF ITS

As many can attest, the Intermarket Trading System, or ITS, is the crotchety old man of electronic linkages. But while in need of an overhaul, to refuse ITS linkage is to make mischief with public investors, depriving them of both transparency and access. And SEC action clearly indicates that refusing ITS linkage has regulatory consequences: by letting the technological perfect be the enemy of the investor good, Island and Instinet brinksmanship beat a path to a Conrad-esque heart of ETF darkness.

Happily, ITS reform is not far off. To address this very issue, the SEC summoned the country's exchanges to Washington last week to discuss the trade-through provisions of the ITS Plan. With the introduction of decimal pricing and technology changes that have enabled vastly reduced execution times, the trade-through provisions of the ITS Plan have limited the ability of automated marketplaces to provide executions when a better price is displayed by a market that provides manual executions. For example, the Archipelago Exchange can offer internal executions in a fraction of a second, whereas the NYSE or Amex often takes fifteen or even thirty seconds to respond to a commitment to trade.

At the SEC's urging, the ITS Operating Committee is working on reform. A consortium of Committee members has proposed an approach that would accommodate the differences between floor-based traditionalists and technology-based new entrants. Under this proposal, automated exchanges like Archipelago could trade through the prices displayed by a manual exchange in an amount up to three cents. Prices displayed by an automated exchange could not be traded through, however, since these markets provide an automatic execution. This approach allows for the differences among market centers without a time penalty for those markets that have made speed and efficiency their goal. Moreover, it preserves a "best price" principle to protect investors whose orders were represented at a venue willing to make them accessible for instant execution.

V. CONCLUSION: CONGRESSIONAL OVERSIGHT CHAMPIONS THE INDIVIDUAL INVESTOR

This Committee has a record of championing the cause of the small investor. A case in point: the decimalization of our equity markets. You were a critical catalyst for this positive change that, to date, has narrowed effective spreads in the most liquid stocks on Nasdaq and the NYSE by an average of 50% and 15%, respectively. This fundamental change has directly led to enormous reductions in trading costs and put hundreds of millions of dollars back in the pockets of investors. Thank you for your steadfast perseverance.

Likewise, you should care about the subject matter that I have discussed today. Best execution is a core principle of our markets. By your continued oversight of our markets on matters of transparency and access, you provide effective stewardship in support of best execution. The ITS Plan reform underway by the Committee and the SEC is important work that will lead to better price competition and efficient order execution for consumers.

Archipelago looks forward to continuing to work with the Committee to enhance our securities market for the benefit of investors. I will be glad to respond to any questions that the members of the Subcommittee may have at the appropriate time.

Mr. STEARNS. Thank you.

Mr. O'Brien, welcome.

STATEMENT OF WILLIAM O'BRIEN

Mr. O'BRIEN. Thank you. Good morning, Chairman Stearns and Congressman Towns, members of the subcommittee and their staffs. I am Bill O'Brien, Senior Vice President and General Counsel of Brut. On behalf of Brut, I commend the subcommittee for focusing on the issue of best execution of customer orders at this important time in the history of our Nation's markets.

I would like to thank you for the opportunity to testify. Brut operates one of the largest ECNs, routinely executing over 100 million shares of Nasdaq volume per day with a growing business in exchange-listed stocks as well. In August 2002, Brut was acquired by SunGard Data Systems, a leading financial services technology provider which purchased the interests of a consortium of broker-dealers which included Bear Stearns, Goldman Sachs, Morgan Stanley, Merrill Lynch and Salomon Smith Barney.

The last 5 years have seen an unprecedented transformation regarding the manner in which security transactions are executed. In order to ensure that these dynamic conditions do not produce cataclysmic results, the legislators and regulators will need to work tirelessly to evolve legacy approaches to the oversight of market structure. Nevertheless, the core principles that the Congress gave the SEC in 1975 when it mandated the creation of a national market System can, if applied consistently and balanced carefully, ensure that the most important component of market structure, the individual investor, continues to receive the best possible prices when trading stocks.

The launch this week of Nasdaq's SuperMontage trading system is but a part of the crescendo of competition in the securities industry that is blurring traditional distinctions. This environment has the potential to be a boon for the ultimate consumer, reducing costs, improving service, and furthering innovation if it takes place within a constructive framework.

In drafting the Securities Act Amendments of 1975, the Congress emphasized that fair competition among brokers and dealers, among exchange markets, and among the markets other than exchange markets, and between exchange markets and markets other than exchange markets was in the best interest of the Nation's investors. Given the interdependence among market participants and the impact on market quality on certain competitive tactics, this competition must be carefully nurtured in order to produce the desired impact.

Several of the issues currently facing ECN operators and the market at large are reflective of the debate regarding what is needed to ensure a truly fair and level playing field. SuperMontage has been a focal point for many of these issues. It is a watershed in Nasdaq's efforts to transform itself into the principal provider of execution services in the over-the-counter market. Historically, Nasdaq's primary role has been to serve market makers and ECNs by collecting and redistributing their quote and trade information, leaving the business of actually executing trades to those parties. In a series of steps culminating in SuperMontage, Nasdaq now aims to draw more and more actual executions away from the market makers and ECNs and into their own internal systems, with

the self-stated aim of becoming a central form of the execution of transactions in Nasdaq stocks.

Brut thinks that Nasdaq should be free to move forward with this approach, enjoying the right that all enterprises should have to pursue their own strategic vision. At the same time, however, Brut has been a strong advocate for the creation of viable alternatives to SuperMontage so that Nasdaq's legacy of regulatory monopoly does not produce unintended and uncompetitive consequences. Market structure regulation has long relied upon Nasdaq infrastructure for ensuring the display of best price quotation information to the public. Market makers and ECNs effectively had no choice but to post their quotations in Nasdaq to comply with SEC regulations. As Nasdaq sought to transform those quotations into orders within SuperMontage, the competitive ramifications became clear: Any business whose use is mandated by law is virtually unstoppable.

This is why Brut has been a strong proponent of the development of the alternative display facility, or ADF. Owned and operated by the NASD, the ADF allows market makers and ECNs to do business outside of SuperMontage altogether, publicly displaying their best prices to consumers through a truly market-neutral facility. After over 18 months of development, the ADF took on its first customer earlier this week, providing meaningful choice for the first time since Nasdaq's creation. Whether the ADF fulfills its long-term mission will be dependent upon a collective will to ensure that the NASD continues to provide an effective option to its former progeny, Nasdaq.

Brut has delayed its own consideration of usage of the ADF while the technological and economic barriers to its usage are moderated by the NASD with improved connectivity solutions and more realistic economics. These steps are important for the NASD to prove to market makers and ECNs that it is serious about operating a truly viable SuperMontage alternative. In its May 2002 report, the General Accounting Office noted the need to manage market structure in light of such concerns, stating that an ongoing challenge will be to respond effectively to both real and perceived conflicts of interest. A continued insistence from the SEC and the Congress that the ADF offer modern technological solutions and competitive economics will provide meaningful discipline on Nasdaq as it competes with market makers and ECNs that help to build it.

The adaptation of current regulation to promote even further competition in this arena should be strongly considered. Regional exchanges such as the Cincinnati Stock Exchange are implementing a variety of business models that would provide quotation and trade reporting services to market makers and ECNs in competition with SuperMontage and also remedy some of the inefficiencies in the pricing of market data that have arisen out of Nasdaq dominance. The current regulation of registered security exchanges can at times serve as a barrier to deployment of these business models. The reduced relevance of the distinction between heavily traded exchange-listed and Nasdaq stocks and the increased electronification of both markets dictate a reconsideration of how exchanges are to be regulated going forward, in order to realize the full competitive potential of current market structure.

As ECNs seek to compete within this landscape, the need for ECN pricing flexibility should also be emphasized. In this challenging economic environment, fees are a matter of both extreme importance and sensitivity to Brut's customers. Our rate structure, which is fairly common in the industry, rewards users that are willing to initiate and display orders into its ECN with a cash rebate, while charging firms that seek to access that liquidity a fee. Since the implementation of the SEC's order handling rules in 1997, the debate over these ECN and access fees has ebbed and flowed with changing economic and regulatory conditions. Brut believes that competitive forces rather than regulation are appropriate to discipline the nature and structure of prices. These forces currently serve to pressure ECN rate structures in both directions. The entry of Nasdaq as a competitor and the rate structure for SuperMontage which also offers rebates to initiators of liquidity necessitates similar pricing in the quest to be competitive. What the market will bear in terms of costs also has revealed itself as some ECNs that have attempted to take these rate structures to extremes have experienced financial difficulty and unsustainable collection rates. ECNs themselves have worked to eliminate pricing inefficiencies between one another. Continued vibrant rate competition, rather than intervention and its potential for unintended adverse consequences will best serve the economic needs of both ECN operators and their users.

As ECNs and others have asserted their competitive independence from Nasdaq, some are concerned that increased fragmentation will inevitably impact on another national market system principle, ensuring economically efficient execution of security transactions. Brut counts itself among the firms with the vision and technology to remedy such concerns, providing an example of how the market can respond to a changing environment to provide customers with the best of all possible worlds. Brut is representing our customer orders within SuperMontage, delivering customers the full functionality and liquidity of that market in addition to its own. We are doing so because we believe that to do otherwise will deny our customers best execution opportunities inconsistent with the congressional goal of executing investor orders in the best possible market. In addition, we offer quote information from and direct connectivity to nonSuperMontage ECNs and other significant market centers in order to provide customers with a seamless one stop shopping trading environment.

Our ability to navigate this more complex market structure while still preserving execution quality provides evidence that fragmentation can work to the ultimate benefit of the consumer. Private connectivity between and among ECNs, broker-dealers, and other major markets now exist such that public utilities are no longer a linchpin to ensure execution quality and that customers receive the best prices for their transactions. This gives each market participant the freedom to offer its own unique solution to customers on its terms without any single point of collective reliance. This can free each firm to innovate, letting the market decide whether a firm's offering provides required service to meet trader needs.

Legacy regulations that subvert the ability of a market center to offer customers its version of a quality execution to a need for cen-

tralization should be reevaluated in light of this new reality. With respect to transactions in exchange-listed stocks, ECNs have attracted significant order flow in recent years as innovative products like exchange-traded funds, the Qs, SPDRs, the transition to decimalization, and the homogenization of trading operations have all eroded resistance to electronic trading of these securities. This success has triggered SEC requirements that dictate at times participation in the Intermarket Trading System, or ITS, an exchange-dominated consortium with requirements that do not fit all ECN business models. This has put some ECNs in the uneviable position of choosing between options that all dilute their value proposition and customer execution quality. Some, like Island, have chosen to cease displaying their order prices to all customers, forcing people to trade blind. Others, like Instinet, have ceased trading some of these securities altogether. While Brut is an ITS participant through its involvement in the Nasdaq Intermarket, we see this development as counterproductive. In this era of customer mobility and information availability, regulations that thwart an ECN's ability to deliver what it perceives that it customers want should be reconsidered in light of the continued relevance of their original purpose.

The rapid rate at which our markets are transforming creates the potential for a regulation gap which ECNs often find themselves in the middle of, due to their innovative nature, that puts consumer interests at risk. Chairman Pitt has recognized this risk, asking the staff of the SEC to hold public hearings on market structure issues which will be held over the next several weeks. ECNs have had an important role in helping consumers achieve the best prices by increasing transparency, reducing spreads, and perhaps as the greatest fulfillment of the congressional directive, to provide an opportunity for investor orders to interact without the participation of a dealer. In light of the changing market structure before us, Brut believes the principles enunciated by the Congress in 1975—fair competition, efficient execution, and flexible regulation—can continue to serve as a road map to promote market structure quality and investor interests.

Mr. Chairman, Brut welcomes the subcommittee's interest in these important issues and I look forward to answering any questions that you or members have at the appropriate time.

[The prepared statement of William O'Brien follows:]

PREPARED STATEMENT OF WILLIAM O'BRIEN, SENIOR VICE PRESIDENT & GENERAL COUNSEL, BRUT, LLC

Good morning Chairman Stearns, Congressman Towns, and members of the Subcommittee. My name is William O'Brien, and I am Senior Vice President and General Counsel of Brut, LLC ("Brut"). On behalf of Brut, I commend the Subcommittee for focusing on the issue of best execution of customer orders during this pivotal point in the history of the nation's securities markets, and would like to thank you for the opportunity to testify.

Brut operates one of the largest electronic communications networks (or "ECN") for the trading of Nasdaq and exchange-Iisted securities. Brut routinely executes 100 million shares per day of volume in Nasdaq securities, and has a growing business in exchange-listed stocks and exchange-traded funds through. In August 2002, Brut was acquired by SunGard Data Systems, which purchased the interests of the other members of a consortium that had previously owned Brut, which included Bear Stearns, Goldman Sachs, Knight Trading Group, Merrill Lynch, Morgan Stanley, and Salomon Smith Barney.

INTRODUCTION

The last five years have seen an unprecedented transformation regarding the manner in which equity security transactions are executed. The pace of change, however, is poised to increase exponentially, as developments in the economic, technological and competitive environments converge to alter the landscape with rapid-fire regularity and seismic frequency. In order to ensure that these dynamic conditions do not produce cataclysmic results, legislators and regulators will need to work tirelessly to evolve legacy approaches for the oversight of market structure. The core principles that the Congress gave the SEC as its mandate in 1975, when the SEC was instructed to foster the creation of a "national market system," continue to be a relevant and insightful road map as to how to respond to the pressing issues of today's markets. Applied consistently and balanced carefully, these values can offer insight across a variety of scenarios and ensure that the most important component of market structure—the individual investor—continues to receive the best possible prices when trading stocks.

CONSTRUCTIVE COMPETITION

The launch this week of Nasdaq's SuperMontage trading system is but a part of the crescendo of competition in the securities industry that is blurring traditional distinctions. Nasdaq, a former not-for-profit utility intended to serve the collective interests of the brokerage firms that paid to build it, is now aggressively pursuing an IPO-driven strategy that dictates rivalry with its creators. Regional exchanges, trying to remain relevant, are attempting to gain a piece of certain information businesses that had previously been Nasdaq's monopoly. And new technologies that allow for instantaneous changes in usage patterns have helped unleash a ferocious price war among ECNs, who can no longer count on customer loyalty lasting longer than a single trading day. All the while, firms with proprietary trading operations face their own competitive pressures in light of an atmosphere of declining share prices and sagging investor confidence.

This competitive environment has the potential to be a boon for the ultimate consumer—reducing cost, improving service, and furthering innovation—if it takes place within a constructive framework. In drafting the Securities Act Amendments of 1975, the Congress emphasized that "*Fair* competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets" was in the best interest of the nation's investors. Given the inter-dependence among market participants and the impact on market quality of certain tactics, however, this competition must be carefully nurtured in order to produce the desired impact. Several of the issues currently facing ECN operators—and the market at large—are reflective of the debate regarding what is needed to ensure a truly fair and level playing field.

The implementation of Nasdaq's SuperMontage trading system has been a focal point for many of these issues. SuperMontage is a watershed in Nasdaq's efforts to transform itself into the principal provider of execution services in the over-the-counter market. Historically, Nasdaq's primary role has been to serve market makers and ECNs by collecting and re-distributing their quote and trade information, leaving the business of actual execution of transactions to those parties. In a series of steps culminating in SuperMontage, Nasdaq now aims to draw more and more actual executions away from market makers and ECNs and into their own internal systems, with the self-stated aim of becoming "a central forum" [1] for the execution of transactions in Nasdaq stocks.

Brut thinks that Nasdaq should be free to move forward with this approach, enjoying the right that all enterprises should have to pursue their own strategic vision. At the same time, Brut has been a strong advocate for the creation of viable alternatives to SuperMontage so that Nasdaq's legacy of regulatory monopoly does not produce unintended anti-competitive consequences. Market structure regulation has long relied upon Nasdaq infrastructure for ensuring the display of best-priced quotation information to the public. Market makers and ECNs effectively had no choice but to post their quotations in Nasdaq to comply with SEC regulations. As Nasdaq sought to transform these quotations into executable orders within SuperMontage, the competitive ramifications became clear—any business whose use is mandated by law is virtually unstoppable.

This is why Brut has been a strong proponent of the development of the Alternative Display Facility ("ADF"). Owned and operated by the NASD, the ADF allows market makers and ECNs to do business outside of SuperMontage altogether—pub-

[1] *See* Exchange Act Release No. 43514 (November 3, 2000), 65 Fed. Reg. 69084 (November 15, 2000) at 69108.

licly displaying their best prices to consumers through a truly market-neutral facility. After over eighteen months of development, the ADF took on its first customer earlier this week, providing meaningful choice to market participants for the first time since Nasdaq's creation. Whether the ADF fulfills its long-term mission will be dependent upon a collective will to ensure that the NASD continues to provide an effective option to its former progeny, Nasdaq. Brut has delayed its own consideration of usage of the ADF while the technological and economic barriers to its usage are moderated by the NASD offering improved connectivity solutions and more realistic economics. These steps are important for the NASD to prove to market makers and ECNs that it is serious about operating a truly viable SuperMontage alternative. In its May 2002 report, the General Accounting Office noted the need to manage market structure in light of concerns regarding viability, stating "an ongoing challenge . . . will be to respond effectively to both real and perceived conflicts of interest."[2] A continued insistence from the SEC and the Congress that the ADF offer modern technological solutions and competitive economics will provide meaningful competitive discipline on Nasdaq as it competes with market makers and ECNs.

The adaptation of current regulation to promote even further competition in this area should be strongly considered. Regional exchanges such as the Cincinnati Stock Exchange are considering a variety of business models that would provide quotation and trade reporting services to market makers and ECNs in competition with SuperMontage. The current regulation of registered securities exchanges can at times serve as the barrier to deployment of these business models. The reduced relevance of the distinction between heavily traded exchange-listed and Nasdaq stocks, and the increased electronification of both markets, dictate a reconsideration of how exchanges are to be regulated going forward in order to realize the full competitive potential of current market structure.

As ECNs seek to compete within this landscape, the need for ECN pricing flexibility should also be emphasized. In this challenging economic environment, pricing is a matter of both extreme importance and sensitivity to Brut's customers. Our rate structure, which is fairly common in the industry, rewards users that are willing to initiate and display orders into its ECN with a cash rebate, while charging firms that seek to access Brut's liquidity a fee. Since the implementation of the SEC's Order Handling Rules in 1997, the debate over these "ECN access fees" has ebbed and flowed with changing economic and regulatory conditions. Brut believes that competitive forces, rather than regulation, are appropriate to discipline the nature and structure of prices. These forces currently serve to pressure ECN rate structures in both directions. The entry of Nasdaq as a competitor and the rate structure of SuperMontage (which also offers rebates) necessitates similar pricing in the quest for liquidity. What the market will bear in terms of cost has also revealed itself, as ECNs that have attempted to take rate structures to the extreme have experiences unsustainable collection rates. ECNs themselves have worked to eliminate pricing inefficiencies between one another. Continued vibrant rate competition, rather than intervention and its potential for unintended adverse consequences, will best serve the economics needs of both ECN operators and their users.

EFFICIENT FRAGMENTATION

As ECNs and others assert their competitive independence from Nasdaq, some concerned that increased fragmentation will negatively impact on another national market system principle, ensuring "economically efficient execution of securities transactions."[3] Brut counts itself among the firms with the vision and technology to remedy such concerns, providing an example of how the market can respond to a changing environment to provide consumers with the best of all possible worlds.

Brut is representing customer orders within SuperMontage, delivering customers the full functionality and liquidity of that market in addition to its own. We are doing so because we believe that to do otherwise will deny our customers best execution opportunities inconsistent with the Congressional goal of "executing investors orders in the best market."[4] In addition, we offer quote information from and direct connectivity to non-SuperMontage ECNs and other significant market centers, in order to provide customers with a seamless, "one stop shopping" trading environment that fulfills the need for "availability to brokers, dealers and investors of information with respect to quotations for and transactions in securities."[5] All the while

[2] United States General Accounting Office, Securities Markets: Competition and Multiple Regulators Heighten Concern About Self-Regulation, at 29 (May 2002).

[3] Exchange Act Section 11A(a)(1)(c)(i).

[4] Exchange Act Section 11A(a)(1)(c)(iv).

[5] Exchange Act Section 11A(a)(1)(c)(iii).

we are exploring ways to reduce our Nasdaq reliance from a cost perspective, so as to eliminate dependencies without jeopardizing customer interests.

Our ability to navigate this more complex market structure while still preserving execution quality provides evidences that fragmentation can and will work to the ultimate benefit of the consumer. The private connectivity between and among ECNs, broker-dealers and other major markets now exists such that public utilities are no longer a lynch-pin to ensure that consumers receive the best prices for their securities transactions. This gives each market participant the freedom to offer its own unique solution to its customers, on its terms, without any single point of collective reliance. This can free each firm to innovate, letting the market decide whether a firm's offering provide required service to meet trader needs. The SEC's proactive efforts to ensure market centers provide the investing public with objective, consistent information regarding execution quality, as embodied by recent Rules 11Ac1-5 and 11Ac1-6 under the Exchange Act, allow investors to compare "apples to oranges" and make smart order-routing decisions.

