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# THE FUTURE OF THE SECURITIES MARKETS

## HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES AND INVESTMENT

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

ON

THE STRUCTURE OF THE U.S. EQUITIES MARKETS, WITH PARTICULAR REGARD TO THEIR FAIRNESS AND EFFICIENCY

OCTOBER 15, 2003

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# C O N T E N T S

## WEDNESDAY, OCTOBER 15, 2003



## WITNESS

# THE FUTURE OF THE SECURITIES MARKETS

**WEDNESDAY, OCTOBER 15, 2003**

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES AND INVESTMENTS,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, DC.*

The Committee met at 10:10 a.m., in room SD–538, Dirksen Senate Office Building, Senator Michael B. Enzi (Chairman of the Subcommittee) presiding.

## OPENING STATEMENT OF SENATOR MICHAEL B. ENZI

Senator ENZI. I call to order the hearing on the future of the securities market. This is the first hearing of the Subcommittee on Securities and Investment. One of the reasons it is the first hearing that we have held is that so many of the hearings have been elevated to a Full Committee status, and we have been pursuing a number of these things throughout the year. In fact, Chairman Donaldson has been here several times and testified. And in order for them to be able to do their work, we hope that we can change that to maybe a once every 6 months thing instead of a weekly or monthly appearance here.

We do thank you for being here, and also for Annette Nazareth, the Director of the Division of Market Regulation of the SEC, for being here as well.

There is no doubt that the securities markets of the United States are the best in the world. Over the years, our competitive market system has brought the best of the floor-based and electronic markets to the forefront. The laws that are the underpinning of the structure of our securities market, the Securities Exchange Act of 1934, and the provisions of the Securities Acts Amendments of 1975 that created the national market system, have held up fairly well in the face of constant change. One of the things that has set our markets apart from international markets has been our ability to foster innovation and technology. Maintaining that competitive edge is an absolute priority.

Several years ago, the securities market saw unprecedented change. The bull market of the 1990's retreated, the arrival of trading in decimals forever changed the markets, and then the events of September 11 put tremendous stress on the system. Then the accounting issues of a year-and-a-half ago added stress and as a result, the system we have today appears to be at a crossroads.

The Securities and Exchange Commission has recognized that the changes in the market have caused issues of market structure to become more complex and intertwined. In 2000, the Commission created an Advisory Committee on Market Information. In addition, it was exactly a year ago that Commissioner Glassman chaired a series of Commission hearings on market structure.

Just a few of the issues facing our markets include: One, whether to update the Intermarket Trading System established by the 1975 Act; two, whether to change the collection and distribution of market data fees; and three, whether there currently exists fair and equitable access to trading venues.

With respect to modernizing the Intermarket Trading System, both traders on the floor-based and electronic markets have concerns with the system and, in particular, with its trade-through rule. When the Intermarket Trading System was implemented in 1978, no one could have predicted the level and speed of trading done today. Unfortunately, the national market linkage that it was supposed to achieve has come to represent the great divide between our competing market structures and the diverse trading venues available to investors. Clearly, fixing the system needs to be a priority.

With regard to market data fees, again, the system, as originally intended, was to fairly and equitably collect and distribute monies to facilitate the market data to investors and to finance the regulation of the markets. Over the years, the fees have been subject to a number of factors, including being tied to incentives for trading platforms and to elements to boost market shares.

While the underlying goal of the fees is to create market data that is accurate, uniform, and available in real-time to investors, the fees also must ensure a strong regulatory environment. Today, I believe the system is not operating as it was intended.

On a related matter, the access to and trading on the various trading venues and markets also must be done in a fair and equitable manner. Our current system has brought about innovation and change to the market. However, as our markets continue to evolve and mature, level playing fields are harder to achieve. It has become even harder for market participants to act in the best interests of their investors. Should all fees and charges involved in a securities purchase be fully taken into account toward the price of securities, or should investors be given more comprehensive information on how the markets perform prior to placing an order are but two of the many questions that need to be addressed to determine whether we have fair and equitable markets.

In addition to these issues, we must also address whether the self-regulatory structure that we rely upon for oversight of the markets is in need of change. Recent events have shown significant strains and weaknesses on that structure. I will be interested to hear how the reforms that you implemented over the summer are proceeding and what additional reforms will be necessary.

With any review of the future of the securities markets, we should take a look back to how our markets have evolved over the past 20 or 30 years. The tremendous changes to the markets are due, in large part, to how technology and innovation have transformed not only the markets, but also our economy. For example, the Nasdaq Stock Market was transformed by the technology boom of Silicon Valley. As venture capitalists invested money into the high-technology companies, they needed a way to “cash out” their investments through initial public offerings on Nasdaq. Today, the testaments to the high technology market are household names. Today, not only are our securities markets at a crossroads, but also our economy is at a crossroads. Recently, numerous articles have appeared in the news stating that many of the high technology jobs are being transferred overseas. In addition, one article discussed how many countries, including China, are spending lots of money to create their own Silicon Valleys. While the U.S. initial public offerings, IPO's, were at a standstill for the first 6 months of this year. The Asian stock markets dominated the number of IPO's.

Will overseas venture capitalists and investment bankers transfer foreign securities markets to facilitate high technology industries in a similar manner that happened with Nasdaq? Time can only tell.

However, we must ensure that our securities market remain the best in the world. In doing so, we must ensure that technology and innovation are key to our evolving stock markets. Currently, market participants are unwilling to invest in infrastructure and technology without clear guidance from the Securities and Exchange Commission of where the markets are headed. If the securities markets are at a crossroads, then they are looking to the SEC for guidance.

Chairman Donaldson, thank you again for being with us today. I have to commend you for doing an excellent job in your very short time on the Commission. There have been a lot of issues vying for your attention during these past few months. I also appreciate, Ms. Nazareth, the Director of the Division of Market Regulation. We welcome both of you, and I look forward to your testimony.

I will call on Senator Sarbanes for any comments.

## STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Chairman Enzi. I want to commend you and Senator Dodd on holding this morning's hearing on the important subject of the structure of the securities markets.

This subject inevitably raises important and complex questions about market structure, among them what form should self-regulation take; how can we assure fair access to the securities markets; does an exchange need to provide time, price, priority; what constitutes best execution of an investor's stock order; and of course many others.

Because markets change over time in response to the needs of investors and issuers, these questions recur. The answers are not fixed in stone. Chairman Donaldson was quoted as saying in *The Wall Street Journal*, markets experience "operating stresses and strains," similar to the experience of the Chairman and those of us on the Committee, I might add.

[Laughter.]

It is, therefore, important for the Commission to resolve these issues in a timely manner through rulemaking, ruling on applications and working with self-regulatory organizations. It falls to the Commission to adjust the regulation of the markets to accommodate the legitimate needs of market participants, while at the same time upholding its fundamental mandate to assure the investor protection and market integrity mandated by our securities laws.

I welcome SEC Chairman Donaldson and Ms. Nazareth before the Committee. Chairman Donaldson returns to testify before the Committee or one of its Subcommittees for the sixth time this year and for the third time since the end of the summer recess. This Committee and its Subcommittee hearings and Chairman Donaldson's frequent appearance in them, underscore both the central importance of the securities markets to the Nation's economy and this Committee's concern that these markets operate at the highest levels of transparency and efficiency.

Chairman Donaldson, I want to commend you for your willingness to come before the Committee or its Subcommittees repeatedly. I think it is a very important part of laying these issues out for public discussion, and I think it contributes markedly to enhancing the understanding of the Members of the Congress, but also the members of the public on a range of complex issues that are on the agenda of the SEC. We are pleased to have you back before us today.

Thank you.

Senator ENZI. Senator Bunning.

**STATEMENT OF SENATOR JIM BUNNING**

Senator BUNNING. Thank you, Mr. Chairman, for holding this very important hearing. You picked a very important and timely topic to which you hold your first Subcommittee meeting.

I would also like to thank Chairman Donaldson and Ms. Nazareth for testifying today.

Our equity markets are the envy of the world. They have obviously taken a beating and battering over the last few years, but they are once again showing their resilience. Last May, I had, in my Subcommittee, a hearing on economic policy, increasing investment in the equity markets. Since that hearing, the Dow has gone up 1,200 points——

[Laughter.]

—the Nasdaq 435 points. Now, there may have been a tax bill that was passed that day, also. That may deserve some of the credit for the rebound in the markets, but that is okay. I can share the credit with the President.

Senator SARBANES. We urge you to hold another hearing as soon as you can.

[Laughter.]

Senator BUNNING. Though the markets are looking stronger, there can be improvement. I worked in the security industry for 25 years, so market issues have a special place in my heart. There are many issues confronting the markets today—overall structure, fragmentation, hedge funds, the impact of decimalization, and we have to worry about market manipulations and fraud.

I am very interested in hearing what you have to say about the issue confronting our markets. It is no secret that there has been a lot of turmoil at the SEC over the last couple of years. It is my hope you will bring needed stability there. Our markets need that stability.

Once again, Chairman Enzi, thank you for holding this important and timely hearing and thanks to our witnesses for their testimony today.

Senator ENZI. Any other statements?

[No response.]

If not, again, we thank you for coming, and I would mention that of course when we do the full Committee hearings, those are the ones where we get into concepts. When we get to Subcommittee, we get into technicalities. So this may be as easily understood as some of the accounting hearings that we had last year.

[Laughter.]

But it is the technicalities that make the difference, and so we do appreciate your being here to provide the testimony that we can delve into and figure out what we, as Members of Congress, need to do to aid you in your work.

Again, we thank you for coming.

You may begin Chairman Donaldson.

**STATEMENT OF WILLIAM H. DONALDSON, CHAIRMAN ACCOMPANIED BY ANNETTE L. NAZARETH DIRECTOR, DIVISION OF MARKET REGULATION U.S. SECURITIES AND EXCHANGE COMMISSION**

Chairman DONALDSON. Thank you, and good morning, Chairman Enzi, and Ranking Member Dodd, and Members of the Subcommittee. I am delighted to be here to discuss some of the significant market structure issues that we are facing in the U.S. equities market today.

In the coming months, the Commission will be focusing with increased intensity on the structure of the U.S. equities markets, with particular regard to their fairness and efficiency. As you know, Congress formally directed the Commission to address market structure when it enacted the Securities Acts Amendments of 1975. That legislation instructed the SEC to facilitate the creation of a national market system for securities that would maintain fair and orderly markets and tie together all buying and selling interest so that investors would have the opportunity for the best possible execution of their orders, regardless of where in the system they originate.

