MARKET STRUCTURE III: THE ROLE OF THE SPECIALIST IN THE EVOLVING MODERN MARKETPLACE

FIELD HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTEREPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

FEBRUARY 20, 2004

Printed for the use of the Committee on Financial Services

Serial No. 108–68

U.S. GOVERNMENT PRINTING OFFICE

93–839 PDF WASHINGTON : 2004

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

HOUSE COMMITTEE ON FINANCIAL SERVICES

MICHAEL G. OXLEY, Ohio, *Chairman*

JAMES A. LEACH, Iowa
DOUG BEREUTER, Nebraska
RICHARD H. BAKER, Louisiana
SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
ROBERT W. NEY, Ohio
SUE W. KELLY, New York, *Vice Chair*
RON PAUL, Texas
PAUL E. GILLMOR, Ohio
JIM RYUN, Kansas
STEVEN C. LaTOURETTE, Ohio
DONALD A. MANZULLO, Illinois
WALTER B. JONES, Jr., North Carolina
DOUG OSE, California
JUDY BIGGERT, Illinois
MARK GREEN, Wisconsin
PATRICK J. TOOMEY, Pennsylvania
CHRISTOPHER SHAYS, Connecticut
JOHN B. SHADEGG, Arizona
VITO FOSSELLA, New York
GARY G. MILLER, California
MELISSA A. HART, Pennsylvania
SHELLEY MOORE CAPITO, West Virginia
PATRICK J. TIBERI, Ohio
MARK R. KENNEDY, Minnesota
TOM FEENEY, Florida
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
TIM MURPHY, Pennsylvania
GINNY BROWN-WAITE, Florida
J. GRESHAM BARRETT, South Carolina
KATHERINE HARRIS, Florida
RICK RENZI, Arizona

BARNEY FRANK, Massachusetts
PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
DARLENE HOOLEY, Oregon
JULIA CARSON, Indiana
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
BARBARA LEE, California
JAY INSLEE, Washington
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
HAROLD E. FORD, Jr., Tennessee
RUBÉN HINOJOSA, Texas
KEN LUCAS, Kentucky
JOSEPH CROWLEY, New York
WM. LACY CLAY, Missouri
STEVE ISRAEL, New York
MIKE ROSS, Arkansas
CAROLYN McCARTHY, New York
JOE BACA, California
JIM MATHESON, Utah
STEPHEN F. LYNCH, Massachusetts
ARTUR DAVIS, Alabama
RAHM EMANUEL, Illinois
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
CHRIS BELL, Texas

BERNARD SANDERS, Vermont

Robert U. Foster, III, *Staff Director*

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

RICHARD H. BAKER, Louisiana, *Chairman*

DOUG OSE, California, *Vice Chairman*
CHRISTOPHER SHAYS, Connecticut
PAUL E. GILLMOR, Ohio
SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
FRANK D. LUCAS, Oklahoma
EDWARD R. ROYCE, California
DONALD A. MANZULLO, Illinois
SUE W. KELLY, New York
ROBERT W. NEY, Ohio
JOHN B. SHADEGG, Arizona
JIM RYUN, Kansas
VITO FOSSELLA, New York,
JUDY BIGGERT, Illinois
MARK GREEN, Wisconsin
GARY G. MILLER, California
PATRICK J. TOOMEY, Pennsylvania
SHELLEY MOORE CAPITO, West Virginia
MELISSA A. HART, Pennsylvania
MARK R. KENNEDY, Minnesota
PATRICK J. TIBERI, Ohio
GINNY BROWN-WAITE, Florida
KATHERINE HARRIS, Florida
RICK RENZI, Arizona

PAUL E. KANJORSKI, Pennsylvania
GARY L. ACKERMAN, New York
DARLENE HOOLEY, Oregon
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
JAY INSLEE, Washington
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
HAROLD E. FORD, JR., Tennessee
RUBÉN HINOJOSA, Texas
KEN LUCAS, Kentucky
JOSEPH CROWLEY, New York
STEVE ISRAEL, New York
MIKE ROSS, Arkansas
WM. LACY CLAY, Missouri
CAROLYN McCARTHY, New York
JOE BACA, California
JIM MATHESON, Utah
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
RAHM EMANUEL, Illinois
DAVID SCOTT, Georgia

CONTENTS

MARKET STRUCTURE III: THE ROLE OF THE SPECIALIST IN THE EVOLVING MODERN MARKETPLACE

Friday, February 20, 2004

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

The subcommittee met, pursuant to call, at 10:00 a.m., in the Auditorium of the Native American Museum, One Bowling Green, New York, New York, Hon. Richard H. Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Kanjorski, Ackerman, Meeks, and McCarthy.

Chairman BAKER. I'd like to call this meeting to order and express my appreciation to Mayor Bloomberg and the great city of New York for making these facilities available to the committee this morning. As usual the reception by your great city has been warm and courteous and we appreciate that very much.

This morning the committee is here to conduct a review of the regulatory environment in which the New York exchange and our capital market currently function. The New York exchange has long been held up as the premier example of how the capital market function could even double. In recent weeks, however, there have been developments that have brought into question many aspects of conduct of the exchange beginning unfortunately with disclosures of the compensation package made available to the chief executive officer on his departure. It also became evident with the discussions of those discomforting facts that the oversight board of the employee compensation and other matters may need to be examined and other matters more closely. The revelations begin to turn in the direction of the adequacy of regulatory oversight of those engaged in fiduciary responsibilities on the floor of the exchange for millions of investors not only in our own country but around the world.

We are here to receive comment with regard to the adequacy of or the need for modification to this regulatory structure. I have recently corresponded with the SEC with regard to taking moves now under consideration with the view that the current rules may in fact constrain competitive opportunity. And it appears to at least cursory examination that individuals may have engaged in actions to enhance their own financial condition at the expense of the uninformed investor class made evident by several recently announced in the newspapers in the city just two days ago. And let me digress as to the obvious need by the Congress to engage in this overview. The Capital Markets Subcommittee of the Financial Services Committee, then congressional terms has only recently been given the responsibility to oversee directly the securities markets. But it is our professional responsibility within the Congress to ensure that we have rules which are fair, that disclosures which are transparent because today there are over 95 million households directly invested in mutual funds alone.

It is one thing in the financial past for the sophisticated investor to deal at arms length with another sophisticated investor. It is another matter when there are those people who do not have the time nor pay the attention necessary to make investment decisions properly that they engage in these activities without the necessary tools or skills to protect their financial interests. Stated another way, it was perhaps okay for Congress to turn its head to the conduct of markets when it was one shark after another. But when the sharks turn their attention to the minnows it's time for the Congress to make sure the minnows know which body of water they are in.

This will not be a one press conference, one bill remedy if remedies are in fact needed. This is the obligation of the Capital Market Subcommittee. It will be an ongoing duty from year to year to ensure that our markets are in fact the broadest, most liquid center of capital market function in the world. That they operate consistent with the highest standards of fiduciary responsibility with sufficient transparency for responsible judgments to be made by all and with significant and prompt responses for those who violate their professional duties.

We are most appreciative of those who are here on the panel this morning to hear their perspectives, and the Committee will carefully consider those recommendations as they are received.

Mr. Kanjorski, for an opening statement.

Mr. KANJORSKI. Mr. Chairman, we meet for the third time in the 108th Congress to review the structure of our capital markets and evaluate the needs for further reforms in light of technological advances and competitive developments. Today's hearing will examine the role of specialists on the New York Stock Exchange and recently announced changes to the Big Board's trading systems.

As I have noted at our previous hearings, a variety of participants in the securities industry have questioned one or more aspects of the regulatory system during the last several years. We have also, without question, come to a crossroads in the securities industry, facing a number of decisions that could fundamentally alter its structure for many years to come.

Because we have elaborately interlocking systems and relationships in our securities markets, however, I believe that we should refrain from pursuing change for change's sake. In our last hearing, the Chairman of the Securities and Exchange Commission further observed that in pursuing any change to fix those portions of the system experiencing genuine strain, we must ensure that we do not disrupt those elements of our markets that are working well.

In the near future, the Commission is expected to put forward for comment a series of proposals that would reshape the structure of our securities markets. In adopting the Securities Act Amendments of 1975, the Congress widely decided to provide the Commission with a broad set of goals and significant flexibility to respond to market-structure issues. From my perspective, this legal framework has worked generally well over the last three decades.

Mr. Chairman, I have made investor protection one of my highest priorities for my work on this Committee. As the Commission proceeds with its reform proposals, it is therefore my expectation that it will thoroughly examine the effects of these plans on average retail investors.

Under our present regulatory system, retail investors are guaranteed the best price that our securities markets have to offer regardless of the location of the trading transaction. By ensuring fair treatment, this best-price guarantee has significantly increased confidence in our securities markets.

Interestingly, some recent news reports have suggested that the Commission may issue a proposal to permit participants in our capital markets to opt out under certain circumstances of this best-price guarantee. Such a plan has the potential to produce unintended consequences like fragmenting our securities markets, decreasing liquidity, and limiting price discovery. Because such results could prove deleterious for small investors, I will be monitoring this issue very closely in the weeks and months ahead.

At our previous hearings on these matters, Mr. Chairman, some have further suggested that specialists are an anachronism in our capital markets. I have a different view. The human involvement of specialists in the trading process can contribute to smooth and efficient functioning of our capital market. Rather than complain about the specialist system, each securities marketplace should, with the appropriate oversight of the Commission, have the freedom to decide for itself the best way to organize the trading operations.

As I have studied the role of the specialist on the New York Stock Exchange, I have also come to appreciate its similarity to the role of legislators in Washington. With today's technology, we could each remain in our district offices and vote on pending bills. It is, however, our interaction with one another in the halls of the Capitol complex and during the debate on the House floor that allows us to improve legislation and get the best deal for our constituents. In the same way, it is the interaction of the specialist with floor brokers and others that should help to produce the best price for investors.

Before I close, Mr. Chairman, I should acknowledge that we are fortunate to have John Thain, the new leader of the New York Stock Exchange, with us today. In the last few weeks, he has announced several important reforms, including one to significantly expand the Big Board's automatic trading platform and another to restrict specialists from participating in certain trades. As the Commission proceeds in its market-structure deliberations, I hope that it will follow a prudent course of action and allow sufficient time for the effective implementation of these recently announced changes before creating greater uncertainty with respect to reforming our National Market System.

In sum, Mr. Chairman, I believe that our panel must continue to conduct vigorous oversight of the securities industry to determine whether its regulatory structure is working as intended, and to examine how we should make it stronger. The observations of today's witnesses about these complex matters will also help us to discern how we can maintain the efficiency, effectiveness and competitiveness of our Nation's capital markets into the foreseeable future.

Thank you.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 52 in the appendix.]

Chairman BAKER. Thank the gentleman for his statement.

Mr. Ackerman?

Mr. ACKERMAN. Thank you very much.

Good morning, Chairman Baker, Ranking Member Kanjorski. I would like to take a moment to welcome you to New York, yet again. This city is not just great, but as you might have noticed, it is also quite big. We have more of anything than anybody else has.

New York is the home of the greatest financial markets in the world. We employ more than 110,000 people in our financial industry in addition to having 20 of the top 25 foreign branches of international banks, 8 of the world's 10 top security firms. We also have more Irish than Limerick and Cork, more Italians than Genoa, more Haitians than Port-au-Prince, more Muslims than Mecca, more Jews than Jerusalem, more gentlemen than Verona and more barbers than Seville.

That being said, we thank you for the opportunity to hear today from the distinguished panelists on the issues that are so important to our capital markets. Each panelist has a unique insight into our markets, and I am interested in hearing their perspective on the costs and benefits to investors of the continuation of the trade through rule, the role of the specialists in today's market and increasing technologically advanced and yet uncertain times and the outlook of the future of the capital markets. I am particularly interested in what effect any proposed changes would have on New York, it's capital markets and its people.

As times and technology changes, I think it is wise to examine the processes used to make sure that we are providing the best opportunities and protections for investors.

Again, I appreciate being here. Appreciate having such distinguished panelists before us. And thank you, Mr. Chairman and Mr. Kanjorski for conducting this hearing.

Chairman BAKER. I thank the gentleman. He should have included one more little enumeration only, he should have included more gold than Texas. But that would have been perhaps a little more than necessary.

Mr. Meeks, you are recognized.

Mr. MEEKS. And more bears.

Thank you, Mr. Chairman, and it is good to have you in New York, and Mr. Kanjorski, the ranking member, good to have you here.

The financial markets are one of America's great strengths, especially in this city, the city that I call home and been born and raised in; my city, New York.

In the most recent economic boom of the late 1990's, as Wall Street went, so went New York's economy. And as New York's economy went, so went the U.S. economy.

The New York Stock Exchange is the granddaddy of the capital markets. Constantly reinventing itself to keep pace with the needs of ever more demanding and sophisticated investors.

The electronic communication networks are the new kids on the block, maximizing the use of remote technology to serve their customers and help many newly public companies raise critical expansion capital. The competition among these different entities is welcomed and desired because in a free market society the advantage of competition is higher quality, more efficient services for customers.

As members of Congress, we ask ourselves what is our role and the role of the regulatory agencies in this great free market process. I say it is a balancing act of protecting investors' interests, ensuring fair play and knowing when you just stay the heck out of the way.

The question that we are seeking to answer is where does the trade through rule fit in the balancing act? Some say we should eliminate it. Others say maintain the status quo, or perhaps we should expand it beyond the New York Stock Exchange listed stocks. The right answer, in my opinion, is probably what works best for investors; big and small.

I look forward to hearing most of the hearing today from all of our panelists, particularly the new CEO at the New York Stock Exchange. We welcome you here. And all of the CEOs from the ECNs and other current companies. As long as you all keep creating jobs and making the city money, you will have my continued support.

Thank you.

Chairman BAKER. Thank you, Mr. Meeks.

Ms. McCarthy?

Ms. MCCARTHY. Thank you, Mr. Chairman.

As which is always been my habit, I will hand you my opening statement. I would prefer hearing from those that are waiting. I apologize for being late, but I had to give a speech at 8:00 this morning, and that could not be changed.

Though, I am happy you are in New York. As you can see we need some money for restructure of our cities and our streets, and I hope you will vote with us when the bill comes up. But welcome to New York.

Chairman BAKER. Thank you so much.

This morning I would like to proceed——

Mr. KANJORSKI. Mr. Chairman?

Chairman BAKER. Mr. Kanjorski?

Mr. KANJORSKI. Could I suggest, I have done a count of the Committee here.

Chairman BAKER. Yes.

Mr. KANJORSKI. And it is proper under the rules for us to put a nomination of the new chairman. I think we out number you, Chairman.

Chairman BAKER. We will certainly take that under advisement. Let us see how it goes and I may be happy to hand over the reins.

Mr. ACKERMAN. Some of us New Yorkers are open to a deal, Mr. Chairman.

Chairman BAKER. Well, I am from Louisiana, and that's music to my ears.

Let me again express my appreciation to our distinguished list of panelists representing broad perspectives and enormous skill and knowledge of the function of our markets.

As is the usual custom, your statements will be made a part of our official record. To the extent possible, if remarks can be limited to five minutes each, it will enable the members of the Committee then to engage in questions to obtain information that would be helpful to Committee considerations.

With that in mind, I would first welcome to give his testimony, Mr. Gerald D. Putnam, Chairman and Chief Executive Officer of Archipelago Holdings.

Welcome, Mr. Putnam.

STATEMENT OF GERALD D. PUTNAM, CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF ARCHIPELAGO HOLDINGS

Mr. PUTNAM. Good morning, Chairman Baker, Ranking Member Kanjorski and other distinguished members of the Subcommittee.

I am Jerry Putnam, the CEO of The Archipelago Exchange or "ArcaEx." And it is a privilege to be here this morning to provide my testimony.

Something that is pretty unusual for us, we do not really have a strong opinion on whether the specialist system has a role in the evolving marketplace. We feel very strongly that the specialists have the right to conduct their business and the New York Stock Exchange has the right to promote that market structure. Because ultimately competition, if we have a fair and level playing field among competing marketplaces, customers and market participants, will ultimately decide on which system that they favor. And the specialist system in New York is either going to live or die by the vote of its customers.

The real issue is the anti-competitive rules that bind the intermarket trading system and protect the interests of various competitors. This has been a big problem with the New York Stock Exchange, and a problem for us over the years. And I would like to cite a couple of examples, and you are all familiar with these.

One of the best is Rule 390, which was a prohibition on off-board trading by New York Stock Exchange members. So if you chose to trade someplace else, you were not allowed to. And as an industry we held our nose over that rule for about 15 years until it was finally regulated out of existence by the New York Stock Exchange.

Another important rule is Rule 500. This was a prohibition on New York listed companies who later chose to list on another trading venue from actually doing that. And recently Rule 500 was abolished. NASDAQ was a huge leader in this fight, because they were obviously a major beneficiary of a potential delisting of a New York company stock and onto Nasdaq.

We went along. Obviously with Nasdaq. We didn't have a stake in the issuers game at the time. But we certainly supported the elimination of any anti-competitive rule that was a barrier to competition among those of us competing in the marketplace.

The final one I will cite is the trade through rule. And you are real well versed on the trade through rule at this point. But I think somebody who works for me, I think has really summed up what it means, the trade through rule, in our current market structure. And what it boils down to is—I mean it sounds to everyone that the best price is certainly what you want to achieve. And we want to achieve best price for our traders on our exchange. And New York wants to achieve the same for its customers. But the New York price has historically not been a best price, but a maybe price. It is an indication of where New York specialists may be willing to conduct a trade, but not necessarily a firm quote.

And it is interesting, actually I should say curious, that along the way depending on the trade, New York has either been the biggest defender of the trade through rule or the biggest offender of the trade through rule.

This week we had—and you all know about it, because I have talked about this many times before, the infamous ITS Committee. And we had one of those meetings this week out in California. And at that meeting a lot of conversations about New York's new electronic interface it is going to provide to its customers was discussed, but our interest was mainly in what kind of an interface are you going to provide to your competitors. Because the barriers, like trade through and maybe price is definitely affected by that linkage. And to our disappointment, we were told that New York has no intention of linking the ITS system up to its direct plus system, which means customers in New York can get an electronic execution, but if you are a competitor, you stand in line, you wait just like we do today for an execution.

The second disappointment was we have had a promise that has gone about nine months now. New York, you know there is an issue with trade groups and New York promised us in the first quarter a software solution that would prevent its specialists from trading through better prices elsewhere. So the Exchange itself would generate a commitment, ship it off to an away market, us in my example, and they would deliver fill back to the specialists. What we heard this week was, you know what, we are really busy with Direct+, that is software that prevents a trade through, maybe 2005, maybe 2006.

So what we are hearing at the headline level is electronic executions, what is really happening beneath the surface is that New York is trying to defend the old model, which is use trade through when you want it and avoid it when it does not suit your interests.

Another situation that occurred just in the last couple of weeks. This is just the most incredible thing that I have seen in the 7 years that I have been doing this.

NASDAQ has recently introduced its version of Rule 500, a prohibition on listing on another exchange. And let me explain to you how this works.

NASDAQ has an index. It's called the NASDAQ 100. And that index is comprised of the 100 largest companies that trade on NASDAQ. NASDAQ also has a product known as the Triple Qs, which is a security that is intended to track that index. And the way this works is investors come in and buy QQQ, give their money to a trust and the trust goes out and buys the company's actual stock in the NASDAQ 100. It is a great benefit, right? You get into the 100. Investors buy the QQQs. NASDAQ goes out and buys your stock with the trust.

They made a change to the document that governs eligibility to being in the NASDAQ 100. And they did this on January 30th, effective January 1st. And they changed one word in one sentence describing eligibility. And it changed from you need to be on NASDAQ to be eligible to be in the NASDAQ 100 to saying "You need to be exclusively listed on NASDAQ to be eligible for the NASDAQ 100."

What that means is if you choose to duly list your security on another exchange, NASDAQ will remove you from the index and dump millions of your shares on the open market. What company would ever choose to list on another exchange and have that happen?

Now, I want to quote something here from a brochure that NASDAQ made available to potential listers. And it is called The NASDAQ Dual Listing Guide: The Power of Choice. And here it says make a choice to dual list for the benefit of your company and your investors. Now who on earth could say that and then provide a rule that would create an index requirement that basically says if you do what we think is good for New York Stock Exchange companies and you are a NASDAQ 100 company or you want to be, we are going to dump millions of your shares on the market on a single day? It is a prohibition to dual listing and it is a disgrace.

Now knowing I was going to come in here and talk about this, I wanted to give NASDAQ the benefit of the doubt. So we contacted them and said, "Guys, you did not mean that word "exclusive?" I mean, you could not possibly have fought the Rule 400 or against Rule 500 all of these years and put the word exclusive in there." And there is a simple solution. What you need to say is instead of exclusive, say primary. And what primary does is preserve the value of the NASDAQ 100 because primary means this is where your stock trades, you are primarily listed here. Exclusive means if you choose a competing model like the New York Stock Exchange or ArcaEx to list your stock, you are out, we are going to dump your stock. No CEO or CFO would ever agree to do that. So this is effectively a Rule 500. And we were very disappointed to hear from an NASDAQ official that when we said, you know what, guys, it is Rule 500. They said New York got theirs for 15 years, now it's our turn.

I guess I would like to conclude with a final remark. You have to remove barriers to competition so markets can evolve. We do not have to worry about whether specialists are going to evolve. But if there is fair, open level playing fields markets will evolve. And ultimately, that is what is going to serve investors and that is what is going to serve issuers.

Thank you very much.

[The prepared statement of Gerald D. Putnam can be found on page 79 in the appendix.]

Chairman BAKER. Thank you.

Our next witness is Mr. John A. Thain, Chief Executive Officer of the New York Stock Exchange. We certainly welcome you here this morning, Mr. Thain. We know the transitions the Exchange has been engaged in in recent months have been broad and meaningful, and I know to a great extent your leadership has been a contributor to those efforts. So welcome.

STATEMENT OF JOHN A. THAIN, CHIEF EXECUTIVE OFFICER OF THE NEW YORK STOCK EXCHANGE, INC.

Mr. THAIN. Thank you. Good morning, Mr. Chairman, Congressman Kanjorski, Congressman Ackerman, Congressman Meeks in absentia and Congresswoman McCarthy. It is good to see you this morning.

Thank you for inviting me to testify this morning. But also thank you particularly for coming to New York and for coming to lower Manhattan. Those of us who work in lower Manhattan appreciate the show of support to come to the financial district.

I'd like to start my comments just giving you a little bit of overview of my thoughts after the first five weeks on the job. The first comment I would make is the New York Stock Exchange is a great American institution. And I am very proud to have been offered the opportunity to be the CEO and serve the Exchange.

It is also a fundamental part of the U.S. financial system. And I think it is a leading component of what makes the U.S. financial markets the most robust markets in the world.

I would also like to put on the record a thank you to John Reed, who I think has done an excellent job of restructuring the governance of the New York Stock Exchange and beginning the process of rebuilding and restoring the credibility of the Exchange.

Now in the first five weeks I have focused first on our customers, and I have spent time with listed companies and various institutions listening to their concerns and comments. I have also spent a lot of time with the members, both the specialists and the brokers. And I have obviously spent a lot of time with the employees.

And I am pleased to report that although there is much to do, the New York Stock Exchange and the agency-auction model is, I believe, fundamentally sound. And it does, in fact, offer investors the best prices over 90 percent of the time. It offers the most liquidity and it is the most efficient venue to buy and sell stocks in this country, and for that matter in most countries in the world.

Now, there are a set of changes that have been referred to already which I want to just cover. And those changes are really derived from listening to our clients and trying to be responsive to our clients.

One of the comments I heard was listed companies were concerned about the performance of their specialist and they wanted to be able to change their specialist if they were unhappy with that performance. And we have now made that much easier for companies to do.

We also have to develop a better set of metrics so that we can actually measure what is good performance on the part of specialists.

A second rule change that we have applied for will allow that customers always come first. There were certain circumstances where specialists were allowed to trade alongside customers. We are in the process of eliminating that so our customers have always the right to trade first before our specialists.

And the third set of changes has to do with the ability of customers to execute trades on the Floor of the Exchange electronically. One of the comments that I heard, particularly from large institutional customers, was that they wanted a higher speed, a higher degree of certainty and an anonymous form of execution. And although the Exchange has an electronic execution mechanism called Direct+ which allows for sub one second execution, it had both timing and size restrictions that made it unattractive to large financial institutions to use. So we are in the process of removing those timing and size restrictions so that in fact if institutions or individuals want, they can execute trades electronically, quickly, anonymously and be competitive within any marketplace in the world. They will, of course, still be able to choose price improvement if they desire.

I also want to comment for a moment on competition. And there has been commentary in the press and other places about the New York Stock Exchange having a monopoly. That is simply not true. The New York Stock Exchange has very good and very tough competitors, many of which are on this table here today. The New York Stock Exchange trades about 80 percent of the volume in its listed securities. That means that 20 percent of the trades trade away; again, many of those trade on the various different ECNs and exchanges are listed here.

Also, if you look at the best bid and ask spread, the best bid/best offer, you have seen a tremendous contraction over the last 12 months where for the S&P 100 stocks, those listed on the Exchange, you have seen the spread contract from five cents to two cents, which obviously benefits investors.

Now, although the New York Stock Exchange does have the best price 93 percent of the time, if customers want to, they can trade away. And if they want to execute in a different way than the New York Stock Exchange offers, they have the right to do that, and they do. So there is no question, I believe, that the New York Stock Exchange has a tremendous amount of competition and we do have to be responsive to our customers to allow them to execute in the way that they choose or they will in fact trade away.

I just want to cover briefly the role of specialists. The specialists along with the Floor brokers are the ones who really facilitate the competition between buyers and sellers which ultimately leads to the best price.

The specialist also reduces intra-day volatility. And the best proof of that is if you look at companies that move from NASDAQ, where there is not a specialist, to the Floor of the Exchange. There are about 39 stocks that have moved over a 15 month period. You see intra-day volatility in those stocks has been cut in half.

Specialists also provide liquidity, bridging the gaps between buyers and sellers. And the specialist also manages imbalances and sometimes commits their own capital when they do that.

The specialist helps to establish a fair market price on opens and closes. And I think this is a particular strength of the Exchange.

You know, I was on the Floor of the Exchange the morning that Comcast announced its hostile bid for Disney. And as we worked to get the stock open, the specialist was balancing about 5 million shares, of buys and sells and balancing those orders to come up with a fair price for both the buyers and the sellers. That is not something that can happen in an electronic marketplace.

I am pleased that there has been a settlement of the specialist investigation. I am confident that the new systems and procedures that we put in place will prevent these types of abuses from occurring. I think that it is in the best interest of the Exchange that we move forward. There is no question that there were abuses and I think that those are being suitably dealt with.

On the trade-through rule specifically, the trade-through rule is one of the mechanisms that guarantees that investors get the best price. Now, I am sympathetic to the concerns on the part of institutions who say where there are dramatically different execution speeds, that price is not the only important thing. But if competing markets offer comparable execution capabilities, then the best price has to be what prevails.

Who is harmed if you trade through a better price? Well, first obviously the investor who either paid too much or sold too cheaply. But also, and this is actually what the trade-through rule was meant to protect, it is the investor who had a better bid or who had a lower offer who did not get traded with.

Also, trade-throughs undermine the process of price discovery and undermine confidence in the quoted market prices, because obviously those prices are not the best prices. And market liquidity will suffer over time if buyers and sellers who have the best bids or the best offers on the books are not executed on, they will then stop doing that.

There has also been talk about a de minimus exemption. And in today's market of pennies, I do not think there is anything de minimus about two or three cents a share. We trade on the New York Stock Exchange about 1.7 billion shares a day. And two or three cents a share worse execution quickly adds up to billions of dollars. So I think it is very important when we are talking about the trade-through rule that all investors, big or small, sharks or minnows, should get the best price. Anything less, I think, undermines confidence in the markets.

So, in conclusion, I am committed to helping to rebuild the reputation of the New York Stock Exchange and investor confidence in the marketplace overall. I am also committed to making sure the New York Stock Exchange is in fact more responsive to its clients. And I am committed to providing buyers and sellers of stocks the absolute best price. And I am certainly willing and committed to working with you, Mr. Chairman and your Committee, on these important topics as you deliberate on the structure of the marketplace.

Thank you.

[The prepared statement of John A. Thain can be found on page 117 in the appendix.]

