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REGULATION NMS AND RECENT MARKET DEVELOPMENTS

HEARINGS

BEFORE THE

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

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

ON

EXAMINATION OF REGULATION NATIONAL MARKET SYSTEM (NMS) DESIGNED TO STRENGTHEN OUR NATIONAL MARKET SYSTEM FOR EQUITY SECURITIES, FOCUSING ON RECENT MARKET DEVELOPMENTS

MAY 18 AND 19, 2005

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C O N T E N T S

WEDNESDAY, MAY 18, 2005

WITNESSES

THURSDAY, MAY 19, 2005

WITNESS

REGULATION NMS AND RECENT MARKET DEVELOPMENTS

WEDNESDAY, MAY 18, 2005

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:07 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing shall come to order.

This morning, the Committee will hold the first of two hearings examining Regulation NMS and the impact of two recently announced mergers involving leading market centers. Today, we will hear from representatives of a number of market participants and tomorrow, the Committee will hear from Chairman Bill Donaldson at SEC.

Since Chairman Donaldson last appeared before this Committee in March, much has transpired concerning our national market structure. On April 7, the SEC approved Regulation NMS by a 3 to 2 vote. Then within weeks of the adoption of the regulation two major transactions were announced. These mergers will lead to the creation of two dominant market centers. On April 20, the New York Stock Exchange announced that it would merge operations of Archipelago to form a new public company. Next, on April 22, Nasdaq announced that it would buy Instinet's electronic trading platform.

The equities trading industry is clearly in the midst of a significant transition. The convergence of a new regulatory framework created by Regulation NMS and the impact of the proposed mergers creates a new dynamic for our markets. The implementation of Regulation NMS will be a challenge for all market participants, and the long-term effect of the regulation remains to be seen. Combined with this evolving regulatory landscape, the merger announcements raise questions about industry consolidation and competition, the future direction of our equities markets, and the ultimate impact on investors. These are all issues that need to be examined.

This Committee will continue active oversight of Regulation NMS and will closely monitor new market developments. I think it is important for this Committee to understand the impact of these changes for all investors and for the efficiency of our securities markets.

To discuss these issues with us this morning we have a number of leading industry experts. On the first panel we will hear from Mr. Sandy Frucher, Chairman and Chief Executive Officer, Philadelphia Stock Exchange; Mr. Robert Greifeld, President and Chief Executive Officer, Nasdaq Stock Market, Inc.; Mr. Edward Nicoll, Chief Executive Officer and Director, Instinet Group, Inc.; Mr. Gerald Putnam, Chairman and Chief Executive Officer, Archipelago Holdings, Inc.; and Mr. John Thain, Chief Executive Officer, New York Stock Exchange.

On the second panel we will hear from Mr. Kim Bang, President and Chief Executive Officer, Bloomberg Tradebook, L.L.C.; Mr. Scott Evans, Executive Vice President and Chief Investment Officer of TIAA–CREF; Mr. Thomas Joyce, Chairman and CEO, Knight Trading Group, Inc.; Mr. Marc Lackritz, President, Securities Industry Association; and Mr. Gus Sauter, Chief Investment Officer and Managing Director of the Vanguard Group.

I want to thank all of you for appearing here this morning, and we look forward to your testimony.

Senator Allard, do you have an opening statement?

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, I do have an opening statement. It is very brief, and would like to make that part of the record.

Chairman SHELBY. Without objection, so ordered.

Senator ALLARD. And just take this opportunity to thank the panels for coming forward and being willing to share their thoughts with this Committee.

And thank you, Mr. Chairman, for holding this hearing.

Chairman SHELBY. Thank you.

Chairman SHELBY. Senator Hagel.

STATEMENT OF SENATOR CHUCK HAGEL

Senator HAGEL. No opening statement, Mr. Chairman. I look forward to our witnesses' testimony. Thank you.

Chairman SHELBY. Mr. Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman. I will look forward to hearing the witnesses today.

Chairman SHELBY. We will start with you, Mr. Thain.

All of your written testimony will be made part of the hearing record in its entirety. If you will sum up your main points. Thank you and welcome.

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

Mr. THAIN. Mr. Chairman, Members of the Committee, thank you for giving me the opportunity to be here today. We appreciate your Committee's oversight of our national market system, and we share with you I think a common challenge to maintain the competitive position of the U.S. financial markets in the world, and to ensure the interests of investors are protected.

The New York Stock Exchange stands at the center of the U.S. financial markets. We serve 90 million investors. We have over

2,700 companies listed on the New York Stock Exchange, and those companies have a market capitalization of $20 trillion. We take great pride in providing our customers the highest standards of market quality, the deepest liquidity, the lowest volatility, the tightest spreads, and the best prices.

But we also recognize that the rapid pace of change in our industry demands that we, the New York Stock Exchange, do better in terms of speed and innovation. That is why we are building our hybrid market, to offer investors a choice between sub-second speed of electronic execution and the price improvement and lower volatility of our auction market. It is also why we are taking the historic step to become a public, for-profit company by merging with Archipelago, which is an outstanding entrepreneurial company that has pioneered leading edge platforms and products.

And finally, it is why we strongly support Reg. NMS, because it protects and promotes the interests of U.S. investors and U.S. competitiveness. Let me briefly talk about each of those issues starting with Reg. NMS.

We believe Regulation NMS is good for investors and good for U.S. markets. It is designed not to favor one market over another, but to strengthen competition among all markets to create the best possible national market, for investors, for issuers, and for our economy.

How will it do this? By preserving the best price rule and by extending it to all markets and updating it to encourage innovation and competition. We believe the new best price rule advances these essential goals three ways. First, it is indisputably pro-investor. It will strengthen the integrity of markets and it enhances U.S. competitiveness. The new best price rule ensures that any one of your constituents can invest and trade on an equal footing with large institutions. It does so by requiring that intermediaries, such as brokerage firms and mutual funds find the best price for investors' orders by selling their shares at the highest possible prices or buying them at the lowest price.

Second, it ensures that stocks are priced at their true value, that the best price rule improves the transparency and the price discovery process. Our markets are certain to be fair and honest.

And third, markets will be more competitive, because as investors are encouraged to maintain and increase their limit orders, liquidity will deepen.

Critics have from time to time complained that the old trade-through rule was flawed because it did not distinguish between fast and slow markets and prices could change in the time it took to trade in our auction market. The new trade-through rule protects only prices that are available for immediate electronic execution. This is a very significant change. What it means is that the New York Stock Exchange must deliver on our hybrid market. We must make our quotes immediately electronically accessible, and we are going to do that.

Our goal is to offer a choice between that immediate electronic execution or the possibility of getting a better price through the auction process on the floor of the exchange with the specialists and the floor brokers.

We believe that our trading floor continues to offer superior market quality. We outperform electronic exchanges on opens and closes, during order and balances, and in earning surprises. We provide the best prices in our New York-listed stocks 89 percent of the time, and companies, when they transfer from the purely electronic markets to the New York Stock Exchange get better executions in the marketplace. Price volatility is cut in half, quotes are narrowed, and execution costs fall.

Finally, investor groups, representing millions of investors and investor companies, support the SEC's decision to extend the best price rule to all markets. Investors agree that once trading conditions for speed are comparable, there is no justification in any market for providing customers anything less than the best price.

Let me talk a moment about our proposed merger with Archipelago to become a public, for-profit company, the NYSE Group. Our merger is about meeting global competition. The competition for capital today is global, and our major competitors are public, for-profit exchanges that are well-capitalized, have a multiplicity of products, and they are attempting to gain footholds in the U.S. marketplace. We have to compete and we have to have the means to compete to the fullest extent or our abilities, and we have to be world class. We have to be an exchange that offers investors the strongest platforms with cutting-edge products, and that is what Archipelago brings with a new expanded menu of equity products, options, exchange-traded funds, and fixed-income securities.

With a more robust and innovative business model we can better serve our customers, and as a profitable public company we will offer an opportunity for investors, institutions, listed companies, and members to share in our growth and success as stockholders. As a stronger and more competitive exchange we will enable the United States to respond and prevail in the world financial market competition.

Let me also assure this Committee that the new structure of the New York Stock Exchange Group will not only protect but also strengthen the independence and oversight of our regulatory functions. So to sum up, we believe that Reg. NMS, the completion of our hybrid market, and our combination with Archipelago represent a comprehensive response to the twin challenges that we face to build the world's best marketplace for our customers and to preserve the leadership and preeminence of the U.S. capital markets in the world.

Thank you.

Chairman SHELBY. Mr. Greifeld.

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

Mr. GREIFELD. Chairman Shelby, distinguished Members of the Senate Banking Committee, I thank you for inviting me to discuss Reg. NMS and the recent industry developments.

When I last appeared before this Committee on July 21, 2004, I stated that the current trade-through rule is the primary obstacle to competition amongst our Nation's equity markets, and competition is the driving force in making the U.S. markets the strongest in the world, the best for investors large and small and accountable to the public. I also stressed that the markets had uncovered a fundamental truth. Today, electronic trading is best for investors.

After well over a year of hearings, discussion and comments, on April 6 of this year the SEC approved Regulation NMS. NMS replaces the old ITS trade-through rule that protected the listed market from competition with a new trade-through rule which will be applied uniformly across all markets to protect a market's top-of-the-book quote if it is automatically accessible. Regulation NMS also includes needed restrictions on sub-penny trading, establishes uniform market access rules, and updates the formula used to allocate market data revenue.

I believe Regulation NMS does remove a substantial obstacle to competition among our Nation's equity markets and establishes incentives for floor-based markets to move to electronic trading. The new rule will bring benefits to investors and it will enhance the ability of our Nation's capital markets to face growing international competition. Nasdaq commends the work of the SEC, as well as the constructive oversight of this Committee and the entire Congress throughout the rulemaking process.

As you know, Nasdaq and many others urged the Commission to eliminate the trade-through rule entirely. Our position reflects the belief that market forces and best execution responsibilities should serve as the bedrock principles in the securities market. We are proud of the market quality experienced by investors every day on the Nasdaq Stock Market which does not have a trade-through rule. Given our experience and the cost of implementation, we believe the extension of the rule to Nasdaq represents an unnecessary tax on our market participants.

Nonetheless, although Nasdaq does not believe the application of a trade-through rule to Nasdaq is necessary, we are pleased by the fact that the new trade-through rule approved by the Commission will force floor-based markets to follow the path to automated trading that has been blazed by Nasdaq since 1971.

Specifically, the distinctions between fast and slow markets will force manual floor-based markets to automate in order to compete effectively with the faster electronic exchanges. The rule acknowledges the value of speed and certainty of execution, and allows electronic markets to compete for the trading of New York Stock Exchange-listed securities. Manual markets will no longer be the weak link in the national market system, slowing down faster markets, while humans—some with a very distinct time and place advantage on the floor—attempt to execute orders.

As you know, the rule will be rolled out in a limited manner next April and will take full effect in June 2006. Even before NMS was approved, the New York Stock Exchange was compelled by market pressure to move to modernize their market structure as seen with the proposed hybrid model. As a result of NMS, the American Stock Exchange and the regional exchanges have strong incentives to modernize their markets, and are poised to emerge as competitors. There is no doubt that this will be good for competition and for investors.

The Committee has also asked about our recent acquisition of the Instinet Group. On April 22, Nasdaq announced the acquisition of

Instinet Group and concurrently entered into a definitive agreement to sell Instinet's Institutional Brokerage division to Silver Lake Partners. As a result, Nasdaq will own only Instinet's electronic communications network, their ECN called INET.

This deal proceeded from a public competitive process. Reuters, Instinet's parent company, announced in November 2004 that it was selling Instinet. In January, Nasdaq first submitted a proposal to acquire Instinet. We understand that several industry participants considered bids for Instinet.

Nasdaq acquired Instinet to enhance our trading environment to serve investors better and respond to the increasing competition across global capital markets. It is a synergistic deal that will create a fast, high-performing, low-cost platform for trading U.S. securities. Given the compatibility of the two platforms, the real-time market surveillance by a well-respected regulator, the NASD, and Nasdaq's proven technological reliability, this transaction will position Nasdaq to compete more effectively with U.S. and other international market centers. This acquisition will result in more cost efficiency and improve quality of execution in our market, qualities that today's individual and institutional investors demand. Nasdaq will continue to innovate and will also have the ability to tap new opportunities in other asset classes.

The rapid structural changes sweeping through our Nation's securities markets are being propelled by a convergence of several forces. The principal regulatory force is Regulation NMS. Its most direct impact, greater competition in the trading of New York Stock Exchange securities, will be felt when the rules take effect. However, the indirect impact of Reg. NMS is already being felt as the NYSE is poised to become a competitor in the trading of Nasdaq securities. That combined with the expected rise in the trading of Nasdaq securities by the regional exchanges creates a national market structure in which market centers no longer specialize in the equities of a single market.

Another important force is the rapid globalization of capital markets. Companies around the world are seeking access to capital and stock markets are the key facilitator in this process. When a company in China or Russia seeks to bring capital from outside its country's borders, it typically considers the major markets in Europe as well as in the United States. As such, we are now competing not only with the U.S. exchanges but also, for example, with the Europeans. Enhanced competition for listings also encourages competition in the quality of trading as companies seek to list in a country and a market that offers the best trading for their securities.

Finally, it is becoming increasingly necessary for stock markets to be mindful of competition from venues that trade derivatives and other instruments that are not equity securities. If trading quality in equities is inferior, or the costs of trading are relatively high, then some investors will focus on a type of securities that trade more efficiently. Again, all investors are potential winners in this competition.

Recent developments in the marketplace also offer the opportunity to improve and make more efficient the regulation of the securities market. As part of its transaction, the NYSE announced their intention to further separate its regulatory function into a nonpublic, not-for-profit entity governed by an independent board of directors. This follows the lead established by the Nasdaq/NASD relationship. Nasdaq supports separating the regulator from the regulated market, and in fact, once the Commission approves our application to register as an exchange, Nasdaq will completely separate from our regulator, the NASD.

In this regard, I am pleased to report that the Commission has been working closely with us on our exchange application and we are hopeful that the application will be approved shortly. With Reg. NMS codifying uniform rules for trading of all equities, exchange status for Nasdaq will achieve a level playing field. A Nasdaq exchange will be good for competition, good for regulatory framework, and good for market quality, and ultimately good for investors.

I appreciate your time here today, and welcome Senator Sarbanes. Thank you.

Chairman SHELBY. Mr. Putnam.

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

Mr. PUTNAM. Good morning, Chairman Shelby, Ranking Member Sarbanes, and other distinguished Members of the Committee.

The headline for this hearing I think would be consolidation, and I would like to start by congratulating two of my toughest competitors, Bob Greifeld and Ed Nicoll on their merger.

I know the saying goes the best offense is a good defense, but I think if you are sitting in my shoes today you have to turn that around the other way and say the best defense is a good offense. We have had a few disagreements with the New York Stock Exchange over the years, and I am not actually sure—I will take that back—I am sure they were not happy about it, but we have agreed with them on a couple of things, on a few occasions.

Specifically, we disagreed with the trade-through provision, Reg. NMS, as adopted by the SEC. This Committee and the House Financial Services Committee asked the SEC to tackle pretty tough questions, some thorny issues over our national market system. In the end, while we did not agree on everything, we do now have certainty in the rules.

I think also the consolidation that we are seeing is bringing our markets closer together here in the United States, and the distinction between them is starting to fade.

I would like to talk a little bit about our merger, and specifically negotiations that John and I had starting back in January. We have disagreed, as I said, on some things in the past, but one thing was certain to me after those negotiations, is that we do share a common vision, and that is to leverage the respective strengths of the NYSE and ArcaEx and to develop a world-class exchange. We are going to do this by listening to our customers and responding with high-quality service, products, and choice.

Our merger will represent the largest ever among securities exchanges. It will combine the world's largest, most liquid and reliable, the New York Stock Exchange, with the most successful, totally open, fully electronic one in ArcaEx.

And I believe the combination is going to bring us several benefits, specifically: Strengthen America's leadership and boost our global competitiveness in capital markets; better server all investors and traders; support the continued growth and global leadership of the NYSE; it will help us maintain the highest standards of integrity, transparency, and disclosure; produce efficiencies; drive innovations; create new business and revenue opportunities; and finally, enable the public to own shares in the world's leading exchange.

Now, competition is changing things once again and today it is on a global scale. These recent consolidations, I believe, are about our ability to compete in the globalization and convergence of exchange models. Past exchanges in the United States have traded either stocks, options, or futures. But today, as you look around the world—let us start in Europe—the Deutsche Borse, Euronext, and the LSE are bringing different products together under one roof to create one-stop shopping. In Asia, exchanges like the Singapore Exchange and the Hong Kong Exchange are commingling equities and derivatives under one umbrella. The Tokyo market is one of the most integrated, if not the most integrated, in the world.

Here in the United States, the Chicago Mercantile Exchange, it is a public company, they advertise nearly round-the-clock trading and boast customers around the world. The Chicago Board of Trade has plans to go public this year. The Boston Stock Exchange teamed up with the Montreal Exchange to create the Boston Options Exchange or the BOX. The ISE, another public company, is an all electronic options exchange born in the late 1990's and is already the largest options exchange in the United States and in the world.

Finally, the Chicago Mercantile Exchange, the Chicago Board of Trade, and the Chicago Board Options Exchange teamed up to create OneChicago, an all electronic single stock futures exchange.

The competitive trend is very clear: To stay competitive exchanges are looking to trade not stocks, options, or futures, but stocks, options, and futures on a single platform, and the competition is global.

Before concluding, I would like to say how proud I am of all the employees. There is 250 of them now at ArcaEx that made our company the success that it is today. We all look forward to our future with John Thain and the rest of the team at the New York Stock Exchange.

Thank you.

Chairman SHELBY. Mr. Nicoll.

STATEMENT OF EDWARD J. NICOLL
CHIEF EXECUTIVE OFFICER, INSTINET GROUP

Mr. NICOLL. Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, I appreciate this opportunity to discuss the role that I believe regulation and legislation will play in the future of our Nation's securities markets.

While others on the panel today may begin by looking ahead and outlining the challenges and opportunities facing our markets, I would like to begin with an appreciative glance back at how we got here. I do so because I think it is worth remembering, indeed, quite important to remember, on whose shoulders we stand here today and why so much of the recent discussion has been about building better and stronger electronic markets.

From my perspective, the story begins with a company called Island ECN, which was one of the first of the so-called "Electronic Communications Networks" or ECN's.

In the wake of scandals in the mid-1990's the SEC adopted regulations known as the Order Handling Rules, designed to introduce competition and greater transparency into the U.S. equity markets, which led directly to the creation of ECN's. Island seized this opening and offered investors a less expensive, faster, and more reliable forum for trading. From Island's inception we counted on the fact that investors, when given the choice, would always demand a more accessible and transparent marketplace. To reach that goal we focused on what we considered the glaring gap in the traditional model, the inability of investors to meet directly in the marketplace without having to rely on professional intermediaries.

The Island story was about fighting for a chance to compete in new markets and allowing investors to vote with their feet. We fully understood that if we could not offer a better product, we should be out of business. But investors welcomed our products and services, and Island enjoyed explosive growth, eventually merging with Instinet, the company which I serve as CEO today.

For these reasons, Mr. Chairman, I doubt you will find a witness today who is a greater champion of our Nation's free markets and the individual's ability to profit from hard work and innovation.

But more than anything else, my experience at Island gave me the privilege to meet some of the most insightful traders and software programmers on the street, individuals who grasped a magnificently simple and elegant truth: The markets could be made far more rational and fair if investors were allowed access to the same type of information that were, at the time, uniquely available to market professionals.

On my first day as Chairman of Island, I walked into the office—and we were literally just a handful of employees in one office—and sat down with gifted individuals such as Josh Levine and Matt Andresen. The one thing we all shared, beside a broken-down desk with four folding chairs, was a commitment to provide investors with an unprecedented degree of accountability, openness, and transparency in the marketplace. I recall how many market professionals had insisted that making arcane, real-time market data widely available would be at best a distraction, and probably a nuisance for investors. How wrong they were.

As we know, investors today demand access to real-time data, and the latest research reports, as well as the ability to enter orders more efficiently and at a fraction of the cost once paid for such transactions. Yet, while the investor had been empowered to know what and when to buy, a key component of this equation had been missing: How to buy it.

That is where Island jumped in. Traditionally, investors had only been provided with the highest bid and the lowest offer in a security. The depth of the market, which gives an indication of the true supply and demand for a security, had been the exclusive province of market professionals.

That lack of accountability, in other words, denial of information to the investor, was unacceptable to us. To provide the best resource possible to the investor we became the first marketplace to provide a free, real-time display of all of its orders through the Island Book Viewer.

There is probably nothing I am more proud of, Mr. Chairman, than to know that the technology that we built for the Island ECN, which then became the technology behind Instinet Group's INET ECN, is now expected to become the technology platform for the merger Nasdaq-INET platform.

With this history in mind, Mr. Chairman, let me try to summarize some lessons we can learn from those experiences that are particularly relevant as we look ahead at the issues we will face in our markets over the coming years, lest we be doomed to repeat the mistakes of the past.

First and most important are the benefits resulting from a regulatory environment that encourages true competition among marketplaces. It is true that much of the original electronic marketplace story was about harnessing technology to provide investors with a more efficient, faster and lower-cost forum for trading. Yet Island's success and the success of other electronic markets like Archipelago and Nasdaq is much more than a technology story, it is about the tremendous benefits that redound to the investor when the securities laws and regulations allow our markets to compete; when one marketplace can challenge another with a dizzying array of innovations and offer the investor unprecedented opportunities to leverage technological breakthroughs.

The Island story and the rise of ECN's embody the benefits of competition. The dramatic changes in technology have allowed new competitors to offer new services at a lower cost and capture market share from traditional market participants in a relatively short period of time. Just one example: I can remember when it cost some individuals as much as $200 per trade. Today, you can pay as little as $7. There has never been a better time to be an individual investor.

A second lesson from our experience concerns the policing and surveillance of markets. By eliminating the informational disparities of the traditional floor-based manual markets, many of us built a marketplace that is inherently safer, fairer, and importantly, easier to surveil, all issues I know, Mr. Chairman, that this Committee takes very seriously. For example, participants on the floor of an exchange generally possess more trade and order information than the average investor sitting at home.

Through surveillance and the implementation of restrictions on the activities of those in the trading crowd, regulators attempt to prevent the misuse of this information. As recent events have shown, however, no amount of surveillance or regulation can completely prevent or eliminate the potential for its misuse. With that in mind, Mr. Chairman, I note that electronic markets reduce the opportunities for improprieties by eliminating informational disparities.

Finally, Mr. Chairman, let me at least raise for the Committee's consideration one of the most enduring public policy issues we face. Now that electronic markets have done so much to empower the investor by providing an open and transparent marketplace, there remains one final challenge: How do we unleash these benefits on as wide a scale as possible without sacrificing investor protection or the integrity of our capital markets? How can we continue the process of democratizing the markets?

Long before electronic markets were even a glimmer in anyone's eye, Congress anticipated exactly what rules should guide us. In 1975, Congress created a national market system with the goal of creating a more efficient and transparent market. We could not have asked for a better building block. Over the subsequent decades, the SEC has worked hard to strengthen and improve this regulatory structure. While Instinet had particular concerns with some of the elements in the recently approved Regulation NMS, I do commend Chairman Donaldson for finally resolving many of the outstanding market structure issues and setting forth a clear and definitive regulatory roadmap for the U.S. equities as a whole.

There are many different models currently used in the equity markets, and with entry becoming even cheaper and easier, over the coming months and years I have no doubt more will emerge. Each model has its supporters and detractors. But what history does teach us is that regardless of the model, two principles must hold into the future. First, competition must continue to be permitted to flourish between the different models, but in a manner that safeguards the integrity of our markets.

Second, market structure must remain free from unfair advantages and unreasonable barriers.

While much has changed since I sat in that small downtown office with my young colleagues, we must remain vigilant in the protection of our free markets from over-regulation. As Chairman Donaldson said, "We need to identify real problems, consider the practice consequences of the possible solutions and then move pragmatically and incrementally toward the goals Congress staked out."

My own rule, Mr. Chairman, would be that regulatory action should only be taken when it is clear that the market is failing and less drastic remedies are inadequate. In all other cases, let us embrace free competition and always work toward greater openness, transparency, and accountability in the marketplace. In so doing, we can continue to leverage our Nation's technological superiority in a manner consistent with the best aspects of America's entrepreneurial capitalism. There is too much at stake to do otherwise.

Thank you for this opportunity to again testify before your Committee. It has been a great pleasure to work with you and your colleagues on this issue.

Chairman SHELBY. Mr. Frucher.

STATEMENT OF MEYER S. FRUCHER
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
PHILADELPHIA STOCK EXCHANGE, INC.

Mr. FRUCHER. Chairman Shelby, Senator Sarbanes, Members of the Committee, my name is Sandy Frucher, and I am Chief Executive Officer and Chairman of the Philadelphia Stock Exchange, and I would like to say that the Philadelphia Stock Exchange appreciates the opportunity to participate in today's very, very important hearings.

A century ago there were more than 100 regional stock exchanges in the United States. They served the needs of local issuers and investors. Several of the descendants of those exchanges survive in the United States today. Although still referred to as regionals, in fact we are competing parts of our national market system. We trade stocks listed by the New York Stock Exchange and Nasdaq.

PHLX is the oldest securities exchange in the United States. We trade over 2,000 stocks listed on the New York and American Stock Exchanges, as well as over 1,000 individual equity and industry sector options.

Today, the smaller U.S. exchanges, including PHLX, account for a very small percentage of the trading of the New York and Nasdaq stocks. Frankly, the ability of the competing exchanges to survive was an open question even before the mergers were announced. The competing exchanges will not be able to continue in their current form. To survive, we must continue to innovate in terms of ownership structure, trading systems, fees, and so on.

The question for the SEC, this Committee, and the broader marketplace is, should we be concerned about the survival of competing exchanges? The answer should be a resounding yes. Without competition, the two great markets emerging from these proposed combinations will have little reason to innovate, to improve services, and to keep fees down. We heard it in the testimony today. They had 82 percent market share of the New York and 100 percent of the Nasdaq stock market. But without the competitors that they faced, an Island that morphed into an Archipelago, that has now morphed into a continent, was not enough. They have to effectively have competition in order to compete.

The competing exchanges have played a role in the U.S. markets greater than their share of stock trading would suggest. We have repeatedly served as laboratories of innovation. We were the first to adopt clearinghouses, to adopt net settlements of trades, to allow automated execution of small orders, all improvements that the New York later embraced.

And, frankly, we have helped our competitors. The SEC's adoption of Reg. ATS in 1998 gave new force to nonexchange alternative trading systems. These firms use new technology to offer investors rapid, cheap, anonymous electronic trading without a dealer acting as middle man. Two leading ATS's, Instinet and Archipelago, developed relationships with smaller exchanges as part of their growth strategy, respectively with the National Stock Exchange, formerly known as Cincinnati, and the Pacific Stock Exchange. They took advantage of the regulatory and trading infrastructure of the exchanges in order to compete better with New York and Nasdaq. They were so successful that they are now in effect being bought out by the incumbents they challenged.

The proposed mergers look like smart moves from the perspective of the owners and members of the four organizations represented at this table, and I think they were. They are brilliant deals. But it is too soon for investors to celebrate. Competition will be enhanced only if the resulting duopoly competes vigorously for listings and to trade each other's listed stocks. If they do not, investors will really suffer.

Policymakers must be aware of the elimination of competitors. My colleague, John Thain, has recently said that the United States has too many exchanges and needs consolidation. The clear implication is that he believes that the number of competitors must shrink. PHLX does not believe that issuers and investors are best served by a market with just two competing exchanges. To keep trading costs for investors low, to keep the quality of execution high, to ensure future innovation, additional competition is essential.

The SEC's Chief Economist said recently, "Requiring markets to expose orders to competing prices offered on alternative platforms forces platforms to address how they compete for business." In plain English, competition between market forces them to constantly improve, which is good for investors.

Unfortunately, the SEC's recent actions have tended to limit competition. Regulation NMS will likely reduce the competing exchanges' share of market data revenues, a critical source of our funding. We actually do not know the formula, because notwithstanding the fact that the rule has been approved, it has not been published. It will also raise barriers to entry for new ATS's, and the pending rulemaking on governance, ownership, and administration of exchanges could raise costs and limit flexibility of the existing exchanges that compete with New York and Nasdaq. The SEC must ensure that its regulatory process does not unintentionally create a monopoly for these business entities.

In order to survive, the smaller exchanges must innovate. We will have to strike alliances and embrace new trading systems to stay alive. At each step, we will have to make rule and fee filings with the SEC. Regulatory actions like Regulation ATS can promote competition. Regulatory actions and inactions can also inhibit competition.

To ensure competition, the SEC must be open-minded to the approval of new and innovative structures that will allow smaller exchanges to compete, and the Commission must act on those competitive actions quickly, frankly, by the first quarter of 2006, given the timetables announced by the merger participants. These mergers are anticipated to become complete before the new Reg. NMS becomes the law.

In that time frame, if that time frame is not met, if alternative systems are not allowed to be online and become effective at that time, the potential for competition frankly may be lost forever.

In conclusion, the smaller exchanges will be the only competitive vehicle to challenge the duopoly. Our survival is already under threat from changes the SEC has adopted in Reg. NMS and has under consideration in the exchange governance rulemaking. Reg. NMS has made a lot of improvements in the system. I agree that it has rationalized the system in a lot of ways. But underneath it, it also has the seeds for the elimination of competition, and those have to be watched very carefully.

The regulator will control the survival of competition in our marketplace. For our survival and the continuation of the competition that is so essential for investors, the SEC must process promptly the proposals that smaller markets are hopefully likely to file to introduce new rules, trading facilities, fee structures, and affiliations.

Only in this way can we continue to offer innovative alternatives to ensure the potential for competition in the new duopoly.

Thank you very much.

Chairman SHELBY. I thank all of you. Much of the debate on Regulation NMS focused on how to best modernize the national market system to account for new technologies and efficiencies. Aside from the legal certainty provided by the final adoption of Regulation NMS, is there a correlation between the adoption of the regulation and the recent merger announcement? Are these mergers a direct result of the new regulatory environment? Are they a necessary reaction? Are these transactions evidence of larger market trends? They seem to be.

Mr. Thain.

Mr. THAIN. Yes, Mr. Chairman. I would answer that the following way. The changes in the market are in line with the expectations of the SEC when they applied Reg. NMS across all of the marketplaces. I do not think I would say that the combinations are a result of Reg. NMS, but I think Reg. NMS anticipated the type of combinations that you have seen. In the case of the New York Stock Exchange and Archipelago, you have a combination of New York-listed trading with a significant position in the over-the-counter trading market.

I think Reg. NMS, as it was adopted, is quite consistent with that more global or more national marketplace. It would be very inconsistent to have one set of rules apply to the trading of IBM and a different set of rules apply to the trading of Microsoft, particularly where both of those stocks will be traded under the same umbrella. So, I think actually Reg. NMS did a very good job, and Chairman Donaldson should get credit for that, in anticipating the developments in the marketplace.

Chairman SHELBY. Mr. Putnam, do you have anything to add to that?

Mr. PUTNAM. I agree with John. I would say though that the pressure on a consolidation was there, and as I thought about what to do next, Reg. NMS and the trade-through rule was not hanging over my head as, oh, we have to do something specifically because of that. I think our view, as we looked around the world and thought about how things would change in the United States, as we have to compete with foreign competitors. The idea of combining products, meaning trading futures, options, and stocks on a single platform is my vision for where we are headed in the future, and there are certainly signs of that from the competition abroad.

So the real driving factor for me was we needed some scale and some size to be able to compete globally.

Chairman SHELBY. Mr. Frucher, you have a different view?

Mr. FRUCHER. No, actually, I do not, but I just have a slight modification. I think we should not confuse internal competition with a need for vertical integration. I think what has been stated, for us to compete globally we have to have the ability under one roof to trade equities, options, futures, and maybe even look at clearing, and certainly technology, to be competitive. That is not the issue. The issue is whether or not we have internal competition to spur the innovation and that kind of vertical integration.

Chairman SHELBY. Mr. Nicoll, you agree with that?

Mr. NICOLL. I do. I mean I do not think there is any large disagreement here. My own view, running a company, was the pressures to deliver profitability and in an extremely competitive environment where our ability to charge per unit had drastically declined over the past 5 years. The price that Instinet was able to get to trade 100 shares in the 3 years prior to this merger agreement had gone down by 80 percent. So those are enormous economic pressures on an organization, and we needed to have scale. I think this would have happened with or without the regulatory changes. I do agree with John that they are concordant with the changes that have been passed.

Chairman SHELBY. Mr. Greifeld, you have a comment?

Mr. GREIFELD. I agree with everybody.

[Laughter.]

Chairman SHELBY. Our national market system tries to strike a balance between competition among orders, and competition among market centers. If the mergers are finalized, there will essentially be two dominant players in the equity markets controlling most of the liquidity. How will this consolidation affect the balance between order and market competition? How will the mergers alter the competitive dynamic that we have? Should we be concerned that a duopoly will emerge? Mr. Frucher, I will ask you.

Mr. FRUCHER. I actually think that strong market centers are very important for competition, but we should not be looking at Eurex and Euronext really as the paradigm of what we want in markets. Those are monopolies. They trade in their own silos. They are not as transparent as our markets. They are not as liquid as our markets, and we can face that competition. I am sure every Member of this Committee got a ton of mail last year urging them to keep Eurex out of the futures market in Chicago, and look what happened? They came in and they got their butts whipped. But the investor got much cheaper fees because of the competition.

The SEC does not look at it as a threat. The SEC has lowered the barrier to entry and it now allows foreign markets to come in and effectively buy U.S. markets.

The question really is not whether or not we have a duopoly, we do. The question is, will they be challenged by the next generation of Islands, Instinets, and Archipelagoes? And if we use regulation to inhibit, to restrict, or to preclude competition within our markets, that duopoly will atrophy.

Chairman SHELBY. Mr. Nicoll.

Mr. NICOLL. I totally agree with Sandy. What the Committee has to understand is there are two real components in NMS which would lower barriers to competition for new people to come in.

There are two guiding principles, fair display and fair accessibility. Now, if you have the highest bid in the United States, your bid is going to be displayed throughout the entire country, and that gives anybody, even the smallest market, the ability to come in, offer the highest price, and get access to this national market system.

Moreover, the largest markets cannot unreasonably discriminate against anybody who wants to access their marketplace, so they do not have the ability to use their scale to allow people not to get into their marketplaces.

Chairman SHELBY. Information changes everything, does it now?

Mr. NICOLL. That is correct.

Chairman SHELBY. Mr. Thain, you have any comment?

Mr. THAIN. Yes. I think there are two important points, one of which Ed was talking about, which is the Reg. NMS actually protects the smaller markets, and there are very low barriers to entry into our marketplace. Archipelago is only an 8-year-old company. The ISE and the options market was created 5 years ago from zero and has a 35 percent market share. So there is plenty of room for new competitors to come in, and Reg. NMS actually protects them from being ignored. I think that is one point.

But on the second point, which is you have heard a number of people talking about global competition. I think that from the perspective of the United States, where we do today have the dominant position in the world in terms of our financial markets, we do face competition from those much more diversified global competitors. So you have heard the talk about Euronext or Deutsche Borse who trade a much broader range of products.

Deutsche Borse has a market cap of about $8 billion, so they have a tremendous amount of financial flexibility. They have a currency to make acquisitions, and yes, it is true that they have not been all that successful so far, but we are going to have to compete on a global scale and we need entities who are competitive on that basis.

Chairman SHELBY. Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman. I want to welcome the panel.

I am interested in how the self-regulation would proceed under these proposed arrangements. The SEC concept released concerning self-regulation, published December a year ago said:

> The SRO demutualization raises a concern that the profit motive of a shareholder-owned SRO could detract from proper self-regulation.

And just a few weeks ago *The New York Times* had an article, "Big Changes at the Exchanges Bring Their Self-Regulation into Question," and went on to say:

> The New York Stock Exchange's plan to acquire an electronic trading system has called into question the future of the self-regulation system that exchanges use to oversee their markets and the conduct of their members.

I understand that the exchange and the plans to reorganize the regulatory function as a not-for-profit organization, but I understand that this organization would be under the board of the for-profit merged entity. Is that correct?

Mr. THAIN. That is substantially correct. It would not include any nonindependent members of that board, so it would be a subset of the board.