Legacy regulations that subvert the ability of a market center to offer customers its version of a quality execution to a need for centralization should be re-evaluated in light of this new reality. With respect to transactions in exchange-listed stocks, ECNs have attracted significant order flow in recent years, as innovative products like exchange-traded funds (such as the "QQQ" and "SPDR"), the transition to decimalization, and the homogenization of trading operations have all eroded resistance to electronic trading of these instruments. This success has triggered SEC requirements under Regulation ATS, which mandate the display of ECN order prices into the public quotation system once certain volume thresholds have been surpassed. Unlike mechanisms for Nasdaq securities, however, the means to comply with this requirement for listed stocks also require participation in the Intermarket Trading System (or "ITS"), an exchange-dominated consortium with requirements that do not fit all ECN business models. This has put some ECNs in the unenviable position of choosing between options that all dilute their value proposition and consumer execution quality. Some have chosen to cease display of their order prices to all customers—forcing people to "trade blind". Others have ceased trading these securities altogether. While Brut is an ITS participant, through its involvement in the Nasdaq Intermarket, we see this development as counterproductive. In this era of customer mobility and information availability, regulations that thwart an ECN's ability to deliver what its customers want should be reconsidered in light of the continued relevance of their original purpose.

CONCLUSION

The rapid rate at which our markets are transforming creates the potential for a regulation gap—which ECNs often find themselves in the middle of due to their innovative nature—that puts consumer interests at risk. Chairman Pitt has recognized this risk, asking the staff of the SEC to hold public hearings on market structure issues. ECNs have had an important role helping consumers achieve the best prices, by increasing transparency, reducing spreads, and perhaps as the greatest fulfillment of the Congressional mandate, to provide "an opportunity . . . for investors' orders to be executed without the participation of a dealer."[6] In light of the changing market structure before us, Brut believes that the principles enunciated by the Congress in 1975—fair competition, efficient executions and flexible regulation—can continue to serve as a road map to promote market structure quality and investor interests.

Mr. Chairman, Brut welcomes the Subcommittee's interest in these important issues, and I look forward to any questions you and the other Members may have.

Mr. STEARNS. I thank the gentleman.

Mr. Gasser, welcome.

STATEMENT OF ROBERT C. GASSER

Mr. GASSER. Good morning, Chairman Stearns, Mr. Towns, and members of the subcommittee. I am Robert Gasser, Chief Executive Officer of NYFIX Millennium. On behalf of our parent company NYFIX, Inc., our partners and clients, I thank the committee for the opportunity to appear before you today to discuss the role ECNs play in current U.S. Market structure. I thank you for hold-

[6] Exchange Act Section 11A(a)(1)(c)(v).

ing this hearing on the subject that is at the heart of the matter when talking about market structure, and that is the effects that changes, and sometimes lack of change, have had on the end investor.

In 1999, Millennium was founded by a partnership comprised of NYFIX, Inc. and 10 prominent U.S. Investment banks, including ABN Amro, Bank of America, Deutsche Bank, JP Morgan, Lehman Brothers, Morgan Stanley, SC Bernstein, SG Cowen, UBS Warburg, and Wachovia Securities. We are a firm focused on the electronic interaction of listed equity order flow. As a result, my comments will almost exclusively focus on listed equity securities.

Millennium went live in September of 2001 and has steadily grown its daily executed volume to our current average of approximately 9 million shares a day in the most recent 90 day period. Our customers are comprised of investment banks, on-line trading firms, and program trading entities. In total, we have 65 contracted users of the system. Importantly, they contribute a pool of liquidity to our system by passing their DOT and institutional block volume through Millennium by default on its way to the floor of the New York Stock Exchange.

This pass-through, as we refer to it, is allowed to interact with resting orders that can improve the price reflected on the New York Stock Exchange by at least one penny. If our system cannot improve price, that order is immediately, 100 to 150 milliseconds as we clock it, sent on to its original destination. Trades are immediately printed in the Nasdaq Intermarket. We do not publish a quote in competition with the New York Stock Exchange and we presently have no aspirations to become a U.S. Stock Exchange.

NYFIX, Inc., the parent of Millennium, is the dominant provider of network services and order management technology to the listed trading marketplace. We estimate that we touch approximately 40 percent of institutional block trading liquidity every trading day. On the reopening of the exchange September 17, 2001, NYFIX, Inc. touched 1.2 billion shares of executed listed volume. On any given day, 15 to 20 percent of that volume is passed through Millennium.

U.S. Listed market structure is differentiated in one very critical way from the Nasdaq marketplace. In 1996, the change in Nasdaq order handling rules mandated by the regulatory overhaul of that market catalyzed growth of the ECN model. In effect, Nasdaq market access was democratized. The U.S. Listed marketplace has not experienced a transformational event of this magnitude. While investors who have electronic access, such as DOT, with the New York Stock Exchange, they must always interact with a gatekeeper, that being the New York Stock Exchange specialist, when transacting with trading counterparties. Firms wishing to compete with the New York Stock Exchange specialist have historically been relegated to the ITS. Many of our constituent clients aspire to compete with the New York Stock Exchange specialist. We provide a mechanism by which they can interact electronically with a subset of New York Stock Exchange liquidity as long as they are willing to improve price. We give these firms the ability to submit order flow instantaneously and cancel order flow instantaneously. Their only obligation when they submit a live order into our system is to transact.

There is a quiet revolution starting in the U.S. Listed marketplace. Investors and traders who have become disenchanted with current market structure are moving beyond the experimentation phase. They are starting to employ ATSs like the ones represented here today. The value proposition is clear. Execution that is electronically matched without human intermediation takes one middleman and the resulting economic impact of that middleman out of the equation. What makes that possible today? I would submit to you that advanced technology, industry protocols, and high-speed networks support this type of healthy competition without the resultant risk of fragmentation.

This quiet revolution combined with the decimalization of stocks, the consolidation of the New York Stock Exchange specialist units, the requirement to submit quality of execution data for the public record, and the extended bear market in the U.S. Equity markets is in the process of causing profound change to the security industry.

Given the lack of investment returns generated in the past 3 years, there has been increasing scrutiny placed on transaction costs by end investors. In an era where outsized investment returns have been eliminated by poor market performance, best execution is not a luxury item; it can make or break best performance.

Market centers are compelled to publish their quality of execution data in accordance with SEC Reg 11ac1-5. We welcome this objective measurement of performance. In our most recent filing as of August 2002, we compared very favorably against the listed equity market center average in the four main categories used to measure performance. They are the following: percentage of order flow executed in 0-9 seconds; percentage of orders that were price improved; average order size; and percentage of orders exercised outside the quote. Millennium executed 97.9 percent of its order flow within 0-9 seconds versus a market center average of 52 percent. Millennium price improved 75.6 percent of its order flow versus a market center average of 32.9. Millennium's average order size was equal to 926 shares versus a market center average of 882 shares. Millennium traded outside of the quote 5.9 percent of the time as opposed to a market center average of 21.3.

While we can argue about the changing role of an intermediary, round or flat, there is one inescapable and unavoidable truth to the present supply chain in the trading of U.S. Listed equity securities. There are a lot of middlemen. The question becomes how does each link in that chain justify its own unique cost/benefit. We would argue that technology is changing the answer to that question and the possible outcomes. Special interests that argue against fragmentation are really arguing against competition. Our publicly available quality of execution data clearly makes the case for the automation of client interaction and the resultant benefits.

We thank you, Chairman Stearns, Mr. Towns, and members of the committee for your focus on these issues.

[The prepared statement of Robert C. Gasser follows:]

PREPARED STATEMENT OF ROBERT C. GASSER, CHIEF EXECUTIVE OFFICER, NYFIX MILLENNIUM, LLC

Good morning Chairman Stearns, Mr. Towns and members of the Subcommittee. I am Robert Gasser, Chief Executive Officer of NYFIX Millennium, L.L.C. (Millen-

nium). On behalf of our parent company NYFIX, Inc., our partners, and clients, I thank the committee for the opportunity to appear before you today to discuss the role ECN's play in current US Market Structure.

I. COMPARING AND CONTRASTING MILLENNIUM AND OTHER NASDAQ-CENTRIC ECN'S

In 1999, Millennium was founded by a partnership comprised of NYFIX, Inc. and 10 prominent US Investment Banks including ABN Amro, Bank of America, Deutsche Bank, JP Morgan, Lehman Brothers, Morgan Stanley, SC Bernstein, SG Cowen, UBS Warburg, and Wachovia Securities. We are a firm focused on the electronic interaction of listed equity order flow. As a result my comments will focus exclusively on Listed equity securities.

Millennium went live in September of 2001 and has steadily grown daily executed volume to our current average of approximately 9 million shares/day. Our customers are comprised of Investment Banks, Online Trading Firms, and Program Trading entities. In total we have 65 contracted users of the system. Importantly, they contribute a pool of liquidity to our system by passing their DOT and institutional block volume though Millennium by default on its way to the floor of the NYSE.

This pass through volume is allowed to interact with resting orders that can improve the price reflected on the NYSE by at least $0.01. If our system cannot improve price that order is immediately (100-150 milliseconds) sent onto its original destination. Trades are immediately printed in the NASDAQ Intermarket. We do not publish a quote in competition with the NYSE and we presently have no aspirations to become a US Stock Exchange.

NYFIX, Inc. the parent of Millennium is the dominant provider of Network Services and Order Management Technology to the Listed Trading Marketplace. We estimate that we touch approximately 40% of institutional block trading liquidity every trading day. On the re-opening of the exchange September 17, 2001 NYFIX, Inc. touched 1.2 billion shares of executed Listed volume. On any given day, 15%-20% of this volume is passed through Millennium.

II. A QUIET REVOLUTION

US Listed market structure is differentiated in one very critical way from the Nasdaq marketplace. In 1996, the change in Nasdaq order handling rules mandated by the regulatory overhaul of that market catalyzed growth of the ECN model. In effect, Nasdaq market access was "democratized". The US Listed marketplace has not experienced a transformational event of this magnitude. While investors have electronic access (such as DOT) to the NYSE, they must interact with a "gatekeeper" (NYSE Specialist) when transacting with trading counterparties. Firms wishing to compete with the NYSE Specialist as market makers have historically been relegated to the ITS (Intermarket Trading System). This has created a market opportunity for Millennium. Many of our constituent clients aspire to compete with the NYSE Specialist. We provide a mechanism by which they can interact electronically with a subset of NYSE liquidity as long as they are willing to improve price. We give these firms the ability to submit order flow instantaneously and cancel order flow instantaneously. Their only obligation when they submit a live order into our system is to transact.

There is a quiet revolution starting in the US Listed marketplace. Investors and traders who have become disenchanted with current market structure are moving beyond the experimentation phase. They are starting to employ ATS' like the ones represented here today. The value proposition is clear—execution that is electronically matched without human intermediation takes one middleman and the resulting economic impact out of the equation. What makes that possible today? I would submit to you that advanced technology, industry protocols, and high speed networks support this type healthy competition without the resultant risk of fragmentation.

III. PROFOUND CHANGE

This quiet revolution combined with the decimalization of stocks, the consolidation of NYSE Specialist units, the requirement to submit quality of execution data for the public record, and the extended bear market in the US Equity Markets is in the process of causing profound change to the Securities Industry.

Given the lack of investment returns generated in the past three years, there has been increasing scrutiny placed on transaction costs by end investors. In an era where outsized investment returns have been eliminated by poor market performance, best execution is not a luxury item. It can make or break best performance.

Market centers are compelled to publish their quality of execution data in accordance with SEC Regulation 11ac1-5. We welcome this objective measurement of per-

formance. In our most recent filing as of August, 2002 we compared very favorably against a listed equity market center average In the four main categories used measure performance. They are the following: 1) Percentage of order flow executed in 0-9seconds, 2) Percentage of orders that were price improved, 3) Average order size, and 4) Percentage of orders executed outside the quote. Millennium executed 97.9% of its order flow within 0-9 seconds versus a market center average of 52%. Millennium price improved 75.6% of its order flow versus a market center average of 32.9%. Millennium's average order size was equal to 926 shares versus a market center average of 882 shares. Millennium traded outside of the quote 5.9% of the time versus a market center average of 21.3%.

IV. SUMMARY

While we can argue about the changing role of an intermediary all day long, there is one inescapable and unavoidable truth to the present supply chain in the trading US listed equity securities—there are a lot of middlemen. The question becomes—how does each link in that chain justify its own unique cost/benefit. We would argue that technology is changing the answer to that question and the possible outcomes. Special interests that argue against "fragementation" are really arguing against competition. Our publicly available quality of execution data clearly makes the case for the automation of client interaction and the resultant benefit.

Mr. STEARNS. I thank you.

Mr. Ryan.

STATEMENT OF MICHAEL J. RYAN, JR.

Mr. RYAN. Good morning. My name is Michael Ryan and I am Executive Vice President and General Counsel for the American Stock Exchange. Chairman Stearns, Mr. Towns, and your staffs, I appreciate the opportunity to testify before this subcommittee today.

Over the past year, as you noted, a great deal of the financial community's attention has been focused on the threat of terrorism and the need to bring law and order back to corporate America. As operator of a securities market that happens to be located less than 300 feet from Ground Zero, we cannot overstate the importance of both of these efforts. We believe the current efforts by the government will strengthen the existing market systems and provide new protections to customers, and we intend to remain an active participant in this process. Indeed, we look forward to participating in the SEC's upcoming hearings on market structure.

Today, however, I would like to focus on a series of activities that relate to serious violations of the Federal securities laws. Before I discuss my specific points, though, I would like to give you a brief overview of the American Stock Exchange and the National Market System. The American Stock Exchange has a long history of innovation and is unique among U.S. Securities markets in that we are the only market that actively lists and trades securities across three diverse business lines: We trade equities, options, and exchange-traded funds, commonly referred to as ETFs.

In equities we focus principally on providing a well-regulated auction market for small- and mid-cap companies. Our options market is the second largest in the United States, and for the first time since getting into the business more than 25 years ago, recently have had days where we are the most active equity options market. What really sets the Amex apart from all of the markets in the U.S. Are ETFs, which is the fastest growing, most innovative financial product offered by an exchange over the last decade. After more than 4 years of working with the SEC and millions of dollars

in R&D expense, the Amex pioneered ETFs in 1993 with the introduction of an ETF base on the S&P 500 index, known as the SPIDER. Since then, we have spent millions more in developing new products, in educating the marketplace about the benefits of ETFs. Nine years later the Amex remains the clear leader in ETF listings, listing 121 of the 123 in the U.S. Market today, including in addition to SPIDERs, the QQQ which is based on the Nasdaq 100 and DIAMONDS, which is based on the Dow 30.

Now we are also planning the next generation of ETF products, variations that will provide investors even greater flexibility and new investment opportunities. We launched fixed income ETFs this summer and are getting ready to introduce leverage ETFs, inverse ETFs, and, most significantly, actively managed ETFs.

We have been able to leverage our reputation in ETFs to create a global presence for the Amex. In the last year we have reached agreements to trade Amex-listed ETFs in Europe and Asia. In short, the American Stock Exchange has emerged as a strong, innovative, international competitor, especially in the development and trading of sophisticated derivative securities.

I would like to turn to a brief description of the National Market System. In 1975, Congress adopted substantial amendments to the Federal securities laws that mandated the creation of a National Market System for trading securities. To achieve this congressional mandate, at the direction of the SEC, we now have in place three critical National Market System plans for Amex-listed securities.

Two of these plans consolidate trade and quote information which is sold to market participants on a real-time basis. The revenue generated is shared among the exchanges and Nasdaq ratably based on the number of trades executed in Amex-listed securities by each market.

The third plan provides the mechanism for market participants to access trading interest across all markets, which is critical in achieving best execution for investors orders.

Of course, with the evolution of the markets, the Commission has found it necessary from time to time to take additional steps to ensure that the National Market System is kept current. Most significantly, on December 8, 1998, the Commission adopted a new rule known as regulation ATS for alternative trading systems. This new rule is designed to integrate significant alternative trading systems into the National Market System. The SEC took this action to deal with the growing regulatory disparity between ATSs and other markets, disparities the SEC found negatively affected other securities markets and, most importantly, investors. Without justification however, one ATS, Island, has openly violated and disregarded ATS by steadfastly refusing to display its best price orders and the consolidation quotations and providing access to those orders by investors across all markets.

Because of these violations of this new rule, we have now a two-tiered market rife with fraudulent and misleading trade reporting. To fully appreciate this problem, it is important to connect a few dots. First, NASDAQ has in place a payment for order flow program under which they pay their members, including Island, for trades and Amex listed securities. Because of an historical anomaly, NASDAQ is given credit for Island's trades, even though Island

refuses to participate in the two most significant components of the National Market System, consolidating quotations and providing fair access to those quotes.

To restore balance to the National Market System, in February of this year the overwhelming majority of the markets proposed an interpretation of the National Market System plans to end the practice of giving NASDAQ credit under the revenue sharing formula for Island's trades until Island became a full partner in the National Market System. Ironically, if this interpretation were permitted to stand, many of the problems today that I am raising would long have been resolved. It would also absolutely have prevented the next problem on the horizon, which is fraudulent and misleading trade reporting, which is the second situation I will describe to you today.

At the beginning of this year, Island also began paying for order flow using the money it receives from NASDAQ. The clever structure of their scheme has directly led to a practice known as trade shredding and at least in some instances to manipulative wash sales. Yesterday's enforcement settlement by the NASD was swift securities is directly attributed to wash sales on Island solely for the purpose of collecting market data revenue.

Third, to exacerbate matters, Island has recently announced that it will begin reporting—that is, selling—its trades and ETFs to the Cincinnati Stock Exchange in a manner that will neither display their best price quotes nor make them accessible to public investors. Regrettably, we note that the Cincinnati arrangement with Island, which has not been filed with the SEC, undermines the core purposes of Regulation ATS and the National Market System. Island will not be displaying its best orders through Cincinnati and none of Island's quotes will be accessible to other markets through ITS.

Fourth, this past August the Commission provided an exemption for one of the most significant ITS rules for the three most active ETFs. This action was obviously designed directly to accommodate Island. Despite this and many other accommodations, Island has cavalierly ignored the Commission's efforts to have it join the National Market System, most recently by going dark in an effort to use a loophole in the provisions of Regulation ATS. As a result, Island has all the benefits of being exchanged without any of the burdens. It does not regulate the practice of its subscribers. Trading in wash sales are classic examples of this. Nor does it provide surveillance of the trading activity of its own market, does not need SEC approval of changes to its system or changes to its rules or fees, and it can pick and choose who is and who is not a member.

To make matters worse, it markets itself as faster and less costly than exchanges, a claim so absurd that it is insulting to the intelligence of anyone truly familiar with their practices. The principal reason Island is faster is because it ignores investor protection rules followed by the other markets that ensure investors receive the best available price in the market. That is, it refuses to participate in the congressionally mandated National Market System.

Worse still, although it defies new SEC rules explicitly requiring them to join the National Market System, they actually receive revenue generated from the National Market System. In other words,

we, the markets that comply with the Federal securities laws by fully participating in the National Market System, are actually providing a direct financial support to a competitor that is ignoring these laws.

In closing, we are simply asking that all investors be given the greatest assurances that they have access to the most fair and efficient markets, and that the Amex and the rest of the markets be given a fair playing field by ensuring even-handed enforcement of the rules.

Thank you for your time, and I look forward to your questions.

[The prepared statement of Michael J. Ryan, Jr. follows:]

PREPARED STATEMENT OF MICHAEL J. RYAN, JR., EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, AMERICAN STOCK EXCHANGE

Good morning, my name is Michael Ryan and I am Executive Vice President and General Counsel for the American Stock Exchange. Chairman Stearns, Mr. Towns and distinguished members, I appreciate the opportunity to testify before the Subcommittee on Commerce, Trade and Consumer Protection concerning "ECNs & Market Structure: Ensuring Best Prices for Consumers" and wish to thank you for holding this important hearing. Over the past year, a great deal of the financial community's attention has been focused on the threat of terrorism and the need to bring law and order back to corporate America. As the operator of a securities market less than three hundred feet from Ground Zero, we cannot overstate the importance of both these efforts. We believe current efforts by the Government will strengthen the existing market system and provide new protections and assurances to consumers and we intend to remain an active participant in this process. Indeed, we look forward to participating in the SEC's upcoming hearings on market structure. In examining the current market structure today, I would also like to bring to your attention several issues that relate to serious violations of the federal securities laws that until recently went unchecked for more than a year and a half and are, without a doubt, counter to those principles that ensure a fair market for investors.

Before I discuss specific points, however, it is important to provide you a brief overview of the American Stock Exchange and of the National Market System (NMS).

The American Stock Exchange has a long history of innovation and diversification, and it proudly carries on this distinguishing trademark among exchanges today. As one of the most diversified financial marketplaces in the U.S., the Amex is the only primary exchange in the United States that actively lists and trades securities across three diverse business lines—equities, options and exchange traded funds or ETFs. We continue to provide investors—whether it be retail or institutional investors—with investment opportunities that best meet their needs.