Chairman BAKER. Thank you, Mr. Thain. We appreciate your participation.

Our next witness is Mr. Edward J. Nicoll, Chief Executive Officer, Instinct Group Incorporated.

Welcome, sir.

STATEMENT OF EDWARD J. NICOLL, CHIEF EXECUTIVE OFFICER, INSTINCT GROUP INCORPORATED

Mr. NICOLL. Thank you. Thank you, Chairman Baker and members of the Subcommittee. Thanks for holding this hearing and for inviting me to speak before you.

Today I would like to make three brief but important points. First, it is time to eliminate barriers to competition with the New York Stock Exchange monopoly.

Second, if the New York Stock Exchange continues to advocate a market structure that puts specialists in a privileged trading position even after recent revelations that they have abused that privilege, then we should at the very least demand greater disclosures of specialist trading positions and activity.

And third, if NYSE wants to claim the benefits of electronic markets, we should insist that it adopt the principles of transparency and immediacy that are fundamental to electronic markets.

As you look into the role of the specialist system and the regulations that keep it in place, I would encourage you to support regulatory changes that allow electronic markets to compete on a level playing field with manual Floor based markets. The most significant impediment, of course, is the trade-through rule. Media reports and the hard work of many in this room have educated most legislators and regulators on why the trade-through rule in fact hinders competition and hurts investors. And the chorus calling for the rule's reform continues to grow:

In October 2003, the Wall Street Journal published an editorial calling the abolition of the rule.

In January 2004, California State Controller Steve Blestly, a Democrat whose oversees billions of dollars invested on behalf of California retirees, wrote to Chairman Donaldson that "the trade-through provision is obsolete" and "reforming trade-through will improve investor choice."

Just last week, Florida Attorney General Charlie Crist, a Republican who also sees his State's retirement investments, wrote Chairman Donaldson that "elimination of the trade-through rule would abolish this antiquated system. Progressive reform would ensure Florida's investors access to a competitive marketplace, prevent manipulation, and guarantee securities are bought and sold at the true best price."

And of course, Mr. Chairman, your leadership on this issue is well known. However, there are still opponents to trade-through reform. They argue that without a rule, investors would not get the best price. But as you heard in last fall's testimony by numerous experts, this is simply not the case. Brokers still have a fiduciary duty to secure best execution for their clients, but best execution does not and should not mean attempting to execute against the best-advertised price without considering other factors.

The debate about trade-through is really a debate about whether one market structure fits all or whether investors should be free to choose how and where they trade. It's about competition.

The NYSE's prestige may make some reluctance to submit it to the competitive forces of the marketplace. They want to preserve the monopoly status of the specialists because they claim the specialist helps to maintain a "fair and orderly market." But they offer little proof to support that claim.

We do not really know whether the specialists trade in a way to maintain fair and orderly markets or whether they trade in a way to maximize their own profits at the expense of others. In fact, recent headlines seem to suggest the latter. But this is too important an issue to leave to either apologists of the status quo or headline writers. Thus, I challenge the New York Stock Exchange to make all specialist trading activity publicly available. Trades where specialists participate accompanied by their trading position at that time should be promptly disclosed so market participants, academics and policymakers can better evaluate specialists' trading activity.

Today when investors complain about an execution, they cannot obtain sufficient data to evaluate the propriety of the specialist's activity. Without a real time audit trail, they have little insight into the NYSE's trading process and less confidence that their orders receive fair treatment.

Lastly, the NYSE has recently responded to investor complaints by updating Direct+. With great fanfare, the NYSE recently submitted rule changes to the SEC that would at least in theory make it easier to obtain automatic executions via Direct+. In fact, the NYSE now boasts that Direct+ will provide "ECN-like" features to investors. But let's look at how Direct+ will really operate.

While it may provide some automatic executions, there will be some pretty substantial exceptions. One exception is that there is no obligation to automatically execute an order if the quote is in "non-firm" mode. How often does the NYSE publish quotes that are non-firm? Again, there is not much transparency into how the specialist operates its book.

Another exception is that automatic execution is not available when the market is only for 100 shares. I am told this is frequently around 10 to 20 percent of the trading day. While this does not sound like much, it is likely that 10 to 20 percent of the trading day occurs at moments when the market is volatile and receiving an automated execution is most valuable.

A further exception is that auto execution is only available against the orders composing the NYSE's quoted market, and not the usually substantially amount of trading interest available at a penny or more behind it. And once the interest at the NYSE's quote is exhausted, Direct+ is unavailable until the specialist displays a new quote.

In sum, it seems the NYSE is guaranteeing an automatic execution except when it is not, which may be often. Not much of a guarantee.

In contrast to the NYSE, every order on an ECN is real and immediately accessible. It is not possible to display an order that is non-firm. There are no delays and no turning off the automated nature of ECNs. Further, every order sent to an ECN for display is immediately displayed. No delays, no freezing and no manual keystrokes from a clerk. That is why I am surprised that the NYSE would even try to compare itself to an ECN.

If they truly want to offer an automated execution system that competes with ECNs, I challenge the New York Stock Exchange to make two additional changes:

First, immediately display all limit orders received electronically for display; no delays, no human intervention, and no exceptions.

Second, immediately execute all matching orders that are received electronically; no delays, no human intervention, no exceptions.

These two changes would be a start in making the NYSE into a fair 'ECN-like" marketplace.

In conclusion, over the past months, NYSE has desperately tried to perpetuate the current regulatory structure by asserting that it's market model is superior. I do not believe that the NYSE provides sufficient data to adequately evaluate that assertion. I also believe that the changes that the NYSE is making to Direct+ will have little impact on investors. Regardless of these changes, there is still a need for unleashing competition between markets. Certainly if the NYSE is stirred to propose these changes to simply stave off the threat of competition, actual competition will produce even greater benefits for investors.

Clearly, Mr. Chairman, the time for reform is now.

Thank you.

[The prepared statement of Edward J. Nicoll can be found on page 73 in the appendix.]

Chairman BAKER. Thank you very much.

Next witness to speak is Mr. Robert H. McCooey, Jr., President and Chief Executive Officer of The Griswold Company.

Welcome, sir.

STATEMENT OF ROBERT H. MCCOOEY, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER OF THE GRISWOLD COMPANY

Mr. MCCOOEY. Good morning, Chairman Baker, Ranking Member Kanjorski and members of the Subcommittee.

Excuse my laryngitis.

My name is Robert McCooey and I am proud member of the New York Stock Exchange and President and Chief Executive Officer of The Griswold Company, a member firm. Griswold is an agency broker working for institutional clients on the Floor of the New York Stock Exchange. I'm a practitioner. As an agency broker, we execute trades on behalf of our customers. We do not make markets in securities or engage in proprietary trading. Our clients include some of the largest mutual and pension funds in the United States.

Thank you for inviting me here to testify in connection with your review of the capital market structure in the United States. I would like to commend the Chairman for his choice of New York City, the center of global capital markets, as the site for this hearing. New Yorkers take great pride in our city. We have clearly worked hard to achieve this status, one that is the envy of our international competitors.

Chairman Baker, I am also very pleased that you have chosen my new partner at the New York Stock Exchange, John Thain, to address the Committee today. Five weeks ago, John joined an organization that was desperate for new leadership to implement previously announced changes and to address important customer needs.

What John has accomplished in just this short period of time coupled with the work of interim Chairman John Reed is nothing short of remarkable. I think it is clear to all that there has been a dramatic change at the New York Stock Exchange. The membership is hopeful that regulators and legislators will support these changes for the continued benefit of all the users of our institution.

The discussions we will engage in today should focus on how we should enhance the National Market System for the benefit of all investors. In that vein, we should promote the aspects of the current National Market System to provide positive results in the execution of investors' orders. I would contend that the agency-auction market at the New York Stock Exchange is one of those important competitive aspects. The specialist, the focus of today's hearings, plays a vital role in that system.

The topic of today's hearing is to identify that role the specialist will play as the markets continue to change. As an agent on the Floor of the stock exchange I've seen that role evolve over the past 16 years. A fundamental principle is to place the interest of the customer first and provide each customer the best experience trading at the New York Stock Exchange. The specific value that accrues to investors can be broken down into two major categories: information flow as an important part of the specialist catalyst function and liquidity provides to the marketplace.

As I speak to my customers about multiple marketplaces in which they trade, one theme about the NYSE is consistently voiced. Customers appreciate the fact that the Floor-based NYSE provides participants in that market with valuable information that aids buyers and sellers in making market entry and exit decisions. Through this information flow specialists act as catalysts for actively bringing together buyers and sellers, thus creating trades that otherwise would not have occurred.

Responding to a buyer, for example, a specialist may recall selling interests on the part of a particular agent and then call that agent into the crowd to help effect a trade. This happens within seconds. The buyer can then negotiate directly with the agent representing the seller. This results in natural buyers meeting natural sellers almost 90 percent of the time with minimal market impact. Without the specialist as the catalyst for providing that information, the trade may have occurred at the wrong price or worse, never have happened at all. This kind of information flow is impossible in electronic markets. Furthermore, the information gathered from the specialist at the point of sale is available impartially to all who ask.

The second and equally important function to customers is the liquidity that the accountable specialist adds to the marketplace. It is important to remember that specialists do not set the price for stocks. At the New York Stock Exchange, that pricing function is reserved for the buyers and the sellers. The important role of the specialist is to provide the liquidity necessary to the market to assist agents in getting orders executed correctly for their clients. What specialists do is risk their capital, in excess of $11 billion on a daily trading day, to add market depth and stabilize prices. They inject liquidity by bridging temporary gaps in supply and demand. Each of these trades for the specialist is a one-sided risk transaction. The best method for me to explain is to give you an example.

With a market $28 bid for 25,000 shares and 18,000 offered at $28.05. My customer entrusts me with an order to buy 25,000 shares. My goal is always get that order executed at the best possible price with minimal market impact. I want to purchase my stock at $28.05, but there is only 18,000 shares offered. The only way for this to happen is to have the specialist add the necessary liquidity. Sell that 7,000 shares to complete my client's order. In the absence of the specialist, my natural buyer would have to reach to the next price point where liquidity is available to purchase those shares. For the sake of the argument, let us assume that the customer had to pay $28.10 to purchase the shares. Without that capital it would cost that customer $350. That may seem like a very small amount but multiple those savings by the thousands of times that happens daily on the New York Stock Exchange and the millions of dollars adds up very quickly.

Contrast that with an ECN. It is true that if two orders reside in an ECN system match, the computer can execute that trade instantaneously. But because ECNs are passive, order driven systems in which orders wait on the ECN book until a matching order arrives. In the absence a contra side the order is sitting on a park bench waiting for it to go. There is no obligation on the part of market makers on NASDAQ to provide for a fair and orderly market. No rule that forces them to buy or sell at any price, no matter how far the security has moved from its previous price.

A perfect example of this occurred last week, the infamous stock of Imclone. Absent any news and in just three minutes the stock dropped more than 20 percent, from 42 to 33.50 on no news before it was faulted. Reviewing these trades paint a picture of a stock that was in free fall where 100 share lots declined the stock by a dollar or more. Where were the NASDAQ market makers? Mr. Greifeld's written where it claims 300 market makers who were willing to commit capital to help with the execution of buy and sell orders. In this example, how were those investors well served by those NASDAQ market makers.

Therein lies the difference between markets and goes to the heart of why we are here today. At the New York Stock Exchange specialists have an obligation to investors to provide that fair and orderly market, cushioning moves between price points for investors. There is no such obligation in other market models. Their market makers can simply decide when they want to participate and when they do not.

The trade-through rule was designed to convert multiple marketplaces in to a National Market System. The rule turns each market into a gateway to ever other market and ensures that investors will not be disadvantaged by the virtue of having bids and offers displayed in one venue versus another.

I will not go through my example that I previously put on the record back in October, but John Thain went through very clearly the fact that multiple people, buyers, sellers getting wrong prices is a reason why we should protect and maintain the trade-through rule. Investors are ignored when we have a trade-through rule.

One of the major factors that draws companies to the New York Stock Exchange is the incontrovertible fact that reduced volatility after a stock has moved from NASDAQ to the New York Stock Exchange. Management and boards of directors realize that tightening of spreads and minimizing trade to trade volatility are serving their shareholders, your constituents best interests. A key factor in why this occurs is the accountable specialist. The liquidity the specialist adds to the market on a moment to moment basis prevents stocks from declining or advancing too quickly. Volatility scares investors and therefore has an impact on the capital raising process for many firms. The dampening of volatility by a specialist give confidence to the investor that there will always be a continuous two-sided market in that security. Trading that occurs outside of the NBBO will effect volatility, it will increase it in these issues and adversely affect those investment decisions.

Modifying or eliminating the trade-through rule would produce inferior prices and increase costs, increase market volatility, reduce accountability and transparency. These added costs and negative impacts to the market would have dramatic harmful effects on your constituents' accounts. This is not the way we want to promote investor trust and confidence.

The role of specialists and that of the Floor broker, for that matter, will continue evolve. At the New York Stock Exchange we embrace change. Providing choices to our customers has been the hallmark of the New York Stock Exchange for as long as I have been a member and we are again addressing the news of our customers who have asked us for more choice.

Two weeks ago our board passed on significant structural proposals sent to the SEC for final approval. Briefly the plan calls for automatic execution of all displayed liquidity To enhance the product, we have proposed removal of prior restrictions to our Direct+ and this will allow execution choice for 87 percent of the orders that are entered in our marketplace for a one second execution, thus disposing of the issue of the New York Stock Exchange as a slower market. We are going to trade a 100 million shares in this manner today. Within our price discovery dynamic we will preserve the role of the specialist and bring the buyers and sellers together, committing capital to dampen volatility and the contribution of agency Floor brokers who will reduce market impact and execution costs for institutional size orders.

Mr. Chairman, I must say that I am very disappointed in the way this debate, not today but in general, has progressed. Competitors, some of who have garnered over 10 percent of the New York Stock Exchange volume on a daily basis, have resorted to the use of media driven buzz words to describe the New York Stock Exchange. Others complain about what I do as a Floor broker as I diligently work in my fiduciary capacity to produce the best results for my client on each and ever order. I do not think that those who employ different execution models should attempt to eliminate other models that their competitors find very effective.

Moreover, some techniques employed by a Floor broker in filing his customer's orders exist in electronic markets, too. They just go by fancy names like Egging and Reserve Book.

Finally, I would like to refocus our debate on the end result: Creating market models that benefit investors. Mr. Chairman, this is not a debate about diet coke or milk or ice cream, none of which I believe the Subcommittee has any jurisdiction over. What we ought to debate about is best price, something we have delivered at the New York Stock Exchange for 200 years and will continue to deliver everyday going forward. At the New York Stock Exchange we will continue to change, adapt and innovate to serve our customers' needs and for fulfill our commitment to producing the highest level of market quality. We will continue to provide a fair and level playing field for investors, something that they expect of us. We will compete on the basis of discovering price and delivering it coupled with the highest levels of transparency. The interaction between specialist and agency Floor brokers creates a value proposition at the New York Stock Exchange that delivers to customers the best prices, the deepest liquidity, the narrowest spreads and the lowest volatility. This results in multi million dollars of savings to your constituents each and every year. In all that we do we take pride in the fact that we always place the investor first.

Thank you, sir.

[The prepared statement of Robert H. McCooey Jr. can be found on page 61 in the appendix.]

Chairman BAKER. Our next witness is Mr. Robert Greifeld, President and Chief Executive Officer of the NasDaq Stock Market, Inc. Welcome.

STATEMENT OF ROBERT GREIFELD, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF THE NASDAQ STOCK MARKET, INC.

Mr. GREIFELD. Thank you, Chairman Baker. I am proud to be here today. And I like to thank Ranking Member Kanjorski and other members of the panel for this invitation.

NASDAQ is a New York based company. Through NASDAQ and the National Association of Security Dealers we collectively employ over 500 people in New York. In addition, NASDAQ supports 2500 employees who directly work on NASDAQ listed tradings here in the city. These include market makers and order entry firms.

The subject of today's hearing is the role of the specialist in the evolving modern marketplace. But we cannot separate the market structure debate from the specialist settlement announced just this week. The $240 million settlement with five specialist firms is an outward symptom of an organizational problem at the New York Stock Exchange and an organizational failure at the Stock Exchange because its regulatory structure when it was unable to proactively address the issue of specialist trading ahead of investors.

Now, this large settlement may make us feel good, but it does not in fact solve the problem. Let us examine the failures and the root cause.

The overriding principle that we must hold foremost in our mind is that we are entrusted with the protection of investors' interests. Our markets must have this as a guiding philosophy. The New

York Stock Exchange did not protect investors as the settlement makes clear, and the failure to protect investors and the continuing failure that is harming investors today reveals a structural flaw in their market structure.

The monopoly specialist system of the New York Stock Exchange allowed these intermediaries to put their profit interests ahead of investors. The trade-through rule isolated these intermediaries, these monopolists from competition. History shows us that absolute power will corrupt. If they did not have this absolute power, they would not have been in this position to harm investors.

The fundamental flaw in the New York Stock Exchange model is there is a lack of intra-market competition and the outdated protectionist rule such as trade-through prevent intra-market competition. This result has not been positive.

We have heard of the New York Stock Exchange plans to introduce reforms into their market. As we listened to the press conference we said we have to pay attention to the details. The devils are in the details. It did not take us long for the details to see how transparent and shallow this attempt is. And I quote from their proposal which they have filed to the Securities and Exchange Commission. "An auto-X order shall receive an immediate automatic execution against orders reflected in the Exchange's public quotation and shall be immediately reported as New York Stock Exchange transactions." That's the good part. One caveat: "Unless with respect to a single sided auto-X order the New York Stock Exchange published bidder offer is a 100 shares." In other words, the specialist can turn off auto-X for 10 shares. When he does that, they are operating in the same manner that has resulted in this $240 million penalty.

But, if the Stock Exchange chooses to pursue this approach, truly I believe it is their business. They should have the ability to dictate the market structure that they deem appropriate for themselves. If they believe a monoplus controlled market structure that pays lip service to electronics is best for the Stock Exchange, they should be permitted to adopt that policy. But, we have to be clear. The competition has to be in place. If you have competition in place, if you have intra-market competition, then the New York Stock Exchange's structure will be resolved through competitive measures. We will not have to read the details in this sort of electronic release. Competition will ensure that that 100 share rule and others like it disappear.

Investors know that, and investors have spoken. Institutions, pension funds like CalPERS and the elected public officials and investor advocates like the Attorney General of the State of Florida and the Comptroller of the State of California all believe the trade-through rule has outlived is usefulness and is preventing competition.

How can you argue as a public policy matter that investors cannot have choice that they cannot seek the best deal as they define it for themselves?

As we think about the repeal of trade-through, we certainly have to be concerned about what that will mean for the U.S. markets. We are not talking about Coca Cola, we are not talking about milk, we are talking about something that is incredibly important. But the interesting thing is NASDAQ is the case study for competition. We do not have a trade-through rule in the NASDAQ marketplace today, and we have never had one. So what is the results? Let us look at it.

The SEC several years ago mandated something that we know as the Dash 5, and it measures the actual performance of the markets. What I have for you today is data that comes from this SEC mandated program.

We also wanted to pick data that made sense that was clear and objective. So we picked indices in this country. One is S&P 50 stocks, the large cap stocks. In the large cap stocks NASDAQ has an effective spread of 1.2 seconds. New York Stock Exchange 1.7. In the Dow Jones Index we are at 1.1 cent. They are 1.7. Russell 1000, we are 1.4, they are at 1.9. That spread, that difference between the buying and the selling is really the effective measure of how well the market works.

The NASDAQ market structure where we have open competition between multiple participants where we allow buyers and sellers to meet electronically, if that is what makes sense, yields a tighter spread.

In addition, we want to look at how often we actually trade at or within the spread. We consider that the quality of the market. The S&P large caps, we trade at or within our narrower spread 91 percent of the time. New York Stock Exchange 82 percent. The Dow Jones large cap, 91 percent again for NASDAQ, New York 80 percent. Their spread is wider and they trade outside of it more often.

The Russell 100 91 percent for NASDAQ, 82 percent for the New York Stock Exchange.

Our market model without a trade-through works.

In addition, we talk about how we have multiple participants. Our market makers have to compete with each other to get any order flow, to get any trading activity. They do not get to put a single, say I am a market trader, send all the orders to me like you do have to do in the specialist system. They have to compete among each other.

We also run a continuous market system. I think it is very interesting to point out what happened in Disney and Comcast. Comcast is a NASDAQ traded company. Last week they made the announcement, an offer to buy Disney. New York Stock Exchange opened up Disney at 9:57. They halted the stock. Did not trade it. To me, that is not a market, it is an absence of market. NASDAQ opened up Comcast at 9:30. At 9:57 had traded 20 million shares of Comcast within one percent of its opening price.

We, in fact, then had greater volatility than New York. One percent movement. But we had a market and we traded. They had zero volatility, they did not have a market. It was halted to 9:57. We had traded 20 million shares by 9:57.

When we talk about this $240 million settlement, one thing that really stands out is how they came to that determination. Early reports was the settlement was going to be around $30 million. The reports said it was $30 million because they were looking at sample trades that happened outside of 60 seconds. SEC got involved, said 60 seconds is too long. Investors should have an execution sooner than that, and at 15 seconds which is what the settlement was reportedly agreed upon, the fine become $240 million. At 60 seconds investors outside of 60 would have gotten $30 million. At 15 seconds it was $240 million.

The average execution time on NASDAQ is 5 seconds. If the Commission had held the New York Stock Exchange to the practicing standards that exist on the NASDAQ, we can extrapolate the fine would have been a lot closer to three quarters of a billion dollars. The NASDAQ market where we have a electronics and we have competition works.

It is time to take the next step. More shares are traded on the NASDAQ on every day than any other market in the world. We protect investors, we support the principles of free markets. It is time for the repeal of the trade-through rule.

One last comment. I alluded to the organizational failure with respect to regulation. We strongly believe that the regulatory body has to be separated from the market centers. These market centers and the individuals represented on this panel compete vigorously every day for order flow. We want a fair structure to allow that competition to proceed. The regulatory function has no function being anywhere near the competitive function. The regulatory function has to be separated out. That will ensure investors know there is a tough cop on the beat.

It is an exciting time. In conclusion, we are about competition. Let us ensure that we have competition. Let us ensure that we have benefits of participants. If we have that kind of competition, then we know that we do not have to worry about the details of is it 100 shares, is it a 1,000 shares; we know the competition will force the better outcome.

We look forward to an engaged debate on this in the weeks and months to come.

[The prepared statement of Robert Greifeld can be found on page 54 in the appendix.]

Chairman BAKER. Thank you, sir.

Our next witness is Mr. Frank C. Sullivan, President and Chief Executive Officer and Chief Operating Office, RPM International, Inc.

Welcome, Mr. Sullivan.

STATEMENT OF FRANK C. SULLIVAN, PRESIDENT, CHIEF EXECUTIVE OFFICER AND CHIEF OPERATING OFFICE, RPM INTERNATIONAL, INC.

Mr. SULLIVAN. Thank you, Mr. Chairman, Congressman Kanjorski and the members of the Subcommittee for extending an invitation to appear before you to discuss market structure, a matter of great importance to the shareholders, board of directors and management of RPM International, a company traded on the New York Stock Exchange.

I am Frank Sullivan, President and Chief Executive Officer of RPM, a company founded by my grandfather in 1947. Fifty-six years later, RPM is a world leader in specialty coatings, serving both industrial and consumer markets. We have achieved record growth in each of our 56 years and have delivered 30 consecutive years of cash dividend increases to our shareholders. RPM products include such well-known names as Rust-Oleum Paints, DAP Caulks and Sealants, and many other industrial and consumer DIY products.

For the fiscal year ended May 31, 2003, RPM had sales of $2.1 billion and $122 million in net income before we took a $140 million asbestos charge, asbestos being another issue we are hopeful the Congress will address soon.

A member of the S&P 400 Midcap Index, we are highly committed to our approximately 300 institutional investors and, more importantly for us, our more than 100,000 individual shareholders. RPM is a favorite of retail investors who are members of the National Association of Investment Clubs. We have made it a priority to get to know these retail investors very well and we feel that we appreciate their needs. We take very seriously the quality and fairness of our trading in our shares to ensure the interests of all investors, large and small, are well served.

I would like to relate to the Committee today my perspectives on how stock exchanges and their models affect companies, and specifically how the specialist system has impacted our business. As my company has experience with both NASDAQ and the New York Stock Exchange, we can give you through our experience a case study in how they have differed.

RPM went public in 1969 and was one of the original listings on NASDAQ in 1971. In 1997 as CFO of RPM, I understood a review of our markets to determine whether there was a reason to consider a transfer then to the New York Stock Exchange. One of the most important decisions we had to make in moving to the NYSE was selecting a specialist. From the beginning, we understood the importance of the specialist as he or she would be accountable for the quality of the trading in our stock and also available to provide commentary and help us understand trading dynamics.

After interviewing five firms, we ultimately ended up choosing Benjamin Jacobson and Sons, which was later acquired by Speer Leeds and Kellogg. In June of 1998, we transferred to the New York Stock Exchange.

In the five and a half years we have been listed, we and our investors have come to appreciate the value of both the Exchange model and the specialist in a very practical sense. Our objectives in listing have been met as we have continued to maintain a broad individual investor base while increasing our institutional ownership from 43 percent when we listed to 57 percent today. At the same time we have seen a significant increase by almost two-thirds in our liquidity since listing.

Our specialist, Speer Leeds and Kellogg, accounts for eight percent of the trading in RPM on average. So 92 percent of the time public orders are meeting directly to set the price. I believe that having orders for our shares compete in one pool of liquidity is the most effective mechanism for pricing. The specialist role in overseeing this process and ensuring fair and orderly markets is, in and of itself, a benefit. But it is in times of stress that this value has been most clearly seen and appreciated by us. And I'd like to relate two examples.

The first occurred on January 22nd, 1999, shortly after we listed. Our stock did not trade until 9:51 when it opened at $12.87, down eight percent from the prior day's close. I was informed by the Exchange staff and also by Jim Jacobson, head of the specialist firm, that the opening would be delayed due to a sell side imbalance equal to three quarters of our average trading volume. The specialist acting as a catalyst attracted buyers to our stock and acting as a dealer, purchased shares himself ultimately opening the stock on a trade of 143,000 shares. On that day the specialist represented 15 percent of our market, nearly double their average. There is no doubt in my mind that had RPM been trading on NASDAQ, the stock would have opened lower and been more volatile as there is no regulatory requirement or formal process for dealers or ECNs to step in and stabilize a market.

What impressed me most, however, was that Jim Jacobson, having explained the trading to me himself, took the extra step of asking the Exchange to take a formal review. I received the report about a week later. It was a detailed chronology of the day, showing how and when the specialist stepped in to stabilize the market. I clearly would not have received this level of detail or service in my prior market, quite simply because at that pace there was no one to call.

Another example occurred in March 2002 when we issued $150 million of common stock to reduce debt associated with a recent acquisition. While investors were attracted to the offering due to the sound fundamentals of RPM, there is no doubt that we benefitted from the liquidity that existed on the New York Stock Exchange, our reduced volatility and investors' confidence in the market for our shares. On March 26th the stock closed at $14.91. That evening we priced 10 million shares at $14.25 and opened the following morning at $14.93. The increase in shares amounts to 10 percent dilution but the stock price held steady, reflecting the ability of a centralized market to absorb the significant increase in shares with minimal price dislocation.

The specialist kept us well appraised of the buy and sell interest indicated prior to the market open, throughout the opening itself, and for the remainder of the day. We were well informed at all times. Investors' ability to buy shares in the offering and just as important, to add to or liquidate their position in the future with minimal price dislocation is critical in ensuring their confidence. And this example highlights one of the factors in our decision to change to the NYSE as our experience in secondary or follow-on equity offerings on the NASDAQ was relatively very poor.

The principle point of these examples and our experience is that trading our shares on the New York Stock Exchange has provided better liquidity and better execution versus our prior market and other alternatives. And this is confirmed by numerous studies.

As important to us is the accountability the New York Stock Exchange and our specialist provides that cannot be found in competing markets.

I'd like to make a few concluding points. I'm very well aware of the current debate regarding the importance of speed versus price. I support the Exchange Initiative to increase its automatic execution capabilities, but do so because they are at the same time preserving the principle of best price. As both an investor myself and CEO of a company who actively engages with retail investors on a regular basis, it is hard for me to imagine why speed, all things being equal, would take precedence over best price for any reason.