Senator SARBANES. What consideration was given to spinning off the regulatory function to a totally independent body and why was that approach, which would seem to avoid at least some of the problems that people perceive, not followed?

Mr. THAIN. Ranking Member Sarbanes, we believe that the best structure for the regulatory functions of a marketplace is one that balances the independence of the regulatory functions, and so that we have to keep the regulatory functions separate from the business of the exchange, but keeps the regulatory functions close to the marketplace, so it does not in fact spin it off totally. Because we think that by being close to the marketplace there is an expertise and an understanding and a sophistication that allows them to do their job better.

And so the structure that we are proposing is actually an extension of the structure that we have today that was approved by the SEC a little over a year ago, whereby the regulatory functions, which are led by Rick Ketchum, report up to a subcommittee of our board of directors, and as you know, our board of directors is now new, and with the exception of myself, is totally independent. So the board members are not members of the regulated firms. They are not CEO's of listed companies. They do not have interests in the operations of the exchange. And so the regulatory functions report up to a subcommittee of our board that is completely independent, so I, as the CEO of the exchange, run the business, I have nothing to do with the running of the regulatory side.

What we are proposing in this structure is an extension of that. In some ways even more separate, where we are taking those regulatory functions, which are currently inside the exchange. We are putting them in a not-for-profit, not-public entity, and the board structure will be similar. So the board of that new regulatory entity will be comprised of members of our current board, who again are totally independent. It will not include me, as well as some third-party independent individual. So in some ways it is slightly more separate, but we do believe that keeping it close to the business of the exchange, keeping it close to the marketplace, allows it to be a better regulator.

Senator SARBANES. Mr. Greifeld, how does Nasdaq propose to deal with this?

Mr. GREIFELD. Senator Sarbanes, how Nasdaq handles it today is certainly different than what Mr. Thain is recommending. We have our regulatory services performed by the NASD. The NASD is separately capitalized. They are separately funded, and they have a separate board from Nasdaq. The NASD, I think, is certainly widely recognized as the gold standard for regulation, and they are incredibly close to the business and understand it.

In our relationship, we contract with them for regulatory services. We do not have any input in terms of how they go about conducting regulation. If they choose to conduct a intensive investigation of a member firm which happens to be a very large customer of the for-profit Nasdaq entity, we have no control and/or knowledge of it, and we believe that is the best way to operate.

We do have the ability to go in and audit for waste with respect to how they discharge their regulatory function without knowing precisely who they are regulating, and we certainly take that opportunity. We are happy to see that the NASD certainly has become a very lean and effective regulator.

So they are close to the business, but it is a separately funded board, and I think this set up came about as Nasdaq evolved to a for-profit company, and they do not have to look to us for any input or control in their finances.

Senator SARBANES. Mr. Chairman, my time is up. Thank you.

Chairman SHELBY. Senator Hagel.

Senator HAGEL. Mr. Chairman, thank you.

Gentlemen, welcome. You all have spoken this morning about global competition and I want to focus my few minutes in questions on that large issue.

Mr. Thain, in your prepared testimony, you talked about Part 2 consolidation of securities markets, and you go on to say, "While the SEC has streamlined the rules and structure for our national market system, it is up to the U.S. markets themselves to respond to a rising global challenge. The players must now perform on a new playing field." You go on to talk about today equity and capital markets are global, competition for capital is global. All five of you have noted that.

A couple of questions I would like to present to all of you and would appreciate each of your answers. One, when we talk about, as Mr. Frucher has, the consolidation of exchanges, is the consolidation of exchanges, as we see that developing, is that good for global competition? And the broader question is, what is, in each of your opinions, the greatest challenge to our markets when we factor in the global dynamic of options, now that we have global competition for capital? The options and opportunities are far wider and deeper than they ever have been, and I suspect will continue to increase in the depth and width of those opportunities for investors.

Mr. Thain, start with you.

Mr. THAIN. Senator Hagel, thank you. If you look at our foreign competitors today, they, in one platform, trade cash equities, they trade options, they trade futures, they trade certain derivative products, and they trade certain fixed income products. So they have a much greater product diversification, and they gain great advantage by being able to trade those multiple products, both in terms of their earnings power and their growth prospects, as well as increasing the overall level of trading in their marketplace because of that.

And so that is probably the single biggest competitive factor today, is that our markets are for the most part fragmented. So the cash equity markets are separate from the options market, which are separate from the futures markets. And that is a competitive disadvantage to us.

The second factor is that some of our foreign competitors, particularly Euronext and Deutsche Borse, are vertically integrated. So not only do they run the exchanges, but they also run the clearing, the settlement, and the custody functions, and that gives them much greater earnings power, and therefore greater financial power in the world.

In the United States in cash equities, the clearing and settlement functions are in industry utility, DTCC and NSCC, which is good from an investor point of view because they are much lower cost, but is a negative from a competitive point of view of having to compete with these global marketplaces.

I think that when we look at the world competitive landscape, we will seek to be more product diversified because we really cannot be more vertically integrated, and really making sure that as our markets develop, that we increase the overall level of activity by allowing, for instance, cash equities and options to be traded in the same place. That will both diversify our businesses, but also allow for more trading.

Senator HAGEL. Thank you.

Mr. Greifeld.

Mr. GREIFELD. I agree with a lot of what John said. I do believe that our foreign competitors do not actually run on one platform but they are under one holding company, and they are all characterized by having monopoly positions within their home market and can use that monopoly position to cross-subsidize international efforts, and certainly we saw that happen with Eurex coming to the United States.

But what I think will be our calling card and our ability to compete is the fact that we are battle tested, we compete very aggressively here in the United States, and our markets are very efficient. So to the extent that we have foreign competition, and we will, and it will be real, I would not sell short the ability of the people at this table and others representing the capital market system to be able to compete. We are battle tested and we know how to win in this scenario.

Senator HAGEL. Thank you.

Mr. Putnam.

Mr. PUTNAM. I will start with the greatest challenge. Those are technology and capital. On the technology front, I believe that we are going to get to a point where we can have multiproduct, single platform type trading which will increase demand for trading, as John pointed out, but it will take some real innovation for us to get there.

On the capital front, both of those things actually lead to what I think motivated these mergers, which is to get scale. As Ed pointed out, the prices that we can charge have dropped dramatically. We do have highly automated systems that we run today, and if you just add volume to it, you can actually survive. So technology capital leads to scale.

Senator HAGEL. Thank you.

Mr. Nicoll.

Mr. NICOLL. I do think there is real benefit for derivatives and cash markets to trade in the same system. I think the derivatives markets are very positive. These are markets in which people are exchanging risks in the world, and it is very important that risks are held by the parties that can most tolerate those risks, they are priced properly in that sense.

Part of that, of having good derivatives markets is having very low cost between the derivatives markets and the cash markets because the higher the arbitrage costs of those markets, the less efficient the derivatives markets are.

So, I think we will evolve toward one of the promises and one of the real changes that I think will occur over the next 10 years, is you will see both derivatives and cash markets trading over one platform because it is more efficient. We can lower the cost of the derivatives markets and we can more efficiently exchange risks than we can in the current scenario.

So that is one of the real promises of these mergers and real promises of the electronic marketplace as a whole.

Senator HAGEL. Thank you.

Mr. Frucher.

Mr. FRUCHER. Thank you, Senator. I agree with Mr. Greifeld. The European competition, the big markets, Eurex and Euronext, they do not trade on the same platform and we should not confuse competition with a business structure. They, in fact, have vertically integrated. That is the right business structure. You should trade equities, options, and futures, regardless of your size, under one roof and ultimately on one platform. That is an aspiration that we really all, whether big or small, have to achieve to be competitive, and actually go ahead of the European competition. So the business structure, vertical integration is necessary.

But the only way we are going to be competitive with those European markets and those bigger markets is to have internal competition.

I disagree, respectfully, with Jerry Putnam, who actually has been a genius in developing his structure by merging with a regional exchange. This is not a question of scale. If it was a question of scale we should have been very happy with New York having 82 percent of the market and Nasdaq having 100 percent of its existing market. That was scale.

What changed them and brought them into the position to now toast the ability to compete internationally, is the fact that they had competition who pushed them forward technologically, who pushed them forward in a heck of a lot of different ways. And if we eliminate, as NMS can—and I believe it can—create barriers to entry by taking what was a 20 percent standard to a 5 percent standard for new competitors in the marketplace, by changing the formula so regional exchanges cannot get the tape revenue, then Mr. Nicoll and Mr. Putnam who came to be at this table through their affiliation with regional stock exchanges who were able to use their tape revenue to lure them in is what sustained it.

So the biggest threat is the elimination of internal competition because duopolies will atrophy without internal competition and make them unable to compete against the global competition.

Senator HAGEL. Thank you.

Mr. Chairman, thank you.

Chairman SHELBY. Senator Crapo.

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

Before I get into the main area I want to talk about, I want to go back to the question that the Chairman first asked, which was the relationship between the mergers that we are looking at here today, between the four companies that we have here at the table, and Reg. NMS. And if I understood your answers to the Chairman's question, it was that Reg. NMS had nothing to do with these mergers, which is interesting to me because there has been a lot of speculation about that, as you know. There are those who were opponents of Reg. NMS, who said, look, this is proof, soon as Reg. NMS was adopted, we see these mergers and it is proof that Reg. NMS is going to crimp down competition and Archipelago and Instinet saw that their future was bleak, and so they had better merge. Others said, no, this is proof that Reg. NMS is working just the way we wanted it to work because there is too much internal competition and this is starting to consolidate markets in the

United States, and it is just exactly what we should have happening, but all of those explanations were that there was a connection between the adoption of Reg. NMS and these mergers.

Now, is there or is there not?

Mr. GREIFELD. I certainly believe that there is, and I think that is what the panelists commented on, but it is not a 100 percent correlation. Clearly, the certainty that Reg. NMS expressed to the marketplace made it more comfortable I think for the participants to enter into very significant transactions. The fact that the New York Stock Exchange would have to go electronic to compete in their post-Reg. NMS world gave me comfort to consummate the transaction with Instinet, knowing that we will then be in a better position to compete in that world.

Senator CRAPO. Mr. Nicoll.

Mr. NICOLL. I think the question is, I mean much of the debate centered around the trade-through rule and Reg. NMS. So the question is, did the SEC's final trade-through rule force these mergers? I do not believe that to be the case. They were all being negotiated well before that had been decided one way or another.

If the question is, does Reg. NMS create a competitive environment which helped to spur these mergers, I agree that the answer is yes. I mean, realize that these exchanges are without two major sticks in the bundle of private ownership. When you own your house, you get to exclude somebody from coming in and sitting down in your living room. Neither the Nasdaq nor the New York Stock Exchange nor INET, nor anybody up here actually has that right. Anybody can come into our living room because we cannot unreasonably discriminate in terms of our competitors. So if the New York Stock Exchange wanted to use its monopoly power under Reg. NMS, it cannot. It cannot keep people out from its marketplaces.

Also any small person, the smallest competitor under Regulation NMS, under the display rules, gets to participate in the national market system, and this is a major spur toward competition. I believe that that competition was a background condition which helped to make the argument for further consolidation in the marketplace. So to that extent I agree, but I disagree with the notion that because of the trade-through rules, that is what created these mergers.

Senator CRAPO. Thank you. My time is running out, so for the others who may want to jump in on this, maybe you can add your comments to this next question, because it is related, and that is, one of the rationales for Reg. NMS seems to be—and Mr. Frucher has talked about this—the notion that there is too much competition internally in the United States and that we need to consolidate, and that will strengthen us for international competition.

And I know that I have worded it in a way that might cause it to be a little bit of a scary proposition, to be approaching our market by saying we have too much competition and trying to say it is better in the United States to have regulatory policy that discriminates against competition. There is concern out there about whether Reg. NMS does that.

Could you discuss with me—and any of you can jump in on this—is that correct? Are we concerned that there is too much competition or there are too many competitors internally, or just what is it that is the rationale behind the notion that we need to try to drive consolidation in our markets?

Mr. GREIFELD. The one thing I would like to say is that there is two types of competition, and Chairman Shelby kind of touched on it before. We need in this market to have competition between limit orders, and that is introducing a time competition. And these mergers will definitely increase the competition among limit orders to get executed. As you put more limit orders in one place, you have increased competition among limit orders, not so much against markets, so that is a positive of these markets.

I think what Ed was speaking about, under Reg. NMS you will have a lower barrier to entry. Now, Ed, Jerry, and myself have spent a substantial portion of our careers as entrepreneurs, and I would say here this is a best entrepreneurial activity, to come in and try to compete against the largest players, in that all you have to do is have one customer post one order and the larger markets cannot trade through you at this point.

When you think about what Jerry and Ed accomplished under the old rule set, it is a lot easier today for new competitors to come in.

Senator CRAPO. Mr. Thain.

Mr. THAIN. Yes. I would reinforce what Mr. Greifeld said, which is Reg. NMS, in its current form, encourages competition. It protects competition. It protects small markets from being ignored. It requires orders to be routed to whatever marketplace has the best price, and if that is a little start-up entity, that is who the order goes to. So it does in fact allow for and protect competition.

I also do not agree that there is too much competition in the United States. I think there is a lot of competition, and I think that is good. I think that the consolidation is not being driven by too much competition in the United States, that consolidation is being driven by the desire to compete with those global players that are in fact more diversified.

Senator CRAPO. Mr. Frucher.

Mr. FRUCHER. Let me say that in order to compete, you have to be there. And you cannot just look at Reg. NMS in isolation and say, well, you know, Reg. NMS does in fact have features that enhance competition. In fact, the single most important part of Reg. NMS is that it in effect will hopefully spur the two large behemoths to compete with each other, but I do not believe economic entities do that unless they are forced to do that by competition.

Yes, NMS makes it possible to have competition, but if you add Reg. NMS with the concept release that the SEC has out, and the various changes that they are compelling regional markets to make, you price them out of business. So you will not have competitors.

And in fact, I disagree, respectfully, with the notion that NMS has made it easier for new entrants. Reg. ATS did in fact open up the door for competition. This is ATS–2. We call it NMS, but this cleans up some of the problems and unanticipated problems created by Reg. ATS, and I do not want to get into jargon, but effectively there were issues like tape shredding and other kinds of issues that it needed to address and to force cross-market debate.

But in fact when you drop the barrier from 20 percent to 5 percent, you are not enhancing the ability for somebody to enter the market to be competitive. You are going up against significant giants. The fact of the matter is that the two successful ATS's who are sitting in the table, who are celebrating their success by consolidation, that was made possible by the fact that they were able to team up with the regional exchanges. Take my word for it, regional exchanges are endangered entities.

I am not looking for protectionist legislation. If we do not come up with ideas to present to the SEC, then we do not have a right to exist. But the process is almost monumental in some instances to get rules.

I love the fact that Mr. Greifeld said that he is expecting to get his rule through for it to become an exchange. Ask him how long he has been expecting that rule to get approved? Four and a half years. And I have submitted rules in which I have been told, well, we will deal with your rule after we deal with that rule. How do you compete?

Senator CRAPO. Mr. Putnam, my time is way over. If the Chairman will allow, Mr. Putnam wanted some response to this. Is that all right, Mr. Chairman?

Chairman SHELBY. Go ahead.

Mr. PUTNAM. I will be quick. In response to Sandy's point about the behemoths not wanting to compete, today the New York Stock Exchange has zero market share trading Nasdaq stocks. The acquisition of ArcaEx will put it in a new competitive game, competing with Nasdaq for trading Microsoft and Intel and those securities.

Bob's deal with Ed is going to add an electronic component to his marketplace for trading in NYSE-listed stocks. Both of us traded everything going into this.

The last thing I would say is with respect to the trade-through rule, if you looked at the New York Stock Exchange's position with 80 percent market share in trading its stocks, no trade-through rule would have allowed it to ignore every other smaller marketplace, including ours, when it came to trading IBM, and just simply under this rule they cannot, and I do not see how that in any way restricts competition. Anyone can come in, as Bob pointed out, with one order for 100 shares and going forward you are going to have to trade with it. Thank you.

Senator CRAPO. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks, Mr. Chairman.

Gentlemen, welcome. It is good to see you. Thanks for spending your morning with us. I think maybe Senator Sarbanes may have asked a question similar to the one that I am going to ask, and I think maybe Mr. Thain and Mr. Greifeld had a chance to respond to it. I am going to ask my neighbor from the north, up in Philadelphia, if he would not mind responding to the question. Let me just set the stage.

We have seen in the last month or so some interesting even exciting changes in our Nation's market system. The New York Stock Exchange is now merging with Archipelago. We have seen Nasdaq announcing acquisition of I think it is Instinet Group. These mergers are going to result in a need we note for a change in regulation.

In this new environment, Mr. Frucher, let me just ask, do you think it is critical that there be effective regulation to keep our market strong and to protect investor confidence? If you do not mind, just comment for the record on your views on what the new regulatory structure of these marketplaces should be. And finally, are you satisfied with the suggestions of others, including maybe some we have heard here this morning?

Mr. FRUCHER. I think both marketplaces have responded very well in terms of ensuring the integrity of their markets. I think the most important point has to be made that a monopoly in regulation is as bad as any other monopoly. You will simply have an increase in fees and an increase in cost, and bringing the FBI in to do local law enforcement is not exactly the best model.

Self-regulation does not connote sole regulation. I think the structure or the concept of the structure that we have now, which is self-regulation of your marketplace and a regulator that sits over them, is an effective structure. It just has to be staffed adequately, it has to be funded adequately, and it has to be made to work.

I think Nasdaq chose to divest itself, or NASD chose to divest itself of Nasdaq and separate themselves completely. New York is approaching this in a very intelligent and systemic way. Gerry Putnam, when he made his deal with the Pacific Exchange, created a very good structure, where he separated the regulation from the operations of the stock market. So, I think the key here is that you can have a diversity of regulatory structures. It is not a sole structure. They all have to be funded. They all have to be vigilant. But one single regulator is not a good structure.

Senator CARPER. Thanks. Anybody else have a comment on this? Yes, sir? He took your name in vain, is it?

Mr. PUTNAM. It would not be the first time.

[Laughter.]

I believe in competitive regulators for the same reasons that Sandy pointed out. If you do not have competition among the regulators, you are going to see costs rise and the quality of the service diminish.

That said, a marketplace doing its own regulation, I mean the brand is about quality regulation within your marketplace. So whether it is done by a completely separate regulator like our relationship with the PCX or one that is a little bit closer like the one that the New York Stock Exchange is proposing, each market is going to really have to, especially in the information age and the willingness of the press to report on any bad deeds among regulators, it is a process that I think is going to work regardless of how it is structured.

Senator CARPER. I apologize for not being here sooner. I have three Committee hearings going. You are probably wondering where is everybody? We have a lot of things. We are trying to be in three or four places at once, so just bear with me on this question. One of the great advantages for having a panel like this, smart, well-informed people, is to get a diversity of opinion and find out where they disagree, but maybe even more importantly, to find out where they agree. Let me just ask you for a take-away for me from this hearing. Is it Nicoll, your last name Nicoll?

Mr. NICOLL. Yes.

Senator CARPER. Mr. Nicoll, what would be a good take-away for me with respect to where do you all agree?

Mr. NICOLL. I think we all agree that Regulation NMS has moved us forward. We do not agree with every aspect of it, but we agree that finality has enormous value to all of us and that the SEC has done all in all a good job at addressing a very comprehensive, very difficult issue, and making decisions about it.

We all agree that there are many procompetitive elements to it. Sandy is concerned about some elements to it, but we all believe that it is pretty competitive, and I think we all agree that competition going forward is going to continue, and that it is a good thing. And I suppose one of the things that we could all agree on is that we do not know the future, and if we come back 5 years from now or 2 years from now and we do find that competitive forces are not continuing to shape the innovation in the marketplace, that we might have to take another look at it. But right now it looks to us like all in all it is a pretty procompetitive environment out there.

Senator CARPER. Mr. Thain and Mr. Greifeld, do you agree with anything that Mr. Nicoll just said about your——

[Laughter.]

Mr. THAIN. I basically agree with everything that Ed said.

Mr. GREIFELD. I agree we do not know the future.

Mr. THAIN. Yes. I certainly agree that Reg. NMS, as it was passed, is a good rule and we want it to stick, and we do not want to disrupt it because it is good for the marketplace, it is good for investors, it is good for competition, and it is also good to know what the answer is.

I think all of us collectively are happy with the rule. Not everyone is happy with every single aspect of it, but people are generally happy with the rule and want it to stick, so that is absolutely one important take-away.

The only thing that I would add is I think there is pretty clear consistency that we do have to worry about global competition. We have to worry about the competition among the players outside the United States that are more diversified, that do have a broader product mix, that do have a different business model, particularly being vertically integrated, and who have great financial strength both in terms of earnings power, market capitalization.

Senator CARPER. Thank you.

Mr. GREIFELD. I would agree with that. Just to kind of make the point, on my stock watch screen at my office I have up the Chicago Mercantile Exchange, the International Securities Exchange here domestically, in addition to, obviously, ArcaEx and Instinet, and internationally, I watch every day what is happening to the LSE, Euronext, and Deutsche Borse. So that is what we look at. That is what we know where the competition is coming from.

Senator CARPER. Thank you all.

Chairman SHELBY. Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Mr. Chairman, thank you.

I apologize to all of the witnesses, particularly our two New Yorkers, Mr. Thain and Mr. Greifeld, for being a little late. It is a very busy day, as you have probably heard.

I want to thank you, Mr. Chairman, for holding this important hearing. I think we are in a totally different place than we were last time we discussed this. Regulation NMS has passed, and I think, in a sense, a certain wisdom of NMS has been shown by developments since then. We are going to have some real competition in terms of major players, two at least, who are going to be up and down the line trading stocks in ways that their customers want them to trade, and I think that is all to the good. As somebody who is worried about the liquidity of the markets and the depth, and worried about fragmentation, and yet like every American, I love competition, I do not think you can draw a better structure to try and see how this works.

So, I am very laudatory of what has happened so far in the markets, as somebody who cares about them both parochially—New York's point of view—but also in a more catholic way, because we care as Americans and as citizens of the world about having deep markets, as Mr. Greifeld mentioned. They are always looking over their shoulder now and if we fall here in America, those markets will go before you can say whoopie.

I am excited about the markets. I think they are going to promote competition. They are going to be orderly, but they are going to be transparent, and they are going to be liquid, and I think both mergers have ended up being a very good idea as well, which will fortify both of those markets.

Now we have a few other things we have to look for, NYSE's hybrid. I think that is excellent, and Mr. Thain has really performed close to miracles in a very difficult situation. We have a tough job. I guess one of the few jobs that might be even tougher is right now to be head of the NYSE with all the pushes and pulls in there, and I want to say I think you have handled it very well. You know, I think we are in pretty good shape. I think we can watch and see what happens. We have to make sure that things roll out as people appear, and I also want to compliment—he will be here tomorrow—Chairman Donaldson, who I think took the bull by the horns, and——

Chairman SHELBY. Senator, it is past 11:30. There has been an objection under the rules to us meeting by a Democratic leader, and so we are going to have to——

Senator SCHUMER. I would ask unanimous consent to submit my questions in writing?

Chairman SHELBY. Without objection, so ordered.

I want to thank the first panel for being here.

More than that, I want to thank the second panel, and note that we have to recess under the rules, but your testimony will be made part of this hearing record in its entirety, your written testimony.

We are in recess according to the rules of the Senate.

[Whereupon, at 11:33 a.m., the Committee was recessed.]

[Prepared statements supplied for the record follows:]

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

I would like to thank Chairman Shelby for holding this hearing to discuss the Securities and Exchange Commission's recently adopted Regulation NMS and other recent developments in the U.S. equities markets.

I applaud the Chairman and Ranking Member's commitment to examining this proposal, as it has broad reaching implications for the way in which the U.S. equities markets will operate going forward.

In fact, we have already seen some of the implications of this rule in the New York Stock Exchange's recent acquisition of Archipelago, and the Nasdaq's acquisition of Instinet.

I have been encouraged by the haste of these recent transactions that healthy competition will continue to thrive among U.S. market centers.

Reg. NMS is likely the most substantive SEC proposal many of us have seen during our tenure as Members of this Committee. It also generated a great amount of debate amongst industry participants, Commissioners, and even Members of this Committee.

The U.S. markets will now operate under a new regulatory framework that I am hopeful will address the needed changes resulting from technological developments in the markets.

I would like to thank our witnesses for appearing before the Committee this morning. I know this has occupied a great amount of your time and energy over the past several years. I look forward to your testimony.

PREPARED STATEMENT OF SENATOR MIKE CRAPO

I am disappointed and troubled that the Commission was unable to proceed with one voice on Regulation NMS (National Market Structure). Instead, a divided Commission, with deeply held convictions both for and against the rule, voted 3 to 2 in favor of the 500 page rule.

Although Regulation NMS covers four primary topics, the majority of the debate centered around the trade-through rule. The lack of consensus inside or outside the commission on the need for a trade-through rule at all, let alone extending the trade-through rule, raises many red flags

Additional red flags were raised due to the fact that there was very little proof that this was something required in the markets. According to the SEC Office of Economic Analysis, approximately 2 percent of all trades on Nasdaq and NYSE were traded through in 2003 and the majority of trade-throughs only trade-through by a penny or two.

These numbers are also curious since the NYSE market currently has a trade-through rule, while the Nasdaq market does not. These numbers do not demonstrate to me that the market is not working and that more regulation is the answer. I am interested in whether our witnesses believe this rule will substantially stop trade-throughs and what will be the cost of implementing this rule.

While investors clearly care about price, other attributes like anonymity, trade size, and execution speed also factor into an investor's trading decisions. An investor might be willing to forgo best price, at times, if that anonymity, or some other factor, helps him or her to protect a valuable trading strategy, for example.

It is unfortunate that the Commission decided against developing a more consensus-based alternative to Regulation NMS, rather than forcing such divisive mandates with so many experts unconvinced of the benefits. A credible alternative was available that would have allowed for more evaluations and then a future Commission vote to determine if the rule should apply to the Nasdaq market.

Thank you, Mr. Chairman for holding this important hearing, and I look forward to hearing the testimony of the panels.

PREPARED STATEMENT OF JOHN A. THAIN

CEO, NEW YORK STOCK EXCHANGE

MAY 18, 2005

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. I am John Thain, Chief Executive Officer of the New York Stock Exchange, Inc. Thank you for inviting me to participate in today's hearing. I am grateful for the opportunity to speak to you.

Mr. Chairman, we appreciate your Committee's leadership and oversight of our national market system. We view our Nation's financial markets from different vantage points, but I believe that our respective responsibilities unite us in a common challenge: Put simply, how can we best serve the interests of U.S. investors and issuers, and how can we strengthen the competitive position of U.S. markets in the world.

For its part, the New York Stock Exchange stands at the center of our Nation's financial system. We are a $20 trillion market facilitating the capital-raising process in the Nation's ongoing quest to create new jobs and to fuel strong and sustained economic growth. Our leadership was built upon a commitment spanning over two centuries to gain the confidence of our customers. Today, they include America's 90 million investors, the institutional community, market professionals, and over 2,700 of the world's leading corporations.

Since I assumed the position of Chief Executive Officer last year, the New York Stock Exchange has initiated a transformation that has reached into every corner of our business. Following a difficult period, we are doing everything possible to restore trust in the Exchange and to better serve our customers. Today, we have an entirely independent board, with the exception of me, a new governance structure with regulation independent from the business side, and new and higher levels of disclosure and transparency. In short, we are on the right track.

At the same time, we have renewed our commitment to deliver the highest standards of market quality. Day-in, day-out, customers can expect that the New York Stock Exchange will provide them with the deepest liquidity, the lowest volatility, the tightest spreads and the best prices. We offer the best price to customers in stocks of our listed companies 89 percent of the time. That we are able to provide a market of this caliber for listed securities significantly enhances the position of U.S. financial markets in the global competition for capital.

We have built our reputation upon a great tradition of service. However, what we have not offered to a sufficient degree is speed and innovation. Speed is important to a segment of our customers, particularly on the buy-side. So, too, is innovation, by which I mean providing our customers more options on how they can trade, and from which products they can choose.

Just as importantly, we recognize that only by offering customers—investors and issuers alike—a better marketplace, and only by providing them with more choices, can the New York Stock Exchange strengthen its ability to grow and to compete both domestically and globally.

Meeting these twin challenges—to provide the world's best marketplace for customers, and to strengthen the position of U.S. capital markets in the world—defines and drives the mission of the New York Stock Exchange.

This is why we are building the Hybrid market, to offer investors a choice between the sub-second speed of electronic trading, and the opportunity for price improvement that distinguishes the auction market.

This is why we are taking the historic step to become a public, for-profit exchange, by merging with Archipelago, an outstanding, entrepreneurial company that is pioneering leading-edge platforms and products.

Our initiatives to embrace electronic trading and provide investors with the ability to choose the way their trades are executed are very much complementary with the value that the specialists and floor brokers will continue to provide investors and our listed companies.

Finally, this is why we urged that Regulation NMS (Reg. NMS) set as its paramount purpose the protection and promotion of the interests of U.S. investors and U.S. competitiveness, while modernizing the rules for America's 21st century national market system.

I will touch briefly on each of those topics. Let me begin with Reg. NMS.

Regulation NMS

Mr. Chairman, the regulatory environment governing our market and all of the U.S. securities markets is undergoing dramatic change. In adopting Regulation NMS on April 6, the Securities and Exchange Commission established rules that will strengthen the protection of U.S. investors, while fostering robust competition and innovation in the U.S. markets.

The rule accomplishes these goals in the right way, not by favoring one marketplace over another, but, rather, by strengthening competition among all markets to create the best possible national market system with a deep pool of liquidity for all investors, for all issuers, and for our economy.

In addition, the process was carried out in a manner that was open, thorough and solicitous of all views. The decision follows over a year of hearings and multiple rounds of Congressional testimony, as well as comments from thousands of investors, leaders, and members of our major equity markets and financial services industry.

The centerpiece of the regulation, which is strongly supported by U.S. investors, is the modernization of the trade-through rule.

We believe that the new trade-through rule will advance the cause of three critically important national goals:

It will be proinvestor; it will strengthen the integrity of our markets; and, it will enhance the competitiveness of U.S. markets globally.

First, the new rule will make certain that an investor's order, regardless of the market it is sent to, has the right to be executed at the best price.

It will require that intermediaries, such as brokerages and mutual funds, find the best price for investors, either by selling their shares at the highest possible price or by buying them at the lowest possible price.

This means that any of this Committee's constituents—from Toledo to Tucson, and from Atlanta to Anaheim—can invest and trade on an equal footing with the largest institutions. Their displayed limit orders cannot be traded through.

Second, as the Investment Company Institute has observed, the new rule will increase investor confidence in the markets by helping to eliminate an impression of unfairness that is created when an investor's order executes at a price worse than the displayed quote.

Third, the new rule will advance U.S. competitiveness. As more investors are encouraged to display their limit orders, collectively, they will have the effect of deepening liquidity and invigorating the entire capital formation process.

In the past, critics charged that the trade-through rule inhibited innovation and favored the New York Stock Exchange by failing to distinguish between fast and slow markets. They pointed out, and with some justification, that prices can change in the time that it takes a trade to occur in the auction market.

The Securities and Exchange Commission has seen fit to address that criticism directly. It has updated the old trade-through rule, and the new rule will protect only prices that are available for immediate electronic execution.

This is a significant change that will serve to promote greater competition among all markets. Just as important, the onus is now on the New York Stock Exchange to make our Hybrid market a reality, a responsibility we welcome.

Mr. Chairman, we are ready for the challenge. We are moving forward toward completion of the Hybrid market and we hope for expeditious approval of our proposal by the Commission.

Our goal is to offer investors the choice of two investor-friendly paths—an immediate, electronic and anonymous execution, or the possibility of price improvement that is the hallmark of specialists and floor brokers working in tandem in the auction market.

Our floor offers superior market quality, and demonstrates daily its ability to outperform purely electronic exchanges during opens and closes, order imbalances and unforeseen, outside events. I am speaking of the value of human judgment in an auction market process. It is this market model that generates real price discovery, and creates the best prices on 89 percent of all trades compared to other markets that compete for order flow in NYSE-listed stocks.

Stocks that have switched from the Nasdaq to the NYSE exhibit markedly improved executions. For example, 39 stocks that we reviewed saw their price volatility cut by half, their quotes narrowed by over a third and their execution costs cut in half. In addition, the SEC staff's analysis found that "transitory volatility is significantly higher for Nasdaq stocks than for NYSE stocks," noting that "retail investors, in particular, tend to be relatively uninformed concerning short-term price movements and are apt to bear the brunt of the trading costs associated with excessive transitory volatility." These statistics translate into real savings for investors who buy these stocks, and real value for companies seeking to raise capital in a cost-efficient manner.

Finally, Mr. Chairman, now that the SEC has ensured comparable trading conditions for speed, we believe that there can be no remaining justification for giving investors anything less than the best price.

In sum, we strongly support the new market-wide trade-through rule. So, too, does a broad base of investor groups that represent millions of investors and investor companies.

They include the Investment Company Institute, the Consumer Federation of America, Vanguard, T. Rowe Price, Bank of New York, and the National Association of Investment Clubs (NAIC).

A typical viewpoint was expressed by NAIC, which represents over 21,000 investment clubs. NAIC stated that the new trade-through rule " . . . will ensure that investors' quotes will not be compromised when sending quotes to the markets of their choice. This will produce tighter spreads, improve liquidity and provide equal treatment of all investors who seek a fair and level playing field—while ensuring market competition based upon best price."

We believe the new rule will empower investors and remove barriers to innovation. We believe that the U.S. markets now have the opportunity to become more robust, dynamic, competitive and efficient than ever before in our history.

Now, let me conclude with comments on the proposed merger between the New York Stock Exchange and Archipelago.

Consolidation in the Securities Markets

While the SEC has streamlined the rules and structure for our national market system, it is up to U.S. markets themselves to respond to a rising global challenge. The players must now perform on a new playing field.

On April 20, I announced the decision of the New York Stock Exchange to merge with Archipelago, and to become a public, for-profit marketplace. As I stated then, we are in a competition with great stakes for the future of U.S. financial markets.

Today, equity and capital markets are global.

Competition for capital is global.

Stock exchanges across Europe and Asia today are increasingly well-capitalized. Most are public and for-profit companies, and many have very high profit margins. And many have set their sights for further growth on the United States, seeking to take U.S. market share from domestic U.S. exchanges.

Mr. Chairman, we believe that to sit passively would be to surrender to the competitors who challenge us. This is not the course that we choose to follow. We believe that the merger of the New York Stock Exchange with Archipelago will help us compete head-to-head with these global players. We believe that consolidation among other market centers will also improve the competitive position of the U.S. financial system. For our part, we are determined that our new company, the NYSE Group, will become a world-class competitor that can maintain and, indeed, enhance our leadership, in every possible respect. This will begin, as I noted earlier, with providing customers greater choice on the type of execution venue that they prefer.

The merger with Archipelago promises to add to and enrich customer choices by introducing new platforms for new investment products that will include equities, options, exchange-traded funds (ETF's), and bonds.

Let me point out that these products not only present us with significant growth opportunities, but also give retail investors valuable investment opportunities. Investors in some of these products must currently pay higher spreads and transaction costs because markets are fragmented and inefficient. Through our merger, the New York Stock Exchange will provide a platform that is well suited to offer these products efficiently and expeditiously to our customers. We believe this will be a great benefit to our customers, America's investors. ETF's are attractive to retail investors because they provide the benefits of diversification with generally very low fees. In the fixed income area, there is little transparency in that market; by growing this platform through our merger, we expect to increase transparency and reduce spreads for investors. And our addition of an options platform will further increase product and market choice for investors. We are confident that a more robust and innovative business model will be good for our customers. As a public company, we look forward to having our individual investors, institutions, listed companies, as well as our members all participate in our success and our growth as stockholders. And as a stronger, more competitive exchange, the NYSE Group will fortify the U.S. position globally at a time when the Deutsche Börse, Euronext, and the Toronto Stock Exchange are offering a multiplicity of products, attempting to gain a foothold in the United States, and looking hungrily to seize further advantage.

With its new, for-profit status, the NYSE Group will increase its capability to invest in future growth to a much greater degree than we had as a not-for-profit entity.

In addition, we anticipate that our merger will boost competition in the trading of over the counter stocks and in the listing of smaller companies that do not yet meet the New York Stock Exchange's listing standards.