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

The 1975 Amendments to the Exchange Act created a framework for fostering transparency, interconnectivity, and competition in our securities markets. As a result, today, equity market centers compete with one another in an environment where quotes and transaction prices are widely available to all market participants.

Direct and indirect linkages among competing market centers help ensure that brokers can access the best quotes available in the market for their customers. Market centers, including exchange markets, over-the-counter market makers, and alternative trading systems, have an incentive to offer improvements in execution quality and to reduce trading costs in order to attract order flow away from other market centers.

The national market system has worked remarkably well for the past quarter century, and in recent years, it has become increasingly efficient. At the same time, this very efficiency, arising from technological and other market developments, has put strains on existing national market structures. One significant change has been the proliferation of new electronic markets, such as the ECN's, that offer fast executions and have spurred competition among market centers, but at the same time have exacerbated concerns about market fragmentation, the feasibility of integrating different market models into the national market system and maintaining a level regulatory playing field among functionally equivalent market participants. The implementation of decimal pricing in 2001, and the concurrent move to a minimum tick of one penny in the equity markets, has narrowed spreads and enhanced the efficiency of the price discovery process, but at the same time reduced the liquidity available at each price point and made it easier to step ahead of limit orders and placed economic strains on the dealer business.

Decimal pricing has also put a premium on swift access to displayed prices so investors can quickly reach these smaller quotes before they change. The trend toward demutualization of exchanges, and their conversion to for-profit enterprises, has heightened concerns about the inherent tensions in the self-regulatory model, in particular the concern that the funding and vigor of the regulatory function might be sacrificed in favor of delivering returns to shareholders.

Over the last several years, the Commission has taken a number of steps to address concerns facing our national market system. In the Order Handling Rules and Regulation ATS, for example, the Commission broadened the class of market centers required to make their quotations and orders publicly accessible. In doing so, it sought to redefine the idea of an exchange to include not just traditional exchanges, but also trading systems where orders interact according to specified trading rules. The Commission has also adopted rules to improve the disclosure by market centers of execution quality data, and the disclosure by broker-dealers of their order routing practices, in order to enable investors to "comparison shop" among the myriad market centers and to stimulate competition on the basis of execution quality.

There is no doubt that there are issues regarding our national market system that call for our attention. Commission staff is in the midst of developing proposals that address, in a comprehensive fashion, the various market structure issues. I would like to focus the remainder of my testimony on four key areas of the Commission's market structure initiative: First, access to markets; second, market data; third, the whole self-regulatory model; and, four, the nature of a securities exchange.

Access to markets and fair access. A significant market structure issue on the Commission's agenda is making sure that access between markets is as fair and as efficient as it can be. If best execution is to be achieved in an environment characterized by multiple competing markets, broker-dealers must be able to identify the location of the best available prices and obtain access to those prices routinely and efficiently.

The Commission's approval last year of the NASD's Alternative Display Facility as a pilot program has highlighted the issue of intermarket access. Rather than obtaining access through "hard" linkages directly between markets, in a way that competing markets can access the New York Stock Exchange, in the Alternative Display Facility, competing market centers obtain access to each other directly through privately negotiated access agreements and indirectly through subscribers. The Commission will be evaluating this decentralized access approach to determine whether, as a practical matter, it would be an appropriate model for the national market system and thus could be applied to other market centers.

Access fees. Access fees charged to reach a quote create another difficult market structure problem. Some markets charge varied per-share transaction fees for access to their quotes. Therefore, a displayed price may represent the true price that a customer will pay or it may represent only a base price to which an undisclosed access fee will later be added. To ensure real access to public quotes between competing markets, it is important that quotes be accessible to other market participants on clear and fair terms.

Price protection. As part of our examination of intermarket linkages, we also intend to reassess the question of intermarket tradethroughs, which occur when orders are executed in one market at prices inferior to the prices disseminated on another market. The challenge before the Commission is to devise standards that allow faster markets and slower markets to thrive within a single system of interconnected markets, while at the same time providing order executions to customers that display prices and for those customers who desire the best price on their orders.

Market data. An additional market structure challenge facing the Commission involves the collection and reporting of trading information and influence of the market data revenues on market structure. Under the current system, distributions of market data revenues to self-regulatory organizations are based primarily on each self-regulatory organization's reported trade volume. This compensation scheme has created a financial incentive for self-regulatory organizations to report as many trades as possible. As a result, markets are vying for ECN's and market makers to report their trades through them, as this allows markets to tap more deeply into the pool of available market data revenue and to rebate substantial portions of the additional revenue to the entity reporting the trade.

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

Third, the self-regulatory model. Another matter of great importance is the effectiveness of the self-regulatory system of securities markets. The principle of self-regulation is based on the idea that regulation can best be done as close as possible to the regulated activity. However, an SRO that operates a market has an inherent conflict of interest between its roles as a market and as a regulator. The advent of for-profit, shareholder-owned exchanges creates additional issues, including ensuring that self-regulatory obligations do not take a back seat to the interests of shareholders. The challenge for the Commission and the SRO's is to ensure that as the securities markets grow more competitive, the SRO's continue to dedicate their energies and resources to surveillance and enforcement. We also must prevent fragmentation of trading from creating gaps in SRO oversight of these markets.

As part of our review of the self-regulatory structure, I believe the Commission must thoroughly review the SRO's governance practices. Recent events at the New York Stock Exchange point to the need for this review. SRO's play a critical role as standard setters for sound governance practices. Just as SRO's have demanded that their listed companies strengthen their governance practices, we must demand that, at a minimum, SRO's match the standards that they set for listed companies. There are several topics that merit our consideration, including board composition, independence of directors, and independence and function of key board committees, the transparency of the SRO's decisionmaking process, and the diligence and competence required of board and committee members and ensuring their focus on the adequacy of regulation.

Exchange criteria. The last topic that I would like to touch upon is what it means to be registered as a national securities exchange. All currently registered exchanges have a limit order book, in which the better-price orders take precedence. But a mandatory order book system is not easily reconciled with a dealer model, such as the Nasdaq stock market, in which there is no central limit order book.

I spoke earlier about the merits of price protection across the markets. Nasdaq's application to register as an exchange places squarely before the Commission the issue of whether price protection within a market is a requirement of exchange registration. One issue is customer expectations. I suspect the customers generally expect their better-priced orders to be protected within an exchange.

We do not expect all exchanges to be identical, much less to replicate any market's faults. Yet, until now, all exchanges have given their limit orders priority throughout their marketplace. If the Commission were to approve Nasdaq's application, other exchanges would likely seek to eliminate intramarket price priority from their rules. As a result, the protection of limit orders within markets would decrease. For this reason, Nasdaq's exchange application raises market structure issues that transcend the particular question of whether Nasdaq, or any other particular market, should be registered as an exchange.

In conclusion, I would like to reiterate that the market structure challenges that I have discussed may shape the national market system for years to come. I look forward to continued input from this Subcommittee on these important matters.

Thanks again for inviting me to speak on behalf of the Commission. I would be happy to answer any questions or hear any observations.

Thanks very much.

Senator ENZI. Thank you, and I appreciate your taking a very complex subject and making it relatively simple.

We are going to be interrupted by a vote. I believe it is a stacked vote of two. I think that we should be able to get through one round of questions before the lights show up for the half-time of the vote, and at that time we can go vote on two issues and then come back and continue with rounds of questioning.

To begin the questioning, in 1975, Congress passed legislation that established the national market system that led to the creation of the Intermarket Trading System in 1978, and the governance of that system requires there has to be a unanimous vote of the system's participants before any changes can be made to the system.

Currently, it appears that there is not an agreement by all of the participants on how to amend the trade-through rule. There is precedent of the SEC stepping in to fix the system when not all of the parties agree. Will the SEC step in to solve the trade-through problem?

Chairman DONALDSON. Well, as I intimated in my formal testimony, the issue of trade-through is a considerable one, and it has to do, essentially with the different desires of investors, and let me try and elaborate on that.

You have, as a result of the nanosecond capability of some of the electronic markets, the ability to transact a transaction in a nanosecond—so fast you can hardly see it with your naked eye. And at the same time, we have had decimalization of the spread, so that now we have a penny difference, if you will, in markets, and price improvement represents a penny improvement. So that we have created a new desire, on the part of many investors, to give up the opportunity for price improvement of only a penny in order to achieve immediacy of execution and surety of execution.

And that is in contrast to some of our more particular markets, and in particular the New York Stock Exchange, where the guarantee of the best price requires a period of time to search for that best price. And although that period of time seems pretty fast, in terms of the current situation; for example, 30 seconds or so, 30 seconds is an eternity for somebody who trades in nanoseconds, and that is the problem. And what you have seen is a strain on our trade-through regulations, where people are willing to "accept a less good price" to trade through a better bid in order to get immediacy of action.

Senator ENZI. You think the Intermarket Trading System needs to be completely overhauled?

Chairman DONALDSON. Well, I think there needs to be a reexamination of the trade-through rules. I think we need to try and see if we cannot get a compromise between what I have just been talking about. There are many different ways of achieving that. Customers or clients could formally opt out of seeking best execution and, in so doing, allow brokers to deal in the faster market. There are a number of things that can be done.

You might want to add to that, Annette.

Ms. NAZARETH. Yes. I agree with everything you said. I think, in response to the issue, the Commission, as you alluded to, would probably have to take some action because, as you said, the governance rules require unanimity, and it certainly would be in keeping with what the Commission has done in the past to step in when the markets cannot agree on a solution.

Senator ENZI. It has been argued that there is not enough enforcement of that trade-through rule. For example, some market participants believe offers to purchase securities through the Intermarket Trading System are posted without the intent of execution. A good indicator of this is when a posted quote fades away, when the 30-second time limit to accept an offer expires, how do the SEC and the self-regulatory organizations police for market participants an attempt to manipulate the market in this manner?

Chairman DONALDSON. This is again one aspect of changes that we are in the process of examining. I think the unanimity rule, I did not answer your question directly, but that is something we are going to have to take a good hard look at.

I think we are also going to have to take a good hard look at the ability to monitor trade-through after we come up with an approach to allowing perhaps some modification of the trade-through rules.

Senator ENZI. My time has expired. I will do another follow-up in writing on that one.

Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

The market structure issues you have discussed, and contained in your statement, are complex. They obviously require significant staff expertise to resolve. My first question is whether the division of market regulation has been given the additional staff to handle these new issues.