Investors expect and deserve to have the confidence that they will be getting the right price, or to put it another way, the fair price. One of the great things about our current system is it allows small investors to buy and sell their shares on exactly the same terms as large institutions. There is no wholesale price or retail price for our shares. There is just one price. And I and our other investors can always find out what that price is.

Whatever the motive of large institutions, it should be fully transparent and understood by those who entrust their hard-earned dollars to them. The New York Stock Exchange already provides what investors most want. The Exchange has the best price 93 percent of the time. Around 78 percent of RPM shares are traded at the exchange precisely because it offers the best price. That matters because it ensures a deep and liquid market for RPM shares, dampens volatility and correctly prices our shares so the value of our company is fairly reflected. I believe that the combination of all these factors results in a much more confident investing public and ultimately reduces our cost of capital.

Finally, I applaud this Committee's undertaking to study market structure and to ensure fair and orderly markets for all investors. The decisions you reach are important for the future of our company and many others like it, and, most importantly, for the investors of this country.

I am pleased to have an opportunity to share my experience with you and hope that any changes you consider will strengthen the market, but not diminish the liquidity and accountability that the auction market model provides to our shareholders. Clearly, the New York Stock Exchange has been and will continue to be central to our capital raising process. I fully support its goal of ensuring that all investors, large and small, have fair and equal access to the shares of companies traded on the largest and most liquid equities market in the world, and that they can do so with great confidence.

Thank you.

[The prepared statement of Francis Sullivan can be found on page 106 in the appendix.]

Chairman BAKER. Thank you, sir.

Our final witness is Mr. Gus Sauter, Chief investment Officer and Managing Director of the Vanguard Group.

Welcome, sir.

STATEMENT OF GEORGE U. "GUS" SAUTER, CHIEF INVESTMENT OFFICER AND MANAGING DIRECTOR, THE VANGUARD GROUP

Mr. SAUTER. Thank you.

Good morning, Chairman Baker, Ranking Member Kanjorski and all of the other distinguished members of the Subcommittee. My name is Gus Sauter, and I am the Chief Investment Officer of The Vanguard Group. I oversee the management of approximately $520 billion in mutual funds held by more than 7 million investors.

I am very pleased to be here representing The Vanguard Group. We have been working with various market places over the past decade to improve the quality of the markets to meet investors' needs.

I would like to thank the Subcommittee for having this hearing on the role of the specialist system. The issues surrounding the market structure of the specialist system are very important issues for investors to ensure a fair and efficient marketplace.

We have heard arguments over time that investors are best served by always obtaining the best price. We have also heard that investors are best served by obtaining speed of execution and certainty. In short, I believe investors should not have to make that choice. We need all of these features.

Speaking as an institution that invests for more than 7 million individual investors and being bold enough to assume that I speak for all investors, we're not greedy but we want it all. We want the best price and we want it immediately with no uncertainty. We want to be able to execute our entire trade at the most favorable price in an instant. In other words, we want a perfectly liquid market which will by definition enable investors to minimize transaction costs and maximize their returns. In the final analysis we are indifferent to market structure as long as it provides perfect market liquidity.

So what is a perfectly liquid market? It is one that has an infinite number of limit orders willing to buy or sell a stock with a very small spread between the buy and sell price. In our view, the challenge is to create a market structure that attracts and even incents investors to place limit orders. I cannot overstate the value of limit orders. Limit orders are liquidity. Limit orders are the backbone of a perfectly liquid market.

So how do we encourage limit orders? In order to incent limits orders, they must be protected. In other words investors or traders should not be allowed to hide in the crowd and jump in front of a limit order. If jumping in line is permitted, then there is no incentive to stand in the line in an orderly fashion.

We at Vanguard have lived this. We stood in line to the point where we realized it worked against us. In response, we now place fewer limit orders than we used to. We now hire more people to jump in line for us. This is not an efficient market system.

In the short run, this is the optimal strategy for our investors, and for many investors. However, in the long run it significantly negatively impacts the quality of the market. Limit orders will disappear.

In addition to providing protection to limit orders, these orders must be made accessible. How can we do this? By implementing automatic execution for all orders. Automatic execution is a process of matching new orders in the marketplace with existing orders. Auto-X ensures that natural order flow interacts with the limited orders on the book allowing limit orders to fill the demand without interference.

There are arguments that without automatic execution a market order might have been able to receive price improvement. If so, this advantages the market order while detrimenting the limit order. The market order gets filled and it would have been filled anyway, while the limit order goes unfilled. Market orders are like Pac Man. They roam around the market devouring liquidity. It is not the market order that should receive preferential treatment. Simply put, limit orders should not be disadvantaged in favor of market orders.

Limit orders not only need protection within the market in which they've been entered, they also need protection from other markets. The trade-through rule protects limit orders across markets. It prevents a trade from being executed in another exchange at an inferior price. Without the trade-through rule trading would tend to be locked into the marketplace in which the orders are entered, a process known as internalization. In the short run, this would enable trades to be executed immediately. In the long run, it would create a tremendous disincentive to place limit orders, or should I say a tremendous disincentive to provide liquidity. Who would place a limit order in one market with the knowledge that trades could be executed all around that limit order in another market without the limit order ever being filled?

I agree that with the current market structure environment the trade-through rule impedes efficient execution. There are legitimate complaints about orders not being filled when they must be transmitted to another exchange. We certainly experience this. However, we believe the best way to address these issues is to fix the linkages between markets and to require automatic execution, not to completely eliminate the trade-through rule at this time.

Again, I would like to thank the Subcommittee for allowing me to express our views, and I would be happy to answer any questions you might have.

[The prepared statement of Gus Sauter can be found on page 95 in the appendix.]

Chairman BAKER. Thank you, Mr. Sauter.

I would like to start first with an observation and question to you, Mr. Thain. It was in the spring of 2001 this Committee began its work examining the reported conflicts of interest between investment banking community and that of the analyst. And we were assured by those in the business at the time that although there were conflicts of interest, that they were managed and that there were Chinese walls constructed to ensure accountability. We did not know at that time that there was a very prosperous Chinese ladder business ongoing in the community at the same time. It was only later revelations that indicated that those conflicts had not been properly managed.

Professional conduct is at the heart and core of any capital market functioning in a reliable and in the long term consistent manner. And it has only been in recent years, the last two perhaps, that the Exchange's conduct has come into question. It has been for decades the center of world capitalism. And for that, I am very appreciative.

I do have concerns, however, that prior to your arrival—and this is not a statement as to your own conduct, for which I have great appreciation, that the Board apparently did not have insight or understanding of Mr. Grasso's compensation package. I have found, when the disclosure was made, it to be excessive. Do you have a public position on whether that compensation was appropriate or not? If not, I will get back to you later.

Mr. THAIN. Mr. Chairman, as you know, I was not involved with or present at that point in time. But the Exchange itself, including me and the new Board of Directors of the Exchange has taken the position that that compensation package was excessive and has, in fact, turned over a report which was prepared which came to that same conclusion. And turned that report over to the SEC and to the New York Attorney General.

Chairman BAKER. Thank you.

Secondly, I was distressed to read in the paper that it took the SEC, not noted for its swift enforcement actions of recent date, to discover and take action with regard to specialist misconduct.

I note in your statement you indicate that you believe sufficient regulatory enhancements have been made to ensure such activity will not occur into the future. It would appear on the face of it, however, that the authorities granted in the manner in which the business is conducted, there is inherent conflicts of interest when a person can trade for his own account on dollars which only he has access to as to the price a willing buyer will pay and a willing seller will take with him having the ability to legally trade for his own account, given Mr. McCooey's persuasive testimony relative to those instances in which there wasn't a proper match and the specialist can step into the gap and provide that momentary liquidity to close the deal purportedly for the interest of the consumer. My observation would be if the specialist knew that transaction would ultimately lead to his own personal financial loss, how likely would he be to extend that courtesy?

Mr. THAIN. Mr. Chairman, you are getting at the function of the specialist as a whole. The specialist at the point in time when they commit capital don't know whether they will recognize a gain or a loss. The positions on the book, the limit orders, are in fact available to the marketplace. We disclose the limit book positions. So the specialists at the point in time where they're actually doing a transaction does not necessarily have any special information.

Chairman BAKER. The fact that there were five firms fined $240 million for something that apparently didn't fit the mold of appropriate conduct, there has been the accusation that things don't work perhaps the way they should. In your testimony you said best price must be the model of standard for all of us to comply. I agree. There is one critic publicly stating that in a one-week period through their own work, there were perhaps 7500 trades that could have been executed on their exchange which were not, they were traded on the New York Exchange to the best price detriment of the customer.

Do you believe that criticism to be valid or is it something that is worth further examination?

Mr. THAIN. Mr. Chairman, there are trade-throughs that occur in the marketplace as a whole, including at the New York Stock Exchange. I think that is not a good state of affairs. I think it would better if the linkages between the markets were such that trade-throughs were minimized. But there's also one fundamental difference between trade-throughs that occur on the exchange.

The trade-through rule, as I mentioned before, was designed to protect the investor who wasn't traded with. The New York Stock

Exchange as a policy, if it trades through someone, will in fact make the person who wasn't traded with whole.

Chairman BAKER. Let me go on with one other observation. If I knew for a fact as a former Louisiana real estate person that a buyer was willing to pay $125,000 for a home, the seller was willing to sell for $100,000; if both asked me to represent them in the transaction, under current law we must have a written dual disclosure agency statement signed. And at that point I can no longer advise either client other than as to what is publicly known information. I can't tell one what the other take, I cannot tell the other one what the other might sell for. The point being that under Louisiana State licensure law I can't do what the New York Stock Exchange permits a specialist to do. And if I were to step into the transaction and buy it for 105, give the seller a really good deal and turn around and sell it to the buyer at 120 giving him a really good deal, I would still go to jail. Because I can't represent both parties and not disclose my position in the transaction.

I guess that is what has brought me to the concerns about the current market structure. I told Mr. Kanjorski some days ago I really hadn't made up my mind about whether elimination of the trade-through rule was to the market's best advantage or not. And if I were convinced that obtaining the best price was in fact the consequence of the trade-through rule it might definitively be in the consumer's best interest. But based on the data provided to date, at least that I have seen, I don't know that that in fact is occurring.

Let me throw one more thing out, and we'll come back for at least a couple of rounds, and this will be my last. I know some have schedules. They need to be on their way.

Attorney General Crist of Florida just wrote Chairman Donaldson of the SEC stating that the trade-through rule effectively grants Floor specialists monopoly power over the New York Exchange-listed stocks. As a result, investors suffer from slower trade executions, increased transaction costs and decreased competition. I know there are others at the table who would probably agree with that statement. But can you give to the Committee any other groups, organizations, certainly the Louisiana based ArcaEx company that's engaged in activities found benefit of the specialist system? Other than those who have a direct financial linkage to the Exchange, where are the arguments outside the Exchange relationships for maintenance of the trade-through rule?

Mr. THAIN. Mr. Chairman, as I've said in my testimony, the trade-through rule ensures that investors get the best price. My constituency that defends that rule are the 95 million Americans that own stocks. They are the ones who are damaged if we eliminate or substantially change the trade-through rule.

Chairman BAKER. I appreciate that view and the only thing I would suggest is that of the 95 million that own stocks, there is probably 94.9 who do not know what it is. They are looking to the Congress and the SEC to provide a fair and transparent marketplace, and I'm not sure we have.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

I'm glad you still have an open mind, Mr. Chairman, as regard to our discussion on the floor the other day. And I'm glad you allowed for this hearing, because I've got to tell you as I break this down, I think we have mud fights in the Congress, good-natured guys. Don't all have a drink afterward?

Anyway, almost everybody at that table has a self interest, starting all the way down the first five witnesses. And I'm going to get back to you.

But I do want to congratulate Mr. Sullivan and Mr. Sauter. Compelling testimony. If you were closing your case and I were the jury, I think you have persuaded me that if it isn't broken, don't change it. And particularly Mr. Sullivan. You are the corporation out there that had the choice of staying with NASDAQ and taking their stock restriction. You were dealing with the interest of your corporation. Obviously, self interest because you are obviously a large stockholder in the corporation. I think that is very compelling evidence and I think you delivered the advantages of having a more stable, less broadly fluctuating market. It's very compelling.

Now let me move to the others. Mr. Thain, you're on the team pretty young, so we are not going to punch too much of you. But, obviously, the New York Stock Exchange is the 800 pound gorilla. Mr. Nicoll, you were talking about, you don't have, thank you, you're an operating exchange, competitive as hell, you're going to beat those guys, you're going to close down the New York Stock Exchange because you're so good at doing what doing you do that why, in a competitive market like America, would anyone go to the New York Stock Exchange when they can have all the advantages that you've put forth in your testimony. And that sounded pretty compelling. What I couldn't understand is why do you want to set the rules for the other guy and interrupt his rules since they do not impact on you and you can be so competitive with all your electronic transfer and not having to have specialists create a market, you're going to clean their clock. The best thing in the world for us to do, and the Commission to do, is leave the rule in place and you're going to have 100 percent of the trades of stock in this country because you're so competitive.

Now, the fact of the matter is there is a reason why you should exist and I think a reason, probably, why they should exist and why an auction market with a specialist gives some advantages as to Mr. Sullivan's corporation. And, as Ms. Sauter said, there are limited trades out there that otherwise could get blown off the table and just eliminated. And as far as the big institution buyers, oh sure, they want that price and they would like to have anonymity and no one know what they're doing and have a double-market situation. But, you know, the only person not sitting at this table is Mrs. Jones, the independent private owner of stock in this country.

I mean, in a way I'm sort of surprised to—I am pleased, because as I said, it is obviously not the Congress alone that argues like hell and makes fools of ourselves; it also is the financial market participants.

But I do not see at this time, and Mr. Nicoll, we have had the occasion to discuss, you are a competitor. You are trying to sell something. And I understand that. And I think if I had what you have, I would be out here trying to sell it too and close anybody that stopped buying what I have.

Mr. McCooey, he probably owns a yacht somewhere because of the great business he can do as a specialist. But in our system we don't punish him for that. We reward him if in fact Mrs. Jones gets a better price and has a market at 9:30 for her stock that she wants to make available for her grandson to go to school. He is there. It would not have been the tremendous loss that we just reflected in the testimony, the $10 without a market. That does not happen on a pure electronic market. It takes a specialist, somebody in there to shore up that market.

Mr. Thain, the New York Stock Exchange probably over the last six months or a year are not going to win any accolades for success. The institution has been attacked. But my observation in the American system is that whenever you slip, fall or show weakness, the rest of us kick the living bejesus out of you. So as long as you move in with what I understand your tenants are to, again, make the auction market one of the most—and maintains its greatest success and example in the world, I am not worried about it. We will be back to effort.

I am going to persuade my friend here from Louisiana that ultimately we've got several choices here. If your markets are so bad, I guess we should prove we're Democrats and just put the government to run the markets.

Chairman BAKER. The gentleman's out of order.

Mr. KANJORSKI. I think if we had that proposition here today, we would have at least seven witnesses testifying against us. We're obviously not going to do that.

But taking the next best thing, we have a very open nonprofit set of exchanges that have been functioning, some, for over 200 years very successfully and new ones coming in with new technology and operating very successfully.

It would be my predilection to give you all the chance to clean up your act, to enforce some of your rules, amend and change some of the rules necessary for better market operations for the customer. And for us to get involved only when it's essential to do so.

I really don't think you would want to convince the Congress to get involved in this in a big way, or even the Commission to try and find some politically acceptable position as opposed to what's the most efficient effective rule or non-rule to allow to be implemented.

I'm glad we had this hearing, Mr. Chairman. I hope it's given the rest of the Committee, and I hope the members of the Committee that haven't been here today are going to be able to read some of this testimony and get a little more appreciation of trade-through rule, specialist operations, electronic exchanges, option exchanges. I know I knew nothing about them when I first came to Congress, or very little.

And I'm not asking a question. Who knows I thought I was going to put some of you on the spot, however, I am not. I think I have classified what I thought your testimony would be. I'm critiquing it. But as I close and allow my fellow members of a majority of Democrats, I again want to tell you, Mr. Sauter, but you particularly Mr. Sullivan compelling, absolutely compelling, you just publish what you've testified here today and I think this argument is over. And if I have a copy of your testimony, if it was prepared and in writing and not extemporaneous, I myself would go forward.

And thank you very much.

Chairman BAKER. Thank you.

Mr. Ackerman?

Mr. ACKERMAN. Thank you, Mr. Chairman.

I want to agree with Mr. Kanjorski. He's gotten tough. I kind of suspect that money's involved here.

As people in our position in the Congress, we are required with any investments that we make over some very minimum, couple hundred dollar threshold, to make public disclosure of it. And I think that those things in which we might have some financial vested interest are being done not to our own advantage, but because of the interests of the public.

With that, I'd like to ask Mr. Thain why wouldn't you accept Mr. McCooey's challenge for thorough transparency with specialist accounts?

Mr. THAIN. First, Congressman Ackerman, on the toughness. You know, I may be new to this game, but I have many years in the investment banking business. And I found there were many ways to slice and dice data to be able to show that you were number one in this or that over some period of time. But I have never seen information used in quite so misleading a way as some of the information that was thrown out here today. Let me just give you one little example.

Mr. Greifeld talked about the spreads in NASDAQ and the fact for the S&P 500 the spreads in the NASDAQ stocks were 1.21 cents. And that the spreads were in the New York Stock Exchange stocks was 1.76 cents. Well, that's a very interesting statistic except for one small problem. The average prices that NASDAQ stock trades at are much lower than the stock prices that New York Stock Exchange stocks trade at.

So if you think about, a two-cent spread on a $2 stock is not at all the same as a two-cent spread on a $100 stock. It would be similar to saying if you had a sales tax, a fixed sales tax of a nickel is the same on a dollar purchase as on a $100 purchase.

So if you actually use exactly those same numbers that Mr. Greifeld talked about and you divide them by the average stock prices, you would see that in fact the New York Stock Exchange spreads are 42 basis points cheaper than the NASDAQ spreads.

So just an interesting example of the use of information——

Mr. GREIFELD. This is the tough part of the conversation. I have to interrupt in that the spreads that we talked about were net effective spreads——

Mr. ACKERMAN. Just for the sake of decorum, wait until he's finished.

Mr. GREIFELD. Okay.

Mr. THAIN. Thank you. It was interesting to see how much decorum exists here.

The information about the specialists——

Mr. ACKERMAN. It's a good thing we're not on ceremony.

Mr. THAIN. That's true.

The actions of the specialists are not—the actual positions of the specialists are currently not disclosed because there is a concern about the trading against those positions. They, like any other principal trader, if they have a position and it were widely known that they were long stocks, they'd be up against the ability to short against them; if they were short stocks, you would have the ability to be long against them. But the activities as a specialist are very tightly constrained. And so they cannot operate inside of their customers. They cannot trade in front of their customers. The only thing you can do is provide liquidity in ways that are helpful to customers.

The number of times—you look at the total trading activity on the Floor of the Exchange, the specialists are only involved about 10 percent of the time. So 90 percent of the time it is natural customers, natural buyers, natural sellers, being matched up in the marketplace. The 10 percent of the time is the times that the specialists are operating, and there they are in fact using their capital to dampen the volatility. So as the stock prices are trading down, they tend to be buying. As stock prices are trading up, they tend to be selling. They are the ones who are providing that buffer or that capital when buyers and sellers don't exactly match.

Mr. ACKERMAN. Well, why not take away the question that people are concerned about and why the fine was levied and show the transparency so that everybody would know what is or is not happening?

Mr. THAIN. The fines were actually levied against behavior that was against the rules. And so in the case of the specialist fines, they're being fined for violating the rules.

At the time that those violations took place, we didn't have the technology to actually catch those. Today the technology actually prevents them from doing most of that activity and we have much better oversight over what exactly they're doing so that in fact those types of behavior can't occur anymore.

Mr. ACKERMAN. Mr. Greifeld, you had stated that it's paramount to protect the interest of the investors, the investors come first. But you also said competition has to be in place. And you also said we are about competition. With all that being said, how do you respond to Mr. Putnam's suggestion that in changing one word to "exclusive," you have basically eliminated the ability of people to have competition?

Mr. GREIFELD. Well, I'll first respond to Mr. Thain's point with respect to spreads. The spreads that we quoted were net-effective spreads. So to the extent that it was a $10 stock, it was a percent of $10. And if it was a $100 stock, it would mean percent of $100.

With respect to competition, we certainly believe that as a bedrock principle in this country, and it should be a bedrock principle in these markets, and we want to see the ability to compete against the New York Stock Exchange for their trading volume and we think that's the best discipline that will exist. Competition, the discipline of competition will prevent us from getting in a situation where investors were cheated out of $240 million.

Mr. ACKERMAN. But that does not answer my question.

Mr. GREIFELD. I am going to respond to the question. We have a separate product which is an index product which we compete with a very large number of index companies. Right? We compete against S&P. We compete against Dow Jones. And we certainly welcome Mr. Putnam to get into the index products game.

In our index products we have certain ways that we constitute it and we look at that on a regular basis. And it is a feature of that particular product, and we're proud of it.

Mr. ACKERMAN. I appreciate your promotion, but how do you answer the question?

Mr. GREIFELD. That's a——

Mr. ACKERMAN. How does dumping somebody out of your exchange because they want to participate somewhere else——

Mr. GREIFELD. No, no, no.

Mr. ACKERMAN. How does that promote competition?

Mr. GREIFELD. No. We would not dump somebody——

Mr. ACKERMAN. And what effect does that have on the value of their company?

Mr. GREIFELD. Okay. Let me get to that. We would not dump anybody out of the NASDAQ Exchange. If they choose to do a list on another exchange, we certainly don't welcome that, but that happens and certainly companies have left NASDAQ who have gone to New York. And we have no restriction on that movement. All it requires is a vote of the board of directors and the company can move from NASDAQ to New York Stock Exchange or any exchange that they want. A simple vote of the board.

Now, we have an independent product, which is an index product which is called the NASDAQ 100. We have developed it over the last 10 years. It's a very successful product, we're proud of it. And we define the rules for that index product the same way the S&P does for the S&P 500, the same way the Dow does. And that index product is geared around the concept of NASDAQ being a growth market and a growth industry. And we have a requirement that if you want to be part of NASDAQ's index product, you are on the NASDAQ Exchange. But you're not forced to stay on the NASDAQ Exchange, you can certainly go wherever you want.

Mr. ACKERMAN. So you would have to leave?

Mr. GREIFELD. What's that?

Mr. ACKERMAN. You have to leave.

Chairman BAKER. If I may clarify for the gentleman. I think what I am hearing is that you are not suggesting you have to vacate the Exchange.

Mr. GREIFELD. No.

Chairman BAKER. But what I think he's asking you, is once you vacate the index—excuse me. When you were simultaneously listed on another exchange——

Mr. GREIFELD. Then you are not on the index.

Chairman BAKER.——then you are out of the index.

Mr. GREIFELD. Then you are out of the index. And that is what the NASDAQ listing companies want. I mean, it is an attribute of the product of being listed on New York. And when we talk to our customers, such as, you know, Microsoft, Dell, Cisco and we get their advice on the index, they said this is for companies that list on the NASDAQ stock market.

Mr. ACKERMAN. Okay.

Mr. GREIFELD. It's an attribute of the stock market.

Mr. ACKERMAN. Not interested in Tom, Dick and Harry then.

Anyway, can I ask Mr. Putnam to respond, too?

Mr. PUTNAM. Thank you.

You know, ARCA has come up on the rough end of this, being an upstart in 1997. So I could tell you an awful lot about competition and anti-competitive rules. And I'd like to answer the question, but just to point out a couple of examples.

We have suffered from the day last February when we went to move our first NASDAQ stock onto our Exchange. NASDAQ called us the night before and said, "If you move it, we're going to disconnect your wires, deny access to NASDAQ." That was settled by the SEC, thank God, that evening.

Prior to that when we really started to make some inroads in the ECN business, Instinet—and not all these people that were at the companies that are there today that were at the time. But Instinet said to us you know what, you guys are doing pretty well we're going to create a special class of customer. And you're in that class. You are the only one in it. And we are going to charge two to five times what we charge our other customers for similar access. We protested and said we are not paying the bill. Guess what? Do not pay the bill, we are going to disconnect your wires.

When we went to get our exchange approved, we had to become a member of the ITS plan. The New York Stock Exchange said to us you're electronic, you're different, you can't use this system. You agree to a 15 percent cap on your use of the system or we are going to disconnect your wires.

So this has been used. We know it. I think, actually our model and I feel like I can stand here and speak purely. I mean our model has been do the right thing and you'll win. And we're talking about doing the right thing by Mrs. Jones. Now what has happened here with the NASDAQ 100, everything you have heard is absolutely true. It is an index. It is a product. The problem is that rule about or qualification for being in that index has been extended to compete with us on dual listings. Because what you didn't hear was, yes, you are free to dually list on the New York Stock Exchange and you are free to dually list on ArcaEx, but if you do you're no longer a participant in this index. And what that means is we will dump millions of shares of your stock on the open market. Now what CEO is going to agree to do that? And that's what the implication is.

So it's fine to have your index. S&P has an index. If you do dually list on ArcaEx or New York, S&P doesn't blow your stock out of the index, doesn't dump your shares. I mean this is a prohibition against dual listing, something these guys have told us is so important and preached, and is now injected into the system. It's wrong. It's got to go away. It's Rule 500 in sheep's clothing, and that is the problem with it.

Chairman BAKER. You will be yield——

Mr. ACKERMAN. I would be delighted, Mr. Chairman.

Chairman BAKER. I think it would be designated in the past as the roach motel room—roach motel rule. You check in but you never check out. And that's the consequence of this to—in the old days when it was the New York Exchange is how it was characterized. That's Mr. Ackerman's——

Mr. KANJORSKI. This wouldn't be a monopolistic practice, would it?

Chairman BAKER. Oh, of course not. It sounds like the State of Legislature in Louisiana's competition rules. If you're not on the right team, you got a problem.

Mr. Ackerman, have you concluded?

Mr. ACKERMAN. Yes. I just want to let you know, Mr. Chairman, back where I live which is in Queens, not too far from here, there's a guy painting my bedrooms in the house. And I interviewed a couple of painters. And one of them, I said to him, are you good and are you reasonable. And he said, no, but I'm fast.

Chairman BAKER. I don't want to get into your personal business.

Mr. ACKERMAN. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Ackerman.

Ms. McCarthy?

Ms. MCCARTHY. Thank you, Mr. Chairman.

Number one, let me say that the competition that we're seeing at the table ahead of us has to be one of the most lively debates that we've seen in front of our Committee in a long time.

Number two, I want to make sure, we have been kidding back and forth with the Chairman only because he talks funny, but one of the things I have to say, I'm one of the newest members on the Committee. Our Committee actually does work very bipartisanally and we actually try and do the best thing for the country and for everybody else. And I thank you, Mr. Chairman, for the leadership. It is not too often we outnumber the Republicans, so we got to throw a rib in once in a while. After all, we are New Yorkers.

But in all seriousness, listening to all your testimony and I think what was terrific we were able to get the testimony yesterday so we could actually read it. And reading each and every testimony, I found it fascinating. Of course, I probably would have preferred reading a novel in some instances. But we're very used to hearing both sides or three sides, or four sides and then it's up to us to really go through all of that and to try and find out—I mean we do it in Washington all the time. You know, we get information on both sides and then it's up to us to try and find out where is the truth, and where is it really in there.

I guess the bottom line is, though, certainly myself in looking at it is where the competition is. What is going to be the best thing for the average buyer. Now, obviously, the large corporations, they're going to have people representing them, they're going to be there. It is the small buyer I am actually interested in, because it is the small buyer that ends up getting hurt if someone is not watching out for them. We have seen that in the past.

So I'm worried about my next door neighbor or myself, to be honest with you. I'm 60. I only have, you know, a few more years. I got to make sure Social Security is there. I got to make sure that the money I have put away in the market, when it recovers a little bit more—let's hope the market keeps going up. But I mean, that's the money that we are going to be living on. That is the average person in this country. And, unfortunately, in the last two years we have seen corporations, we've seen some bumps with the stock exchange where people have lost confidence. And that is the worst thing in the world for any of you, and it is. Because the only thing any of you have is your reputation. If your reputation is not there, if it's not on the line, I am certainly going to go back to the bank and put my money for 2 percent; at least I'll know. But we are trying to keep this country growing, so we need all of you and we need the competition that's out there.