Since being purchased by the NASD in 1998, the Amex has undergone dramatic changes. For the next couple of minutes, I'd like to highlight some of those exciting changes and the distinguishing characteristics of the Amex as a self-regulatory organization (SRO), and how it differs and offers critical advantages to the market as compared to the other exchanges and ECNs.

Essentially, the Amex marries the rules of the auction market and the expertise of an Exchange professional to create a high-quality, well regulated trading environment. The result of this advantageous combination is the Amex's ability to provide investors with greater liquidity, narrower spreads, decreased volatility and meaningful price discovery.

The Amex market is a technologically advanced centralized auction and specialist system whose strength comes from the fact that the specialists have an affirmative obligation to maintain a fair and orderly market. This means they risk their own capital, maintaining a continuous two-sided quotation. With a specialist intrinsically linked to creating the best market for a stock, the best interest of listed companies and their shareholders are achieved. Other markets—whether they be regional exchanges, dealer markets or ECNs—provide far less of a commitment to the investing public.

By buying and selling from their own account, specialists increase liquidity and maintain orderly markets by helping companies avoid the wild fluctuations and price volatility securities often seen on other markets. Investors also benefit from "truer price discovery" and decreased fragmentation, as customer orders in our market are matched up together over 70 percent of the time.

The combination of our auction market, diversified product line, state-of-the-art technology and large pools of liquidity on our market provided by Wall Street's most experienced and well-capitalized firms, delivers a superior marketplace for investors in all our products.

EQUITIES

The Amex equity marketplace continues to outperform the market. Following a strategic restructuring of the equity program which refocused the business on small and middle market companies, the Amex composite index outperformed every other domestic exchange and virtually every other index in both 2000 and 2001, and is on track to do so again this year.

The Amex, unlike the other primary markets which focus exclusively on servicing large cap stocks, acts as a conduit in helping small and mid-sized companies develop and grow.

We feel that now, more than ever, in this economic and political climate, it's critical to provide support to the capital markets—especially the small and mid-cap companies who are more often than not our nation's principal source of innovation, job creation and future economic growth.

Our advanced centralized auction and specialist system is especially beneficial to small and mid-cap companies as it maximizes liquidity at the point of sale. Specialists also serve as a single point of contact that a company can turn to for critical insight on their company's trading activity.

By offering a catalogue of value-added services through our Investor Relations Alliance to our listed companies, we've created a niche marketplace for companies who can use guidance and assistance in seeking visibility and coverage in a difficult economy and an increasingly sophisticated market environment.

Offering additional diversification and opportunities to investors—we also began trading NASDAQ stocks this summer. By trading NASDAQ stocks, the Amex is providing for the first time in these securities, a meaningful auction market environment with real opportunities for price improvement. The Amex is providing deep liquidity for large, institutional size orders, which creates new investment opportunities for investors.

OPTIONS

The Amex is also the second largest options exchange in the U.S., trading options on broad-based and sector indexes as well as domestic and foreign stocks.

We trade call and put options on more than 1,800 stocks and 25 broad, sector-specific and international indexes. And we continue to close in on becoming the number one domestic options marketplace for equity options.

Even amid tough market conditions, we continue to see growth in our options business. In looking at third quarter Amex's total options equity volume for this year, it is up 18% as compared to this same time last year.

ETFS

In addition to its role as a national equities market and leading options exchange, the Amex is the pioneer of the Exchange Traded Fund ("ETF"). ETFs are the fastest growing, most innovative financial products offered by an exchange over the last decade. After more than four years of working with the SEC and millions of dollars of R&D expense, we launched the first ETF in 1993 with the creation of the Standard & Poor's Depository Receipts (or commonly referred to as the "spider"), which is based on the Standard and Poor's 500 Composite Stock Price Index.

Over the next several years, we spent millions more developing new products and educating the marketplace about the benefits of ETFs. Nine years later, the Amex remains the clear leader in ETF listings, listing 121 of the 123 in the U.S. market today.

For a six-year stretch through 2001, the Amex had seen ETF assets and average daily volume nearly double year after year. In 1999, ETFs at the Amex had $35.9 billion in assets. That grew to $70.3 billion in 2000 and to $87 billion by year-end 2001. Last year, we witnessed ETF assets increase more than 26% at a time when most underlying indexes were declining.

Remarkably, ETFs have grown globally in the face of the market downturn. That is due in large part to the basic features of the ETF and the attractive advantages they offer investors, especially in turbulent markets. ETFs offer investors diversification, flexibility against intra-day price swings and lower cost structures. Certainly, today these qualities are even more appealing to any investors—whether retail or institutional.

Now, we're also planning the next generation of ETF products—variations that will allow investors even greater flexibility and new opportunities. We launched fixed income ETFs this summer and are getting ready to introduce leveraged ETFs, inverse ETFs and actively managed ETFs.

GLOBAL

We have been able to leverage our reputation in ETFs to create a global presence for the Amex. In the last year, we have reached agreements to trade Amex-listed ETFs in Europe and Asia.

Our global expansion includes a joint venture with the Singapore Exchange. In May, we began trading Amex-listed ETFs in Asia, becoming the very first fungible trading of a product across time zones.

We've also listed the first U.S. equivalent of an ETF trading on the Tokyo Stock Exchange. And we continue to work on agreements with the Tokyo Stock Exchange and Euronext with respect to the listing and trading of each other's ETFs.

As regulations allow, we anticipate that these centers will also provide international trading venues for our listed companies seeking exposure to the global markets.

CRITICAL ISSUES

In short, the new American Stock Exchange has emerged as a strong, innovative international competitor, especially in the development and trading of sophisticated derivative securities.

Amidst all of this, we are also preparing to separate from the NASD. As the NASD has publicly stated, it is ready to refocus solely on its role as a regulator, divesting itself of ownership of both NASDAQ and the Amex. That process is well underway for NASDAQ, and the Amex is actively discussing with interested parties the best opportunities for our separation from the NASD.

Importantly, at the Amex, we pride ourselves on being a guardian of the capital markets as well as a proponent of innovation. The Amex has always been a regulator that is focused not only on strong regulation but also enhancing prospects for current and future economic prosperity. This has been at the core of the Amex for many, many years and will continue to be well into the future, regardless of ownership.

NATIONAL MARKET SYSTEM

Let me now turn to a brief description of the national market system—its formation and purposes.

In 1975 Congress adopted substantial amendments to the federal securities laws designed to enhance the integrity and efficiency of our national securities markets and to ensure that all investors, wherever located and irrespective of their connections or affiliations, were provided contemporaneous, equal and fair access to market information and pricing.

Thus, Congress directed the SEC to develop a national market system. The Commission, in turn, adopted rules under this mandate to enhance transparency of market information and to foster interaction of investor trading interest. These rules require that the markets disseminate to the marketplace, in real time, consolidated order and quotation information as well as trade executions. These rules also require that the markets maintain linkages among one another in order to minimize fragmentation.

The SEC directed all the exchanges and NASDAQ to adopt plans to implement a national market system and to integrate the various exchanges into them. Ultimately, three critical national market system plans were adopted for equity securities: the Consolidated Quote ("CQ") Plan, the Intermarket Trading System ("ITS") and the Consolidated Tape Association ("CTA") Plan.

To put it in simple terms, CQ lets market participants see trading interest as soon at it arises, ITS provides the mechanism for market participants to access this trading interest across markets and CTA provides the mechanism to learn about trades that occur almost immediately after they are executed. Collectively, these three plans achieve the Congressional mandate of developing a national market system by enhancing real time consolidated transparency of market data (i.e., the CQ Plan for quotes and CTA Plan for trades) and fostering interaction of investor trading interest (i.e., ITS). Each of the Plans was submitted to and approved by the Commission.

The CQ and CTA Plans provide that the market data generated from these Plans is to be sold to market participants on a real-time basis. The revenue generated is

then shared among the exchanges and NASDAQ ratably based on the number of trades executed by that market.

Since the adoption of these Plans, the Commission has on many occasions refined its national market system related rules, reinforced the importance of the national market system and underscored the central role these Plans play in meeting the mandate set forth in the 1975 Amendments.

Most significantly, on December 8, 1998, the Commission adopted a new rule—Regulation ATS (Alternative Trading System)—designed to integrate significant alternative trading system activity into the national market system. This new rule was adopted after extensive and careful consideration and for the express purpose of integrating ATSs into the national market system.

Much like the Commission's 1996 order handling rules that were designed to eliminate the two-tiered market being created by Instinet in NASDAQ securities, Regulation ATS was adopted to address the Commission's well-founded concerns that these systems were leading to market fragmentation and harming market transparency by operating as private "'hidden markets,' in which a market participant privately publishes quotations at prices superior to the quotation information it disseminates publicly." Further, the SEC did this to deal with the growing regulatory disparity between ATS's and other markets, disparities the SEC found negatively affected other securities markets and, most importantly, investors.

The SEC noted at the time that ATS trading activity was not fully disclosed to or accessible by public investors, that this activity would likely not receive adequate surveillance for market manipulation and fraud, and that ATS's had "no obligation to provide investors a fair opportunity to participate in their systems or to treat participants fairly."

Without justification, however, Island has openly violated and disregarded the clear provision of Regulation ATS that expressly requires orders entered in Island to be publicly displayed in the consolidated quotation. The violation of these important aspects of our federal securities laws has created a two-tiered market, complete with unfair advantages for certain market professionals, to the direct disadvantage of the other market participants and, most significantly, retail investors. Because of these violations of this new rule, we now have a two-tiered market rife with fraudulent and misleading trade reporting.

The American Stock Exchange believes very strongly that this subcommittee should view with deep concern Island's open and continuous violation of Regulation ATS since May 2001. For more than a year the Amex has repeatedly raised objection to these violations and other related abuses.

To add to this problem, NASDAQ has in place a payment for order flow program whereby they pay their members—including, most notably, Island—for trades in Amex listed securities. To be precise, NASDAQ "kicks back" to Island a percentage of the market data revenue NASDAQ receives as a result of Island's trades, even though Island refuses to participate in the two most significant components of the national market system—consolidating quotations and providing fair access to those quotes.

We believe NASDAQ's payment for order flow program raises serious and significant issues regarding investor protection, market transparency and best execution. This program directly violates the fundamental principles of the national market system as it was conceived and mandated by this Congress. Indeed, the entire system has now seriously deteriorated and broken down.

Back in February, the overwhelming majority of the CTA participants proposed an interpretation of the CQ and CTA Plans to end the practice of giving NASDAQ credit under the revenue sharing formula for Island's trades. After all, it defies both logic and principles of fundamental fairness to permit NASDAQ or Island to receive direct financial benefit for Island's trades from the national market system when Island stubbornly refuses to participate in the most fundamental national market system functions.

Ironically, if the American Stock Exchange and a majority of the other CQ/CTA participants were not forced to reverse this interpretation, much if not all of this problem would have long been resolved. It would also have absolutely prevented the next problem on the horizon—fraudulent and misleading trade reporting.

Beginning sometime in February or March, Island also began paying for order flow. They cleverly structured their scheme along the lines of the NASDAQ payment for order flow program, which mirrors the CQ/CTA market data revenue sharing plan. That is, you get paid for every trade in excess of 100 shares. Needless to say, it wasn't long before Island's customers were breaking up trades into 100 share increments—a practice know as "trade shredding" in its most benign form and, in many instances, wash sales, an explicit violation of the antimanipulation provisions of the federal securities laws. So, for example, if Island is paying you $1.00 per

trade regardless of the size and you want to trade 1000 shares, you are going to send into Island 10 orders at 100 shares rather than 1 order at 1000 shares. Trade shredding and wash sales flowing from Island's scheme have proliferated since then.

Unfortunately, this is not even the latest chapter. There are two more.

First, to exacerbate matters, Island has recently announced that it will begin reporting (that is, selling) trades in ETFs to the Cincinnati Stock Exchange ("CSE") in a manner that will neither display their quotes nor make them accessible to public investors. According to Island, CSE will pay Island 90% of CSE's market data revenue that it receives under the CTA Plan. Island therefore will be able to pay its users even more than under NASDAQ's Pilot Payment for Order Flow ("PFOF") Program, with the aim of further increasing Island market share and siphoning even greater volume away from national market facilities. In this regard, we note that CSE's arrangement with Island, which has not been separately filed with the SEC, undermines the core purposes of Regulation ATS. Island will not be displaying its best orders through CSE and none of Island's quotes will be accessible to other markets through ITS. Indeed, Island has explicitly stated that orders matched at a price outside the best market—that is, that trade through a better price in the national market system, will continue to be reported to NASDAQ and be compensated for under NASDAQ's Pilot PFOF Program.

Finally, against this backdrop, we were amazed and frustrated when we learned this past August that the Commission without discussion or debate amended the ITS plan for SPY (the S&P 500 ETF), QQQ (the Nasdaq 100 ETF) and DIA (the Dow 30 ETF). The action was obviously designed directly to accommodate Island.

During this entire period the Amex has honored every request by the Commission to refrain from taking any action based on the Commission's promises that the issues would be addressed expeditiously. While we have complied with the Commission's requests, Island has cavalierly ignored the Commission's efforts to have it join the national market system, most recently by "going dark"—and thereby making an absolute mockery of the entire purpose of Regulation ATS—after the Commission granted a three cent exemption to the ITS trade-through rule. Our frustration with the situation has reached the breaking point.

What has happened here sends a clear message to market participants: If you are part of the private club (in this case, Island), you don't need to worry about the rules and you can trade away. This means that outsiders cannot see or get access to a better price within the private club. What's more, because the private club refuses to connect to the national market system, investor's orders in the private club are disadvantaged because they cannot access a better price in a competing market.

Although characterized as ATSs, these private clubs on one level operate for all practical and competitive purposes as an "exchange," competing each day with the registered national securities exchanges.

On another level, however, these private clubs have none of the regulatory burdens of an exchange. They do not regulate the practices of their subscribers (to wit, trade shredding and wash sales). They do not provide surveillance of the trading activity of their own market. They do not need SEC approval of changes to their systems. They do not need SEC approval to change their rules or fees. They can pick and choose who is and who is not a club member. And, in complete defiance of Regulation ATS, has operated in blatant and open violation of the federal securities laws for 18 months. In violating Regulation ATS, they do not disseminate their best available orders for consolidation with all other markets and they do not provide access to anyone who is not a part of their club.

As a result, an ATS has all the benefits of being an exchange without any of the burdens. To make matters worse, they market themselves as faster and less costly than exchanges—a claim so absurd that it is insulting to the intelligence of anyone truly familiar with their practices.

The only reason an ATS is faster is because they ignore the investor protection rules followed by the other markets that ensure investors receive the best available price in the market—that is, they refuse to participate in the Congressionally mandated national market system.

Worse still, although they defy new SEC rules explicitly requiring them to join the national market system, they actually receive revenue generated from the national market system. In other words, we—the markets that comply with federal securities laws by fully participating in the national market system—are actually providing direct financial support to a competitor that is ignoring the federal securities laws.

CONCLUSION

During this session, Congress has had to shore up the integrity of our markets and the governance of our corporations in the context of such examples as Enron and WorldCom, which involved private "deals" to accommodate "star performers," all undertaken in an opaque regulatory environment. We view the current regulatory scheme applied to ECNs as perilous because a regulatory pattern has emerged that has allowed certain market participants to operate outside the rules and outside the Congressionally mandated national market system. We are simply asking that all investors be given the greatest assurances that they have access to the most fair and efficient markets and that the Amex be given a fair playing field by ensuring evenhanded enforcement of the rules. If the house of cards falls, then Congress, together with regulators, securities markets and investors, will be asking why the warning signals had not been adequately dealt with. Thank you for your time.

Mr. STEARNS. I thank the gentleman. Let me just say, as many of you mentioned, we have had—this is a second hearing. And we invited NASDAQ and we invited the New York Stock Exchange. They came to the first hearing; they decided not to come to this one. Mr. Ryan, we invited Island; they didn't want to come. So—for whatever reason. We want to thank you folks for coming.

As a person that is really not a sophisticated—has a sophisticated understanding of all this, it seems to me, just as a person standing on the outside, every time I go toCNN and I see the New York Stock Exchange and people running around down on the floor, human beings running around, making orders, it occurs to me, gee whiz, this could be done by computers. It seems something simple, but as we move forward in technology it seems like you could handle many more sales of stock and bonds by computer rather than having people run around on the floor.

The second thing that occurs to me after 9/11 is that, why does it have to be in Wall Street in New York?

And, third, why does it have to be a certain hour? Because if you go to an electronic communication network, you could actually get it at midnight. If you go on and log in and you find somebody selling IBM, you could buy the stock yourself. And so that you would have this type of fluid market where you wouldn't need to have a location and 9/11, which is very susceptible to terrorists. Second, it could have any hours. And then, third, it seems like it would be more efficient.

So that is sort of the impetus that all of us think to have these hearings, is to understand how can ECN start to play a more prominent role, not just for the institutional investors, but also for the everyday investor who wants to buy.

Probably a fourth reason for the ECN being advantageous is if you want to sell a large block of shares today. If you sell them in which you have a lot of interface with a lot of people, a lot of other people are going to tell a lot of other people and pretty soon that is going to affect the market. So it is like the old Heisenberg uncertainty principle: You never know exactly where something is because as soon as you go to touch and look at that particular subatomic particle, you changed its location. So if T. Rowe Price and Merrill Lynch goes in, wants to sell a million shares of IBM and pretty soon all the people who are on the floor of the Stock Exchange know it, that is going to impact it in some way.

So the Heisenberg uncertainty principle, which was enormously famous, it almost applies to this in that you cannot sell large

blocks unless you go out and get 10 brokers to sell the stock for you and let them do it under a code name or under a false name so that you don't disrupt the market.

So there seems to be a lot of advantage to ECNs, and I think our purpose today is to understand what is preventing ECNs from becoming more competitive and at the same time not disrupt the market or not try to put any particular self-interest at risk, but just try to let, as you pointed out, democracy work; that is, democratize this Stock Exchange so that we have innovation, speed, higher productivity and efficiency, and at the same time protect investors so that we don't have some exclusive processor having all the information, making all the money, and having perhaps a self-interest at the same time they are pushing stocks.

So toward that end, let me just start out and move to this Intermarket Trading System, which all of you seem to think is the problem. I mean, that is what I suspect.

So, Mr. Foley, if you can, just try to give us in a very short amount of time or quickly tell me what the Intermarket Trading System is. It looks to us it is a little bit like the Senate where you need a unanimous consent from everybody to get anything done, whereas in the House it is not quite like that. So everybody says, well, why do you want to be a Senator? Well, everybody wants to be a Senator because one person can hold up the train, and whereas a U.S. Congressman for the House, it is much more difficult.

But this Intermarket Trading System, give us a little bit of a layman's term what this is and how it prevents this democratization of the market.

Mr. FOLEY. Well, let us first describe—excuse me. Let us first describe the era in which the ITS came to be. I mean, I am still listening to the Rolling Stones, and I think we all are as we were in 1975. But at that time I listened on an eight track, and in the middle of a song there would be a 10-second pause with a loud click before the song would continue. And that is the era in which the ITS was originally conceived. We don't think it is designed to work. And, as you referred to the governance structure, that is not designed to help anybody who wants to make it work. It is a method whereby an exchange that has an order that wants to be executed and doesn't have the best price on the other side of that order can send a commitment to trade to another exchange that does have the best price.

All right. The structure of ITS is at the heart of the debate between Island and the American Stock Exchange. Island under ITS rules would have to slow itself down to the pace of the ITS system and wait 30 seconds and so forth to find out if they have a trade with another exchange before they are allowed to effect an exchange—rather, a trade in their system. That is rather like telling a consumer using eBay that before you can buy these baseball cards we have got to go send all the information about the pending transaction to Sotheby's and wait until Sotheby's convenes an auction and make sure that Sotheby's doesn't have a better price, whereas the guy on eBay just wants to buy his baseball cards.

So at the heart of this debate is that the current system really would eviscerate the benefits to consumers, which is, after all, why

they are going to ECNs like Island to trade things in the first place.

We have chosen to wait for the SEC to resolve some of the market structure issues that make us reluctant ourselves to participate in ITS. Island made a different choice. But to say that they are not abiding by investor protection rules, I would say they are probably not abiding by exchange protection rules, and that is a serious matter of concern. We think that the solution is for the SEC to move forward quickly on rules for how folks can be able to display their orders and listed shares in the alternative display facility, which will put it on every, you know, Reuters and Bloomberg machine and TV screen across the globe. That is the disinfectant, transparency.

In the meantime, we think it is important that this committee take a serious look at the consumer protection issues that are, we think, at the heart of the issue.

Mr. STEARNS. Mr. Ryan, would you like to comment on that?

Mr. RYAN. Sure. I agree with Kevin's assessment that the ITS system needs a lot of work. I think——

Mr. STEARNS. It was started in 1975.

Mr. RYAN. Yes.