Let me assure this Committee that the new structure of the NYSE Group will not only protect but also strengthen the independence and initiative of our regulatory functions. The holding company will have separate subsidiaries for the NYSE and Arca markets. These markets will continue to operate as separate markets with separate listings and offer different trading platforms. The structure we will propose for the regulatory function for the two markets will remain inside a not-for-profit, not publicly traded entity providing reliable, independent regulation. We envision that the new Board of the regulatory entity will consist of independent members of the NYSE Group Board, along with several other independent directors with no affiliation with the NYSE Group holding company. Preserving the regulatory responsibilities in a separate but related entity will strengthen its independence, while retaining proximity to the business it is regulating. That proximity, together with the unique expertise our regulatory group has developed, will enable it to continue performing effectively.

It is worth noting that the consolidation in the financial services arena that has taken place since the approval of Reg. NMS illustrates two points. First, the rule's new best-price policy applied across all markets is the right one: The new NYSE Group will be a market that caters to customers of both over-the-counter stocks and listed stocks. There is no reason that our customers should receive different protections based on which stock they happen to be trading in. Under the new rule, all our customers will receive the same protections.

Second, the certainty created by the final rule enabled the markets to take steps to innovate and grow.

Conclusion

Mr. Chairman, this is an important time for U.S. financial markets. New competitors have arisen with broad product mixes, diversified earnings streams, and access to public capital. They seek to challenge the United States as the global leader in financial markets. We must respond to this challenge—decisively, wisely, and effectively.

The New York Stock Exchange is eager to take the next, critical steps to help the United States retain its global leadership. We will ensure that our customers are advantaged by the highest market quality, the best investment executions and the greatest, possible choice in investment products. The result, we are confident, will be a win-win—for investors in U.S. markets, and for U.S. markets in the world.

Thank you again Mr. Chairman, for inviting me to testify before this Committee. I look forward to responding to your questions.

PREPARED STATEMENT OF ROBERT GREIFELD

CEO AND PRESIDENT, THE NASDAQ STOCK MARKET

MAY 18, 2005

Chairman Shelby, Senator Sarbanes, and distinguished Members of the Senate Banking Committee, thank you for inviting me to discuss Regulation NMS and the recent industry developments.

Regulation NMS

When I last appeared before this Committee on July 21, 2004, I started my testimony by stating that: "[t]he trade-through rule is the primary obstacle to competition amongst our Nation's equity markets, and competition is the driving force in making the U.S. markets the strongest in the world, the best for investors large and small, and accountable to the public." I also stressed that the markets had uncovered a fundamental truth: "Today electronic trading is best for investors."

After well over a year of hearings, discussion, and comments, on April 6, 2005, the Securities and Exchange Commission (the SEC or the Commission) approved Regulation NMS. Regulation NMS replaces the old ITS trade-through rule that protected the listed market from competition with a new trade-through rule which will be applied uniformly across all markets to protect a market's top-of-the-book quote if it is automatically accessible. Regulation NMS also includes needed restrictions on sub-penny trading, establishes uniform market access rules that will insure that all market participants can access each others' quotes, and updates the formula used to allocate market data revenue amongst the SRO's.

I believe that Regulation NMS does remove a substantial obstacle to competition amongst our Nation's equity markets and establishes incentives for floor-based markets to move to more electronic trading. The new rule will bring benefits to investors and it will enhance the ability of our Nation's capital markets to face growing international competition. Nasdaq commends the work of the SEC as well as the constructive oversight of this Committee and the entire Congress throughout the rulemaking process.

As you know, Nasdaq, joined by many others representing both industry participants and investors, urged the Commission to eliminate the trade-through rule entirely. Our position reflected, and still reflects, our belief that market forces and best execution should serve as the bedrock principles in the securities markets. We are proud of the market quality experienced by investors every day on the Nasdaq Stock Market, which does not have a trade-through rule. Given our experience and the costs of implementation, we believe the extension of the rule to Nasdaq imposes a tax on market participants.

Nonetheless, although Nasdaq does not believe the application of a trade-through rule to Nasdaq is necessary given our highly efficient electronic market, we are pleased the new trade-through rule approved by the Commission will force floor-based markets to follow the path to automated trading that has been blazed by Nasdaq since 1971.

Specifically, the Commission's decision to allow investors to make distinctions between fast and slow markets will force manual floor-based markets to automate in order to compete effectively with the faster electronic exchanges. The rule acknowledges the value of speed and certainty of execution, and allows electronic markets to compete for the trading of NYSE-listed securities. Manual markets will no longer be the weak link in the national market system, slowing down faster markets while humans—some with a distinct time and place advantage on the floor—attempt to execute orders.

As you know, the Commission has announced that the rule will be rolled out in a limited manner next April and is not scheduled to take full effect until June 2006, so that markets have time to make and test the necessary system changes. Even before Regulation NMS was approved, however, the NYSE was compelled by market pressure to move to modernize their market structure, and they developed and proposed an electronic-floor hybrid model. Now, as a result of Regulation NMS, the American Stock Exchange and the regional exchanges have strong incentives to modernize their markets and, if they proceed, are poised to emerge as competitors to both Nasdaq and the NYSE in the national market system. There is no doubt that this will be good for competition and for investors.

Nasdaq Acquisition of Instinet

On April 22, 2005, Nasdaq announced the acquisition of Instinet Group and, concurrently, entered into a definitive agreement to sell Instinet's Institutional Brokerage division to Silver Lake Partners. As a result, Nasdaq will own only Instinet's electronic communications network, INET.

This deal proceeded from a public, competitive process. Reuters, the parent company of Instinet, announced in November 2004 that it was selling Instinet. We understand that several industry participants considered bids for Instinet. As early as January 25, 2005, as part of a registration statement filed at the SEC, Nasdaq disclosed that we had submitted a nonbinding proposal to acquire "a major ECN."

Nasdaq acquired INET to enhance Nasdaq's trading environment to serve investors better and respond to the increasing competition across the global capital markets. It is a synergistic deal that will create a fast, high-performing, low-cost single platform for trading U.S. securities. Given the compatibility of the two platforms, the real-time market surveillance by a well-respected regulator, the NASD, and Nasdaq's proven technological reliability, this transaction will position Nasdaq to compete more effectively with other U.S. and international market centers. The acquisition will result in more cost efficiency and improved quality of execution in our market—qualities that today's individual and institutional investors demand. Nasdaq will continue to innovate and also will have the ability to tap new opportunities in other asset classes.

The combination of Nasdaq and the INET ECN will bring technology enhancements that optimize our electronic trading platform. It will provide greater cost efficiencies to the benefit of investors and improved quality of execution. Nasdaq will be able to offer investors increased limit order interaction. In addition, the INET transaction will allow Nasdaq to continue its market innovation leadership. We will offer faster time-to-market on new products and services that will benefit market participants, investors, and our listed companies.

The efficiencies of one integrated platform and single router will provide other benefits as well. Critically, it will enable Nasdaq to maintain its status as the low cost provider for execution services for equities. In addition, by constantly improving and innovating for the benefit of investors, Nasdaq will continue to provide a superior listing venue for public companies and their investors.

Dynamic Marketplace

The rapid structural changes sweeping through our Nation's securities markets are being propelled by a convergence of several forces, some of which are regulatory in nature, while others are market-driven.

The principal regulatory force is Regulation NMS. Its most direct impact—greater competition in the trading of NYSE securities—will be felt when the rule takes effect. However, the indirect impact of Regulation NMS is being felt already, as the NYSE is poised to become a competitor in the trading of Nasdaq securities. That, combined with the expected rise in the trading of Nasdaq securities by the regional exchanges, which Regulation NMS will serve to encourage, creates a national market structure in which market centers no longer specialize in the equities of a single market. Rather, the NYSE will trade Nasdaq as well as NYSE securities; Nasdaq will be able to more effectively trade NYSE securities; other exchanges and market centers will trade Nasdaq-, NYSE- and American Stock Exchange-listed equities; and large market makers will likewise internally match trades in all of these securities.

Another important force is rapid globalization of capital markets. Companies around the world are seeking access to capital, and stock markets are the key facilitator in this process. When a company in China or Russia seeks to bring capital from outside its country's borders, it typically considers the major markets in Europe as well as in the United States. As such, we are now competing not just with the U.S. exchanges but also, for example, with the Europeans. Enhanced competition for listings also encourages competition in the quality of trading, as companies seek to list in a country and a market that offers the best trading for their securities.

Finally, it is increasingly necessary for stock markets to be mindful of competition from venues that trade derivatives and other instruments that are not equity securities. If trading quality in equities is inferior or the costs of trading are relatively high, then some investors may prefer to focus on the types of securities that trade more efficiently. Again, all investors are potential winners in this competition.

Improved Regulation

Recent developments in the marketplace offer the opportunity to improve and make more efficient the regulation of the securities markets. First, as part of the NYSE-Archipelago transaction, the NYSE announced their intention to further separate its regulatory function into a nonpublic, not-for-profit entity governed by an independent board of directors. Nasdaq supports separating the regulator from the regulated market and, in fact, once the Commission approves our application to register as an exchange, Nasdaq will completely separate from our regulator, the NASD.

Broker-dealers who operate on both the NYSE and Nasdaq often become members of the NYSE and the NASD. Accordingly, they face duplicative regulation and costs associated with the regulation. Some companies, like the Charles Schwab Corporation, are moving to eliminate this duplication by dropping their NYSE membership.

Last November, the Commission published a concept release concerning the self-regulatory system of the securities industry. One of the options offered by the Commission in its concept release is the establishment of a hybrid regulator model which would simplify and streamline the current regulatory model. Under this alternative, a market neutral single self-regulatory organization would surveil and enforce rules related to broker-dealers nonmarket specific activity, such as their financial condition and registered representative representation, while SRO's that operate markets would regulate broker-dealers' activities within those markets.

This approach would offer substantial benefits to broker-dealers and investors alike by eliminating the costs associated with duplicative member regulation. At the same time, each market would be in the best position to surveil activity on its own systems and would therefore retain authority over market regulation. The quality of market regulation, moreover, could be enhanced through adoption of intermarket surveillance and audit trail enhancements, and through targeted Commission efforts to promote greater uniformity in SRO market rules in areas where problematic disparities exist. Accordingly, Nasdaq supports the proposal in the SEC's concept release on SRO governance for a single regulator to administer broker-dealer membership rules.

Nasdaq Exchange Registration

Finally, even with Regulation NMS codifying uniform rules for the trading of all equities, there is an additional element necessary to achieve a level playing field—granting Nasdaq status as a national securities exchange. I am pleased to report that the Commission has been working closely with us on our exchange application and we are hopeful that the application will be approved shortly. A Nasdaq exchange will be good for competition, good for the regulatory framework, good for market quality and integrity, and, ultimately, good for investors.

PREPARED STATEMENT OF GERALD D. PUTNAM

CHAIRMAN & CHIEF EXECUTIVE OFFICER ARCHIPELAGO HOLDINGS, INC.

MAY 18, 2005

Good morning Chairman Shelby, Ranking Member Sarbanes, and other distinguished Members of the Committee. As Chairman and CEO of Archipelago Holdings, Inc. (Archipelago) and the Archipelago Exchange (ArcaEx), and on behalf of our shareholders, directors, and employees, it is a privilege and a great honor to be provided the opportunity once again to testify before the Committee. I request that my written statement on today's topic, "Regulation NMS and Recent Market Developments," be submitted into the record. Thank you.

A Tale of Two Rivals

Let me take you back for a moment to the events of April 20, 2005. For much of that day, the focus of the business news was analysis of Yahoo's first quarter financial results and reporting on market jitters brought about by volatile oil prices and interest rates. In Chicago, the Cubs' victory over the Reds the night before lifted their record to an even .500, although our Cubbies have unfortunately backslid since then. Our White Sox, however, still remain the best team in baseball!

Later on April 20, of course, something else was about to be announced, something very big: At exactly 4:30 p.m. (EDT), two rivals decided that the world had changed and that the time had come to join together to meet increasing demands of investors and issuers. It would be akin to the New York Yankees and the Boston Red Sox agreeing to put down their bats and balls, terminate their blood feud, and join forces. Two days later, on April 22, other famous rivals decided to follow suit, as if the Alabama Crimson Tide and Auburn Tigers announced the end of the Iron Bowl rivalry. (I can see Senator Shelby with head in hands exclaiming, "No, it can't be true, it can't be . . . .)

Like my fictional examples, I am sure that many people were quite surprised to hear the news of the respective intentions of the NYSE and Archipelago on April 20 and Nasdaq and Instinet on April 22 to merge. What's next: *The Wall Street Journal* endorsing Democrats and *The New York Times* endorsing Republicans?! What in the world is going on here? Well, let me do my level best to provide some insight on the strong business logic that underlies both transactions.

Before doing so, however—if I may for a moment—I would like to symbolically extend my hand in warm congratulations to Bob Greifeld and Ed Nicoll on their announcement to merge Nasdaq and the Instinet ECN. ArcaEx—and before it, the Archipelago ECN—has been knocking heads with Nasdaq and Instinet for years now, and we have the battle scars to prove it. Both Nasdaq and Instinet under Bob's and Ed's respective leadership have commanded my personal respect in what has been and continues to be a ferociously competitive, fast-paced, and dynamic business. Upon consummation of these mergers, we would expect even greater competitive vigor from the combined Nasdaq-Instinet. Congratulations again to both of you.

A Common Vision Built On A Simple Premise

Let me take you back to last winter, when John Thain and I began talking about a potential business combination between the NYSE and Archipelago. I must frankly admit that I was a little skeptical entering our discussions; not because of John, mind you, who I have known for several years now and who I regard as a very astute business man. Rather, I perceived differences between the NYSE and ArcaEx that I was not sure could be overcome. I will not sit here and pretend that Archipelago has not had some disagreements with the NYSE over the years. And, as you know, we have not been shy about expressing our displeasure when the NYSE took actions that we did not like. That said, what I quickly discovered from my conversations with John is that he and I share a common vision that is built on a simple premise. Our vision: To build upon the respective strengths of the NYSE and ArcaEx to develop a world-class exchange that provides topnotch services to U.S. and international consumers of execution, data and issuer services. The premise: To listen
intently to customers and respond with the highest quality products and services with choices that fit the needs of different kinds of customers. At times, and to their detriment, this simple premise has been ignored or forgotten by many business leaders. We promise not to forget. Today's global consumer, who demands excellence and flexibility from exchanges, will not let us forget.

Starting from our common vision, the NYSE and Archipelago ultimately negotiated and announced a merger which, upon consummation, will result in a new entity called the NYSE Group, Inc. (NYSE Group). The merger will combine the world's largest, most liquid, most reliable equity marketplace in the NYSE with the most successful totally open, fully electronic one in ArcaEx. We believe the combination will deliver high quality products and services to investors, traders, and issuers, and create long-term value for NYSE Group shareholders as a public company. It will allow us to provide diverse platforms for the trading of listed and OTC securities, options and other derivative products, including ETF's, under a single umbrella, which is what customers want.

Further, in my view, this combination will:

- Strengthen America's leadership in financial services and boost our global competitiveness in capital markets;
- Better serve investors, traders, and issuers;
- Maintain the highest standards of integrity, transparency, and disclosure; and,
- Produce efficiencies, drive innovations, and create new business and revenue opportunities.

Without wanting to sound overly dramatic, I believe the merger between the NYSE and Archipelago is a bold one, but 21st century competition requires boldness. The merger represents the best of both worlds: Respecting and taking the best from the past while embracing the future. It marries the 24 entrepreneurs of the Buttonwood Era with the Archipelago entrepreneurs of the Information Society. I imagine that Nasdaq and Instinet share many of these same aspirations for their merger. I know that I speak for Archipelago's shareholders, directors, and employees when I say that we are thrilled to join forces with the NYSE to build on what both organizations have accomplished to date in an effort to create something truly great for our customers.

Globalization and Convergence Cause Reinvention of Exchange Models

One of the hallmarks of Archipelago has been its nonstop drive to come up with new ideas, product offerings and technology. And for good reason: Investors, traders, and issuers continually require better services and more sophisticated products to satisfy their needs. If capital markets in this country do not fulfill these needs for customers, then almost certainly the markets in London, Frankfurt, Hong Kong, and elsewhere will. A failure to keep pace with the times poses serious risks for us all.

One of the most striking trends in capital markets around the world over the last decade or so has been the convergence of both exchanges and products. In Europe, enterprising initiatives at the Deutsche Börse, Euronext, and the London Stock Exchange are bringing different products and services together under one roof. In response to clear customer demand, our competitors overseas are creating "one-stop shopping." The Deutsche Börse sees "a clear trend toward convergence between trading on the cash and derivatives markets, as well as between equity and bond trading."[1] Euronext, which is an organization resulting from the merger of the exchanges in Amsterdam, Paris, and Brussels, also acquired a controlling interest in LIFFE and announced plans to integrate its derivatives markets. In Asia, too, exchanges like the Singapore Exchange combine equities and derivatives under one umbrella. The same is true in Hong Kong. The Tokyo Stock Exchange is one of the most integrated exchanges in the world, trading stocks, bonds, derivatives, and futures.

Furthermore, almost all of the world's significant exchanges have reorganized and are no longer membership organizations. Many of these de-mutualized exchanges have issued shares and gone public to finance their development of new and improved product offerings as well as their geographic expansion. The Deutsche Börse, which went public in 2001 and commands a market capitalization over $8 billion, now competes with "marketplace operators in London, Paris, Chicago, and New York."[2]

Exchanges in the United States are responding to these global challenges. Some examples: The Chicago Mercantile Exchange (CME) went public in 2002 and trades futures on physical commodities like pork bellies and lumber, and trades futures on financial products like the S&P 500 and the Nasdaq–100 as well. The CME advertises that it has "customers around the world, a global product line, nearly around-the-clock electronic trading and strategic alliances with other exchanges."[3] The Chicago Board of Trade, which has filed to go public, recently signed a multiyear technology and services contract with Euronext.liffe, under which the Chicago Board of Trade is licensing the Euronext.liffe trading system and buying support and

[1] Deutsche Börse Group. *Partner of Global Customers, Annual Report 2004,* (Frankfurt: Deutsche Börse Group, 2005), p.18.
[2] Deutsche Börse Group website. "Deutsche Börse Group—The Company." May 16, 2005.
[3] Chicago Mercantile Exchange website. "Global Marketplace" in "About CME." May 16, 2005.

maintenance services from them. The Boston Stock Exchange teamed up with the Montreal Exchange to create the Boston Options Exchange, a fast-growing electronic options exchange. Several U.S. equities exchanges, including the Philadelphia Stock Exchange, have restructured and de-mutualized their ownership. The International Securities Exchange, born only in the late 1990's, is already the largest equity options exchange in the United States (and the world).

Finally, options and futures exchanges are converging on equity trading through single stock futures trading. OneChicago, a joint venture of the Chicago Board Options Exchange, the Chicago Board of Trade, and the Chicago Mercantile Exchange, now trades futures on over 130 stocks and ETF's. From the standpoint of sophisticated investors and traders, all of these exchanges provide alternatives to executing trades of cash equities on the NYSE and Nasdaq—or ArcaEx or Instinet for that matter.

The competitive trend is very clear: Historically, exchanges typically traded stocks, options, *or* futures within a single Nation's borders. Today, to stay competitive and serve customer demands, exchanges need to trade stocks, options, *and* futures on a single platform and to do so with a global footprint. I believe that the recently announced mergers of NYSE-Archipelago and Nasdaq-Instinet fit squarely within the context of this competitive dynamic. It is my strong belief that both mergers are necessary for the United States to remain competitive in capital markets globally.

The Secret Of ArcaEx's Success: Its People

No statement today would be complete without a quick retrospective of Archipelago's history and business successes. I know this may sound formulaic, but at the center of that history and at the heart of that success are our people, the employees of Archipelago. We have achieved what we are today because of the sweat, blood, and tears expended by our employees, who now number about 250. I cannot tell you how proud I am of them, and I cannot thank them enough for their contributions.

You may not recognize these names, but here are just a few representative examples of people who have worked so hard and contributed so mightily. Our version of Paul Bunyon is Paul Adcock, who has headed our trade support desk from day one. Paulie, as he is affectionately known, grew up on a working farm in central Illinois, and still rises at 4 a.m. daily to begin his workday. Paul is highly respected by our customers and traders around the country.

My assistant and our office manager, Therese Wallace, came to Chicago via New York from Jamaica. The attraction of Chicago must be pretty strong to pull a woman away from a tropical paradise of white beaches to a city known more for another type of white, as in snow and lots of it. Therese was one of Archipelago's first employees, and from time-to-time she reminds me who *really* built the company.

One of our top technologists, Dave Weiss, arrived at Archipelago by way of the Nutmeg State of Connecticut while riding a bicycle for a messenger service. Today, Dave is Archipelago's "Lance Armstrong" when it comes to providing our customers with high-speed connectivity, yet somehow finds the time to continue his high-speed cycling in long distance charity rides.

Our lead software developer is Tom Haller, who grew up in a Chicago neighborhood, but moved to Florida several years ago so his kids would be close to their grandparents. Tom is an incessant tinkerer. After coming home from work at night, Tom used to go into his garage and . . . tinker. Tom joined Archipelago in 2002, where his development team has tinkered their way to producing the technological guts of ArcaEx, which is a marvel in my view.

Finally, I would be remiss if I did not give a special mention to Archipelago's cofounders along with me, MarrGwen and Stuart Townsend, both of whom were University of Chicago Ph.D. candidates and are software developers. In January 1997, we launched the Archipelago ECN—financed by my mortgage broker and supported by the eternal patience of my family—with no customers and no trades. In 2001, we graduated to exchange status when the Securities and Exchange Commission (SEC) approved our transaction with the Pacific Exchange, and in 2002, we launched ArcaEx. In the first quarter of 2005, Archipelago reported that ArcaEx handled 23.5 percent of the share volume in the OTC marketplace, 25.5 percent of AMEX-listed share volume (mostly ETF's), and 2.5 percent of NYSE-listed share volume. On behalf of everyone at Archipelago, we feel lucky and blessed to have achieved these successes.

The Aftermath of Regulation NMS

Before concluding, I would like to comment, as requested by the Committee, on the recent approval of Regulation NMS and, in particular, on the adoption of the modification of the trade-through rule. This Committee and the House Financial Services Committee have conducted oversight of and pressed the SEC to address some of the thorny market structure issues that had been lingering for some time. Since Regulation NMS was first publicly proposed in early 2004, a lot of smart people have engaged in a good faith debate about its implications and would-be effects. While Archipelago supported parts of Regulation NMS, we did not support the trade-through rule as it was adopted by the SEC. That said, the SEC has now addressed many of the market structure issues that Congress and our capital markets had asked them to confront. In my view, although not always in agreement with the SEC, we will now have regulatory certainty. Furthermore, the concept of "trade through" and the practical reality of trading through another marketplace become much less germane if and when the mergers recently announced are consummated.

It is worth noting that we will vigilantly review the final release of the Regulation NMS rules, which are not yet public.

Conclusion

No, the Yankees and Red Sox have not ended their century's long feud; and, yes, the Iron Bowl between Alabama and Auburn is scheduled to occur again next fall, like it does every year. Ending those old rivalries would never make sense.

In sharp contrast, the merger between the NYSE and Archipelago makes a whole lot of sense. Above all else, it makes sense because of our shared vision to maintain America's leading position in the global capital markets by creating a world-class exchange that provides U.S. and international consumers with first-rate execution, data and issuer services. In a world where both exchanges and financial products are fast converging, we believe the NYSE Group will be positioned to better serve all traders, investors and issuers by producing efficiencies, driving innovations, and creating new business and revenue opportunities, while maintaining the highest standards of integrity, transparency and disclosure.

America cannot be left behind in a world of tectonic shifts in financial markets. History so clearly, if cruelly, teaches us that societies, nations, governments, and businesses that are unwilling to embrace and shape change are relegated, over time, to the failed forgotten. In all sincerity, we believe that the NYSE-Archipelago merger (and, yes, the Nasdaq-Instinet one) reflects an acceptance of change in our global capital markets, and the NYSE Group intends to engage constructively and positively in that change.

This Committee has had the foresight to be mindful of the importance of market competition and market integrity. Our capital markets need your continuing leadership if we are to maintain our global preeminence in financial services. We at Archipelago look forward to working with the Committee throughout its review of the many changes occurring in today's capital markets, and we look forward to becoming part of the NYSE Group. Thank you again for providing me this opportunity, and I will be happy to respond to your questions at the appropriate time.

PREPARED STATEMENT OF EDWARD J. NICOLL

CEO, INSTINET GROUP

MAY 18, 2005

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, I appreciate this opportunity to discuss the role that I believe regulation and legislation will play in the future of our Nation's securities markets.

While others on the panel today may begin by looking ahead and outlining the challenges and opportunities facing our markets, I would like to begin with an appreciative glance back at how we got here. I do so because I think it is worth remembering—indeed, quite important to remember—on whose shoulders we stand here today and why so much of the recent discussion has been about building better and stronger electronic markets.

From my perspective, the story begins with a company called Island ECN, which was one of the first of the so-called Electronic Communications Networks, or ECN's. I am proud to have been the first and only Chairman of that company.

In the wake of scandals in the mid-1990's, the SEC adopted regulations (known as the Order Handling Rules) designed to introduce competition and greater transparency into the U.S. equities markets—which led directly to the creation of ECN's. Island seized this opening and offered investors a less-expensive, faster, and more reliable forum for trading. From Island's inception, we counted on the fact that investors—when given the choice—would always demand a more accessible and transparent marketplace. To reach that goal, we focused on what we considered the glaring gap in the then traditional model: The inability of investors to meet directly in the marketplace without having to rely on professional intermediaries.

The Island story was about fighting for a chance to compete in new markets and allowing investors to vote with their feet. We fully understood that if we could not offer a better product, we should be out of business. But investors welcomed our products and services, and Island enjoyed explosive growth—eventually merging with Instinet, the company where I serve as CEO today.

For these reasons, Mr. Chairman, I doubt you will find a witness today who is a greater champion of our Nation's free markets and the individual's ability to profit from hard work and innovation.

But more than anything else, my experience at Island gave me the privilege to meet some of the most insightful traders and software programmers on the Street—individuals who grasped a magnificently simple and elegant truth: The markets could be made far more rational and fair if investors were allowed access to the same sorts of information that were at that time uniquely available to market professionals.

On my first day as Chairman of Island, I walked into the office—and we were, literally, just a handful of employees in one office—and sat down with gifted individuals such as Josh Levine and Matt Andresen. The one thing we all shared—beside a broken-down desk with four folding chairs—was a commitment to provide investors with an unprecedented degree of accountability, openness, and transparency in the marketplace. I recall how many market professionals had insisted that making "arcane" real-time market data widely available would be at best a distraction, and probably a nuisance for the investor. How wrong they were.

As we know, investors today demand access to real-time data and the latest research reports as well as the ability to enter orders more efficiently and at a fraction of the cost once paid for such transactions. Yet while the investor had been empowered to know what and when to buy, a key component of this equation had been missing: *How* to buy it.

That is where Island jumped in. Traditionally, investors had only been provided with the highest bid and lowest offer in a security. The depth of the market, which gives an indication of the true supply and demand for a security, had been the exclusive province of market professionals.

That lack of accountability—in other words, denial of information to the investor—was unacceptable to us. To provide the best resource possible to the investor, we became the first marketplace to provide a free, real-time display of all its orders, through the Island BookViewer™.

There is probably nothing I am more proud of, Mr. Chairman, than to know that the technology we built for the Island ECN, which then became the technology behind Instinet Group's INET ECN, is now expected to become the technology platform for the merged Nasdaq-Inet platform.

With this history in mind, Mr. Chairman, let me try to summarize some lessons we can learn from those experiences that are particularly relevant as we look ahead to the issues we will face in our markets over the coming years—lest we be "doomed" to repeat the mistakes.

First and most important are the benefits resulting from a regulatory environment that encourages true competition among marketplaces. It is certainly true that much of the original electronic marketplace story was about harnessing technology to provide investors with a more efficient, faster, and lower cost forum for trading. Yet Island's success and the success of other electronic markets like Archipelago and Nasdaq is much more than a technology story—it is about the tremendous benefits that redound to the investor when the securities laws and regulations allow our markets to compete; when one marketplace can challenge another with a dizzying array of innovations and offer the investor unprecedented opportunities to leverage technological breakthroughs.

The Island story and the rise of ECN's embody the benefits of competition. The dramatic changes in technology have allowed new competitors to offer new services at a lower cost and capture market share from traditional market participants in a relatively short time period. Just one example: I can remember when it cost some individuals as much as $200 per trade. Today, you can pay as little as $7. There has never been a better time to be an individual investor.

A second lesson from our experience concerns the policing and surveillance of markets. By eliminating the informational disparities of the traditional, floor-based manual markets, many of us built a marketplace that is inherently safer, fairer, and easier to surveil—all issues, I know Mr. Chairman, that this Committee takes very seriously. For example, participants on the floor of an exchange generally possess more trade and order information than the average investor sitting at home.

Through surveillance and the implementation of restrictions on the activities of those in the trading crowds, regulators attempt to prevent the misuse of this information. As recent events have shown, however, no amount of surveillance or regulation can completely prevent or eliminate the potential for its misuse. With that in mind, Mr. Chairman, I note that electronic markets reduce the opportunities for improprieties by eliminating informational disparities.

Finally, Mr. Chairman, let me at least raise for the Committee's consideration one of the most enduring public-policy issues we face. Now that electronic markets have done so much to empower the investor by providing an open and transparent marketplace, there remains one final challenge. How do we unleash these benefits on as wide a scale as possible, without sacrificing investor protection or the integrity of our capital markets? How can we continue the process of democratizing the markets?

Long before electronic markets were even a glimmer in anyone's eye, Congress anticipated exactly what rules should guide us. In 1975, Congress created the National Market System, with the goal of creating a more efficient and transparent market. We could not have asked for a better building block. Over the subsequent decades, the SEC has worked hard to strengthen and improve this regulatory structure. While Instinet had particular concerns with some of the elements in the recently approved Regulation NMS, I do commend Chairman Donaldson for finally resolving many of the outstanding market structure issues and setting forth a clear and definitive regulatory roadmap for the U.S. equities markets as a whole.

There are many different models currently used in the equity markets, and, with entry becoming even cheaper and easier, over the coming months and years I have no doubt more will emerge. Each model has its supporters and detractors. But what history does teach us is that, regardless of the model, two principles must hold into the future: First, competition must continue to be permitted to flourish between the different models, but in a manner that safeguards the integrity of our markets. Second, market structure must remain free from unfair advantages and unreasonable barriers.

While much has changed since I sat in that small downtown office with my young colleagues, we must remain vigilant in the protection of our free markets from overregulation. As Chairman Donaldson said, "We need to identify real problems, consider the practical consequences of the possible solutions and then move pragmatically and incrementally toward the goals Congress staked out."

My own rule, Mr. Chairman, would be that regulatory action should only be taken when it is clear that the market is failing and less drastic remedies are inadequate. In all other cases, let us embrace free competition and always work toward greater openness, transparency, and accountability in the marketplace. In so doing, we can continue to leverage our Nation's technological superiority in a manner consistent with the best aspects of America's entrepreneurial capitalism. There is too much at stake to do otherwise.

Thank you for this opportunity to again testify before your Committee. It has been a great pleasure to work with you and your colleagues on this issue.

PREPARED STATEMENT OF MEYER S. FRUCHER

CHAIRMAN AND CHIEF EXECUTIVE OFFICER, PHILADELPHIA STOCK EXCHANGE, INC.,

MAY 18, 2005

On behalf of Philadelphia Stock Exchange, Inc. (the PHLX), I appreciate the opportunity to participate in this hearing on the implementation of the Securities and Exchange Commission's (SEC) recently adopted Regulation NMS and the consolidation of the U.S. securities markets. This is a historic juncture for our markets. Future generations of investors, economists, lawyers, and commentators may view 2005, as they do 1934 and 1975, as being a point in time where decisions made and paths taken changed the character and quality of securities trading in the United States for decades to come.

Introduction

Adoption of Regulation NMS and the combinations of the New York Stock Exchange (the NYSE) and Archipelago (Arca) and of the Nasdaq Stock Market (Nasdaq) and Instinet Group (Instinet) could very well result in a sound and healthy market structure and two strong organizations capable of competing to serve the needs of issuers and investors. However, conditions also exist for the development of an anticompetitive duopoly. For all the talk in recent years of market fragmentation, the fact is that the marketplace for trading stocks is dominated by a small number of venues—particularly the NYSE. The survival of the smaller exchanges that challenge the NYSE and Nasdaq is by no means assured. The SEC must act by the first quarter of 2006 on proposals by competing exchanges to ensure that the benefits of vigorous inter-market competition in the securities markets, particularly for equity securities, are not lost. Because there are significant and growing regulatory and other barriers to entry for new exchanges, if this competition is weakened, it may be gone forever. Therefore, it is important that this Committee in exercising its oversight responsibility be vigilant that the SEC takes action to ensure competition.

ROLE OF THE COMPETING EQUITY MARKETS

To better understand the PHLX's perspective on competition, this statement provides information first about the smaller securities exchanges that compete with the NYSE and Nasdaq and second about the PHLX in particular.

The Competing Securities Exchanges

A century ago, there were more than 100 local and regional stock exchanges in the United States. They served the capital needs of companies and investors in their area by listing local companies for trading. Although today's smaller securities exchanges are the descendants of those exchanges and are still often referred to as "regional exchanges," they are no longer regional markets. They do not list local companies or serve local investors. Instead, they are competing parts of our national capital market and collectively form an essential pillar of the national market system.[1]

While they differ in many respects and with regard to many aspects of their business models, the competing stock exchanges share an important role: They all make markets in stocks listed by the NYSE; some also trade Nasdaq-listed stocks. They thus provide competition to the Big Board and Nasdaq. Of particular significance is that the NYSE's share of trading in the stocks it lists has regularly exceeded 80 percent, a dominance that almost surely would invite government scrutiny in any other industry. The PHLX believes this dominance is unhealthy for investors.

Today's competing stock exchanges have survived because the competitive environment in which they operate forces them to be innovators. The PHLX and a number of the other securities exchanges employ an electronic system of remote competing specialists, described below. On some of the exchanges, many stocks have three or four specialists competing to offer the best price, rather than a single specialist setting a price as on the Big Board.

Most importantly from the perspective of investors, the smaller securities exchanges have repeatedly served as "laboratories of invention." They were the first to adopt innovations as essential as the securities clearing house, continuous net settlement of trades and automated execution of small orders—all improvements that the NYSE embraced after other exchanges had first paved the way. The PHLX believes that investors would be best served if competition continued to spur the NYSE and Nasdaq to innovate. However, as described in greater detail below, the continued survival of competing exchanges is far from certain.

Background on the Philadelphia Stock Exchange

The PHLX is the oldest securities exchange in the United States. The PHLX is both a stock and an options exchange. It trades over 2,000 stocks listed on the NYSE and American Stock Exchange (Amex) and over 1,500 equity options, as well as industry sector options created by the PHLX and currency pairs.

While the PHLX is comparable to the NYSE in age and tradition, its method of equity trading differs from the NYSE's in an important respect. While both the NYSE and the PHLX use a floor-based specialist system, the PHLX employs competing specialists rather than a single specialist per stock. The Remote Competing Specialist System implemented by the PHLX in 2002 lets specialists make markets and trade from the PHLX equity trading floor or from remote sites. This secure communication network expands trading beyond a fixed number of specialists to enable qualifying firms to operate from their offices. It means that more than one equity specialist can make a market in an eligible stock, so order flow providers can direct orders to the specialist of their choice. The result is a boundless market center permitting virtually unlimited access to qualified specialists and customers alike.

NEED FOR COMPETITION

The PHLX is not advocating some form of protection for itself and other stock markets that compete with the NYSE and Nasdaq. Instead, the PHLX merely asks

[1] This testimony refers to the smaller U.S. securities exchanges that trade equities, namely the American, Boston, Chicago, National, and Philadelphia Stock Exchanges.

that the SEC take all steps to ensure that it and other venues are allowed to compete vigorously and aggressively, and that the smaller exchanges be allowed to do what they have always done, namely to innovate and find new products and trading technologies. After all, if the smaller exchanges do not step up and offer competitive alternatives, where will competition to the NYSE and Nasdaq come from?

To ensure competition, the SEC must quickly and with an open mind address proposals submitted by smaller exchanges to establish new facilities, rules and fees. If the SEC does not do so, any hope of competition from existing participants will very quickly be extinguished. Put another way, if the SEC focuses all of its attention on analyzing and approving the rule changes and other actions necessary to facilitate the completion of these two historic mergers and their post-merger market operations, and does not listen receptively and process expeditiously proposals from the other exchanges, there will be no other competitors. This is an urgent problem that affects the entire market system.