Chairman DONALDSON. We have been through a rather intensive process of evaluating where our additional hiring capability should, how that should be divided between the various competing divisions within the SEC. I believe that we have allocated adequate resources to the market regulation, but let me ask the Director of Market Regulation whether she agrees with that.

Ms. NAZARETH. Absolutely. Yes. We have been allocated a substantial number of additional positions that we are in the process of filling in order to meet the additional needs in the Division.

Senator SARBANES. Do you think the resources you are being given are adequate to your tasks?

Ms. NAZARETH. Yes, I do.

Senator SARBANES. We will hold you to that.

*The Wall Street Journal*, Chairman Donaldson, on September 26—I am going to quote them a little at length—they talked about Mr. Reed coming back to the United States to take on his job.

He is dumping a draft report of corporate governance changes prepared by the New York Stock Exchange board for the SEC in favor of a new review that promises to recommend tougher changes.

One of the main issues being reviewed, according to people with knowledge of the matter, is whether issues such as pay, corporate governance, and audits should be reviewed by board committees, as they now are, or by the full New York Stock Exchange board.

A number of broader issues facing the big board remain on the table, among them, whether to split the chairman and CEO posts, whether to split off the New York Stock Exchange's regulatory function, and whether to issue shares to the public.

The scandal also has intensified the debate over whether the New York Stock Exchange can continue as a human-dominated system after most exchanges around the world have replaced people with matchmaking software.

Is the Commission examining all of these issues that I just referenced in the course of its oversight over the New York Stock Exchange and what is your view of these issues and how they should be resolved?

Chairman DONALDSON. Let me begin by saying that, yes, we are very much concerned with the governance structure of the New York Stock Exchange. I wrote the then Chairman of the Stock Exchange a number of months ago—I think in March I believe of this year—asking him and, I might add, the heads of all of the other exchanges to report to us on the governance structure of their exchanges, to report to the SEC on the many issues involved that you just brought up that fall in the general category of governance issues: Salary setting, how new directors are elected, basically how the place is run, from a corporate governance point of view.

If you fast forward now to the time that we are in, John Reed, and then if I can put my comments specifically to the New York Stock Exchange, John Reed has, in a public-spirited way, agreed to come out of retirement and come back to the New York Stock Exchange in an acting role as a chief executive to spearhead a thorough examination of the corporate governance structure.

We are in touch with Chairman Reed. We want to be of whatever help we can. However, at the first instance here, the responsibility for the governance structure of the New York Stock Exchange remains with the New York Stock Exchange. We have an oversight responsibility. We will exercise that oversight, but the first step here is for the Stock Exchange itself to come up with whatever revisions they believe is necessary in light of current circumstances.

Senator SARBANES. I take it that means that the last step, if necessary, though, is with the Securities and Exchange Commission.

Chairman DONALDSON. The last step will be the approval of the governance structure by the SEC.

Now, you bring up a most important issue here which has to do with not only the structure of the governance, but also the definitions of independence that apply to that structure, what is a truly independent director, can it be a member of the securities industry, can it be a sitting executive of a listed company, are these independent directors or are they not? Are they true public directors?

The second issue is of course the structure of how that board is elected, the structure of the nominating committee, the compensation committee, the audit committee, all of these things which pertain particularly to the New York Stock Exchange, but also pertain to companies listed on the New York Stock Exchange.

That raises some additional issues that you have touched on, which has to do with the self-regulatory function of the exchange. And, again, if I can oversimplify this, it seems as though there are two main functions that a stock exchange market like the New York Stock Exchange has.

One is the market itself, a competitive entity which is competing with other market centers, and with ECN's, and with broker dealers, and so forth; and the second is the regulatory function that is there to make sure that the dictates or competitive nature of the marketplace does not act to the detriment of public investors, both institutional and individual.

And I think the issue confronting the New York Stock Exchange now and confronting Mr. Reed's efforts here are what a structure can you come up with that, in effect, separates that regulatory responsibility so that it does not get mixed up with the competitive aspects of running the marketplace.

I would suggest that there are a number of different ways of doing that, ranging all of the way from reporting structures within the exchange framework that separate out a reporting line for regulation that reports to a newly defined, independent board, all of the way to taking regulation totally away from the self-regulatory organization and putting it out in space somewhere as a separate organization.

And this is an interesting issue. I think that traditional thought has been that the regulation should be as close to the marketplace as it can be and be effected by people who are familiar with the marketplace, as opposed to some disengaged bureaucracy. But I think that is the issue now that faces John Reed and faces the board of directors of the Stock Exchange.

Senator ENZI. Senator Bunning.

Senator BUNNING. Thank you. I have three questions. I am going to ask one and submit two because we are on a—we have got 10 minutes on a vote, and we have a 7-minute vote to follow.

The first question I would like to ask, because of all of the turmoil over at the SEC for the last few years, I am concerned with the length of time it takes for an application to be approved or disapproved. Do you agree that 2-plus years is too long for an application decision, and are you doing anything to speed up the process?

Chairman DONALDSON. Well, I think, if you are referring to an application such as the Nasdaq application to become a market, if that is the——

Senator BUNNING. That type of application or any other applications that are submitted to the Securities and Exchange Commission.

Chairman DONALDSON. Yes. This is an extremely complex subject. It is not just——

Senator BUNNING. I understand that, sir. I am just asking you over a period of 2 years seems to be plenty of time to make a decision, even though it is complex.

Chairman DONALDSON. I believe that the fact of the matter is that the application by Nasdaq to become a market, to become a stock exchange brings with it implications for the entire market structure system. It is not a simple decision for them alone; it is a decision that has ramifications for the entire rest of the marketplace.

Senator BUNNING. I understand that.

Chairman DONALDSON. And that is an issue that the SEC has been faced with long before I got there, and it is not a matter of somebody dragging their heels or the application in an out-basket or an in-basket; it is a matter that has been before the Commission. There have been all types of panels, and discussion groups and so forth. It is a tough question, Senator.

Senator BUNNING. I understand that, but 2 years is too long.

So, therefore, the decision should be made and all of the consequences of the decision should have been considered, and whether you like the application or whether you do not like the application or whether you think of the unintended consequences that come from the decision. Obviously, we know that it is complex. It would not take 2 years to make a decision if it were not complex. But I think somebody deserves an answer.

Chairman DONALDSON. Well, I agree with you in the sense that a certain amount of time has passed. On the other hand, the stakes are tremendous. If you step back from our market system, with all its warts and pimples, the U.S. market system is the best in the world, and it is functioning the best.

If we make a quick decision that has implication for the whole rest of the marketplace, we run the risk of doing great damage to our central market system. I want to assure you that there is nothing that we are looking at now that has a higher priority than the restructuring of the central market system. We have the best minds that we have in the SEC working on it. We are reaching out to everyone we can, and I see it as a top priority item for my tenure as Chairman of the SEC.

I do not know whether you want to add to that. You have been in the midst of this, Annette.

Ms. NAZARETH. I have. I guess I would just add the point that if we are to be faulted for anything, it is that we do not say, no, we keep saying maybe. Let us see if we can get to a yes answer, and that unfortunately takes some time. It is very easy to say, no, but I can fully appreciate the——

Senator BUNNING. Ms. Nazareth, what is “some time”?

Ms. NAZARETH. What is?

Senator BUNNING. What is “some time”? What are you considering that “some time” is? Is it 2 years, 4 years, 6 years, 10 years?

Ms. NAZARETH. I think it would be normally something quite short of 2 years.

Senator BUNNING. Something short of 4 years?

Ms. NAZARETH. Of 2 years.

Senator BUNNING. Of 2 years.

Ms. NAZARETH. Normally, it would be.

Senator BUNNING. Some applications are sitting there over 2 years.

Chairman DONALDSON. The issue has not just been sitting there, Senator. It has been worked on.

Senator BUNNING. But it is still not resolved. That is the whole question.

Chairman DONALDSON. That is absolutely right, and we have it as a priority item, and we are going to resolve it.

Senator BUNNING. I can be assured of that, the next time I come back, if I ask the same question?

Chairman DONALDSON. No.

Senator BUNNING. Will you say it is less than 2 years?

Chairman DONALDSON. I will have to ask the Chairman when he is going to ask me back again.

[Laughter.]

Senator BUNNING. You will be back before the full Committee before you get back to the Subcommittee.

Thank you very much, and I will submit the other two in writing.

Chairman DONALDSON. Thank you.

Senator ENZI. We are in a very fortunate situation. Senator Dodd has already voted, so we will have Senator Sununu ask his questions, and then we will allow Senator Dodd to continue the hearing while we go vote.

Senator SUNUNU. Thank you, Mr. Chairman.

I only have easy questions.

Mr. Donaldson, is the role of the regulator, I heard you use the phrase "price improvement" and "price protection," and it put a question in my mind, which is, is the role of the regulator to guarantee the best price or to ensure a fair and transparent system that is free from conflicts of interest?

Chairman DONALDSON. As I tried to say, rather inarticulately, the definition of what the participant in a marketplace wants is changing, and it used to be that best price was a sine qua non of the market, that small investors were guaranteed, alongside large institutional investors, that they would get the best price. But as I said, I think that in the age of electronic markets, the very rapid transaction times, and the decimalization, the best price is not always, in some people's minds, worth waiting for.

Senator SUNUNU. I understand that point that you made, which is that different investors have different needs and different wants——

Chairman DONALDSON. Right.

Senator SUNUNU. —from the exchange or the broker or the system that they are using to execute a trade. I understand that. But my question is what is the job of the regulator? Is your job to ensure the best price or is your job to ensure a fair and open system, free of conflicts of interest? And I think that is a very important distinction because I can go to an auction for furniture or go to buy a rug at auction and that auctioneer may be working very hard to give the seller of that coffee table the "best possible price" in a way that involves people planted in the audience or someone working against bidders or ensuring that the price is bid up in a way that participants in the auction do not necessarily know, and I think this is an important distinction.

My sense would be that, as an investor, I simply want to make sure that we have the fairest possible process, the best possible transparency, and of course a system that is free from conflicts of interest. And I respect the fact that you brought up the issue of conflict of interest in discussing the role of SRO's. So that is just a distinction that I want to make, and I imagine, and I hope, does carry through in the work that the SEC does.

Let me talk about a specific example, and then you can elaborate, because I want to ask you a question not just ask you to make conceptual comments, and that is with the auction specialist process used by the NYSE.