Mr. STEARNS. Okay.

Mr. RYAN. It is an outgrowth—I mentioned that in my testimony—an outgrowth of the National Market System. It is the critical part of the National Market System for trading listed securities.

Mr. STEARNS. So would you agree that something that was established in 1975 probably needs updating or at least some change or not?

Mr. RYAN. Unequivocally. I think that is true. I think that the—and you addressed this earlier—that the issue of market data and the notion of how that is distributed among the market participants needs a lot of work and within the next 2 or 3 weeks the American Stock Exchange is going to be meeting with the other markets to talk about and put a proposal on the table to give credit for market data along the lines of markets who provide liquidity and better price discovery.

So we look forward to the SEC's hearings and look forward to working on all of these issues, and I think no doubt the time has come to take a real hard look at this.

I do want to make one note, though, that in terms of kind of the distinction—a distinction between exchanges and ECNs and a point that you were making about the role of an exchange, exchanges have specialists who have a deferment of obligation to the market to maintain a fair and orderly market to risk their capital. ECN marketplaces don't do that. They don't provide any liquidity if their subscribers don't show up. So, for—and ECNs never trade in any significant volume when—unless the primary market is open with the specialists providing that liquidity. And the ECNs do come in and their members do come in and access that liquidity.

That is not to say that I don't think that there may be room for ECNs in the marketplace, but I think that this committee and the SEC and the marketplace should be very concerned about what incentives there are to go risk capital and provide a continuous two-

sided market and do that in a fair and—have the affirmative obligation of maintaining a fair and orderly market which exchange markets do require. I think that is critical and it is—unless you pull that away and let the markets kind of go without having the specialists there you will never really know the answer to that question.

But I think when you see events like 1987, you see September 11th, and you see how our markets respond, and obviously in the days after both of those events there was a lot of chaos and you had specialists there who have committed millions and millions of capital maintaining fair and orderly markets, that is critical in that process.

I also want to address the issue you raised about the electronic environment. The exchange markets—speaking for the American Stock Exchange, we are incredibly innovative in terms of our electronics, and we are always rolling out new trading systems, new mechanisms for routing orders to our floor, and we are in the process as well of developing a whole new trading environment. It will be a floor-based system, but it will also be capable of going off floor, if that is where the markets take us. We believe that the markets should drive where and how trading occurs, but we do think that the price discovery mechanism of in-person trading in today's environment provides a lot of value. Floor brokers going in—and they can go in and represent a customer order and they can have 100,000 shares and only show 1,000 shares or 10,000 shares and work that order for their customer. So that they are not by showing up and moving that price. And there is a variety of mechanisms for doing that.

So I think there are significant value added having exchange markets and the specialist and the deferment of obligations that they provide to the marketplace.

Mr. O'HARA. Chairman Stearns.

Mr. STEARNS. Yeah.

Mr. O'HARA. If I may be heard on this, becauseArchipelago, like the Amex, is actually part of—through the PCX we actually operate or are a participant on these National Markets Plans. And I think it is worth noting that what ITS stood for as a principle is a good principle, and that was the concept of linkage. Now, we can argue about the technology and some of the rules surrounding that linkage, but the concept of linkage to getting best price or best execution for customers is a good idea and worth fighting for. And today, through this plan, the ITS committee and the SEC, we are working very quickly toward—or apparently we are working very quickly toward amending the plan so that automated markets can interact in a way that don't hurt their business models with these traditional marketplaces.

I hear this argument about Island not wanting to participate because it slows them down. Well, there is two ways of operating in this world: There is one that if there is a stop sign outside your house, you want the stop sign shouldn't be there? You don't just keep running through the stop sign. You go down to the mayor's office and you complain and you show statistics why it shouldn't exist. Well, Island just keeps running through the stop sign.

What we did, Archipelago—we operate much like Island, we are an automated market. What we did within the System, we went down to ITS, we went down to ITS, we went down to the SEC, we have come up to the Hill, we have our data supporting us, and we have made what I believe are very solid arguments which have resulted in an ITS proposal for a major overhaul, the plan which I spoke about today. And a consortium of people on the committee——

Mr. STEARNS. Mr. O'Hara, would you want to make that part of the record?

Mr. O'HARA. Yes, I would. It is ITS Proposal, ITS Operating Committee of October 10, 2002.

Mr. STEARNS. By unanimous consent, so ordered. If you don't mind giving a copy to our staff, then we will make it part of the record.

[The information referred to follows:]

ITS Proposal

ITS Operating Committee

October 10, 2002

Proposal: Participation Options

All ITS Participants could choose one of three participation options:

Option 1.) Manual execution:

Manual execution with all other Participants pursuant to existing Plan (with removal of 100-share de minimis exemption)

Option 2.) Limited Automatic execution:

Auto-execution within a size limitation with all Participants

- Size limitation is 1000 shares (1000 share size covers approximately 80% of all trade-throughs)

A. Commitment received from Manual Participant: Commitment is automatically executed at the lesser of the displayed size or 1000 shares if the commitment is for 1000 shares or less. If commitment is greater than 1000 shares, the entire commitment is filled manually.

B. Commitment received from Auto-execution Participant (Limited or Full): Commitment is automatically executed up to the lesser of the displayed size or 1000 shares; the balance of the commitment is filled manually.

Option 3.) Full Automatic execution:

Auto-execution up to the displayed quote size with all Participants regardless of whether the commitment is received from a Manual or Limited/Full Auto-execution Participant

- Remove existing restrictions on automated markets use of ITS

Proposal: Trade-through rules

Trade-through responsibilities and privileges would vary based on the choice of participation:

- Manual Participants could not trade through (or quote through) any other Participant (including removal of existing 100-share de minimis TT exemption)
- Limited and Full Automatic execution Participants could not trade through (or quote through) other Automatic execution Participants
  - An Automatic execution Participant could not trade through any other Automatic execution Participant's quote (must first attempt to obtain an execution at the lesser of the displayed size or guarantee) except to the extent that the quote exceeded the Participant's automatic execution guarantee (see Example A pg. 4).
- Automatic execution Participants could trade through (or quote through) Manual Participants no more than $.03 away from the NBBO up to their automatic execution limits

Proposal: Examples

Assumptions:
MKT A: Manual
MKT B: Limited auto-ex
MKT C: Full auto-ex
MKT D: Limited auto-ex

Example A — MKT A bid .50
MKT B bid .48
MKT C bid .47

- MKT B may execute at .48 without satisfying MKT A up to auto-ex size
- MKT C may execute at .47 without satisfying MKT A up to any size; MKT C must first satisfy MKT B at .48 up to the lesser of the quote or guarantee size before trading through the balance (if any) of MKT B's quote

Example B — MKT B bid 5000 @ .50
MKT C bid 6000 @ .48

- MKT B receives commitment for 900 shares from MKT A. MKT B will auto-ex 900 shares.
- MKT B receives commitment for 5000 shares from MKT A. MKT B will fill the entire 5000 share commitment manually pursuant to existing Plan rules.
- MKT B receives commitment for 900 shares from MKT C. MKT B will auto-ex 900 shares.
- MKT B receives a commitment for 5000 shares from MKT C. MKT B will auto-ex 1000 and fill the balance of the commitment manually.
- MKT B receives commitment for 900 shares from MKT D. MKT B will auto-ex 900 shares.
- MKT B receives a commitment for 5000 shares from MKT D. MKT B will auto-ex 1000 and fill the balance of the commitment manually.

Proposal: Definition of automated executions

The term "immediate and automated response" means a response to a commitment that:

- is handled by automated means as soon as received, that is, it does not require the intervention of a person to permit acceptance or rejection of the commitment
- is handled by the receiving market in time priority that does not discriminate against the commitment as compared to any order received within the receiving market
- takes no longer than [4] seconds to accept or reject the commitment from the time the market receives the commitment through the ITS system 95% of the time as measured over a calendar quarter

Mr. O'HARA. Great. And this was presented to the SEC. That was vetted last week. The ITS committee is talking about it today, and we believe in very short order this plan or a derivative of it will come in and will be approved and will make major changes with the ITS plan. It is worth noting that the two main obstacles to the plan are the New York Stock Exchange and my friend down at the end of the table, Mr. Mike Ryan. And if Mr. Ryan says he wants to support the ITS proposal today, I would be willing to hand it down and he can sign up on the dotted line.

But in truth, again, we are working very quickly in the system to get it changed so that automated markets can interact with traditional markets. And I just want to underscore, the idea of linkage isn't a bad idea. It is good for consumers. Best price is good for consumers and investors and your constituents.

Mr. STEARNS. My time has expired. I just remember from the last hearing when we were talking about ECNs, we asked them that, during 9/11 they had trading—trading on Enron had stopped. The New York Stock Exchange specialist stopped trading blocks of it, and there were imbalances, and the ECNs picked that up and that was a success story. So I remember that from the last hearing.

Mr. O'HARA. Right. That was the—this was last November when the specialists on the New York Stock Exchange shut down his post because that one person, the anointed person who controlled all the orders decided that he or she was overwhelmed and they couldn't get a guaranteed profit. So while he or she shut down their post, and in order to sort of balance things out so they would get their guaranteed profit, alternative trading systems, ECNs were in there executing trades for institutions, broker-dealers, and small investors.

Mr. STEARNS. Okay.

Mr. Towns.

Mr. TOWNS. Thank you very much, Mr. Chairman. Let me begin by first answering the question that you raised, Mr. Chairman. Mr. Chairman, let me begin by answering the question that you raised. You said why this has to be done in New York, Mr. Chairman. New York is the appropriate place for it to be done. I know that is not the nature of this hearing, but I will explain that to you later.

Mr. STEARNS. I think we touched a hot button.

Mr. TOWNS. Let me begin by asking you, Mr. O'Brien. You testified that Brut has delayed its usage of the alternative display facility because of technological and economic barriers to its usage, and you urge the SEC and the Congress to insist on improved connectivity solutions and more realistic economics.

Could you explain what these technological and economic barriers are and even the solutions you might propose?

Mr. O'BRIEN. Sure. I would be happy to. And it was interesting to note that the NASD announced that the alternative display facility was quote, unquote, live on July 29, when it didn't take on its first actual user until just this week, which highlights some of the difficulties of connectivity to these systems.

When the NEC undertook the commitment to build the ADF, they went out and hired a Swedish technology vendor, OM Group, to help them build it. The technology platform that OM used was something basically unknown to U.S. financial market participants,

which basically meant that to build connectivity to the ADF you need to build an interface, which would require significant investment of technology resources at a time when there are just not that many to spare. And when you are talking about wanting to have a viable competitive alternative, barriers to users of that alternative need to be really low.

We have been a strong advocate for ADF interfaces to accommodate the financial information exchange protocol, also known as FIX, which is basically a standard messaging language by which security market participant systems talk with one another.

When we were required by the SEC to certify as to whether or not we could use the ADF as our primary means for quoting NASDAQ securities on or before October 11th—which they required us to do at the end of the month—we talked with the folks at the NASD and asked when they might have fixed connectivity, which they had alluded to for quite some time. They gave us the good news that they had undertaken to hire a vendor to provide that connectivity, but that testing for quotation capability wouldn't be available until sometime in December. So that made how we answered that certification request very easy.

But it is the example—I mean, I guess ITS provides a good example, that you can't create a static system at a single point in time and assume that that is going to be viable, and given that the pace of change in this industry really is week to week.

On the economic front, they had originally come forth with a fee schedule that mimicked that of NASDAQ despite the fact that the systems they are offering are far less complex and their justification for that was, well, we needed to recoup our costs to build the system. I had a little hard time accepting that answer when you realize that they oversaw the creation of NASDAQ, they spun off NASDAQ, and received over $400 million in return, and that spinoff really necessitated the need to build the ADF. So the justification of cost recovery for a noncompetitive fee structure was a little hard to swallow.

They have since modified that fee structure, offering volume discounts and the like, but only on a pilot basis, and it will be interesting to see when they set a permanent fee structure going forward that it will be a realistic alternative to SuperMontage usage, and I would implore the subcommittee to focus on that and be a strong advocate on that.

Mr. FOLEY. Congressman Towns, could I address a portion of that question?

Mr. TOWNS. Sure.

Mr. FOLEY. The exchanges in NASDAQ have a monopoly on the gathering and dissemination of market data. All right? And through that monopoly we believe they seek to perfect a monopoly in the execution of trades as well. And we believe and the SEC agreed that the alternative display facility would give market participants a competitive alternative and would allow the free market competition really to be the regulator on a number of market structure issues. The SEC said the ADF had to be ready before SuperMontage was allowed to go forward. Now, the ADF from the NASD—the NASD and NASDAQ have interlocking directorates.

They have members on each other's boards and so forth. And NASDAQ——

Mr. O'BRIEN. Common spelling.

Mr. FOLEY. Right. And NASDAQ is a for-profit entity. The people that run NASDAQ have stock options to profit from the performance of NASDAQ, and NASDAQ's own prospectus indicates that the success of the ADF would be a bad thing for NASDAQ's shareholders. And we think that may have something to do with why the ADF was approved as viable when the very market participants who argued for its creation indicated from—by our nonparticipation at this point it just isn't viable. The alternative display facility just doesn't display in the ways that we would need it to do for us to bet our business on it.

So we are currently in the position of—for our NASDAQ stocks of being stuck with the SuperMontage. We believe that is implicitly in the market structure plan for the ADF, but it just isn't there right now.

Mr. TOWNS. Any other comments on that before I move on? Okay.

Mr. Chairman, I am going to take mine right now, because I want to ask them all the same question.

Mr. STEARNS. Sure. Go ahead.

Mr. TOWNS. Okay.

Several of you mentioned the phenomenon of Island going dark and ceasing to display private market in five popular exchange trading funds while Instanet shut down its private market altogether in certain popular listed securities during regular trading hours. Mr. Ryan characterized this activity as a serious violation of the Federal Securities laws. My question is, what has the SEC done about this? And let me just go right down the line. I would like for all of you to respond to that, starting with you, Mr. Foley.

Mr. FOLEY. Okay. Well, first let me say that I don't view this as a long-term market structure problem, because Island, for example, their market shares collapsed since they have denied their own participants the ability to see their liquidity. So transparency is good for business. Right? So I think maybe there is a fait accompli over how things have played out and how the SEC has moved kind of slowly.

Securities law violations, I leave that to the Securities law cops for them to indicate.

Mr. TOWNS. Has anything been done?

Mr. FOLEY. Well, using the word "done," we wouldn't be informed about enforcement action against somebody else. But I don't believe—I am not expert on it, but I don't believe that the decision to go dark is a securities law violation. I do recall at the beginning of this year Chairman Pitt asked the NASD and Barry Shapiro not to take action against Island for the activity they had going on in the queues, and we thought presumably because they thought that was good for investors and they were going to work out the market structure issues. All right?

I am not comfortable that the ITS Committee, in spite of having a great plan, needs unanimous vote to get anything done. After 27 years, I am not confident that they are going to resolve these issues. All right? I am confident that they wouldn't be meeting to

talk about this if the envelope hadn't been pushed a little bit. And I think, you know, we have to understand the underlying conflicts and maybe be a little bit sympathetic to the behavior of all participants while we are still awaiting these issues to be fully resolved.

Mr. TOWNS. Mr. O'Hara.

Mr. O'HARA. Yes. Thank you, Congressman Towns.

First off, on the ITS issue, note that not only is the committee involved, but the SEC is involved. And in fact, one of the Commissioners at our meeting last week said: You guys get it done; that is, reform it, or we will do for you.

So literally, I mean, the tone we are getting from the SEC is it had better be done—and reading between the lines—and it better be done before the end of the year.

Putting that aside, the reason—and again, I will venture some guesses. I am lawyer. I know a little bit about this, but again I will defer as well to the SEC and the regulators. The reason that Island and Instanet—well, with Island, has gone dark, or suffering a brownout, if you will, and Island—or Instanet has completely shut down its market is because they were forced to comply with the law.

Let us just take a step back. When the NASDAQ collusion investigation settlement broke, one of the consequences or one of the observations was there was a world of two markets in OTC or NASDAQ stocks. There was the public market that you and I would see, retail investors would see, and then there was the private, clubby market that no one saw except the people in the room. And that was on the one hand NASDAQ and on the other hand was Instanet. Instanet then was a private market that most of the world didn't have access to. What the SEC did in implementing the order handling rules and other types of rules associated with that was to force Instanet to show its market to retail customers and the rest of the world, if you will, to get a quote out in the public. And what has gone on with these ETF, these exchange-traded fund products primarily, is that Island and Instanet decided—and apparently against, if you look at the text of Reg ATS—that they refused to reflect their quotes to the world again.

Again, we went back—sort of went back to the future, if you will. That is, they went back to sort of 1990's, pre-1997, refused to show the world their quotes, and only let their club members see the quotes. And my understanding is that the SEC stepped forward and said, either get yourselves into the quote—okay?—show yourself, let ordinary retail investors have access and see your quote, or shut it down. It is illegal.

And I believe—if I may be heard. I believe, instead of integrating technology and showing their quote, they decided to take these actions, and that is to go dark, if you will.

Mr. FOLEY. Wasn't it true that Island—I mean, they are not here and we don't have a horse in this race, you know, Bloomberg, really. But wasn't the case that Island published all this information on the Internet?

Mr. RYAN. Yes. But it was not consolidated. So you, as a public investor, you needed to go to two different places. And the National Market System requires at this stage consolidation of information.

Mr. O'HARA. Plus, I mean, Kevin, how many traders do you know that actually trade from a sophisticated standpoint staring at the Internet?

Mr. RYAN. Quite frankly——

Mr. FOLEY. A lot of people.

Mr. RYAN. Kevin, your own business model is undermining the market, the data that Bloomberg sells, because it is not selling—it doesn't have all the information that should be available to it.

Mr. TOWNS. I didn't mean to start a fight.

Mr. FOLEY. We are in favor of transparency, and you are right——

Mr. RYAN. But Bloomberg as a disseminator of market data to customers is not getting all of the data because you are not taking the fee from——

Mr. TOWNS. Mr. O'Brien.

Mr. O'BRIEN. But I think it underscores a need in listed market structure reform to separate information display issues from execution issues. If you compare NASDAQ and the NASDAQ market, NASDAQ and now slowly but surely the ADF offer means for market makers and ECNs to show their best prices to the public without participating in execution system rules that undermine their business models. Actually, NASDAQ begrudgingly at times has been good about modifying the rules of its execution system to address ECN needs. For example, ECNs don't need to take automatic executions from NASDAQ because that subjects ECNs to financial risks as opposed to market makers, which are—unfortunately in the listed market, to display your best price quotations to the public you need to participate in ITS and the execution rules that come with it.

And with all due respect to my colleague from Archipelago, nothing happens quickly with respect to ITS nor ever will with its current governance structure. And Brut says this as an ITS participant through our participation in the NASDAQ intermarket.

But basically, each ECN is subjected to a Hobsian choice of getting its quotes out into the public marketplace in ways that may force it to undermine the execution quality of its own system, and that separation needs to take place.

Mr. TOWNS. Thank you very much.

Mr. Gasser.

Mr. GASSER. Yeah. I think as a Reg ATS, that the philosophy behind Reg ATS is very simple, and that is publish a quote to one and you must publish it to many or to all. And I think Island in the ETF controversy, of which we are not a part, thankfully, but Island in the ETF controversy is interesting in that I think it represents some of the unintended consequences of the things we talked about today on the ECN front, and that is democratization of the, quote, democratization of access participation within that quote. And at the end of the day I suspect that the SEC delayed enforcement of the Reg ATS because of Island's arguments regarding investor protection for some of the folks that were used to operating within their system.

But that does not, or and should not—and I think it is inconsistent with, I think, the views you have heard today from major vendors in the ECN space—it should not give them the ability to

trade through, it should not give them the ability to trade through anyone. Anyone that has a legitimate quote and posts a better offer should have that ability to trade against counterparties entering the National Market System.

But I think what it has also proven is that at the end of the day free market forces will prevail when the rules are enforced. And they certainly have in this case in that Island has lost significant share in the ETF as a result.

Mr. TOWNS. Thank you very much, Mr. Gasser.

Mr. Ryan.

Mr. RYAN. Sure. A couple points just to be clear. Although I personally believe that Island is operating in violation of the Federal securities law right now in the way it is operating, I think it is clearly a much closer call than prior to when they went blank, where there was no doubt, I don't think anybody reasonably could say, they were operating in compliance with the law. They are certainly in violation of the spirit of Regulation ATS and in violation of the spirit of the National Market System by going blank.

I also am not fully convinced that they have been damaged as much as others might be because of their arrangement with the Cincinnati Stock Exchange, and in some of the products involved where Instanet has not shut down, they may be shifting some of that overflow there. There is a lot of moving pieces, it is hard to tell.