To allow actual and potential competition from smaller markets to wither would be inconsistent with decisions already made by Congress. In 1975, when it amended the Securities Exchange Act of 1934 (the Act), Congress authorized creation of the National Market System (NMS), specifically noting the importance of the securities markets as "an important national asset" and declaring an intention to foster technological innovation and intermarket competition.[2]

If the SEC Approves These Mergers, It Must Also Act to Preserve Competition

NYSE-ARCA AND NASDAQ-INSTINET: GREAT DEALS FOR SHAREHOLDERS AND SEAT OWNERS. WHAT ABOUT INVESTORS?

From the perspectives of the owners, members and other constituents of the NYSE, Arca, Nasdaq, and Instinet, these transactions look like smart moves. The NYSE becomes a public company, takes a quantum leap into electronic trading, positions itself to benefit from Regulation NMS, reenters the world of options trading, and gains a strong presence in the trading of Nasdaq stocks. Arca shareholders become important stakeholders in a liquidity-rich and resource-laden combined enterprise of global scope. Arca itself will have access to the powerful listings and regulatory infrastructure of the NYSE. Instinet and Nasdaq also have bright prospects for their combined enterprise. While less transformational, in that Nasdaq and Instinet both focus on Nasdaq stocks, the combined entity should be a formidable force to be reckoned with. And to the extent the NYSE-Archipelago and Nasdaq-Instinet entities compete to trade each others' listed securities, competition will be enhanced.

In principle, small and large investors alike may benefit from the evolution of these markets. Yet, legislators and the responsible regulatory authorities should not lose sight of the fact that these mergers will result in a huge concentration of trading volume and resources in these two entities. For example, the combined NYSE-Arca will have an 81 percent market share in the trading NYSE-listed shares, based on adding the current market shares of both markets. Likewise Nasdaq-Instinet will have a 56 percent market share of Nasdaq-listed issues. Depending upon how these enterprises integrate their operations, virtually all shares traded in the United States will be traded on 1 of 2 trading systems and under 1 of 2 fee structures, and subject to the self-regulatory oversight of 1 of 2 self-regulators. The lion's share of market data revenues for NYSE and Nasdaq securities will accrue to these two markets on a combined basis, both because of their sheer size and in the NYSE's case because it may have three chances at any given moment of posting the national best bid or offer (namely on the floor, on the NYSEDirect+ electronic "hybrid," and on Arca).

Indeed, presumably one of the main points of these mergers is to eliminate competition through "consolidation." On May 9, NYSE Chief Executive John Thain was quoted as saying: ""The U.S. has too many exchanges—it is too fragmented. . . . The U.S. financial marketplace needed to be rationalized and consolidated . . . ." The implication is clear that he believes the number of competitors should shrink.

Rather than reduce the number of competitors to two, PHLX believes that additional competitors are needed, both to ensure that investors and traders have alternatives, and to force these two behemoths to keep trading costs low and the range and quality of execution and other services high. And we are not alone. The SEC's Chief Economist explained it as follows: "Requiring markets to expose orders to the competing prices offered on alternative platforms forces platforms to address how

[2] See Section 11A(a)(1)(A)–(C) of the Act.

they compete for business."[3] In layperson's terminology, competition between markets forces markets to constantly improve, which is good for investors.

Also relevant is the fact that the NYSE will, as part of this process, become a "for profit" institution, and as Nasdaq completes its separation from the NASD, it will no longer operate in the shadow of a "not-for-profit" enterprise. Though the PHLX has no quarrel with for profit markets—having become one itself by demutualizing in 2004—PHLX believes that the SEC must be particularly mindful that its regulatory process does not unintentionally become an instrument of monopoly creation for these business entities.

In short, while the announced mergers may result in greater returns for the institutions involved and their constituents, we believe that investors may ultimately be disadvantaged.

THE SEC SHOULD BE CONGRATULATED ON THE SUCCESS OF ITS PROMOTION OF INNOVATION BY ELECTRONIC MARKETS. BUT IN THIS VERY SUCCESS ARE THERE THE SEEDS OF FAILURE?

The SEC, too, should be congratulated on having addressed in Regulation NMS many of the criticisms that have been levied over the last decade regarding the operation of the markets. Although the PHLX does not agree with every aspect of the final product (recognizing that the Regulation, as approved, has not yet been published), we believe that the SEC has tackled many of the perceived systemic issues—by adopting clear and uniform trade-through protection in the listed and Nasdaq markets, limiting access-fees and barriers to cross-market access, restricting subpenny quoting and bringing greater transparency to NMS Plan governance. Regulatory reform of the rules for interaction between competing marketplaces will not end with Regulation NMS, but the system as a whole should benefit from the reforms that it embodies.

In an important way, the SEC should be praised for its vision and openness to innovation for reasons beyond Regulation NMS. After all, the two transactions being discussed today are really the culmination of actions taken by the SEC just a few years ago.

In 1997, under the leadership of then Chairman Arthur Levitt, the SEC issued a Concept Release concerning the Regulation of Securities Exchanges[4] and in 1998 approved the seminal rulemaking concerning Regulations of Exchanges and Alternative Trading Systems, which included the adoption of Regulation ATS.[5] At issue in these releases was the fact that some market participants, including Instinet, were using new technology to offer new types of financial services that had many of the aspects of exchanges. In particular, these entities, which have become known as "alternative trading systems," permitted institutions to trade with each other, in many cases without the involvement of a securities dealer, cheaply, anonymously and rapidly.

As alternative trading systems have many of the characteristics of securities exchanges, the SEC was faced with a dilemma regarding how such entities should be regulated. National securities exchanges and national securities associations are subject to comprehensive—some might say onerous—regulation, as compared with the regulatory regime for broker-dealers that applied to nonexchange trading systems. In particular, virtually every material aspect of the operation of a securities exchange or association must be filed with the SEC as a proposed rule change under Section 19 of the Act. In most cases, such proposed rule changes must be approved by the SEC, following a notice and public comment period. In practice, such approval can take many months, and in some cases even longer. The substance of proposed rules must also meet certain statutory criteria.[6]

The SEC was (and is) aware that this approval process can delay significantly the introduction of new products and services, thereby stifling innovation. However, the SEC was concerned that, without some safeguards, the unchecked growth of alternative trading systems could result in the fragmentation of liquidity, a lack of transparency, discrimination against certain market participants, and systemic risk associated with having some market centers that did not meet standards of technical capacity and integrity reliability. The SEC was very innovative in determining ultimately to permit alternative trading systems to elect to be regulated either as broker-dealers or as exchanges, subject to some additional requirements for systems that represent a significant percentage of the trading activity in a given security.

[3] Chester S. Spratt, Address at the Market Microstructure Meeting of the National Bureau of Economic Research (May 6, 2005) (the "Spratt Microstructure Address).

[4] Release No. 34–38672 (May 23, 1997).

[5] Release No. 34–40760 (December 8, 1998).

[6] See Section 6(b) and 15A of the Act.

At the same time, recognizing that this structure would potentially give a competitive edge to alternative trading systems, the SEC adopted a rule that would, in theory permit exchanges to introduce certain "pilot trading systems" with relatively limited regulatory interference.[7]

Alternative trading systems thrived under Regulation ATS—proving the recent assertion of the SEC's Chief Economist that "well placed regulatory changes can affect innovation."[8] Their growth is partly attributable to the alternative trading systems' ability to be nimble in both introducing new products and services and in responding to competition. In fact, it can be said that Regulation ATS allowed Instinet and Arca to challenge the industry incumbents—perhaps even making the transactions that we are discussing today inevitable.

By contrast, for many reasons, some economic, some political, some historical and some regulatory, the exchanges and Nasdaq did not evolve as rapidly. The SEC's structure for leveling the playing field and permitting the rapid introduction of pilot trading systems did not accomplish that end. In PHLX's experience (and it is believed that of other markets), the SEC has generally been extremely cautious about permitting exchanges to flexibly respond to competitive challenges from alternative trading systems.

In the intervening years since 1998, as the alternative trading systems expanded, and the SEC and the marketplace got a view of the full potential of the all-electronic matching engine and (in some cases) electronic routing capabilities that are the hallmark of alternative trading systems, pros and cons emerged. No doubt, the flowering of this model gave rise to challenges, including some that the SEC envisioned as possibilities—discrimination, inaccessibility, fragmentation and discrimination—and some that were perhaps not so clearly foreseen, such as issues raised by subpenny trading, "tape shredding," technical problems and worse caused by access fees, and concerns about regulation of this diffuse marketplace. However, despite these perceived flaws, it is clear that the SEC strongly favors the electronic trading model that is the hallmark of alternative trading systems.

In many ways, Regulation NMS should be viewed as "Regulation ATS—Part 2." It addresses many of the criticisms of how the equities market has evolved since 1998, but also, in effect, powerfully endorses an electronic trading model, especially in relation to its definition of which quotations are "protected" in the "order protection" (that is, trade-through) rule and the new methodology for calculating critically important market data revenues. It may be that these reforms will ultimately doom other modalities of trading in the equities market, including trading floors manned by specialists and floor brokers.

Whether for good or ill, in some respects the market combinations that we discuss today are also a consequence of the success of the alternative trading systems that the SEC's vision helped to foster. Many commentators feel that NYSE's decision to merge with Arca is in large measure a hedge against the future and a recognition of the power of the electronic trading business model. Similarly, Nasdaq clearly perceives that the best way for them to grow stronger quickly is by absorbing their alternative trading system competitors—first Brut ECN and now Instinet.

So, how do we evaluate the success of Regulation ATS, which in effect culminates in 2005 with the advent of Regulation NMS and the two mergers? Surely we must say that the SEC did well in fostering the innovations that have been so successful, and in forging Regulation NMS, which will correct some flaws that have developed over the years in the NMS. However, not only can regulatory actions foster innovation, they can impede innovation as well—as can regulatory inaction. The PHLX thinks that regulatory actions often actively shape business outcomes in the securities markets they can determine winners and losers. PHLX notes that both Instinet and Arca developed relationships with smaller exchanges (the Cincinnati (now known as the National) and Pacific Stock Exchanges, respectively) as part of their growth strategy. So successful were they that they are now, in effect, being bought out by the incumbents they challenged. Investors will suffer if future innovators are not able to collaborate with smaller exchanges.

OTHER SEC INITIATIVES THAT MAY BURDEN COMPETITION

At the same time as it completes its work on Regulation NMS, the SEC is (i) proposing fundamental changes to the governance, ownership and administration of exchanges[9] that will both add considerably to the cost of operating an exchange and limit flexibility in terms of joint ventures and other structures pertaining to ex-

[7] Rule 19b–5.
[8] See Spratt Microstructure Address at p.3.
[9] Release No. 34–50699 (November 18, 2004).

change "facilities,"[10] and (ii) questioning the role of exchanges as self-regulators and funding for regulatory operations in the context of a recent concept release concerning self-regulation.[11] Together, these initiatives have the potential to increase costs and reduce flexibility for competitors to the NYSE-Arca and Nasdaq-Instinet duopoly.

COMPETING EXCHANGES HAVE MUCH TO DO IF THEY ARE TO REMAIN VIABLE: ALL ROADS LEAD THROUGH THE SEC

For the future of inter-market competition, this means smaller exchanges and their members need to adapt quickly if competition is to be preserved in the equities markets. The NYSE hopes to close on its transaction by the first quarter of 2006. Nasdaq and Instinet hope to complete their merger by the end of this year. Note that both of these are prior to the announced implementation of Regulation NMS, which the SEC does not intend to implement fully until June 2006. Competing exchanges therefore must seek out the strategic alliances, develop the technologies, and submit the rule changes they will need to remain competitive before the first quarter of 2006. And the SEC must act on those proposals before the first quarter of 2006. If that timeframe is not met, the potential for competition to the NYSE and Nasdaq may be lost forever.

The PHLX believes that it and other competing exchanges will have to do the following to remain viable:

- If smaller exchanges are to continue to attract orders in the new world, they must modify their systems and trading rules so that they respond to incentives and disincentives contained in Regulation NMS. Failure to adapt will mean that orders sent to floor-based exchanges will be subject to being traded through on electronic markets—a risk that firms routing customer limit orders will not want to take;
- The new market data revenue allocation formula adopted in Regulation NMS rewards a particular type of business model, namely electronic SRO's. The PHLX believes this will direct market data revenues away from floor-based and smaller exchanges. Failure to adapt will also mean the loss of significant revenues from the sale of market data, which is critical to funding and maintaining our regulatory programs and limiting our members' costs of doing business on competing markets;
- We will need to find new and innovative revenue sources and also operating cost efficiencies in order to sustain the significantly increased ongoing regulatory and reporting costs implied by the SEC's proposed rulemaking on SRO governance, ownership, and administration;
- We may be forced to cede, or may voluntarily relinquish, some or all of our self-regulatory functions—functions that many may argue are essential characteristics of each market—either because they will become economically unsustainable or as a result of initiatives that may flow from the SEC's Concept Release on Self-Regulation; and
- Perhaps most importantly, we will have to supercharge our systems, develop creative trading rules and reinvent our fee structures in order to convince our customers, the trading community and the investing public that we offer a clear cut alternative to the impressive trading facilities to be offered by the combined NYSE-Arca and the combined Nasdaq-Instinet.

The PHLX is willing to adapt, and to fight for its survival in these ways. However, at each step we will need to file our rules and fees with the SEC, and if they do not handle these quickly and flexibly, we will not be able to do what is objectively necessary to survive, and no amount of creativity, efficiency, or technological proficiency will make any difference.

The Commissioners and the staff of the Commission—particularly in the Division of Market Regulation, which processes SRO rule filings—are highly knowledgeable, professional and hard working. Moreover, they intend to process rule filings and other requests for the markets in an even handed way. However, they have limited resources. To ensure competition, the SEC must vigorously process the filings of competing markets, and be open minded to the approval of new and innovative structures that will allow markets to compete—fairly and consistently with the mandates of the Act.

[10] See letter dated March 8, 2005 from Meyer S. Frucher, Chairman and CEO of the PHLX, to Jonathan G. Katz at 3 (for a discussion of the implications of the ownership of exchange facilities) and pages 14–21 (for a discussion of the costs and burdens of additional proposed requirements).

[11] Release No. 34–50700 (November 18, 2004).

Of course, one might argue that the regulatory structure under the Act permits prolonged agency consideration, and provides the potential for discretionary (and therefore conservative) handling of SRO proposals to modify their rules and systems. Because of the importance of innovation, however, Congress and the Commission should consider revising the Act or the regulations under it to permit more proposals to become "effective on filing" without prior staff review.[12] The Commodity Futures Modernization Act of 2000 may offer an example. In that legislation, Congress gave futures exchanges greater flexibility to introduce new products and new trading systems through "self-certification" of proposed rules' compliance with statutory requirements.[13] These changes appear to have enhanced the degree of competition in the futures markets, as evidenced by the number of new entrants to the marketplace. The PHLX suggests that Congress and the SEC must grant similar flexibility to securities exchanges to ensure the survival of competition.

Conclusion

Regulation ATS allowed for the blossoming of the alternative trading system electronic model, which can in effect declare victory today, because alternative trading systems were allowed to innovate without undue regulatory friction. Considering that the smaller exchanges will be the only remaining competitive challenges to NYSE-Arca and Nasdaq-Instinet, and that there are numerous other threats to their survival, the reduction or elimination, consistent with the principles of the Act, of regulatory roadblocks is a significant public policy objective.

PHLX believes that it is critical to the survival of competition that the SEC process promptly and with an open mind proposals from all markets, and particularly smaller markets, to introduce new rules, trading facilities and fee structures, and to engage in affiliations, so as to permit them to continue to offer innovative competitive alternatives that will be attractive to the marketplace. We would respectfully urge this Committee to keep itself appraised of developments in this regard during the weeks and months to come. If it is necessary to streamline the process by which such initiatives may be introduced, then we would likewise submit that such reforms would be worthwhile in the interest of keeping competition alive, before it is too late to do so.

[12] See Section 19(b)(3)(A) of the Act.

[13] See Section 5c(c)(1) of the Commodity Exchange Act.

TESTIMONY OF KIM BANG,

PRESIDENT AND CHIEF EXECUTIVE OFFICER

BLOOMBERG TRADEBOOK LLC,

BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

REGARDING

"REGULATION NMS AND RECENT MARKET DEVELOPMENTS"

MAY 18, 2005

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, MY NAME IS KIM BANG, AND I AM PLEASED TO TESTIFY ON BEHALF OF BLOOMBERG TRADEBOOK REGARDING "REGULATION NMS AND RECENT MARKET DEVELOPMENTS".

BLOOMBERG TRADEBOOK IS OWNED BY BLOOMBERG L.P. AND IS LOCATED IN NEW YORK CITY. BLOOMBERG L.P. PROVIDES MULTIMEDIA, ANALYTICAL AND NEWS SERVICES TO MORE THAN 200,000 TERMINALS USED BY 250,000 FINANCIAL PROFESSIONALS IN 100 COUNTRIES WORLDWIDE. BLOOMBERG TRACKS MORE THAN 135,000 EQUITY SECURITIES IN 85 COUNTRIES, MORE THAN 50,000 COMPANIES TRADING ON 82 EXCHANGES AND MORE THAN 406,000 CORPORATE BONDS. BLOOMBERG NEWS IS SYNDICATED IN OVER 350 NEWSPAPERS, AND ON 550 RADIO AND TELEVISION STATIONS WORLDWIDE. BLOOMBERG

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BLOOMBERG TRADEBOOK IS A GLOBAL ELECTRONIC AGENCY BROKER SERVING INSTITUTIONS AND OTHER BROKER-DEALERS. WE COUNT AMONG OUR CLIENTS MANY OF THE NATION'S LARGEST INSTITUTIONAL INVESTORS REPRESENTING — THROUGH PENSION FUNDS, MUTUAL FUNDS AND OTHER VEHICLES — THE SAVINGS OF MILLIONS OF ORDINARY AMERICANS.

WE'VE BEEN ASKED TO PROVIDE OUR TAKE ON THE PROPOSED MERGERS AND ON REGULATION NMS. WE ARE DELIGHTED TO DO SO, WITH TWO CAVEATS. FIRST, AS TO THE MERGERS, IT'S EARLY IN THE PROCESS AND CLEARLY WE'LL BE INTERESTED IN GATHERING MORE INFORMATION BEFORE REACHING A CONCLUSIVE ASSESSMENT. SECOND, AS TO REG NMS, AS YOU KNOW THE FINAL RULE ITSELF HAS NOT BEEN MADE PUBLIC YET. WE MAY HAVE A DIFFERENT REACTION TO REG NMS ONCE WE HAVE AN OPPORTUNITY TO ANALYZE THE TEXT OF THE RULE AND THE COMMISSION'S DISCUSSION OF IT IN THE ACCOMPANYING RELEASE.

I. THE UNDERLYING ISSUE DRIVING REG NMS IS THE NEAR MONOPOLY THE NYSE ENJOYS OVER THE TRADING VOLUME IN ITS LISTED SECURITIES

THE NYSE HAS AN 80% MARKET SHARE IN ORDER FLOW AND COMPLETE CONTROL OF THE FUNDAMENTAL RAW MATERIAL OF TRADING, MARKET DATA. THAT MARKET SHARE AND CONTROL ARE THE RESULT OF GOVERNMENTALLY CONFERRED PRIVILEGES, NOT THE RESULT OF COMPETITIVE EXCELLENCE.

NOW, INVESTORS ARE BEING CONFRONTED WITH A PROPOSED MERGER THAT WOULD TRANSFORM THE NYSE INTO A FOR-PROFIT ENTITY. WHILE SUCH A TRANSFORMATION WILL BE A BOON FOR NYSE SEAT-HOLDERS, IT IS FAIR TO ASK — WILL IT BE A BOON FOR THE INVESTING PUBLIC? DOES REG NMS CONSTITUTE ENOUGH OF A REGULATORY OVERHAUL OF THE NYSE THAT THE PROPOSED TRANSFORMATION TO A FOR-PROFIT ENTITY WILL RESULT IN A SUPERIOR NATIONAL MARKET STRUCTURE?

II. THE OTC MARKET AS A MODEL FOR A SUPERIOR NATIONAL MARKET SYSTEM

THE NASDAQ MARKET SINCE 1996 PRESENTS THE OPPOSITE PICTURE — IT IS A MARKET INTO WHICH REGULATION INTRODUCED AND ENCOURAGED COMPETITION AND INNOVATION. THE NASDAQ PRICE-FIXING SCANDAL OF THE MID-1990S RESULTED IN THE SEC'S 1996

ISSUANCE OF THE ORDER-HANDLING RULES. THOSE RULES ENHANCED TRANSPARENCY AND COMPETITION IN THE NASDAQ MARKET AND PERMITTED ELECTRONIC COMMUNICATIONS NETWORKS — ECNS — TO LEVEL THE PLAYING FIELD BETWEEN INVESTORS AND INTERMEDIARIES BY GRANTING INVESTORS THE ABILITY TO DRIVE THE QUOTE AND ACCESS LIQUIDITY DIRECTLY. THIS IMPROVED OUR NATIONAL MARKET SYSTEM.

INDEED, THE INCREASED TRANSPARENCY PROMOTED BY THE SEC'S ORDER-HANDLING RULES AND THE SUBSEQUENT INTEGRATION OF ECNS INTO THE NATIONAL QUOTATION MONTAGE NARROWED NASDAQ SPREADS BY NEARLY 30%. THESE, AND SUBSEQUENT REDUCTIONS IN TRANSACTIONAL COSTS, CONSTITUTE SIGNIFICANT SAVINGS THAT ARE NOW AVAILABLE FOR INVESTMENT THAT FUELS BUSINESS EXPANSION AND JOB CREATION.

IN THE RECENT SCANDALS INVOLVING THE NYSE SPECIALISTS, THE SEC HIT A GRAND SLAM FOR INVESTOR PROTECTION — ALL SEVEN SPECIALIST FIRMS WERE FOUND TO HAVE DAMAGED INVESTORS BY TRADING AHEAD OF THEIR ORDERS AND ENGAGING IN OTHER ILLEGAL CONDUCT AS A ROUTINE COURSE OF BUSINESS. THE SPECIALISTS WERE FINED 250 MILLION DOLLARS AND FACE ADDITIONAL REGULATORY SANCTIONS. THE NYSE ITSELF WAS CENSURED FOR FAILURE TO ENFORCE THE LAW — WHICH IS REMINISCENT OF THE

SANCTIONS IMPOSED ON THE NASD IN 1996. THAT ILLEGAL BEHAVIOR UNDERSCORED THE WEAKNESS OF THE NYSE'S SELF-REGULATORY SYSTEM AND DEMONSTRATED THE NEED FOR SUBSTANTIAL REFORM. AS WAS THE CASE IN THE NASDAQ MARKET, THE PROBLEM IN THE NYSE WAS SYSTEMIC. WHEN WE GET THE NATIONAL MARKET STRUCTURE RIGHT, THERE WILL BE MORE TRANSPARENCY, MORE DIRECT ACCESS FOR INVESTORS, AND HENCE SIMPLY LESS OPPORTUNITY FOR ABUSE MOVING FORWARD.

III. HISTORICAL BACKGROUND — THE INTERMARKET TRADING SYSTEM (ITS) TRADE-THROUGH RULE HAS FUNCTIONED AS PROTECTIONIST REGULATION

THE EXISTING INTERMARKET TRADING SYSTEM TRADE-THROUGH RULE HAS BEEN AMONG THE FOREMOST IMPEDIMENTS TO COMPETITION AND MARKET EFFICIENCY. IN THEORY, THE EXISTING INTERMARKET TRADE-THROUGH RULE IS SUPPOSED TO RESULT IN INVESTORS' RECEIVING THE "BEST PRICE". IN REALITY, THE EXISTING RULE HAS PROTECTED THE NYSE WHILE FRUSTRATING INVESTOR EFFORTS TO OBTAIN THE "BEST PRICE".

THE MECHANISM OF THIS PROTECTIONIST PROP IS SIMPLE. WHILE ELECTRONIC VENUES OFFER FIRM QUOTES, THE NYSE OFFERS INDICATIVE QUOTES — QUOTES THAT MAY OR MAY NOT BE REAL.

ELECTRONIC VENUES ARE REQUIRED TO TAKE WHAT MAY BE A 30-SECOND DETOUR TO THE NYSE — OFTEN CHASING ILLUSORY QUOTES. WHILE SOMETIMES PRICE IMPROVEMENT OCCURS, OFTEN THE ORDER IS HELD OR REJECTED AS THE MARKET MOVES AWAY OR THE ORDER IS FILLED AT A PRICE INFERIOR TO THE ONE ADVERTISED.

IV. A NEW TRADE-THROUGH RULE

THE SEC'S REG NMS WAS DESIGNED TO REFORM THE NYSE BY FIRMING UP THE NYSE'S QUOTES, IMPROVING TRANSPARENCY, AND ENCOURAGING DIRECT ACCESS TO THE NATIONAL MARKET SYSTEM. TO THE SEC'S CREDIT, ITS SUSTAINED EFFORTS ARE FORCING MOVEMENT TOWARD REFORM.

LET'S LOOK AT THE NEW TRADE-THROUGH RULE RECENTLY APPROVED BY THE SEC (AT LEAST BASED ON WHAT WE HEARD IN THE OPEN MEETING). FIRST, IT ELIMINATES THE OLD INTERMARKET TRADING SYSTEM TRADE-THROUGH RULE, WHICH HAS BEEN A BAR TO COMPETITION AND A PROTECTIONIST PROP FOR THE NYSE. SECOND, BY PROVIDING PROTECTION ONLY TO "FAST" QUOTES, IT OFFERS THE POTENTIAL THAT INVESTORS WON'T HAVE THEIR ORDERS HELD ON THE FLOOR. THESE ARE ENORMOUS BENEFITS.

WHILE A NEW TRADE-THROUGH RULE ISN'T BLOOMBERG'S PREFERRED APPROACH, IT IS ONE POTENTIALLY EFFECTIVE PATHWAY TO

THE GOAL OF PROMOTING A SUPERIOR NATIONAL MARKET SYSTEM. EFFECTIVELY IMPLEMENTED, THE SEC-APPROVED REG NMS COULD BE A LARGE NET PLUS FOR THE MARKET.

V. PART OF THE PUZZLE—TRADE-THROUGH INTERACTION WITH THE HYBRID

WHAT DO WE MEAN BY "EFFECTIVELY IMPLEMENTED"? THERE ARE MANY PIECES TO THE MARKET STRUCTURE PUZZLE — REG NMS, THE NYSE'S "OPEN BOOK" MARKET DATA PROPOSAL, PROPOSED MERGERS AND THE NYSE HYBRID PROPOSAL. WE NEED TO GET ALL OF THEM RIGHT. AS PRESENTLY PROPOSED, SEVERAL ASPECTS OF THE HYBRID PROPOSAL CUT AGAINST THE COMMISSION'S GOALS OF TRANSPARENCY AND FAIRNESS.

THE HYBRID MARKET PROPOSAL IS DESIGNED AT LEAST IN PART TO PROTECT AND PRESERVE THE SPECIAL TIME-AND-PLACE ADVANTAGES THE NYSE FLOOR CURRENTLY ENJOYS. UNLESS REINED IN BY THE SEC, THIS HYBRID SCHEME COULD WELL UNDERMINE THE GOOD INTENTIONS OF THE SEC EMBODIED IN REG NMS.

HOW MIGHT THE HYBRID UNDERMINE REG NMS? THE NYSE HAS PROPOSED A "CLEAN UP" PRICE — THAT IS, THE PRICE AT WHICH INCOMING ORDERS WILL BE FILLED AGAINST ORDERS ON THE SPECIALIST'S BOOK — WHICH UNFAIRLY PENALIZES INCOMING MARKET

AND MARKETABLE LIMIT ORDERS. IT DOES SO BY CHOOSING ARBITRARILY TO GIVE LIMIT ORDERS ALREADY ON THE SPECIALIST'S BOOK A BETTER DEAL THAN THEY HAD BARGAINED FOR IN SETTING THEIR LIMIT PRICES, AT THE EXPENSE OF THE INCOMING PUBLIC INVESTOR'S ORDER.

IF ALL ORDER GIVERS WERE BEING TREATED EQUALLY, THAT REGULATORY SUBSIDY FOR LIMIT ORDERS MIGHT BE DEFENSIBLE ON THE THEORY THAT INVESTORS SHOULD BE FAIRLY REWARDED FOR STEPPING UP AND GIVING THE MARKET WHAT IS IN ESSENCE A FREE OPTION. BUT ALL ORDER GIVERS AREN'T BEING TREATED EQUALLY. UNDER THE PROPOSED "BROKER AGENCY INTEREST FILE" AND "SPECIALIST INTEREST FILE", FLOOR BROKERS AND SPECIALISTS WILL BE PERMITTED TO PLACE HIDDEN ORDERS INTO THE MARKET THAT WOULD BE PERMITTED TO JUMP AHEAD OF PUBLIC, DISCLOSED ORDERS. FLOOR MEMBERS SHOULD NOT BE ALLOWED TO JUMP AHEAD OF THE PUBLIC.

VI. WHAT IS THE IMPACT OF THE RECENTLY-ANNOUNCED MERGERS AMONG MAJOR MARKET PARTICIPANTS?

THE CURRENT ROUND OF MERGERS TAKES PLACE ON TOP OF AN ALREADY SIGNIFICANT ROUND OF CONSOLIDATIONS, INCLUDING NASDAQ'S PURCHASE OF BRUT. ARE THESE DEVELOPMENTS GOOD OR BAD FOR INVESTORS AND THE MARKETS? THAT DEPENDS ON THE STEPS

TAKEN BY POLICY MAKERS HERE ON THE HILL, AT THE SEC, AND ELSEWHERE.

IN MANY WAYS, THE MAJOR CONSEQUENCE OF THE PROPOSED NYSE/ARCHIPELAGO MERGER IS THE FACT THAT THE NYSE WILL NOW BECOME A FOR-PROFIT ENTITY. WHILE THE CONTROVERSY OVER FORMER CHAIRMAN GRASSO'S PAY PACKAGE SUGGESTS THAT THE NYSE WASN'T FUNCTIONING AS A TRADITIONAL NOT-FOR-PROFIT, THIS CHANGE IN THE NYSE'S STATUS AND INCENTIVES IS STILL ENORMOUS.

THE NYSE WILL NOW FUNCTION AS A FOR-PROFIT ENTITY, ONE THAT STARTS WITH MORE THAN 80% MARKET SHARE, AS WELL AS BEING THE REGULATOR, THE MARKETPLACE, AND THE BENEFICIARY OF A GOVERNMENT-SPONSORED INFORMATION MONOPOLY. THE NYSE IS WEARING A LOT OF HATS, MANY OF THEM CONFLICTING. AS A FOR-PROFIT ENTITY, THE NYSE WILL HAVE A FIDUCIARY OBLIGATION TO EXTRACT MAXIMAL BENEFIT FOR SHAREHOLDERS. WHAT ARE THE REAL-WORLD IMPLICATIONS OF AN ENTITY THAT ENJOYS MONOPOLY POWERS SUDDENLY BEING CHARGED WITH MAXIMIZING BENEFIT FOR SHAREHOLDERS? THE POLICY RAMIFICATIONS ARE SUBSTANTIAL AND THE NEED FOR VIGILANCE WILL BE AS WELL.

LET'S LOOK AT JUST TWO ISSUES — THE COST OF, AND ACCESS TO, INFORMATION.

VII. CONFLICTS INHERENT IN A FOR-PROFIT EXCHANGE ENJOYING A GOVERNMENT-SPONSORED INFORMATION MONOPOLY — COST OF INFORMATION

MARKET DATA IS THE "OXYGEN" OF THE FINANCIAL MARKETS. ENSURING THAT MARKET DATA IS AVAILABLE IN A FASHION WHERE IT IS AFFORDABLE TO INVESTORS AND WHERE MARKET PARTICIPANTS HAVE THE WIDEST POSSIBLE LATITUDE TO OBTAIN AND ADD VALUE ON A LEVEL PLAYING FIELD MUST BE CRITICAL PRIORITIES.

BEFORE THE 1970S, NO STATUTE OR RULE REQUIRED SELF-REGULATORY ORGANIZATIONS (SROS) TO DISSEMINATE MARKET INFORMATION TO THE PUBLIC OR TO CONSOLIDATE INFORMATION WITH INFORMATION FROM OTHER MARKET CENTERS. INDEED, THE NYSE, WHICH OPERATED THE LARGEST STOCK MARKET, CLAIMED AN OWNERSHIP INTEREST IN MARKET DATA, SEVERELY RESTRICTING ACCESS TO MARKET INFORMATION. MARKETS AND INVESTORS SUFFERED FROM THIS LACK OF TRANSPARENCY.

AT THE URGING OF THE SEC, CONGRESS RESPONDED BY ENACTING THE SECURITIES ACTS AMENDMENTS OF 1975. THESE AMENDMENTS EMPOWERED THE SEC TO FACILITATE THE CREATION OF A NATIONAL MARKET SYSTEM FOR SECURITIES, WITH MARKET PARTICIPANTS REQUIRED TO PROVIDE — IMMEDIATELY AND WITHOUT

COMPENSATION — INFORMATION FOR EACH SECURITY THAT WOULD THEN BE CONSOLIDATED INTO A SINGLE STREAM OF INFORMATION.

AT THE TIME, CONGRESS CLEARLY RECOGNIZED THE DANGERS OF DATA-PROCESSING MONOPOLIES. THE REPORT ACCOMPANYING THE 1975 AMENDMENTS EXPRESSLY WARNS THAT:

> "PROVISION MUST BE MADE TO INSURE THAT THIS CENTRAL PROCESSOR IS NOT UNDER THE CONTROL OR DOMINION OF ANY PARTICULAR MARKET CENTER. ANY EXCLUSIVE PROCESSOR IS, IN EFFECT, A PUBLIC UTILITY, AND THUS IT MUST FUNCTION IN A MANNER WHICH IS ABSOLUTELY NEUTRAL WITH RESPECT TO ALL MARKET CENTERS, ALL MARKET MAKERS, AND ALL PRIVATE FIRMS." REPORT OF THE SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS TO ACCOMPANY S.249, S. REP. NO. 94-75, 94TH CONG., 1ST SESS. 11 (1975).

UNDER REG NMS, THE SAME CONCERNS THAT ANIMATED THE CONGRESSIONAL WARNINGS ABOUT A CENTRAL PROCESSOR APPLY TO EXCLUSIVE SECURITIES INFORMATION PROCESSORS, SUCH AS THE NYSE, THAT COLLECT AND DISTRIBUTE INFORMATION ON AN EXCLUSIVE BASIS. THE COMMISSION SHOULD BE NO LESS VIGILANT IN POLICING THE CONDUCT OF SUCH EXCLUSIVE PROCESSORS THAN THE COMMISSION WOULD BE IN GUARDING AGAINST THE CENTRAL PROCESSOR ABUSES OF WHICH CONGRESS WARNED.

EVEN AS NOT-FOR-PROFIT ENTITIES, SROS HISTORICALLY HAVE EXPLOITED THE OPPORTUNITY TO SUBSIDIZE OTHER COSTS (E.G., EXECUTIVE COMPENSATION, COST OF MARKET OPERATION, MARKET REGULATION, MARKET SURVEILLANCE, MEMBER REGULATION) THROUGH THEIR GOVERNMENT-SPONSORED MONOPOLY ON MARKET INFORMATION FEES. THIS SUBSIDY IS TROUBLING ENOUGH BY ITSELF — IT'S NOT CLEAR WHY THE INVESTOR SHOULD BE SUBSIDIZING MARKET OPERATIONS THAT GENERATE ENORMOUS BENEFITS AND REVENUE FOR LARGE EXCHANGE MEMBERS. THE INCENTIVE TO EXPLOIT THIS MONOPOLY POSITION WILL BE EVEN STRONGER AS SROS CONTEMPLATE FOR-PROFIT FUTURES AND NEW LINES OF BUSINESS.

BEFORE THE MERGER WAS ANNOUNCED, THE SEC LAUNCHED A PUBLIC DISCUSSION OF MARKET DATA REVENUES AND WHETHER THEY SHOULD BE COST-BASED. BLOOMBERG STRONGLY SUPPORTS COST-BASED LIMITS ON MARKET INFORMATION FEES AND BELIEVES THE IMPENDING FOR-PROFIT STATUS OF THE NYSE LENDS GREATER URGENCY TO THIS INITIATIVE.