But I think the thing that confuses me when you have talked about you have never used the buy-through or the best price, why do you care if they do? I mean, that is the part I do not understand. Because customers, businesses, your clientele, they'll leave the New York Stock Exchange, they'll go with any of you, whoever gives them the best deal. I mean, that is the way I am looking at it. Now I am not as smart as my colleagues that have been on the Committee a lot longer than I have. But just sitting here if I am the customer, I am going to go to who is going to take care of me the best. So whether it is I want the best time, great, I will go to you. If I want the best price, I will go to you. I mean, that is how I kind of look at things.

And so I do not understand where you see the competition not being there.

Mr. GREIFELD. Well, to respond to the question, in the NASDAQ market we do not have trade-through, and as a result of that NASDAQ has very capable competitors on the trading of its stocks, and they are on this panel here. And you probably could not tell it from the testimony, but the fact that we have good and effective competitors is a better thing for investors. And I do appreciate the fact that Jerry and Ed are here competing. We are better for it and investors are served.

So when we talked about how tight our spreads are and how we often trade inside the spread, that is because our competitors are here driving us to a better outcome for investors. You do not have that situation today with the New York Stock Exchange. So myself and the ECNs here are saying let us bring to investors in this country the good results that we have gotten in the NASDAQ market in the trading of New York Stock Exchange stocks. That is the request.

Ms. MCCARTHY. Then just go to you.

Mr. GREIFELD. What is that?

Ms. MCCARTHY. I mean, that is the part I am trying to understand.

Mr. NICOLL. Congresswoman, you have asked the question, let me if I can and then you can respond.

Let me try and give you an exact example of how the trade-through rule prohibits Instinet from competing with the Floor. Note that we have no trade-through rule in NASDAQ. We do about a quarter of the NASDAQ volume. We have no trade-through rule in three listed stocks, and we do about a quarter of the volume in those three listed stocks where we have a three-cent de minimus exception. In all the rest of the stocks where there is a trade-through, we do less than one percent.

So our contention is that the trade-through rule—the direct and causation is that the trade-through rule prohibits competition rather than another away around. And let me give you a precise example.

The New York Stock Exchange has a bid on the Floor, it is a high bid, maybe for a 100 shares of a particular stock. And let us say it is for something and 10 cents. There is a bid on Instinet system for something and nine cents. Maybe it is for 100,000 shares in this particular example.

We have a customer who wants to hit that bid right now. They want to sell to Instinet at nine cents even though there is a 100 shares on the New York for 10 cents. Now why would he want to trade for less on Instinet than he could trade on the New York? Because he has found time and time again when he goes down to the Floor, not only does he not get that 10 cents, but he may end up selling for seven cents. And he is better off hitting the nine-cent bid that is on Instinet.

The trade-through rule specifically prohibits Instinet from accepting that trade. When the trade comes in, we have two alternatives. We can ship it down to the specialist. We can say, we cannot execute that order, we have got to send it down to New York because there is a better bid down there. Of course, if we do that, as you can tell from what is happening here, we are not doing our customers any favor because all of a sudden that order is being shipped to the New York under the guise of Instinet and it does not get treated very well, quite honestly. So we are left with the only thing that we can do, which is to reject the order.

The trade-through rule does not allow the customer to choose that nine-cent bid on Instinet or to choose the bid that is on Archipelago. It requires the competing exchange or the competing ECN to not accept the order. That is why it is so anti-competitive.

And you said, Congresswoman, that you should let competition play out. The trade-through rule prevents competition from playing out. And it is not a question of us advocating that customers want to get an inferior price on our system than they get on the Floor. The question is what is the net price that the customer is going to get. And we believe that the customer is best situated to make that decision. Not you, not me, not Mr. Thain. The customer.

Mr. KANJORSKI. If I may?

Ms. MCCARTHY. Absolutely.

Mr. KANJORSKI. Did you listen to your——

Mr. NICOLL. Sure.

Mr. KANJORSKI. 100 shares and 100,000 shares.

Mr. NICOLL. Sure.

Mr. KANJORSKI. You are interested in 100,000 shares. I think if you recall Ms. McCarthy, what she was telling you, we got to protect the 100 share customer. And what you fellas are going to do is, you know, just as Mr. Putnam indicated, you want to cut the lines on anything other than 100 shares.

At some point, you know, that is what disturbs me. We hear competition, but you do not really want to compete. Everybody here is trying to get a role that advantages them and is monopolistic in some way. And everybody can turn the facts and the information to highlight that. And I appreciate that. But the reality is if the New York Stock Exchange is so archaic, an anachronism, it will fall of its own weight. If the specialist system on the New York Stock Exchange is so grossly and grievously acting, although it has acted for 200 years and a lot of people have dumped billions and billions and hundreds of billions of transactions and it is still surviving, it will fall of its own weight.

What I sort of resent is you all have a business-competitive interest here and you are either trying to use the SEC or the Congress to give you a leg up on that business. And what I was trying to warn you about, you may not want to win that competition because here I am the guy arguing Burkean political philosophy, that is pretty conservative. My party normally says these cats cannot get along, the government will run it. You really want us to?

Mr. NICOLL. Let me respond in two ways. First, my background is retail. I started two very large retail brokerage firms. And I have served millions of retail investors over the last 20 years. That is where I cut my teeth. I know what it is like to serve individuals, and those that are knowledgeable, have been bitterly complaining about the treatment that they have gotten at the hand of the specialist since I started my firm, Waterhouse Securities in 1978.

Two, the real individuals I believe who do not understand what is going on and who are ill served by the system are the millions and millions of mutual fund customers who rely upon professionals and institutions to trade upon those behalf. Those are the real people.

The people that I used to serve at Waterhouse and at Daytech and that are now at Ameritrade, those are pretty sophisticated investors and they want choice. I believe we have to think about the mutual fund investors who are represented by institutions.

Mr. KANJORSKI. And I——

Mr. NICOLL And if I could just respond. And lastly, I totally agree with your assessment, Mr. Kanjorski. We need to get the government out of regulating these entities and let competition play out amongst them. The trade-through rule is already a barrier——

Mr. KANJORSKI. Except because you have a punter on your team or a field goal kicker that can kick 90 yards, you want the field to be 90 yards. I have a kicker that can only kick 10 yards and I say I want 10 yards. And that's what this fight is. It is who's going to get the short term advantage out of the rules promulgated by the SEC or statutes passed by the Congress. And I am saying the pox on both your houses. Unless there is some criminality, and if there is that is what we have a great Attorney General from New York to move in. And we are going to keep him with a variety of business.

Chairman BAKER. Ms. McCarthy.

Ms. MCCARTHY. Reclaiming my time.

Chairman BAKER. I am sorry. I hope your time has expired, Ms. McCarthy.

Ms. MCCARTHY. Well, I am trying to reclaim it.

I actually would like Mr. Thain to answer.

Mr. THAIN. Yes, I wanted to respond.

Ms. MCCARTHY. We never had this opportunity, by the way, in Congress. You are cut off, that is it and we can never have a real conversation——

Chairman BAKER. And let the record note this Chairman is most accommodating.

Ms. MCCARTHY. Yes, he is.

Mr. THAIN. Well, let the record also note that if this is any indication of the degree of competition that is in this marketplace, then I do not think anyone has to worry about an uncompetitive environment.

I wanted to make one thing clear, though, because I think some of my colleagues need to read what the trade-through rule really says. The trade-through rule does not say that you could not trade with that 100,000 shares if it happened to be at a slightly worse price. It only says that you have to make whole the 100 shares that you did not trade with. So as long as you in fact take care of that 100 share, which is the little person, you can in fact do the trade, the 100,000-share trade at the lower price. And that does in fact happen and it does in fact happen quite frequently, but you have to make whole that 100-share person. That is what the trade-through rule does. It protects the little person.

Mr. KANJORSKI. Eventually they will be able to create their own little specialty operation that they are handling.

Mr. SULLIVAN. Congresswoman, I would like to address your question on competition. We chose to move from NASDAQ to the New York Stock Exchange because we were convinced that we would have better liquidity and better execution in our perspective of raising capital at the best cost and providing a good market for our shareholders.

I can assure you when the day comes that we feel that our shareholders would be best served and our company could raise capital deeper and at lower costs at the NASDAQ, we would move from our current market. And that competition exists today.

Chairman BAKER. The gentlelady yields back her time.

Again, I want to come back at this. I certainly understand Mr. Kanjorski's view of getting out of the way of competitive interests and not having the Congress determine winners or losers. That is not our role. Our role is to review the market requirements to determine if in fact there is not a competitive bias in one direction or another.

In 1995 Netscape had five employees. Today they are a fairly significant business enterprise which many people in this room use for Internet activities.

The trade-through rule was adopted in 1975, 20 years earlier. Now, the reason for making those two observations is that trade rule at that time in the inter-market trading system adoption was to ensure that given the technologies of the day, that the individual investor did in fact get operatively the force and effect of the best price available.

I think the consequence of that rule today in a world crammed with technology where you buy processors at 3 gigahertz processing speed when we couldn't spell gigahertz in 1975, is that the market delivery systems have changed, the rules have not.

For years members of Congress come to Washington and we look at the capital markets as a big pasture. And a good successful influential New York delegation comes in and tries to fence off as much of that pasture as is possible up on the lush, green fertile valley end while you push the Louisianans down on the rocks on a small two-acre patch; that would be a successful outcome. I understand it. And over the course of the years, many fence lines have been built and delegations sent to Washington to move the fence line, your fence line, just a couple of yards over into the other guy's back yard while of course not relinquishing any of your own fenced-in property.

My view is that we should take down all the fences and let you roam where you choose, eat as much grass as you like. But if you get sick, do not come back to me, that's your problem. What I think we now have is a relic of that fenced in pasture and I do not believe the result is a competitive environment for the consumer.

Now, I have not heard yet any discussion, for example, of the SEC pilot on the 3 ETFs, which has run for about a year with a three-cent de minimus trade provision. I would be interested to know from those who defend the current circumstance, what was wrong with the outcome of the pilot, because I have not heard anything that was negative. It appears the SEC has now extended it for another time certain so that we can further assess it. It looks to me that that in a microcosm is an example of what the outcomes would be. If Mr. Sullivan wants to continue to go to the New York Exchange and work through his associates, he could continue to do so. Elimination of the trade-through rule won't eliminate his access to that capital and those opportunities.

Mr. McCooey, I see you are anxious to respond?

Mr. McCOOEY. Absolutely. I have not had a chance yet. Tough group here.

First of all, when we talk about Mr. Nicoll, I used to talk about them as stocks. ETFs are not stocks. They're exchange traded funds. They are baskets of stocks. They are derivative product. They have underlying net asset values and most of them are being used by professional trade marketers.

Chairman BAKER. They have a net value. It is done on a day-to-day, hour-to-hour basis. It may be a slightly different disease, but it is similar.

Mr. McCOOEY. These are products that are derivative products, Mr. Chairman

Chairman BAKER. Certainly.

Mr. McCOOEY. And so, therefore, there are underlying stocks that people use to offset their positions in those stocks, and they do that—and this is a minute-to-minute time, second-to-second time that they are. And Mr. Thain, I know, wants to talk about this. But if you will notice, at the time when the New York Stock Exchange entered the fray and began to trade the ETFs, the compression between the spreads went from six cents to two cents. There is the competitive marketplace. There is where we continued to add best price and value to our customers, and we do not believe that there should have been a de minimus trade-through in the ETFs.

Chairman BAKER. And then you make a good point. The New York Exchange showed up, and when they did the spreads narrowed. Why would that not be the case without a trade-through rule? If you are a player, and you are in the market and your liquidity and your resources are so overwhelming, why do you worry about the nets?

Mr. McCOOEY. Well, first of all, we're a bit player. We are late to the game and people who were there before us, kept spreads wide to the disadvantage of their clients. The bigger players kept spreads wide to the disadvantage of their clients until competition came in and spreads narrowed. And we think that there should be a trade-through rule in the ETF products. We think there should be a trade-through rule in NASDAQ. In the same way as you want to talk about your green pastures, it sets the barriers for investors. It sets a benchmark to make sure that investors get the best price. And that is at the end of the day what this is all about; this is about the investors getting the best price. Not trading outside.

And when we talk about a competitive marketplace, the word monopoly has been thrown around like monopoly money so far today, but I think what we need to understand is the New York Stock Exchange boasts 93 percent of the best bids and offers on a daily basis. We only get 80 percent or a little less than 80 percent of the volume on a daily basis. Thirteen percent of that goes to NASDAQ, our fine competitors there.

Chairman BAKER. I heard that 93 percent figure was 94, but I never could find out who was doing the calculating. If there is some sheet someone can send me about how that is derived, that would be helpful.

And let me jump to Mr. Thain because I know he wanted to respond.

Mr. THAIN. Well, I just wanted to add something. First of all, what Mr. McCooey said is absolutely true. The biggest reduction in the spreads in the ETFs is when the New York Stock Exchange started to trade them, and I would be happy to give you the information. In fact I have a chart that shows that.

The de minimus rule when it was applied to the ETFs in terms of the bid ask spread actually did not make any difference. Their spreads are not that different since that rule has been put into place. But what is different is if you—and we did this in a particular day, and it was a randomly picked day, calculated how many times and how much did it cost investors to not trade at the best price. So what would be that value of that two or three cents' difference that they got, and it was $900,000 on that particular day. So it cost people real money to not trade at the best bid and the best offer.

Chairman BAKER. But I will——

Mr. THAIN. Can I just continue?

Chairman BAKER. I will let you continue, but just specifically on that point, hold your thought.

But aren't there not occasions and is it factually incorrect that there are times when best price was offered on other exchanges and the trade occurred the New York Exchange instead in light of the fact that there was a best price offered on an alternative exchange and it was not executed? Is that not also true?

Mr. MCCOOEY. Well, yes, although that is a different point. The point that I was making on the ETFs is that two or three cents de minimus rule when you are trading in the case of the stocks on the Floor of the Exchange, 1.7 billion shares a day, and the second best bid—so if you just looked at the best bid and the best offer and you said customers should have to execute the best bid/best offer; if you look at the second best bid and the second best offer, on average that is about a four-cent worst execution.

So if you allowed people even to get the second best bid or offer, it would cost consumers billions of dollars over the course of the year to not be able to get at that best bid or best offer.

Now, I will go back to what you said. It is in fact true that trade-throughs occur both with the Exchange and off the Exchange. That is not good. One of the reasons they occur is we do not have good enough linkages between the exchanges, and we should fix that. And that is actually one of the things that Mr. Putnam said. But the other thing is, the trade-through rule as I was saying before, is designed to protect the person who was not traded with. So if the New York Exchange trades through on 100,000 shares, which is actually the much more likely case because we have 80 percent of the volume; if the New York Stock Exchange trades 100,000 shares and there is 100 shares somewhere else that had a better price, we will make that person whole. And that is the difference.

Chairman BAKER. Mr. Putnam.

Mr. PUTNAM. We heard earlier from John Thain that the numbers and the way you measure things have a funny way of working out depending on who is doing the measuring. And we have heard about how spread the tightening on ETFs at the time when the New York Stock Exchange started trading them. Well, there is another part to that story.

Instinet and ArcaEx, we control roughly 50 to 60 percent of the trading that is done in those ETFs, and we also happened to start trading them at the time of the New York Stock Exchange came in. We were a little bit of ahead of them, but the price compression has incurred on our open systems where buyers and sellers are free to compete for price without any intermediary. And the fact is with these ETFs, I mean these are extremely—and in the case of the triple Qs or the Spiders, extremely liquid securities. You need nobody's help in getting that trade done. There is so much liquidity there, there is always a buyer and a seller that can agree on price, they can do it instantaneously. We compress the spreads, we actually dominate that marketplace.

Mr. THAIN. But the trade-through rule was in effect at that time.

Mr. PUTNAM. The modification to the trade-through rule has had very little effect on the trading because investors have great access to those. Those securities they trade very heavily. But here is what the issue is with the trade-through rule, and I think it is to clarify, maybe make this a little bit—we need to step back on what it means. We heard, you know, New York, NASDAQ, you guys you do not have, you have one; why do you not just go ahead and do your own thing. Now the problem with that is there is two rules. There is one rule for trading Microsoft, which says you can trade-through and there is another rule for trading IBM which says you cannot trade through. So NASDAQ does not have the right to trade through on IBM because it is listed in the New York like they do to offer that in Microsoft. So there is a difference. The reason why you cannot just do your thing and you do your thing is because there is separate rules. Now, we think there should be a uniform rule.

The other point is we heard earlier today investors are ignored without a trade-through rule, and we agree wholeheartedly with that. We have investors on our system. We do not have specialists. We only represent investors' orders.

We get traded through about 7500 times a week by the New York Stock Exchange. So investors are harmed, investors are ignored. We are screaming bloody murder about the trade-through rule.

Now, our solution, it is a bit in between where the two of you come out. We are not saying eliminate the trade-through rule. We are saying either enforce it, because it is not enforced today because investors are ignored, enforce the rule or modify it so our customers can choose to ignore it.

As long as New York is going to ignore it whenever they want to—see, we will not break the rules on our system. They are hardwired not to ever let that happen. The computer will never trade at a worse price. It is programmed to always go after the best regardless of where it is. We do not have that option of just ignoring the rules.

So we are saying if you are not going to enforce it, at least let our customers choose when they want to trade-through. And, I think that is where we have come out on it, and that is what has to happen. One of those two things or the rule is a joke and it is anti-competitive when a marketplace can choose when they want it and when they do not want it arbitrarily.

Chairman BAKER. Well, it seems the consequence of the rule and the listing criteria and how difficult it appears to leave any exchange to be listed on another, the cost and time necessary to go through those exercises is very little. What happens if everybody, let us assume there is no IBM, Microsoft division anyway and that you have access to trade any stock through any exchange and the best price execution is still the standard?

Mr. MCCOOEY. At the New York Stock Exchange with the rule proposal that we put in front of the SEC and our automatic execution there is no reason why people should ever trade-through. We should make sure that customers still get the best price. We are going to have automatic execution on all the liquidity displayed on the inside market. And so customers that want to buy 100 shares, 1,000 shares or 100,000 shares offered in General Electric will be able to instantaneously, from their desktop, access our liquidity on a one second execution.

Mr. THAIN. Mr. Chairman?

Chairman BAKER. Go ahead.

Mr. THAIN. IBM currently does trade on all of these markets. So IBM is available on all these different markets, and I do not know the specifics about IBM, but on average about 20 percent of the volume trades—spread among these different marketplaces.

Mr. PUTNAM. And you know what you are hearing here, too, you know, is this is our marketplace. But when it is our investor those rules do not exist on the New York—they are not worried about when it is our investor getting the best price. Just when it is New York's investor getting the best price. And history proves that that's exactly where we stand.

Mr. MCCOOEY. That's as long they do not want to be hidden by a reserve book and not be displayed through a transparency which allows for price discovery.

Chairman BAKER. Anybody else?

Mr. NICOLL. If I could, if I can just make a couple of very quick points.

It is interesting to listen to the New York Stock Exchange talk about trade-through. One of things they say is, for instance, is that anybody can trade-through, that they can make the trade that is traded through whole. Well, that is only the case if you are an exchange which really is a partnership between traders, okay, and the exchange itself. It is a mixed model.

The New York Stock Exchange is a mixed model. The reason why I am standing between two people who are saying the same thing is because they're a partnership. The Floor members and the bureaucrats who run the Exchange should really be seen as one entity, okay? No, seriously.

And the reason that they can choose to make somebody whole is because they both trade on an agency and a principle basis.

Now, what an electronic market does is it rigorously enforces the fact that it only is an agent. It never takes a position.

Instinet pledges to its customers, and one of its value propositions is that it will never be in a conflicted position. The only way to make another market whole is to be a mixed model and be both an agent and a principle. And that requires—and what is interesting about the New York Stock Exchange rule, you know, we found the Chinese walls do not work between departments of firms.

What the New York Stock Exchange expects of a specialist is that he build a Chinese wall in his brain. We expect one person to rigorously enforce standards of conduct which sometimes allows him to profit and sometimes does not allow him to profit.

If Chinese walls do not work within firms, they certainly are not likely to work within the brain of an individual, and they have shown by recent headlines not to work.

So when you have a model which is strictly an agency model, you can never choose to "clean up" the activity at a competing firm.

The other point I would like to make is that the trade-through rule allows a specialist to be in compliance with this trade-through rule by matching the competing exchange's bidder offer. In other words, if they are in the same situation that Instinet is in and they got that 100 shares at another exchange, which is preventing them from executing their order, they can choose rather than ship it to literally give a trade to the customer at that price. Act as a principal.

If Mr. Thain is so right and he is so concerned about that person who has placed that limit order not getting an execution on the other exchange, how can he justify his specialist matching the order that is sitting on the other exchange? Because the consequence of that is that that order does not get executed.

So we have to be careful about comparing mixed models with agency models. And this is exactly the point. And I actually agree with the minority member, Mr. Kanjorski, that everybody up here is going to give you a different set of numbers. Everybody up here is going to sell their own book.

The answer from my perspective, from a policy perspective, is let them compete. And the trade-through rule prevents them from competing.

Chairman BAKER. I think it would be best to keep the members of the Committee informed on the subject, get away from the distinguished quests and contrive a marketplace set of rules that were focusing on delivery of product at the best price to consumer, not constructing any competitive edge for any participant. The members on a philosophic basis would think that is a worthwhile goal if the gentleman believes that the current system does not provide that opportunity. And I think that may be the issue at hand.

Mr. Kanjorski, I have taken so much time.

Mr. KANJORSKI. Yeah, Mr. Chairman, I think you perhaps properly pointed out that the trade-through rule is—in fact I think it was some 30 years ago. In my understanding it was not to the advantage or disadvantage any one group, it was instituted to create a national market and not fragment the market. And now we have these competing interests here who would like us to do away with a rule that the unintended consequence may easily be that we fragment a market again. And that market become fragmented based on technological change.

Mr. McCooey has the advantage and Mr. Putnam has the technological change today but it may be someone else tomorrow. And they are going to come in and see how they can benefit the rule.

What I would suggest is I think we heard from Mr. Putnam, his solution is if we had enforcement. Well, who is the responsible party to enforce?

Mr. PUTNAM. One, it is the SROs themselves that have to regulate their members——

Mr. KANJORSKI. So we have to do something to the SROs to enforce? And if they are not enforcing, who is the next?

Mr. PUTNAM. SEC.

Mr. KANJORSKI. SEC.

Mr. PUTNAM. SEC then enforces it on the SROs.

Mr. KANJORSKI. So I could go back to Washington and say I was up in New York, and Wall Street had really condemned the SEC for lack of enforcement, is that correct?

Mr. PUTNAM. Yes.

Mr. KANJORSKI. Good. I am with you.

Mr. PUTNAM. Okay. And you know one great point that you made here is whether it is a mandated linkage like was done with ITS. We actually do not have a trade-through rule on the NASDAQ side of the business and there was no mandated linkage. But guess what is happening there? Competition, so we do not have this trade-through rule—competition has forced us all to link. We have very, very good private high speed linkages and we do not trade through one another.

Mr. KANJORSKI. Great.

Mr. PUTNAM. Because we are accessible and open. So competition——

Mr. KANJORSKI. We would hope eventually as a specialist here said that the market works so efficiently and effectively that the trade-through rule disappears because you've struck.

Mr. PUTNAM. That is right.

Chairman BAKER. I will quote you on that, too.

Mr. KANJORSKI. No. In the meantime to get to that efficient market, why do away with a rule that is protective of Mrs. Jones? I wanted to make a point.

You know one of the things I hate more than almost anything else in life to do? Is to shop for an automobile. Have you ever had the experience regardless of what dealership you go in, this guy is giving you 10 percent off, this guy is giving $2,000 off, he is going to give you an interest rate of 3.8 percent, another one gives you zero interest rate, most amazing thing I have ever seen. You can lend money without cost. And it was very appealing to me when finally Saturn came along and said we are just not going to play this silly game. We are going to have one price, we are going to disclose it and everybody gets it.

I imagine that Saturn buyers are the most satisfied automobile buyers because they know for one thing they did not get taken. Everybody pays the same price.

Now, that is what really we are trying to do or was attempted with the beginning of the trade-through rule that now has had the overlay of technology. And what I am hearing from this panel is that we could probably get closer to the Saturn single price for Mrs. Jones if we had better enforcement. But we do not have to be radical, strike out the rule which gives the tremendous competitive advantage to the electronic market and disadvantages the auction market, does away with the specials.

And incidentally, I know you—I was going to come back to Ms. McCarthy—you referred to Mr. Thain as a bureaucrat.

Ms. MCCARTHY. Yes.

Mr. KANJORSKI. Damn. He is the most highly paid bureaucrat.

Chairman BAKER. And I would out point, Mr. Thain, he is on your side.

Mr. THAIN. I would also point out that as a highly paid bureaucrat, I also took a substantial pay reduction to do this job.

Could I just give one perspective on this? In my prior life, my prior employer is one of the biggest players on the Floor of the New York Stock Exchange. It also one of the biggest participants in the NASDAQ market. It also owns the biggest single piece of Archipelago or certainly one of the biggest pieces of Archipelago.

And my prior employer, and the ability to access all of these markets and to look across all of the markets and figure out where can you in fact get the best price.

And I agree that there are things that have to be changed. And one of the things is the linkages between the markets have to be made better so that they are fast linkages and there are certain linkages. And as Mr. Putnam knows, because he is already doing this, he will in fact have the ability to link with the New York Stock Exchange and execute there. But no matter what at my prior employer we still always sought to get the best price for our customers.

So, there are things we should fix, and one of them is the linkages between the marketplaces, but we should not move away from the concept which has been fundamental to this marketplace for about 30 years that customers should get the best price wherever it is. And that is particularly true for the small investor.

Mr. KANJORSKI. Let me make my point here, because I heard what I did not like, what I considered a monopolistic practice, the threat of cutting the lines if you do something that would benefit—I imagine the SEC has rules and regulations that protect you against that, do they not?

Mr. PUTNAM. Yes, they do. And they are called fair-access rules so you are not allowed to discriminate against participants. In each one of these cases the SEC did come to our rescue and did prevent the lines from being cut.

Mr. KANJORSKI. The difficulty of enforcement again.

So, you know, I sat on this Committee. And I have got to tell you this, and I cannot resist telling you. So about three or four years ago when Wall Street came in to the Congress and said oh my heavens, we have all these fees on transactions that we were paying, overpaying, billions. $2 billion, I think. And we think we ought to reduce those fees because the SEC does not need any money for enforcement or other purposes. And I think there was a starvation diet out there, about $400 million a year that suddenly the present Administration had a meeting, a come to Jesus meeting and now it has doubled it or on its way to tripling it.

You know, you guys ought to cooperate, too, with our side of the transaction. You knew that the SEC was underfunded and lacked the enforcement and that an extraordinary amounts of money were being paid inappropriately for the Justice Department and other agencies of the Federal Government to keep this market as straight and as honest as possible. And I do not think anybody has made this point. But all of you up here in Wall Street are just perhaps as responsible as anyone else for not having the enforcement that allowed things to get out of hand. And you got to stop that.

I mean, the fact that you saved a little money on the less fees you paid have not only cost the customer, but I think it has cost you and the credibility of this marketplace because of your shortsightedness. Now you got to stop that.

I know there is a competitive advantage in everything here. But you know what? Long term, that is not important. Long term is that we get the trillions of dollars that this American market needs and the world market needs to transact or we are all going to be poor.

And in some ways I am hoping, and I want to compliment this Chairman. I think this meeting has brought a lot together here. And I think we are getting closer to finding something that can be formulated that meets everybody's needs; better enforcement, not doing necessarily away with a rule that protects us and encouragement of more efficient operation and spread in the specialist area because of the electronic technology. Keeping the access to private corporations to select and drive in a competitive sense who is going to get their business. And then finally, through Mr. Sauter, making available to all investors across America the best price. And then everybody links.

Mr. SAUTER. Mr. Kanjorski, may I say that if we step back and started a new system today and suppose it is a central limit order book. Essentially we would have one marketplace in the United States. Then we would be sure that everybody would get the best price because there is only one place to get the price.