I agree with both Kevin Foley and Kevin O'Hara. It is difficult for me to kind of speculate as to why the SEC hasn't taken more action in this area. I know we have raised these issues with them many, many times. They have been struggling internally with a lot of conflicting principles that are involved. I think they were completely caught off guard that Island would take this much market share as quickly as they have. There was a lot of transition obviously at the SEC and a lot of very significant issues facing the Commission over the last year. And in many respects, this is probably a very unfortunate accident of timing, but it is, I think, a very, very serious accident, and something needs to be done about it and something should be done to look at what can avoid these types of situations in the past where a law can go 18 months like this with no enforcement.

One thing I think is very important to note, and this goes back to Kevin's analogy of a stop sign, you know, maybe that stop sign shouldn't be there or maybe it should be a yield sign, you know. And there is a lot of complexities to these issues and a lot of varying views, but there is a process for fixing things. And the SEC is the arbiter of this. And if you don't like it, you go and try and change it. And the frustrating part for us is we had in fact a little over a year ago started having conversations with Island about coming to some arrangement with them and having them become part of our market to help bring them in compliance with the Reg ATS, and it was rejected because that approach would have violated other principles that have been kind of near and dear to the securities markets long before the 1975 act amendment.

So what is frustrating from our perspective, and I think to a degree I am probably speaking for the rest of the panel here at some level, that there are rules and we should be following those rules.

If they are broken, they need to be fixed, and there is a process for doing that. Until they are changed, everybody should be abiding by the rules that apply to them. There has got to be some sense that we know what is right and what is wrong. And it is not a perfect world and things take time. And God knows, you know, these are complicated times and complicated issues. But there has got to be some degree of reliability that the system is going to work and that you know that the rules are going to be enforced and abided by. And I know that at least some of the panel here have modified their trading models so that they are in compliance with these rules, and it has been to their disadvantage. We have been handcuffed, and things that we wanted to do we have not been able to do. A lot of innovative issues that we have tried to bring to the forefront, until we get the approval from the Commission, we are not doing them, you know. And we think everybody else should be held to that standard as best as possible.

Mr. O'HARA. Congressman Towns, if I could just follow up on that. What that gets is the concept of regulatory arbitrage, some people who play by the rules and have to pay the expense of playing by the rules and others that don't. And that is what Michael is alluding to. And, for instance, Island, you know, running through the stop sign and getting to where they want to get quicker while the rest of us are having to stop.

And again, our system looks a lot like Island from the extent that we are an electronic system and we reach out for best price, but we have worked in the system. And, quite frankly, we have had to go through what we call the sort of fraternity house hazing of getting into these ITS committees. We did. We did it successfully. Was it easy? No. Did it cost some money and time? Yes. But is it changing—are our circumstances changing? They are. And again, we have a marketplace here.

Bill, my good friend Bill O'Brien, says he doesn't think there is going to be change at the ITS, a quick change. I think there is. And we will come back several months from now and we will compare notes, and I think it would be important for this committee to follow up on that issue.

Some of our friends from the SEC are here. They have told this ITS Committee last Friday—they said, get it done or we will get it done for you. Right from the lips of one of the Commissioners.

So again, I think that we are at a point in time where it will change, but that the underlying philosophy of ITS and what it was created for, linkage to give customers best prices, your constituents to get them best prices, is still a concept, a principle worth fighting for.

Mr. TOWNS. Thank you very much. Thank all of you for your answers. On that note, I yield.

Mr. STEARNS. Thank you.

I think after just listening to you, I think a lot of us on this subcommittee think it probably would be appropriate for the subcommittee to start looking at legislation to modernize ITS. So that is probably one of the things that we are getting out of this hearing, to try and move toward that. I am just going to ask two more questions, and then if Mr. Towns wants to ask two more then we

will complete. So we appreciate your patience. Maybe it is a good question for Mr. Foley.

Are customers still paying too much for market data?

Mr. FOLEY. Yes.

Mr. STEARNS. And let me just go down. Mr. O'Hara?

Mr. O'HARA. Correct.

Mr. STEARNS. Mr. O'Brien.

Mr. O'BRIEN. Yes.

Mr. STEARNS. Mr. Gasser.

Mr. GASSER. Yes.

Mr. STEARNS. Mr. Ryan.

Mr. RYAN. I think it is a great bargain for customers.

Mr. STEARNS. Okay. You think it is a great bargain. Okay. And I ask who collects the money for the market data.

Mr. FOLEY. It is, after all, the customers' own information that they contribute in the form of their orders that they then are required to buy back through information vendors. You know, if you look at the debates over payment for order flow from the 1990's, which we don't really hear so much about, the reason we had payment for order flow was because spreads were artificially wide, and this committee addressed that issue and went right to the heart of the matter. Spreads are not artificially wide any more, and so the profit from extracting those spreads isn't being funneled back to investors in the form of cheaper commissions they get through payment for order flow. Now they get better execution of their orders.

Similarly, plans to share market data fees with the brokers who contribute the orders that make up the market data, those plans can result in lower commissions and increased benefits for the investors that contribute that data or those data in the first place. But if the market data fees weren't artificially high, you wouldn't have that situation either.

Mr. STEARNS. Just to get on the record, has NASDAQ addressed the competitive concerns raised by the ECNs regarding the SuperMontage? Anybody can answer that.

Mr. FOLEY. Kicking and screaming, right, and not in any, you know, willing fashion they have addressed some of the issues. But you have to be on your toes. New ones pop up in the technology. We are dealing with a pernicious problem right now where the SuperMontage technology can take an ECN's order out of the quotation system. Now, they use their monopoly as a place to go quote securities to try to effect a monopoly as the place for executing and trading securities. That monopoly would work to the benefit of NASDAQ shareholders, but it is not in the benefit of investors who, you know, would otherwise enjoy the fruits of competition. Real competition for NASDAQ, SuperMontage, just as real competition for the New York Stock Exchange through the ADF we think will be a solution. And then that is something we think the committee ought to, you know, continue to look at.

Mr. STEARNS. Okay. What are the different fee structures in place for access to ECN systems? Mr. O'Brien?

Mr. O'BRIEN. I am happy to talk to that. As I said in my remarks, most if not all ECNs offer a rebate for initiated order flow. And what do I mean by that? If the market in Cisco Systems is $10.00 to buy and $10.02 to sell, someone wishes to put in an order

to buy at $10.01 into the system, which means it is not marketable against anything else either within the system or with Brut, in the public market, that will be displayed within Brut system and in the public quote. That is an initiated order. When that order gets executed against, the person who put that order into the system would receive a cash rebate.

On the flip side, where someone executes against the order that has been put on Brut's book, basically withdrawing liquidity from the system, they are charged an access fee. This is very similar to the pricing model that NASDAQ uses for SuperMontage. It is a horse by different color in the sense that they call the rebates they hand out to market makers liquidity provider rebates and their charge is execution fees. But it is that basic same model.

Mr. GASSER. And that is actually where the NASDAQ and the lucid markets are actually radically apart from one another, in that that is no cross subsidy, if you will, in the lucid marketplace. There is no encouragement to post limit order flow while folks like Arch and Island will do that, there—the inefficiency of that market—and that inefficiency gets back down to this ITS issue. By inefficiency, I mean the inability for that quote to always interact with the marketplace and the listed. The marketplace has prevented that type of encouragement for folks to add liquidity to the market in competition with the New York Stock Exchange specialists. So in the listed centric marketplace, such as the one that we operate in, it is a usage fee only. It is only a charge today.

Mr. O'HARA. Chairman Stearns, if I may add to that, the concept of access fees is a very American concept. That is, if you provide a service or a product, one should have to pay for it. And I think we all believe in that concept. Whether Archipelago reached in and took liquidity from the New York Stock Exchange or from Brut or from any other venue for one of our customers, we should have to pay for that. And that should apply across the board, quite frankly, that whether it is a market reaching into a market maker on an ECN or any other venue that has a service or product to provide, they should pay a market rate for it.

One problem, however, that has cropped up with these access fees is that some venues are using their market power to charge competitors with sometimes three, four, five times what they would charge a normal ordinary customer for a hit and take. So, for instance, we have a best execution obligation, and we believe in it because Congress told us to believe in it, and we believe in it just as a business philosophy. So when we reach out to our customer—previously when we reached out to our customer, to Islander or Instanet, Island would charge us five times what they would charge a normal customer to access liquidity. Again, we are reaching out because Congress told us to get best execution, we want to get best execution for our customer, and they would charge us five times that rate. Instanet, not as bad, but a multiple of two or three times what they would charge their customer.

Now, as of recently, they have changed their ways, and we will see if they stand on that position going forward, although I do note that Island has arbitrated against us. We received a filing saying that they want to recoup all these gouge fees that we have refused to pay recently, and some of my ECN friends as well have had to

endure that. Again, we are reaching out for best price for our customers, and some of these other venues out there are saying, well, if you want to do that, guess what, I know it is a Federal regulation, I know it is a Federal concept, but we are going to charge you five times what we charge our customers for that.

That is unfair and it is something that this committee—this subcommittee should mark, because in the future we may be coming back and discussing this issue depending how Island and Instanet act going forward.

Mr. FOLEY. Mr. Chairman, there is an easy way to clear up this issue, we think. We believe access fees should be abolished. As former SEC Chairman Levitt said a couple years ago, there is no room for these access fees in what is in the listed markets, for example, and otherwise fee-less world. They don't exist in contravention to the order handling rules because they were created by the order handling rules, and, you know, as a market compromise at the time. We charge ECN access fees. We are not going to unilaterally disarm when our competitors have that source of funding for their business models. But we deplore the fact that NASDAQ has now—NASDAQ, who has been given the power by the SEC all along to abolish these fees, NASDAQ has instead determined to adopt the model of access fees in their government-sponsored monopoly position as a for-profit entity, managed by people whose, you know, personal fortunes ride on the success of the NASDAQ securities. They have decided that access fees are going to be a permanent part of the landscape for NASDAQ securities, and we are very sorry to see that happen.

Mr. O'BRIEN. Now, I am going to disagree quite a bit, because access fees, you know, it is what it is. It is just a business model. It is not per se wrong. ECNs is a pure agency broker. They do not make money on proprietary trading activity unless they have to charge a per transaction fee for users of their system. There is nothing wrong with that. I think sometimes the outcry over ECN access fees is a thinly veiled attempt to eliminate paying ECNs altogether for the valuable services of transparency and connectivity and order management that they provide to the marketplace.

So I think the subcommittee should be focused more upon ways to keep the access fee market competitive. There is one example that I believe that NASDAQ is considering right now. How SuperMontage works is that within any certain price point—meaning, by that, I mean $20 or $19.99—they allow people entering orders into SuperMontage to trade against firms that do not charge an access fee, market makers, before trading with firms that do, ECNs, offering price protection within any one—within one-cent increment, but reducing, if not eliminating, ECN access fees.

I think they are looking at improving the technology even further, because right now when looking at someone as to whether or not they charge an access fee, it is kind of a Y or N logic. But they are exploring making that logic scaler, and by that meaning treating ECNs that charge lower access fees better than those that have taken that rate structure to an unreasonable extreme.

Things like that which promote competition within a business model as opposed to, you know, draconian measures to force industries to change business models altogether are what the sub-

committee should be looking at to reduce cost and improve efficiency in this area.

Mr. STEARNS. Gentlemen, I thank you. What we are going to do is wrap up here. We appreciate all of you staying and participating. What we would like all of you to do, we have some follow-up questions we will submit in writing to you, and we would like you to respond. And also, we will leave the record open so that members can offer their opening statements who are not here.

The jurisdiction of this committee today includes consumer protection, obviously, but also dealing with commerce, and this electronic ECNs are applicable. So we feel a certain amount of fiduciary responsibility for our constituents to bring up consumer protection as well as commerce. So I think we have done that this morning. And so I want to thank you for your participation, and I look forward to continuing this in the future. And I thank the distinguished members for being here today.

With that, the subcommittee is adjourned.

[Whereupon, at 12:26 p.m., the subcommittee was adjourned.]

[Additional material submitted for the record follows:]

RESPONSES FOR THE RECORD OF KEVIN FOLEY, CHIEF EXECUTIVE OFFICER, BLOOMBERG TRADEBOOK LLC

Question 1. What are the potential costs and benefits to investors of a market in which market information is available through competitive forces rather than an exclusive processor?

Response. The potential benefits to investors of a market in which market information is available through competitive forces are truly substantial. A quick look at how we have arrived at the current situation is instructive.

Historically, under the cover of a non-transparent bureaucracy, non-profit self-regulatory organizations (SROs) have exploited their government-sponsored monopoly over market data fees to subsidize their other costs—for example, costs of market operation, market regulation, market surveillance, and member regulation. While at present most SROs are non-profit organizations, NASD has largely completed its privatization of Nasdaq and it may well be that other privatizations will follow. For all SROs, the incentive will be strong to continue to exploit this government-sponsored monopoly over market data by charging excessive rates from a captive rate base (i.e., investors) and by using the resulting monopoly rents to subsidize their competitive businesses. Indeed, shareholders of for-profit exchanges will demand that market data charges remain at whatever level will maximize shareholder profit, which likely will result in excessive charges.

The public creates the data. While the public should bear the cost of consolidating the data—plus a reasonable rate of return for the consolidator—the public should not subsidize other exchange activities and thereby give them unfair advantages over their non-subsidized competitors.

In enacting the Securities Acts Amendments of 1975 (the "1975 Amendments"), the Congress presciently warned against possible abuses of market power by market centers such as the New York Stock Exchange (NYSE) and Nasdaq that control or operate an exclusive securities information processor:

> The Committee believes that if economics and sound regulation dictate the establishment of an exclusive processor for the composite tape or any other element of the national market system, provision must be made to insure that this central processor is not under the control or domination of any particular market center. Any exclusive processor is, in effect, a public utility, and thus it must function in a manner which is absolutely neutral with respect to all market centers, all market makers, and all private firms . . .

Securities Acts Amendments of 1975, Report of the Senate Committee on Banking, Housing and Urban Affairs to Accompany S.249, S. Rep. No. 94-75, 94th Cong., 1st Sess.11-12 (1975).

We think the 1975 Amendments got it right. If consolidation of market data is truly a public utility function, it is imperative that it be regulated as such—with some measure of cost controls—and that the exclusive processor be independent of

any exchange that intends to compete in the downstream market for financial information.

In short, the public can have the benefits of competition even with an exclusive processor—as long as that monopoly public utility function is separated from competitive functions.

Otherwise, the public is disadvantaged twice. First, the public is disadvantaged when they pay excessive rates to see the data *the public itself* creates. Second, the public is disadvantaged when those monopoly rents are used by SROs to unfairly subsidize entrance into currently competitive businesses because that anticompetitive behavior will undoubtedly have an adverse effect on competition in those businesses and will restrict output, reduce innovation and keep the prices in those businesses artificially high.

Question 2. What are market data rebates and how do they work?

Question 3. Are market data rebates good for investors? Why or why not?

Response 2 and 3. Nasdaq and the NYSE have exploited their government-sponsored monopoly over market data to charge the public sums far more than the actual value of their consolidation function. Some of this excess market data revenue can be paid by exchanges to brokers that give them order flow.

Imagine if a city government provided a hypothetical company "call it Acme Transportation—with a monopoly to manage the city subway and permitted Acme to charge fares that far exceeded the all-in costs of operation plus a reasonable rate of return on Acme's invested capital. If Acme periodically defused public criticism by rebating some fraction of their overcharges, would subway riders be well served?

In the short run, the rebates are positive—rebates are the only way our hypothetical subway riders receive some share of what they are overcharged. In the long run, however, the public would be better served if government ensured the public that they were not being overcharged for services provided by a government-sponsored monopoly. In a case where government in fact grants monopoly mandates' to either private or quasi-private entities—it should maintain close scrutiny on the rents the monopolist can charge, precisely to prevent overcharges. In the case of the SROs, our markets would be far more efficient and fair if charges for the fruits of the government-sponsored monopoly over market data bore a closer relationship to actual cost, plus a reasonable return on capital necessary to sustain the service.

Rebates were recently halted in the Nasdaq market because of concerns over the potential for market manipulation—activity that is already illegal and is easy to spot and to punish. We believe rebates should be reinstated until such time as the revenues generated by government-sponsored monopolies bear a closer relationship to costs. At present, these rebates are the only method for redistributing excess market data fees to the people who both create the data and then have to pay too much for it—the investors.

Question 4. Will market data rebates solve market data issues or is a regulatory solution required?

Response 4. I believe market data rebates should be reinstated. Until real reform occurs, these rebates are important as a means of allowing the public to receive some percentage of the overcharges they are paying.

The rebates, however, are not the real reform. Far from being a solution, market data rebates are, in part, symptomatic of an underlying problem. In effect, the exchanges can afford to provide market data rebates because they use governmental power to require their members to give them for free the raw material for generating market data, and the exchanges then extract monopoly rents by charging fees for market data that bear no reasonable relation to the actual costs of producing, consolidating and making it available. Regulatory action—coupled with the ongoing engagement of elected officials—will be essential to address these issues.

Question 5. Are market data rebates creating problems with wash trades—are buy and sell quotes being entered simultaneously by the same party to generate trade revenue from market data rebates? If so, how do we solve this problem?

Response 5. Not being in the enforcement business, I cannot offer much insight into whether wash trades are currently a problem. I'd note that market manipulation is already illegal and easy to spot and punish.

Question 6. Is current ECN access to ITS adequate? Why or why not?

Response 6. The ITS is an exchange-dominated consortium whose outmoded technology and antiquated governance structure serve as a significant barrier to ECNs who would seek to compete in the NYSE-listed market. Current ECN access to ITS is thoroughly inadequate.

Along with ITS reform, urging the SEC to take the steps necessary to facilitate the promised display of NYSE-listed stocks in the Alternative Display Facility (ADF) may be the best way to bring the benefits of competition to the listed market.

The SEC should approve the ADF rules proposed by the NASD regarding NYSE-listed stocks.

Question 7. Are the access rules for ITS responsible for ECNs' lower trading volume in listed securities than in NASDAQ securities? Why or why not?

Response 7. Certainly the access rules for the ITS contribute to the lower trading volume in listed securities. ECNs' share of the listed market is lower because ECNs are not allowed to quote in the listed market independently of the exchanges, which brings ECNs under the umbrella of the ITS. ECNs should be able to quote in the listed market without having to participate in the ITS.

There are, of course, additional impediments to ECN participation in the listed market. In the mid-1990s, the SEC issued the Order Handling Rules. The resultant transparency and the subsequent integration of ECNs into the national quotation montage narrowed Nasdaq spreads by nearly 30% in the first year. Reform of comparable scope has not occurred at the NYSE.

For years, the NYSE has erected barriers to competition. Its infamous Rule 390, which prohibited NYSE members from dealing in listed securities off an exchange, is a case in point. Even if the ITS were reformed tomorrow, we would anticipate renewed efforts to establish other roadblocks to competition. That's why it is critical that there be significant ongoing scrutiny provided by regulators and legislators on market structure issues and also why it's critical that the SEC approve the NASD's proposed rules as soon as possible regarding the promised display of NYSE-listed stocks in the Alternative Display Facility.

Question 8. Do access rules for ITS presume best execution at the NBBO? Are there any other factors that should be considered for best execution?

Response 8. ITS justifies their rules by talking about best execution, but investors taking matters into their own hands have chosen ECNs for best execution when given the choice. There are indeed numerous other factors that should be considered for best execution, particularly in a decimalized environment, including speed, size, and quality of execution and the role of the trade-through rule.

Question 9. Please describe the governance structure of ITS. Does the governance structure of ITS inhibit innovation? If so, please explain.

Response 9. We are not members of the ITS, but it is our understanding that unanimity is required to effectuate major changes. That is clearly a major impediment to change, and a major impediment to bringing competition to the NYSE-listed market.

Question 10. What is the difference between the old NASDAQ as an infrastructure for quotations and the new Nasdaq with the SuperMontage as an order execution facility?

Response 10. Through a series of developments starting with the inauguration of the Small Order Execution System ("SOES") in the 1980s and progressing through the development of SuperSOES and, more recently, SuperMontage, Nasdaq has evolved from a decentralized, quotation-and-telephone system into a screen-based, electronic communications network embodying a central limit order book.

In theory, NASD members can bypass SuperSOES through private wire connections between a market maker and a customer or dealer. In reality, however, that means of avoiding SuperSOES is not on an equal competitive footing with the use of SuperSOES. Orders transmitted through SuperSOES impose obligations on the market maker to execute against its published quotation.

Only Nasdaq has the monopolistic power to deliver mandatory executions to market makers against their quotations. Individual market participants do not have the market power to replicate that obligation through private contractual arrangements or other private ordering.

SuperMontage represents the next step in this process of potentially harmful centralization. It is particularly disconcerting as it effectively expands Nasdaq's government-sponsored monopoly powers at exactly the moment when the changed incentives of privatization would argue for curtailing Nasdaq's government-sponsored monopoly powers.

Question 11. What potential benefits or risks does the SuperMontage bring to the marketplace?