IN ITS 1999 CONCEPT RELEASE ON MARKET DATA, THE COMMISSION NOTED THAT MARKET DATA SHOULD BE FOR THE BENEFIT OF THE INVESTING PUBLIC. INDEED, MARKET DATA ORIGINATES WITH SPECIALISTS, MARKET MAKERS, BROKER-DEALERS AND INVESTORS. THE EXCHANGES AND THE NASDAQ MARKETPLACE ARE NOT THE SOURCES OF

MARKET DATA, BUT RATHER THE FACILITIES THROUGH WHICH MARKET DATA ARE COLLECTED AND DISSEMINATED. IN ITS 1999 RELEASE, THE SEC PROPOSED A COST-BASED LIMIT TO MARKET DATA REVENUES.

THAT COST-BASED APPROACH WOULD NOT REQUIRE THE NYSE AND NASDAQ TO SELL THE DATA AT COST. INSTEAD, IT WOULD REQUIRE THE CHARGES TO BE REASONABLY RELATED TO THE COST OF COLLECTING AND DISSEMINATING THE DATA. TODAY, *AS NOT-FOR-PROFIT ENTITIES* THE SRO NETWORKS SPEND ABOUT $40 MILLION ON COLLECTION AND DISSEMINATION AND RECEIVE OVER TEN TIMES THAT MUCH — $424 MILLION — IN REVENUES.[1] THOSE REVENUES COME FROM INVESTORS. FOR MONOPOLISTS SUCH AS THE NYSE AND NASDAQ TO CONTINUE TO RIDE ON THAT GRAVY TRAIN IS SIMPLY WRONG. IF INVESTORS ARE PAYING ROUGHLY TEN TIMES THE COST OF AGGREGATION AND DISSEMINATION OF MARKET DATA WHEN DEALING WITH NOT-FOR-PROFIT ENTITIES, WHAT WILL INVESTORS BE PAYING WHEN THE NYSE AND NASDAQ ARE FOR-PROFIT ENTITIES CHARGED WITH MAXIMIZING SHAREHOLDER INTEREST?

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1 *See*, Regulation NMS, Securities Exchange Act Release No. 50870 (December 16, 2004) in text accompanying n. 286:

> In 2003, the Networks collected $424 million in revenues derived from market data fees and, after deduction of Network expenses, distribute $386 million to their individual SRO participants. [footnote omitted].

THE SEC WILL BE REVIEWING MARKET DATA FEES AS PART OF THE SRO STRUCTURE CONCEPT RELEASE. WE URGE THE SEC TO MOVE EXPEDITIOUSLY TO ADDRESS THIS IMPORTANT ISSUE, AND WE EMBRACE THE SECURITIES INDUSTRY ASSOCIATION'S CALL FOR A COST-BASED APPROACH TO MARKET DATA FEES. INDEED, IT IS POWERFUL TESTIMONY WHEN AN ORGANIZATION LIKE THE SIA NOT ONLY OPPOSES THE EXPENDITURE OF MARKET DATA FEES FOR REGULATION BUT ALSO FAVORS THE IMPOSITION OF SEPARATELY CHARGED AND TRANSPARENTLY ACCOUNTED-FOR REGULATORY FEES, TO COVER THE REGULATORY COSTS.[2] IT SPEAKS VOLUMES ABOUT THE FEARS THAT INFORMED MARKET PARTICIPANTS HAVE ABOUT THE CURRENT MARKET DATA FEE STRUCTURE THAT THEY WOULD PREFER TO HAVE A SEPARATE FEE LEVIED ON THEM THAN TO CONTINUE WITH THE STATUS QUO.

EVERY INVESTOR WHO BUYS AND SELLS STOCKS HAS A LEGITIMATE CLAIM TO THE OWNERSHIP OF THE DATA AND LIQUIDITY HE OR SHE PROVIDES TO MARKET CENTERS. FUNNELING EXCLUSIVE LIQUIDITY INFORMATION TO EXCHANGE MEMBERS AND FUNNELING MARKET DATA REVENUES TO EXCHANGES AND NASDAQ AND NOT TO INVESTORS SHIFTS THE REWARDS FROM THOSE WHO TRADE TO THOSE WHO FACILITATE TRADING. THAT IS WRONG IN OUR VIEW — THE BENEFITS OUGHT TO BE CONFERRED UPON THE PUBLIC.

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2 SIA letter to SEC (June 30, 2004) in SEC File No. S7-10-04, at page 23.

IN 2002, BLOOMBERG L.P., IN CONSULTATION WITH TWO DISTINGUISHED ECONOMISTS — DR. GEORGE HAY, THE FORMER DIRECTOR OF ECONOMICS OF THE ECONOMIC POLICY OFFICE OF THE ANTITRUST DIVISION OF THE UNITED STATES DEPARTMENT OF JUSTICE AND DR. ERIK SIRRI, THE FORMER CHIEF ECONOMIST OF THE SEC — SUBMITTED TO THE SEC A DISCUSSION PAPER ENTITLED "COMPETITION, TRANSPARENCY, AND EQUAL ACCESS TO FINANCIAL MARKET DATA". THE PAPER DELINEATED THE WAYS IN WHICH THE EXCHANGES, IN THE ABSENCE OF STRUCTURAL PROTECTIONS, MAY ABUSE THEIR MONOPOLY POWER OVER THE COLLECTION OF MARKET INFORMATION TO THE DETRIMENT OF CONSUMERS, COMPETITORS AND THE NATIONAL MARKET SYSTEM. THE PAPER PROPOSED STRUCTURAL CHANGES TO ADDRESS THESE POSSIBLE ABUSES. THE ISSUES RAISED IN THE PAPER ARE SQUARELY BEFORE US WITH THE NYSE'S PROPOSED MERGER. INDEED, THESE ISSUES HAVE BEEN ILLUSTRATED BY BLOOMBERG L.P.'S THREE YEAR-LONG CONFLICT WITH THE NYSE OVER RESTRICTIONS THE NYSE HAD HOPED TO IMPOSE ON THE DISSEMINATION OF DECIMALIZED INFORMATION TO INVESTORS.

VIII. CONFLICTS INHERENT IN A FOR-PROFIT EXCHANGE ENJOYING A GOVERNMENT-SPONSORED INFORMATION MONOPOLY—ACCESS TO INFORMATION

DECIMALIZATION HAS BEEN A BOON TO INVESTORS, DRAMATICALLY REDUCING SPREADS, AND AN ENORMOUS SPUR TO MARKET EFFICIENCY. HOWEVER, THE RULES GOVERNING THE DISPLAY OF MARKET DATA — RULES CRAFTED IN AN ERA OF EIGHTHS AND SIXTEENTHS — HAVE NEVER BEEN UPDATED TO REFLECT DECIMALIZATION.

SINCE DECIMALIZATION INTRODUCED 100 PRICE POINTS TO THE DOLLAR AND QUOTING IN A PENNY -- IN PLACE OF THE PREVIOUS PRACTICE OF QUOTING IN FRACTIONS OF A DOLLAR AT SIX AND ¼ CENTS OR 12 AND ½ CENTS -- THE AMOUNT OF TRANSPARENCY AND LIQUIDITY AVAILABLE AT THE NATIONAL BEST BID AND OFFER IS MUCH SMALLER THAN BEFORE. THE SIA, IN COMMENTING ON REG NMS, ACCURATELY OBSERVED: "THE VALUE OF THE NBBO — THE CORNERSTONE OF THE MARKET DATA SYSTEM — IS LESS THAN IT WAS PRIOR TO DECIMALIZATION. WE BELIEVE THAT THE SEC HAS A RESPONSIBILITY TO ADDRESS THIS ISSUE IN LIGHT OF THE OPERATION OF ITS QUOTE AND

DISPLAY RULES (RULES 11Ac1-1 AND 11Ac1-4 UNDER THE EXCHANGE ACT)…."[3]

BLOOMBERG L.P. PUBLISHES DATA ON EQUITY SECURITIES MARKETS THROUGHOUT THE WORLD. EVERY SIGNIFICANT MARKET OTHER THAN THE NYSE AND THE MEXICAN MARKET CURRENTLY PUBLISHES REAL-TIME QUOTATIONS AT A MINIMUM OF FIVE LEVELS DEEP FOR ALL INVESTORS TO SEE AND IMMEDIATELY ACCESS ELECTRONICALLY. AS THE LARGEST EQUITY MARKET IN THE WORLD, THE NYSE SHOULD NOT CONTINUE TO DENY INVESTORS AND FIDUCIARIES THE SAME TRANSPARENCY AND ACCESS TO LIQUIDITY BEYOND THE NATIONAL BEST BID AND OFFER.

THUS, BLOOMBERG L.P. WAS ENCOURAGED WHEN, LATE IN 2002, THE NYSE FILED WITH THE SEC A PROPOSED RULE CHANGE THAT WOULD PERMIT THE DISPLAY AND USE OF QUOTATIONS IN STOCKS TRADED ON THE NYSE TO SHOW ADDITIONAL DEPTH IN THE MARKET FOR THOSE STOCKS.

THE GOOD NEWS — THE NYSE'S "LIQUIDITY QUOTE" PROPOSAL COULD RESULT IN THE DISPLAY OF ADDITIONAL DEPTH. THE BAD NEWS — THE NYSE HAD PROPOSED TO EXPLOIT ITS STATUS AS A

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3 Securities Industry Association, Comment letter on Regulation NMS (February 1, 2005) at p. 24, in SEC File No. S7-10-04.

GOVERNMENT-SPONSORED MONOPOLY TO REQUIRE CERTAIN VENDORS TO SIGN CONTRACTS THAT WOULD PLACE SEVERE RESTRICTIONS ON THE USE OF LIQUIDITY QUOTE DATA. THOSE RESTRICTIONS WOULD HAVE REQUIRED VENDORS TO ADVANTAGE THE NYSE OVER COMPETING MARKET CENTERS WHEN IT CAME TO THE DISPLAY OF DECIMALIZED DATA WHILE ALSO PRECLUDING BLOOMBERG FROM ADDING VALUE TO THIS DATA IN A WAY THAT BENEFITS INVESTORS AND THE MARKETS. THE NYSE'S ORIGINAL PROPOSAL WOULD HAVE PROHIBITED DATA VENDORS FROM INTEGRATING NYSE LIQUIDITY QUOTE DATA WITH DATA FROM OTHER MARKET CENTERS.

IN SHORT, THE PROMISE OF ENHANCED TRANSPARENCY AT THE HEART OF DECIMALIZATION WOULD HAVE BEEN THWARTED. INSTEAD, THE NYSE PROPOSED TO LEVERAGE ITS GOVERNMENT-SPONSORED MONOPOLY OVER MARKET DATA DOWNSTREAM TO UNFAIRLY DISADVANTAGE NOT ONLY COMPETITORS IN THE TRADING MARKET, BUT ALSO COMPETITORS IN THE INFORMATION MARKET.

WHEN FACED WITH COMPARABLE TERMS IN THE CONTEXT OF THE NYSE'S OPEN BOOK PROPOSAL, THE SEC STATED THAT "THE NYSE'S PROPOSED RESTRICTIONS ON VENDOR RE-DISSEMINATION OF OPEN BOOK DATA, INCLUDING THE PROHIBITION ON PROVIDING THE FULL DATA FEED AND PROVIDING ENHANCED, INTEGRATED, OR CONSOLIDATED DATA FOUND IN THESE AGREEMENTS ARE ON THEIR FACE DISCRIMINATORY,

AND MAY RAISE FAIR ACCESS ISSUES UNDER THE ACT." Securities Exchange Act Release 44138 (December 7, 2001).

IN LIGHT OF THIS ADMONITION, IT IS UNFORTUNATE THAT THE NYSE OPTED TO ATTEMPT TO IMPOSE IN THE LIQUIDITY QUOTE CONTEXT THE SAME ILLEGAL AND ANTICOMPETITIVE CONDITIONS THAT SO TROUBLED THE SEC IN THE OPEN BOOK CONTEXT. AFTER EXTENSIVE REVIEW AND ANALYSIS, THE SEC ON APRIL 2, 2003 UNANIMOUSLY STRUCK DOWN THE NYSE'S RESTRICTIVE CONTRACTS. THE COMMISSION HELD THE NYSE'S BARRIERS TO INTEGRATED MARKET DISPLAYS WOULD: "IMPOSE ON USERS INTEGRATION COSTS WITH RESPECT TO IMMEDIATELY EXECUTABLE, MARKET-WIDE QUOTATIONS IN A MANNER THAT WOULD: (1) BE INCONSISTENT WITH FOSTERING "COOPERATION AND COORDINATION WITH PERSONS ENGAGED IN PROCESSING INFORMATION WITH RESPECT TO SECURITIES"; (2) "BE DESIGNED TO PERMIT UNFAIR DISCRIMINATION BETWEEN CUSTOMERS"; AND (3) IMPEDE, RATHER THAN REMOVE IMPEDIMENTS TO, A "FREE AND OPEN MARKET AND A NATIONAL MARKET SYSTEM." Securities Exchange Act Release No. 47614 (April 2, 2003), SEC File No. SR-NYSE-2002-55.

EVEN AS A NOT-FOR-PROFIT ENTITY, IN THE CONTEXT OF LIQUIDITY QUOTE AND OPEN BOOK THE NYSE'S IDEA OF COMPETITION HAS BEEN TO TRY TO USE ITS MONOPOLY TO BAN OTHERS FROM COMPETING. IF THE NYSE BECOMES A FOR-PROFIT ENTITY AS A RESULT

OF THE PROPOSED MERGER, THE INCENTIVES FOR ABUSIVE MONOPOLY BEHAVIOR THAT UNDERMINES THE GOALS OF THE NATIONAL MARKET SYSTEM WILL BE FAR GREATER. IF THERE IS CONSOLIDATION IN THE MARKET BECAUSE THE MARKET DEMANDS IT, THAT IS A GOOD THING, BUT SUCH CONSOLIDATION ARGUES FOR GREATER REGULATORY VIGILANCE.

FOR EXAMPLE, THE FEES THE NYSE PROPOSES TO CHARGE FOR ACCESS TO LIQUIDITY QUOTE DATA ON A REAL-TIME BASIS ARE APPROXIMATELY EQUAL TO THE FEES THE NYSE CURRENTLY CHARGES FOR ACCESS TO ALL OTHER NYSE MARKET DATA ON A REAL-TIME BASIS — ABOUT $50 A MONTH PER USER. THESE FEES WOULD EFFECTIVELY ***DOUBLE*** THE AVERAGE FEES INVESTORS PAY TODAY FOR NYSE REAL-TIME DATA. SINCE DECIMALIZATION HAS REDUCED THE VALUE OF THE EXISTING BBO DATA, THE INVESTORS WOULD EFFECTIVELY BE PAYING TWICE TO RECEIVE INFORMATION EQUIVALENT IN ECONOMIC VALUE TO WHAT THEY USED TO RECEIVE BEFORE DECIMALIZATION. THE NYSE SHOULD NOT BE ABLE TO EXTRACT THESE KINDS OF MONOPOLY RENTS FROM THE MARKETS AND INVESTORS WITHOUT JUSTIFICATION AND WITHOUT EVEN A CURSORY SHOWING OF THE COSTS INVOLVED IN PRODUCING THIS DATA.

THESE FEES AND RESTRICTIONS ON USE OF INFORMATION LED NUMEROUS MARKET PARTICIPANTS — INCLUDING THE UNITED

STATES CHAMBER OF COMMERCE, THE SECURITIES INDUSTRY ASSOCIATION, THE SECURITY TRADERS ASSOCIATION OF NEW YORK, AND OTHERS — TO EXPRESS SERIOUS CONCERNS REGARDING THE NYSE'S ACTIONS.[4]

THE SEC IS TO BE COMMENDED FOR ITS EXTRAORDINARY COMMITMENT OF TIME AND EFFORT ALREADY IN ANALYZING THE ONGOING LIQUIDITY QUOTE/OPEN BOOK ISSUE. THAT KIND OF OVERSIGHT WILL NEED TO BE THE MODEL IF WE ARE TO ADDRESS CONFLICTS IN AN INCREASINGLY CONCENTRATED MARKET.

IX. TRANSPARENCY IS GOOD FOR INVESTORS AND THE NATIONAL MARKET SYSTEM

CONGRESS AND THE COMMISSION SHOULD GIVE CONSIDERATION TO UPDATING AND EXPANDING THE VENDOR DISPLAY RULE TO REFLECT THE REALITIES OF DECIMALIZED TRADING. THE VENDOR DISPLAY RULE WAS ADOPTED WHEN THERE WERE EIGHT PRICE POINTS TO THE DOLLAR AND IT REQUIRES CONSOLIDATED INFORMATION ONLY WITH RESPECT TO

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[4] The Commission appropriately blocked the NYSE's efforts to impose via contracts with market vendors improper limits on Liquidity Quote, which is substantially similar in operation to Open Book. These improper limits would have diminished the opportunity for competing market centers to offer comparable transparency. *Matter of Bloomberg*, Securities Exchange Act Release No. 49076 (January 14, 2004), avail. at: http://www.sec.gov/litigation/opinions/34-49076.htm. The NYSE has refiled its Liquidity Quote proposal with the Commission. There still are imperfections and shortcomings in Open Book. This issue continues to be under review at the Commission.

THE BEST BID AND OFFER. UNLESS THE VENDOR DISPLAY RULE IS UPDATED AND EXPANDED, INVESTORS RISK HAVING LESS TRANSPARENCY AND ACCESS THAN EXISTED BEFORE DECIMALIZATION. SPECIFICALLY, THE SEC SHOULD:

- AMEND THE LIMIT ORDER DISPLAY RULE, EXCHANGE ACT RULE 11Ac1-4, TO REQUIRE EXCHANGES, MARKET MAKERS AND OTHER MARKET CENTERS (INCLUDING ECNS) TO PUBLISH ANY CUSTOMER LIMIT ORDERS RECEIVED OR COMMUNICATED TO OTHERS WITHIN FIVE CENTS OF THEIR BEST PUBLISHED QUOTATIONS (THAT IS TO SAY, FIVE CENTS ABOVE THE BEST OFFER AND FIVE CENTS BELOW THE BEST BID).

- AMEND THE VENDOR DISPLAY RULE, EXCHANGE ACT 11Ac1-2, TO REQUIRE VENDORS, SUCH AS BLOOMBERG L.P., TO CARRY ON THE SAME TERMS AS TOP-OF-FILE QUOTATIONS ALL DEPTH-OF-BOOK QUOTATIONS PUBLISHED BY ANY MARKET CENTER AS THAT TERM WOULD BE DEFINED IN RULE 600 OF PROPOSED REGULATION NMS, WITH THE POSSIBLE EXCEPTION OF MARKET CENTERS WHOSE SHARE OF VOLUME IS INSIGNIFICANT.

THIS IS A MODEST PROPOSAL. THE IMPACT OF THESE STEPS WOULD BE TO RESTORE THE TRANSPARENCY THAT HAS BEEN LOST AS AN UNINTENDED AND UNFORESEEN RESULT OF DECIMALIZATION. AS A POLICY MATTER IT IS HARD TO ARGUE THAT DECIMALIZATION SHOULD LEAVE THE PUBLIC WITH *LESS* TRANSPARENCY.

X. ACCESS FEES

I'D LIKE TO TOUCH BRIEFLY ON ACCESS FEES AS WELL. REG NMS IS NOT ENTIRELY CLEAR ON WHETHER THE NYSE CAN CHARGE ACCESS FEES. I'D NOTE THAT A FOR-PROFIT ENTITY THAT STARTS WITH A BETTER THAN 80% MARKET SHARE WOULD BE IN A POSITION TO ENJOY AN ENORMOUS UNEARNED WINDFALL AT THE EXPENSE OF INVESTORS IF ACCESS FEE CHARGES WERE PERMITTED.

XII. CONCLUSION

THIS IS A TIME OF ENORMOUS MARKET EVOLUTION. WILL REG NMS AND THE MAJOR CONSOLIDATIONS CURRENTLY UNDER REGULATORY REVIEW PROVE TO BE IN THE PUBLIC INTEREST?

THAT ANSWER IS UP TO POLICYMAKERS HERE, AT THE SEC AND AT THE DEPARTMENT OF JUSTICE. THERE IS ENORMOUS POTENTIAL FOR ANTI-COMPETITIVE ABUSE, PARTICULARLY IN THE NYSE MARKET WHERE ONE ENTITY STANDS AS UMPIRE, REFEREE, AND HOME TEAM. THE

CHANGE TO FOR-PROFIT STATUS — WHICH IS THE MAJOR CONSEQUENCE OF THE PROPOSED MERGER WITH ARCHIPELAGO — RADICALLY ESCALATES THE POTENTIAL FOR ANTI-COMPETITIVE ACTIVITY.

THE SEC ROSE TO THAT CHALLENGE IN ADDRESSING THE NASDAQ SCANDALS OF THE MID-90S. TO ITS CREDIT, THE SEC HAS TAKEN STRIDES TOWARD ADDRESSING THAT CHALLENGE IN THE CONTEXT OF THE RECENT LIQUIDITY QUOTE/OPEN BOOK CONTROVERSY, AND INDEED IN ENDING THE ARCHAIC INTERMARKET TRADING SYSTEM TRADE THROUGH RULE.

ENCOURAGING AN ENVIRONMENT CHARACTERIZED BY COMPETITION AND INNOVATION WILL POSE A SIMILAR CHALLENGE AS FIVE INVESTOR ALTERNATIVES (NYSE, ARCA, NASDAQ, BRUT, INSTINET) ARE CONSOLIDATED INTO TWO (NYSE AND NASDAQ).

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PREPARED STATEMENT OF SCOTT EVANS

CHIEF INVESTMENT OFFICER, TIAA–CREF

MAY 18, 2005

Chairman Shelby, Senator Sarbanes and Members of the Banking Committee, my name is Scott Evans, and I am the Chief Investment Officer at TIAA–CREF. I appreciate your invitation to appear here today to express my company's opinion on how recent regulatory and structural changes in the U.S. market will impact all market participants, including individual investors.

TIAA–CREF has been focused on the financial welfare of individuals since Andrew Carnegie formed the Teachers Insurance and Annuity Association of America (TIAA) in 1918 as a fully funded retirement system to help colleges attract talented teachers. Our mission is "to aid and strengthen" the institutions we serve and to provide financial products that best meet their unique needs. TIAA created the College Retirement Equities Fund (CREF), a stock-based fund and the world's first variable annuity, in 1952. CREF is registered with the SEC as an investment company and TIAA is a life insurance company.

With over $340 billion in assets under management, TIAA–CREF is a leading financial services organization, a major institutional investor, and one of the world's largest private retirement systems with more than 3.2 million participants at more than 15,000 institutions. We serve the direct economic interest of these members of the academic, medical, cultural, and research fields without profit to our company. Our customer reach extends to every State in the Nation. We have over 13,000 participants from 98 institutions in Alabama; nearly 40,000 participants at 395 institutions in Maryland.

In addition to our pension activities, TIAA–CREF also serves the general public by providing mutual funds, financial counseling, and 12 State-sponsored 529 college savings programs. Each of our clients relies on us to invest their money wisely in the U.S. financial markets.

I commend the Committee for its forward-looking concern with the issues surrounding the rapid evolution of the U.S. equity markets.

Both the recently enacted SEC Regulation NMS and the proposed mergers involving our two major domestic stock exchanges represent seismic shifts that require careful scrutiny. As consumers become more aware of these issues, they will be most appreciative of your proactive oversight.

As background, we would like the committee to be aware that our CEO, Herb Allison, is on the NYSE Board, and he did participate in the vote on the merger. He did not attempt to influence the company's position on Regulation NMS.

Although we, at TIAA–CREF, do not pretend to be able to predict the future, we have a long history of large scale participation in the equity markets that may be helpful in understanding the implications of all this change for the American investor. We hold equity shares of more than 3,000 U.S. companies on behalf of our clients. This broad involvement requires us to use the full spectrum of trading venues in today's markets, including listed exchanges, Nasdaq, Electronic Communication Networks (ECN), and Alternative Trading Systems (ATS). We conduct about half of our trading activities using traditional physically intermediated methods (floor brokers or upstairs dealers) and the other half through anonymous electronic transactions. The traditional methods are used primarily for large trades and the electronic techniques for smaller lot sizes. Since we regularly use both types of trading, we share the perspectives of both index funds who conduct most of their activity electronically and active managers who spend the bulk of their time doing traditional trades.

When we filed our comments with the SEC on Regulation NMS, our concern was that a trade through rule which requires brokers to always honor the best posted price may sometimes have the unintended effect of making it more difficult for investors to get the best deal available for all of their shares. This is because it is more important to get best execution on the whole order than the best price on every trade. The trade through rule in NMS essentially mandates that all large trades done at prices necessary to move large volumes of stock also include shares posted publicly on better terms. For our trades that are large enough to warrant private negotiations, we fear that such restrictions may impede our ability to conclude satisfactory agreements for large blocks of stock.

For example, should we desire to quickly sell a multimillion share stock holding, it would be impractical for us to use electronic limit orders to accomplish our objective since the volume of such limit order activity is usually inadequate to handle such a large order. Therefore, in order to trade our entire volume for the best price, we would usually turn to a broker-dealer or alternative peer to peer trading system like Liquidnet to assemble a block trade. These trading venues allow us to obtain sufficient quantity of shares without distorting the market price for normal sized trades. Block trades are difficult transactions that require customized attention. The cost and complexity of linking the small trades on the public limit order books to these large private transactions is likely to be prohibitive. Furthermore, it is likely that the mandatory inclusion of trade volumes from the public limit order books might reduce the incentive for brokers to participate in these large trades. If institutional traders are not able to obtain the best price possible for the large trades that they seek, then the millions of individuals that they serve will be harmed as the returns on mutual funds and other institutionally managed savings vehicles are negatively impacted.

The U.S. equity market is increasingly dominated by large institutions who regularly conduct these types of large block trades. According to the Federal Reserve, over 50 percent of total equity assets in the U.S. market are now held by mutual funds and other institutional intermediaries on behalf of individual investors. In 1980, these same institutions controlled only 36 percent of equity assets. This is why the protection of institutional trading efficiencies is of growing importance to the American consumer. From our perspective, individuals investing directly in the markets would be better served if regulators redoubled their efforts to ensure that retail brokers fulfill their duties to provide best execution to individual traders than by establishing pricing rules on our stock exchanges that favor small volume retail trades. While we think it is too soon to conclude that regulation NMS will snuff out the encouraging trend toward increased innovation and competition in U.S. equity markets, the devil is in the details.

We also think it is premature to draw conclusions regarding the likely impact of recently announced mergers involving the NYSE and Nasdaq. The parties involved will build a system that best meet the needs of their customers and we would hope that the regulatory landscape will continue to support the innovation and competition that is needed to keep our equity market system world class. Thanks to a healthy environment for innovation in the past, U.S. investors now have Instinet and Archipelago to execute small limit orders quickly and Posit, Liquidnet, and Pipeline to execute large trades anonymously and efficiently. They exist precisely because we have had a regulatory framework that encouraged entrepreneurial activities. We support any regulatory rule or business consolidation that will enhance this atmosphere of innovation and competition. Individual investors and savers, whether direct or indirect participants in the market, are better for this free market, and ultimately, so is the American consumer.

I would like to thank the Committee for inviting TIAA–CREF to share our views on this important topic. I look forward to answering any questions you may have.

PREPARED STATEMENT OF THOMAS M. JOYCE

CHAIRMAN AND CHIEF EXECUTIVE OFFICER, KNIGHT CAPITAL GROUP, INC.

MAY 18, 2005

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you for the opportunity to participate in this hearing regarding the Securities and Exchange Commission's market structure rule, Regulation NMS, and recent market developments in the industry.

Knight Capital Group, through its affiliates, makes markets in equity securities listed on Nasdaq, the OTC Bulletin Board, the New York Stock Exchange, and American Stock Exchange, both in the United States and Europe.[1] On active days,

[1] Knight is the parent company of Knight Equity Markets, L.P., Knight Capital Markets, Inc., and Knight Equity Markets International, Ltd., all of whom are registered broker-dealers. Knight also owns an asset management business for institutional investors and high net worth individuals through its Deephaven subsidiary. Knight is a major liquidity center for the Nasdaq and listed markets. As a dealer, we make markets in nearly all equity securities. Knight's clients include more than 850 broker-dealers and 600 institutional clients. Currently, Knight employs nearly 700 people. Recently, Knight announced its acquisitions of Direct Trading Institutional, Inc. (DTI), based in Irving, Texas, and the ATTAIN ECN which is based in Montvale, NJ. DTI is a registered broker-dealer and was founded in 1998 to provide institutional investors trade executions and reduced trading costs. DTI now provides execution services to roughly 300 institutions that are trading in excess of 2 billion shares per year. ATTAIN is a registered electronic communications network (ECN) pursuant to Regulation ATS and currently provides facili-

Continued

Knight executes in excess of one million trades with volume exceeding one billion shares.

Regulation NMS

For several years Knight has called on the SEC to address several problems in the equity markets, namely the lack of market linkages and efficient access to quotes, the ability of ECN's to charge access fees to nonsubscribers, and the negative impact of sub-penny quotations. By adopting Regulation NMS, the SEC took an important step to address some of these issues, which have long been areas where potential gaming or distortion create inefficiencies in the markets.

Knight supports the ban on sub-penny quotations and the rule prohibiting locking the quotation of an automated market included as part of Regulation NMS. Sub-penny quotations diminish liquidity at each price point and make it easy for professionals to jump ahead of limit orders. By capping ECN access fees for nonsubscribers, Regulation NMS will help to establish more integrity and transparency of the quote. The rule will also address the market distortions such fees cause, mitigating the economic incentive of certain market participants to lock and cross markets, which can lead to confusion in the marketplace.

Knight applauds the SEC for its action in these areas. However, Knight continues to believe that there is no need to extend any form of trade-through rule to all markets due to competitive forces and the lack of data supporting such a rule. As we noted earlier this year in testimony before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Financial Services Committee on February 15, 2005, there is no evidence to suggest that an intermarket trade-through rule will increase limit orders, one of its stated goals. However, various data sources reveal that retail investors use limit orders on Nasdaq-listed stocks (with no trade-through rule) much more often than on exchange-listed stocks (with a trade-through rule).[2] Additionally, we believe that the typical U.S. retail investor prefers the use of market orders, as opposed to limit orders, as it provides them the opportunity to immediately gain access to the displayed price and size they see in the market. Further, the SEC's data on trade-through rates is nearly the same for Nasdaq, which currently has no trade-through rule, and the NYSE, which already has a form of the trade-through rule. Finally, we are also concerned that a trade-through rule may have the unintended consequence of further reducing liquidity in the market, particularly if large block-sized prints move offshore.

Knight instead has advocated repeatedly that competition, rather than mandated and prescribed paths to trading, benefits market participants and all investors. For example, the SEC's Rule 11Ac1–5 (Rule 5) is an excellent example of regulation that increases competition by promoting transparency and comparability. The rule requires market participants to post their execution statistics in accordance with standardized reporting metrics, thus enabling order routing firms to make more informed routing decisions to meet their clients' needs. This has increased competition and pressured market participants to continue to improve the execution of customer orders, while resulting in dramatically reduced costs for investors. We believe the dramatic decrease in brokerage commissions and the split-second executions for most marketable trades in recent years is a direct result of these competitive forces, not regulatory fiat. Therefore, Knight still believes that a regulatory approach encouraging competition such as Rule 5, coupled with strengthened linkage requirements mandating that all markets connect so all displayed quotations can be immediately accessible and executable, would provide a far less disruptive and less costly way to achieve the goals of a trade-through rule.

With the adoption of Regulation NMS, Knight is focused on implementation to ensure compliance and a smooth transition to the new rules. The trade-through rule in particular has numerous exceptions and other requirements that will make implementation extremely challenging. The vetting process which has taken place to date has produced numerous comments, many of which have raised critical issues for this Committee and the SEC. The SEC and its staff should be commended for their hard work in reviewing all of the various comment letters, conducting numerous industry meetings, and for their efforts at drafting the final Rule. As the "devil is always in the details," it will be important to carefully examine the final Rule once published to ensure we fully understand its nuances and then work closely with the SEC staff to address any questions.

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ties for broker/dealer customers to quote Nasdaq listed and OTC Bulletin Board securities. Both acquisitions are currently pending regulatory approval.

[2] See letter from Jeffrey T. Brown, Senior Vice President, Charles Schwab, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, February 1, 2005.

I will briefly identify some areas that warrant significant attention as Regulation NMS is implemented.

1. The need for clear guidance from the SEC and an incremental phase-in. We encourage the SEC staff to continue to work with industry on implementation of the rules in a transparent and open manner to achieve consensus on the technical details of Regulation NMS.

The SEC should gradually phase-in and implement the rules, particularly the trade-through rule, in a methodical manner. Regulation NMS provides a limited phase-in of the trade-through rule, beginning with a small group of representative NMS stocks on April 10, 2006, with full implementation by June 12, 2006.

Knight recommends a more incremental phase-in to help ensure that market participants have the system capacity necessary for successful implementation. For example, we suggest that 100 stocks be part of the first phase-in stage, which should last one month, followed by additional phases of 500 stocks per month thereafter. This incremental phase-in approach will allow for a more reasonable implementation schedule and will permit market participants to conduct the proper stress testing on their trading systems for those changes associated with the new requirements.

There is adequate precedent for such a phased-in implementation of major changes to market rules. For example, the implementation of decimal pricing began with a phase-in of decimal pricing in August 2000 and ended with full implementation in April 2001. There are other examples, such as the move from Nasdaq's SelectNet to SuperMontage and the implementation of Regulation SHO, where the SEC took a deliberate and careful approach to implementing new rules. The transition to SuperMontage took several years to implement and included testing the trading systems on weekends for many months. The implementation of Regulation SHO governing short sales includes a one year pilot consisting of stocks of varying liquidity and size. These examples demonstrate that when the regulators and industry work carefully together on complicated matters, it helps to smooth the transition to the new rules with the least disruption to market participants and investors.

2. Improve connectivity. Regulation NMS permits private linkages to promote more connectivity among the markets. However, the SEC should mandate minimum standards for such linkages and ensure that quotes can be accessed immediately. Knight believes that this requirement alone would have prevented the need for any trade-through rule and provided for a more efficient national market system. Although Regulation NMS encourages connectivity, these provisions should be strengthened to ensure that the markets are linked and accessible, especially in light of the new trade-through rule.

3. Trade-through rule design. The most complex aspect of Regulation NMS will be the implementation of the new intermarket trade-through rule. A number of questions remain regarding how to program trading systems for the new trade-through rule. Although the rule provides an exemption from the trade-through rule for flickering quotes, there remain questions as to how this will work in practice. For example, in a flickering quote environment, would the execution of a trade that occurred two cents from the "best price" be considered a trade-through?

With automatic and electronic trading, fast response times are critical for an efficient trading environment. If rules establish specific response times of 1–2 seconds, it may create a safe harbor for markets to respond within that time frame rather than promoting innovation and sub-second response standards. These latencies will ultimately harm the investors, and only serve to reduce transparency and to decrease liquidity.

Rules for response times should be dynamic, reflecting the current state of technology at any point in time. The Securities Exchange Act of 1934 (the "Exchange Act) states that the securities markets are an "important national asset which must be preserved and strengthened." [3] Further, and by way of analogy, when considering unlisted trading privileges, Congress directed the SEC to take into account many factors, including " . . . the character of trading, the impact of such an extension on the *existing* markets for such securities, and . . ., the progress that has been made toward the development of a national market system" (emphasis added).[4] The message from Congress is clear. The implementation of rules should take into account the impact on "existing markets." Consequently, in *existing* markets that benchmark executions in sub-seconds, rules should not be promulgated which encourage or permit much slower executions. To do so, would not only ignore the state

[3] See, Section 11A(a)(1) of the Exchange Act, 15 U.S.C. Sec. 78k–1(a)(1).
[4] See, Section 12(f) of the Exchange Act, 15 U.S.C. Sec. 78I(f).

of technology in *existing* markets, but could also hinder the continued "development of a national market system."

The issues relating to defining "fast" and "slow" markets are equally complex and challenging. For example, who determines whether a quote is fast or slow? Additionally, as currently drafted, the rule applies to "quotes." Thus, market participants will have to develop processes to monitor each stock traded in each market venue. To illustrate the complexity, there are roughly 6,000 securities that trade on Nasdaq and the NYSE. Imagine needing a stopwatch to time the response times of all market participants in those 6,000 issues, clicking on and off with each trade, in each security, by each market participant, every second of the trading day. As you can imagine, there are a number of possible outcomes if there is not sufficient specificity or a bright line to set forth the standards.

