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On

"The SEC's Market Structure Proposal: Will It Enhance Competition?"

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Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
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I. Introduction

Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee. I am Robert Britz, President and Co-Chief Operating Office of the New York Stock Exchange Inc. (NYSE). I lead the Exchange's Equities Group, which is responsible for the day-to-day operation of our Trading Floor and our data processing sites, technical infrastructure, software development and information business. In addition, I serve as the Chairman of the Securities Industry Automation Corporation ("SIAC"), the NYSE's technology subsidiary.

On behalf of the NYSE, our Chairman John Reed and our Chief Executive Officer John Thain, thank you for providing me with the opportunity to testify this morning on securities market structure and the Securities and Exchange Commission's Regulation

NMS. We appreciate your initiative as we collaborate on how best to modernize our National Market System.

Today, over 2,760 companies are listed on the NYSE, with a market value in excess of $20 trillion. The NYSE has helped to both fuel the growth of U.S. enterprise and maintain the global pre-eminence of the U.S. capital markets. Our success has been won on the basis of our ability to provide the world's deepest pool of liquidity, the best price discovery, the highest certainty of order execution, the lowest overall cost of trading, and very importantly, the lowest volatility.

We applaud the SEC for its leadership in advancing a comprehensive proposal that serves as the basis for our discussions. We believe that the goal of Regulation NMS should be to protect investors by providing a framework to ensure their limit orders are protected and they receive the best price on their transactions, while at the same time ensuring they benefit from the forces of competition and innovation that have made our markets the envy of the world. This policy will not only provide the greatest benefits to investors, but is also the surest way to keep the United States in the forefront of global competition. The SEC has put on the table two alternatives, one of which achieves both these objectives, and the other of which would effectively transform our markets into a homogenized government utility.

I. <u>The Market BBO Alternative</u>

Throughout its deliberations of Regulation NMS, the Commission has properly emphasized the importance of protecting the best prices in each market center. This principle, which is embodied in the "trade-through rule," gives investors, both large and small, confidence that if they take the risk to be the best bid or offer, they will not be "traded through" – that is, ignored. This principle creates an incentive to gather at the best price, or improve it. The results are tighter spreads, greater liquidity, and equal treatment for all investors.

We are pleased that, since the last time we testified before your Subcommittee, investors have expressed substantial support for the establishment of a marketwide trade-through rule (applying to all markets, not just marketwide within one market).[1] The Investment Company Institute, for example, states in its comment letter that it "strongly supports the establishment of a uniform trade-through rule across all market centers and for all types of securities, including Nasdaq-listed securities.' They have stated that a marketwide trade-through rule represents a significant step in providing protection for limit orders, which would improve the price discovery process and contribute to increased market depth and liquidity. In addition, they point out, the rule would increase investor confidence in the securities markets by helping to eliminate an impression of unfairness when an investor's order executes at a price worse than the displayed quote.

[1] See, e.g., comment letters of The Investment Company Institute, (June 30, 2004, and January 26, 2005), T. Rowe Price Associates, Inc. (January 27, 2005), and the National Association of Investors Corporation (January 14, 2005), all of which represent the interests of investors.

Similarly, T. Rowe Price has taken the position that the fundamental rule should be that firms be rewarded for competing on price to attract order flow, which will enhance true market transparency and price discovery (noting that "[t]he Market BBO Alternative will also preserve and enhance intermarket competition. It will accommodate different trading models, allowing markets to continue to compete for order flow on the basis of the services they provide (e.g., negotiated floor auctions, speedy automated trade execution, ability to handle complex orders), the depth and liquidity of their markets and trading costs.")

In addition, many other market participants have expressed their support for the Commission's Market BBO Alternative, including Deutsche Bank, Bear Stearns, Barclays Global Investors, The Interactive Brokers Group, EWT, LLC (the Market BBO Alternative "[w]ill promote investor confidence in the fairness of the U.S. equity markets by protecting limit orders reflected in the BBO quotations displayed by the SROs against trade-through and protecting market and marketable limit orders against trading at prices inferior to those displayed best quotations. By protecting BBO quotations, the rule should encourage investors to use limit orders, leading to increased market depth, liquidity and efficiency."), the National Association of Investors Corporation, and others.

The Commission's "Market BBO Alternative" (sometimes also referred to as the "top of book" alternative) will benefit investors by establishing a marketwide trade-through rule that will ensure that investors' limit orders are protected and they receive the best price on their transactions, while at the same time giving them the benefit of competition between the various markets trading stocks. It will also advance the following fundamental policy objectives:

- Promoting investors' ability to choose among alternative trading venues and order types;
- Lowering costs to investors and to issuers raising capital by accommodating market models that minimize price volatility; and

Importantly, the Market BBO Alternative strikes the appropriate balance between order competition and market competition. We agree with the Commission that relevant data supports the need for an intermarket rule to strengthen price protection and improve the quality of trading in both Nasdaq and exchange-listed stocks. By protecting the best bid and offer in each market, the Market BBO Alternative will encourage aggressive quoting within markets and assure the interaction of orders across markets, while at the same time permitting markets to compete on the basis of costs, liquidity and other elements of service and market quality. It will foster investor choice by avoiding the imposition of a single market model on investors. It will be practical to implement without undue costs. In turn, these benefits will minimize trading costs for investors, reducing the cost of capital for listed companies.