Response 11. SuperMontage centralizes display and order execution in one soon-to-be for-profit entity, unfairly disadvantaging all other competitors. Nasdaq has argued that the benefits of SuperMontage include upgrading Nasdaq's technology and promoting the display of greater depth of book. While all Nasdaq members applaud Nasdaq's upgrading its technology, this upgrade could have been done without centralizing display and order execution in a Nasdaq controlled entity. All of Nasdaq's competitors upgrade technology constantly without the carrot of an enormous government gift, the grant of Nasdaq's power to use regulatory compulsion to enforce its restrictions on competition and to advance its commercial objectives.

Likewise Nasdaq could have opted to display greater depth of book without requiring the centralization of display and order execution. Indeed, as Nasdaq fought hard to make sure that the Alternative Display Facility didn't actually display quotes, it became clear that Nasdaq is interested in displaying its own quotations, but not in allowing the market-wide transparency that would foster competition. The SEC wisely rejected Nasdaq's position and instead issued vendor display rule guidance that goes a long way toward ensuring that Alternative Display Facility quotations can be seen.

The potential risks of SuperMontage are clear. A for-profit Nasdaq will have a powerful incentive to leverage its existing government-sponsored market data monopoly and its newly granted trade execution monopoly to deter competitors and discourage innovation. Nasdaq will have incentives to "keep pace" with market innovators not by moving forward themselves, but by slowing down all market participants and centralizing order flow. Everyone loses if exchanges—comfortably situated as government-sponsored monopolies—fail to innovate, leaving American markets vulnerable to offshore competition.

The potential remedies are also clear. For good reason, the SEC deemed the ADF so critical to the maintenance of competition that the SEC set the existence of a viable ADF as a precondition to both the rollout of SuperMontage and the possible approval of the Nasdaq exchange application. A commercially viable Alternative Display Facility, coupled with strong and engaged government oversight, will create an environment in which SuperMontage can yet be a net plus for the market.

Question 12. Is SuperMontage a Central Limit Order Book (CLOB)?

Response 12. SuperMontage is certainly an order book. The implication of a "central" order book is that everyone is compelled to participate in it. We think compelling everyone to participate stifles competition and robs consumers of the benefits of innovation and reduced costs.

While no single rule compels everyone to participate in SuperMontage, an arcane combination of rules gives many market participants little choice but to participate in SuperMontage. That's great for Nasdaq shareholders, but it would be better for investors if Nasdaq had to entice, rather than compel, participation in SuperMontage.

A few years ago, proponents of centralization urged support for a time priority central limit order book (CLOB) to deal with the alleged "problem" of market fragmentation. The notion behind the CLOB was that, by centralizing orders in one place, a single "black box", maximum order interaction and perhaps better prices might be achieved. While the CLOB was ultimately rejected as unworkable and unwise, the interaction of SuperSOES and SuperMontage represent the same effort to centralize. The recent Nasdaq pricing proposal, which would clearly discourage execution of trades outside of Nasdaq—even if the best price were being offered outside of Nasdaq—is simply the latest manifestation of this urge toward centralization. As exchanges contemplate becoming for-profit companies, this urge to centralize order flow and execution and cut off the development of competitive alternatives—to "CLOB" the market—will grow more pronounced. This threat emphasizes the need for a functional, fully competitive Alternative Display Facility as a means to mitigate the potential anticompetitive impacts of SuperMontage. It may well be that additional remedial measures are needed. The continued vigilance of the Congress and the SEC will be essential as these developments unfold.

Question 13. Have structural changes that have accompanied the privatization of the NASDAQ been sufficient to ensure a competitive marketplace?

Response 13. Structural changes necessary to ensure a competitive marketplace have simply not been effectuated. The most significant structural change to ensure a competitive marketplace would be the creation of a commercially viable ADF. Unfortunately, a number of obstacles have been placed in the way of creating a commercially viable ADF, some flowing from the structural problems associated with the fact that NASD—which is charged with organizing and running the ADF—is not independent of Nasdaq.

NASD and Nasdaq have interlocking boards. NASD retains a significant ownership interest in Nasdaq and a commercial interest in Nasdaq's eventual success as a for-profit exchange. For example, NASD claims they no longer have any common stock in Nasdaq, except the stock that underlies the warrants issued in the Nasdaq private placement—but underlying those warrants held by NASD are more than 43 million shares of Nasdaq common stock, a significant ownership interest in Nasdaq representing a considerable stake on the part of NASD in the success of Nasdaq as a stock exchange. In addition, when NASD sold 33.7 million shares of Nasdaq common stock to Nasdaq earlier this year, it received approximately $440 million, payable in a combination of cash and the issuance to NASD of two newly issued series of Nasdaq preferred stock.

While we could go on, the bottom line is that NASD's holdings represent a substantial and continuing economic interest in the success of Nasdaq.

The significance of NASD's not being independent of Nasdaq is driven home in Nasdaq's Amendment 2 to its Form 10 Registration Statement. Discussing the ADF and its competitive potential, Nasdaq states:

> If this market becomes a viable alternative to Nasdaq, then Nasdaq faces the risk of reduced market share in transactions and market information services revenues, which would adversely affect Nasdaq's business, financial condition, and operating results.

Nasdaq views the ADF as a potential threat. The entity charged with organizing and running the ADF—NASD—has a powerful interest in Nasdaq's success. The structural change of separating NASD's interests from Nasdaq's interest may be a necessary predicate to the structural change of ensuring a viable ADF.

Question 14. How does the NASD's Alternative Display Facility (ADF) differ from the SuperMontage? Has Bloomberg signed up for the ADF? Why or why not?

Response 14. Bloomberg intends to participate in the ADF at the earliest opportunity permitted by safe and prudent procedures for implementing new technology.

There are a number of differences between the SuperMontage and the ADF. SuperMontage is both a display facility and an execution/clearance facility. ADF is just a display facility. SuperMontage is building on Nasdaq's enterprise value, which NASD's members developed over 30 years. The ADF is forced to start from scratch. Those responsible for organizing and running SuperMontage—Nasdaq—have a clear and unequivocal financial interest in the success of SuperMontage. Those responsible for organizing and running the ADF—NASD—not only lack an unequivocal financial interest in the success of ADF, but also have a significant financial interest in seeing SuperMontage succeed.

Bloomberg Tradebook believes a commercially viable ADF is critical to address the anticompetitive aspects of SuperMontage. We believe a viable ADF will present our clients with new opportunities to lower their overall transaction costs. That's why we were the first market participant to commit publicly to the ADF, and it is why we remain committed to undertake the technical steps necessary to enable Bloomberg Tradebook to display quotations in the ADF.

Bloomberg has signed up for the ADF, although we have not certified participation to the SEC. The distinction between signing up and certifying requires brief discussion.

The SEC made its January 2001 approval of SuperMontage contingent on the NASD's establishing an Alternative Display Facility as an alternative to Nasdaq. To say the least, the NASD has not moved expeditiously to take the basic steps necessary to allow potential ADF participants to move into the ADF. To take but one example, the NASD took from January 2001 until August 6, 2002—18 months—to provide market participants with final technical specifications necessary as an initial step to connect to the ADF. We believe many of the impediments to development of the ADF have been a function of the NASD's financial interest in Nasdaq and the interlocking Nasdaq/NASD boards.

On August 28, 2002, the SEC asked ECNs to certify, under oath, an intention to use the ADF as our primary order collection and display facility for a significant portion of our business in Nasdaq securities on or before October 11, 2002. As a business matter, we certainly did not feel we could commit to move significant business to a facility that did not yet exist. As a technical matter—having only received technical specifications necessary for coding on August 6—we believed it impossible for us to ensure we could display quotes by October 11, especially in light of other programming demands generated by the simultaneous rollout of SuperMontage. Thus, we did not certify participation on the timetable laid out by the SEC, but we have communicated to the NASD a commitment to participate in the ADF.

I would add that SEC approval of the proposed rules regarding ADF display of listed stocks would certainly attract additional market participants to the ADF.

Question 15. Is the ADF a true alternative to the NASDAQ's SuperMontage?

Response 15. The ADF is not presently a true alternative to Nasdaq's SuperMontage, but it is imperative for investors and the markets that it becomes a true alternative.

Recognizing the potential anticompetitive impact of SuperMontage, the SEC made its January 2001 approval of SuperMontage contingent on the establishment of an ADF—a display facility that would stand as an alternative to Nasdaq. The ADF was deemed so critical to the SEC that it was cited as a precondition not only to the rollout of SuperMontage, but also to the possible approval of the Nasdaq exchange application. A commercially viable ADF is intended to make participation in SuperMontage "voluntary". Without a viable ADF—a facility where market participants could find potentially superior stock prices and liquidity in venues other than

Nasdaq—the enormous reductions in investment spreads and transaction costs enjoyed by Americans in recent years will be imperiled.

ADF is, of course, a display facility while SuperMontage combines in one place display and execution of orders. Despite that difference, the ADF can be an alternative. As long as market participants can see and identify liquidity, market participants can build the connectivity necessary to execute orders. Indeed, that is exactly what has transpired in the Nasdaq market over the past six years, as ECNs have built faster, more reliable connections to each other in the process of working around slower and less reliable Nasdaq systems.

Question 16. How does the "full contribution member" and "partial contribution member" dichotomy punish NASD members for doing business on a facility other than SuperMontage?

Response 16. There are a number of elements of Nasdaq's proposed SuperMontage fee schedule that are intended to suppress competition. Nasdaq has proposed extending the pricing scheme it currently uses for SuperSOES—its current order execution system—to SuperMontage. Under the SupersSOES pricing scheme, NASD members that report to Nasdaq at least 95% of their trades in Nasdaq securities for the preceding month are deemed "full contribution members". Those reporting fewer than 95% of their trades in Nasdaq securities for the preceding month to Nasdaq are deemed "partial contribution members."

"Full contribution members" would pay substantially lower Nasdaq access fees than "partial contribution members." In short, the access fee differential would punish NASD members for doing more than *de minimis* business on the ADF, or any trading facility other than Nasdaq's SuperMontage. It is hard to imagine an action more contrary to consumers' interests than extending such an anticompetitive pricing structure to SuperMontage.

Question 17. What are the main ADF issues that need to be addressed on an ongoing basis?

Response 17. There are a number of ADF issues that need to be addressed on an ongoing basis. The most important of these issues would include the following: (1) The ramifications of NASD—which is charged with organizing and running the ADF—not being independent of Nasdaq, an entity that ardently desires that the ADF fail; (2) the potential for Nasdaq to misuse the proceeds of its government-sponsored market data monopoly and/or its government-sponsored trade execution monopoly to preclude the realization of a competitive ADF; (3) the imposition by Nasdaq of discriminatory fees intended to discourage use of the ADF; (4) the necessity that the NASD hire the staff and invest in the hardware necessary to run the facility, especially as volume increases; and (5) the importance of the SEC approving the pending rules that would permit trading in NYSE-listed stocks on the ADF. This will help bring the benefits of competition and innovation to the NYSE listed market, while helping to ensure the ADF's commercial viability.

Question 18. Why would an ECN elect to receive orders rather than executions? How do SuperMontage fees discriminate against ECNs that elect to receive orders rather than executions?

Response 18. ECNs are required by SEC rules to respond immediately—and I mean immediately—to orders at any given price in the time sequence they are received, whether they come from our best customers or from our competitors. Bloomberg Tradebook, like many ECNs, has a system that is much faster than Nasdaq's. If Bloomberg Tradebook elected to receive executions, our combination of speed and immediate response would result in double executions.

SuperMontage fees discriminate against ECNs that elect to receive orders rather than executions. In Nasdaq's nomenclature, a "preferenced order" is an order sent to a specific market participant that has a quotation displayed in SuperMontage at the best bid or offer. A preferenced order is executed through the use of the SuperMontage execution algorithm. A "directed order" is an order sent to a specific ECN or other market participant that has elected to receive orders rather than executions.

Nasdaq proposes to impose a penalty of 150% on orders directed to ECNs or other participants that are permitted to accept order delivery rather than automatic executions. By charging 150% more for directed orders than for orders executed using the SuperMontage algorithm, the fee structure penalizes ECNs and other market participants that wish to use their own trading algorithms to access liquidity on the SuperMontage screen via directed orders. These deliberately discriminatory fees would force orders into SuperMontage's execution algorithm, thereby restricting market participants from having equal access to all avenues of execution.

Effectively, the proposed fees impose a penalty on NASD members that use alternatives to SuperMontage. By increasing the cost of using facilities other than SuperMontage, the SuperMontage fees compel NASD members to keep their trading vol-

ume on SuperMontage and discourage them from using the ADF or other alternatives to SuperMontage.

Question 19. Are access fees consistent with ECN obligations under the order handling rules to provide access to the best prices in the marketplace?

Response 19. While Bloomberg Tradebook is not prepared to "unilaterally disarm" by forswearing collection of access fees while others charge us such fees, it is clear as a matter of public policy that access fees should be abolished. They distort order flow and add to everyone's execution costs, costs that deliver no benefit to the marketplace. Access fees also create an artificial distinction between ECN and market-maker liquidity.

Unfortunately, the pricing structure Nasdaq is promoting threatens to make access fees and payment for order flow an even more dominant part of the National Market System. This year, in a series of pricing changes, Nasdaq has not only mandated an access fee for all market-maker liquidity in SuperSOES, but also positioned itself as the collector of those access fees.

Nasdaq's embrace of access fees and rebates won't decrease market-place distortions or increase innovation. Rather, the goal is to establish the dominance of Nasdaq's execution facilities and enhance its own revenues. As bad as access fees are when charged by ECNs, the ability to go to an ECN with lower fees provides a market check on excessive charges. Unless there is a commercially viable ADF, there is no comparable check on the access fees charged by Nasdaq.

Nasdaq is a stock market. The role of Nasdaq should be to act as an impartial clearinghouse that doesn't favor one set of market players, including itself, over another. Access fees should be abolished for both ECNs and Nasdaq.

Question 20. Should ECNs be required to apply uniform charges to subscribers and non-subscribers?

Response 20. As described above, we believe access fees should be abolished. Access fees distort the market and disadvantage investors by raising costs and undermining efficiency. That said, the worst kind of access fee is one in which a non-subscriber (i.e., competitor) is charged fees that are often many times the amount charged to subscribers. These charges, of course, bear no relationship to cost or value—they are simply intended to punish a competitor without the bother of actually bringing greater value to investors. There shouldn't be access fees, but if they exist, public policy dictates such fees be uniform for subscribers and non-subscribers.

I should add that, while ECNs should be required to apply uniform charges for subscribers and non-subscribers, the same principle should apply even more strongly for Nasdaq. Nasdaq has proposed a series of fees that similarly bear no relationship to covering costs or providing value—rather these fees are intended to thwart competition by establishing obstacles to trading outside of SuperMontage. Again, by virtue of the fact that there are multiple competing ECNs, there is some market check on potentially abusive ECN access fees. Unless there is a viable ADF, there is no comparable market check on abusive Nasdaq fee practices.

Question 21. Should an ECN be required to fill an order it has displayed when the counterparty refuses to pay the access fee?

Response 21. Again, it would be a better world for investors and the markets if access fees didn't exist. However, as long as access fees are a legitimate and widely accepted element of the business models of ECNs, ECNs should certainly have the authority to refuse to fill an order when counterparty refuses to pay an access fee.

The ramifications within SuperMontage of an ECN's refusing to fill an order when a counterparty won't pay an access fee illustrates the kind of discriminatory and anticompetitive practice that merits both SEC and Congressional attention. In this regard, I wish to call your attention to the controversy surrounding the issue of quotation decrementation.

Quotation decrementation has to do with how orders are displayed and adjusted on SuperMontage to the disadvantage of ECNs and their customers. Under SuperMontage rules, if an ECN posts a quotation for a certain price and quantity in a given security, it will be penalized for declining an order from a counterparty with whom the ECN chooses not to do business. Such counterparty may be an entity that is an unacceptable credit risk or one that refuses to pay an ECN's access fees.

Under the SuperMontage rules, when an ECN declines an order, even if only for part of the quantity displayed in its quotation, the ECN's entire quotation will be removed from the SuperMontage quotation display. As a result, the ECN's customers will lose their place in the SuperMontage time-price queue. In addition, ECNs will be at increased risk for incurring costs instead of revenue.

What is telling about the quote decrementation feature of SuperMontage is that its adverse effects fall exclusively upon ECNs. That is deliberate on Nasdaq's part, and grossly discriminatory.

Question 22. Mr. Ryan, General Counsel of the American Stock Exchange, testified that some of the ECNs operate as de facto clubs and, in effect, an exchange without the regulation or burdens associated with being an exchange. What should be the regulatory burden for ECN business as an agency order matching facility?

Response 22. In his testimony, Mr. Ryan takes issue specifically with one ECN—Island—characterizing it as a "private club" because of Island's refusal to display its quotes in a handful of stocks. I understand the Amex's frustration at Island's decision. I also understand Island's frustration at being locked into a market structure where including Island's quotation data in the consolidated quote would require that Island participate in the Intermarket Trading System—a participation that would negate Island's advantages of speed and certainty of execution. This controversy underscores how critical it is for policy makers to comprehensively address these market structure issues.

As to the general question of the proper regulatory burden for ECN's, I would say the SEC got it right with Regulation ATS. The level of regulation necessary to ensure the integrity of an agency order matching facility characterized by maximal transparency is going to be different than the regulation necessary for an exchange.

I would add that Island's (unsuccessful) and Archipelago's (successful) bids to become exchanges suggest that rational market players do not view exchange regulation as excessively burdensome vis-à-vis ATS regulation, especially when that regulation is viewed in the context of the substantial benefits of being an exchange—i.e., sharing directly in market data revenue that bears no relationship to cost, listing revenue, etc.

RESPONSE FOR THE RECORD OF WILLIAM O'BRIEN, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, BRUT, LLC

Question 1. What are the potential costs and benefits to investors of a market in which market information is available through competitive forces rather than an exclusive processor?

Response. Multiple distributors of market data would likely restore prices to true competitive levels, rather than the artificially high prices that exist today. An exclusive processor has no incentive to lower prices to the actual consumers of market data. Competition among multiple distributors of such data would require pricing reflective of the cost of collection of such information. This competition could take place without any deleterious consequences for market data users, given a regulatory framework that already requires the provision of complete market information by vendors.

Question 2. What are market data rebates and how do they work?

Response. Market data rebates reflect the inefficiencies of the current pricing structure for market information. Because prices are artificially high, it produces substantial revenue for exchanges and Nasdaq far in excess of the costs of collection and dissemination of such data. These profits compel Nasdaq and some exchanges to lure the true generators of market data to use their facilities to report market information, which is done by "rebating" a portion of the revenue received from the exclusive processor to the participant generating the data.

Question 3. Are market data rebates good for investors? Why or why not?

Response. Given the current structure for dissemination of market information, market data rebates provide some value because they transfer excessive market information revenues back to the trading and investing public, albeit indirectly, which heretofore have previously been kept by Nasdaq and the exchanges, who provide relatively little value in the process other than commodity-like collection and transmission facilities. These rebates, however are highly imperfect, in that they:

a. Favor the *generators* of market data while still imposing excessive costs on the users of market data. A broker-dealer with an extensive retail brokerage operation, but little proprietary trading activity, will continue to pay non-market costs for market information without receiving any rebates. High-volume proprietary or agency trading operations are the prime beneficiaries of such rebates.

b. It maintains the current system whereby Nasdaq and the exchanges control the cost of market information. These parties set the rebate structures and continue to cloud the discussion of market data pricing inefficiency by linking such revenues to regulatory and other costs, with Nasdaq pursuing a for-profit business models that makes such arguments suspect.

c. They create incentives for perverse market behavior, such as "wash" transactions and "shredding" of large trades into smaller ones, that furthers no national market system objective and degrades the quality of market information.

Question 4. Will market data rebates solve market data issues or is a regulatory solution required?

Response. A regulatory solution is required to impose a system whereby the rates paid for market information by end users reflect the true cost of collection and distribution of such information. Given the essential nature of widely-distributed market data to comply with best execution obligations and advance various national market system objectives, the creation of a system of competing market data processors would produce optimal pricing for the marketplace.

Question 5. Are market data rebates creating problems with wash trades—are buy and sell quotes being entered simultaneously by the same party to generate trade revenue from market data rebates? If so, how do we solve this problem?

Response. Market data rebates do create perverse incentives to: (a) create "wash transactions"; and (b) "shred" large transactions into a series of smaller ones, given revenue is received on a per trade basis. Both practices degrade the quality of the market information without any benefit. Recent SEC enforcement actions regarding these practices highlight that regulatory oversight is important given the current framework. A more long-term solution, however, would flow from more market-driven structures for the pricing of such data.

Question 6. Is current ECN access to ITS inadequate? Why or why not?

Response. Current ECN access to ITS is adequate. What is inadequate is an unequal application and enforcement of ITS rules between manual and electronic market center participants. Whereby an ECN must configure their system's operation to ensure 100% compliance with applicable rules, the NYSE and other manual-intensive market centers routinely flout ITS requirements by "trading through" better prices posted on ECNs.

Question 7. Are the access rules for ITS responsible for ECNs lower trading volume in listed securities than in Nasdaq securities? Why or why not?