Another concern about implementation of the rule lies with the exemption of trade-through protection for slow quotes. Regulation NMS does not exempt trade-throughs of manual quotes from best execution obligations. Knight recommends some form of a safe harbor from best execution obligations for slow quotes. If there is no safe harbor, it could create significant uncertainty and inefficiencies in the markets and it could ultimately defeat the incentives for slow markets to become fast markets.

4. Potential gaming opportunities. Careful and poised implementation will be vital in preventing potential gaming opportunities of professional traders who may seize upon unintended opportunities resulting from a rapid roll-out of the rule. A lesson can be learned from the retired Nasdaq Small Order Execution System (SOES) system. SOES was initially designed, in part, to remedy the problems experienced after the 1987 stock market crash to ensure the small orders of many investors could be executed automatically. SOES allowed small orders to be executed automatically against dealer quotes; however, an eventual unintended consequence was the creation of a cottage industry of professional traders, often called "SOES bandits," that took advantage of small quote differences using rapid trading. It took several years to take action against these abuses, some of which impacted small investors by disadvantaging pension and mutual funds. In a similar way, care should be taken not to create gaming opportunities for certain professionals at the expense of most investors.

Recent Market Developments

Competition helps to foster innovation, creativity, and greater efficiencies to the benefit of the individual investor. Knight has always been an advocate of policies that foster competition. For instance, Knight was a proponent of rules that increase transparency and comparability of execution quality. The SEC later adopted Rule 5, which as I described earlier, has provided transparency and comparability of execution statistics. This has increased competition and pressured markets to continue to improve execution and reduce costs of customer orders.

Regulation NMS, to the extent practicable, should avoid prescribing specific paths to trading, which may limit the ability to innovate and to enter markets. Additionally, we need to be mindful of the fact that costs associated with complying with a very intricate rule could create barriers to entry. The current uncertain business and regulatory environment impacts profitability and tends to encourage more consolidation. Clear and effective regulation will help to reduce some of these uncertainties. Although a degree of consolidation is inevitable as firms strive to gain efficiencies and economies of scale, it is unclear to what extent investors may benefit as further consolidation of the markets takes place.

Conclusion

Knight appreciates the constructive role this Committee has played in the oversight of the markets and the rulemaking process. Regulation NMS represents the first fundamental rewrite of the market system rules in 30 years. Therefore, we urge the Committee to continue its oversight role as the industry and the SEC work on implementation of Regulation NMS. Your involvement helps to ensure that the U.S. capital markets remain competitive and innovative, thus benefiting all investors.

Thank you for your interest in these issues and for the opportunity to contribute to this important dialogue.

PREPARED STATEMENT OF MARC E. LACKRITZ

PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

MAY 18, 2005

Introduction

Chairman Shelby, Senator Sarbanes, and Members of the Committee, I am Marc E. Lackritz, President of the Securities Industry Association.[1] SIA commends you for holding this hearing and appreciates the opportunity to testify on the implementation of Regulation NMS, as well as on issues related to the proposed mergers between the New York Stock Exchange (NYSE) and Archipelago Holdings, Inc., and The Nasdaq Stock Market (Nasdaq) and Instinet, LLC.

Our Nation's securities markets are the most transparent, liquid, and dynamic in the world. New forms of competition, technological advances, globalization, and broader investor participation have driven phenomenal changes in the capital markets and the securities industry over the past decade. Indeed, we only have to look at developments over the last month to see that this continues to be the case. Both the NYSE and Nasdaq proposed major restructurings and the Securities and Exchange Commission (SEC or Commission) adopted Regulation NMS after a vigorous and healthy debate over the future trading structure of our securities markets.

SIA does not have a position on the proposed mergers, but we strongly believe they raise two critical regulatory issues that the Commission should address. First, they highlight the need, and present the opportunity, to bring the structure of self-regulation into the 21st century. Although the current model of self-regulation has generally worked well to protect investors, we believe the time has come for a major restructuring of the self-regulatory system. SIA supports the adoption of a hybrid self-regulatory model, which would embody regulation into two types of organizations that would be divided by function. Each marketplace would have its own SRO, which would regulate and enforce all aspects of trading, markets, and listing requirements. The other type of organization would be a Single Member SRO that would handle regulations relating to the operations of broker-dealers. By eliminating unnecessary regulatory duplication and inherent conflicts of interest, a revamped self-regulatory structure can strengthen investor protection and increase the competitiveness of the U.S. capital markets.

Second, the proposed mergers heighten concerns about the potential for consolidated market centers to develop an unchecked monopolistic hold on market data to the detriment of investors and markets. We have urged the SEC to address market data issues comprehensively, and we are disappointed that the SEC has not done this yet. The Commission has indicated, however, that it intends to address the remaining issues in the context of SRO reform. We urge the Commission to consider the recent plans for consolidation of market centers in addressing the outstanding market data issues.

The periodic reevaluation of market structure is vital to maintaining our global preeminence and to ensuring that investors are fully protected. SIA commends the Commission and its staff for tackling such difficult issues and for their continued efforts to engage all market participants in the debate. The SEC has acted diligently and in good faith to explore reforms that will strengthen the U.S. capital markets. Although many of the solutions are controversial and not necessarily what SIA would prescribe, the policy debate has been necessary and productive. The trade-through rule was particularly divisive, as evidenced by the unusual 3–2 split among the Commissioners on final adoption of the rule. However, it is important to note that the issues raised in Regulation NMS are inherently complex, and finding consensus is an enormously difficult task.

Since the text of Regulation NMS has not yet been released, we have not identified the full range of implementation problems yet. We are in the process of forming working groups with our member-firms to address all operational and compliance implementation issues, and plan to work with the self-regulatory organizations

[1] The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. At its core: Commitment to Clarity, a commitment to openness and understanding as the guiding principles for all interactions between investors and the firms that serve them. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated an estimated $227.5 billion in domestic revenue and $305 billion in global revenues. (More information about SIA is available at: *www.sia.com.*)

(SRO's) over the next 14 months. Given the significant systems and other changes that will be necessary to implement the new rules, we are grateful that the Commission has provided lengthy implementation periods for most of the rules.

Regulation NMS

Guiding Principles

SIA believes any regulatory approach to market structure should:

- Protect investors.
- Ensure the markets are fair, orderly, and honest.
- Be sufficiently flexible to adapt to the development of new trading practices and technological innovations by competing market centers.
- Foster effective intermarket executions and enhance market access to ensure that all investors' orders—both retail and institutional—are executed in the manner most beneficial to the investor.
- Assure equal, fair, and consistent regulation across market centers.
- Ensure quality, fairly priced, cost-effective market data.

The SEC's Action on Regulation NMS

The newly adopted Regulation NMS includes new or revised rules for trade-through regulation, intermarket access, quoting in sub-penny increments, and market data reforms. Although we agree with many of the SEC's decisions, there are a few significant areas where we differ and/or had offered refinements.

Intermarket Price Protection (Trade-Through Rule). The Commission proposed two alternatives for the trade-through rule, a "top-of-book" option and a voluntary "depth-of-book" alternative. SIA member-firms were not convinced that either approach was appropriate and recommended putting in place the National Best Bid and Offer (NBBO) model before considering implementing either of the options. The SEC, however, adopted the top-of-book approach, which will protect the best bids and offers of each exchange, Nasdaq, and the NASD's ADF. Trading centers will have to establish and enforce written policies and procedures that are reasonably designed to prevent trade-throughs.

Given the vital importance and the extreme complexity of the trade-through rule, we argued that it would be more prudent to take a methodical approach to implementation to ensure we get it right from the start. Using the NBBO model as a first step would strengthen existing trade-through protection and extend it beyond the listed market to cover the entire Nasdaq market as well. Such a strategy would provide greater investor protection and facilitate competitive, innovative markets while avoiding the unnecessary, burdensome regulatory effects or unintended consequences that could result from the more extensive trade-through rules.

SIA supported the adoption of many of the Commission's proposed exceptions to the trade-through rule and offered some fine-tuning of others. Although the rule did not contain a general "opt-out" exception that would have allowed market participants to disregard displayed quotations, the rule included several exceptions to help ensure its workability with, among others, intermarket sweep orders, quotations displayed by markets that fail to meet the response requirements for automated quotations, and flickering quotations with multiple prices displayed in a single second.

The Commission did not adopt, however, our suggestion for a new liquidity exception for the most actively traded, highly liquid securities. We recommended this exception because the manner in which these securities trade already affords investors with effective protection. Trade-through regulation should be focused on those securities for which it would have the greatest benefit in protecting investors—less liquid securities, for example. The adoption of such an exception would have allowed the SEC to study the effect of having a trade-through rule versus not having one for a specified period of time (such as a year). The SEC would then have been able to consider the necessity for any further action, in much the same manner as it plans to do with the pilot program for Regulation SHO (short-sale rule).

We are also concerned about the treatment of manual quotes in the new trade-through rule, and discussed these concerns and our recommendations for addressing them in our comment letters.

Intermarket Access. SIA supported adoption of the Commission's proposed access standards for private linkages and the proposed rule to minimize locked and crossed markets. The private-linkage approach establishes uniform market access for all by promoting nondiscriminatory access to quotations displayed by SRO trading centers. We suggested, however, that the antilocking and anticrossing rule include two of the proposed exceptions to the trade-through rule—flickering quotes and systems malfunctions.

SIA supported the Commission's efforts to craft a market-wide solution to the access fee problem, but we still have concerns about excessive fees related to unprotected quotations, the administrative difficulties of tracking whether quotations are protected or not, and the broad definition of access fees.

Sub-Penny Quoting. We endorsed the Commission's ban on sub-penny pricing as a way to help prevent "stepping-ahead" of customer limit orders for an economically insignificant amount. This practice, over time, could discourage investors from placing limit orders, an important source of market liquidity.

Market Data. We are deeply disappointed that the SEC did not deal with all of the market data issues in the context of the Regulation NMS debate, but the Commission has indicated it intends to address the remaining issues in the context of SRO reform. We strongly believe the resolution of these issues—sooner than later—is of the utmost importance for the integrity of the markets, particularly now in light of the proposed NYSE and Nasdaq mergers.

The Commission adopted rules to revise formulas for the allocation of market data revenues to: Create advisory committees to the joint industry plans composed of non-SRO representatives; authorize markets to distribute their own data independently, while still providing their best quotations and trades for consolidated dissemination through the plans; and, streamline the requirements for the display of market data to investors. According to the SEC, these changes will help correct the flaws of the current formulas, reward SRO's that contribute to public price discovery by dividing market data revenues equally between trading and quoting activity, and improve the transparency and effective operation of the plans.

Those revised reallocation formulas, however, do not address a number of other critical market data issues—such as opaque fee-setting practices—that have resulted in unwarranted and excessive market data fees. We had recommended that the Commission consider all of the following market data related issues as a whole:

- Current and future fees should be accounted for transparently, and supported by independent audits of the networks and annual filings that cover expenses, revenues, and projections;
- Unlike the SEC's rule filing process, fees should be set and changed through a collective process that involves market participants, operates transparently and permits real challenge;
- Fees should be limited to the cost of collecting and disseminating market data, thereby rendering rebates unnecessary;
- The networks' contractual and usage requirements should be reduced, streamlined, and made uniform, which will assist in lowering fees and associated administrative burdens;
- Plan governance also should be transparent, with any advisory committee structured to reflect industry and investor involvement and empowered beyond the merely cosmetic;
- Most firms believe that information should be channeled through a single securities information processor (SIP);
- Any fees chargeable for noncore data such as depth-of-book should be subject to market forces;[2] and,
- Market data provisions, including definitions and applications of fee categories such as "professional" and "nonprofessional" and limitations on the redistribution of data, should be the subject of a fresh review and uniform rulemaking.

We believe Congress did not intend for market data to generate revenues for SRO's to subsidize their regulatory obligations or to fund competitive business activities, as it does today. The purpose of disseminating market data is to create transparency in the prices that investors receive for buying and selling securities and, where there are competing market centers, to increase investor choice and opportunity. For that reason, SIA advocated a revised method for funding regulation that does not depend on revenue from market data fees.

We do not believe our proposed cost-based approach for establishing market data fees puts the SEC in a role of rate maker, but instead relies upon its oversight role over SRO's to ensure that access to this information is available on terms that are "fair and reasonable" and "not unreasonably discriminatory."

Our proposed cost-based approach will minimize many of the conflicts of interest related to market data fees that SRO members of the plans face now. The conflicts arise from control over a monopoly product with the ability to use the monopoly rev-

[2] The SIA believes, however, that the Commission should undertake a study of the impact of different levels of transparency among market participants (for example, between retail and institutional investors) in this era of decimalization where depth of book data is not readily available to all.

enue to subsidize other activities. By limiting the market data revenue, the business incentive to seek greater data revenue is restricted as well. We believe the narrow cost-based approach is the most straightforward method to accomplish this, and is most closely aligned with the congressional purposes underlying the Exchange Act.

Of course, in determining the reasonableness of fees under the cost-based approach, the SEC also must consider whether the fee limits fair and reasonable access to market data, particularly where such access is imperative for compliance with regulatory requirements, such as proposed Regulation NMS. We need to recognize that decimalization has decreased the value of consolidated market data even though the price has remained the same. Prior to decimalization, the consolidated data reflected in the NBBO signaled the depth in the market up to 12 cents. Today, the depth of the market reflected in the NBBO is only a penny or two, generally representing very few shares.

The valuable data that used to be reflected in the NBBO is now in the nonconsolidated data that the SRO's are distributing on their own, at an additional charge. This trend is continuing and, indeed, sanctioned by the Commission's recent amendments. The Commission should not only look at the high cost of producing such data, but also whether market data fees are in fact cross-subsidizing the production of proprietary market data products. We believe a cost-based approach to all market data would ensure the availability of both depth-of-book and NBBO information at a reasonable cost.

The proposed NYSE and Nasdaq mergers only heighten our concerns in these areas. Indeed, some member-firms are apprehensive that the SRO's will have an even greater monopolistic hold on market data with the consolidation of the markets, which could work toward the detriment of both our markets and investors. We therefore strongly encourage the Commission to review all of these market data issues with these new concerns in mind.

The Need for Structural Reform of Self-Regulation

Guiding Principles

The proposed NYSE-Archipelago merger further heightens the importance of examining the securities industry's self-regulatory system. SIA has thought a great deal about the structure of self-regulation over many years. Five years ago, when the NYSE and Nasdaq first proposed to become for-profit entities, SIA commissioned a White Paper titled "Reinventing Self-Regulation." The White Paper examined the effectiveness of self-regulation in a rapidly changing environment, and considered the advantages and disadvantages of different models for regulation of our Nation's securities markets.[3]

Our reviews of self-regulation include a set of guiding principles, many of which are listed in the previous section addressing market structure issues. Two additional principles, however, should be considered in the debate over the self-regulatory system. First, the regulatory system should ensure the primacy of the SEC as a strong national regulator, but should include appropriate roles for, and coordination with, the SRO's, the States, and market participants, to achieve uniform national standards. Second, the regulatory staff overseeing day-to-day activities must possess the requisite expertise necessary to perform their duties. This can best be achieved if the regulator has: (i) effective industry input into the regulatory process; (ii) the power and prestige to attract talented staff; and (iii) the ability appropriately to tailor regulation to fit the diversity of entities that it regulates, rather than relying upon a "one-size-fits-all" approach.

Based on our experience with these issues, we have concluded that the time has come for a major restructuring of self-regulation. Although we believe the current model of self-regulation has generally worked well to protect investors, concerns about regulatory conflicts of interest and regulatory duplication have taken on new significance as market centers combine and competition—both domestically and internationally—intensifies. In that vein, we propose consolidating regulation of broker-dealers into one "hybrid" SRO, while each marketplace retains separate SRO's to regulate and enforce all aspects of trading, markets, and listing requirements. We describe this proposal in more detail later.

Strengths and Weaknesses of the Current SRO System

The success of today's self-regulatory governance is directly related to member involvement in the process.[4] For example, member expertise and involvement in SRO

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[3] The White Paper is available at *http://www.sia.com/market*_structure/html/siawhitepaperfinal.htm.

[4] See generally S. Rep. No. 94–75, at 22 (1975) (accompanying S. 249, 94th Cong., 1st Sess. (1975)) (In enacting the Exchange Act, Congress balanced the limitation and dangers of permit-

rulemaking processes has led to more effective, less costly rules. In addition, self-policing by professionals who have the requisite working knowledge and expertise about marketplace intricacies and the technical aspects of regulation creates a self-regulatory system with valuable proper checks and balances. Supplemented by government oversight, this tiered regulatory system can provide a greater level of investor protection than the government alone might be able to achieve.

Because self-regulators have an intimate knowledge of industry operations, trading, and sales practices, they can develop and revise rules more quickly and frequently. Similarly, self-regulation utilizes the insight of those who are on the front-line of marketplace developments, meaning they can be more forward-looking and up-to-date with market realities than traditional government regulators. In addition, SRO rules often are designed to set ethical standards that exceed the legal minimums. For example, the NASD requires that its member firms adhere to "just and equitable principles of trade," a standard that in many instances exceeds the antifraud requirements of SEC statutes and rules.

In spite of how well self-regulation has worked, both market participants and governmental bodies have recognized in recent years a growing need for structural reform of self-regulation. This view is based on three concerns: (1) increased competition among SRO's and their members for customer orders could cause conflicts of interest due to the SRO's' roles as both market operators and regulators;[5] (2) "multiple SRO's can result in duplicative and conflicting SRO rules, rule interpretations, and inspection regimes, as well as redundant SRO regulatory staff and infrastructure across SRO's;"[6] and, (3) the profit motive of a shareholder-owned SRO could detract from self-regulation.[7]

Significance of the NYSE-Archipelago Merger

Because several of our large members have divergent views on the proposed NYSE-Archipelago merger, it would be inappropriate for us to comment on its merits as a business transaction. We do, however, strongly believe that the proposed merger represents an important opportunity to address the concerns outlined previously. The following are some observations about the NYSE-Archipelago merger.

(1). The merger both illustrates and accelerates the trend toward increased consolidation of, and competition between, market centers. While this competition is in most respects a very healthy development, it does raise questions about the NYSE's continued regulation of broker-dealers that could be potential competitors for order flow or for development of new investment products. The very fact that NYSE apparently seeks to maintain regulation of its broker-dealer members under the NYSE name and the oversight of some of its directors, rather than spin it off into a separate entity under a different name with entirely separate directors, suggests that the NYSE sees value in continued "branding" of its regulatory authority over broker-dealers. The measure of any value that may be perceived in retaining broker-dealer regulation within the NYSE brand is also the measure of the problem of the NYSE regulating potential competitors.

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ting the securities industry to regulate itself against 'the sheer ineffectiveness of attempting to assure [regulation] directly through the government on a wide scale.'"); SEC Report of Special Study of Securities Markets, H.R. Doc. No. 88–95, Part 4 (1963) (Special Study).

[5] "Securities Markets: Competition and Multiple Regulators Heighten Concerns about Self-Regulation," General Accounting Office, May 2002, GAO–02–362, available at *http://www.gao.gov/new.items/d02362.pdf,* at 1–2 (GAO SRO Report). The GAO also noted, "Heightened competitive pressures have generated concern that an SRO might abuse its regulatory authority—for example, by imposing rules or disciplinary actions that are unfair to the competitors it regulates." The SEC shares this concern. "As intermarket competition increases, regulatory staff may come under pressure to permit market activity that attracts order flow to their market. . . . Also, SRO's may have a tendency to abuse their SRO status by over-regulating members that operate markets that compete with the SRO's own market for order flow." Concept Release Concerning Self-Regulation, 69 Fed. Register 71256, 71262 (Dec. 8, 2004) (SEC SRO Concept Release).

[6] SEC SRO Concept Release at 71264. The GAO has noted similar "inefficiencies associated with SRO rules and examinations." GAO Report at 2.

SIA has recently had productive discussions with the NYSE and NASD, as well as the SEC's Office of Inspections and Examinations (OCIE), on improving coordination among these three regulators' examination programs. An overview of the results to date of those discussions is available at *http://www.sia.com/RegulatoryCoordination/index.html.*

[7] "Another significant conflict of interest for SRO responsibilities is with SRO shareholders. SRO demutualization raises the concern that the profit motive of a shareholder-owned SRO could detract from self-regulation. For instance, shareholder-owned SRO's may commit insufficient funds to regulatory operations or use their disciplinary function as a revenue generator with respect to member firms that operate competing trading systems or whose trading activity is otherwise perceived as undesirable." SEC SRO Concept Release, at 71263.

(2). The merger underscores the significance of increased competition, not just narrowly between U.S. market centers, but also globally among all capital markets. This competition applies to securities exchanges and financial intermediaries of all stripes. Unnecessary regulatory duplication is a weight around the ankles of financial intermediaries in the United States that has a real cost in terms of the future competitiveness of our capital markets. The merger represents an opportunity to address this regulatory duplication.

(3). The merger raises exactly the issues about conflicts between shareholders' interests and regulatory authority about which the SEC and SIA have both voiced concerns.

In fairness, it appears that the NYSE sshould address several of these issues in structuring the merger. The NYSE stated that it would take steps to separate the NYSE's regulatory arm from its business side, which should help ameliorate concerns about the possible misuse of the NYSE's regulatory authority to benefit its business side and its shareholders.[8] However, the NYSE's proposal does not appear to address the critical issue of regulatory duplication between itself and the NASD in regulating dually registered broker-dealers. While the NYSE is, appropriately, focused on strengthening the competitiveness of its own business position, the proposed merger represents an opportunity to reconfigure the self-regulatory system so that the competitiveness of the overall U.S. capital markets is also strengthened.

The Hybrid SRO: Toward a Better System of Self-Regulation

Last winter, the Commission sought comment on a variety of self-regulatory models as possible alternatives to the current structure of self-regulation. Of the seven models the SEC proposed, SIA believes the Hybrid self-regulatory model offers the best alternative regulatory structure for preserving competitive, innovative markets while fostering more efficient and effective regulation. Under this model, self-regulation would be embodied in two types of organizations that would be divided by function. Each marketplace would have its own SRO, which would regulate and enforce all aspects of trading, markets, and listing requirements. The other type of organization would be a Single Member SRO that would handle regulations relating to the operations of broker-dealers (sales practices, financial responsibility requirements, qualification of personnel, recordkeeping, etc.).

The Hybrid model will require the SEC to designate a Single Member SRO to regulate all SRO members with respect to membership rules such as financial condition, margin, registered representative qualification testing, customer accounts, sales practices, and supervision. Each SRO operating a market would be responsible for the oversight of its market operations regulation (for example, its trading rules), including enforcement of those trading rules. The creation of the Single Member SRO addresses the two primary areas of weakness in the current self-regulatory structure. First, it eliminates the inefficiencies in rulemaking and examinations, and the potential for inconsistent regulation that exists in a multiple SRO system. Second, it eliminates conflicts of interest between an SRO's regulatory and market functions with regard to membership rules.

A Hybrid Will Give Better Regulatory Mileage. Most broker-dealer compliance resources currently are devoted to complying with rules of multiple SRO's. For example, conduct rules—the area of the most duplicative SRO rules—have the same regulatory purpose but require different compliance efforts.[9] The Hybrid model would strengthen the effectiveness of compliance resources by creating a single comprehensive regulatory oversight structure. At the same time, the existence of multiple-market SRO's, each with responsibility over those regulations applicable to its unique trading structures, will keep market expertise where it is most useful. Much of the innovation that makes the U.S. markets so strong occurs in market operations, so the maintenance of separate market SRO's will foster continued competition and innovation and preserve U.S. capital market dominance.

In general, the SEC has already begun moving toward more universal capital market rules. For instance, Regulation SHO creates a uniform definition of what constitutes ownership of securities, specifies aggregation of long and short positions, and requires broker-dealers to mark sales in all equity securities "long," "short," or "short exempt" to establish a uniform system across markets.[10] Parts of Regulation NMS, such as the ban on sub-penny quotations for securities priced over one dol-

[8] Joint NYSE-Arca/Ex News Release, April 20, 2005, available at *http://www.nyse.com/pdfs/joint*__release.pdf, at 2.

[9] For example, the NYSE and NASD have different order audit trail requirements, each of which requires unique programming and compliance efforts that are costly, and both of which are intended to provide similar information for surveillance purposes.

[10] See Exchange Act Release No. 50103 (Jul. 28, 2004), 69 Fed. Reg. 48008 (Aug. 6, 2004) (Regulation SHO).

lar,[11] also reflect a convergence of rules. The Hybrid model will continue this consolidation and streamlining of regulations to increase efficacy and efficiency, and to eliminate redundancies and gaps in regulatory coverage.

Overseeing the Hybrid. We realize the Single Member component of the Hybrid model would concentrate regulatory power and authority in one entity. Therefore, and notwithstanding our advocacy of the Hybrid model, this regulatory structure will function effectively only if the SEC provides attentive and cost-effective regulatory oversight. This oversight should include the SEC's vigilant review of the Single Member SRO's costs and fee structures to ensure that the SRO is providing sufficient regulatory oversight without imposing excessive fees and budget demands. Similarly, the Commission's robust review of the Single Member SRO's final disciplinary proceedings will counter any possible self-serving interest by the Single Member SRO in levying excessive enforcement fines that would be paid into its own coffers.

Additionally, strong member involvement will become even more important to prevent the Single Member SRO from becoming an unresponsive entity with prohibitive cost structures. The Single Member SRO will need substantial member input—especially from smaller cost-sensitive members—to effectively oversee regulation across a diverse group of members with divergent needs and business models.[12] Member involvement and SEC oversight of the Hybrid SRO also will be necessary to identify and harmonize any "boundary" issues between conduct rules subject to the Single Member SRO's regulatory oversight, and market rules subject to the continued oversight of the various market SRO's.

The Commission should develop increased transparency requirements for the Single Member SRO, particularly concerning funding and budgetary issues. Making the Single Member SRO's operations transparent to both members and the investing public will place appropriate checks on the Single Member SRO and will enhance accountability to its constituents.

To further foster the regulatory efficiency offered by the Hybrid structure, market SRO's should be permitted to continue to outsource their market enforcement activities. We understand that the ability to outsource such activities, while retaining ultimate responsibility as an SRO, has worked well for various existing SRO's.[13]

Fueling the Hybrid. The final issue for the SEC to resolve is how to fund the Single Member SRO. SIA believes that any future self-regulatory structure must be adequately funded and that fees for regulation should be apportioned to the industry on a fair and reasonable basis. The fees should be unbundled and cost-justified whenever possible. Imposing regulatory fees on the securities industry that exceed the true costs of regulation acts as a tax on capital and imposes undue harm on the capital-raising system. SIA recommends that the SRO's define the costs necessary to meet their self-regulatory obligations, prepare and make public a budget to meet those obligations, and then fairly apportion those costs among members by making periodic filings with the Commission subject to public notice and comment.

As stated earlier, we are convinced that market data fees should not be used to fund regulation and should instead fund only the collection and dissemination of market data.[14] Cost-based market data fees will not reduce regulatory funding, but will provide greater accountability and transparency in the way market data fees are assessed and self-regulation is funded. Explicitly tying market data fees to the cost of producing the data, while requiring the SRO's to prepare public regulatory budgets and charge specific fees for regulation, will fully meet regulatory funding needs without over-charging for market data.

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[11] See Regulation NMS.

[12] The needs of fixed-income markets differ from those of equities markets, for instance. The knowledge members have about the ramifications of these differences is essential to ensure that a self-regulatory system works well for all participants.

[13] For example, the American Stock Exchange (Amex) and Nasdaq have delegated regulatory activities to the NASD. See, for example, Exchange Act Release No. 37107 (Apr. 11, 1996), 61 Fed. Reg. 16948 (Apr. 18, 1996) (creating the NASDR and Nasdaq as two operating subsidiaries of NASD); SEC Set to Release Proposals on SRO Governance, But Details Are Still Thin, Securities Week, Nov. 8, 2004, available at 2004 WLNR 14154116 (quoting NASD chairman and CEO Robert Glauber's statement that the NASD "will continue to regulate Nasdaq and Amex under contract.).

[14] In 2003, the Plans spent $38 million on Plan expenses and collected $424 million in market data revenue. The revenue exceeds costs by a significant margin. See Exchange Act Release No. 49325 (Feb. 26, 2004), 69 Fed. Reg. 11126 (Mar. 9, 2004) (initially proposing Regulation NMS).

Of course, eliminating market data fees as a source of regulatory revenue may produce a shortfall of regulatory funding.[15] To address this possibility, and to underscore how strongly we feel about (i) the need for a hybrid SRO approach, and (ii) the need to move away from market data fees as a source of regulatory funding, *the industry is willing to pay higher regulatory fees to the Single Member SRO than it now pays to the NYSE and NASD.* Our only qualification is that any increase in regulatory fees on member firms should be, with the SEC's assistance, allocated in a fair manner among all member firms such that there is not an undue burden on smaller firms.[16] Notwithstanding the potential for increased regulatory fees for members of the Single Member SRO, we believe the benefits of the Hybrid model should exceed the costs.

SIA also believes that a fair and reasonable portion of the Single Member SRO's funding should come from issuers and other constituents of the trading markets. Trading markets will benefit significantly from regulatory oversight of broker-dealers and the various examination and continuing education programs conducted by the Single Member SRO under a Hybrid model. Such regulation and education initiatives foster the market integrity and investor confidence that bring so much business to the U.S. capital markets. Under the Hybrid model, markets would receive these benefits, and market SRO's should assume some of the associated regulatory and administrative costs.

Conclusion

America's securities markets are the envy of the world, but we cannot take it for granted that they always will be. Maintaining the preeminence of our capital markets in an increasingly globalized economy will require sustained efforts to remove unnecessary regulatory inefficiencies that hinder our ability to compete. SIA is eager to work with Congress, the SEC, the SRO's, and all other interested parties to ensure that our markets remain the most transparent, liquid, and dynamic, with unparalleled levels of investor protection.

Thank you.

PREPARED STATEMENT OF GEORGE U. "GUS" SAUTER

CHIEF INVESTMENT OFFICER AND MANAGING DIRECTOR, THE VANGUARD GROUP

MAY 18, 2005

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, my name is Gus Sauter. I am the Chief Investment Officer and a Managing Director of The Vanguard Group. I oversee the management of approximately $600 billion in mutual fund assets. I am very pleased to be here representing The Vanguard Group. We have been working with various marketplaces over the past decade to improve the quality of the markets to meet investors' needs.

I would like to thank the Committee for having this hearing on Regulation NMS and recent market developments. The issues surrounding market structure are very important issues for investors to ensure a fair and efficient marketplace. We believe that Regulation NMS, specifically the trade-through rule, will promote direct investor order interaction and support the best execution of investor orders.

National Market System Principles

The national market system (the NMS) was created in 1975 through amendments to the Securities Exchange Act. These amendments set forth Congress' findings about our securities markets and directed the Securities and Exchange Commission (the SEC) to facilitate the establishment of an NMS. Congress recognized that new data processing and communications technology created the opportunity for the more efficient operation of markets. It also found that the linking of all markets would enhance competition, increase information available to intermediaries and investors, facilitate the offsetting of investors' orders and contribute to best execution.

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[15] We note, however, that the increase may be less than one-for-one because, although SRO's may use market data fees to fund regulation today, it is equally likely that SRO's use market data revenues to fund competitive or proprietary activities such as rebates for trade prints, advertising and brand marketing, and to attract listings.

[16] For example, such fees might be based on any number of factors designed to approximate the degree of resources required of the Single Member SRO in overseeing a particular firm, such as the number of registered representatives of a firm, or the scope and nature of its customer base or operations.

Specifically, Congress directed the SEC to use its authority to assure the following five principles:

- Economically efficient securities transactions (efficiency);
- Fair competition among brokers and dealers and among markets (competition);
- The availability of quotation and transaction information (price transparency);
- The practicability of brokers executing investors' orders in the best market (best execution); and
- The opportunity for investors' orders to be executed without the participation of a dealer (direct investor order interaction).

I would like to focus on two of the principles set forth in these amendments: (1) best execution and (2) the promotion of direct investor order interaction.

Best Execution

What is best execution? Some say it is obtaining the best price. Others say it is obtaining speed of execution and certainty. We believe it is a combination of both into something we call the *expected best price.* It is the best price an investor thinks he or she can obtain for the entire trade at the instant the investor decides to buy or sell securities. This enables investors to minimize transaction costs and maximize returns.

What is the optimal market environment for achieving best execution? A perfectly liquid limit order book. Ideally there would be an infinite number of limit orders willing to buy or sell a stock with a very small spread between the bid and offer prices.

Limit Orders

The ideal national market system encourages a perfectly liquid limit order book by creating rules that entice investors, market makers, and other market participants to place limit orders on an order book.

Limit orders are the building blocks of transparent price discovery. Although there may be many market participants willing to trade at a certain price, it is only the limit order on the book that enables transparent price discovery. Without a book of limit orders, market orders have no meaning. Limit orders frame the market-clearing price of a stock.

Transparency of limit orders promotes competition among them. In order to improve the likelihood of execution investors are incented to enter limit orders at improved prices. This creates narrower spreads and additional depth of book, both of which serve to reduce transaction costs for investors.

Displaying limit orders is crucial to promoting liquidity. But displaying limit orders runs contrary to most traders' instincts. Like a poker player, they desire to see everyone else's cards without revealing their own. Economically, a limit order grants a free option against which traders can execute their orders. This free option creates a profitable opportunity for traders who are allowed to step in front of a limit order with the knowledge that they are protected from adverse price movement by the book of limit orders. If the market moves against their position, they can always "put" their position to the book of limit orders. Since one trader's gain (from taking advantage of the free put) is another trader's loss (from providing the free put), there is an economic disincentive to place limit orders.

Trade-Through Rule

All of this points to the need to overcome the inherent impediments to creating limit orders. These types of orders should be encouraged. We believe that with a uniform trade-through rule, limit orders are protected and therefore encouraged.

We believe that those who opposed the Regulation NMS trade-through rule placed too much emphasis on the short-term goal of satisfying market orders. This disregards the longer-term effects on the markets of diminishing limit orders. If executions outside of the NBBO are permitted, the investor that placed the limit order at the NBBO is disadvantaged by not receiving an execution. Why would an investor place subsequent limit orders when they can simply be circumvented? Of course, the order taking the liquidity is immediately filled in a fashion that is satisfactory to the trader, but why should the order taking liquidity out of the market be favored over the order contributing to liquidity in the marketplace? We believe this creates an unintended consequence of significantly negatively impacting liquidity, and the ability to fill market orders efficiently, in the future.

Competition and Free Markets

Much concern has been expressed over competition and free markets versus regulation. We absolutely think competition is imperative. But the competition that is most important for investors is the competition among orders—bids competing against bids driving the willing purchase price higher, and offers competing against offers encouraging the sale at a lower price. This promotes the perfectly liquid limit order book we desire.

Our obligation is to get best execution for our trades. We execute against other orders. We do not execute against exchanges. Exchanges only provide services. They are a venue through which we execute our trades. The trade-through rule will have the effect of linking the exchanges into a more central marketplace. In this respect, the national market system will be analogous to the internet. The internet is a centralized repository of information with hundreds of internet service providers (ISP's) that compete on speed, price, and other services. But ultimately, each ISP provides its subscribers with access to the same internet as every other ISP. Similarly, each exchange is a portal into the national market system, and they can compete on speed, price and other services.

Concern also has been expressed about the extension of any trade-through rule to Nasdaq stocks. I would like to make two points about this. First, although Nasdaq does not formally have a trade-through rule, it operates as though it does. Applying the uniform trade-through rule to it will not be a large burden. Second, different types of markets may trade the same NMS stocks, regardless of where the stocks are listed. For example, today Nasdaq stocks are traded on Nasdaq's Super-Montage, ECN's and "listed" exchanges. And several NYSE listed stocks are traded on Nasdaq. This cross trading of stocks will certainly increase in the future. In this environment, it only makes sense that there should be intermarket protection against trade-throughs for all NMS stocks.

Recent Market Developments

Two recent developments will intensify competition between markets and, hopefully, investor orders. The NYSE and Archipelago recently announced their proposed merger, followed a few days later by Nasdaq's agreement to purchase Instinet's electronic trading network.