I read some articles recently that threw out two numbers that I found to be interesting. One is the trend toward or the increase in trades that are made on the specialist account. Now, a specialist is there to act as a buyer or seller of last resort when a market does not exist for a particular trade, but over recent years the number of trades made on specialist accounts has gone from 8 to 15 percent, and maybe even a more impressive number is that I think that it was over 70 percent of the profits made by specialist firms are on trades made for their own accounts.

I think those numbers are right. If they are not right, please correct me, and what thoughts or comments do those evoke from you?

Chairman DONALDSON. Let me go to your first line of questioning in terms of the role of the regulator. I think that our role is to make sure that the price discovery process, if you will, is free from conflict and is as efficient as it possibly can be.

I think that our role also is to effect rules such that even the smallest knows that he or she has made the decision to forego, let us say, price improvement in order to get speed, that cannot be a decision made for them. There have to be rules and regulations that allow the individual investor to understand exactly what the executing broker is doing with that order within the context of fairness of the marketplace itself.

In terms of your statistics on the option exchanges and the specialists, I am going to ask Annette to comment on that.

Ms. NAZARETH. I think the numbers were in the range, but your question really went to do we have issues with this or are we looking at the——

Senator SUNUNU. Well, if a specialist is intended to be a buyer or seller of last resort, what market rationale is there for a dramatic, 100-percent increase—I suppose that is pretty dramatic—dramatic increase in the number of trades being executed on their accounts? Are there market phenomena to explain this, and why would it be that the lion's share of trading profits come from trades executed on their own accounts, again, if you are acting as a market of last resort?

I thought that the question or the point was a pretty clear one.

In this line, could you also talk a little bit about internalization and maybe provide me—I have only heard of the term recently—and provide a little bit of a description about the phenomena and whether that is problematic for investors. The question with specialists is no big surprise. It is one of front-running and whether or not this is a problem, whether or not it exists, and nobody is for that, but can you talk about internalization and whether or not that raises any similar concerns about conflict of interests.

Chairman DONALDSON. Go ahead.

Ms. NAZARETH. I will go back for a minute to the specialists. I mean, as you know, it is widely publicized that we are looking, as is the New York Stock Exchange, at certain issues in the specialist system, including how they satisfied their affirmative and negative obligations. Obviously, to the extent that there are any issues there, they will be addressed. And the statistics that you point out do raise questions about whether or not they needed to be stepping into the in-between orders or interpositioning in situations where two customer orders could meet. So, I can assure you that, to the extent there are issues there, they will be acted upon.

In internalization, as you know, the concern that we have with internalization really goes again to whether or not it has some negative affect on the price formation process. To the extent that many believe that the best way to achieve the most efficient price is to have the most order interaction in a single venue with the most, the greatest number of orders competing on the basis of price.

When you have internalization, you have taken a whole subset of those orders out of the equation and, as you know, what they do is they mimic the price that was set in the more price formation venue.

Senator SUNUNU. Does that suggest that your rulemaking or approval or disapproval of rule changes would tend to favor the elimination of internalization or a movement away from allowing that to happen?

Chairman DONALDSON. Are you referring now to options exchanges?

Senator SUNUNU. Yes, that is where it has, again, been in the news most recently, having to do with the options exchanges and whether or not this is a good practice, a positive practice.

Chairman DONALDSON. I think that the competition that we are looking for between natural buyers and sellers, in terms of price discovery, can be severely impeded, if you will, by internalization, where, in fact, orders are put together inside a particular entity, firm, whatever, and are not exposed to the general interests in those orders outside. And taken to its extreme, you would have a less-efficient price discovery mechanism. You would have orders that have had a fence put around them and can only deal inside a firm, as opposed to orders that rightly need to be exposed to outside the firm to the broad market.

Senator SUNUNU. Now, how is that any different, conceptually, than a specialist providing price improvement in front of a book of limit orders?

Chairman DONALDSON. Again, this gets to the price improvement is part and parcel of a marketplace that exposes the orders to the general market, as opposed to exposing those orders just to a limited part of the market. You are depending, in a fractionalized situation, on the price discovery coming from only a fraction of the marketplace, a limited part of the marketplace. This is not true in terms of the way that a pure auction market works.

Ms. NAZARETH. I think you are, if I gather what your point is, your point is that if the specialist does not act in a manner consistent with the way the affirmative and negative obligations of the rules work, then what the specialist is doing is akin to an internalizer who—I understand that point.

Senator SUNUNU. That is correct.

Ms. NAZARETH. Yes, I understand the point. That is why the rules prohibit that activity.

Senator SUNUNU. Thank you very much.

Thank you, Mr. Chairman.

Senator DODD. [Presiding.] Thank you very much, Senator Sununu. Excellent questions.

And I apologize to both of you for not being here at the outset of your testimony. I was unavoidably absent. I will take just a few minutes before the next vote occurs to raise a couple of questions, if I may. I thank Senator Enzi for allowing me to chair the Subcommittee for a few minutes. If I look around, I might get away with some things here.

[Laughter.]

Anyway, just a couple of questions. First of all, let me thank both of you. Ms. Nazareth, it is good to have you here. The last time I was looking at you I think I saw you sitting in the seat behind the witness we had.

Ms. NAZARETH. That is right.

Senator DODD. So it is a pleasure to have you sitting at the witness table with us.

Mr. Chairman, I have said, on numerous occasions, that I think we are very fortunate to have you in charge of the SEC. You and I have known each other a long time, and I am very confident you are going to do a very fine job.

A couple of questions come to mind. If these have been raised, by the way, some of my colleagues have already brought this up, stop me immediately, and I will go onto another question. I am not aware of all of the questions that have been raised, and not having been here to hear them, I do not want to be duplicative.

I do not know if the issue of decimalization has been raised with you this morning. Has that been raised?

Chairman DONALDSON. Only tangentially.

Senator DODD. Well, I am interested, if you might, just give us a few questions I have associated with the issue. Obviously, this was a big change and a lot of anticipation about what the change and decimal pricing how it would change the environment and the structure of our markets, and I wonder if you might just give us some sense of what the anticipated benefits have been. Have they been realized, such as price improvement and the declining affect on spreads? Does it also change the necessity to change rules, any rules changes or regulations? And is there an appropriate minimum decimal pricing increment that you think might be necessary?

And the last question I maybe should have raised first, and that is has liquidity been reduced as a result of the increase in the number of price points here?

Senator DODD. Decimalization has resulted, at least insofar as the markets are operating today, basically, with a proliferation of price points, it has obscured in a way the true size of the market. In other words, the amount of shares offered at a particular point are not necessarily reflective of the amount of shares offered or bid for at points only pennies away from that.

Senator DODD. Right.

Chairman DONALDSON. So you have a proliferation of price points.

In addition to that, because of some of the arrangements in some of the markets, you have the threat of an explosion of price points if we get into subpenny decimalization, and that is why we have real trouble with subpenny decimalization.

In terms of the impact on the market, there are lots of different judgments on this emanating from academic institutions and so forth. I think it is clear that the individual investor has been advantaged, if you will, in terms of the efficiency of the marketplace and the functional cost of doing business. I think it is equally clear that perhaps some of the institutions are paying more. And then if you consider an institution to be an amalgamation of individuals, if you follow that through, individual holders of institutional funds have been disadvantaged.

I think that there is some feeling that the depth of the markets has eroded, particularly in thinly traded stocks, where the profit motive, if you will, for the dealer, the profit potential for the dealer is less, and therefore the liquidity in that market is not what it used to be.

Senator DODD. Yes.

Chairman DONALDSON. But those are all things that we are trying to get more information on and trying to make judgments on. We read everything that is written and then try and make judgments on it, but those are at least a partial answer to the question you asked.

Senator DODD. Let me, because you have raised, ask two quick questions: One, are you anticipating any rule or regulation changes to address some of these questions? For instance, you have identified what I think is a very legitimate point, and that is the minimum increment in the fractions. So is there some idea here to set a minimum? That seems to be what you are saying.

Chairman DONALDSON. If you are talking about going back to eighths, and quarters, and halves, and so forth, I do not think so, Senator. I think that we are past that point. I think in terms of subdeci-malization, if you will, I, personally—and I do not speak for the Commission, but speaking personally—I hope we can avoid that because I think it will just cause an impossible not only computer capability, but also an impossible marketplace if we are dealing in subpennies.

Senator DODD. And the issue of rules and regulations of this at all, other than just conversation at this point or is there any anticipation of changes necessary in the market structure?

Chairman DONALDSON. No, we had a brief discussion here about exactly what the Commission is doing, and what we are seeking to do is—you push this thing in one place, and it pops out in another place, and we are trying to look at the whole.

Senator DODD. Sure.

Chairman DONALDSON. And we are trying to come up with some rules and regulations that look at the whole structure, and this is a top priority for the Commission. It is a complex subject, but we are going to do something about it.

Senator DODD. Let me jump—I gather Senator Sarbanes may have raised some points here regarding the review of the SRO structures, the functions of the New York Stock Exchange, but also the functions of both Nasdaq and NASD.

In your testimony, I gather here, you reference the numerous concerns about obviously the conflicts of interest, governance, excessive compensation and the like, and I know that you have responded in part, anyway, to Senator Sarbanes about the SEC's role in the SRO review.

I wonder if you might give us some sense of timing with regard to Nasdaq and NASD, where they are in some stage of separating ownership and governance questions there, and I wonder if you can tell us what the time line for the completion of the complete separation would be.

Chairman DONALDSON. Are you referring to the governance and regulatory aspects of just Nasdaq or the New York Stock Exchange or the other exchanges?

Senator DODD. Just Nasdaq.

Chairman DONALDSON. Just Nasdaq, yes. Well, the resolution of the Nasdaq application to be treated as an exchange depends upon the impact that recognition would have on other parts of the marketplace.

As you know, each of the registered exchanges have priority rules, and they are designed to promote order interaction. If the Commission were to approve the Nasdaq application, as it has been proposed, it would have to likewise permit other exchanges to abandon priority rules, and thus the Nasdaq application raises profound market structure issues that could have implications for all of our registered exchanges and ultimately the investors in the markets.

I could go through a whole list of other aspects of the Nasdaq application which have profound implications for the rest of the marketplace, and I would simply say that we are trying to treat the Nasdaq application—it has not been shelved, and gathering dust and so forth—within the context of our overall market structure review.