Response. ITS rules inhibit the growth of ECN trading of listed securities for two reasons: (a) greater visibility of order prices that flow with ITS participation come at the cost of compliance with a rule set that can dilute the attractiveness of certain ECN business models; and (b) ECNs that choose to comply with ITS requirements do not get the advantages of increased exposure of their orders and access to other liquidity pools because the NYSE and other established markets do not comply with ITS requirements.

Question 8. Do access rules for ITS presume best execution at the NBBO? Are there any other factors that should be considered for best execution?

Response. The ITS access rules imply a policy of strict "price/time" priority—that is, the market posting the best bid or offer should participate in the next transaction, subject to limited exceptions. This presumes: (a) that price is the paramount factor in all best execution analyses; and (b) the best-execution interests of the provider of liquidity (i.e., the party placing a limit order for display to the market at large) are paramount to those of the taker of liquidity (i.e., the party placing a market order for immediate execution against previously displayed interest). Both assumptions should be re-considered in light of diverse views on what truly is best execution.

Question 9. Please describe the governance structure for ITS. Does the governance structure inhibit improvement? If so, please explain.

Response. The ITS Plan is the document which governs the operation of ITS. The Plan calls for oversight by an Operating Committee composed of one representative from each SRO participant (i.e., the exchanges and Nasdaq, on behalf of the NASD). Votes to make material amendments to the ITS Plan generally require the unanimous vote of all Plan participants. This requirement inhibits meaningful reform. Imagine the amount of legislation that would be passed if Congress had a similar requirement.

Question 10. What is the difference between the old Nasdaq as an infrastructure for quotations and the new Nasdaq with the SuperMontage as an order execution facility?

Response. The primary difference between the "old" Nasdaq that merely collected and distributed broker-dealer quotations and trade reports, and the "new" Nasdaq that, culminating in SuperMontage, offers execution services bundled with those facilities, is that Nasdaq now competes directly with the market makers and ECNs it was originally created to serve. This is exacerbated by Nasdaq's desire to shift from a non-profit, market-neutral subsidiary of an self-regulatory organization (the NASD) to a publicly-held, for-profit entity.

Question 11. What potential benefits and risks does SuperMontage bring to the marketplace?

Response. SuperMontage has the potential to provide benefits to the marketplace as a new competitor in the field of trade execution services, offering its own unique

value proposition in terms of price, technology and service. Given Nasdaq's regulatory legacy and historical monopoly privileges, however, the risk is Nasdaq will thwart competition through unfair use of its status within current market structure.

Question 12. Is SuperMontage a Central Limit Order Book (CLOB)?

Response. SuperMontage is a limit order book that Nasdaq hopes will become a CLOB. Provided that the Alternative Display Facility and other market centers are allowed and committed to providing non-Nasdaq alternatives for compliance with SEC quotation-display and trade-reporting requirements, SuperMontage will likely remain in vibrant competition with other limit order book operators and never gain CLOB status.

Question 13. Have structural changes that have accompanied the privatization of Nasdaq been sufficient to ensure a competitive marketplace?

Response. There has been positive steps towards preserving market competition but more must be done. The Alternative Display Facility must continue to reduce technological and economic barriers to usage, both now and on a continuing basis in the future, to provide a non-exchange, market-neutral facility to comply with SEC quotation and trade reporting obligations. The SEC should also take action regarding proposals by existing exchanges that wish to modify their rules to provide further competition to Nasdaq for these services.

Question 14. How does the NASD's Alternative Display Facility (ADF) differ from the SuperMontage? Has Brut signed up for the ADF? Why or why not?

Response. The ADF much resembles the "old" Nasdaq in that it merely provides broker-dealers a facility through which to comply with SEC quotation and trade-reporting obligations, without providing any supplemental execution services. Brut has not yet signed up to use the ADF for the reasons described below, along with a desire to offer subscribers the flexibility to expose their limit orders in SuperMontage.

Question 15. Is the ADF a true alternative to the Nasdaq's SuperMontage?

Response. The Alternative Display Facility can become a truly viable alternative to SuperMontage if the NASD: (a) completes the creation of compatibility with the Financial Information Exchange ("FIX") protocol, which will ease the technological burdens of connectivity; and (b) makes permanent a fee structure that reflects the limited purposes of the system and operates the ADF like the low-cost utility it should be.

Question 16. How does the "full contribution member" and "partial contribution member" dichotomy punish NASD members for doing business on a facility other than the SuperMontage?

Response. This pricing dichotomy, which we understand has been withdrawn as a rule filing, is anti-competitive in that it effectively ties the use product in a market where there is competition (trade reporting) to use of a market where there is not (removal of liquidity from SuperMontage). Firms seeking to pursue savings by reporting trades to non-Nasdaq venues would be faced with higher costs for trading against market makers via SuperMontage, which is effectively required to provide best execution of customer orders.

Question 17. What are the main ADF issues that need to be addressed on an ongoing basis?

Response. See the answer to question 15 above. The NASD must be committed on an ongoing basis to ensure that the ADF is technologically and economically viable. It should operate the ADF on a true "non-profit" model, and not allow ADF-related fees to subsidize other NASD activities, including but not limited to the provision of regulatory services to Nasdaq. Potential conflicts of interest between the NASD and Nasdaq should be completely eliminated to ensure this commitment.

Question 18. Why would an ECN elect to receive orders rather than executions? How do SuperMontage fees discriminate against ECNs that elect to receive orders rather than executions?

Response. ECNs elect to receive orders rather than executions because to do otherwise exposes them to "double liability" (i.e., the execution of one order twice—within its own system and within Nasdaq simultaneously) that would crate proprietary trading risk inconsistent with ECN business models. SuperMontage fees currently do not discriminate against ECNs that elect to receive orders rather than executions (though early versions of the SuperMontage proposal sought to do so).

Question 19. Are access fees consistent with ECN obligations under the order handling rules to provide access to the best prices in the marketplace?

Response. SEC no-action letters provided to ECN operators under the "ECN Display Alternative" component of the Order-Handling Rules validate the practice of ECN access fees. Such fees are consistent with execution service fees charged by other market centers, and facilitate an agency business model where an ECN operator engages in no proprietary trading activity.

Question 20. Should ECNs be required to apply uniform charges to subscribers and non-subscribers?

Response. ECNs are currently required, under the terms of their no-action letters with the SEC as referenced above, to charge non-subscriber broker-dealers a rate no higher than that paid by a substantial portion of its active broker-dealer subscribers. When this requirement is complied with, it is more than sufficient to meet fair access requirements. In October 2002, over 80% of Brut's broker-dealer subscribers paid fees at the rate that non-subscribers were charged.

Question 21. Should an ECN be required to fill an order it has displayed when the counterparty refuses to pay the access fee?

Response. ECNs should not be required to fill orders for counterparties that refuse to pay access fees. Much of the debate surrounding ECN access fees can be eliminated if: (a) viable alternatives to Nasdaq are created and maintained so that ECNs may comply with SEC quotation-display requirements through a facility that does not have execution capabilities (such as the ADF); and (b) greater clarity is given that Nasdaq and other execution system operators can restrict ECN participation in their systems based on access fee considerations. If ECNs have viable alternatives for public display of their quotations (which did not exist until very recently), the concern that firms are "forced" to trade with ECNs becomes an issue for Nasdaq and other execution venue operators to decide. They will balance the liquidity provided by ECNs versus the user concerns regarding access fees and make decisions within a competitive market framework.

Question 22. Mr. Ryan, General Counsel of the American Stock Exchange, testified that some of the ECNs operate as de facto clubs and, in effect, an exchange without the regulation or burdens associated with being an exchange. What should be the regulatory burden for ECN business as an agency order matching facility?

Response. The argument that ECNs have unfair advantages due to their classification is without merit, given that each market participant is free to choose its regulatory classification and the benefits and compliance burdens associated therewith. Exchange registration brings with it: (a) the ability to generate revenue from listing securities on your exchange; (b) direct participation in national market system plans such as ITS and the CTA/CQS plans (which govern market data); (c) can reduce clearing costs; and (d) offer certain brand advantages. Firms that choose to operate as exchanges and enjoy these advantages must comply with applicable regulatory requirements, while those that choose to operate as broker-dealers forego exchange-related privileges for a less restrictive compliance regimen. Current exchanges, however, should not be hamstrung by their current classification if they wish to seek alternative business models; any exchange wishing to de-register and pursue operation as a broker-dealer operator of an ATS should be allowed to do so by the SEC.

AMERICAN STOCK EXCHANGE
November 22, 2002

Mr. CLIFF STEARNS
Chairman
Subcommittee on Commerce, Trade and Consumer Protection
U.S. House of Representatives
Committee on Energy and Commerce
Washington, D.C. 20515-6115

Re: ECNs and Market Structure

DEAR MR. STEARNS: In response to your October 25, 2002 letter, The American Stock Exchange appreciates this opportunity to provide additional information to the Subcommittee on the important issues raised during the October 17, 2002 hearing regarding ECNs and market structure.

The American Stock Exchange

The American Stock Exchange has a long history of innovation and diversification, and it proudly carries on this distinguishing trademark among exchanges today. As one of the most diversified financial marketplaces in the U.S., the Amex is the only primary exchange in the United States that actively lists and trades securities across three diverse business lines—equities, options and exchange traded funds ("ETFs"). We continue to provide investors—whether they be retail or institutional investors—with investment opportunities that best meet their needs.

The Amex market is a technologically advanced centralized auction and specialist system whose strength comes from the fact that the specialists have an affirmative obligation to maintain a fair and orderly market. This means they risk their own

capital, maintaining a continuous two-sided quotation. With a specialist intrinsically linked to creating the best market for a stock, the best interests of listed companies and their shareholders are achieved. Other markets—whether they be regional exchanges, dealer markets or ECNs—provide far less of a commitment to the investing public.

The combination of our auction market, diversified product line, state-of-the-art technology and the large pools of liquidity provided by Wall Street's most experienced and well-capitalized firms, delivers a superior marketplace for investors in all our products.

Equities

The Amex equity marketplace continues to outperform the market. Following a strategic restructuring of the equity program which refocused the business on small and middle market companies, the Amex composite index outperformed every other domestic exchange and virtually every other index in both 2000 and 2001, and is on track to do so again this year.

The Amex, unlike the other primary markets which focus exclusively on servicing large cap stocks, acts as a conduit in helping small and mid-sized companies develop and grow.

We feel that now, more than ever, in this economic and political climate, it is critical to provide support to the capital markets—especially the small and mid-cap companies who are more often than not our nation's principal source of innovation, job creation and future economic growth.

Our advanced centralized auction and specialist system is especially beneficial to small and mid-cap companies as it maximizes liquidity at the point of sale. Specialists also serve as a single point of contact that a company can turn to for critical insight on their stock's trading activity.

Offering additional diversification and opportunities to investors—we also began trading NASDAQ stocks this summer. By trading NASDAQ stocks, the Amex is providing for the first time in these securities, a meaningful auction market environment with real opportunities for price improvement. The Amex is providing deep liquidity for large, institutional size orders, which creates new investment opportunities for investors.

Options

The Amex is the second largest options exchange in the U.S., trading options on broad-based and sector indexes as well as domestic and foreign stocks.

We trade call and put options on more than 1,800 stocks and 25 broad, sector-specific and international indexes. And we continue to close in on becoming the number one domestic options marketplace for equity options.

Even amid tough market conditions, we continue to see growth in our options business. In looking at third quarter Amex's total options equity volume for this year, it is up 18% as compared to this same time last year.

ETFs

In addition to its role as a national equities market and leading options exchange, the Amex is the pioneer of the Exchange Traded Fund ("ETF"). ETFs are the fastest growing, most innovative financial products offered by an exchange over the last decade. After more than four years of working with the SEC and millions of dollars of R&D expense, we launched the first ETF in 1993 with the creation of the Standard & Poor's Depository Receipts (commonly referred to as the "spider"), which is based on the Standard and Poor's 500 Composite Stock Price Index.

Over the next several years, we spent millions more developing new products and educating the marketplace about the benefits of ETFs. Nine years later, the Amex remains the clear leader in ETF listings, listing 121 of the 123 in the U.S. market today.

Global

We have been able to leverage our reputation in ETFs to create a global presence for the Amex. In the last year, we have reached agreements to trade Amex-listed ETFs in Europe and Asia. Our global expansion includes a joint venture with the Singapore Exchange. In May, we began trading Amex-listed ETFs in Asia, becoming the very first fungible product traded across time zones. We've also listed the first U.S. equivalent of an ETF trading on the Tokyo Stock Exchange. And we continue to work on agreements with the Tokyo Stock Exchange and Euronext with respect to the listing and trading of each other's ETFs. As regulations allow, we anticipate that these centers will also provide international trading venues for our listed companies seeking exposure to the global markets. In short, the new American Stock

Exchange has emerged as a strong, innovative international competitor, especially in the development and trading of sophisticated derivative securities.

Background of the National Market System

We believe an overview of relevant national market system developments will serve as a useful context for the issues raised in your October 25 letter. In 1975 Congress adopted substantial amendments to the Securities Exchange Act of 1934 ("Act") designed to enhance the integrity and efficiency of our national securities markets (the "1975 Amendments"). Specifically, Congress mandated the implementation of a national market system. The Securities and Exchange Commission ("Commission"), in turn, adopted rules under this mandate to require the industry to develop mechanisms and procedures designed, among other things, to enhance transparency of market data (e.g., timely display of trading interest and trade executions) and foster interaction of investor trading interest (that is, minimize fragmentation and intermediation).

Central to meeting these requirements, all the exchanges and the NASD/Nasdaq adopted three critical national market systems plans for listed equity securities: the Consolidated Quote ("CQ") Plan, the Intermarket Trading System ("ITS") and the Consolidated Tape Association ("CTA") Plan (collectively referred to as "Plans").

Collectively, these three plans enhance real time consolidated transparency of market data (i.e., the CQ Plan for quotes and CTA Plan for trades) and foster interaction of investor trading interest (i.e., ITS). Each of the Plans was submitted to and approved by the Commission. Their common objective is to provide the investing public with a consolidated national market system which provides, *inter alia,* best bid and offer information that can be viewed and accessed by any investor, regardless of the market to which the order is routed.

The CQ and CTA Plans provide that the market data generated from these Plans be sold to market participants on a real-time basis. Under the current Plans, the revenue generated is then shared among the exchanges and NASD/Nasdaq ratably based on the number of trades executed by each market, but without reference to the number or quality of quotes displayed or whether any quotes are displayed at all.

Since the adoption of these Plans and other similar Plans, the Commission has on many occasions refined the rules relating to the national market system (including adopting the Quote Rule and Regulation ATS), reinforced the importance of the national market system and underscored the central role these Plans play in meeting the mandate set forth in the 1975 Act Amendments. The Commission has done this by approving amendments to these Plans, approving rule changes submitted by all the exchanges and the NASD/Nasdaq in connection with the implementation of these Plans, and by adopting Commission rules governing the operation of the exchanges, the NASD/Nasdaq and broker-dealers.

In 1998, reacting in part to its well-founded concerns documented in the Commission's 21(A) Report against the NASD that alternative trading systems were leading to market fragmentation and harming market transparency by operating as private "hidden markets," the Commission adopted Regulation ATS. Specifically, the operation of these alternative trading systems was—and, unfortunately, still is—leading to a two-tiered market, an unofficial one only viewable and accessible by the alternative trading system's members and the official market being created by the national market system and used by public investors. The Commission also took this step to address the growing regulatory disparity between ATS's and other markets, disparities the Commission found negatively affected other securities markets and, most importantly, public investors.

In adopting Regulation ATS, the Commission sought to establish a better balance between the regulatory needs of the Congressionally mandated national market system and the need to encourage the development of innovative new markets. The Commission sought to accomplish its goal by allowing, on the one hand, an ATS that operated below a threshold of 5% of the average daily trading volume in a security largely to escape the regulatory constraints placed upon registered exchanges. On the other hand, in an effort to bring ATSs into the national market system, Regulation ATS attempted to subject an ATS that exceeded the 5% threshold to an order display and equivalent access requirement and an ATS that exceeded a 20% threshold to a fair access and certain requirements relating to its operational system.

Since its adoption, it has become increasing clear that Regulation ATS has not resulted in the better balance between regulation and innovation sought by the Commission. While a single *de minimis* ATS (an ATS with less than 5% market share) may not have a significant impact on the U.S. securities markets, the Commission failed to anticipate that the trading of multiple ATSs operating under the *de minimis* exemption can, in the aggregate, have a very negative overall impact

on the national market system's guiding principals of transparency, best execution, equal regulation and fair competition. Amex advocates the repeal of Regulation ATS in its current form, and we have communicated this view to the Commission.

The ability of an ATS to frustrate the Regulation ATS requirements designed to integrate ATSs into the national market system has recently been vividly demonstrated by The Island ECN's choice to "go dark" (with no information at all disseminated about priced orders entered in Island), a tactic it adopted notwithstanding the Commission's grant of an unprecedented exemption to a core national market system principle—the ITS trade-through rule—designed specifically to accommodate Island. Thus, a market, like Island, that matches customer orders with other customer orders, does not display its customers' orders and reports its trades through the CT Plan avoids the most substantive provisions of Regulation ATS, including: (1) the order display and equivalent access requirement, (2) the limitation on fees that are inconsistent with the equivalent access requirement, (3) the fair access requirement, and (4) the requirements with respect to the capacity, integrity, and security of the ATS's automated systems.

By going dark, Island achieved precisely the result that the Commission sought to avoid with the adoption of Regulation ATS, namely the presence of a two-tired market—an unofficial one only viewable and accessible by the alternative trading system's members and the official market existing within the national market system that is available to all investors. Island's actions have lead to the truly perverse result seen today of an alternative trading system (Island) and a facility of a national securities association (Nasdaq) sharing in revenue generated by two national market system plans (the CQ and CTA Plans) while the ATS is invisible and inaccessible to the intended beneficiaries of the national market system—the investing public. Nasdaq receives the revenue and then pays a portion of it over to Island as payment for order flow. It should go without saying that allowing significant ATSs to opt out of the national market system because the Commission is reluctant to allow Regulation ATS to be enforced or because of the exception that allows markets, like Island, to go dark, undermines the core national market principles of transparency, best execution, equal regulation and fair competition.

The Commission's permissive attitude toward Island provides incentives to these enterprises to proliferate outside the national market system constructs that the Amex and other market participants are required to abide by. Amex acknowledges the benefits of competition, and is eager to see the Commission facilitate market innovation. But by continuing to allow Island to reap artificial financial benefits (by the receipt of payment for order flow), to be unreachable and, in the actively-traded ETFs, invisible, the Commission is not allowing Amex to compete to attract those orders and to provide investors with superior executions.

Question 1. What are the potential costs and benefits to investors of a market in which market information is available through competitive forces rather than an exclusive processor?

Response. As Amex stated during its participation in the SEC Advisory Committee on Market Information (known as the Seligman Committee) in 2000 and 2001, there are certain types of facilities that should be exclusive because they call for centralized operations that can best be performed by a single entity. Securities clearing operations are a good example of this type of exclusive utility. Although there were five different equity clearing systems at the time the 1975 Securities Acts Amendments were adopted, today there is only one. The additional costs associated with operating multiple clearing organizations outweighed any benefits of competition. We believe a central processor operates in a similar manner.

Under the existing market structure, there are two kinds of exclusive securities information processors: entities like SIAC and Nasdaq that actually process trade data, and entities like the CTA and Options Price Reporting Authority ("OPRA") that administer, collect and distribute market data fees. Leaving Nasdaq aside for the moment because it serves several simultaneous roles as securities information vendor, marketplace and central processor, the other central processor, SIAC, performs its service at cost. We find it hard to believe that a for-profit entity could perform the services SIAC currently performs, with the same level of service, for less money.

Amex sees no advantage in having multiple, competing consolidators of market data. The consolidation function should be performed by an exclusive consolidator under each of the plans. We are concerned that increasing the number of consolidators would simply introduce complexity and inefficiencies, such as the need for multiple disaster recovery sites and plans, without producing any real, offsetting benefits. Moreover, we believe that the competing consolidator model would create the possibility of differing data streams and thus is fundamentally at odds with the national market system. Data streams may vary for many reasons, including dif-

fering standards for rejecting apparently inaccurate data, differing transmission times among markets or differing timestamps for incoming market data among consolidators. If data streams are different, both last sale and quotation information could differ among vendors.

Amex believes that SIAC has done an exemplary job as the exclusive information processor under the CTA and CQ Plans. The efficiency of its operations is demonstrated by its long record of providing reliable, real-time market data to the industry without significant disruptions. This record is all the more impressive if one takes into account the exponential growth in recent years in the amount of data that SIAC has had to collect, consolidate and make available for re-dissemination. That said, Amex is willing to explore opening the exclusive processing function to competitive bidding, if other markets believe that is appropriate.

Questions 2 through 5. Market Data Rebates

As background for the issues raised in Questions 2 through 5 relating to market data rebates and associated regulatory problems, we believe it is helpful to describe how market data is calculated and distributed for listed securities.