On the surface, any contraction in the number of market centers could be worrisome. The devil is in the details, but these mergers will result in two major markets pitted against one another. Our view is that investors will be better served by two strong competitors fighting with more automated processes.

The consolidation of the order book on Nasdaq should reduce order fragmentation and increase competition among orders. Competition for listings and unlisted trading privileges will also increase.

In the case of New York and Arca, we will have to wait and see the details of the proposed merger. We would like to see the best aspects of both merged together. However, we understand that the platforms may not be merged together. If this is the case, there would be little upside advantage of the merger. There would not be a negative effect, but a significant opportunity to reduce order fragmentation and increase order interaction would be lost.

We want to see a competitive environment where various marketplaces offer value as venues into a more centralized market. Just as ISP's that offer cutting edge services are able to compete against the Comcasts of the world, we believe there will be opportunities for smaller exchanges that offer a value proposition to thrive. And, there will be sufficient competition between exchanges to keep each other in check and reduce order fragmentation. Depending on how the mergers play out, they could end up satisfying the Regulation NMS objective of promoting limit order competition.

Again, I would like to thank the Committee for allowing me to express our views. I would be pleased to answer any questions you may have.

REGULATION NMS AND RECENT MARKET DEVELOPMENTS

THURSDAY, MAY 19, 2005

U.S. SENATE,
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 Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing shall come to order. This morning, the Committee continues its examination of Regulation NMS and the recent industry consolidation. This morning, the Committee will hear from Chairman Bill Donaldson of the Securities and Exchange Commission.

At yesterdays hearing, a number of leading market participants addressed the changing dynamic of our equities markets. The convergence of a new regulatory framework established by Regulation NMS and the impact of the proposed mergers between the New York Stock Exchange and Archipelago and Nasdaq and Instinet has significantly altered the marketplace. We look forward to continuing this discussion with Chairman Donaldson this morning.

I would also like to remind Members of the Committee and also Chairman Donaldson that we will likely be operating under some time restrictions this morning due to the Minority Leader's objection to hearings continuing 2 hours after the Senate is in session. It might not affect us. It depends on how long we go and if that objection is made. But, Mr. Chairman, I thank you for appearing here today, and we look forward to your testimony, and a lot of things have happened in the last several months in this area.

Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

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

This is the second of 2 days of Committee hearings on the subject of Regulation NMS and recent market developments. The third week of April brought two announcements of significant changes to the U.S. securities markets. The New York Stock Exchange announced its merger with Archipelago in what *The Wall Street Journal* called: "A historic transaction that will turn the 212-year-old Big Board into a public company and help it expand electronic training." Nasdaq announced its acquisition of Instinet in what the

Journal called: “A reflection of, and a result of, seismic changes in the business of being a stock market.”

These mergers hold the potential for benefits such as greater market efficiency, transaction costs to investors, narrower trading spreads, increased depth of book and liquidity, and more choice in terms of trading multiple types of securities: Stocks, options, exchange-traded funds on the same platform. However, some questions and concerns have arisen about the resulting organizations, and the SEC’s review of these transactions will, of course, determine how these concerns are addressed.

I want to make reference to one issue in particular, which I addressed yesterday at the panel that was here. The SEC’s concept release concerning self-regulation published in December 2004, not quite a year and a half ago, pointed out, “SRO demutualization raises the concern that the profit motive of a shareholder-owned SRO could detract from proper self-regulation.” I think as we move forward with respect to market structure, we must carefully consider what is the best structure for a regulator of a for-profit exchange so that we can be assured that it will exercise independent and effective judgment, and we heard two different models yesterday, and I think that is an issue to which attention needs to be paid.

Passing Reg. NMS was the culmination of painstaking work by the Commission. For more than 5 years and during the tenure of four Chairmen, the Commission has heard the concerns of industry and investors about market structure, formulated proposals, held hearings, meetings, and read over 2,000 comment letters so that all interested parties could be heard. Chairman Donaldson said in acting, we have our eye on one overriding objective, the protection of investors, with particular attention to small investors.

I welcome the indication by the Commission and its staff that it will engage in robust and ongoing communications with industry to assist in implementation of Regulation NMS and to closely monitor whether the rule is having any unintended consequences. In sum, the SEC has issued a rule that is, as Investment Company Institute President Paul Schott Stevens described, an important step in the development of a market structure that best serves all investors and advances the key goal of modernizing the U.S. securities markets.

Chairman Shelby, I join with you in welcoming Chairman Donaldson. This is Chairman Donaldson’s third appearance here before the Committee this year, I believe, which follows on 11 appearances before the Committee in the last Congress. You are a regular visitor, Mr. Chairman. We are pleased to have you here touching a whole range of security issues, and as always, I look forward to your testimony this morning.

Finally, I want to take this opportunity to note the completion of the successful tenure of your Director of Enforcement Stephen Cutler. Mr. Cutler served at the Commission during an historic time, faced very significant challenges and, in my view, did an outstanding job. I congratulate him and the dedicated staff of the Enforcement Division for their many impressive achievements during the period he headed the Division. I certainly wish him well in the future.

And likewise, I would like to express my appreciation for the fine work done by Paul Roye, the recently departed Director of the Division of Investment Management and his staff and wish him the very best. All of these dedicated SEC employees a great debt of gratitude, and we thank them for their dedicated service to the public interest.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

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

I appreciate these hearings that you are holding, and I will submit an opening statement for the record.

Chairman SHELBY. Without objection, it will be part of the record.

Chairman SHELBY. Senator Dodd.

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you, Mr. Chairman for holding these hearings, and welcome to Chairman Donaldson before the Committee. I associate myself with the comments of Senator Sarbanes. I think he covered the waterfront pretty well here. I mean, we come back to the words over and over again, and that is investor protection. It is what our job is up here, and it is certainly job of the SEC. I think we have to watch all the time. This is obviously a period of transition that is occurring.

I think the SEC did a very thorough job. This was not a decision reached hastily at all, to put it mildly, after 4 or 5 years, and obviously, there is a significant debate about it, and I know my colleague Senator Crapo and others have strong feelings, and there are arguments to be held, so it is worthwhile to go through this process as we go forward, but I, for one, think the SEC is fulfilling its historic obligation here, and that is dealing with investor protection, and it is awkward, these changes, but to do otherwise, I think, would be to fail on our responsibility collectively.

So, I welcome the opportunity to listen to what you have been through, the rationale and the arguments. I know it was contentious on the Commission itself, highly divided. That is not normally the case on like this that come before the Commission, and so, I commend all of the Commissioners for the work and time they put in on this effort to reach the conclusion they did. I look forward to hearing your testimony.

Chairman SHELBY. Senator Reed.

STATEMENT OF SENATOR JACK REED

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

Let me welcome Chairman Donaldson, and let me commend you and Senator Sarbanes for holding this hearing on a very important topic of national market structure, and as Senator Dodd pointed out, we have an obligation collectively to ensure the protection of investors and confidence in the markets. And these markets are changing dramatically because of technology and other forces.

And interestingly enough, the national market structure is the title, but really, it is an international market today in securities, so many of the changes that are being pursued have to be pursued in the context of not just our markets but world markets. And so, I look forward to your testimony, Chairman Donaldson. I thank you and commend you for the work you have done so far.

Chairman SHELBY. Mr. Chairman, your written testimony will be made part of the record in its entirety. You may proceed as you wish. Welcome to the Committee again.

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

Chairman DONALDSON. Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you once again for inviting me to testify today concerning the important recent developments in the equity markets that occurred last month. As you all know, on April 20, the New York Stock Exchange and Archipelago agreed to merge and become a publicly held company, and 2 days later, Nasdaq announced an agreement to purchase Instinet's electronic trading network.

These are, of course, the four largest markets trading equity securities in the United States, and the importance of these transactions, if completed, can hardly be overemphasized. Today, I will touch on some of the broader policy implications of the proposed consolidations. I will start by placing these transactions in the context of the Commission's market structure initiatives and particularly Regulation NMS. Next, I will offer some thoughts about how the consolidations may impact competition in the markets going forward. And then, finally, I would like to highlight some important issues relating to industry self-regulation that the Commission will be addressing in the coming months. As many of the details of the proposed transactions are not yet clear, and my observations are necessarily preliminary, my testimony today reflects my own views and not those of my fellow Commissioners.

As I have discussed with you in prior hearings, one of my highest priorities over the last 2 years has been to complete the Commission's extended review of market structure regulation. Last month, the Commission took a critical step forward in adopting Regulation NMS, a comprehensive set of reforms designed to strengthen and modernize our national market system. In my view, subsequent events in the marketplace have only reconfirmed the importance of this Commission initiative.

The fact that the two transactions were announced only weeks after the Commission acted on Regulation NMS may not have been entirely coincidental. To be sure, the transactions were driven primarily by economic and competitive forces in the marketplace, but prior to Regulation NMS, uncertainty about the regulatory landscape may have hindered the ability of markets to plan for the future.

Of course, certainty could have come with any Commission decision on market structure, but I believe the choices we made were the right ones. By adopting consistent rules of the road that apply to exchange-listed and Nasdaq stocks alike, the Commission made sure that market consolidation can take place against a regulatory background that protects investors at the same time as it levels the playing field for competitors. This new level playing field will, in turn, facilitate competition between the New York Stock Exchange and Nasdaq.

The new trade-through rule expands opportunities for electronic markets to compete with the New York Stock Exchange floor for order flow and ratchets up the pressure for the New York Stock Exchange to implement its hybrid market proposal. In addition, if it merges with Archipelago, the New York Stock Exchange will have a formidable electronic platform for acquiring market share in Nasdaq stocks.

Under the new regulatory framework, competition in all national system stocks will be based on three basic principles: The best price, open access, and transparency. First, the new trade-through rule underscores the principle that no matter where a customer order is routed, it should receive the best price that is immediately and automatically available anywhere in the national market system. The best price principle also will promote vigorous competition among individual market centers by ensuring that smaller markets displaying the best price cannot be ignored by larger, dominant markets.

Second, competition will be governed by the principle of open access to these displayed prices. Markets will be permitted to compete across a wide range of services, but they cannot penalize their competitors by unfairly restricting access to their displayed quotations.

Third, markets must be transparent. All significant markets must make their displayed quotations and trade reports available on terms that are fair and not unreasonably discriminatory.

Turning to the proposed consolidations themselves, I would focus on two basic questions: First, what effect are these transactions likely to have on competition among markets and among orders? Second, how will the new consolidated markets meet their responsibility to assure effective regulation?

The national market system is premised on promoting fair competition among individual markets while, at the same time, assuring that all markets are linked together in a unified system that promotes interaction among the orders of buyers and sellers. It thereby incorporates two distinct forms of competition: Competition among markets and competition among orders. The Commission's challenge has been to maintain an appropriate balance between these two vital forms of competition. Generally speaking, I believe the effect of the proposed consolidations combined with the new trade-through rule should be to increase market depth and liquidity and enhance order competition.

Moreover, I do not agree, as some may fear, that the consolidations represent the death knell for competition among the markets. Although at first glance, it appears that the New York Stock Exchange and Nasdaq will dominate the landscape, I believe that competition among markets should continue to thrive. The New York Stock Exchange will have to battle to maintain its market share, given the expanded opportunities for fully electronic markets to compete in New York Stock Exchange stocks after implementation of NMS. This competition, I believe, promises substantial benefits for investors and faster, more efficient trading, particularly in the most active New York Stock Exchange stocks.

Similarly, I anticipate a continued battle for market share in Nasdaq stocks. The new trade-through rule will require trading to interact with the best displayed prices on the electronic limit order books, and this is likely to produce deeper, more liquid markets and more efficient pricing. In addition, as I noted earlier, the trade-through rule will enhance the ability of smaller markets to attract order flow by simply offering the best price, and I believe market participants will have an interest in sending them order flow to preserve multiple options for order executions.

The proposed consolidation should also be viewed against the backdrop of the changing structure of industry self-regulation. Last December, the Commission published for comment a series of new rules designed to strengthen the current system of industry self-regulation. Among other things, these rules would ensure the independence of SRO boards and restrict the ownership interest of any SRO member to no more than 20 percent. At the same time, the Commission also published a concept release seeking comment on a range of longer range issues, including the conflicts of interest between an SRO's business and regulatory functions, the potential costs and inefficiencies of multiple SRO model and the manner in which SRO's fund regulatory operations.

With the announcements of the proposed market center consolidations last month, I believe it is even more critical that the Commission act promptly on the SRO proposals.

With respect to the proposed consolidations, very few details are available regarding the plans for self-regulation. At this point, I can simply highlight a few issues that will be examined prior to reaching any decision. First, the New York Stock Exchange would, for the first time in its history, become a publicly held company, raising at least the potential for conflicts of interest between the profit maximizing interests of its shareholders and the need for effective self-regulation. Second, the proposed consolidation of the Instinet trading platform into Nasdaq preliminarily would appear to streamline the overall regulation of trading on the combined Nasdaq-Instinet platform.

The regulation of such trading would be consolidated into two regulatory entities: The NASD and Nasdaq. Any examination of the Nasdaq-Instinet transaction would occur in the context of Nasdaq's application for registration as a national securities exchange; and, in this regard, I believe the staff has resolved all of the major issues with Nasdaq, and I expect Nasdaq to file an amended exchange application early this summer.

Finally, given the potential competitive clout of the two consolidated entities, the Commission's role in reviewing their rule filings will be extremely important. The issues addressed in these rule filings will include the fairness of market data fees and other fees as well as potentially discriminatory rules against competitors or market participants.

I have covered all of these topics, as you know, in much greater detail in my written statement, and I would be pleased to elaborate further. I look forward to hearing your views and trying to answer your questions and, again, thanks for having me back.

Chairman SHELBY. Thank you, Mr. Chairman.

Chairman Donaldson, some people still remain troubled by the SEC's three to two vote on Regulation NMS. There was a concern that the lack of consensus undermines the SEC's credibility and establishes an unfortunate precedent. Despite the potential for consensus, the rule was adopted on a split vote.

Should such fundamental policy changes as extending the trade-through rule to Nasdaq not be supported by a greater consensus, and are you troubled as Chairman by lack of consensus on this regulation and what it means for the SEC going forward, or is that just part of the turf that you work under?

Chairman DONALDSON. Good question. Let me just spend a minute trying to answer it.

First of all, during my Chairmanship, there have been close to 3,000 Commission votes. Of these, just slightly over 98 percent of 3,000 votes were unanimous votes. Of the 2 percent that were not unanimous votes, in one case, two Democratic Commissioners voted in the minority. In eight cases, one Democratic Commissioner voted in the minority. In 15 cases, two Republican Commissioners in the minority; in 44 cases, or about two-thirds of our nonunanimous votes, a single Republican Commissioner voted in the minority.

I suppose that you could draw a lot of conclusions from these statistics, but let me just try and say how I feel about this, and that is that I believe that the structure of five Commissioners and three to two with the three being from the party of the Administration sets the stage for decisionmaking, and again, even as you all are debating differences of opinion right now in other areas, there will be differences of opinion at the SEC, particularly when we are dealing with the kind of contentious, complicated, and highly technical issues associated with a central marketplace.

My own personal view is that the common denominator here is the investing public, that constantly, we have to remind ourselves that we are going to do what is best for the public investor, and with that thought in mind, I believe that you leave your party credentials at the door, and again, speaking personally, that is what I have tried to do in all of the decisions that we have made.

I might also add that you try to bring to bear, and I am sorry to elaborate on this, but I do feel strongly about it, because the press has made such a big point about this, and I am trying to put it in context. But we all try to bring our experience to bear on the issues before us, and I have tried to bring my experience based on far too many years in the markets, if you will, to make decisions based on that experience.

I might also add, just in terms of historic content, and then, I will be quiet, under my predecessor, Chairman Pitt, I understand that 99 percent of the votes were unanimous, so we are not that far off the recent track record.

Chairman SHELBY. Mr. Chairman, it has been over a month since you at the SEC approved Regulation NMS, yet the SEC has not issued the final rule. When do you contemplate that?

Chairman DONALDSON. We expect that the final rule will be coming down within the next couple of weeks at the most. It is a very detailed rule, very complicated, and we are just about a week or so away from it.

Chairman SHELBY. Do you contemplate substantial changes to what you have published?

Chairman DONALDSON. No.

Chairman SHELBY. Okay; the Nasdaq exchange application: We heard testimony yesterday regarding market participants' needs to innovate quickly and to adapt to changing market conditions in order to compete. You alluded to some of this. The witnesses stated that their ability to compete is directly linked to the SEC's timely approval of proposed rule changes at the market centers. It was pointed out that rule changes often linger before the SEC for months or even years without any action. For example, Nasdaq's exchange application has been pending before the SEC, I believe, for over 4 years.

Why does it take so long, Mr. Chairman, to obtain SEC approval? Is this inaction here fair to market participants who need to respond quickly to market changes? And is the Nasdaq exchange application more complicated than Reg. NMS? I know it is different.

Chairman DONALDSON. It is very different, and let me try and dispel the image of the Nasdaq application to become an exchange as something that has been lying on the desk, and people are sitting with their feet up and doing nothing about it. There is a fundamental principle having to do with requirements for an exchange to have price priority built into their operation. Nasdaq has refused to do that. And therefore, we have not moved on their application until recently.

Recently, I suspect as a part of all this consolidation going on, they now are prepared to include time and price priority in one of their operations which qualifies them now to become an exchange, and I would expect that their application will be approved fairly shortly. As far as the other implication here of the rapidity or lack thereof of passing rules, I have to say that this area of the national market system is extremely complicated, detailed, and filled with all sorts of pitfalls, and I think that, in effect, the staff and the SEC have been pondering this for years, if you will, taking testimony, talking to all parties, et cetera, et cetera.

But I think, that in the last 2 years and particularly the last year, we have decided that something must be decided, because the technology continues to escalate. So, I think that, now that we have taken a whole package of rules, and we have addressed a whole system here. There will be rule changes applied for coming down the pike, and if we are now able to simply act or be asked to act upon a single modifying thing, I think the complexity will be a lot less, and hopefully, the speed will be a lot faster.

Chairman SHELBY. I agree with you that what you deal with is very complex issues, and they have to be done right, and they have to be thought out and the implications, but sooner or later, as you have just mentioned, there should be a decision made, should it not, one way or the other?

Chairman DONALDSON. Yes.

Chairman SHELBY. Most applications.

Chairman DONALDSON. Well, I agree. And this goes for everything that we are dealing with. Where we can, where the issues are simple, we need to act swiftly. It takes a little longer when things are complex.

Chairman SHELBY. Senator Sarbanes.

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

Chairman Donaldson, we are pleased to have you before us. I just want to follow up very briefly on the first question that Chairman Shelby asked. My understanding, as I was listening to the figures you gave close to 3,000 votes that the Commission has taken that in all but 68 of them, they were unanimous votes and that of the 68, 52 of those had just one Commissioner dissenting, so that it seems to me a pretty impressive record in terms of developing consensus, and I know that in the past, the Commission has had split votes.

In fact, David Ruder once observed to us that on tough decisions, sometimes, you just have split votes. People see things differently. But I think in looking at these figures, the number of real close divisions is pretty minimal, as a matter of fact, in the context of the decisions that you have been making.

Let me address the regulatory structure issue, because I am quite interested in this. You addressed it in your statement, particularly the critical issue of addressing conflicts of interest between SRO business and regulatory functions. What is the Commission's plan or course of consideration moving forward with respect to this a rather critical issue?

Chairman DONALDSON. It is a critical issue, and again, if you go back into history, I think the decision was made quite correctly by the new SEC and the new securities law rules back in the 1930's to go to a system of self-regulation, and that was based, as I understand it, on the thought that the closer you could build the regulation to the actual operating entities, the more effective that regulation would be. And so, the decision was that the SEC would be the national regulator but would delegate self-regulation to the markets and to people acting in the markets.

Fast forward to where we are now. Clearly, there has been a breakdown of self-regulation. It reached its zenith 2 years ago when the governance of the New York Stock Exchange was brought into question, and, at that time, I wrote a letter to all of the exchanges and asked them to review their self regulatory structure and their governance structure and to come back to us with their thoughts on how this should be organized.

And the New York Stock Exchange responded with the organizational structure that you now see, which in effect took the whole self regulatory side of the exchange, the whole enforcement side, and had it report into an independent subcommittee; in other words, the regulatory mechanism was taken out of the chain of command, and no longer reports to the chief executive officer of the exchange. It reports to an independent committee. That is one model.

There are other models that have been suggested and we will have under review as we go forward. The other models will range all the way from a total separation of regulation and placing of that in an independent body that would regulate all exchanges down to several other models.

I think you are absolutely right when you point out that, in addition to the business regulatory conflict that exists in the exchange markets now, the difference between being in a business and regulating that business, now, you interject a third dimension of public owners, and again, that is another potential conflict.

So we have to address this. We have reached no conclusions on it. We have gotten all the advice we possibly could from the industry itself, and we are at the point now where we are wrestling with what the best model should be.

Senator SARBANES. Yes, I think as you wrestle with that issue, I just want to observe that in considering these various models, I think, it is important to look at the issue of the appearance of a conflict of interest as well as the reality of a conflict of interest. I say that for this reason: After all, what is at stake is people's confidence in the workings of the market, and it may be that if you go through a careful analysis and everything, you can reach a conclusion there really is not a reality of a conflict.

But if there is the appearance of a conflict, which the ordinary person on looking at the thing would be what he or she would be struck with, it may well create a confidence issue, and of course, that is one of the things we are very anxious to make sure those questions do not arise. So, I think this issue of the independence of the regulator and the assurances that particularly when you go from nonprofit to profit, and then, the concern begins to be that there is a benefit that accrues, depending on the regulatory decisions.

We know the Commission is working very closely on this issue, and we simply commend your efforts. We will be following it very closely as you move ahead.

Mr. Chairman, I see my time is up. Thank you very much.

Chairman SHELBY. Senator Crapo.

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

Chairman Donaldson, I want to just cover actually a couple of issues that both of the previous Senators have covered with you. I was very pleased to hear your testimony with regard to the Nasdaq exchange application, and as I understood you, you have indicated that all of the remaining issues from your point of view have been resolved, and you expect it to be addressed promptly.

Can you give me any kind of an idea as to how quickly we could expect to see this issue resolved?

Chairman DONALDSON. I think that I will be vague enough to say in early summer. I mean, for all intents and purposes, we are almost there, and we are now just putting the final touches on it.

Senator CRAPO. All right; well, I do appreciate that. I think that is a piece of a lot of what is going on that many of us have been focused on and wondering if there was some kind of delay that we could figure out a way to get around, and your testimony today is very welcome.

The other thing I wanted to talk to you about is, again, the issue of the split votes on the Commission. And I realize that there have been, as you indicated, 3,000 votes, with 98 percent of them unanimous. But we cast a lot of votes around here, too, and there are a lot of votes that are pretty much unanimous or not controversial. And then, there are some seriously controversial issues, of which we have a few on the floor right now.

And I was just thinking back as you were testifying over some of the major three-two votes on the Commission which have happened recently which seem to be on issues that impact our markets in very broad ways. There is Reg. NMS, the hedge fund regulatory decision, the decision with regard to mutual funds, on independent chairmen and the like.

It seems to me that although one can argue that there is a lot of unanimity when you look at the broad array of issues that the Commission is dealing with, it also seems to me that on the three biggest issues that I can remember coming to the attention of this Committee in the last period of months, every one of them has been a three-two decision. I think that is why the impression out there is that there is getting to be a lack of consensus on the Commission that is disturbing. Can you respond to this, please?

Chairman DONALDSON. Sure, I will try to.

You are absolutely right in terms of some of the major issues here, there has been the three-two vote. I think that there is a tradeoff here between reaching consensus and reaching a decision. The issues we have been dealing with are so important and so time-sensitive that we have, or I would say I have, because it has been my vote, resolved the issue in the interests of not delaying and watering down what needs to be done in months and months if not years of discussion and back and forth and not making a decision. And then we could have end up with a decision that is not what should be done and a decision that is reached after way too much time.

Now, I think that the process at the SEC is a very open and fair process; in other words, there is a tremendous amount of work that is done, and then, an open debate on the record of people's positions. And I think that because of the nature of the times we live in now, I think there has been a deterioration, if you will, of that process. After the debate has gone on and after a decision has been made and after a majority has decided, then, there is a follow on of minority dissent. A minority dissent, by the way, which could have been brought out in the open arena but a minority dissent that is out there with no comment on it, no ability for comment. And I think that, frankly, is a serious step in the wrong direction.

We are not the Supreme Court. We are not in the business of giving a majority and minority dissents, but maybe that is what we are headed for. But I believe that the traditional way that the Commission functions is the best way of resolving differences. I think you are quite correct in that this particular period here, the last couple of years, we have been facing up to some very important issues, and it is on those issues that we have had the disagreements.

Senator CRAPO. Well, I appreciate your grappling with that issue. As you were describing the dynamic at the Commission, which raises concerns about process and how the Commission is working out, I was thinking about the very issues that we are grappling with here in the Senate with similar kinds of process conflicts.

Chairman DONALDSON. Yes.

Senator CRAPO. So, we are certainly not immune to the same kind of thing that you are talking about or that you are discussing there, and I just wanted to wrap up my comments by saying it has been no secret; I have been very open in public about my disagreement with some of the stands that you have taken and the direction that the SEC has gone on some of these rulings.

I have appreciated you getting back to me and working with me personally on it, and I will state publicly what I have stated to you: My interest here is to see if we cannot work toward improving the process and improving the ability to develop greater consensus. And again, I appreciate you personally as well as your staff being willing to work on that, and I will continue to work with you as we try to work through these difficult issues.

Chairman DONALDSON. If I could just comment on that and I appreciate your comments. I just want to assure you that we have worked very hard to get consensus, very hard; and, as you know, we welcome working with you and the rest of this Committee. I mean, these are important things. We need all the judgment we can get.

Senator CRAPO. Thank you.

Chairman DONALDSON. Thank you.

Chairman SHELBY. Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Thank you, Mr. Chairman. Yesterday, we heard testimony from both Nasdaq as well as the New York Stock Exchange group, and there was, you know, some interesting testimony I thought there. For example, Mr. Thain said that Reg. NMS did a good job in anticipating changes in markets, and then, Mr. Putnam said that Archipelago felt the pressure to consolidate. And further, with regard to competition among the order and market centers, Mr. Thain said that Reg. NMS protects the smaller markets and provides room from competition.

Then, we had testimony from Mr. Frucher, who, on the other hand said that Reg. NMS will create significantly more barriers to entry for smaller markets. And could you share with the Committee your thoughts on these dissenting views and ultimately how you see Reg. NMS impacting the scope of U.S. market centers?

Chairman DONALDSON. Right; let me say that I believe that Reg. NMS is procompetition for both the large markets and the small markets. And the reason I say that is that the smaller markets have an unbeatable weapon, if you will, to compete with the big guys, and that is to offer the best price. And if they offer the best price, that is where the order will go.

Now, the best price trade-through aspect of what we have proposed here is extremely important, because it says that, in an electronic environment, you must honor the best price, and you must honor that in a market that is instantaneous and has eliminated from it the delays that made it difficult to compete with particularly the floor-based markets, New York and so forth.

I believe that, if you step back and look at the history of these electronic markets, they are not that old. I mean, Archipelago was founded, I think, 8 or 9 years ago, and because they competed with a then even more dominant New York Stock Exchange, they were able to insert themselves into the competitive fray, and I predict that we are going to see, as time goes on, ways of doing business that we cannot imagine today, and I predict that the entrepreneurial, small entities either out there now or which are going to be out there will be very competitive in this new environment.

Senator ALLARD. In Bloomberg's testimony, I think Mr. Bang expressed their concern that some of the hybrid proposals put forth by the New York Stock Exchange might undermine Reg. NMS. Do you see any potential there?

Chairman DONALDSON. Again, the concept here is that those who want speed will get it in the electronic part of the hybrid. On the other hand, the structure will accomodate those who voluntarily value other aspects of trading, and that would be specifically the capital that the specialist brings to the game; it would be the capital that can be accumulated in times of stress to step in and moderate violently moving markets and the human judgment involved in executing an order in a tumultuous time. I believe that the alternative to go into that kind of a market and to have it available as we move into the electronic age preserves what has been a pretty valuable part of our national market system.

I might comment that this is going to be a much more competitive world for both of these emerging duopolies, if you will. There is going to be competition for capital. There is going to be competition for having a business that works and makes a process, and I think that it will remain to be seen just how people decide which one of these two markets they want to operate in, and I think anybody that predicts exactly what is going to happen has got more insight than I do in terms of how it is all going to work out. But I think we are headed in the right direction.

Senator ALLARD. Mr. Chairman, I see my time has expired.

Chairman SHELBY. Thank you.

Chairman Donaldson, yesterday, we received testimony concerning how the proposed mergers would have an impact on the regulation of market data. What issue do the mergers raise with respect to the cost, collection, and allocation of market data, and will the SEC need to take further action on market data to account for the proposed industry consolidation?

Chairman DONALDSON. Market data and our proposals on market data are basically a first step to rationalize the inefficiencies and inequalities in the way market data is gathered and allocated. And by that, I mean as a result of the morass, if you will, of different ways of competing in the system that has been prevalent for quite awhile, 5 years if not 10, there have grown up a number of practices that serve no economic benefit other than to create revenues for certain trading centers. And we refer to such things as tape shredding and so forth, where orders are broken up in order to have more prints on the tape in order to get the revenues. And our initial thing here is to try to eliminate that and try to reward revenue sharing, if you will, for centers which are actually contributing to the liquidity in the marketplace.

There is a second step here which we have not addressed, and that is the absolute level of revenues. And again, this is inextricably involved with how the new institutions are going to dedicate their revenue flows; in other words, we now have businesses, if you will, who will have a profit motive, but we also have regulatory responsibilities which are not money making; they are money using.

And so, the issue becomes how these institutions will protect the revenues that need to be protected to support the regulatory side. And I think that the next step here once we get through our organizational structures, once we get the structure right—is that then we will be able, because of the new transparency that we will demand of these exchanges, to get a better feel for just what those revenues should be in an absolute way.

Chairman SHELBY. Should that not be very positive from your standpoint?

Chairman DONALDSON. I think that there will be a judgment factor here. I mean, there are those who say that those tape revenues should be strictly priced on the cost of developing them, some cost-plus kind of thing, and I do not think you can cross that bridge until you really get an idea of what the regulatory side of things is going to cost. And there are a lot of different ways of financing the regulation in terms of direct taxes, if you will, or fees, and I think we have to take a look at the whole package. For those who feel those fees, tape revenues are too high right now, I understand that; we all understand that. It is just a matter of phasing in our attention to it.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. I will be very brief, Chuck.

Mr. Chairman, I will be very quick.

First of all, I note that the testimony we got yesterday, everyone thought that what you have done is an improvement over the current situation, so that some still have some concerns, but everyone thought depending on their different points of view how far of a great step forward it was, but they were all in agreement that it was a step forward.

I have to tell you, I think the traditional process of the SEC has contributed to this. One of the things you did not mention when you were outlining it that I have always been very impressed with is the receipt of letters of comment on your proposals when you put them out there in tentative form, which enables all interested parties to come back to the SEC with well thought-out, well-considered responses to what the SEC is thinking of doing and therefore enables the Commission to take all that into account as it moves toward shaping a final rule.

And I want to underscore that, because this process in some ways is very special that the SEC has established over the years and that it has followed. I think it is very important for reaching wise decisions and particularly decisions that people are willing to support. I am struck now by the growing degree of acceptance or support of the NMS regulation compared to what was being said not too long ago. So in that sense, we are certainly moving ahead.

I do again want to emphasize again, I think, the need to focus on how this, the regulation, is done, and being clear of any sense of conflict of interest, and that would, of course, also involve how the regulation is financed so that the people who finance it cannot cut off the financing if they are unhappy with the decision. That was one of the big decisions we faced with the PCAOB and FASB, and of course, they now have assured financing, which gives them an independence of decisionmaking, which I think is very helpful.

Let me just close on one point, and I take it from what you are saying you are sensitive to this concern: Sandy Frucher of the Philadelphia Stock Exchange yesterday said that the smaller securities exchanges have repeatedly served as laboratories of invention, and then, he mentioned the number of innovations that they had adopted, all of which were then adopted by the larger exchanges. They had paved the way.

And he asked in his statement that the SEC take all steps to ensure that it and other venues are allowed to compete vigorously and aggressively, and the smaller exchanges be able to innovate and find new products and trading technologies. I take it that squares with what the SEC wishes to do. You are not out to establish a duopoly here with respect to the working of the markets and the exchanges.

And so, I take it that you are already sensitive to these comments, but I just thought I should ask you that for the record.

Chairman DONALDSON. Absolutely. I think that we are extremely conscious, aware of, and applauding the entrepreneurial changes that come along here from competition, and we have experienced that now, as I say, with the rise of these electronic exchanges. I think that the one thing we do worry about is competition that is improper competition, I mean, competition that basically serves no economic purpose and undermines the fundamental principle of best price for the individual client, and there has been some of that that has grown up here in recent years.

I think the rules we put in, this is repeating myself, but I do believe they set the stage for even the smallest most entrepreneurial new exchange who has the right technology to come in and compete with the big guys.

Senator SARBANES. If people in the industry do not place the investor first and foremost and therefore run the risk of undercutting investor confidence, they are going to kill the goose that lays the golden egg, and they more so than anyone since they benefit from the investor involvement should be concerned to provide the appropriate protections.

Thank you very much.

Chairman DONALDSON. Exactly.

Chairman SHELBY. Senator Hagel.

STATEMENT OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, thank you.

Chairman Donaldson, I am sorry I was not here for your statement. We have been holding other hearings, and I wanted to make certain that I did get some time with you, and I again appreciate your appearing here this morning, and I will read your statement.

Two sets of questions I would like to address this morning: One, you may have addressed some of these issues in your statement or in the question and answer period with my colleagues, but I want to ask a couple of questions on Fannie Mae and then talk about implementation of regulations in a general sense. You, of course, are aware that in December 2004, the SEC informed Fannie that it did not properly apply an accounting derivatives standard known as FAS 133. Last week, Fannie May disclosed that it will delay its 2005 first quarter financial report with the SEC and that it misapplied another accounting standard, FAS 115, which it uses to classify its mortgage-backed securities.

A couple of questions: Will Fannie's misapplication of FAS 115 cause Fannie to further restate its earnings? If it would further cause a restatement of earnings, by how much?

Chairman DONALDSON. This is something that I think I probably cannot comment on in that we are in there now in the midst of an investigation, and I do not want to prejudge where we come out on that. Clearly, just as you understand for sure, you know, our function here with Fannie is not the overall structure of Fannie Mae; ours is the accounting and reporting systems, and we are right in the midst of looking at that, even though our first ruling was that their accounting was improper.

Senator HAGEL. Do you have any sense of when you would complete these investigations? There are other dynamics, other parts of this investigation.

Chairman DONALDSON. Sure. I do not want to mislead you. If you will, I would like to get back to you with a time judgment on that. I do not want to say something I will regret.

Senator HAGEL. And what I will do is not at a public hearing present some specific questions; maybe if we could talk privately on some of these issues, and I know that you are in a difficult spot with an ongoing investigation, but these are very serious matters that continue to dribble out every other week, it seems, as to what is going on, and obviously, you know this Committee is most likely going to be looking seriously at a markup of a GSE reform bill which is focused much on these kinds of issues as to how did they happen, why did they happen, and, of course, the SEC's involvement, and I will ask for some time with you whenever it works.

Chairman DONALDSON. I would be delighted to do that.

Senator HAGEL. I want to go to the implementation of Sarbanes-Oxley, which you have been reviewing, and you have been laying out new regulations and refined regulations to try to make it work and adjust in the way that it was intended to work. I suspect that I am not alone in being a U.S. Senator and a Member of Congress, who has heard from especially small businesses saying that the implementation of Sarbanes-Oxley has been a huge burden on these companies.

I have talked, met with several of these companies about what they consider excessive costs and regulatory burdens for complying with the requirement. I have got, which I will not go through now, but I will give to you later about five pages of individual companies, specific companies, specific issues, and problems. I know these are imperfect systems and processes, and you are trying to seek some equilibrium. And I know you have issued new guidelines addressing some of these overall concerns.

But can you address these in a general way without us taking the time, since we do not have it, to go into going through each of these companies' specific problems that they are having?

Chairman DONALDSON. Sure.

Senator HAGEL. This is a burden. I mean, I think it is very real. I used to be a small businessman. I have some sense of this. What is the SEC doing here to deal with this? The big companies are the big companies, and they have the resources; they have the law firms, and they can margin in some way. The little guy, the medium-sized companies cannot.