And when you were not in the room, I said, and I will say again, that we have market structure as the resolution of this very high on our agenda, on our front burner, and I do not want to put a specific time frame on it, but we recognize that some final decisions must be made here. But we recognize that if we make the wrong decisions and are precipitous and haven't tried to anticipate the unanticipated consequences, we could do severe damage to the whole system.

Senator DODD. I think we all understand that because not making a decision either has consequences, too.

Chairman DONALDSON. Well, we are working on it.

Senator DODD. You will be back before the Committee, and I presume that this is a good answer you have right now of dealing with the whole, but there is going to come a point when people are going to want some answers on how these things, the time lines and so forth are going to be there. So, I am not telling you something you do not know.

Let me jump, last, to one other point I would like to raise with you. In your prepared statement, you stated that the rise of ECN's had exacerbated concerns, "a number of concerns and issues including the feasibility of integrating different market models into the national market system."

Now, it is not entirely clear to me from the statement whether you believe that the existence of more than one market model is a source of concern, something which would be surprising to some of us, in a way, given our market's long history of innovation and advance or whether you see the concern as the current framework for integrating those different models, in a sense, following the response, again, trying to be more cautious and careful about how this all works.

I wonder if you might offer us a little clarification on which of those two points should I take as the reason for your statement.

Chairman DONALDSON. Well, we believe very strongly in the innovation inherent in the many different market models that have come into being, the electronic markets, et cetera.

I think what we are seeking here is an ability for all of these different models to operate together in a national system that allows for efficient price discovery and allows for the individual investor and the large investor to operate side-by-side, allows for transparency, and allows for the efficiency inherent in true price discovery. I believe we encourage the innovation of these new models and the new electronic markets, but we want to be very careful, that they are not operating to the detriment of those principles I just talked about.

Senator DODD. Yes.

Chairman DONALDSON. If they act to increase internalization and fragmentation, that is not so good. If they act to somehow deprive a customer or client of price improvement that that customer wants, that is not so good either.

So we are trying to find a way to get a compatibility between the, to put it in superficial terms, the "fast" and "slow" markets.

Senator DODD. I do not disagree with that. I do not think anyone on this side of the dais would at all either.

Obviously, there are some wonderful opportunities as well emerging with the technologies to be provided, and we do not want to miss the opportunity to provide the consumer with a heightened degree of confidence, which is critical in this area, but also recognizing what the consumer needs today in light of the tremendous pressures they are under as well and looking for efficiencies in these systems.

So, I would be very interested to see how this progresses. There has been a lot of hostility in the past, at least perceived hostility, merely because it was almost a threat, a business threat, and that is not a good reason, in my view. And if that is all it is, then it has no place in this debate or discussion.

If it is as you have described it, very legitimate reasons, then obviously proceeding with caution is necessary. But there is a growing concern that maybe there is more of the former and less of the latter, in some people's minds, and we want to move through this if we can.

It is getting harder and harder to explain to the consuming public, the investing public, why we cannot move in this direction, given our ability to innovate in so many other areas, and given the fact that our markets have been so innovative over the years.

That is one of the reasons the world still comes here and a reason we have been able to generate as much wealth and strength in our economy is because of innovation. So we are still interested in pursuing those goals, keeping in mind the points you have raised, which I think are very legitimate.

Chairman DONALDSON. I think it is not to protect individual business models, but rather to protect the investor. And I think there are a number of characterizations out there that are put forth by those who want to push their model, and there is the glorification of immediacy in electronics and so forth——

Senator DODD. I agree.

Chairman DONALDSON. —which is very appealing. There is, also, for us old-timers, if you will, when we see markets——

Senator DODD. What are you talking about now? Speak for yourself there.

[Laughter.]

Chairman DONALDSON. Not "us" old-timers, sorry. But there are periods of stress where we sometimes are glad to have human beings putting together trades in periods when there is stress, and I think it is too easy to just discount that completely in terms of the speed of electronics.

Senator DODD. I do not disagree, and I feel the same, whether that is because we both have gray hair or not, I do not know. I certainly am conscious of those points. But I also understand there are a lot of other things that can urge to do as well, that there is wonderful ability to innovate so effectively here that we can really make some wonderful changes in the system, in the models.

Anyway, I see we have been joined once again by my good friend and colleague from New Hampshire. I did not intend—obviously, I can see you have your coat off. You thought you were going to get out of here. I do not think you are yet, Mr. Chairman.

Senator SUNUNU. I do have a couple more questions.

Senator DODD. There you go.

Senator SUNUNU. Unless you wanted to pursue your tough line that you had there.

Senator DODD. No, no. We have covered—there are some other questions here, but let me ask the Senator from New Hampshire to proceed.

Senator SUNUNU. I just wanted to take a couple of minutes to finish the line of questioning or the discussion we were having. You indicated that you did not feel that internalization was a positive thing for investors with regard to options markets. My question is are there existing options markets that allow this process and procedure? How commonplace is it among the existing options exchanges?

Chairman DONALDSON. Let me turn to our options expert here.

Ms. NAZARETH. It is probably much more prevalent than you would imagine.

Senator SUNUNU. Is it allowed? Are there options exchanges——

Ms. NAZARETH. It is a question of how it functions. If a firm is bringing its own orders to the floor and is trading against those orders as the market maker on the floor and others are not participating in the trade, that is akin to internalization, and that goes on a fair amount even in our floor-based options markets today.

So it is not a notion that is foreign to our existing options markets.

Senator SUNUNU. I believe former SEC Chairman Pitt had raised this issue with a number of options. It said that he wrote to the other exchanges and requested they eliminate rules that guarantee members a portion of internalized orders. Has any progress been made on this request? Is this something that you are still pursuing?

Ms. NAZARETH. We are working on a concept release on internalization in the options markets that the staff is hoping to bring to the Commission within the next several weeks. So we are following up on the issues that were raised by Chairman Pitt at the end of his tenure.

I should also point out that even embedded today in the options markets' rules, order entry firms can basically cross 40 percent.

They can keep 40 percent of the orders that are above 50 contracts. So there are notions of internalization currently embedded in, some notion, some amount of it. It does not encourage full-blown internalization, but 40 percent, being able to get a guarantee of 40 percent of the order flow that you bring to the floor is a form of internalization.

Senator SUNUNU. When the staff brings forward this concept paper, does it become public at that time?

Ms. NAZARETH. Yes.

Senator SUNUNU. Excellent.

With regard to self-regulation, and in particular the governance structure between the trading entity and the regulatory entity, there has been some discussion and I suppose there may be some markets that are actually engaging in outsourcing of their regulation. I think this nice article with the Chairman's picture in it that I showed him earlier, I think that the Nasdaq is heading in this direction; that their long-term goal is to have a formal break and then to contract, the exchange to contract with the NASD—that is not an exchange, I know—but for them to contract with the NASD. So it would be effectively outsourcing their regulation.

My question is, is this a good trend? The concept or the idea of outsourcing regulation where you engage with or contract with a separate entity or separate party to enforce regulation?

Chairman DONALDSON. Well, I think it is an interesting concept. I do not think it is the only concept, in terms of this clash, if you will, between regulatory responsibility and the responsibility for running a profitable market business.

There are, taken to its extreme, you could have a total outsourcing of all regulation in an outsourced regulatory body that would be a junior varsity SEC or you could take it all of the way to the SEC if you want to. I mean, that is one extreme, and I think that the bureaucratic aspects of that, and the expense of doing that, would not be in the best interests of keeping up with fast-paced markets. I think that bureaucracy could not move fast enough, and I think that the original concept of the self-regulatory organization or the delegation of that responsibility to the market centers was a good decision.

Now, I think we have to, in light of all that has gone on, I think we have to examine whether there is not, are not other ways of getting that regulation more independent, without destroying the efficiency of having it close to the marketplace itself. And this is, I think, one of the things that the New York Stock Exchange is facing right now, and I think there are a number of different models.

I would not say that the Nasdaq model is, it is fine for Nasdaq, but it is not the only model.

Senator SUNUNU. Thank you.

Thank you very much, Senator Dodd.

Senator DODD. Thank you, Senator.

I just wanted to ask a few more questions. I do not know if enough time has elapsed to allow you to answer this question. I would like to raise it with you anyway, and it has to go to the issue that has been discussed, in broad terms. Over the last number of months since the accounting scandals of Enron and WorldCom and the worry that was raised, investor confidence. I am wondering if there has been any assessment that the SEC has been able to make about market volume and liquidity that you have been able to detect, decline as a result of the accounting scandals.

Also, the concern was raised that we might find, in fact, investors moving off-shore or off-shore investors not coming here. Have we seen any benefit accrue to foreign exchanges because of any perceived loss of confidence in the U.S. markets?

And, last, just the related, which would obviously be part of your answer, I suspect, and that is whether or not the market structures are operating efficiently enough to allow us to maintain the global leadership we have historically prior to these set of incidents.

Chairman DONALDSON. To answer your last question first, we do not see any movement off-shore in order to deal in better regulated markets or to deal in markets that investors would want to be operating in. As a matter of fact, the volumes that are being done here in the United States continue to increase.

I think the ability of our markets to be competitive with the rest of the world is again, in the biggest picture, a trade-off between regulation that those who are regulated want to deal in a market that is regulated, and that regulation tends to inhibit, if you will, in certain instances, but people are willing to accept that because of the positive aspects of it.

And I think that, to date, if you ask most investors, institutional and individual, they still have considerable faith in our marketplace.

The confidence aspect that you are talking about, I think we are making some considerable strides through the Sarbanes-Oxley formation of PCAOB and the new standards in investigation and so forth.

I think we are also making some progress, although it is slow, in terms of reconciliation of foreign accounting schemes, with our own accounting schemes, working toward an international scheme, although that is going to be a while in coming.

I think that my judgment is that the combination of all of the things that are going on now, in terms of the independence of audit committees and the restructuring of the responsibility of a corporate entity, I think that is having is effect. I think directors are paying more attention than ever.

Senator DODD. Certainly.

Chairman DONALDSON. I think confidence will slowly come back, but unfortunately there continue to be evidences of malfeasance, and rulebreaking, and so forth that undermine that concurrently with it.

Senator DODD. But in the meantime, we have not discerned any shift.

Chairman DONALDSON. I do not think so. No, I do not think so.

Senator DODD. Thank you.

John, anything else?

Senator SUNUNU. No. Thank you.

Senator DODD. Well, listen, I thank both of you very, very much. Obviously, we will stay very much in touch with you. Chairman Enzi, I know, feels as I do. We need to stay in close contact with you to see how things are progressing.