III. <u>Mandatory Depth-of-Book Routing</u>

By contrast, the Commission's "depth of book" routing alternative would destroy the congressionally mandated balance between order competition within markets and competition between markets by completely eliminating the latter. This alternative would mandate that all markets route orders to any displayed limit order at a superior price in any market center. This approach would transform our market system into a virtual Consolidated Limit Order Book, or "CLOB." The CLOB has been proposed in the past, debated at length, and wisely rejected in 1978 and 2000 by previous SEC chairmen and commissioners for a number of reasons. Foremost among them is that it would convert our dynamic, diverse, and internationally competitive markets into a government-mandated, one-size-fits-all monolith.

At their extremes, order competition across markets and intermarket competition are mutually exclusive. Taken to the extreme, maximizing competition among orders at the expense of competition among markets would homogenize the markets and create a single, one-dimensional order-matching system. On the other hand, maximizing competition among markets at the expense of competition among orders would create complete fragmentation of the markets.

The Commission's depth of book routing alternative skews the balance toward order competition at too great a cost to intermarket competition. It would virtually eliminate intermarket competition and, paradoxically, diminish order competition at the same time. As Chairman Donaldson stated at SEC's hearings in April 2004, "Our markets are among the world's most competitive and efficient. Competition among markets has fostered technological innovation and the creation of trading platforms… that address the needs of all types of investors, regardless of size and sophistication." Today, the preferences of investors and issuers, rather than regulation, determine which market models are successful. Investors in the U.S. markets benefit from spreads that are among the tightest and transaction costs that are among the lowest in the world. They also benefit from the freedom to choose the type of execution that is right for their orders. They choose strategies most appropriate for the size of their orders and the nature of the stocks traded. Whether they are retail investors purchasing 100 shares or an institution trading one million shares, they have options that enable them to receive the best prices from the trading venue of their choice. These benefits would be eliminated by the depth of book alternative.

A. The Depth of Book Alternative Will Virtually Eliminate Intermarket Competition

Markets compete in three important ways:

1. The prices at which orders can be executed (efficient price discovery);
2. The depth and liquidity they can attract (order aggregation) to promote optimal pricing and accommodate large orders; and
3. Execution fees.

Imposing depth of book routing on the markets will eliminate the first two bases for competition. The ability for markets to compete on the basis of depth and liquidity will erode if all displayed orders can participate in the pricing of every trade. This, in turn, will degrade the overall quality of prices that orders receive within each market, removing that consideration from the competitive equation as well. Instead, competition for limit orders would be based strictly on execution costs and, in all probability, will push markets into a bidding war to purchase order flow or engage in fraudulent activities to reap market data rebates, fueling practices that harm our markets.[2] Limiting intermarket competition to a race to be the cheapest will also likely deprive markets of the resources they need to develop innovative new products and services, and to assure that their trading systems operate efficiently, securely and without disruption. As noted above, the end result is to homogenize the markets into a single, one-dimensional order-matching system.

B. The Depth of Book Alternative Will Diminish Order Competition

Mandatory DOB routing will diminish order competition by bifurcating the institutional and retail markets. Institutions and their brokers will find it increasingly difficult to execute large orders in the electronic virtual CLOB that mandatory depth of book routing would create. Money managers, institutional investors like pension funds and mutual funds, and other similar firms (otherwise known as the "buy side") also do not typically want the full size of their buying or selling interest publicly disclosed for fear that doing so will reveal important trading information to other market participants, ultimately raising their execution costs. Protecting their orders against trade-throughs

[2] The NYSE continues to believe the Commission should ban payment for order flow, a practice fraught with conflicts of interest. Such payments interfere with the ability of retail orders to interact with each other and obtain the best execution price. In payment for order flow arrangements, individual investors rarely get the opportunity for an execution at the midpoint of the spread or better.

through mandatory depth of book routing will do nothing to reduce this risk; indeed, it would exacerbate it because it would tend to force the display of latent interest as limit orders.

The result would be that large institutional orders would likely migrate to private markets or "upstairs" trading desks to be executed and reported often outside of market hours or in foreign venues. Mandatory depth of book routing would thus bifurcate the U.S. capital market into public retail markets operating within the NMS framework and private institutional markets operating outside the reach of the rule's responsibilities. The benefits that both types of orders enjoy when institutional and retail order flow interacts will be lost. Without large institutional investor participation in the NMS, spreads will widen, and execution quality for retail investors will deteriorate as liquidity evaporates in public markets.