That has a lot of merit to it. The downside of having the central limit order book is that there is no competition. So having many different marketplaces, I think is beneficial. They can compete against each other and create innovation. At the same time we do not want to throw away the advantage of the central limit order book that every investor will definitely get the best price. And I think that's the advantage of the trade-through rule that it does require that all of the various exchanges are linked together.

The problem we have now is a technological problem that I think is easily solved with money, and that is linking the exchanges together and making sure that there are no trade-throughs.

Mr. KANJORSKI. So you think instead of throwing out the rule, let us get our work done. Let us get the linkage made. Let us get the—the efficiency is the technology. But we do not have to do away with the rule that later on can be prostituted to the extent that we slip off and will not have the best price. Is that what you are saying?

Mr. SAUTER. Yes. As an institution we do have smart routing systems that can go to the exchange with the best price. However, an individual certainly does not have that ability.

At the same time it would be nice to be able to enter an order and know that it is going to receive best execution regardless of where it is entered. Then the various marketplaces really compete on services. They become a portal into the marketplace and compete on service that they give us.

We do like the concept of automatic execution. And we think that ensures that investors will get the best price.

There are trade-throughs happening now. It happens to us all the time. What Mr. Nicoll said earlier happens to us, where we will enter an order on an ECN, it goes to New York, it is not filled there. It could have been filled on the ECN at a slightly different price. That is extremely frustrating.

So we do like the concept of automatic execution without the ability to reject it. But we think that there are tremendous advantages of having the exchanges linked together and we need the technology to make sure that all happens.

Mr. KANJORSKI. I just want to the question here. I just ran across a proposal that we could be much more efficient and save a lot of money if we move the New York Stock Exchange to Bombay.

Mr. GREIFELD. Just probably one last thing.

We have a trade-through rule today. Investors suffer under it. We just had a settlement. So the system where you had a concentration of power in one market center did not work. What we are saying here, myself, Ed, Jerry and many others is the best way to solve that problem to prevent it from happening again is to introduce greater levels of competition. And the current trade-through rule is preventing this. And that is a simple request.

Mr. KANJORSKI. We should not a team to $25 million for a particular player, is that it? It is not competitive.

Mr. MCCOOEY. But, Bob, you are mixing things that have nothing to do with each other. The settlement that none of these trades happened outside of the best price. They all happened inside of the quote, inside the best price. So you're in apples and Diet Coke here.

Chairman BAKER. Ms. McCarthy, did you have follow up?

Ms. MCCARTHY. No. Thank you. I actually have enough in my brain right now.

Chairman BAKER. Well, let me respond to my good friend's observations and conclusion. I would think it would enhance the regulatory enforcement would be desirable, no matter what the rules may look at underlying the competitive marketplace. I would be interested to know what Mr. Spitzer thinks about the trade-through rule, for example, and where has he been with all of the current reported misconduct, an issue which of course I have discussed with him on occasion, in fact.

But more importantly, I do believe that there is inherently some question about the ability of our marketplace to function as you philosophically have outlined, Mr. Kanjorski. And I would quickly add I do not think you and I have differing goals. I think that the members of the Committee who participated here this morning, because there are 95 million Americans invested in the markets, want to assure every constituent and every investor that you are being treated professionally and offered the same opportunity to invest as any other investor, whether it is a $100 or a $100 million. And that you are treated with respect. That is the goal.

My observation is the system we currently have in place does not achieve that. Even proponents of the trade-through rule provision acknowledge that the current technologies do not enable someone to be assured. The best price quote issued by the New York Stock Exchange is not a best price quote guarantee. It is a representation. By the time the trade actually occurs, it could be actually a higher price than you could obtain on another exchange. That seems to fly in the face of the goals that members have indicated.

If we are all about competitiveness and assuring that to the best of professional competency individual investors are treated fairly and do actually get access to the best price, we have I think two choices. To pursue technological advance to where everyone is tied at the hip to such an extent that mechanically no such misstep can occur with severe penalties for failure to act professionally or one considers the elimination of the trade-through rule. Despite the fact that we have had a hearing of some length this morning, we have not really talked a great deal about the implications of what would happen if the trade-through rule was suspended. I did raise the ECN question, which was quickly dismissed by advocates as not being a measure of comparability.

There seems to be a great deal of academic, editorial and outside world comment including some within the SEC that elimination has value. I want to explore at some future point the potential consequences to the markets and better understand what would happen if the rule was suspended or eliminated. I think we owe it to ourselves to explore all avenues before arriving at some final determination. But I think we are together as members of the Committee on seeking out the remedy that affords the best opportunity for all American investors, Republican or Democrat, and that everyone be treated similarly whenever they put their hard earned money at risk in these capital markets.

Mr. KANJORSKI. Mr. Chairman, I want to agree with what you have just said. And I think it indicates just how far the Subcommittee has come along these last several months. It is vitally important that we understand the unintended consequences of the change. And I think all the parties have been very responsible and perhaps will assist us and aid that. Maybe they can get together and work out what changes, what things can be done to accomplish a better and more efficient and more better priced market. If we accomplish that, we are home.

Chairman BAKER. I thank the gentleman.

I just want to make sure that no one leaves with the thought that this is going to be a grand project that takes 60 years. This is going to be something the Committee will make some final determinations on in the near term and put it behind us. There are many other issues of grave concern to the capital market function, but this is one that should be set aside one way or the other.

Mr. KANJORSKI. And we know we do not have anything else important going on.

Chairman BAKER. Absolutely not.

If there are no further comments, I wish to again thank our participants for the lively discussion and informative debate. Our meeting stands adjourned.

[Whereupon, at 12:53 p.m., the Subcommittee was adjourned.]

A P P E N D I X

February 20, 2004

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES

THIRD HEARING ON REVIEWING U.S. CAPITAL MARKET STRUCTURE:
THE ROLE OF THE SPECIALIST IN THE EVOLVING MODERN MARKETPLACE

FRIDAY, FEBRUARY 20, 2004

Mr. Chairman, we meet for the third time in the 108th Congress to review the structure of our capital markets and evaluate the need for further reforms in light of technological advances and competitive developments. Today's hearing will examine the role of the specialist on the New York Stock Exchange and recently announced changes to the Big Board's trading systems.

As I have noted at our previous hearings, a variety of participants in the securities industry have questioned one or more aspects of the regulatory system during the last several years. We have also, without question, come to a crossroads in the securities industry, facing a number of decisions that could fundamentally alter its structure for many years to come.

Because we have elaborately interlocking systems and relationships in our securities markets, however, I believe that we should refrain from pursuing change for change's sake. At our last hearing, the Chairman of the Securities and Exchange Commission further observed that in pursuing any change to fix those portions of the system experiencing genuine strain, we must ensure that we do not disrupt those elements of our markets that are working well.

In the near future, the Commission is expected to put forward for comment a series of proposals that would reshape the structure of our securities markets. In adopting the Securities Acts Amendments of 1975, the Congress wisely decided to provide the Commission with a broad set of goals and significant flexibility to respond to market-structure issues. From my perspective, this legal framework has worked generally well over the last three decades.

Mr. Chairman, I have made investor protection one of my highest priorities for my work on this Committee. As the Commission proceeds with its reform proposals, it is therefore my expectation that it will thoroughly examine the effects of these plans on average retail investors.

Under our present regulatory system, retail investors are guaranteed the best price that our securities markets have to offer regardless of the location of a trading transaction. By ensuring fair treatment, this best-price guarantee has significantly increased confidence in our securities markets.

Interestingly, some recent news reports have suggested that the Commission may issue a proposal to permit participants in our capital markets to opt out under certain circumstances of this best-price guarantee. Such a plan has the potential to produce unintended consequences like fragmenting our securities markets, decreasing liquidity, and limiting price discovery. Because such results could prove deleterious for small investors, I will be monitoring this issue very closely in the weeks and months ahead.

At our previous hearings on these matters, Mr. Chairman, some have further suggested that specialists are an anachronism in our capital markets. I have a different view. The human involvement of specialists in the trading process can contribute to the smooth and efficient functioning of our capital markets. Rather than complain about the specialist system, each securities marketplace should -- with the appropriate oversight of the Commission -- have the freedom to decide for itself the best way to organize its trading operations.

As I have studied the role of the specialist on the New York Stock Exchange, I have also come to appreciate its similarity to the role of legislators in Washington. With today's technology, we could each remain in our district offices and vote on pending bills. It is, however, our interaction with one another in the halls of the Capitol complex and during the debate on the House floor that allows us to improve legislation and get the best deal for our constituents. In the same way, it is the interaction of the specialist with brokers and others that should help to produce the best price for investors.

Before I close, Mr. Chairman, I should acknowledge that we are fortunate to have John Thain, the new leader of the New York Stock Exchange, with us today. In the last five weeks, he has announced several important reforms, including one to significantly expand the Big Board's automatic trading platform and another to restrict specialists from participating in certain trades. As the Commission proceeds in its market-structure deliberations, I hope that it will follow a prudent course of action and allow sufficient time for the effective implementation of these recently announced changes before creating greater uncertainty with respect to reforming our National Market System.

In sum, Mr. Chairman, I believe that our panel must continue to conduct vigorous oversight of the securities industry to determine whether its regulatory structure is working as intended and to examine how we could make it stronger. The observations of today's witnesses about these complex matters will also help me to discern how we can maintain the efficiency, effectiveness and competitiveness of our Nation's capital markets into the foreseeable future.

Testimony of Robert Greifeld
CEO and President
The Nasdaq Stock Market
Before the
Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises
Of the House Financial Services Committee

Field Hearing:
Market Structure III: The Role of the Specialist in the Evolving Modern Marketplace

Chairman Baker, Ranking member Kanjorski and members of the Subcommittee, thank you for inviting me to testify before you today in New York. As a New York-based company, The NASDAQ Stock Market is proud to be an integral part of the capital market system in the financial capital of the world.

The purpose of this hearing is to explore what the role of the specialist should be in the evolving modern marketplace. I would argue that the market is already answering that question today, as witnessed by the evolution of NASDAQ, the growth of electronic communication networks (ECNs), and by the fact that my colleague at the New York Stock Exchange (NYSE) is contemplating major structural changes designed to inject some electronic trading into the NYSE's market.

The role of the specialist is diminishing today because investors are demanding faster executions, they are demanding to trade more efficiently and with greater certainty and, consequently, they are achieving better results for themselves and their clients. These investors include many more Americans than was the case even a generation ago. Today, even Americans with limited incomes have 401k accounts at Fidelity, open Individual Retirement Accounts, or receive stock options at work. As more Americans invest their money in the market, American markets are becoming open to greater scrutiny and therefore must be transparent and demonstrate better results. Electronic markets offer these qualities; today's specialist system is based upon an 18th century model that cannot serve today's investor.

Moreover, listed companies are increasingly seeing the benefits of added liquidity which come from electronic trading. Many major corporations have chosen to list their stocks on NASDAQ, and others are beginning to reconsider their market choice in order to take advantage of greater electronic trading.

Specialists in a floor-based system trade slower than electronic markets, they deny investors access to critical market data, and they maintain a monopoly in the trading of individual stocks. It is no wonder that all other major markets worldwide (except of course the NYSE and the American Stock Exchange) have abandoned floor-based systems for electronic markets.

At NASDAQ, we are offering an alternative to the specialists by encouraging competition in the listed company marketplace through our dual listing program and by competing for transactions of NYSE-listed stocks. If you really want to see what the role of the specialists should be in the marketplace, support NASDAQ's dual listing program and repeal the Trade Through rule. These steps will inject competition into the specialist's marketplace, and will enable markets and investors, not monopolists and regulators, to answer that question.

But to offer my opinion, the answer to the question posed for this hearing is that the role of the specialist, as it now exists, will come to an end; it is inevitable as sure as cars replaced horse-drawn carriages.

How NASDAQ operates versus how specialists at the NYSE operate

The evolutionary track of the American capital markets can be seen today at NASDAQ. NASDAQ is not a market floor; it exists in cyberspace. NASDAQ does not grant a specialist a monopoly to trade a company's stock; NASDAQ employs competing specialists, called market makers, electronic order routing technologies called ECNs and direct access brokerage firms to vie with one another for executions by electronically entering customer orders. Every stock has at least three market makers who commit their own capital and maintain a market by providing buy and sell orders, and some stocks may have forty or more market makers. Buying and selling takes place in milliseconds.

NASDAQ offers a dynamic and competitive environment where all market participants view quotes and transactions simultaneously in real-time. NASDAQ ties together all interested market participants; it does not limit trading to an elite few. NASDAQ is the democratization of the marketplace.

NASDAQ is the embodiment of competition and free markets. NASDAQ participants compete for every listing, every quote, every execution, and every trade report, and we feel other markets should do so as well. Our open architecture has facilitated competition. We have nearly 300 market makers who are willing to commit capital to help with the execution of buy and sell orders. If our market makers are not needed to help with the execution of an order, we provide the electronic venue where buyers and sellers can meet at low cost, high speed, and without the knowledge of any unneeded intermediary. NASDAQ's market structure promotes efficiency, and market quality statistics mandated by the SEC bear this out.

This is in stark contrast to the current floor-based system at the NYSE. The floor-based private clubs hoard information. All orders flow to a single specialist for a stock. The only participants with real time views of buy and sell interest are the specialists. Other participants are relegated to less transparent, sometimes questionable, information streams. This lack of uniform transparency undermines investor confidence and is evidenced by investigations into specialists "stepping ahead" of customer orders and a host of other occurrences with equally disturbing names like "penny-jumping," "holding up cancel requests," and "matching the public." The shared flaw in all these manipulations is that the specialists have non-public material information about the trading characteristics of their assigned stock. Investors are at their mercy.

When trading does occur, a live auction can take 30 seconds or more. In that time, a stock may change price hundreds of times on an electronic market.

Many argue that a floor-based monopoly can produce short-term benefits. But history and economics show that monopoly power is corrupting and is bad for investors. Electronic trading has revolutionized trading on NASDAQ, but the listed arena is frozen in time. When electronic orders try to move in the listed environment, they are held up for an "eternity of seconds" because the Trade Through rule requires the orders to get routed to a specialist. But, in a decimalized environment, the specialist can no longer offer significant price improvement opportunities. A 30-second interruption of trading is not justified for the potential of a one-cent improvement in price.

In this regard, it is important to highlight that each price point in the equity market has a total number of shares that are available to trade. If Wal-Mart advertised that it was selling Coke at 99 cents but stated there were only five hundred bottles available at that price, recognizing how busy Wal-Mart is on a Saturday afternoon you would realize that by the time you traveled to Wal-Mart it would be unlikely that you would be able to purchase the Coke for 99 cents. The average trade size on the NYSE is five hundred shares.

What our colleagues from the NYSE are asking for is a continuation of a practice where their specialists have the ability to stop the advancement of the U.S. equity markets because their specialists might advertise, without a commitment to trade, at a certain price. If the specialist, in his discretion, is willing to trade at that advertised price, he can limit that commitment to one hundred shares. If at a point in time there were advantages to the monopolistic manual methods of the specialist system, they have no claim on our future.

Finally, some have raised a false dichotomy between the floor-based monopoly specialist model and electronic markets. For most enterprises, automation is used to improve operations, but it does not replace the value added by humans. The NASDAQ business model represents the best of man and machine. We use an electronic market when it offers a less expensive, faster, more transparent and more consistent forum for investors to trade stocks.

The NASDAQ market model utilizes market makers when people and capital can add true value to investors. In addition to market makers, our market employs hundreds, even thousands, of skilled professionals who engage in activities such as: innovating and improving the services offered to investors; constructing legal safeguards to protect investors and listed companies; and monitoring and interpreting trading data to ensure compliance with the rules. In the State of New York, NASDAQ and its corporate parent the NASD collectively employ 509 people, and an additional 2,500 people work directly in the NASDAQ listed trading community.

At NASDAQ, humans do what humans do best and machines do what machines do best.

Why Repeal the Trade Through Rule

The SEC is now considering changes to the Trade Through rule as part of its market structure reform effort. In the era before fully electronic markets and lightning-fast efficient linkages, the SEC mandated the Trade Through rule to ensure that investors' orders were executed fairly. Because only floor-based markets existed at the time, the SEC premised the rule on the physical limits of floor-based trading.

But the Trade Through rule is an anachronism today, and we believe that it should be repealed. NASDAQ has thrived without a Trade Through rule, and the SEC has already acknowledged the shortcomings of the Trade Through rule by exempting the trading of the largest Exchange Traded Funds (ETFs) QQQ, Spiders and Diamonds – among the most heavily traded stocks in the world – from the strict requirements of the rule. The pilot program has been successful.

This issue is relevant to today's hearing because repeal of the Trade Through rule will enable the marketplace to decide the role of the specialist by requiring them to compete. As CEO of NASDAQ, I know that the structure and operation of the NASDAQ Stock Market is the best in the world. I support the pro-competition policies in place at NASDAQ, and I yearn for the opportunity to compete on a fair and even playing field with the NYSE and the American Stock Exchange. The SEC does not need to outlaw specialists for competition to bloom, but specialists should be stripped of their exclusive trading privileges and forced to compete with alternative models. By abolishing the Trade Through rule, the specialist would be forced to compete just like NASDAQ, the ECNs and market makers.

Therefore, the repeal of the Trade Through rule would inject competition into the specialist's world; it would not eliminate the specialist. Specialists will continue to operate at the NYSE so long as they can add value. If so, as they so ardently claim today, this policy change will not harm them, as investors would continue to send order flow to them. Investors will choose whether they add value or not and will use them accordingly.

This brings us to the most important aspect of Trade Through repeal – investors would benefit from having choice and from the innovation and improvements that competition will unleash, just as they have in the NASDAQ market space with tighter spreads, great liquidity, faster execution times and better fills rates.

Investors are no longer homogenous. Investors have different needs. Investors want the freedom to choose the certainty of faster markets or the minimal market impact of anonymous executions or markets with lower costs. The Trade Through rule stifles investor choice by forcing investors to use slow, manual markets. It stifles competition and innovation by protecting the monopoly of a single specialist. If investors could send their orders to faster, more transparent electronic markets or to market makers willing to compete with specialists, it would force specialists to compete for orders by, among other things, narrowing their spreads and executing trades faster.

There is no mystery to what happens to markets when Trade Through is eliminated. NASDAQ is the laboratory with documented superior results. The SEC's own execution quality statistics – the 11Ac1-5 or "Dash 5" statistics – show that NYSE stocks subject to the Trade Through rule have wider spreads, and trades are executed more slowly and expensively than NASDAQ listed stocks.

- According to the most recent Dash 5 data, the effective spreads for S&P 500 stocks traded on NASDAQ are 1.21 cents. For the NYSE, the effective spread is 1.76 cents.

- The average execution speed for S&P 500 stocks on NASDAQ is 6.7 seconds. For the NYSE the average execution speed is 18.4 seconds.

- The percentage of S&P 500 shares executed at or inside the quote at NASDAQ is 91.1%. That is far better than at the NYSE, where the percentage of shares executed at or inside the quote is only 82.4%.[1]

The move to decimalization has highlighted the benefits of electronic trading as detailed in the Dash-5 statistics. Before share prices were decimalized, bid-asked spreads were often 25 cents or more. If I could cut the spread by a nickel, there was much to be gained by spending the time looking for such savings. Actively traded stocks today have a one-penny or two-penny spread. The effective spread for Microsoft is only seven-tenths of a penny. In such an environment, the only purpose of the auction on the NYSE floor is to provide the specialist the time to gain advantage from the information in the investors' orders.

To use a real world example, consumers sometimes prefer to pay a little extra for a gallon of milk at the convenience store around the corner rather than travel a couple of miles for cheaper milk at the supermarket. The same principle is true for investors. Many want to be able to choose to trade quickly, sometimes forgoing a penny or two in order to ensure they have their order filled rapidly at an acceptable price. But they can't do this today because of Trade Through. They have to trade at the pace of the slowest market – the floor-based exchange. If Trade Through were repealed, investors would still be able to choose the best advertised price. They get to choose whether they want to drive a little further for that gallon of milk.

Clearly, now is the time for reform of the Trade Through rule. As SEC Commissioner Paul Atkins said in a recent speech, the Trade Through rule may actually "prevent individual investors and professional traders from obtaining an execution that meets their

[1] Source for all data is SEC Rule 11Ac1-5 data, November 2003 marketable orders, provided by Market Systems, Inc. See SEC Release No. 34-43590; File No. S7-16-00 (November 17, 2000).

needs." The SEC should let investors decide what they need, avoid the appearance that they favor one market over others, and promote competition.

Dual Listing and Trade Through

While repeal of the Trade Through rule would enable competition for NYSE-listed stocks, NASDAQ already has embarked on a campaign to compete with the NYSE specialists for listings. On January 12, 2004 NASDAQ announced that six companies listed on the NYSE – Apache, Cadence Design Systems, Charles Schwab, Countrywide Financial, Hewlett-Packard, and Walgreens – have agreed to be dual listed on the NASDAQ market. This announcement represents an exciting and proper evolution for competition between primary market centers.

As many do not know, NASDAQ currently trades all NYSE listings through the intermarket trading system; and we have 13 percent share of NYSE volume. With dual listing, we hope to prove to these companies that the NASDAQ structure is better. As long as Trade Through stands as a barrier to trading, however, these outcomes could be limited.

As Sean Harrigan, President of the California Public Employees' Retirement System (CalPERS) Board of Administration said after the announcement of dual listing, "This is an excellent market response to the debate over the specialist system versus an automated system. I believe investors will benefit from this competition by seeing improved liquidity, better execution, and greater transparency. I would encourage other CEOs and their Boards to examine the option of dual listing on both exchanges. It is our hope that the regulatory authorities will further improve the efficiency of the markets by eliminating the trade-through rule."[2]

Languishing NASDAQ Exchange Status an Impediment to Competition

Finally, I want to discuss one unresolved issue critical to fair treatment and competition. For over three years NASDAQ has awaited word from the SEC on our application to become an exchange. As an exchange, NASDAQ would have a legal structure that companies considering their listing decision could not question. Currently, NASDAQ is frozen in a partially separated structure that does not remove all conflicting roles from our governance structure. Most importantly, our regulator the NASD would be completely separated from our market by approving exchange registration.

NASDAQ is not a startup entity. We trade more shares everyday than any market in the world. We diligently protect investors. Our rules are fair and unbiased – and SEC approved. We should be granted exchange status.

[2] Press release, "CalPERS issues statement on dual NYSE/NASDAQ listing of companies," Sean Harrigan, President of the California Public Employees' Retirement System Board of Administration, January 14, 2004.

Of course, NASDAQ is committed to working with the SEC to ensure that the application fully reflects the intentions of Congress and the requirements of the securities laws.

* * * * * *

Thank you again for this opportunity to testify. I am happy to answer your questions.

<u>The Price Matters</u>:
Ensuring All Customers The Best Price as We Enhance the Benefits of the Agency-Auction System at the New York Stock Exchange

Written Testimony of
Robert H. McCooey, Jr.
President and Chief Executive Officer
The Griswold Company, Incorporated
Member, New York Stock Exchange

Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives

Field Hearing on
"Market Structure III: The Role of the Specialist in the Evolving Modern Marketplace"

Alexander Hamilton Auditorium
Native American Museum
New York City

February 20, 2004

Testimony of Robert H. McCooey, Jr. Member of the New York Stock Exchange and Chief Executive Officer of The Griswold Company, Incorporated

February 20, 2004

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

My name is Robert McCooey. I am a proud Member of the New York Stock Exchange and President and Chief Executive Officer of a New York Stock Exchange member firm, The Griswold Company, Incorporated. Griswold is an agency broker executing orders for institutional clients on the Floor of the NYSE. As an agency broker, we execute trades on behalf of our customers. We do not make markets in securities or engage in proprietary trading. Our clients include some of the largest mutual and pension funds in the United States.

Thank you for inviting me here today to testify in connection with your continuing review of the capital markets structure here in the United States. I would like to commend the Chairman on his choice of New York City – the center of global capital markets – as the site for this hearing. New Yorkers take great pride in our city. We have worked hard to achieve this status, one that is clearly the envy of our international competitors.

Chairman Baker, I am also very pleased that you have chosen my new partner at the New York Stock Exchange, John Thain, to address the committee today. Five weeks ago, John joined an organization that was desperate for new leadership to implement previously announced changes and address important customer needs.

What John has accomplished in just this short period of time coupled with the work of interim Chairman John Reed is nothing short of remarkable. I think that it is clear to all that there has been a dramatic change at the NYSE. The membership is hopeful that regulators and legislators will support these new changes for the continued benefit of all users of our institution.

My focus today will be on the major market structure issues that are currently under review by the House Capital Markets Subcommittee, your counterparts on the Senate side and at the Securities and Exchange Commission. The discussions that we engage in today should focus on how to **enhance** the National Market System for the benefit of all investors. In the process of answering that charge, we should also promote the aspects of the current National Market System that provide positive results in the execution of investors' orders. I would contend that the agency-auction market model at the New York Stock Exchange is one of these important competitive aspects of the National Market System. The specialist, the focus of today's hearings, plays a vital role in that system.

As an agent on the Floor of the NYSE for the past 16 years, I have seen the evolution of Floor brokers from providing outsourced executions for the major broker-dealer firms to establishing themselves as strategic partners for institutional clients. Increasingly, the goal for clients has been to find ways to gain efficiencies in the execution process by getting closer to the point of sale. Independent agents working on behalf of these customers now furnish real time market information coupled with tremendous costs savings to these institutional customers. The assets that are managed by my institutional customers are owned by the small retail customer: the pensioner, the parent saving for college, the worker funding their IRA and all the others who invest in equities traded here in America. Today in the United States, when we talk about doing what is right for the marketplace and the participants in that market, we must realize that the retail customer and the institutional customer are one in the same. They are all our assets; institutional is just a larger commingled pool.

Floor brokers play an important role in the price discovery process. The competition between orders represented by brokers at the point-of-sale on the Floor of the NYSE helps to ensure fair, orderly and liquid markets. It is the Floor broker who will seek out contra side liquidity for an order as well as make decisions based upon rapidly changing market dynamics. The Floor broker serves as a point of accountability and information, with the flexibility to represent large orders over time at the point of sale – not found in dealer markets and ECNs – and employs the most advanced technology to support his or her professional judgment. The interaction between the Floor broker and the specialist provides the flow of information necessary to keep customers informed about changing market conditions. That information flow is more often than not the catalyst that provides incentives for traders to provide liquidity in a way that reduces execution costs. The combination of best price and intelligent information flow is the backbone of the NYSE.

Superior technology will continue to be the NYSE's advantage. During the past decade, the NYSE has invested billions of dollars in technology for our trading floor, data centers, and new product and service development. The NYSE Floor has one of the largest deployments of flat screen technology anywhere. Brokers no longer write on little slips of paper and have "pages" transport the information from point-of-sale to a phone clerk for relay to our clients. The agent relies upon a digital handheld communication device, which receives the order, transmits the reports (often directly to the customer) and engages in an ongoing dialogue with the client through the use of digital images. All of this is accomplished without ever leaving the trading crowd.

The Specialist in the Agency-Auction Market

The topic of today's hearing is to identify the role that the specialist will play as the market continues to change. As an agent on the Floor of the NYSE, I have seen the role of the specialist evolve over the sixteen years. A fundamental principle is to place the interests of the customer first and provide each customer with the best experience trading at the New York Stock Exchange. The specific value that accrues to investors can be broken down into two major categories: information flow as an important part of a specialist's catalyst function and liquidity provided to the marketplace.

As I speak with my customers about the multiple marketplaces in which they trade, one theme about the NYSE is consistently voiced. Customers appreciate the fact that the floor based NYSE provides the participants in that market with valuable information that aids buyers and sellers in making market entry and exit decisions. Through this information flow, specialists act as catalysts, proactively bringing buyers and sellers together thus creating trades that otherwise would not have occurred. Responding to a buyer for example, a specialist may recall selling interest on the part of a particular agent and call that agent to the crowd to help effect a trade. The buyer can then negotiate directly with the agent representing the seller. This results in natural buyers meeting natural sellers over 80% of the time with minimal market impact. Without the specialist as the catalyst for providing that information, the trade may have occurred at the wrong price or worse, never happened at all. This kind of information flow is impossible in electronic markets. Furthermore, the information gathered from the specialist at the point of sale is available impartially to all who ask.