Chairman DONALDSON. Thank you.

Senator DODD. We are just recessing the hearing. Thank you.

[Recess.]

Senator ENZI. [Presiding.] I thank everybody for their patience. The 15-minute vote took almost an hour, but we have gotten the second one underway now, and I thank Senator Dodd for voting early and keeping the hearing going.

To return to the questions, and I am not sure whether we will have anyone else come back, but when we finish the round of questions, we will leave the testimony open for a period of 10 days for submission of questions and to give you some time to answer them.

Earlier this year, you sent letters to each of the self-regulatory organizations requesting information concerning their corporate governance practices. In response, several SRO's initiated changes to their corporate governance practices.

In light of the recent events at the New York Stock Exchange, you stated that you will let Mr. Reed, as interim Chairman, evaluate the New York Stock Exchange prior to the New York Stock Exchange submitting changes to the SEC.

What I am interested in is will you move forward with the other SRO's corporate governance reviews while you wait for the New York Stock Exchange to complete its evaluation or will you address all of the SRO corporate governance reviews at the same time?

Chairman DONALDSON. I believe it is a continuing process. We have put out the original letter from me to the other exchanges. We received responses from that. We asked them for some more information subsequent to that. We have all of those pieces of information under review right now. Clearly, front and center is the New York Stock Exchange. This is not to say we are looking for one universal corporate governance structure or regulatory structure, and I think we are going to work on all of them, with the New York Stock Exchange being number one priority now for us.

Senator ENZI. Thank you. To change topics a little bit, a review of the major foreign securities markets reveal these markets primarily are electronic based and have demutualized the regulatory functions from the business operations. In addition, several of the markets operate on a for-profit basis. It is apparent that these markets view their securities markets as business operations, rather than as utilities for the trading and securities.

As the SEC reviews the corporate governance structure of the U.S. securities markets, should the SEC look at separating out the business functions from the regulatory oversight?

Chairman DONALDSON. Clearly, that is an issue, and it is keyed or tied to the words "separating out." Again, I think that there are different ways of separating regulation from the markets in themselves without putting the word "out" there. It has to do I think with the independence of the regulatory mechanism, as opposed to exactly where it is, either inside a corporate structure, an exchange structure, or outside of it.

Senator ENZI. With respect to the market structure issues, the Commission has already held a series of hearings and received recommendations from an independent advisory committee. What additional information does the Commission need in order to start making decisions on the future of the securities market and have you initiated a timetable or a blueprint on how to resolve the significant issues?

Chairman DONALDSON. Well, we have a number of issues not pertaining to market structure on our agenda. As I said way back in my confirmation hearing, I viewed market structure as one of the more important and also more complex issues facing the Commission, and it is very much on the front burner for us right now.

In terms of the exact timing, I would rather not tie us to a specific time, except to say that we are pretty much at the end of the fact gathering. We are pretty much at the end of the conversations that we have had through the various panels and so forth, individual conversations, and we are going to be working on an overall approach just as soon as we can, and it is not years from now and it is not weeks from now.

Do you want to put a more definitive definition on that?

Ms. NAZARETH. No, I think it is somewhere in between there, which sounds like several months to me.

Senator ENZI. I know that in our work a lot of times if it weren't for deadlines, we wouldn't get anything done. I can understand a reluctance to want to put out a timeline for us, but internally do you have more of a timeline than you are giving us here at the hearings?

Chairman DONALDSON. Absolutely. We are working on it just as fast as we can. Again, I would refer back to the statement I made earlier, which is that it is not a matter of it is not being worked on, it is a matter of making some tough decisions and trying to anticipate the unintended consequences of what we are doing within the context of stepping back and saying that, even with the stresses and strains, our system is working pretty well.

And the thing we want to avoid is making some ad hoc decisions that change the whole system rapidly for the worse. And we are keeping our staff's feet to the fire, and we will be keeping the Commission's feet to the fire here in the weeks and months ahead.

Senator ENZI. I appreciate that. I know that if I tell my staff that I want it as fast as I can, it is different than if I say I want it by this afternoon.

[Laughter.]

I do fully appreciate your wanting to review the market structures in a complete and comprehensive manner. However, considering the reluctance of market participants to invest in capital infrastructure and technology until guidance is received from the SEC, some forward movement on these issues is necessary.

With respect to the market structure issues, hearings have already been held by the Commission and by the advisory committee on market information, and that committee has issued its recommendations to the Commission, as I understand it.

At a minimum, should you direct the SEC staff to come up with a staff report on market structure in a similar manner that was done very recently for the hedge funds? Will you be doing that?

Chairman DONALDSON. I think that would be a delaying thing, Senator. I think that we feel more impetus than that to make some decisions. I think that to enter into another study, you know, and have months and months go by would not add much to our knowledge base. I think we know the arguments pretty well now, and it is just a matter of resolving this thing, which is what we want to do.

Believe me, we are as eager as you are to see it done.

Senator ENZI. Well, the securities markets are the best in the world, and in order for us to retain that distinction, the evolution of the underlying structure of the market has to be done to keep innovation, technology, and efficiency of the markets at the forefront.

I thank you for your testimony today and your patience in putting up with the votes. As Senator Sarbanes and I were noting, as we waited for the subway to go over and do our vote, your more relaxed appearance before us, after the practice that you have had——

[Laughter.]

Senator ENZI. We knew you always had the capability, but now you take this a little more in stride, remembering back to the first hearing that you had here. You have given us a greater understanding of what the most pressing market structure issues are that we need to focus on. I am a little disappointed that you did not set out more of a timetable on how to address those concerns. I believe that it is essential for the regulator of our securities markets to give guidance to the markets when necessary and, accordingly, I would like to address these issues again probably in about 6 months from now by this Subcommittee and if possible earlier by the full Committee.

I appreciate the fine job that you are doing at the Commission since your tenure began earlier this year. You have had to address a wide variety of issues. I think you have done it well. I look forward to working with you and the rest of the Commissioners and the SEC staff. And, Ms. Nazareth, I thank you for being here as well.

The Committee record will be open for 10 days. If Members wish to file additional questions, I would encourage them to file them immediately so that the Chairman has time to answer them. We would appreciate your cooperation in responding with those answers.

The hearing is adjourned.

[Whereupon, at 11:54 a.m., the hearing was adjourned.]

[Prepared statement and response to written questions supplied for the record follow:]

**PREPARED STATEMENT OF WILLIAM H. DONALDSON**

CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

OCTOBER 15, 2003

Good morning Chairman Enzi, Ranking Member Dodd, and Members of the Subcommittee. I am delighted to be here to discuss some of the significant market structure issues that we are facing in the U.S. equities market today.

In the coming months, the Commission will be focusing with increased intensity on the structure of the U.S. equities markets, with particular regard to their fairness and efficiency. As you know, Congress formally directed the Commission to address market structure when it enacted the Securities Acts Amendments of 1975. That legislation instructed the SEC to facilitate the creation of a national market system for securities that would maintain fair and orderly markets, and tie together all buying and selling interest so investors would have the opportunity for the best possible execution of their orders, regardless of where in the system they originate.

Congress specified five key objectives of the national market system: (1) economically efficient executions of securities transactions; (2) fair competition among markets and securities firms; (3) the availability of market information to investors; (4) execution of orders in the best market; and (5) direct interaction among investor orders. To achieve these objectives, Congress recognized that communication systems, particularly those designed to disseminate market data, would form the heart of the national market system. Rather than attempt to dictate the specific elements of U.S. market structure, however, Congress chose to rely on an approach designed to provide maximum flexibility to the Commission and the securities industry in its development.

The 1975 Amendments to the Exchange Act created a framework for fostering transparency, interconnectivity, and competition in our securities markets. As a result, today, equity market centers compete with one another in an environment where quotes and transaction prices are widely available to all market participants. Direct and indirect linkages among competing market centers help ensure that brokers can access the best quotes available in the market for their customers. Market centers (including exchange markets, over-the-counter market makers, and alternative trading systems) have an incentive to offer improvements in execution quality and to reduce trading costs in order to attract order flow away from other market centers. This competition among market centers encourages ongoing innovation and the use of new technology. Within all existing registered exchanges and a number of other markets, investor orders have the possibility of interacting directly without the intervention of intermediaries. This furthers Congress's fifth objective—direct interaction of customer orders—allowing investors to obtain executions at better prices than otherwise would be available.

The national market system has worked remarkably well for the past quarter century. And in recent years it has become increasingly efficient. At the same time, this very efficiency, arising from technological and other market developments, has put strains on existing national market structures. One significant change has been the proliferation of new electronic markets, such as ECN's, that offer fast executions and have spurred competition among market centers, but at the same time exacerbated concerns about market fragmentation, the feasibility of integrating different market models into the national market system, and maintaining a level regulatory playing field among functionally equivalent market participants. The implementation of decimal pricing in 2001, and the concurrent move to a minimum tick of one penny in the equity markets, has narrowed spreads and enhanced the efficiency of the price discovery process, but at the same time reduced the liquidity available at each price point, made it easier to step ahead of limit orders, and placed economic strains on the dealer business. Decimal pricing has also put a premium on swift access to displayed prices so investors can quickly reach these smaller quotes before they change. The trend toward demutualization of exchanges, and their conversion to for-profit enterprises, has heightened concerns about the inherent tensions in the self-regulatory model, in particular the concern that the funding and vigor of the regulatory function might be sacrificed in favor of delivering returns to shareholders.

The issues surrounding intermarket access provide a good example of some of the strains impacting U.S. market structure in recent years. In a system with many competing market centers and pools of liquidity, participants clearly need to know what the best prices are and where they are available. But this information is of little use in the absence of effective access to the market centers with the best prices. Implementing market access, however, has raised a number of difficult issues. Offering access to one's market to competitors can conflict with the core business strategy and commercial self-interest of a market. Over the years, markets have sought to maintain strict control over access and often have erected barriers to achieve this objective. These barriers historically have taken the form of direct bans, restrictive membership requirements, discriminatory execution priorities, fees, and information restrictions. Finally, even setting aside intentional barriers to access, significant practical difficulties must be overcome to ensure the availability of access in an environment where scores of separate market centers—floor-based and electronic, both fast and slow—may be actively quoting and trading a security. The existing compulsory market-to-market linkage in stocks—the Intermarket Trading System (ITS)—applies only to NYSE and Amex stocks and, in the view of many, has been less than successful in overcoming these obstacles to providing effective intermarket access.