Chairman DONALDSON. Let me try to address that in two ways.

First of all, in terms of the overall Sarbanes-Oxley, I believe that it is working very well in a cost-efficient way, and by that, I mean the shifting of power to the boards of directors, independent committees, the new authority that Sarbanes-Oxley gave the SEC for fines and our ability to give those fines back to damaged or injured shareholders and fair funds. I think all of that is tremendously positive, and I believe that this law, if you will, will progressively be realized as a very important piece of legislation.

Now, on the particular part of it that you are talking about, so-called "Section 404," which has to do with the obligation of senior management, the CEO and chief financial officer, to basically sign their name on a line with the data that they are giving to the public, I think that there have been two things that have caused expenses that do not need to be there.

First, is the overall application of this to all companies in general and second, is a kind of one-size-fits-all approach taken by some so that a small company has to shoulder the expenses. Disproportionately, those expenses mean a lot; and it is not just the expenses. It is not that easy to get a lot of independent directors, for a small company to have committees filled with directors that are independent.

We are addressing this in two ways: One is we had this roundtable discussion a month and a half ago. We had six different panels. We brought together people who were involved from all different points of view: Heads of companies, accountants, accounting firms, and so forth. And by the way, the kind of horror story that I am sure you had in front of you, we asked everybody to put their horror stories on our website so that they could get that out so that we could devote the day to constructive thought.

It was very constructive. And out of that have come the two pieces of interpretation that we just put out this week, the PCAOB and the SEC and, basically, what we said, the guidance that we have given to the accounting profession and to the corporate world is, if I can say it in simplest terms, use your common sense in applying these rules. Have a risk-based approach to detail and understand where you have to apply this. If you use your common sense and have a risk-based approach, you will not be in trouble with us if you do it that way.

Senator HAGEL. The common sense rule that you just noted, has that also been directed at the regulators?

Chairman DONALDSON. Absolutely, and that is a very good point. And there again, I think by the very publishing of this guidance, we are saying that implicit in that guidance.

Now, just to finish, on the small company side, we formed a panel, a committee not just for 404 but for the whole Sarbanes-Oxley panoply for small companies, and it is a very good committee. They will be in existence for a year. Their charge is not just to address the particular problems of small companies vis-á-vis 404 but also to take a look at all of Sarbanes-Oxley and see if there are any ways that the rules can be modified to accommodate smaller companies. So, I think help is on the way.

Senator HAGEL. Thank you.

Mr. Chairman, thank you.

Chairman SHELBY. Senator Reed.

Senator REED. Thank you very much, Mr. Chairman, and thank you, Chairman Donaldson.

As I mentioned in my opening remarks, this is a national market situation in an international environment. And yesterday, some of the witnesses claimed that an advantage shown by some foreign exchanges that they trade not just in equities but also in options, derivatives, and fixed-income products and all on one market. Do you think it confers an advantage on these foreign exchanges? Is there anything that we should do to think about altering the current statutory and regulatory arrangements?

Chairman DONALDSON. Are you saying will there be a convergence of other kinds of instruments?

Senator REED. No, I am thinking about the instruments that could be traded on our markets in the one-stop shopping.

Chairman DONALDSON. Yes, yes, I think that, as the world of finance has gotten more complex, as these different instruments have come into being, options and futures and so forth, I think you are going to see not just domestically but globally, and we are already seeing it, multiple instruments being traded on the same platform. And there is good reason for that, because these instruments are interdependent, if you will; one moves, the other one has to move kind of thing.

So, I think that, as the exchanges both go public and raise money and use that money to invest in the technology to trade other instruments, I think you will see this happening here and overseas.

Senator REED. Are there things that we should be thinking about now in terms of proposed statutory changes that would either assist convergence or somehow make sure it is done appropriately?

Chairman DONALDSON. I believe that what we are proposing right now is just the first step in a new global competitive situation. I think that as you know, American investors are investing increasing amounts of their money overseas, dealing in markets around the world; vice versa: Markets around the world, whether it be in the European Community or out in the Far East, are serving huge populations and huge industrial bases, and I think you are going to see global competition coming in, and I think that what we have proposed here sets the stage for two things: For U.S. competition that can compete with the rest of the world and the preservation of the capital-raising integrity, if you will, of our markets, which hopefully will preserve the dominance that we have right now.

Senator REED. Thank you, Mr. Chairman.

Let me switch gears dramatically. We have talked to your staff about a particular issue that has come up in the context of the CDC's immunization program for vaccines. We are told that because of accounting rules, vaccine makers cannot claim as revenue sales to CDC under the Pediatric Vaccine Stockpile Program because they have to do that only upon a delivery, but the contracts call for them to buy it and hold it until the crisis erupts. And I am wondering if there is anything that you can do, because apparently, this is causing some difficulty to the CDC and to the vaccine program.

Chairman DONALDSON. We are on the case, Senator.

Senator REED. Good.

Chairman DONALDSON. Basically, the issue, not to get into too much detail, has to do with the structure of the transaction, the business structure of the transaction, which makes it impossible to report a closed sale, because there is a lot of product that goes through that never really closes. And so, we are trying to resolve with HHS the nature of the contracts that they are writing, and we think that it can be done.

And, in the event that it cannot be done, we definitely are not going to stand in the way of these vaccines getting where they should go. But we do not think the real issue is going to be our accounting rule. We think it is going to be the structure of the deal that is struck with the pharma companies.

Senator REED. Thank you, Mr. Chairman.

Thank you.

Chairman SHELBY. Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman, for holding the hearing, and I want to thank Chairman Donaldson for coming. Once again, he has been most accessible to this Committee. I think we see you more than we have seen most of the SEC Chairmen in the past.

And I first want to congratulate you on the reforms that you have made in modernizing the national market system. We have had a difficult problem here: We want to have efficient markets. We want to have competition. But we also want depth and liquidity in markets. And all of that is complicated by the fact that only in the last 10 or 15 years can international markets not governed by any American rules can trade equities like anybody else. The technology did not allow that.

And so, the question is how do you keep the basically sound structure that we have had in this country, which relies primarily on disclosure and openness and at the same time deal with competition and change? And as you know, I have been greatly worried about fragmentation in the markets, about six different centers of trading occurring. I know some of the big interests wanted that, I think because they wanted to either own their own trading mechanisms, or they wanted opacity. They did not want people to know what they were doing, which is not good for the markets.

Well, you came up with Regulation NMS, and, at least to my liking and I think to most people's, kept the trade-through rule so small investors like my father would not be disadvantaged by the big boys, and when it came out, yes, there was a three to two vote, although the bipartisan vote was on the side of NMS, obviously, but I think what we have seen since then is a vindication of what the SEC has done. When the NYSE took over Archipelago or announced that it was intending to take over Archipelago; when the NASD and Nasdaq decided they would take over Instinet, it basically said that we could almost have it all.

We could have deep liquid markets; we can have best price; and at the same time, we can have some competition. And so, I think that the events of the last month or month and a half have vindicated the SEC's approach, and the great worry that I have had, the fragmentation of the markets, the opacity of the markets, is much less of a worry today than it was 2, 3 months ago, and I think you have to give the SEC credit for that. So, I thank you for that.

And it really, what has happened has taken away most of my questions. I have here some nice softball ones on best price, but I think we are getting a nice consensus on that.

[Laughter.]

I would say this: I mean, could you comment? There has been some talk, not so much in this body but the other body, of Congress intervening and trying to either overturn or modify what has happened. One of the worries that I have is now that we have settled into a good place, and we can compete with Europe and everything else is that if we were to have that out there, it could interfere with the progress that we have made in the last while. Could you comment on that?

Chairman DONALDSON. You do not want me to walk into that, do you, in terms of the other body?

[Laughter.]

Senator SCHUMER. I know you will do it in your usual diplomatic and deft way.

Chairman DONALDSON. No, seriously, I think we are going to work very hard, have and will continue to talk to anybody that will talk to us about why we think what we are doing is the right thing, and we will not give up until we have convinced the very last person.

I do think that this business of the global position of our markets is coming over the horizon rapidly, and again, my own view is that if we have the most transparent markets, and if we can maintain what is unique to our market, which is that small investors do get to trade side-by-side with giant institutions, if we can maintain that, if we can move on global accounting standards, if you will, that people will come to our markets because it will be the lowest cost of capital here, and we will be able to compete on a worldwide basis.

Senator SCHUMER. And that is how it has been, and let us hope and pray—I say this as a New Yorker and as an American—that it stays that way.

Okay; I just wanted to follow up. It is interesting that Senator Reed had a question very similar to mine, because I have been notified in New York of the shortage of the vaccines. And it seems to me that to make the vaccine maker put the costs on their books before the vaccine is actually sold does put them in a kind of catch-22 situation, and as I understand it, this happened only since I think it is 1999 when the SEC passed a rule that was far more aimed, and aimed correctly, in my opinion, at larger companies and financial services companies, and nobody paid attention to how it would affect vaccine makers, because the Government has a stockpile which they put into.

Why would it not just make sense to make an exception not with the words vaccine makers in it, but when you have this stockpile that is not used because of an emergency that occurs, a health care emergency or something or some other kind, but it would not be a financial emergency in the mind of the user that you just undo it or just exempt the vaccine area? It does not sound to me like when you say, well, they will change the way their contracts are written as the easiest solution, since the recognition of income or revenue recognition was never intended to deal with this situation?

Chairman DONALDSON. I do not intend it as a flip remark to say it is just the nature of the contracts, but it is. There is a way, I believe, for the companies to adjust the way they sell, loan, or whatever they do with these vaccines to not have to be concerned with our accounting.

Senator SCHUMER. But will CDC do that? That is the issue. As I understand it, the SEC says to CDC you do it our way, and CDC says to SEC do it our way, and the twain have not met for quite awhile.

Chairman DONALDSON. Well, I hope that is not so. I can assure you that we are on top of this. We are working at it. We are talking to HHS. We are talking to the companies. We are trying to work it out. I would be very pleased to try and give you a report on the exact stage of where we are with it.

Senator SCHUMER. Thank you very much.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Sarbanes, we have a minute.

Senator SARBANES. I have no further questions.

Chairman SHELBY. Mr. Chairman, we appreciate your appearance here today. We appreciate your candor, and we will continue to bring you back up here from time to time. I think you like it here.

Thank you.

Chairman DONALDSON. Thank you.

[Whereupon, at 11:30 a.m., the hearing was adjourned.]

[Prepared statements, resposne to written questions, and additional material supplied for the record:]

PREPARED STATEMENT OF SENATOR JIM BUNNING

Thank you Mr. Chairman for holding this hearing and I would like to thank Chairman Donaldson, for testifying today.

I appreciate your coming up here as often as you do. As you know I do have some serious criticisms of some of the policies you have been pushing at the SEC. I cannot however, criticize your accessibility to the Committee and I want you to know how much I appreciate you making yourself available to the Committee. I would also like to take this opportunity to publicly thank 3 members of your staff, Jane Cobb, Allen Beller, and Paula Dubberly for their help and technical expertise in working toward an agreement to bring the Tennessee Valley Authority under SEC enforcement. As you know, this is a very important investor protection development. This agreement with the TVA will help protect bondholders all over the country. I would also like to thank the Chairman's staff, Kathy Casey, Doug Nappi, Bryan Corbett, and Paul Doerrer who served Chairman Shelby on Appropriations and now is with the full Committee. As well as Libby Jarvis of Majority Leader Frist's office and T.A. Hawks, Jenny Reeves Manley and Marie Thomas of Chairman Cochran's office for working so hard to accomplishing this worthwhile task.

That was the good part. Here is the bad. I still do not agree with your rule on mutual funds. Obviously, 2 of your commissioners do not either, or they would not have sent a letter to the Appropriations Committee. I never remember seeing a letter like this from the SEC. It makes me have great concerns about the fairness and accuracy of the study that was put together by the SEC. I hope you will not take Commissioner Atkins and Commissioner Glassman's concerns lightly. I do not. Mr. Chairman, I would like to submit a copy of this letter for the record.

I also have concerns about the recent Reg. NMS passed by the Commission. I guess we have a difference in philosophy. To get to the end you wanted, a consistent rule governing the markets, you could have gone with increasing regulation or deceasing regulation. Obviously, you did not trust the free market and you opted for increasing regulation. I believe you should have decreased regulation to ensure a level playing field.

The regulation itself seems to have been accepted by the industry, they want certainly more than anything, and they have moved on. But I am still concerned about the process. It used to be, a majority of the votes by the SEC were unanimous or, on a bad day, 4–1. Very rarely were their 3–2 votes. Unfortunately, 3–2 votes, on major issues, now seem to have become the norm, and there seems to be open hostility during these votes. Now I know you cannot always get consensus, believe me. We have a perfect example of this on the floor of the Senate as we speak, but these recent votes and open hostility concern me greatly. The Committee looks heavy handed. It looks, to this Senator anyway, that you are more interested in steam rolling opposition, than reaching consensus.

I am also very concerned about how long it is taking the Commission to act at times. While I feel you rushed through a bad rule on mutual funds' independent chairman, market timing, an actual abuse, has not been addressed. Even more worrisome, Nasdaq has had an application before the Commission for 4½ years. That seems excessive to me. I am not as concerned about whether you approve the application or not, as I am with them not getting an answer one way or the other for so long.

In yesterday's hearing, Sandy Frucher of the Philadelphia Exchange testified before us. To paraphrase his comments, he felt the regional exchanges, to compete with the large, recently merged markets, will need to be innovative. But they will also need quick approval of those innovations. When they see applications taking 4½ years, it makes them very nervous.

I hope you will take these comments to heart and in the way they are intended. Investors need a strong SEC. But they need one that works together, not one that has controversy and distension on every major issue.

Thank you again for holding this hearing Mr. Chairman and I thank you Chairman Donaldson for coming before us again today.

PREPARED STATEMENT OF SENATOR DEBBIE STABENOW

Thank you, Chairman Shelby. Welcome, Chairman Donaldson. I appreciate that you are taking the time to come before us today to discuss the important issue of your recently approved Regulation NMS.

I know that approval of Reg. NMS has been somewhat controversial. I, like others, would prefer to see unanimous decisions coming from the SEC for no other reason than it would give comfort and a sense of certainty to the markets.

We, here on the dais, are aware more than most that unanimous decisions are frequently difficult to come by.

Of course, the approval of NMS was not a unanimous decision. But, I do not believe that this should cast a cloud over the soundness of the SEC's decision.

At the heart of Reg. NMS is the trade-through rule. The trade-through rule can be summed up as a mandate that stocks traded on more than one exchange cannot be bought and sold for prices that are worse than those offered elsewhere.

Anything that we can do to promote fair markets and provide assurances to the public that they are obtaining the best execution for a market order should be encouraged. Fairness and dependability should be at the root of our securities markets . . . these amazing engines of growth in this country. And, I will do everything I can to support every movement we take in that direction.

This is not say, however, that I support every decision made by the SEC. I am still troubled by your planned implementation of the "push-out" provisions of Title II of the Gramm-Leach-Bliley Act.

The small and medium-sized banks in my home State of Michigan are very concerned about the costs and consequences of having to implement a regulation that they feel runs counter to the intentions of the Gramm-Leach-Bliley Act.

While you have agreed to suspend implementation of the "push-out" regulation until September 30 of this year at the urging of Senator Bunning, myself, and others, I am still not convinced that industry concerns will be fully addressed. I look forward to continuing our work on this issue.

Mr. Chairman, I am generally happy with the progress that the SEC is making under your leadership and look forward to your testimony.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF WILLIAM H. DONALDSON

CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

MAY 19, 2005

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you for inviting me to testify today concerning the important developments in the equity markets that occurred last month. On April 20, the New York Stock Exchange and the Archipelago Exchange agreed to merge and become a publicly held company—the NYSE Group. Two days later, the Nasdaq Stock Market announced an agreement to purchase Instinet's electronic trading network and consolidate their trading platforms. These are the four largest markets trading equity securities in the United States, and the importance of these transactions, if completed, can hardly be over-emphasized.

Today, I will touch on some of the broader policy implications of the proposed consolidations. I will start by placing these proposed transactions in the context of the Commission's market structure initiatives, particularly Regulation NMS. Next, I will offer some thoughts about how the consolidations might impact competition in the markets going forward. Finally, I will highlight some important issues relating to industry self-regulation that the Commission will be addressing in the coming months. As many of the details of the proposed transactions are not yet clear and my observations are necessarily preliminary, my testimony today reflects my own views and not those of my fellow commissioners.

Market Structure Reform

As I have discussed with you in several prior hearings, one of my highest priorities over the last 2 years has been to complete the Commission's extended review of equity market structure regulation. In recent years, the equity markets have experienced sweeping changes, ranging from new technologies, to new types of markets, to the initiation of trading in penny increments. The pressing need for an up-to-date regulatory structure that properly reflects these changes has been inescapable. Last month, the Commission took a critical step forward in adopting Regulation NMS—a comprehensive set of reforms designed to strengthen and modernize our national market system.

In my view, subsequent events in the marketplace have only reconfirmed the importance of this Commission initiative. The fact that the two transactions were announced only weeks after the Commission adopted Regulation NMS may not have been entirely coincidental. To be sure, the transactions resulted primarily from economic and competitive forces in the marketplace. Even when markets are closely linked, individual markets compete on the basis of size, because size offers greater liquidity for executing customer orders. Thus, natural market forces tend toward consolidation of markets. In addition to this basic driver, other economic and competitive forces likely laid the groundwork for these transactions, such as the need to maximize economies of scale, reduce excess capacity, and, in the case of the New York Stock Exchange, respond to a growing demand for more automated trading and, at the same time, position itself to tap the public capital markets to fund future expansion opportunities.

But prior to Regulation NMS, uncertainty about the regulatory landscape may have hindered the ability of markets to plan for the future. They knew that regulatory change was bound to occur, but were unsure as to when and what form it would take. Therefore, while the adoption of Regulation NMS did not cause the corporate consolidations to occur, it may have helped create the conditions under which the forces of competition and innovation—rather than uncertainty—can drive decisionmaking.

Of course, certainty could have come with any Commission decision on market structure, but I believe the choices we made were the *right* ones. By adopting consistent rules of the road across all national market system stocks—which include all stocks listed on an exchange or Nasdaq—the Commission made sure that market consolidation can take place against a regulatory background that protects investors at the same time that it levels the playing field for competitors.

Prior to Regulation NMS, the lack of consistent intermarket trading rules for all NMS stocks had divided the equity markets into halves: A market for exchange-listed stocks and a market for Nasdaq stocks. For historical reasons, including the history of the NYSE as an auction market and Nasdaq as a dealer market, these stocks traded in quite different regulatory structures. Exchange-listed stocks were subject to the Intermarket Trading System, or ITS, rules. These rules include trade-through restrictions, restrictions on locking or crossing quotations, and participation in a "hard" linkage system. In contrast, the market for Nasdaq stocks was just beginning to develop when the ITS was created and has never been subject to the ITS rules.

In recent years, the result of this bifurcation has been a less than optimal regulatory environment for both exchange-listed and Nasdaq stocks. The old ITS trade-through provisions were an anachronistic holdover from the era of primarily manual markets that hampered competition from automated markets in exchange-listed stocks. On the other hand, the markets trading Nasdaq stocks were characterized by contentious disputes relating to the fees that can be charged for access to quotations, as well as the common practice of posting locking or crossing quotations. Moreover, both markets were characterized by a significant volume of trade-throughs of the best prices—in exchange-listed stocks mainly because of gaps in the ITS rules, and in Nasdaq stocks because of the absence of any restrictions on trade-throughs.

From a purely economic standpoint, there should be no significant difference between trading exchange-listed and Nasdaq stocks: Assuming equal regulatory treatment, a market for a large-cap NYSE stock could look very similar to a market for a large-cap Nasdaq stock, and a market with active trading in one should also be able to host active trading in the other. In adopting Regulation NMS, the Commission swept away the outdated and inconsistent existing rules and resisted calls to perpetuate major disparities in the regulatory environment for exchange-listed and Nasdaq stocks. As a result, Regulation NMS effectively unites the market for trading equity securities in the United States. Market participants will no longer need to adopt trading mechanisms and strategies for one regulatory structure that applies to approximately one-half of NMS stocks, while adopting different mechanisms and strategies for another regulatory structure that applies to the other half of NMS stocks. Instead of basing their strategies on regulatory differences, investors will be able to focus on fundamental economic differences between stocks and markets.

One important ramification of this new level playing field is that it will facilitate competition between the NYSE and Nasdaq across all NMS stocks. By eliminating the advantage the old ITS rule might have given floor-based exchanges, the new trade-through rule expands the opportunities for electronic markets to compete with the NYSE floor for order flow and ratchets up the pressure for the NYSE to implement its Hybrid Market proposal in a way that will truly facilitate automated trading. Moreover, if it merges with Archipelago, the NYSE Group will have a formidable electronic platform for acquiring market share in Nasdaq stocks.

Under the new regulatory framework, competition in all NMS stocks will be based on three basic principles—best price, open access, and transparency.

First, the new trade-through rule underscores the principle that, no matter where a customer order is routed, it should receive the best price that is immediately and automatically available anywhere in the national market system. The trade-through rule prevents markets from ignoring better priced automated quotes displayed by their competitors. As competition heats up, the best price principle will protect investors, particularly retail investors, by assuring that intermediaries act in accordance with the interests of their customers. The trade-through rule will function as a critical backstop to a broker's duty of best execution, violations of which can be difficult to prove and which generally does not apply to retail orders on an order-by-order basis.

The best price principle also will promote vigorous competition among individual market centers. As markets consolidate to build liquidity, they are apt to be reluctant to ship orders to competing markets. By ensuring that smaller markets displaying the best price cannot be ignored by larger, dominant markets, the new trade-through rule will make it easier for all markets to compete on the basis of price. Moreover, the continued existence of the consolidated market data system assures smaller markets that their quotes will be widely distributed to all market participants and investors.

Second, competition in the new regulatory structure will be governed by the principle of open access to displayed prices. Markets will be permitted to compete across a wide range of services, but they cannot attempt to penalize their competitors by adopting unfairly discriminatory rules or practices that restrict access to their displayed quotations. Markets also cannot charge exorbitant fees for access to their quotations that effectively would create barriers to access.

Third, markets must be transparent. All significant markets must make their displayed quotations and trade reports available to all interested parties on terms that are fair and reasonable and not unreasonably discriminatory. Once again, markets cannot attempt to hamper competitors by restricting the dissemination of essential market information to all market participants and investors.

By following these three basic principles—best price, open access, and transparency—I am confident that our equity markets will continue to develop in ways that benefit investors.

Proposed Consolidations—Competition and Industry Self-Regulation

Turning to the proposed consolidations themselves, I would focus on two basic questions. First, what effect are these transactions likely to have on competition—among markets and among orders? Second, how will the new consolidated markets meet their responsibility to assure effective self-regulation?

Promoting Market Competition and Order Competition

The national market system is premised on promoting fair competition among individual markets, while at the same time assuring that all of these markets are linked together in a unified system that promotes interaction among the orders of buyers and sellers in individual stocks. It thereby incorporates two distinct forms of competition—competition among markets and competition among orders. Vigorous competition among markets promotes more efficient and innovative trading services, while vigorous competition among orders promotes more efficient pricing of individual stocks for all types of orders, large and small. Together, they produce markets that offer the greatest benefits for investors and public companies.

Accordingly, the Commission's primary challenge over the years in facilitating the establishment of a national market system has been to maintain an appropriate *balance* between these two vital forms of competition. It particularly has sought to avoid the extremes of: On the one hand, isolated markets that trade an NMS stock without regard to trading in other markets and thereby fragment the competition among buyers and sellers in that stock; and on the other, a totally centralized system that loses the benefits of vigorous competition and innovation among individual markets.

The United States is fortunate to have equity markets characterized by extremely vigorous competition among a variety of different types of markets. These include: (1) traditional exchanges with active trading floors, which even now are evolving to expand the range of choices that they offer investors for both automated and manual trading; (2) purely electronic markets, which offer both standard limit orders and conditional orders that are designed to facilitate complex trading strategies; (3) market-making securities dealers, which offer both automated execution of smaller orders and the commitment of capital to facilitate the execution of larger, institutional orders; (4) regional exchanges, many of which have adopted automated systems for executing smaller orders; and (5) automated matching systems that permit investors, particularly large institutions, to seek counterparties to their trades anonymously and with minimal price impact.

At the same time, competition among multiple markets trading the same stocks can detract from the most vigorous competition among orders in an individual stock, thereby impeding efficient price discovery. The importance of competition among orders has long been recognized. Indeed, when Congress mandated the establishment of an NMS, it succinctly stated this basic principle: "Investors must be assured that they are participants in a system which maximizes the opportunities for the most willing seller to meet the most willing buyer."[1]

To the extent that competition among orders is lessened, the quality of price discovery for all sizes of orders can be compromised. Impaired price discovery could cause market prices to deviate from fundamental values, reduce market depth and liquidity, and create excessive short-term volatility that increases the cost of capital for public companies. More broadly, when market prices do not reflect fundamental values, resources will be misallocated within the economy, and economic efficiency—as well as market efficiency—will be impaired.

Accordingly, the proposed corporate consolidations must be evaluated in the context of their effect on these two forms of competition. Generally speaking, I believe the effect of the proposed consolidations, combined with the new trade-through rule, should be to increase market depth and liquidity and enhance order competition. Moreover, I do not agree, as some may fear, that the consolidations represent the death-knell for competition among markets. To accurately assess the impact of the proposed transactions, one must endeavor to predict what the markets, and the nature of competition, might look like a year or two from now when Regulation NMS has been implemented and the consolidations have been completed, assuming the necessary steps for approval have been obtained.

At first glance, it appears that the two proposed consolidated entities—the NYSE Group and the new Nasdaq—will dominate the landscape for national market system stocks. Based on reported share volumes in March 2005, the NYSE Group and the new Nasdaq would respectively encompass approximately 49 percent and 47 percent of trading in NMS stocks. But in spite of these large market shares, I believe that competition among markets should continue to thrive.

The NYSE currently executes approximately 78 percent of share volume in NYSE stocks, most of which is executed manually. Many believe that the old ITS trading rules have helped the NYSE maintain its dominant market share. Regulation NMS will transform the competition in these stocks by protecting only automated quotations that are immediately accessible. Recognizing that change was coming, the new management of the NYSE has worked steadily over the last year to develop its Hybrid Market proposal, which is designed to give investors a choice of executing their orders automatically or sending them to the floor for manual execution. Nevertheless, even if the Hybrid Market is approved and implemented, the NYSE will have to battle to maintain its market share, given the expanded opportunities for fully electronic markets to compete in NYSE stocks after implementation of Regulation NMS.

The two most formidable competitors of the Hybrid Market are likely to be the new Nasdaq, which currently reports approximately 15 percent of share volume in NYSE stocks, and the Hybrid Market's proposed new corporate sibling—the Archipelago Exchange—which is a fully electronic market that currently reports only 2 percent of share volume in NYSE stocks. Notably, management of the NYSE and Archipelago have stated that both the Hybrid Market and the Archipelago electronic market would continue to exist and to trade NYSE stocks. The stage therefore would be set for continued competition for market share in NYSE stocks between the Hybrid Market and the electronic markets, promising much greater automated trading and, I believe, quite substantial benefits for investors in faster, more efficient trading, particularly in the most active NYSE stocks.

Of course, NYSE stocks also are traded on regional exchanges and other types of market centers that will continue to compete for market share. These include automated matching systems that seek to facilitate the large trades of institutional investors with anonymity and without telegraphing their trading interest to the broader market. They also include securities dealers in the business of providing liquidity for the large trades of institutional investors. All in all, the battle for market share in NYSE stocks promises to be quite heated.

The situation for Nasdaq stocks appears at first glance to be a mirror-image of the situation for NYSE stocks. Giving effect to the Instinet transaction, new Nasdaq would currently report 81 percent of the share volume in Nasdaq stocks. But this summary figure conceals more than it reveals. Approximately 30 percent of Nasdaq share volume currently is executed by dealers and is merely reported, not routed or executed, through Nasdaq facilities. A more accurate depiction of market share is approximately 50 percent in the combined Nasdaq/Instinet market, and 17 percent in the Archipelago market, with most of the balance executed by securities dealers.

[1] H.R. Rep. 94–123, 94th Cong., 1st Sess. 50 (1975).

In the future, I anticipate a continuation of the longstanding battle for market share in Nasdaq stocks, particularly after implementation of the new trade-through rule. Currently, order flow in Nasdaq stocks is fragmented among many market centers, and there is a significant volume of trade-throughs, particularly trade-throughs by block trades of displayed limit orders on the Nasdaq, Instinet, and Archipelago limit order books. For example, many block trades in Nasdaq stocks trade through the best displayed prices, and the total share volume of trade-throughs in many of the most active Nasdaq stocks reaches 9 percent and higher. In 2003, the total dollar volume of trades that bypassed displayed and accessible quotations in Nasdaq stocks was approximately $561 billion. After the trade-through rule is implemented, this enormous volume of trading will be required to interact with the best displayed prices on the electronic limit order books. This heightened competition among orders is likely to produce significant benefits for investors in the form of deeper, more liquid markets and more efficient pricing. Indeed, it was this very prospect that led so many institutional investors to support the application of the trade-through rule to all NMS stocks, including Nasdaq stocks.

In addition, as I noted earlier, I would expect smaller, innovative markets to continue to compete effectively even after the consolidations. The trade-through rule will enhance the ability of smaller markets to attract order flow by offering the best price, and I believe market participants will have an interest in sending order flow to these additional markets to preserve multiple options for order executions.

To summarize, it appears at this point that the vital national market system objective of promoting both competition among markets and competition among orders should not be compromised if the proposed consolidations were approved against the backdrop of the new NMS rules. Again, however, I caution that any final conclusions will have to await review of the full details of the proposed transactions.

Assuring Strong Industry Self-Regulation

The proposed market center consolidations should also be viewed against the backdrop of the changing structure of industry self-regulation. The strength of our national market system is critically dependent on the effectiveness of the SRO's as regulators, and in this regard, the Commission has undertaken over the last 2 years a comprehensive examination of the current structure of industry self-regulation. This examination was initiated in March 2003, when I sent letters to all of the SRO's requesting that they review the adequacy of their governance practices.

In recent years, both the NYSE and Nasdaq have changed significantly their governance and self-regulatory structures. Following the well-publicized controversy relating to the compensation of the former NYSE Chairman, the NYSE created a new, independent board, and established an autonomous regulatory unit that reports directly to a fully independent regulatory oversight committee of the board. I believe that these changes significantly improved the NYSE's governance and regulatory functions.

I also believe that the governance and self-regulatory structure implemented by Nasdaq in the 1990's has worked relatively well. In particular, the market operation functions of Nasdaq have been separated from the NASD, with the NASD now operating as an independent organization focused exclusively on its regulatory functions as a national securities association.

That said, there is clearly room for improvement in industry self-regulation. The well-publicized events that led to the governance changes at the NYSE and NASD have been quite troubling, as have recent enforcement actions that found serious deficiencies in the regulatory programs at several SRO's. To address these problems, the Commission published for comment last December a series of new rules designed to strengthen the current system of industry self-regulation. Among other things, these rules would ensure the independence of the board of directors and certain board committees, restrict the ownership interest of any member of an SRO to no more than 20 percent, require SRO's to maintain their books and records within the United States, and significantly increase the amount of information that SRO's must publicly disclose concerning their governance, regulatory programs, finances, and ownership structure. Finally, the proposals would enhance the Commission's oversight of the SRO's by requiring them to generate detailed periodic reports on their regulatory programs in an electronic format that would be readily reviewable by the Commission.

At the same time that it published specific proposals to strengthen industry self-regulation, the Commission published a concept release seeking public comment on a wide range of issues relating to the overall structure of self-regulation. These issues include: (1) the potential conflicts of interest between an SRO's regulatory obligations and the interests of its members, its listed issuers and, in the case of a demutualized SRO, its shareholders; (2) the potential costs and inefficiencies of the multiple SRO model; (3) the challenges of surveillance across markets by multiple SRO's, and (4) the manner in which SRO's generate revenue and fund regulatory operations.

With the announcements of the proposed market center consolidations last month, I believe it is even more critical that the Commission act promptly on the SRO proposals. The transactions would give rise to important issues of governance and self-regulation, and it is vital that the Commission reach a decision on the standards that will govern its review of the consolidations. Indeed, I believe that many of the proposed rules on SRO governance and transparency would help address issues raised by the proposed transactions, particularly the critical issue of addressing conflicts of interest between SRO business and regulatory functions.

With respect to the proposed consolidations themselves, very few details are available thus far regarding their plans for self-regulation. All of these details will have to be clarified prior to any action on the proposed rule changes that the various entities will be required to file with the Commission for notice and public comment prior to completion of the transactions. I assure you that the Commission will listen to the views of the public and closely scrutinize the proposed transactions to assure that the interests of investors and the public are fully upheld. We will also be sensitive to the concerns of other regulators, including the Department of Justice. At this point, I can simply highlight a few issues specific to the proposed transactions that will be examined prior to reaching any decisions.

First, the NYSE would, for the first time in its history, become a publicly held company, raising the potential for conflicts of interest between the profit-maximizing interests of its shareholders and the need for effective self-regulation. The new NYSE Group will have to assure the genuine independence of its regulatory staff and full funding for its regulatory function. I expect we will carefully review the organization of the regulatory function within the new NYSE Group, including its responsibilities for regulating the new Hybrid Market, the Archipelago Exchange, and member firms. We also will assess the NYSE Group's financial arrangements to assure that all of these regulatory responsibilities can be reliably and fully funded in the future.

Second, the proposed consolidation of the Instinet trading platform into Nasdaq preliminarily would appear to streamline the overall regulation of trading on the combined Nasdaq/Instinet platform. The regulation of such trading would be consolidated in two regulatory entities—the NASD and Nasdaq. In contrast, regulation of Nasdaq and Instinet trading currently is split among the NASD, Nasdaq, and the National Securities Exchange, through which Instinet displays quotations and reports trades. In particular, the National Securities Exchange is responsible for regulating Instinet trading on the exchange, while the NASD regulates Instinet as a member. In the future, Nasdaq likely would continue performing the market surveillance function for trading on the combined Nasdaq/Instinet platform, while the NASD likely would be responsible for all other regulatory functions.

Any examination of the Nasdaq/Instinet transaction would occur in the context of Nasdaq's pending application for registration as a national securities exchange. In this regard, I believe the staff is close to resolving the remaining issues with Nasdaq. The staff has worked with Nasdaq to resolve its concern about Nasdaq's current lack of price priority rules. These rules promote order interaction and price discovery, and are required by all other U.S. exchanges. Last December, Nasdaq filed a proposal that would modify the rules of its execution service, known as SuperMontage, so that all trades would be executed in price/time priority, and this proposal appears to be a significant step in Nasdaq's exchange application process. In addition, the staff is working with Nasdaq to resolve remaining issues relating to the reporting of over-the-counter trades. Once these issues are resolved and reflected in an amendment to Nasdaq's exchange application, the Commission will be in a position to act on the application. At this point, we are expecting Nasdaq to file an amended exchange application early this summer.

Finally, given the increased market share and potential competitive clout of the two proposed consolidated entities, the Commission's role in reviewing their rule filings will be quite important. The issues addressed in these rule filings will include the fairness and reasonableness of fees of all kinds, including for proprietary sales of market data, as well as potentially discriminatory rules against competitors or market participants who trade in other market centers, all of which are required to be considered under the Exchange Act. For example, the NYSE Group would encompass two separate SRO trading facilities—the Hybrid Market and the Archipelago electronic market. No unfairly discriminatory advantages would be allowed between the separate trading facilities that would violate the open access principle of Regulation NMS.

Conclusion

The Commission will have many important decisions to make in the coming months. I look forward to hearing your views and answering your questions on the market structure and self-regulatory issues facing the Commission, with the simple caveat that, as I am sure you appreciate, it would be inappropriate for me to attempt to prejudge where the Commission will arrive in its deliberations on these complex subjects. Thank you again for inviting me to speak.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM WILLIAM H. DONALDSON

Q.1. Do you have any comments about the study on the independent chairman rule and the letter sent by Commissioners Atkins and Glassman to the Appropriations Committee?

Q.2. Do you have any response Mr. Frucher, of the Philadelphia exchange's concerns that the delays on issues before the commission will hinder innovation by the smaller, regional exchanges and jeopardize their very survival?

Answer: Due to the resignation and departure from the Commission of Chairman William Donaldson, his response to these questions is not available.