The second and equally important function to customers is the liquidity that the accountable specialist adds to the marketplace. It is important to remember that specialists do not set the price for stocks. At the NYSE, that pricing function is reserved for the buyers and sellers. The important role of the specialist is to provide the liquidity necessary to the market to assist agents in getting orders executed correctly for their clients. What specialists do is risk their capital – in excess of $11 billion during an average trading day – to add market depth and stabilize prices. They inject liquidity by bridging temporary gaps in supply and demand. Each of these trades for the specialist is a one-sided risk transaction. The best method for me to explain the value that accrues to customers is to give you an example:

The market is $28 bid for 25,000 shares and 18,000 shares offered at $28.05. My customer entrusts me with an order to purchase 25,000 shares – this may be all the customer wants to purchase or the beginning of a much larger order. My goal is always to execute that order at the best possible price with the minimum of market impact. I want to purchase all my stock at $28.05, the whole 25,000 shares. That outcome will be in my client's best interest. The only way for this to happen is if the specialist is there to add the necessary liquidity – the other 7,000 to make 25,000 – to complete my client's order. In the absence of a specialist, my natural buyer customer would have to reach to the next price point where that liquidity was available to purchase those shares. For the sake of the argument, let us assume that the customer would have had to pay $28.10 to purchase those shares. Without the capital that the specialist injected into the market to complete my client's order, the cost to that institution (and the hard working investors in that fund) would have been an additional $350. That may seem like a very small amount but multiply that savings by the thousands of times that it happens daily and the millions of dollars add up very quickly.

It is important to remember that specialists are not allowed to compete with public orders – they can only buy if they are willing to pay a higher price than anyone else and only sell if they are willing to accept a lower price than anyone else. In fact, the vast majority of trades in which specialists participate are those which most investors would avoid. The specialist obligation to the marketplace requires him or her to be buying when prices are falling and selling when prices are rising, all in an effort to provide liquidity and stabilize prices. In doing so, they reduce overall price volatility. In fact, 98% of all NYSE trades occur at 5 cents or less from the last sale, giving investors confidence that price fluctuations will remain orderly.

Trading technology has allowed people at both the customer and broker-dealer level to work more efficiently as the markets have grown. From the late 1980's, when an average trading day's volume was 100 million shares, today we trade well over 1.5 billion shares on a regular basis. Occasionally, technology can have its' problems. There have been several occasions over the past few months that illustrate the need for professionals working in concert with the technology. A number of months ago, a large NYSE member firm initiated a "program trade" for a customer involving a basket of large cap stocks. Unfortunately, someone added an extra zero to the dollar amount of the trade and what was supposed to be a $40 million basket ballooned to $400 million. On the Floor, those trades were quickly identified as possible errors and the firm was contacted. Realizing the problem, the firm was able to cancel the vast majority of those trades before execution. In another scenario, another member firm entered an order to sell 1 million shares of XRX. While preparing to trade the stock at the appropriate price in the market where demand met this supply, the firm was contacted and an error was again prevented. The order was supposed to be for 1,000 shares only. This process could not occur in an electronic market where there is no one designated to recognized a potential problem such as the ones I described. Only through human intervention and immediate dialogue between market participants were huge losses to investors prevented.

In competing markets, we have recently seen examples of how electronic markets function in the face of stress or incorrect order entry. In early December 2003, the stock of Corinthian Colleges Inc. (COCO) plummeted 19 points in just a matter of minutes. The full details surrounding that event, the halting of the stock, trading in other markets and the canceling of trades made in good faith by investors are still unclear. Recognizing that different market models yield different results, I believe that in this case human participation through an agent or specialist would have prevented such a precipitous decline.

Finally, just last week we observed the trading in the stock of Imclone (IMCL). In three minutes, the stock dropped more than 20% from $42 to $33.50 on no news before being halted. After a 2 hour and 40 minute halt, IMCL finally reopened at 4:20PM – 20 after the NASDAQ closed. During this entire time period, Bristol-Myers Squibb, which owns a stake in IMCL, remained open for trading on the New York Stock Exchange. When it did reopen Imclone immediately rose 35%, back to the levels prior to its' decline and halt, but in after-hours trading, a market which serves only institutions.

The Trade Through Rule

The "trade-through" rule was designed to convert multiple competing markets into a National Market System. The rule turns each market into a gateway to every other market and ensures that investors will not be disadvantaged by virtue of having bids or offers displayed in one market versus another.

When trading is allowed to occur outside of the National Best Bid and Offer (NBBO), two investors are being disadvantaged – the bid or offer that has been posted as well as the buyer or seller who received an inferior price to the NBBO. To amplify this, I would like to offer the following example: A buyer posts a bid of $49.05 to buy 5000 shares of XYZ, the stock is offered at $49.10. In the absence of a "trade-through" rule, a trade of 5000 shares might occur at $49.00. In this instance, two investors are not being afforded the full protection that they deserve in the marketplace. The seller who sold stock at $49.00 did not receive the highest price that was bid for those shares in the market. Further, the buyer with the $49.05 bid is left unfilled. This investor posted the best bid in the marketplace and was ignored. In a time of skepticism and as we try to restore confidence in our markets, I do not believe that this is the message that we want to disseminate to the investing public.

There are other parts of the trade through equation that are overlooked by many. Trade throughs cause the mis-pricing of equity securities in the marketplace. When a trade is allowed or sanctioned to occur outside of the

NBBO, the rest of the market is now unsure as to the true price at that moment in time. Investors are now worried about what might be "going on" as a trade takes place away from the best bids and offers. That broker-dealer may now engage in a riskless principal transaction, through the use of sophisticated technology and market intelligence undisclosed to that fiduciary's ultimate customer, to not only accrue a commission but to profit in the firm's principal trading account. The firm will buy outside of the NBBO and then hit the bid or take the offer at the NBBO on the NYSE or another market to offset their position. This activity denies customer the opportunity to engage in the full price discovery process. Moreover, the riskless trading by broker-dealers disrupts the markets and damages the overall pricing mechanism. Why not mandate that customer orders should interact rather than unnecessary dealer interpositioning?

One of the major factors that draw companies to the NYSE is the incontrovertible fact of reduced volatility after a stock moves from being listed on NASDAQ to the NYSE. Management and Boards of Directors realize that a tightening of spreads and minimizing trade-to-trade volatility are serving their shareholders' best interests. A key factor in why this occurs is the accountable specialist. The liquidity that the specialist adds to the market on a moment-to-moment basis prevents stocks from declining or advancing too quickly. Volatility scares investors and therefore, has an impact on the capital raising process for many firms. The dampening of that volatility by a specialist gives confidence to the investor that there will always be a continuous two-sided market in that security. Trading that occurs outside of the NBBO will increase volatility in these issues and adversely affect investment decisions.

The most important starting point for any trade through discussion must be the facts, and how the facts impact every investor. Some proponents of weakening or eliminating the trade through rule do so out of self-interest, not with the interests of all investors in mind. Simply stated, the facts do not support their contention that investor protection provided by the rule stifles competition. At the New York Stock Exchange we welcome competition. However, that competition must be one that ends with the execution of a customer's order at the best price available in the marketplace. The reality is that the NYSE posts the best price nearly 93% of the time in our listed securities. We think that competition should be based upon price. This is not an artificial barrier to competition. Other markets can compete by simply matching or bettering our prices. Certainly, our customers agree with that value proposition every day as we receive approximately 80% of the volume in NYSE listed securities. We do not think that any marketplace should receive regulatory relief from a rule that benefits investors. By ensuring that best price is paramount to markets, customers as well as the competitiveness of the U.S. securities markets will be well served. Tremendous competition exists today and order competition, as the critical factor in price discovery, based upon protecting those who display best prices promotes the entry of limit orders that narrow quote spreads and reduce execution costs.

Modifying or eliminating the trade-through rule would produce inferior prices and increased costs, increase market volatility, and reduce accountability and transparency. This is not the way to promote investor trust and confidence.

A Penny Saved is a Penny Earned

With thirty co-sponsors, Chairman Michael Oxley sponsored **H.R. 1053** "to eliminate legal impediments to the quotation in decimals for securities transactions in order to protect investors and to promote efficiency, competition, and capital formation." It has now been over three years since that dramatic shift in the way securities are traded.

Arguments were made at that time about the tremendous savings to investors from the shift to decimal pricing of securities. Speaking to support "The Common Cents Pricing Act of 1997" Herbert L. Dyer, Executive Director of the State Teachers Retirement System of Ohio told this House Committee that decimals "could save our teachers and retirees millions of dollars annually." J. Kenneth Blackwell, Treasurer of the State of Ohio, explained his support for the legislation by saying that "Decimalization will encourage the laws of free trade to regulate our exchanges, thereby alleviating the need we now have for many of the rules governing trading in our markets." Savings to investors and competition to provide the best and most fair markets to investors; these were the goals and results of this groundbreaking legislation.

For those who propose a "de minimus" or "opt out" exemption to the trade through rule, I would ask: So, what happened along the way to the penny? Has something changed in the Congressional mind in these few short years? Do investors no longer deserve to save money? Have we decided to encourage investors to ignore the best price available in the marketplace? Should investors be prohibited from the opportunity to garner the highest return for the capital that they have invested? Is it acceptable for fiduciaries to accept a worse though speedier price for the stocks that they are buying and selling on behalf of the millions of shareholders who have entrusted them with their hard earned money?

Pennies add up. If fiduciaries are abdicating their responsibility to achieve the best price available, the impact to their shareholders (THE PUBLIC) is very significant. If a fund forgoes better available and accessible prices for the sake of speed, the negative cost impact to the fund's shareholders is in the millions of dollars. For a fund trading an average of ten million shares a day (not unusual today), to receive that incremental penny of price improvement on all those shares and multiplied by 250 trading days in a year, the savings are twenty-five million dollars ($25,000,000), which rightfully belongs to your constituents. Furthermore, I am only giving you one example of just one fund manager. Across thousands of funds and billions of shares traded, the potential negative impact to investors makes the term "de minimus" a real misnomer.

The Specialist in the Evolved Marketplace

The role of the specialist (and that of the floor broker, for that matter) will continue to evolve. At the New York Stock Exchange, we embrace change. Providing choices to our customers has been the hallmark of the New York Stock Exchange for as long as I have been a member and we are again addressing the needs of our customers who have asked us to provide more choice. Two weeks ago, our Board passed on a significant structural proposal sent to them by our Market Performance Committee and the Board of Executives, which has been submitted to the Securities and Exchange Commission for final approval. Briefly, the plan calls for an automatic execution of all displayed liquidity in the quotation. Currently, the NYSE offers a product called Direct+, which provides an automatic execution for order up to 1,099 shares with a prohibition of the same customer entering orders in the same stock within 30 seconds. To enhance the product, we have proposed the removal of these restrictions. This will allow the execution choice for 87% of all orders entering our marketplace in less than one second thus disposing of the issue that we are a slower market. We already trade over one hundred million shares a day in this manner. Within our price discovery dynamic, we will preserve the role of the specialist in bringing buyers and sellers together, and committing capital to dampen volatility, as well as the contribution of agency Floor brokers who reduce the market impact and execution costs for institutional-size orders.

Mr. Chairman, your recent description of the New York Stock Exchange in a letter to SEC Chairman William Donaldson, left many feeling that the portrait was incomplete. To those who do not live the market every day, what we do on the NYSE Floor may seem "old-fashioned" but I beg to differ. At the end of the day, it is not just about the technology – and we have plenty of that – it is about the process and the results that accrue great benefits for investors, your constituents.

Let me offer an analogy: Congress meets in Washington DC. Members have offices and staffs. Gavels are banged. Beautiful meeting rooms, antique wooden desks, pictures of dead presidents – all the trappings of a civilized way to execute the business of governing. Almost three hundred million Americans rely on the sound judgment of their agent in Washington to make the right decisions that will affect many aspects of their daily life and future. However, theoretically, it could all be done from your home districts. A bill could appear on a screen. The Member and his or her staff would read it and analyze its impact, most likely focusing on the member's home district and not the United States as a whole. Then, the vote would come. Point and click on the computer in the district without the benefit of face-to-face discussion and negotiation. That potential system is available today. From my background as a political science major and my time spent with many of your colleagues and fine staff, I do not think that just because it is available (and theoretically might save money) that such a "government structure" is one that we should embrace.

In the same way, we at the New York Stock Exchange – 1366 engaged professionals – feel that there is still value in the face to face negotiation that occur in each trading crowd, 250 days a year. Human interaction coupled with the benefits of technology enable elected agents whether in DC or on the Floor of the world's largest marketplace to make the right decisions on behalf of their constituents.

At the NYSE, we will continue to change, adapt and innovate to best serve our customers and to fulfill our commitment to producing the highest levels of market quality. We will continue to provide the fair and level playing field that investors want and expect from us. We will compete on the basis of discovering and delivering the best price coupled with the highest levels of transparency. The interaction of specialists and agency Floor brokers creates a value proposition in which the NYSE delivers to its customers the best prices, the deepest liquidity, the narrowest quote spreads, and the lowest volatility. That results in multi-millions of dollars of savings to your constituents each year. In all that we do, we take pride in the fact that we always place the investor first.

Thank you. I will answer any questions that you may have.

Testimony of Mr. Edward J. Nicoll
CEO – Instinet Group Incorporated

The House Subcommittee on Capitol Markets, Insurance and Government Sponsored Enterprises

Field Hearing entitled
Market Structure III: The Role of the Specialist in the Evolving Modern Marketplace

New York, New York

Chairman Baker, members of the subcommittee, thank you for holding this hearing and for inviting me to speak before you today.

My name is Ed Nicoll and I am the Chief Executive Officer of Instinet Group. While Instinet Group, through affiliates, exclusively serves financial institutions such as broker-dealers, banks, mutual funds, retirement funds, hedge funds, and the like, I have also had extensive experience serving retail investors as the former CEO of Datek Online, and as the co-founder and President of Waterhouse Investor Services. Both of these companies served millions of retail investors nationwide.

Instinet Group, through affiliates, is the largest global electronic agency securities broker. Through our electronic platforms, our customers can access over 40 securities markets throughout the world. We act solely as an agent for our customers and do not trade securities for our own account or maintain inventories of securities for sale.

As you look into the role of the specialist system and the regulations that keep it in place, I would encourage you to support regulatory changes that allow electronic markets to compete on a level playing field with manual, floor based markets such as the New York Stock Exchange. Specifically, Instinet Group has now spent more than three years calling for the elimination of Intermarket Trading System rules that inhibit electronic markets from competing effectively with the NYSE. The most significant impediment is the trade-through rule.

Media reports and the hard work of many in this room have educated most legislators and regulators on why the trade-through rule in fact hinders competition and hurts investors, and the chorus calling for the rule's reform continues to grow:

- In October 2003, The *Wall Street Journal* published an editorial calling for the abolition of the rule.

- In January 2004, California State Controller Steve Westly, a Democrat whose office oversees the billions of dollars invested on behalf of California retirees, wrote to SEC Chairman Donaldson in January that "[t]he trade-through provision is obsolete" and "[r]eforming trade-through will improve investor choice."

- Just last week, Florida Attorney General Charlie Crist, a Republican who is one of the three state officials who oversee his state's retirement investments, wrote Chairman Donaldson that "[e]limination of the trade-through rule would abolish this antiquated system. Progressive reform would ensure Florida's investors access to a competitive marketplace, prevent manipulation, and guarantee securities are bought and sold at the true "best price."

I have attached these and other similar letters and articles, including those from *Barron's* and *Fortune*, to my testimony and ask that you include them in the record.

However, there are still opponents to trade-through reform. Some argue that without the trade-through rule investors would not get the best price when buying and selling securities. But as you heard in last fall's testimony from numerous experts, this is simply not the case. Brokers still have a fiduciary duty to secure best execution for their clients – but best execution does not and should not mean attempting to execute against the best-advertised price without considering other factors.

Other opponents to trade-through reform appear to consider the issue to be a referendum on the future of the New York Stock Exchange's manual floor-based specialist model. These opponents assert that the rule does not hinder competition. Yet they tend to spend a considerable amount of time explaining the merits of the NYSE's centralized market structure versus other market structures. If the trade-through rule does not hinder competition, then why all the concern about which market structure is superior?

It is because the debate about regulatory reform is really a debate about whether one market structure fits all or whether investors should be free to choose how and where they trade. It is about competition.

The fact that even the trade-through rule's defenders believe that its elimination would affect the market's competitive balance strongly suggests that the trade-through rule is anti-competitive.

And if it is true that trade-through reform will result in greater competition for the NYSE, why should we be concerned about how the NYSE might have to change or adapt to such competition?

The NYSE's well-deserved prestige may make some reluctant to alter its structure. With respect to the role of the specialist, we are TOLD that the specialist has a duty to "maintain a fair and orderly market." We are TOLD that he provides valuable liquidity and that there would be greater volatility without the specialist there to perform his important functions. This all may be true – but how do we KNOW? What PROOF is there that the specialist is trading only when needed to maintain a fair and orderly market or, according to others, trading only when he can make proprietary trading profits. While the NYSE performs studies that purport to show its market is superior to the NASDAQ marketplace, how do we know if that is "in spite of" or "because of" the specialist?

The stakes are too high to not understand completely what the specialist is or is not doing. The principles behind the adoption of the Sarbanes-Oxley Act – enhanced corporate accountability, disclosure, and openness – need to be applied to the nation's markets as well. **I challenge the NYSE to make its trading data, and in particular all specialist trading activity, publicly available.** We owe investors an open and honest look at the numbers. Not just simple assurances that "All is well."

Trades where specialists participate accompanied by their position at that time should be identified in real time so investors, academics, policy makers, and market participants can better evaluate specialists' trading activity.

Today, when NYSE members complain about an execution, they cannot obtain sufficient data to evaluate the propriety of the specialist's activities.

This lack of information hinders market participants' ability to address their concerns with orders submitted to the NYSE for execution.

For example, in October 2003, Fidelity Investments' head of global trading, Scott DeSano, told the *Wall Street Journal*, "You never get any satisfaction, so you stop complaining."

Among our own customers, the most common complaint I hear is that orders sent to the floor are delayed or not executed at the NYSE's then-quoted market. Without a real-time audit trail, they have little insight into the NYSE's trading process, and less confidence that their orders receive fair treatment on the NYSE.

To its credit, the NYSE has taken some initial, albeit small, steps to respond to market participants' concerns by introducing NYSE Direct+. Direct+ is designed to address execution delays by providing market participants with some ability to obtain automatic executions at the NYSE's quoted market. With great fanfare, the NYSE recently submitted rule changes to the SEC that would, at least in theory, make it significantly easier to obtain automatic executions via Direct+.

Many have expressed their support for these new rule changes and the NYSE itself has proclaimed that Direct+ provides "ECN-like" features to investors. However, the proposed changes simply would expand the range of orders eligible to use Direct+ to include all orders, instead of limiting access to smaller orders and eliminating restrictions on the frequency of its use.

I am surprised that anyone would think that these relatively minor changes eliminate the competitive concerns raised in the trade-through debate. I am also surprised that the NYSE would boast that Direct+ offers ECN-like features.

First, with respect to whether the availability of so-called automatic executions on the NYSE eliminates the need to eliminate the trade-through rule, the short answer is "no." Even if the NYSE did provide additional opportunities for automatic executions, there is still no reason to retain a rule that inhibits competition between the NYSE and electronic markets.

But let's look at how Direct+ really operates. While it provides automatic executions there are some pretty substantial exceptions.

One exception is that there is no obligation to automatically execute an order if the NYSE's quote is in "non-firm" mode. How often does the NYSE publish quotes that are non-firm? Again, there is not much transparency into how the specialist operates its book. Without data from the NYSE on these practices, the "guarantee" seems illusory.

Another exception is that automatic execution is not available when the market is only for 100 shares. I am told this is frequently around 10-20% of the trading day. While this does not sound like much, it is likely that this 10-20% of the trading day occurs at moments when the market is volatile and receiving an automated execution is most valuable. Instead, the "automatically" executed order can take minutes.

A further exception is that automatic execution is only available against the orders comprising the NYSE's quoted market, and not the usually substantial amount of trading interest available at a penny and more behind it. And once the interest at the NYSE's quote is exhausted, Direct+ is unavailable until the specialist displays a new quote.

In sum, it seems the NYSE is guaranteeing an automatic execution except when it is not, which may be often. Not much of a guarantee.

In contrast to the NYSE, every order on an ECN is real and immediately accessible. It is not possible to display an order that is non-firm. There are no delays and no turning off the automated nature of ECNs. Further, every order sent to an ECN for display is immediately displayed. No delays, no freezing and no manual keystrokes from a clerk. That is why I am surprised that the NYSE would even try to compare itself to an ECN.

If the NYSE truly wants to offer an automated execution system that competes with ECNs, **I challenge the NYSE to make two additional changes**:

1) Immediately display all limit orders received electronically for display - no delays, no human intervention, and no exceptions.

2) Immediately execute all matching orders that received electronically - no delays, no human intervention, and no exceptions.

It is these delays in displaying and executing orders that many suspect the specialists use to disadvantage investor orders.

Those two changes would be a start in making the NYSE into a fairer "ECN-like" marketplace.

In conclusion, Instinet Group and operators of other electronic markets are only seeking the ability to fairly compete with floor-based exchanges. It appears, however, that the trade-through debate has become a referendum on the NYSE. Over the past months the NYSE has tried to perpetuate the current regulatory structure by asserting that its market is superior to the NASDAQ market. I do not believe that the NYSE provides sufficient data to adequately evaluate its market. I also believe that the changes that the NYSE is making to Direct+ will have little, if any, impact on investors. Regardless of these changes, there is still a need for unleashing competition between markets. Certainly, if the NYSE is stirred to propose these changes to simply stave off the threat of competition, actual competition will produce even greater benefits for investors.

Clearly, Mr. Chairman, the time for reform is now.

Thank you for your time, interest and leadership on these issues, Mr. Chairman. I would welcome the opportunity to answer any questions.

WRITTEN STATEMENT OF GERALD DEAN PUTNAM

CHAIRMAN & CHIEF EXECUTIVE OFFICER

ARCHIPELAGO HOLDINGS, L.L.C.

CONCERNING

"MARKET STRUCTURE III: THE ROLE OF THE SPECIALIST IN THE EVOLVING MODERN MARKETPLACE"

BEFORE

COMMITTEE ON FINANCIAL SERVICES – SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

UNITED STATES HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

FEBRUARY 20, 2004

Good morning Chairman Baker, Ranking Member Kanjorski, and other distinguished members of the Subcommittee. I am Jerry Putnam, Chairman and Chief Executive Officer of The Archipelago Exchange or "ArcaEx." It is high privilege and a great honor to be provided the opportunity again to submit a written statement to and testify before the Subcommittee on issues of market structure. If I may say, is there any more suitable setting for this hearing than, here, in New York City, the financial capital of the world, and in this historical place, the custom house named after Alexander Hamilton, our first Secretary of the Treasury and the founding father of American banking and finance.

I. <u>The ArcaEx Story</u>

The seeds of ArcaEx's beginning were sown in the immediate aftermath of the Nasdaq price-fixing scandal of the mid-1990s, which culminated in sanctions being brought by the Securities and Exchange Commission ("SEC") and the Department of Justice. [1] One of the chief reforms exacted on the OTC marketplace in response to the scandal was the introduction of the so-called Order Handling Rules in 1996. [2] These rules provided me an opportunity to design a trade-execution business that, although seemingly very simple, was revolutionary for its time. It was "to do the right thing" by the customer by creating a level playing field for all investors in an industry traditionally filled with insiders and insider deals. I reasoned that any business model

---

1 *See* Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market, SEC, August 8, 1996.

2 Securities Exchange Act Release No. 37619A (September 6,1996), 61 FR 48290 (September 12, 1996) (File No. S7-30-95).

that focused on the needs of its customers (investors) would be a profitable one. With that, our credo has always been: no special(ist) handshakes, no "negative obligations," no "jaywalking," and no thirty-second free options; rather, all investors are given the opportunity to play on a level playing field. This has been and will continue to be one of our competitive advantages.

From day one, we branded our business as "best execution" by delivering to *all* of our customers: (1) access to full and timely market information; (2) fast electronic and anonymous executions; (3) sophisticated order types and other value-added functionality; and, arguably our biggest contribution to market structure, (4) algorithmic outbound routing to guarantee best price where that price did not reside in Archipelago. This fourth prong was both a sizeable technological innovation and a manifestation of two primary goals articulated by Congress in the National Market System Amendments in 1975.[3] By establishing proprietary ***linkages*** among marketplaces, we were able to create a large virtual pool of liquidity where customers were given electronic access to ***best price*** not only within Archipelago's own system but also at other (competitor) electronic marketplaces. Unlike the listed market, [4] the OTC market does not have a "trade through" rule today. Thus, in lieu of government fiat such as the ITS trade through rule, getting "best price" for our customers was driven by a business idea, newly created customer demand, and our fiduciary obligation to achieve "best execution" for our customers.

3 National Market System (NMS) Amendments of 1975 to the Securities Exchange Act of 1934; Pub. L. No. 94-29, 89 Stat. 97 (1975).

4 The "listed marketplace" is defined as those national securities exchanges and self-regulatory organizations that trade NYSE- and AMEX-listed securities, as well as securities listed on their own markets, and include ArcaEx (as a facility of Pacific Stock Exchange), Boston Stock Exchange, Philadelphia Stock Exchange, National Stock Exchange, Chicago Stock Exchange, NASD (Nasdaq 3rd Market) and, of course, the NYSE and AMEX, themselves. These listed markets interface and interact with one and other in accordance with inter-market regulations and rules governed by national market system committees – ITS and CQ/CTA –and by the SEC. In contrast, the "over-the-counter (OTC) marketplace" is defined as those national securities exchanges and self-regulatory organizations that trade Nasdaq securities and include many of the entities listed immediately above such as ArcaEx. The "OTC marketplace" is structured under a wholly different set of inter-market regulations, rules, and committees than the "listed market."

In late 2001, after working with the staff of the SEC for two years, ArcaEx was unanimously approved by the SEC Commissioners to operate the first totally open electronic stock exchange. ArcaEx became operational to trade listed stocks in 2002 and OTC shares in 2003. Today, ArcaEx is ***the largest electronic stock exchange in the world*** (based on dollar volume) and is the ***second largest exchange in the United States*** (based on trading volume). From literally zero volume as an ECN in 1997, ArcaEx now handles about 26% of the trade volume in the OTC marketplace and 3% in the listed-marketplace, and is the largest marketplace for Exchange Traded Funds ("ETFs"), including QQQ, the most actively traded equity product in the world. ArcaEx handles about 600 million shares a day with our record day of over 800 million shares. In addition to ArcaEx's execution business, we have developed a listings business, which competes with NYSE and Nasdaq for both primary and dual listings. Like the execution business, more competition among listings venues provides issuers with better products and services at a more efficient price.

We believe our business success as an exchange is matched by our success as a regulated entity. In the same spirit of "doing the right thing" for investors by operating an open and un-conflicted trading platform, ArcaEx consciously organized its marketplace to eschew the legal and regulatory conflicts that accompany the traditional Self-Regulatory Organization ("SRO") structure where the regulatory arm is tightly wrapped around and integrally interwoven with the business marketplace. It is just that traditional SRO structure that contributed mightily to the Nasdaq price-fixing scandal of the mid-1990s and the bountiful NYSE scandals of 2003-present. To the contrary, ArcaEx is regulated by the independently owned and operated Pacific Stock Exchange ("PCX"), where the lines between business -- which is operated by ArcaEx – and regulation – which is operated by PCX – are bright and distinct and fireproof. As CEO of

ArcaEx, I am responsible for the business and all ArcaEx employees ultimately report to me. No employees of PCX report to me; rather they all report ultimately to the Chairman and CEO of PCX. Further, PCX has its own board of directors to which its directors owe fiduciary and regulatory obligations. The upshot: by outsourcing our regulation to PCX, our model allows us to avoid conflicts and focus exclusively on building and operating our business and serving our customers.

II. The Cure-All : Dynamic Competition

Nasdaq's price-fixing scandal in the mid-1990s principally involved conflicts of interest between the NASD regulator and its commingled Nasdaq marketplace, and investor execution quality being substantially compromised by inside players (market makers; alias competing specialists) for the direct benefit of those inside players at the expense of investors. The SEC imposed the Order Handling Rules, which benefited investors by lowering entry and competitive barriers in the OTC marketplace. Not surprisingly, these lower barriers cultivated an environment – primarily driven by upstart Electronic Communication Networks ("ECNs") and Alternative Trading Systems ("ATSs") – which introduced rapid technological innovation, unprecedented cost efficiencies, and an "investor comes first" attitude. What once was a Byzantine playground for insiders doling out legally dubious execution quality to investors, today's OTC marketplace – which consists of competitors like ArcaEx, Nasdaq, Instinet, and the National Stock Exchange – provides more choice, functionality, speed, efficiency, and, yes, *better execution quality* than the NYSE.