Over the last several years, the Commission has taken a number of steps to address concerns facing our national market system. In the Order Handling Rules and Regulation ATS, for example, the Commission broadened the class of market centers required to make their quotations and orders publicly accessible. In doing so, it sought to redefine the idea of an exchange to include not just traditional exchanges, but also trading systems where orders interact according to specified trading rules. The Commission also adopted rules to improve the disclosure by market centers of execution quality data, and the disclosure by broker-dealers of their order routing practices, in order to enable investors to "comparison shop" among the myriad market centers, and to stimulate competition on the basis of execution quality.

In addition, the Commission has developed ideas and solicited public comment on some of the more difficult market structure issues, such as the regulation of market data fees and revenues, the fragmentation of the U.S. securities markets, and the regulation of exchanges. A Federal advisory committee also was convened to address market data concerns, and last year the Commission held public hearings on the full range of market structure issues.

There is no doubt that there are issues regarding our national market system that call for our attention. In my view, several aspects of equity market structure raise pressing questions. These include: (1) the implications of differences among markets in the means by which their quotes may be accessed by nonmembers and of access of transaction fees that are not included in displayed quotations; (2) the role of trade-through rules in intermarket trading for very different types of markets and systems; (3) the manner in which market data is consolidated and distributed, and the resulting revenues allocated among the markets; (4) whether a mixed dealer and auction market such as Nasdaq should be allowed to register as a for-profit exchange; (5) whether the fragmentation of markets that results from competition is reducing the effectiveness of regulatory processes; and (6) the effectiveness of the current self-regulatory system for the securities markets.

That said, I firmly believe our system of multiple, competing markets—on balance—has worked remarkably well. We have the world's most competitive and efficient markets. Competition among markets has fostered innovation and led to the creation of a variety of trading platforms designed to meet the needs of different types of investors. New entrants, particularly those with fully electronic platforms, keep the pressure on established markets to innovate. However, new entrants also challenge our existing infrastructure, much of which was created in the 1970's before the dramatic advancements in technology.

As has always been the case in our competing markets model, our challenge as regulators is to ensure fair and efficient markets through a balance of competition and regulation. Fair and efficient markets, of course, are the key goals of securities market regulation. But fairness and efficiency are at least superficially different concepts, creating tensions in our regulatory mandate. Fairness suggests the use of regulation to ensure against unfair results. Efficiency, on the other hand, suggests reliance on free markets and competitive forces to achieve an efficient result, which may not necessarily be a "fair" one. Regulation and competition do not necessarily conflict, as regulation often seeks to remove barriers to competition or promote efficiency. In other cases, there will be a tension between regulation and competition. Striking the appropriate balance is the responsibility of the Commission.

The optimal equity market structure, in my view, is based on several fundamental principles. First, I believe we should seek to achieve the benefits of competition while countering the negative effects of fragmentation from trading in multiple markets, through widely available market data, ready access among markets, price protection principles, and best execution standards.

Second, to the greatest extent possible, I believe we should let market forces determine outcomes by seeking to have the marketplace, rather than the Government or its regulators, choose the "winners" and "losers." We must seek to provide a level playing field in which all markets can compete fairly and aggressively. That said, regulation is necessary in certain situations, such as when an exchange exercises market power, or when externalities such as principal/agent conflicts obstruct otherwise competitive outcomes. Regulation is also appropriate when its benefits to the marketplace exceed its costs and reduce market frictions, such as when settlement date standards or quoting conventions are established.

Finally, I believe that market transparency, fairness, and integrity are key to the strength of our marketplace. These fundamental concepts underpin the Commission's approach to regulation, and contribute substantially to investor confidence in our markets.

With these general principles in mind, I would like to focus the remainder of my testimony on four key areas of the Commission's market structure initiative: (1) access to markets; (2) market data; (3) the self-regulatory model; and (4) the nature of a securities exchange.

**Access to Markets**

*Fair Access*

In our modern-day marketplace for securities, the New York Stock Exchange, Nasdaq, the American Stock Exchange, the regional exchanges, and numerous electronic communications networks, all compete with each other to offer the deepest pools of liquidity to investors at the very best prices. I believe that the Commission must resist the temptation to force these diverse securities markets to mimic each other, but rather to encourage them to compete over their differences within a single, robust, national system. In the end, there is little doubt in my mind that investors benefit from markets that compete, so long as the competition is truly fair.

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

If best execution is to be achieved in an environment characterized by multiple competing markets, broker-dealers must be able to identify the location of the best available prices and obtain access to those prices routinely and efficiently. In contrast, a market center that is inaccessible does little to promote efficiency and fairness in the marketplace.

Most brokers send orders directly to the market that they expect will provide their orders best execution most of the time, and most of these orders are executed in the market that receives them. At times, however, the best price at that moment may be in another market. And traders in one market may need to access prices in another market to keep prices in line. For these reasons, markets need easy access to each other, either directly or indirectly through brokers.

The Commission's approval last year of the NASD's Alternative Display Facility pilot program has highlighted this issue. Rather than obtaining access through "hard" linkages directly between markets, in the way that competing markets can access the New York Stock Exchange, in the Alternative Display Facility competing market centers obtain access to each other directly through privately negotiated access agreements and indirectly through subscribers. The Commission will be evaluating this decentralized access approach to determine whether, as a practical matter, it would be an appropriate model for the national market system, and thus could be applied to other market centers.

*Access Fees*

Access fees charged to reach a quote create another difficult market structure problem. Some markets charge varied per-share transaction fees for access to their quotes. Therefore, a displayed price may represent the true price that a customer will pay or it may represent only a base price to which an undisclosed access fee will later be added.

These pricing disparities can impede access between competing markets, raise trading costs, and create confusion about the true quoted prices. The absence of a uniform quoting convention across all markets also raises the incidence of locked and crossed quotations. To ensure real access to public quotes between competing markets, it is important that these quotes be accessible to other market participants on clear and fair terms.

I should also mention that, because access fees have gradually shrunk to less than one-cent-per-share in most markets, the imposition of the fees results in de facto subpenny pricing. Indeed, many market participants have suggested that these access fees have precipitated trading in subpennies, thus magnifying the strains caused by the move to decimal pricing. The Commission intends to work closely with the industry and investors to find appropriate solutions to the challenges raised by access fees and subpenny pricing. Whatever solution the Commission decides to adopt, we must assure that access fees will not function as a tollbooth that snarls traffic along the national market system.

*Price Protection*

As part of our examination of intermarket linkages, we also intend to reassess the question of intermarket trade-throughs, which occur when orders are executed in one market at prices inferior to the prices disseminated on another market. Today's highly competitive securities markets include fully electronic markets that provide swift automatic execution of customer orders, as well as traditional floor-based markets that execute orders through human interaction. Although a market participant that desires an opportunity for price improvement may prefer that its order be routed to a floor exchange for execution, an investor who values speed and certainty of order execution over a marginally higher price may find such a delay intolerable. Accordingly, the challenge before the Commission is to devise standards that allow faster markets and slower markets to thrive within a single system of interconnected markets, at the same time providing order executions to customers that display prices and for those customers who desire the best price on their orders.

**Market Data**

Another significant market structure challenge facing the Commission involves the collection and reporting of trading information and influence of the resulting revenues on market structure. Our existing market data system has strengthened the U.S. equity markets and has assured that investors have real-time access to accurate, reliable, and affordable information from all significant U.S. market centers. And yet the increasing number and diversity of U.S. market centers, has fueled demands for modernizing the current market data structure. Despite the sweeping changes that have taken place in the markets over the past 30 years, the structure for market data, including the collection and dissemination of a market's best bid and offer, the national best bid and offer, trading volume statistics, and last-trade prices, has changed very little.

The Commission recognizes that market data revenue is very important to our markets. Indeed, in recent years, self-regulatory organizations have drawn as much as 45 percent of their total revenues from market data revenue. In 2001, the Commission convened a panel of experts, chaired by Dean Joel Seligman, that looked into the structure of our market data system, as well as the compensation that markets have been receiving for their market data. The Seligman Committee noted that under the current system, securities information processors distribute market data revenues to self-regulatory organizations based primarily on each self-regulatory organization's reported trade volume. This compensation scheme has created a financial incentive for self-regulatory organizations to report as many trades as possible. As a result, markets are vying for ECN's and market makers to report their trades through them, as this allows markets to tap more deeply into the pool of available market data revenue and to rebate substantial portions of the additional revenue to the entity reporting the trade.

Significantly, in 2002 the Commission determined that programs for rebating market-data fee proceeds to market participants were creating incentives for traders to engage in transactions with no economic purpose other than to increase the amount of the market data revenues that they received. In this regard, the Commission abrogated several more extreme proposals to extend rebates of market data revenues to market participants, to allow more time for consideration of these issues.

It is my belief that market centers should be rewarded for providing better services. The recent developments call into question whether the current method of distributing market data revenue creates appropriate economic incentives, and whether it furthers the goal of rewarding markets that make valuable contributions to the market data being disseminated.

**The Self-Regulatory Model**

Another matter of great importance is the effectiveness of the self-regulatory system of securities markets. Recently, a number of concerns have been raised about the current state of self-regulation, including SRO conflicts of interest, SRO governance, and inefficiencies in self-regulation.

Congress and the Commission have long recognized that self-regulation has both benefits and weaknesses. The principle of self-regulation is based on the idea that regulation can best be done as close as possible to the regulated activity. However, an SRO that operates a market has an inherent conflict of interest between its roles as a market and as a regulator. I believe that the Commission must continue its work in ensuring that SRO's vigorously fulfill their obligation to enforce their rules and the Federal securities laws and rules. The advent of for-profit, shareholder-owned exchanges creates additional issues, including ensuring that self-regulatory obligations do not take a backseat to the interests of shareholders. The challenge for the Commission and the SRO's is to ensure that as the securities markets grow more competitive, the SRO's continue to dedicate their energies and resources to surveillance and enforcement. We also must prevent fragmentation of trading from creating gaps in SRO oversight of the markets.

As part of our review of the self-regulatory structure, I believe the Commission must thoroughly review the SRO's' governance practices. Recent events at the New York Stock Exchange point to the need for this review. SRO's play a critical role as standard setters for sound governance practices. Just as SRO's have demanded that their listed companies strengthen their governance practices, we must demand that, at a minimum, SRO's match the standards they set for listed companies. There are several topics that merit our consideration, including board composition and independence of directors; the independence and function of key board committees; the transparency of the SRO's decisionmaking process; and the diligence and competence required of board and committee members and ensuring their focus on the adequacy of regulation.