C. The DOB Proposal Will Diminish Investor Choice

Investors and issuers benefit from different types of market models that compete with one another by providing different order types and services. The Commission's statistics cited in the reproposing release show that our floor-based auction combined with the current trade-through rule provides lower price volatility and far greater certainty of execution for larger size orders.[3] We believe this is due to the value that auction markets create by aggregating liquidity at a single point of sale. If auction markets must

[3] The SEC's analysis reveals that, compared to NYSE-listed stocks, Nasdaq-listed stocks experience higher price volatility and a higher percentage of trade throughs. See 69 FR 77431-33.

implement mandatory DOB routing, they would be forced to provide uniform execution facilities that disperse this liquidity by chasing quotes that will often disappear almost immediately after they are posted.

Recognizing the disparity between fill rates, as well as the opportunity to access reserve liquidity, buy-side firms and their brokers have developed so-called smart routers that analyze the quotations disseminated by various markets and route orders to them in accordance with a number of factors. One factor is the likelihood that an order routed to that market will in fact be executed. Mandatory DOB routing would force these firms to abandon their intelligent routing systems in favor of uninformed government-mandated routing, which will invariably lead to worse executions.

D. Depth of Book Routing Would Undermine Innovation Currently Underway at the NYSE

The NYSE's proposed hybrid market model cannot co-exist with mandatory DOB routing. We designed the hybrid market to have as many quotations as possible available for automated execution, while providing for the interaction of institutional and retail order flow, negotiated price discovery and the opportunity for the price improvement of a floor-based auction. The structural changes associated with the hybrid market model are widely supported by our customers, who want to have the choice of representing orders in both electronic and auction platforms. They support the hybrid market as an innovative and promising initiative. Regulation should promote innovation, not stifle it. Yet the Depth of Book alternative would prevent us from offering customers this choice.

IV. Market Data

The current model for the dissemination of securities market data has succeeded in making this data widely available, inexpensive and reliable. The Commission states in Regulation NMS that “investors of all types -- large and small -- have access to a comprehensive, accurate and reliable source of information for the price of any NMS stock at any time during the trading day.”[4] Today, market data from all equity and options exchanges is highly reliable and widely used.

Regulation NMS is not the first SEC review of market data. There have been several important, thorough, industry-wide, SEC-mandated studies of market data in recent years, including the Commission’s December 1999 SEC Concept Release: Regulation of Market Information Fees and Revenues (the “1999 Concept Release”) and the SEC's Advisory Committee on Market Data in 2000-2001 ("the Seligman Committee”).

The results of these reviews have essentially been the same: that market data is widespread, accurate, and the basis for and the amount of fees collected are fair and reasonable.

The primary dysfunction that emerges from these studies is that of the government-mandated consortium—the Consolidated Tape Association (CTA). Created

[4] 69 FR 77460.

in 1975 to ensure that investors had access to reliable, consolidated price information, CTA has outlived its usefulness.

The "Seligman Committee" experts concluded that dismantling the market data consortia was the best way to eliminate the distortions and abusive practices that the consortia breed. More generally, they recognized that allowing markets to withdraw from the consortia would eliminate the government allocation of data revenue, substituting the value proposition that each market's data presents as the allocator of revenue flows.

This harnessing of market forces to allocate data revenues would also relieve the markets from their joint administration problems and antitrust exposure; end artificial cooperation among competitors (thereby enhancing the forces of competition); remove incentives for tape shredding, wash sales and the use of exchanges as print facilities; starve payment for order flow, thereby reducing the classic conflicts with their customers that such payments create for brokers; and end inter-market subsidies, cross-network fee distortions and other market dislocations.

We have urged the Commission to embrace the recommendations of its own expert advisors by authorizing markets to withdraw from the market data consortia and thereby to permit and foster competing consolidators. Its consideration of the responses to its SRO concept release offers the next opportunity to do so. We have urged the Commission to seize it.

However, so long as the Commission continues to mandate a revenue-allocation formula, we support the Commission's proposal in Regulation NMS to use of quotes in the formula, the formula's use of square roots and dollar values (i.e., price X size), and the deletion of the NBBO Improvement Share. In the NYSE's January 26, 2005 comment letter to the Commission, we offered five suggestions to mitigate gaming and other distortions, and to facilitate the application of the formula.

We believe that our recommendations will make the proposed formula somewhat less susceptible to gaming, better align the value proposition of data with revenue allocation, and narrow the government's intervention in data display.

V. Conclusion

In conclusion, we appreciate this opportunity to appear before the Subcommittee and we look forward to working with you, Chairman Baker, Ranking Member Kanjorski, and the Members of the Subcommittee on market structure issues. Regulation NMS represents a significant, timely, and sensible reform of the national market system that will help to preserve the position of the U.S. as the leader in the global equities markets. It also represents the most far-reaching reform of the national market system since its creation 30 years ago.

We can best serve the public good by strengthening competition among markets to create a superior national market system that is based upon standards of best price and putting the interests of investors first. These are the principles have made the U.S. securities markets the largest, most liquid and most vibrant in the world, and they can and must continue to do so in the 21St Century.

Thank you again Chairman Baker for the opportunity to appear before the Subcommittee and I would be happy to answer any questions