Today, the NYSE evidences all the lethargic and inefficient symptoms of anti-competitive and monopolistic pathology. A group as diverse and esteemed as John Bogle, [5] the editorial page of **The Wall Street Journal**, [6] Benn Steil, [7] Fidelity, [8] the American Enterprise Institute, [9] CalPERS, [10] and AIG Chairman Hank Greenberg [11] have been highly critical of the NYSE and its rules of inter-market and intra-market operation. It is this pathology, I may suggest, that is a leading cause of why the NYSE is suffering through its current panoply of scandals.

A. Trade Through Rule: Enforce It

As was the cure for the OTC marketplace, we respectfully submit that a large dose of competition would serve as a proper antidote to cure the ills of the listed-marketplace. Over the years, NYSE anti-competitive initiatives have taken on several shapes and forms. For example, NYSE Rules 390 & 394 (repealed under pressure) imprisoned investor trade execution on the floor of the NYSE. NYSE Rule 500 (repealed under pressure) imprisoned issuer listings on the NYSE and erected colossal barriers for issuers to list on alternative listing exchanges. Today, the manifestation of NYSE anti-competitive barriers is the Inter-Market Trading System ("ITS") Plan, its "trade through" rule, and the ITS Operating Committee that "administers" the ITS Plan.

5 John C. Bogle, "SpecialistMan," *Wall St. J.*, September. 19, 2003.

6 "Can We Trade Through?" *Wall St. J.*, October 30, 2003; "A Better Big Board," *Wall St. J.*, February 4, 2004.

7 Benn Steil, "The 'Neanderfloor,'" *Wall St. J.*, October 31, 2003.

8 John Hechinger, "Big Board Under Fire," *Wall St. J.*, October 14, 2003.

9 James Glassman, Testimony before House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, October 16, 2003.

10 "Calpers Sues Big Board and Specialist Firms," *Wall St. J.*, December 17, 2003.

11 M.R. Greenberg, "Lose the Specialists," *Wall St. J.*, December 18, 2003.

Industry insiders have known for years that the trade through rule is the least enforced rule this side of the double nickel speed limit on America's highways. And what may come as great surprise to those outside the industry is that the biggest recidivist and serial violator of the trade through rule is none other than the NYSE. Empirical data shows that the NYSE trots out the trade through rule when it suits its competitive purposes, but ignores it when it does not. Here are some facts: ArcaEx runs software (aptly named "whiner") that messages alerts when exchanges trade through an ArcaEx quote in violation of the ITS plan. The whiner database reflects that ArcaEx customers have suffered up to 7,500 trade-through violations in a single week by the NYSE. In fact, trade-through violations have actually risen most recently despite the glare of the regulator spotlight on the NYSE. Since just this last the fall (2003), the annualized cost to investors of the NYSE specialists trading through ArcaEx's quotes has increased 3-fold from approximately $1.5 million to $5 million. On any given day, ArcaEx has a billion shares on or near the national best bid or offer. Yet on any given day, the NYSE sends only 2 million shares to ArcaEx over ITS when we have the best price.

We have confronted the NYSE with our voluminous data but to no avail. If, in the NYSE's own words, the trade through rule "serves to protect investors," the NYSE has some "splaining" to do and needs to take corrective action forthwith to enforce and comply with the trade through rule in its own marketplace.

B. <u>Trade Through Rule: Reform It</u>

The ITS trade through rule was designed for a 1970s market structure when all exchanges were slow and manual and specialist-based ones. In today's electronic world, it limits customer choice and dumbs-down best execution to the lowest common denominator of the slowest market, which just happens to be the NYSE. It compels fast electronic markets, and their customers, to play at the glacial speed of the NYSE.

The effect of the trade through rule is to prevent electronic markets from competing with the NYSE. As a result, the NYSE can protect its mother load of 80% market share. The most effective long-term means to address specialist misconduct is to remove the anti-competitive stranglehold of the trade through rule. One way to reform the rule would be to limit application of the trade through restriction to the quotes of markets providing automatic execution against their best quotes. If a market still wants to operate in a manual manner, however, then electronic markets should be able to trade through those slow quotes. [12]

Reforming the trade through rule in this manner would free up competition between markets and enhance best execution. The SEC's pilot program begun in September 2002 proves this point. Since then, the SEC has permitted trade throughs of up to three cents in the most actively traded equity product in the world, the QQQ, SPY, and DIA. The pilot has been a smashing success for investors and best execution. QQQ maintains a one-cent spread and deep, liquid markets. Electronic markets now account for almost 60% of the volume in QQQs, while the NYSE executes a mere 5%. No wonder the NYSE has fought reform of the true trade through rule.

Reform would enable investors to choose how they want their limit orders handled. They could then send them to electronic markets that provide instantaneous display and automatic

[12] The distinction between automatic execution markets and manual ones is often misleadingly described as "speed vs. price." This is a complete mischaracterization. If institutions and other customers of the NYSE were really getting "best price," why all the complaints and scandals and public criticism by John Bogle, CalPERS, Fidelity, *et al.*? In fact, the "best price" dichotomy foisted on the industry and the investing public by the NYSE is one of the great spins of our time. The data more and more is showing that the only entities that consistently get "best price" are the NYSE specialists. For the rest of the investing public, it's a "maybe price" as part of a free option for the specialist.

executions against incoming orders. Or, investors could choose to send them to a manual market if they want to expose the orders to specialist and floor broker handling.

Beware, however, of attempts by the NYSE to masquerade a transition to automated execution as "reform." In recent press releases (the rule proposals have not been filed at the time of this hearing), the NYSE announced that it is expanding Direct +, which is an automated execution service. That notwithstanding, the NYSE has just reconfirmed only days ago at an ITS Operating Committee meeting that Direct+ will not interface with inter-market linkage, but instead is for NYSE members only. Additionally, the NYSE refuses to commit to any timeline (2005 or 2006?) on when it will automate its inter-market interface linkage. Do not be lured into believing this fools gold; there are extremely important distinctions between NYSE intra-market and inter-market linkages. It appears that the NYSE may be attempting to proclaim that they are reformists when, in fact, everything remains status quo.

Alternatively, if the trade through rule is not reformed, then the SEC should either get rid of it or enforce it to the letter. As discussed earlier, the NYSE trumpets the importance of the rule as its specialists routinely violate it. Our whiner databases are stuffed with examples of NYSE specialists violating the trade through rule by ignoring better prices on ArcaEx. Perhaps if there were a zero tolerance policy on violations of the trade through rule, the NYSE may decide that they do not want it after all.

III. <u>The 21st Century Specialist: Adaptation or Extinction?</u>

At first blush, a rational response to the query "what will be the role of the Specialist in the evolving modern marketplace" would be simply to cite the law of supply and demand and its related corollaries. The role, or lack thereof, of the 21st century specialist will (should) be determined by the marketplace of competition (subject to regulatory oversight and compliance with SRO rules and federal regulations approved by the Securities and Exchange Commission ("SEC")). If specialists – in whatever shape or form they may take – provide a valuable service to investors and traders and institutions, they will (should) in deed have a material role in the execution of securities in our marketplaces. The corollary of that statement, of course, is also true; if specialists provide little to no value, or even extract value, from investors and traders and institutions, their role will (should) be immaterial and marginal. Like any other business, these observations are only common sense.

The problem with the above analysis is that its methodology does not include the "externality," in economist jargon, of anticompetitive rules and policies. Whether it be NYSE Rules 390 or 500 or the ITS trade through rule and the lack of enforcement thereof (or Nasdaq's newly adopted "Rule 500," discussed below), this Subcommittee and the SEC, among others, need to be vigilant in preventing and rooting out anti-competitive rule-making and policies. Certainly, each marketplace should be able to establish its own business model and rule set (subject to SEC approval and oversight), whether it be with or without specialists, or whether it be vanilla, chocolate, peach or rocky road. At ArcaEx, for instance, we have no specialists. Every ArcaEx customer competes on price with the same market information. However, the days of the NYSE or Nasdaq pressing their thumb down on the scales of competition should be over. And, the rest should be left to competition.

IV. Nasdaq's "Rule 500": What's Good For The Goose Is Not For The Gander

The NYSE certainly does not have an exclusive franchise on anti-competitive reflex. Under the cover of darkness and, apparently at the time, unbeknownst to the SEC, Nasdaq in

January 2004 installed its own anti-competitive version of Rule 500. Like its now defunct NYSE stepfather, the purpose and effect of Nasdaq's Rule 500 is to imprison issuers and maroon them on the Nasdaq listings island. Nasdaq seeks to accomplish these ends by severely penalizing any Nasdaq-listed issuer who is also part of the Nasdaq-100 Index – for instance, Microsoft, Cisco, Intel, Dell, Sun Microsystems – that dare contemplate ***dually listing*** on another competing exchange. The punishment for the crime of dually listing on another exchange is ignominiously being thrown out of the Nasdaq-100 Index Trust (alias "QQQ") and having hundreds of millions or even billions of dollars in the offending issuer's stock (depending on market capitalization) summarily sold overnight by the trust.

Mind you, this is the same Nasdaq who for years valiantly fought against NYSE Rule 500, whose purpose was to maroon issuers on the NYSE. During the course of that fight, Nasdaq argued that NYSE Rule 500 "impedes issuers in selecting the marketplace best suited to their needs" and is "antithetical to the free and open competition that the Commission has consistently advanced and that is the bedrock of the U.S. capital markets system." Mind you further, this is the same Nasdaq that only a month ago embarked on a media campaign that sang the high praises of listings competition when Nasdaq successfully attracted a handful of NYSE-listed issuers to ***dually list*** on Nasdaq. During that media blitz, Nasdaq advertised that "a dual listing ... not only serves to improve the quality of trading in your company's stock – it can generate added visibility for your company and raise awareness and interest with the investing public." Nasdaq exclaimed that "with a dual listing, investors have greater access to liquidity and more opportunity for best execution." Nasdaq's summed up the dual listing value proposition as "the power of choice." What these advertisements failed to disclose in the fine print was that the "power of choice" belongs exclusively to issuers that currently list on the

NYSE and who Nasdaq is marketing to for a dual listing on its market. Apparently Nasdaq issuers should not be interested in "greater access to liquidity and more opportunity for best execution" that a dual listing on another exchange may offer. [13] In other words, Nasdaq issuers "need not apply."

A. **NYSE Rule 500**

Nasdaq led the fight to overturn the anti-competitive NYSE Rule 500, and Archipelago was completely supportive of Nasdaq in that fight Much like Nasdaq's own "Rule 500," the NYSE once erected enormous corporate governance barriers for NYSE issuers who attempted to leave the NYSE and list on another exchange. In its own rulemaking petition to eliminate NYSE Rule 500, Nasdaq aggressively and correctly argued that Rule 500 impeded competition, was antithetical to investor protection, and inhibited openness and responsiveness. [14] Among other things, Nasdaq supported its argument by citing the NYSE's front-running scandal in the 1990s and, at the time, increases in listing fee. Nasdaq concluded that "Rule 500 gives the NYSE a grip on its listed companies that companies cannot break free of, even when faced with an archaic and unfair trading system, extremely onerous fee increases or other anticompetitive burdens that under normal competitive circumstances would drive at least some companies to consider voting with their feet and listing on another market." In the end, Nasdaq's petition was ultimately granted, and rightly so from our vantage point; NYSE Rule 500 was repealed in October 2003.

---

13 Nasdaq dual listing brochure: "Nasdaq Dual Listing Guide" and subtitled "The Power of Choice" (copyrighted 2003).

14 "Petition for a Rulemaking to Repeal Rule 500 of the New York Stock Exchange (Corrected Copy)" dated May 13, 2003, from Edward S. Knight, Executive Vice President, Nasdaq, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission.

B. The Devil Is In The Details

Fast Forward to January 2004: Nasdaq cleverly amends its eligibility requirements in connection with the Nasdaq-100 Index. Prior to January 1, 2004, those rules read that for an issuer to be eligible to join the Nasdaq-100 Index, it had to be "listed" on Nasdaq. Fair enough. This structure required an issuer who sought to be eligible for the Nasdaq-100 Index to list on Nasdaq, but, at the same time, afforded that same issuer the "choice" of dually listing on another exchange. In January 2004, however, Nasdaq amended this language – and apparently without consulting with or making the appropriate regulatory filing with the Division of Market Regulation of the SEC – to require an issuer to be ***exclusively*** listed on Nasdaq in order to be eligible for the Nasdaq-100 Index (except where an issuer had been dually listed on another exchange prior to January 1, 2004.) Like the now repealed NYSE Rule 500, Nasdaq's Rule 500 consciously and purposefully erects a huge barrier for those issuers who would like the choice of dually listing at another exchange, but who also would like to remain eligible for the Nasdaq-100 Index and not have potentially billions of dollars of their stock wantonly sold because of an anti-competitive tying arrangement.

Note that I do not use the words "consciously" and "purposefully" loosely. Out of abundance of caution, and believing that we were in error in our understanding of the amendment, we contacted Nasdaq senior officials and made inquiry. We suggested to those officials that in lieu of an eligibility requirement of "exclusively" listed on Nasdaq, that Nasdaq could accomplish their branding goals through a less onerous "primary listing" requirement. Unlike an "exclusively listed" requirement, the "primary listing" requirement would give an issuer the "choice" that Nasdaq so eloquently articulated in its fight to eliminate NYSE Rule 500 and its own dual listing campaign. The "primary listing" would also protect Nasdaq's own brand identity and identity of its index.

Nasdaq politely listed to our position but firmly rejected them out of hand: the amendment language was in deed accurately drafted and the "exclusively listed" requirement would stand. Further, they argued that the amended eligibility rules were not anti-competitive and that the SEC had no jurisdictional role in reviewing their eligibility amendment.

We beg to differ. We believe that this "sleight of hand" amendment is anti-competitive, harms issuer choice and investor "best execution," and is hypocritical, to say the least. Further, we respectfully believe that this Subcommittee should be interested in its policy implications and, moreover, submit that the SEC and the Department of Justice have statutory authority to investigate this matter. [15] Like the mutual fund investors who have suffered the pain of oppressively high back-end loaded fees, Nasdaq's Rule 500 is the mother of all back-end loaded fees for issuers seeking listings choice.

V. The Lessons of 9/11 and Competitive Marketplaces

Before closing, it is worth touching on how the issues discussed above, especially the ones involving the establishment of a vibrant and dynamic competitive marketplace, impact on our nation's risk management exposed by the events of September 11, 2001. Certainly, a competitive network of multiple competitive market centers linked by robust linkages would

---

[15] This type of restraint may violate Section 11A provisions of the Exchange Act on fair competition among markets and Section 15A provisions of the Exchange Act that the NASD rules not impose any unnecessary burden on competition. Further, Section 19g of the Exchange Act requires SROs to comply with the federal securities laws. Such an anti-competitive action by Nasdaq may not be consistent with the federal securities laws. Finally, both the SEC and DOJ brought actions against the five options exchanges for conspiring to keep the listing and trading of options to only one exchange. While Nasdaq's Rule 500 is not a conspiracy among competitors, but rather a unilateral action, the harm to competition is still just as real.

appear to assuage these risks. Some markets will offer a floor-based solution, with the advantages of "high touch" order handling, while others will offer screen-based and anonymous access, perhaps as a means to mitigate geographic risk. A system of linked competitors is identical to the Internet model, originally designed to provide redundancy and avert a single point of failure. It was precisely this decentralized model that proved unconditionally successful as a means of communication on September 11.

In 1975, Congress laid out the roadmap for a National Market System of informationally-linked competing exchanges. As part of this roadmap, we embrace a less centralized, though linked, marketplace, which we believe will thereby eliminate the risk of shutting our markets down in the face of the unthinkable.

VI. Conclusion

Like the execution business, the role of the 21st century specialist should be determined through competition (subject to regulatory oversight and compliance with SRO rules and federal regulations approved by the SEC). Anti-competitive rules and policies should be repealed and eliminated as was the case with NYSE Rules 390 and 500. Similarly, the trade through rule needs to be reformed and enforced to eliminate its anti-competitive effects that weigh heavily in favor of manual markets like the NYSE. Beware of NYSE's recent announcement concerning Direct + and automating its marketplace. Direct + does not affect inter-market linkage, and the NYSE is noncommittal on when it will establish an inter-market interface that will provide automated execution. It appears that NYSE is attempting to masquerade as a reformist when nothing in fact has changed. Finally, Nasdaq's newly implemented "Rule 500" must be repealed because its purpose and effect is clearly designed to eliminate issuer choice and competition among listing venues.

Thank you again for providing me this opportunity to testify, and I look forward to responding to your questions at the appropriate time.

THE Vanguard GROUP.

TESTIMONY OF GEORGE U. "GUS" SAUTER
CHIEF INVESTMENT OFFICER AND MANAGING
DIRECTOR, THE VANGUARD GROUP

Before The Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Committee on Financial Services
United States House of Representatives

Market Structure III: The Role of Specialists in the Evolving Modern Marketplace

February 20, 2004

Chairman Baker and Members of the Subcommittee:

Good morning. My name is Gus Sauter, and I am the Chief Investment Officer and a Managing Director of The Vanguard Group, a mutual fund company based in Valley Forge, Pennsylvania. Vanguard is the world's second largest fund family, managing more than $725 billion for more than 17 million investor accounts. I oversee the management of approximately 70% of Vanguard's assets, including equity index funds, active quantitative

equity funds, active bond funds, index bond funds and money market funds. The remainder of the assets invested in Vanguard funds are managed by third party advisers we select and oversee on behalf of our funds.
I am pleased to be here representing Vanguard to discuss the U.S. capital market structure, and, in particular, the specialist system. We believe these issues are very important for investors. Simply stated, a fair and efficient market structure is paramount to facilitate the flow of capital, while minimizing transaction costs for investors in that marketplace.

Many of the rules governing the current market structure were adopted decades ago and do not allow for technological advancements that can provide the advantage of speed and certainty of trade execution. Furthermore, some rules inhibit the natural interaction of orders. Therefore, we believe that significant reform of the current market structure is required to address these issues.

The Debate

Some observers claim that investors are best served by obtaining the best possible price, while others advocate speed and certainty of execution. We believe that both of these are important considerations in achieving best execution. However, as an institution representing millions of individual investors, we believe that our needs, and those of all investors, are best served very simply—by a perfectly liquid market. There is no need to debate whether best price *or* speed and certainty is better. Investors require both, and both are provided by a perfectly liquid market.

Given this fundamental objective, market structure should be designed with the simple goal of providing maximum liquidity. This is achieved by creating rules that entice investors and market makers to place limit orders on the order book. And, certainly, any rules that disincent limit orders are contrary to the objective.

Under existing market structure rules, limit orders are not protected from traders jumping in front of them even though they have no standing on the limit order book. Since these orders are allowed to 'jump in line' ahead of limit orders, there is little incentive to take the risk of placing a limit order. There is a much greater incentive to join the ranks of the 'line jumpers.'

Accordingly, we believe the market structure should protect limit orders. Equally important, investors need to be able to access those limit orders.

The Value of the Limit Order

The order book consists of limit orders, which represent all of the transparent liquidity in the marketplace. Therefore, based on the desire to maximize liquidity, we believe that limit orders should be encouraged and provided a certain level of protection. We note, however, that many existing rules favor market orders, which take liquidity out of the market.

Limit orders are a critical feature of transparent price discovery. Although there may be many market participants willing to trade at a certain price, it is only the limit order on the book that enables transparent price discovery.

Another important feature that limit orders provide to the marketplace is the ability of an investor to immediately execute a trade. If an investor must get out of a stock, the limit order acts as a safety net against which the investor can trade. Similarly, if an investor must buy a stock, the best offer can be hit. The limit order provides immediate execution to anyone who requires it.

Economically, this is the same as granting a free option. This option is valuable to the marketplace and should be rewarded. Interestingly, the current market structure significantly disadvantages limit orders and provides little incentive for investors to enhance the depth of the book with their own limit orders.

Require Traders to Put Their Orders on the Book

Floor traders are permitted to step in front of a limit order at a better price, or even participate in a trade at the same price as the limit order even though they had not previously indicated any interest in the stock. This is the famous notion of price improvement. By allowing a better price, even if by only one penny, the availability of price improvement creates serious disincentives to place limit orders, a significant source of market liquidity. Indeed, why would an investor place a limit order when a floor trader has the ability to 'trump' that order on every single trade that goes to the floor? In short, the market order, which takes liquidity *out of* the market, has been favored over the limit order, which provides valuable liquidity *to* the market.

While floor traders are permitted to participate in an order after it comes to the market, the specialist can only step in front of a natural limit order before another order comes to the market. However, both of these orders are placed with the knowledge that if the market turns against the trade, it can always be liquidated against the limit order which provides a backstop for the 'line jumpers.' We support the placement of limit orders inside the 'inside spread,' which thereby increases liquidity in the stock, when they are placed on the limit order book in transparent fashion, but not when they remain hidden in the crowd.

Access to Limit Orders

Even if limit orders are granted protection from 'line jumpers,' there remains an impediment to enticing them. They must enjoy reasonable success of execution, and for that, they must be accessible within a market. We believe this is best accomplished by providing automatic execution of naturally crossing orders.

Automatic Execution

We support automatic execution. We believe that the role of the intermediary is to facilitate the functioning of the market, not to inhibit the natural interaction of order flow. If two orders naturally cross, then they should both be filled. Indeed, we believe it is inappropriate to delay execution of the orders to determine if a floor trader would like to price improve one of them. While the one order obtains a better price, the unfilled order is certainly disadvantaged.

Automatic execution capability does not reduce the specialist's obligation to make a fair and orderly market. Even if there is a market order that would naturally cross with a limit order at a price that is substantially away from the market, the specialist must still ensure that the bid-offer spread is fair and orderly, thereby becoming the best bid or offer against which to execute the market order.

Automatic execution may result in one, or both, of the executing parties foregoing price improvement. But, I can assure you that we would prefer the certainty of an immediate fill at an acceptable price versus a penny price improvement.

We therefore commend the new leadership of the New York Stock Exchange for taking the first steps toward improving the market structure of the exchange by proposing to permit the automatic execution of certain types of orders on the exchange. While we are encouraged by the Exchange's proposal, and look forward to commenting, we believe that additional reforms are necessary.

The Trade-Through Rule

Limit orders must be accessible from other marketplaces. This is ensured by the trade-through rule, which requires that trading occur at the national best bid and offer (NBBO), regardless of which exchange establishes those quotes. However, the linkage between markets and the nature of manual markets prevents this from occurring efficiently.

If there were only one marketplace, or a centralization of the marketplace in a Central Limit Order Book (CLOB), then there could be no logical argument against the trade-through rule. An order would simply 'walk the book,' taking all of the successive inside orders on its way to completion.

However, critics of the trade-through rule point out that often those trades that must be forwarded to the manual exchange that established the NBBO are not executed in volatile markets because of the time required to transmit the order and the time required by the manual market. Indeed, an execution outside of the NBBO in one market may actually be superior to such a failed trade.

We have certainly experienced this in our trading. Nevertheless, we don't believe the trade-through rule is the cause of the problem. Instead, we believe the antiquated linkages between markets and the slower execution of a manual market are the culprits. Addressing these issues would be a better approach to solving trading delays and failures of execution.

Furthermore, we worry that completely abandoning the trade through rule could produce some very unfavorable consequences, such as widespread internalization. If executions outside of the NBBO proliferate, two investors lose. First, the investor receiving a fill outside of the NBBO has either paid too much when purchasing a stock, or received too little when selling one. In behavioral terms, the investor that initiated the execution will suffer remorse that the trade was actually filled, knowing that it could have been executed at a better price. At the same time, the investor with the limit order at the NBBO has lost by not receiving an execution.

As the scenario plays out, both investors will roam from marketplace to marketplace chasing the market that would have provided them the best execution on the last trade, without the assurance that they will receive it on the next trade.

We prefer a system of market linkages that provide immediate access to the NBBO, essentially functioning as a CLOB. Opponents of this concept claim that it will stifle competition. However, we believe that marketplaces will be forced to compete on price (commissions), better service and trading enhancements, as they become a portal into a larger market system. Innovations, such as the reserve book, would still provide a competitive advantage.

Despite our desire to retain the trade-through rule, we would support a rule for a trial period that allowed *de minimus* trade-throughs by automatic exchanges when the NBBO is on a manual exchange. We regret that the limit order on the manual exchange is disadvantaged, but it does not seem appropriate to put another order at risk of not being executed simply because the NBBO has been established on a manual exchange.

U.S. House of Representatives
Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises

"Market Structure III: The Role of the Specialist in the Evolving Modern Marketplace"

Testimony by Frank C. Sullivan
President and CEO
RPM International Inc.

February 20, 2004
New York, NY

Thank you Mr. Chairman, Congressman Kanjorski and members of the Subcommittee for extending an invitation to appear before you to discuss market structure - - a matter of great importance to the shareholders, board of directors and management of RPM International Inc., a company traded on the New York Stock Exchange.

I am Frank Sullivan, President and Chief Executive Officer of RPM International Inc. ("RPM"), a company founded by my grandfather in 1947 as Republic Powdered Metals in Medina, Ohio where it remains today.

Fifty-six years later, RPM is a world leader in specialty coatings, serving both industrial and consumer markets. We have grown both organically and through the successful acquisition of over 100 companies or product lines and, as a result, have achieved record growth in 55 of our 56 years of existence, and in our 57th year are continuing to grow sales and earnings at record levels. RPM's industrial products include roofing systems, sealants, flooring coatings and corrosion control coatings, like our Carboline brand, which protects such well-known landmarks as the Peace Bridge and the Rainbow Bridge to Canada, the Golden Gate Bridge and the Statue of Liberty. Leading industrial brands include Stonhard, Tremco, Day-Glo, Euco and Dryvit.

RPM's consumer products are used by professionals and do-it-yourselfers for home maintenance and improvement, automotive and boat repair and maintenance, and by hobbyists. Consumer brands include Zinsser, Rust-Oleum, DAP, Varathane, Bondo, and Testors.

For the fiscal year ended May 31, 2003, RPM had sales of $2.1 billion and $122.8 million in net income before a $144 million asbestos charge, which is another topic we are hopeful that Congress will address. We have 7,900 employees and hundreds of independent sales and technical representatives, approximately 7,000 of which are employed in the United States. The company's products are manufactured in 49 plants in the United States and 19 plants in 16 countries, and are sold in more than 130 countries around the world. Last year, RPM increased its cash dividend to shareholders 8 percent, which represents our 30^{th} consecutive year of cash dividend increases, which puts us in the top half of 1 percent of all publicly traded companies in terms of continuously increasing shareholder dividends. A member of the S&P 400 Midcap Index, we are highly committed to our approximately 300 institutional investors and, most importantly, our 100,000 individual shareholders. RPM is a favorite of retail investors who are members of National Association of Investment Clubs (NAIC) across the country. We have made it a priority to get to know these retail investors very well and feel we appreciate their needs. We take very seriously the quality and fairness of the trading in our shares to ensure the interests of all investors, large and small, are well served.

Mr. Chairman, the capital markets are critical to American companies as they continue to grow and compete globally. The currency created by our stock as it trades in a secondary market is a critical engine of growth. Our ability to use our equity to continue to grow depends to a large extent on how our stock trades and which investors are willing to hold it. Choosing an exchange for listing is a significant decision for any company, as that choice will help determine how liquid markets are for its shares and how volatile its share price will be.

In that context, I would like to relate to the Committee today my perspectives on how stock exchanges and their models affect companies, and specifically how the specialist has impacted our business. As my company has experience with both the Nasdaq and the New York Stock Exchange, we can give you through our experiences a case study in how they differ. The bottom line, from my perspective, is that the centralized auction market system with the specialist at its center has proven a superior model for us, and has helped improve the quality of our investor base and reduce our cost of capital.