These are critical issues facing the SRO's and the Commission. I am committed to ensuring that our system of self-regulation continues to serve as an effective and efficient means of overseeing our securities markets.

**Exchange Criteria**

The last topic that I would like to touch upon is what it means to be registered as a national securities exchange. All currently registered exchanges have a limit order book in which better-priced orders take precedence. But a mandatory order book system is not easily reconciled with a dealer model, such as the Nasdaq stock market, in which there is no central limit order book.

I spoke earlier about the merits of price protection across markets. Nasdaq's application to register as an exchange places squarely before the Commission the issue of whether price protection within a market is a requirement of exchange registration. One issue is customer expectations. I suspect that customers generally expect their better priced orders to be protected within an exchange.

We do not expect all exchanges to be identical, much less to replicate any market's faults. Yet until now all exchanges have given their limit orders priority throughout their marketplace. If the Commission were to approve Nasdaq's application, other exchanges would likely seek to eliminate intramarket price priority from their rules. As a result, the protection of limit orders within markets would decrease. For this reason, Nasdaq's exchange application raises market structure issues that transcend the particular question of whether Nasdaq, or any other particular market, should be registered as an exchange.

In conclusion, I would like to reiterate that the market structure challenges I have discussed today may shape the national market system for years to come. I look forward to continued input from this Subcommittee on these important matters.

Thank you again for inviting me to speak on behalf of the Commission. I would be happy to answer any questions that you may have.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR HAGEL FROM WILLIAM H. DONALDSON**

**Q.1.** What are the advantages and disadvantages of a floor-based exchange versus an electronic exchange?

**A.1.** An evaluation of the relative strengths and weaknesses of floor-based versus electronic exchanges clearly is an important and difficult issue on which a great deal could be, and over the years has been, written. Moreover, how one views these relative strengths and disadvantages may vary significantly based on the type of orders involved (*for example,* small retail versus large institutional) or the type of stock involved (*for example,* a well-seasoned stock in the top tier of trading volume versus a relatively young stock with limited trading volume). This response necessarily will attempt merely to set forth an overview of the issue.

The primary difference between a floor-based and an electronic exchange is the extent of involvement of human beings in the floor-based model. Both models rely to a great extent on technology to bring buying and selling interest together, such as through electronic order delivery systems. Even the NYSE offers the possibility of automated executions in some circumstances (for example, for small orders pursuant to the NYSE's Direct+ program). The NYSE clearly differs from electronic systems, however, in the opportunity it provides for human beings to interact face-to-face in a single, physical location.

Perhaps the most significant potential strength of human interaction in a trading model is that it enables the flexible representation of very large orders submitted by institutional investors. Because of their size, these orders seldom can be disclosed entirely to the market without significantly moving prices against them. Brokers on the floor of an exchange may be able to use their discretion in "working" these orders so as to obtain favorable executions without significantly moving prices. Notably, electronic trading systems also have developed features that facilitate the working of undisplayed orders. One of the significant issues that ultimately must be determined by competitive forces is whether the electronic models offer a superior level of flexibility and efficiency than the floor-based model.

An exchange floor also facilitates face-to-face contact between the specialist and brokers. This interaction potentially is valuable in a variety of situations, including when there is a short-term imbalance between buying and selling interest in a stock. The specialist, because of his or her intimate knowledge of trading in the specialty stock, could be aware of brokers that might represent offsetting buying or selling interest. If so, the specialist has the discretion to call these brokers to the specialist's post. As a result, the physical presence of the specialist and brokers on the trading floor may help avoid sharp price swings that otherwise could be caused by these short-term imbalances.

Finally, a potentially significant benefit of a floor-based exchange is the accountability and responsibility it focuses on those who act as market makers in a stock. During the toughest market conditions, such as a severe price drop, the floor specialist remains accountable in a most visible way—a human being standing at the specialist post.

A potential weakness of a floor-based model, and correspondingly a potential strength of an electronic model, is cost of operation. A physical trading floor can be expensive to maintain relative to an electronic trading system. In addition, employing human floor brokers to represent orders on a trading floor may be more costly than representing those orders directly within an electronic trading system. Nevertheless, the operational costs of a trading floor must be considered within the larger picture of the total costs of trading in a particular model. For example, the market for Nasdaq stocks in the early 1990's collected quotes electronically, but was also very inefficient and costly to investors because of, among other things, the collusive practices of market makers. Ultimately, competition and market forces must decide the bottom-line efficiency of floor-based versus electronic exchanges.

A potential strength of electronic trading systems, such as those that operate electronic limit order books, is that they facilitate direct interaction of investor buying and selling interest without the participation of a dealer. Although floor-based exchanges frequently match buying and selling interest directly, the specialist also often has the option of taking one side of an order. As discussed below, the NYSE rules are intended to assure that the specialist only participates in trading when it will contribute to the maintenance of a fair and orderly market. Nevertheless, an electronic order book affords no special advantage in trading to any particular intermediary and thereby promotes the most direct interaction of buying and selling interest.

Other issues are separate from, yet frequently linked with, the issue of floor-based versus electronic exchanges. Examples include auction versus dealer markets, and concentrated versus fragmented markets. These linked issues reflect the historical differences between the actual markets for NYSE and Nasdaq stocks as they have developed in the United States. The NYSE floor, for example, is known for its auction market, yet electronic trading systems also have been developed that implement an auction market. Conversely, Nasdaq historically has been primarily a dealer market, yet the entry of ECN's operating electronic limit order books has resulted in a substantial percentage of agency trading in Nasdaq stocks. Analogously, the market for NYSE stocks always has been highly concentrated—approximately 80 to 90 percent of trading in NYSE stocks is funneled through the NYSE floor. In contrast, the market for Nasdaq stocks has been much more fragmented.

**Q.2.** How does the SEC define "best execution?" Are factors other than price considered?

**A.2.** In accepting orders and routing them to a market center for execution, brokers act as agents for their customers and owe them a duty of best execution. The duty requires a broker to seek the most favorable terms reasonably available under the circumstances for a customer's transaction. Brokers must regularly and rigorously review their order-routing practices to assure that they are meeting their duty of best execution.

Although price is a very important term, the Commission often has noted that price is not the sole relevant factor in obtaining best execution of investor orders. Other factors also are relevant, including: (1) the trading characteristics of the security involved, (2) the availability of accurate information affecting choices as to the most favorable market center for execution and the availability of technological aids to process such information, and (3) the cost and difficulty associated with obtaining an execution in a particular market center.

**Q.3.** Specialists are required to buy into a falling market and sell into a rising market, even if they take a loss in doing so. Do you keep track of how often specialists benefit and how often they are hurt by their trading decisions?

**A.3.** The NYSE rules establish procedures for monitoring specialists' performance of their duty to maintain, in so far as reasonably practicable, a fair and orderly market in their specialty stocks. The maintenance of a fair and orderly market includes maintenance of price continuity with reasonable depth, and the minimizing of the effects of temporary disparity between buying and selling interest. Specialists report quarterly on the quality of their performance.

The NYSE uses a number of different objective criteria to monitor specialist performance. One is a specialist's "stabilization rate"—the percentage of shares sold at a price below the last different price, and the percentage of shares purchased at a price above the last different price. The stabilization rate thereby measures the extent to which specialists buy and sell against the prevailing trend of the market. For 2002 (the most recent year for which data are publicly available), the overall NYSE stabilization rate was 80.2 percent. Another objective indicator of specialist performance is "price continuity"—the size of the price variation, if any, from one trade to the next in the same stock. Specialist trading is intended to limit the size of price variations. In 2003, 95.1 percent of NYSE trades were priced within 5 cents of the preceding trade, and 99.9 percent were priced within 25 cents.

Whether any particular specialist trade is profitable or unprofitable depends on a variety of factors, including the status of the specialist's inventory at the time of the trade and the volatility of price movements in a stock. Although the NYSE monitors the dealer profit and loss of specialists in their specialty stocks, its rules focus primarily on whether the specialist has met its affirmative duty to maintain a fair and orderly market. Assuming specialists fulfill this duty, they are not prohibited from profiting from their trading.

**Q.4.** Why do we require specialists to have such a prominent role in determining a stock's price? What would be the result if the price of a security was determined by the market as a whole rather than relying so heavily on the judgment of a specialist?

**A.4.** The overall balance of buying and selling interest in a security ultimately determines the price of NYSE stocks. Specialist trading is intended only to smooth out the sharp price fluctuations that otherwise might result from temporary disparities between buying and selling interest. For example, if selling interest in a stock heavily outweighs buying interest at any particular time, the price of the stock is going to drop. Specialist trading is intended to slow the rate of the drop, perhaps allowing time for compensating buying interest to mobilize and reach the NYSE floor.

**RESPONSE TO A WRITTEN QUESTION OF SENATOR JOHNSON FROM WILLIAM H. DONALDSON**

**Q.1.** Chairman Donaldson, at the hearing before the Banking Committee on September 30, Senator Carper asked if you intended to seek the views of the President's Working Group on Financial Markets before voting on any changes to the regulation of hedge funds. You replied that you intended to do so. Have you requested the input of the President's Working Group?

**A.1.** Over the past decade, there have been periodic calls for increased regulation of hedge funds. In 1999, after the near collapse of Long-Term Capital Management, the Commission participated in the study of hedge funds conducted by the President's Working Group on Financial Markets. The Working Group's principal focus in that study was on the effect of the exposure of large financial institutions, including broker-dealers and banks, on the stability of the financial markets.

In June 2002, the Commission initiated an investigation under Section 21(a) of the Exchange Act concerning the growth of hedge funds. Unlike previous studies, which focused primarily on market stability issues, this investigation focused on the effect of hedge fund growth on investor protection. On May 14 and 15, 2003, the Commission held a roundtable on hedge funds, which included the participation of senior staff members of the Commodity Futures Trading Commission, a fellow Working Group member.

At the conclusion of the hedge fund roundtable, I asked the Commission's Division of Investment Management to prepare a report on the implications of the growth of hedge funds. I kept the Working Group informed on the progress of the report and, as you know, the report was issued on September 29, 2003. At the last meeting of the Working Group, which took place on December 3, 2003, hedge fund issues were included on the agenda and I intend to keep the Working Group informed of the Commission's efforts regarding hedge funds going forward.