The national market system in listed securities is funded by revenues generated from the sale of quotations and last sale transaction data to vendors and subscribers at prices that are fixed by the Participants under the direct supervision of the Commission. As detailed in the Commission's recent study of the economics of market data by the Seligman Committee, market data revenues are an essential mechanism for financing the operation of various markets and their surveillance and compliance programs.

Pursuant to the CTA Plan, the calculation of revenue for each Participant is based upon the number of last sale transactions reported by that Participant. More specifically, the "Gross Income" of each CT Network [1], from which each Participant receives its "Annual Share," is based on fees received from subscribers, vendors and others for the "privilege of receiving and using the network's last sale price information." The "Annual Share" is calculated by a fraction using a numerator based upon the total number of last sale price transactions reported by the Participant and a denominator based upon the total number of last sale price transactions reported by all Participants in the network. Under the CQ Plan, the "Annual Share" is calculated the same way as in the CTA Plan, i.e., according to the number of last sale transaction reported in the network's securities , and not according to the number of quotes disseminated in those securities. This formula was established when the CTA was formed, at a time when there was no real time dissemination of quotation information. In 1978 when the CQ Plan was formed there seemed to be no point in changing this allocation formula since market data charges for trades and quotes were bundled and every market that reported trades in a security was also required to disseminate quotations. Thus, not using quotes to calculate quotation revenues—and using transactions instead—was at the time believed to be relatively inconsequential. However, with significant changes in the markets, including some market participants operating outside of the national market system, the allocation formula rewards market participants for violating the law and undermining the national market system.

This dysfunctionality is exacerbated by the practice of NASD/Nasdaq of rebating a portion of market data revenue to their members to use as "payment for order flow." Island is a beneficiary of this rebate program. Even though Island never reports its quotations to NASD/Nasdaq and never links with ITS, NASD/Nasdaq receives a share of both quotation and transaction market data revenues based on the number of trades Island generates. NASD/ Nasdaq, in turn, passes a substantial portion of its CTA and CQ Plan revenues attributable to Island's trades on to Island as part of its "Payment for order flow" program.

Thus, despite the fact that Island does not disseminate its quotations to any of the Participants or allow other markets to access its quotations, it nevertheless gets "paid" a share of both CTA Plan and CQ Plan revenues. Island then pays over a percentage of the money to brokers or other of its customers as "payment" for executing their trades on Island as opposed to some other marketplace (like AMEX). The Island payment scheme rebates to users of its system a fixed fee for every trade in listed stocks regardless of size. Indeed, Island actively markets on its web site the fact that its customers receive rebates of CTA/CQ tape revenues on a "trade-by-trade" basis, thus encouraging users to break larger trades into small ones,

[1] There are two networks in the CTA and CQ Plans: Network A provides quotes and last sale price information in securities traded on the New York Stock Exchange and Network B provides quotes and last sale price information in securities traded on the American Stock Exchange.

thereby maximizing their rebate (and in the process moving more trades—and thus more CTA Plan and CQ Plan revenues—to Island).

Revenues under the CQ and CTA Plans are allocated among market centers on the basis of the respective number of trades they each report, without regard to share volume or the quality of those markets. This approach disadvantages the market centers that provide greater liquidity by treating a single trade for 100 shares of stock the same as a single trade for 100,000 shares of the same stock in a different market. By the same token, the quality of quotation information is completely ignored in the allocation formula.

Though the current methodology has the virtue of being procedurally simple, its simplicity comes at the great expense of substance. Indeed, its reliance solely on counting the number of trades (a practice dating back to the mid-1970s) causes it to be overly simplistic and, unfortunately, subject to gaming and manipulation solely for the purposes of collecting market data revenue, not improving the quality of the market. The time has come to recognize that the current methodology has utterly failed to achieve what should be the major goals of the Commission and the CQ/CTA participants—to encourage the provision of maximum liquidity to, and the tightest possible spreads in, national market system securities. To that end, Amex has proposed a more logical method of allocating market data revenue, rewarding superior pricing and displayed size.

Question 2. What are market data rebates and how do they work?

Response. Several markets, including the Nasdaq Stock Market, the Cincinnati Stock Exchange and the Chicago Stock Exchange, rebate a portion of their market data revenue under the CQ/CTA Plans to their members as a reward for executing trades on those markets. These payment for order flow schemes are generally filed with SEC without the benefit of publication in the Federal Register for notice and comment before they become effective. They may involve payment or credit for each print in an Amex or NYSE security, for example, or a more elaborate system of credits based on trade volume executed over a specified time period. Amex has had a longstanding opposition to such schemes, which we have communicated to the Commission on numerous occasions—and, indeed, the Commission recognized the abuses that can result from those payments when it abrogated certain payment for order flow programs on July 2, 2002, stating that these programs "raise serious questions as to whether they are consistent with the Act and with the protection of investors. These questions include, among other things, the effect of market data rebates on the accuracy of market data [i.e., the potential distortion of trade reporting through wash sales and trade shredding] and on the regulatory functions of self-regulatory organizations."[2]. The Commission stated further that "[i]f the self-regulatory organizations choose to re-file the proposed rule changes, they must do so pursuant to sections 19(b)(1) and 19(b)(2) of the Act." [Emphasis supplied].

Ironically, despite the Commission's clear directive in its abrogation Order, on July 8, Nasdaq filed a proposal to reinstate its payment for order flow program. The Nasdaq's reinstated proposal did not address any of the serious questions raised by the Commission in the abrogation Order nor did it try to justify why the proposal is consistent with the Act and with the protection of investors. On July 19, 2002, the Commission allowed Nasdaq to reinstate the program retroactively to July 1. To date, none of the important questions raised by the Commission have been answered.

Question 3. Are market data rebates good for investors? Why or why not?

Response. Market data rebates—that is, payment for order flow—are undermining national market system facilities by providing financial support and incentives to market participants that may decide to trade in a particular market based solely, or principally, on rebates, rather than whether investor orders receive best execution; by encouraging violations by ECNs of Regulation ATS under the 1934 Act; and by providing direct and significant financial support for market participants to engage in fraudulent and misleading trade reporting. We can identify no benefit—and a clear potential for harm—to public investors from such practices. The reason that some market centers can provide such inflated market data rebates is that they are not burdened with the regulatory or listing requirements of the primary markets. These market centers are able to offer low cost alternatives to the primary market (including negative costs such as market data rebates) while free-riding on the price discovery process occurring in the primary market. This is even more egregious if members of these markets do not participate in CQ/CTA or ITS, ironically reducing the integrity of the price discovery value of the market data for which they are being paid.

[2] Securities Exchange Act Release No.46159 (July 2, 2002) 67 FR 45775 (July 10, 2002).

Question 4. Will market data rebates solve market data issues or is a regulatory solution required?

Response. Rebates have promoted investor harm as a result of market data revenue distributed under the CQ/CTA Plans, which was not contemplated when the markets agreed to the current revenue distribution methodology under those Plans. Amex views the current methodology for distributing revenue to CQ/CTA Participants as irremediably flawed—and a major contributing factor to incenting to markets to pay their members for order flow, with attendant regulatory problems, noted in Question 5, below. We believe a regulatory response is needed. (See response to Questions 5.)

Question 5. Are market data rebates creating problems with wash trades—are buy and sell quotes being entered simultaneously by the same party to generate trade revenue from market data rebates? If so, how do we solve this problem?

Response. Trading to create artificial reports based on per trade market data rebates has become a serious problem. Nasdaq, for example, pays Island on a per trade basis and Island rebates to users of its system a fixed fee for every trade in listed stocks regardless of size. Indeed, Island actively markets on its web site the fact that its customers receive rebates of CTA/CQ tape revenues on a "trade-by-trade" basis, thus encouraging users to break larger trades into small ones, thereby maximizing their rebate. As a result, for example, an Island customer wishing to execute an order for 1,000 shares of QQQ is, in fact, directly paid to break that order up into 10 trades of 100 shares. Island's users were obviously breaking their orders into 100 share lots, encouraged by the trade-by-trade rebate. This creates the false and misleading impression that 10 separate orders were executed each at 100 shares. Regulators have taken notice. The NASD recently reached a settlement with Swift Trade Securities USA, Inc. and its president, Peter Beck, for engaging in a deceptive trading scheme involving fictitious wash trades in the QQQ ETF in an effort to obtain market data revenue generated from such transactions. (See Exhibit B) In addition, the SEC has taken action to abrogate several markets' payment for order flow programs, based at least in part on potential wash sales problems resulting from those programs. The Exchange views such activity as seriously undermining the integrity of consolidated tape reporting and is contrary to the intent and purpose of the CQ/CTA Plans to distribute revenue based on full participation in all national market facilities by CQ/CTA Participant members.

In order to encourage marketplaces to improve their displayed pricing and order size—and to contribute to market depth and liquidity—Amex has proposed to CTA Participants that CQ/CTA market data revenues be distributed as follows: (1) 25% based on the number of trades; (2) 25% based on share volume traded; (3) 25% based on bids that are at the national best bid (NBB); and (4) 25% based on offers that are the national best offer (NBO). The distributions based on the NBB and NBO would be weighted by volume (the number of shares in the bid or offer), time (the number of seconds the NBB or NBO exists) and the percentage that each stock's traded share volume amounts to of all Network A or Network B securities' traded share volume.

Question 6. Is current ECN access to ITS adequate? Why or why not?

Response. ITS is accessible to all market participants pursuant to the provisions of the ITS Plan. The ITS Plan currently provides for delivery of ITS commitments which expire in 30 seconds, 1 minute, or 2 minutes, at the discretion of the sending market. While a time frame of 30 seconds[3] may not fit into the model of an ECN, the ITS trade through protections are designed to protect the customers of both the participant accessing liquidity and the participant providing liquidity by quoting at the NBBO. Nasdaq and the Cincinnati Stock Exchange, currently provide access by their members to all other markets through ITS. All ECNs can take advantage of the ITS link provided by Nasdaq, as Archipelago has before becoming an Exchange. No ECN that is required to provide equal access should be treated any differently with respect to ITS provisions than the members of Nasdaq and the Cincinnati Stock Exchange.

The ITS Operating Committee recognizes that in a decimal environment, the protection afforded by the ITS Plan to a limit order on an away market priced only 1 cent better than orders on the home market may not always be justifiable if the limit order is not easily accessible, and if the risk of the prices moving in the home market are high. The ITS Operating Committee is currently in discussions regard-

[3] The time frame of 30 seconds is the maximum time that a market center can take to execute an ITS commitment before the commitment automatically expires. Nasdaq and the Cincinnati stock exchange provide immediate automated response to ITS commitments, and manual market centers often provide responses in a time frame well under 30 seconds. In October 2002, over 75% of all ITS commitments received a response in less than 15 seconds.

ing changes to the ITS plan that may be required. The Operating Committee is considering issues raised by all parties, including both manual markets and markets that provide automated executions such as Nasdaq and the Cincinnati Stock Exchange.

Question 7. Are the access rules for ITS responsible for ECN's lower trading volume in listed securities than in NASDAQ securities? Why or why not?

Response. ECNs have access to other markets through their automated order delivery systems outside of ITS. Indeed, the number of orders and share volume sent to Amex's Amex Order File or NYSE's DOT system, for example, from other market participants, including dealers, far exceeds the number of ITS commitments, with associated volume sent through ITS. Even if ITS were inaccessible, this would not be a reason for ECNs' lower trading volume in listed securities. Indeed, in Amex-listed ETFs such as QQQS, SPY and DIA, Island's volume was astronomically high at the same time that it had determined to operate entirely outside ITS in these securities. However, ITS is accessible to all market participants as stated earlier. Island, in its single tepid initiative to inquire to ITS Participants about ITS access several years ago, proposed to have only one-way access—Island to other markets. Island has never seriously explored meaningful ITS access with other participant markets. Their purported lack of access has certainly not had any negative impact on their trading volume in listed ETFs. The fact that Island operates entirely outside ITS in all listed securities, but has only gained significant volume in ETFs clearly shows that their lack of success in non-ETF listed securities has nothing whatsoever to do with ITS rules. The phenomenal success ECNs have seen in Nasdaq securities and in ETFs is due largely to the intra-day volatility of these securities that attracts day traders, the largest constituency of most ECNs. Additionally, ETFs are derivatively priced, so primary market protection is not as important as an execution near the NAV, which is not set by supply and demand on the primary listing market.

Question 8. Do access rules for ITS presume best execution at the NBBO? Are there any other factors that should be considered for best execution?

Response. The NBBO is the starting point for executions through ITS. All ITS participants should attempt to access a superior priced away market (i.e., a market at the NBBO), and should avoid executing an order at a price inferior to the NBBO (a "trade-through"). Proponents of alternative trading systems and Nasdaq recently have been advocating "speed of execution" as the primary consideration in best execution. The Commission however, has clearly stated, "price is the predominant element of the duty of best execution." The Commission's view of a national market system consisting of "equally regulated, individual markets, which are linked together to make their best prices publicly known and accessible," presupposes that price is the most important factor in best execution and that speed of execution, like many other considerations, is a secondary factor.

The SEC also has identified the other factors to be considered by a broker-dealer in satisfying its best execution obligations, including the size of the order, the trading characteristics of the security involved, the availability of accurate information, technological aids to process such data, access to the various market centers, and the cost and difficulty associated with achieving an execution in a particular market center.

Questionn 9. Please describe the governance structure of ITS. Does the governance structure of ITS inhibit improvement? If so, please explain?

Response. The ITS Plan is a national market system. All provisions of or amendments to the Plan are approved by the SEC. The ITS Operating Committee, which includes representatives of all U.S. exchanges and Nasdaq, administers Plan provisions but is not a policy making or rule making body. Amendments to the Plan must be effected by a written amendment to the Plan, executed on behalf of each Participant (unanimous vote required). Plan amendments are filed with the SEC for approval, generally with notice and the opportunity for public comment prior to approval. Any Participant can enforce its views regarding any action or inaction of the ITS Operating Committee to the SEC or any other forum it deems appropriate.

The SEC attends meetings of the ITS Operating Committee and Users Subcommittee. The ITS Operating Committee considers all proposals of all participants; participants affected by an action of the Operating Committee, for example, as a result of failure to approve a Plan amendment proposed by a Participant, are able to petition the SEC to take appropriate action, or the Commission itself can take action it deems necessary to implement or amend provisions of the Plan. The Operating Committee is currently addressing important issues regarding ITS trade throughs and other issues as requested by the Commission. Amex believes that ITS governance promotes consensus by all markets and promotes progress consistent with integrity of the market structures of all participants.

Question 10. What is your per trade revenue for market data? How does that compare to the NYSE's per trade revenue?

Response. The per trade revenue from market data for securities listed on the Amex is $2.39 and for securities traded on the NYSE the per trade revenue is $0.27. The difference in revenue per trade is a reflection of the fact that there are fewer trades executed in Amex securities than in NYSE securities. Market data can not be sold on a per trade basis, the appropriate measure is the revenue per terminal since that is the way revenue is collected under the Plans and is reflective of the infrastructure costs of providing market data. As discussed below, the revenue collected per terminal is comparable to both the NYSE and Nasdaq, however the number of trades occurring on the NYSE and through Nasdaq is greater resulting in lower per trade revenue.

Market data revenue for Amex (CTA Network B), NYSE (CTA Network B) and Nasdaq data are reasonably comparable, on a per terminal basis. Despite a tenfold increase in consolidated share and trade volume in Amex-listed securities since 1992 (the last time rates were raised for Networks A and B), market data rates have not increased. In 1992, the consolidated daily average Network B volume was 19.3 million shares and 15,248 trades. In 2002 (year to date), that figure has climbed to 186.6 million shares and 155,989 trades. Network B rates are $27.25 monthly per terminal (members) and $30.20 (non-members).

Network A utilizes a sliding scale, ranging from $127.25 monthly for the first terminal to $18.75 per month per terminal for 10,000 or more terminals (members and non-members). The price for Nasdaq data, which was most recently changed in 1997, is $20 per terminal.

Question 11. You testified about alleged abuses by Island regarding their trades of ETFs being sold to the Cincinnati Stock Exchange and Island's refusal to report trades. Could you elaborate why this is a violation of the securities laws, how it affects market competition and why the SEC has not taken action?

Response. For more than 18 months the Island ECN has operated in open and notorious violation of the federal securities laws. Without any justification, Island has flagrantly violated Regulation ATS as well as engaging in and fostering other abusive and fraudulent trading practices. Throughout this period, the American Stock Exchange as well as many other market participants and regulators have brought these activities to the attention of the Commission and pleaded with the Commission to take the appropriate action to bring it to an end.

Regulation ATS—On December 8, 1999, the Commission adopted Regulation ATS, which is designed to integrate significant alternative trading system activity into the national market system. Regulation ATS was adopted after two extensive public comment periods and much consideration by the Commission and the industry. The expressed purpose of integrating ATSs into the national market system was to address the Commission's well-founded concerns that these systems were leading to market fragmentation and harming market transparency by operating as private, "'hidden markets,' in which a market participant privately publishes quotations at prices superior to the quotation information it disseminates publicly." Because of the lack of enforcement of Regulation ATS, these concerns continue to be a reality.

Specifically, Regulation ATS requires an ATS to consolidate their quotes with all other markets and to provide access to these quotes when the ATS achieves five percent market share for four out of six months. Island triggered these requirements in QQQ in May 2001, in DIA in August 2001 and SPY in February 2002.

Island has recently announced that it will begin reporting (that is, selling) trades in ETFs to the Cincinnati Stock Exchange ("CSE") in a manner that will neither display their quotes nor make them accessible to public investors. Under the current CSE payment for order flow arrangement, CSE will pay a 50% market data rebate of revenue that it receives under the CTA Plan. Island therefore will be able to pay its users even more than under NASDAQ's payment for order flow program (under which Island is paid a 40% rebate), with the aim of further increasing Island market share and siphoning even greater volume away from national market facilities. CSE's arrangement with Island has not been separately filed with the SEC, and undermines the core purposes of Regulation ATS. Island will not be displaying its best orders through CSE and none of Island's quotes will be accessible to other markets through ITS. As we understand the situation, Island has set up a scheme to report trades through CSE as follows: When an order entered in Island ECN is priced at or between the NBBO, Island ECN transfers the order to Island Execution Services for matching and printing on CSE. Because CSE's displayed quote typically is well outside the NBBO and because few, if any, limit orders are resident on CSE's "book", there is virtually no chance that the Island orders to be matched will be broken up by other trading interest. Island orders not priced at the NBBO would con-

tinue to be executed in Island, outside the NBBO, but still rewarded by Nasdaq payment as a third market print.

Question 12. Please explain how, in your view, Island is exploiting the National Market System (NMS) by collecting fees from it while not participating in it?

Response. Market data revenue should only be distributed to SROs and their members that fully participate in the national market system. This involves all of the burdens necessary to comply with last sale reporting, quotation reporting, making oneself accessible to other markets through ITS and complying with the trade through rules. Markets and their members that choose not to undertake these obligations should not share in the revenues derived from them.

Island does not disseminate quotations for inclusion in the consolidated quote and is not accessible by other markets through national market facilities. Island also receives direct payments from certain CQ/CTA participant markets for trades in listed securities, a portion of which Island has in the past paid to its customers for executing orders in Island. This is an abuse of the revenue sharing provisions of the CQ/CTA Plans, undermines market transparency and best execution of investors' orders, and encourages abusive and potentially fraudulent practices such as wash sales and tape shredding.

Question 13. Your testimony states that some of the ECNs operate as de facto clubs and, in effect, an exchange without the regulation or burdens associated with being an exchange. What should be the regulatory burden for their business as an agency an order matching facility?

Response. ECN order matching facilities, while, in our view, fully within the definition of "exchange" in the 1934 Act and Rule 3b-16 thereunder, shoulder none of the regulatory burdens of other exchanges. Exchanges are subject to a raft of regulatory requirements. Exchanges are obligated to enforce compliance by their members with their rules and the federal securities laws. Amex and other exchanges have spent heavily on technology and incur significant data storage costs in connection with the fulfillment of their obligation to surveil trading in their markets. Not only are these systems very expensive to create, maintain and revise as is frequently needed, but given their necessary limitations, they also require the exchanges to employ large staffs to review the various reports created by them.

In addition to the exchanges' wide-ranging regulatory responsibilities, they also are subject to a number of additional burdensome and costly requirements that are inapplicable to ATSs. Among these additional requirements are obligations to file and obtain Commission approval of rule and system changes, file to adopt, change and even eliminate fees (which must be fair), provide for fair representation of members in the management of exchange affairs, have outside directors on the governing board, dual siting and system redundancy requirements and fair membership access rules. The numerous requirements applicable to exchanges stifle innovation and impede their ability to compete with the less regulated ECN's.

We believe ECN's should be subject to comparable regulatory burdens. If this does not occur, the logical alternative is for other exchanges to be relieved of many of the current regulatory burdens that impact their competitiveness.

Sincerely,

MICHAEL J. RYAN, JR.
General Counsel

cc: Mr. David Cavicke
Mr. William Carty