Experience on Nasdaq and why we switched

RPM went public in 1969 and was one of the original listings on Nasdaq in 1971. In 1997/8, I was CFO of RPM and undertook a review of our market to determine whether there was reason to consider a transfer to the NYSE. In my view, we had been well served on the Nasdaq as a new and growing company but by this time we had grown to become a $1.7B company with 100M shares outstanding, and we met all the NYSE's listing criteria. We heard concerns from our investors about volatility in the trading of RPM stock. Despite our record of growth, we still had a predominantly retail shareholder base (57%). In my view, we needed increased visibility and reduced volatility so that we could better serve our individual shareholders, many of whom had urged us to move to the NYSE for years, and so that we could better attract large institutional investors.

I might note that my father, the then CEO, had served on the Nasdaq Board of Governors for three years, and prior to that was a member of the Issuer Affairs Committee and had a certain loyalty to that market. Any analysis would have to be airtight if he was to be convinced that RPM and its current and future shareholders would be better served on another market.

I visited the NYSE myself in 1997, met with senior staff and spent time on the trading floor where I had the chance to observe the market and the specialist first hand. I knew that at the time volatility of similar stocks was lower for those stocks traded on the Exchange than at Nasdaq. And others who preceded us in transferring to the NYSE were able to increase their institutional share ownership and analyst coverage. I undertook my own due diligence, speaking to others who had made the move and meeting with advisors whose input I valued. Based on the aggregate analysis and input, the entire management team became convinced a move was right for us.

One important decision we had to make in moving to the NYSE was selecting a specialist. From the beginning we understood the importance of the specialist as he or she would be accountable for the quality of the trading in our stock and also available to provide commentary and help us understand trading dynamics. The decision was important enough for Tom Sullivan, our CEO, Jim Karman, our President, P. Kelly Tompkins, our General Counsel, and myself, to come to the Exchange and personally conduct the interviews. We met with five firms. We found each well prepared and able to articulate why they should be chosen and I must say it was not easy making our final determination. In the end, we chose Jacobson and Sons which was later acquired by Speer Leeds and Kellogg. In June of 1998, we transferred to the New York Stock Exchange

Value of the NYSE and the Specialist

In the five and a half years we have been listed, we and our investors have come to appreciate the value of both the Exchange model and the specialist in a very practical sense. Our objectives in listing have been met as we have continued to maintain a broad individual investor base while increasing our institutional ownership from 43% when we listed to 57% today. At the same time we have seen liquidity increase by two-thirds since listing.

But what about the specialist specifically? How do they add value? While I do not understand all the technical nuances of trading, I do have a fairly solid understanding of the basics.

For example, I do know that Speer Leeds and Kellogg accounts for 8% of the trading in RPM. So 92% of the time, public orders are meeting directly to set the price. I believe that having orders for our shares compete in one pool of liquidity is the most efficient mechanism for pricing. The specialist role in overseeing this process and ensuring fair and orderly markets is, in and of itself, a benefit, but it is in times of stress that his value is most clearly seen and appreciated. Let me relate a couple of examples.

The first occurred on January 22, 1999, shortly after we listed. Our stock did not trade until 9:51 when it opened at $12.87, down $1.12 from the prior's day close. I was informed by Exchange staff and also by Jim Jacobson, the head of the specialist firm, that the opening would be delayed due to a sell side imbalance equal to three quarters of our average daily volume. I learned from Jim that by 9:30 am there were sell orders totaling 130,000 shares and that the specialist began the process of reaching out to recent buyers. In addition to what was delivered systemically to his book, the specialist, acting as a catalyst, attracted buy orders totaling 60,000 shares and acting as dealer, purchased 22,000 shares himself to ultimately open the stock on a trade of 143,000 shares. The specialist on that day was 15% of the market, clearly higher than the average. There is no doubt in my mind that had RPM still been trading on the Nasdaq, the stock would have opened lower, as there is no regulatory requirement for dealers or ECN's to step in and stabilize the market.

What impressed me most, however, was that Jim Jacobson, having explained the trading to me himself, took the extra step of asking the Exchange to undertake a formal review. I received the report about a week later. It was a detailed chronology of the day, showing how and when the specialist had stepped in to stabilize the market, and concluding he had done his job effectively. I had not asked Jim to do this. He undertook it himself to ensure that I was satisfied all was as it should be. I clearly would not have received this level of detail or service in my prior market. Very early on, my decision to list was reconfirmed through this experience.

Another example occurred in March of 2002 when we needed to raise additional capital to reduce debt associated with a recent acquisition. We chose to issue common stock, which enabled us to raise $150 million. While investors were attracted to the offering due to the sound fundamentals of the company, there is no doubt that we benefited from the liquidity that existed at the NYSE, our reduced volatility, and investors' confidence in the market for our shares. On March 26, the stock closed at $14.91. Ten million shares were priced at $14.25 and opened the following morning at $14.93. The increase in shares amounted to 10% dilution but the stock price held steady, reflecting the ability of a centralized market to absorb the significant increase in shares with minimal price dislocation.

The specialist kept us well apprised of the buy and sell interest indicated prior to the market open, through the opening itself, and for the remainder of the day. We were well informed at all times. Investors' ability to buy shares on the offering and just as important, to add to or liquidate their positions in the future with minimal price dislocation is critical in ensuring their confidence.

A word on speed vs. price

As noted earlier, I am not a market expert. That said, I am very aware of the current debate regarding the importance of speed vs. price. I support the Exchange's initiative to increase its automatic execution capability but do so because they are, at the same time, preserving the principle of best price. As both an investor myself and the CEO of a company who actively engages with retail investors on a regular basis, it is hard for me to imagine why speed would take precedence over best price for any reason.

Investors I know want to sell shares for the highest price and buy them at the lowest price. Most importantly, they expect and deserve to have the confidence that they will be getting the right price, or put another way, a fair price. This is particularly true with the millions of individual investors who directly or indirectly are the backbone of the most efficient capital market in the world. They always know they can buy our shares, but what will happen when they want to sell them? Why would intermediaries want speed if the investors they represent want best price? One of the great things about our current system is it allows small investors to buy and sell their shares on exactly the same terms as large institutions. There is no "wholesale" price and "retail" price for our shares, just one price, and I and our other investors can always find out what that price is. Whatever the motive of large institutions, it should be fully transparent and understood by those who entrust their hard earned dollars to them. If there are conflicting motives, shouldn't the interests of the ultimate investor take precedence?

The NYSE already provides what investors most want. The Exchange has the best price 93% of the time. Around 78% of RPM's shares are traded at the Exchange precisely because it offers the best price. That matters because it ensures a deep and liquid market for RPM shares, dampens volatility and correctly prices our shares so the value of our company is fairly reflected. I believe that the combination of all these factors results in a more confident investing public and ultimately reduces our cost of capital.

Summary

I applaud this Committee's undertaking to study market structure and to ensure fair and orderly markets for all investors. The decisions you reach are important for the future of our company and many others like it, and, most importantly, their shareholders. I am pleased to have had the opportunity to share my experiences with you and hope that any changes you consider will strengthen the market and not diminish the liquidity and accountability that the auction market model provides to our shareholders. Clearly, the New York Stock Exchange has been and will continue to be central to our capital raising process. I fully support its goal of ensuring that all investors, large and small, have fair and equal access to the shares of companies traded on the largest and most liquid equities market in the world...and that they do so with the confidence that they are receiving the best and fairest price.

Execution Excellence and Investor Protection

U.S. House of Representatives
Committee on Financial Services

Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises
"Market Structure III: The Role of the Specialist in the Evolving Modern
Marketplace"

Testimony of John A. Thain
Chief Executive Officer
New York Stock Exchange, Inc.

Field Hearing
February 20, 2004
New York, NY

NYSE
New York Stock Exchange®

Written Testimony of John A. Thain, CEO, New York Stock Exchange
February 20, 2004
New York, NY

Good morning Mr. Chairman, Congressman Kanjorski, and members of the Subcommittee.

Thank you for extending an invitation to appear before you to discuss the critical market structure issues that confront us. Thank you also for selecting New York City and its financial district as the site for your hearing. The presence of the committee is a strong vote of confidence and support for our great city and your efforts are very much appreciated.

Update on the Status of NYSE

Five weeks ago I assumed the responsibilities of Chief Executive Officer of the New York Stock Exchange (NYSE). As you know, my appointment came after a tumultuous year in which the failures of the Exchange's governance had become evident. Under the leadership of Interim Chairman John Reed a new governance architecture was created, adopted by the NYSE membership and approved by the Securities and Exchange Commission (SEC). These governance changes are now in place, and we are moving quickly to get the Exchange back on its feet and to address the issues at hand.

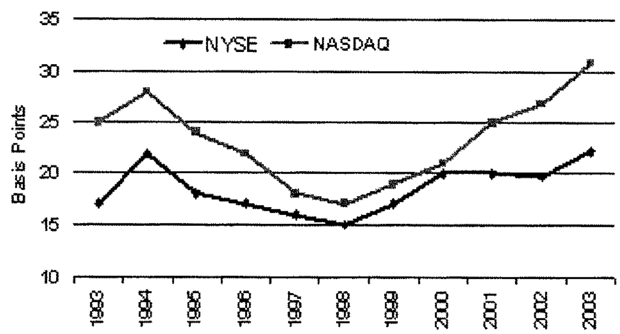
The NYSE is a great institution with a history dating back to 1792, and it has played an important role in the U.S. financial system since the early days of the American republic. It is with pride and humility that I assume stewardship of the Exchange. John Reed provided me with full disclosure on the challenges I would face in taking the job before I signed on, and I of course had my own views about the NYSE.

The good news is that while the Exchange has had its reputation tarnished, it is not broken. The NYSE's technology and infrastructure are actually very solid, and it has the best operating record in the industry. Its systems are in good working order, and its staff and traders are dedicated and highly professional. I have been focused on listening to our customers, our listed companies, and our other constituents. In responding to what they are telling me, my goal is to ensure that we remain the most liquid, most efficient, and most investor-friendly exchange in the world, and that we continue to provide the United States with unquestioned leadership in global equity trading.

I am pleased to report the NYSE is serving investors well in one essential area; we are the lowest trading cost venue in the U.S. We have been able to attract the deep liquidity that makes the market efficient and effective across all types of stock, large-cap, medium, or small-cap, and across all sizes of orders.

Institutional Trading Costs

Costs are lower for NYSE-listed stocks.



Source: Abel/Noser Corp. - Q2 2003
Trading Costs = Execution Cost (Trade Price - VWAP) + Commission

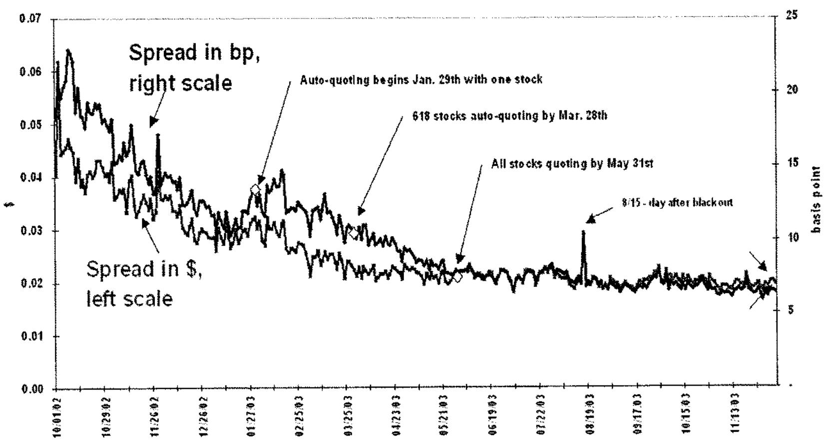
The NYSE utilizes advanced technology to offer customers a breadth of choice in accessing the auction, including automatic execution, electronic order routing for price improvement, and electronic delivery to agency brokers' hand-held devices.

While I am still developing my ideas for what the NYSE needs to do to prepare itself for the future, progress is underway on a number of fronts. One of the areas our customers have told me we need to improve is in our speed of execution. I will speak about that in a moment, but for now will say we are working to expand and broaden our offering which caters to investors and traders who prioritize speed, and I can promise you more improvements are coming in the future.

I am aware the Committee's past deliberations have included discussion of the competition between markets for trading in NYSE-listed shares. It is a fact of life that competition between markets is tough. We are proud of the fact that the NYSE posts the best price in our listed securities 93% of the time. By itself, that fact is far from a guarantee for our success. Nothing today prevents investors from deciding where to send their orders. Our competitors, who have generally had about 20% of the market share of NYSE listed stocks, have recently added several percentage points to that number.

Perhaps the clearest reflection of the very high degree of competition in the market is the price spread between bids and offers. Over the past year the average spread of the National Best Bids and Offers on the 93 NYSE-listed stocks in the S&P 100 Index has fallen from about 5 cents to 2 cents—a fraction of their historical spreads and reflective of the fact we and every other market maker in NYSE shares are competing harder than ever for orders. Clearly, the NYSE does not in any way have a monopoly position.

Average NYSE Quoted Spread: Listed S&P 100 Stocks
October 1, 2002 – December 31, 2003
NYSE-quoted spreads have continued to fall.



These narrowed spreads are a sign of an efficient, liquid market that is disciplined by competition. And they are great news for investors, who can buy and sell with lower transaction costs.

The Role of the Specialist

Today's hearing focuses on the role of the specialist. Specialists play a number of roles and contribute to the smooth and effective functioning of our market.

- Specialists facilitate best price by maximizing public order interaction which, in turn, generates opportunities for better pricing of existing buy and sell orders, thus saving investors millions of dollars.
- Specialists help ensure fair, orderly markets, dampen volatility, and serve as a source of accountability for investors and issuers.
- They have an affirmative obligation with regulatory accountability to cushion price movement and dampen volatility. Only specialists have an obligation to trade against the trend—trades that most other market participants choose not to make.
- Specialists inject liquidity by bridging temporary gaps in supply and demand—not only for large, liquid issues, but also for small- and mid-cap companies where these temporary imbalances, if not addressed, can introduce significant volatility.
- Specialists act as catalysts—proactively bringing buyers and sellers together, thus creating trades that wouldn't have otherwise occurred.
- As auctioneers, at the start of each trading day, they help to establish a fair market price for each of their stocks.
- And throughout the trading day, they ensure markets respond quickly and effectively to news about companies, or to shocks to the entire economy or trading system.

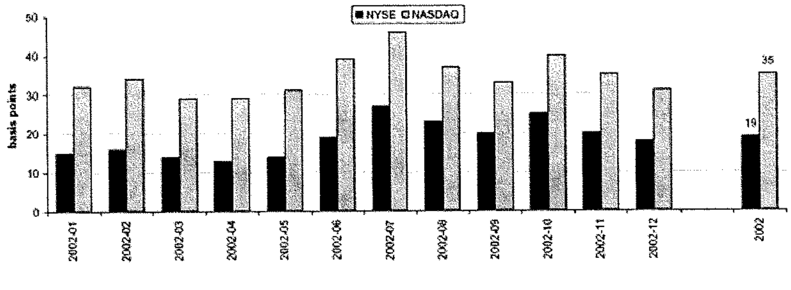
Mr. Thomas S. Caldwell, Chairman, Caldwell Asset Management, wrote in a letter published by the Financial Times October 17, 2003:

> During dramatically changing markets there is always a specialist ready to call a market at the NYSE. This is often not the case in a dealer-only market, where traders simply stop calling markets or become unavailable.

The specialist is one reason our 5-minute volatility is about half that of Nasdaq.

5 Minute Relative Volatility: (High-Low)/High

NYSE shows consistently lower volatility than comparable Nasdaq stocks.

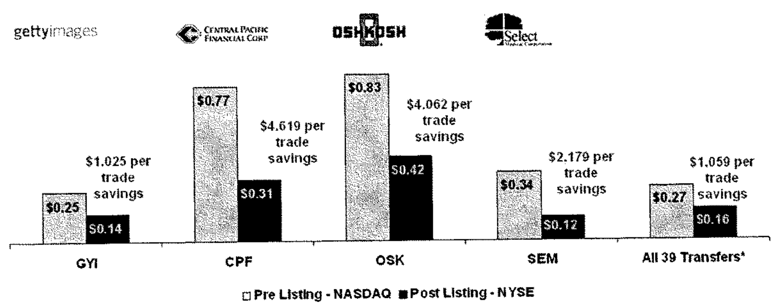


Source: Consolidated tape trades during normal trading hours (9:30am - 4:00pm).
Observations excluded if no activity occurs within the 5 minute time segment.
Trading on primary market only. Excludes Regional and UTP trading. Results are weighted by # of 5 minute observations.
249 stocks matched on trading activity, price and market capitalization in same manner as the SEC's 2001 comparison of order execution across market centers.

And the specialists are one reason NYSE-listed companies have significantly less price fluctuation produced by market impact. Investors in the 39 companies transferring from Nasdaq to the NYSE from February 2001 to January 2003 found the average price change per share for every 10,000 shares traded dropped from 27 cents to 16 cents, saving them on average $1,059 per 10,000-share transaction.

Market Depth

Transferring to the NYSE lowers volatility, reducing market impact costs.



* Average across all 39 stocks transferring to from NASDAQ to the NYSE between February 2001 and January 2003.

NYSE

This volatility is particularly critical at market opening and market closing, when the lack of a specialist often leads to spikes in Nasdaq-listed shares. As reported in the New York Times January 29, 2004, Standard & Poor's, in reaction to investor concerns about volatility and possible price manipulation at the close of Nasdaq trading, will begin a pilot using the closing prices on the American Stock Exchange for certain Nasdaq stocks when compiling daily information for the S&P 500 index. The American Stock Exchange presently provides a market in a select group of Nasdaq listed stocks while the NYSE does not. David M. Blitzer, chief investment strategist at S&P, is quoted in that article:

> It's clear there are times when there are a lot of concerns about prices on Nasdaq. Our big concern is the close. I think it offers a real opportunity for mischief.

Our fill rate for NYSE-listed stocks, that is, the number of orders sent in which are actually executed, is 84%, compared to 45% for Nasdaq. These numbers show clearly that specialists play a useful role in providing liquidity and in matching buyers and sellers, to the benefit of all market participants.

Specialists never have been, nor will they ever be, allowed to trade for their principal account ahead of customers. Our Board of Directors recently approved a rule change now before the SEC which would restrict the specialist from participating even in trades alongside brokers' customers. If our proposal is approved, our customers will always have the right to transact first.

Sometimes lost in the public debate over the role of the specialist is the role of the floor brokers in the execution chain. Each broker attempts to obtain the best price for his or her customer. Brokers compete against brokers in the auction model, and it is this interaction of buy and sell interest that leads to the price improvement, order size improvement, and unequaled fill rates found at the NYSE.

It would be easy to conclude from the ongoing investigation by the NYSE and SEC of the major specialist firms that there is something inherently wrong with the specialist system, and indeed of the entire floor auction model. It is evident to me there were abuses in the past. We have made substantial investments in technology which, coupled with changes in practice, will go a long way to preventing future abuses. And we will monitor behavior carefully going forward and ensure violators are identified and punished. I am confident that the operation of the floor in its current form works to the benefit of all investors.

The Role of Technology in an Exchange

I believe that to look at the role of specialists as a question of man vs. machine is to misstate the proposition. I have spent much of my professional life examining the most efficient means to utilize information technology in the financial services industry. I understand how electronic trading systems work, their strengths and their limitations. And I also understand the importance of the human element in an equities trading operation.

While I was at Goldman Sachs, we invested heavily in technology, and automated as many systems as possible. But we still had thousands of people working on trading floors. An exchange operates differently than an investment bank, but it is evident to me that human interaction, human judgment, and common sense have a role to play in keeping the markets functioning efficiently.

We are moving quickly to leverage technology to the benefit of our investors and all constituents of the Exchange. Two weeks ago, our Board of Directors approved a proposal to make the speed and execution certainty of our existing automatic execution platform—known as NYSE Direct +—available to a wider range of investor orders. If approved by the SEC, this program will respond to requests we have received from some customers for faster speed of execution even if it means foregoing price improvement that often occurs in the agency auction process. Trades that are executed using Direct+ would still be guaranteed the best price available within the national market system, whichever market may be displaying that price.

Expansion of our automatic execution feature in this fashion would not eliminate the need for the specialist because he or she will still need to inject the liquidity that is often needed to maintain an orderly market to protect investors from sudden fluctuations in stock prices. And in fact, specialists at present are participating as principal only when necessary, some 10% of total buy and sell volume. Routine orders where supply and demand are matched are already being executed electronically in the majority of cases, and that percentage is going to increase in the future. But large and complicated orders, or shares of any companies during times of major news or crisis, will continue to benefit from the role of floor brokers and specialists. And these changes will enable us to address the concerns of those who want an immediate and anonymous transaction at a known price.

Market Structure

Mr. Chairman, we believe that our technology intensive, hybrid exchange model will continue to maintain the NYSE as the venue where your constituents can buy stocks at the lowest price and sell them at the highest price. We believe that the interests of Main Street investors should remain paramount. Assuring investors that they will receive the best price when their individual stocks or mutual funds are traded is fundamental to market integrity and investor confidence.

Technology has indeed advanced to the point where trades can be executed at lightning speed, but technology should not drive market structure decisions—principles should.

Mr. Chairman, I know you and all your colleagues on the Committee share the view that the most important mission we have is to ensure that investors can participate with confidence in a market that is fair, liquid, transparent and responsive to their needs.

As you know, the Securities and Exchange Commission is considering a number of changes to market structure rules. One of the issues under consideration is a change to the trade-through rule. The rule guarantees that investors in NYSE listed stocks will receive the best price regardless of which market they send their order, and that investors who provide the best prices are protected. I believe some of the changes proposed to the rule would be contrary to the interests of investors, listed companies, and the integrity of our public markets.

The trade-through rule is an essential part of the national market system established in the 1970's by Congress. The system was designed to recognize that vibrant markets would result from the intermingling of all buy and sell interest. That is why the SEC, when it approved the trade-through rule, said nation-wide price protection was a "critical" national market system goal.

The principle behind the trade-through rule is, in my view, critical to protecting investor interests. Particularly as regulators and our industry confront the pricing issues related to market timing among mutual funds, it is difficult to see how investors would be served by a rule which weakens their protection. Why should investors ever receive anything other than the best price? There is talk of the importance of speed, anonymity, and other factors. But in a commoditized market like that which exists for equities, if displayed prices across all markets are available immediately, there is absolutely no reason to allow agents to buy and sell on behalf of their clients for anything other than the best price.

The trade-through rule is crucial to the entire price discovery process. When it is violated, there are four victims:

1) The investor who bought or sold shares at something other than the best price;

2) The investor or seller whose order was traded-through and was left hanging;

3) The market price discovery system, since a trade is recorded at something other than the true price;

4) And finally, market liquidity, since investors will lose confidence in the fairness of the market and will be less willing to submit limit orders knowing they may be traded through.

There has been some discussion of keeping the rule in principle but allowing a so-called "de minimus" exception where agents could execute not at the best price but a price within several cents of the actual best price. To adopt such an exception would be tantamount to giving financial intermediaries an SEC-approved waiver of one, two, or three cents per share from their fiduciary responsibility to obtain the best price for investors. As our research has shown, these pennies quickly become billions of dollars when they are multiplied by the number of shares traded in our equities markets each day.

Additional Cost to Investors From Relaxing or Eliminating Trade-Through Rules for NYSE Listed Stocks Traded Off the NYSE

Action on the Trade-Through Rule	Cost to Investors
1 cent Exemption**	$1,507,281,200
2 cent Exemption**	$2,299,369,458
3 cent Exemption**	$3,121,665,767
Complete Opt-Out (4.21 cents/share)**	$3,465,737,036

* *Assumes 20% of volume traded off of the NYSE*

** *2004 estimate of NYSE-listed off-exchange consolidated share volume.*

The principle of best price is also critical for listed companies. NYSE-listed companies currently enjoy the advantages of head-to-head price competition — where all buyers and sellers bid against one another in real time for shares. Companies find their share prices are less volatile and more reflective of fundamentals. The reduced volatility helps attract investors and raise share prices. Companies are thus able to raise new capital more easily, allowing them to expand and modernize their factories and create more jobs.

And finally, I would argue, the trade-through rule is good for the integrity of the markets. It ensures the exchanges and ECN's remain linked and in open competition with one another. It enables the smallest investor to receive the same price as the largest institution. It enables the market price to reflect the true supply-demand balance for shares, ensuring stocks are properly valued even for those not participating in the trade. And it is crucial to transparency. Transactions are visible to all market participants, and can be properly tracked for regulatory purposes. In sum, the principle of best price is one worth defending.

Conclusion

Mr. Chairman, again, thank you and the members of the Committee for giving me an opportunity to share my thoughts with you. I thank you for your focus on these important matters, and look forward to working with you on behalf of America's investor community.

Attachments:

"Potential Costs of Weakening the Trade-Through Rule" NYSE Research, February, 2004

NYSE Policy Perspective "The Trade-Through Rule: Protecting Investors, Helping Companies, and Preserving the Integrity of Markets" NYSE, February, 2004

SPENCER BACHUS

COMMITTEES
FINANCIAL SERVICES

TRANSPORTATION AND INFRASTRUCTURE

JUDICIARY

Congress of the United States
House of Representatives
Washington, DC

February 18, 2004

The Honorable William H. Donaldson
Chairman
United States Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Donaldson:

As you know, our securities markets have evolved significantly in recent years. The Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee recently held hearings that examined the efficiency of our complex capital markets and has more such hearings scheduled. The Subcommittee has already heard testimony from yourself, as well as a number of other market experts, that described the challenges that we face in assuring that investors remain confident in the integrity of our markets.

One of the consistent refrains so far from many of the market experts that have testified before the Subcommittee was the need to modernize or eliminate the current rules governing the execution of securities transactions among markets. It is evident from this testimony that the Intermarket Trading System (ITS), especially the governance of the operating committee that administers the ITS Plan and the ITS trade-through rule, is in desperate need of reform. The current ITS system is rife with conflicts of interest, employs ancient technology, and impedes competition for investor orders.

Market participants have indicated that the so-called ITS trade-through rule does not adequately serve the needs of investors in today's markets. The trade-through rule was designed to avoid market fragmentation and assure that customers had access to the best available price - regardless of where the security was trading. The rule requires specialists to route orders, through the ITS system, to exchanges that offer better quotes. However, this rule was based on a market model that in the 1970s was dominated by floor-based, manual executions. It does not reflect the significant changes in technology and market structure that have occurred since its adoption.

In its current form, the trade-through rule appears to have become an impediment to assuring best execution for many investor orders. Both from testimony, and from news reports, the rule is apparently being widely ignored. Further, current policies that allow specialists at competing exchanges to take up to 30 seconds to respond to quotes are unrealistic in an environment in which transactions occur in micro seconds. When the seemingly more attractive quotes are unavailable at the market that they are routed to, the investor is denied the opportunity to achieve a faster, certain execution and may, in fact, ultimately receive an inferior price.

Of equal concern is the testimony of market participants who argue that instead of fostering efficiency and enhancing competition, the trade-through rule harms investors by preserving the monopoly position of some specialists who are insulated from the competition of other markets. These witnesses contend that those markets, whose business models are based on the concept of fast, certain electronic executions, must yield to the limitations of the trade-through rule and the antiquated technology of the ITS. In their view, the rule has become an obstacle that inhibits competition and prevents investors from choosing the manner in which their orders will be executed.

Over a year ago, the Commission initiated a pilot program that provides a *de minimis* exemption from the trade-through rule for several securities that are among the most actively traded. This program has been heralded by many as a tremendous victory for investors, who have benefited measurably from the increased competition for their orders. It is my hope that if the Commission elects not to repeal the trade-through rule that it will expand the current pilot program in the near future to encompass additional actively traded securities.

In addition to such a pilot program, I understand that the Commission currently is evaluating several alternatives to both the ITS governance situation and to the current ITS trade-through rule. Among these alternatives, the Commission should consider rules that will allow a decentralized system in which investors and brokers have efficient access to all markets through private linkages and sophisticated order routing systems. In my view, direct access to markets, coupled with other reforms that the Commission may propose, should encourage competition for orders that will benefit investors.

The Commission will face significant challenges as it seeks to modernize the regulations governing our capital markets. I am certain, however, that the Commission's timely efforts to address the issues that were highlighted in our recent hearings will strengthen our markets and benefit investors. I look forward to continuing to work with you in this endeavor.

Sincerely,

Spencer Bachus
Chairman
Subcommittee on Financial Institutions
and Consumer Credit
Committee on Financial Services

O