TESTIMONY CONCERNING RECENT DEVELOPMENTS IN THE EQUITY MARKETS

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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.

I. Market Structure Reform

As I have discussed with you in several prior hearings, one of my highest priorities over the last two 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 decision-making.

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.

II. 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?

A. 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 counter-parties 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

[1] H.R. Rep. 94-123, 94th Cong., 1st Sess. 50 (1975).

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% and 47% 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% 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% 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% 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% of the share volume in Nasdaq stocks. But this summary figure conceals more than it reveals. Approximately 30% 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% in the combined Nasdaq/Instinet market, and 17% in the Archipelago market, with most of the balance executed by securities dealers.

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% 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.

B. 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 SROs as regulators, and in this regard, the Commission has undertaken over the last two 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 SROs 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 1990s 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 SROs. 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%, require SROs to maintain their books and records within the United States, and significantly increase the amount of information that SROs must publicly disclose concerning their governance, regulatory programs, finances, and ownership structure. Finally, the proposals would enhance the Commission's oversight of the SROs 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 SROs, and (4) the manner in which SROs 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.

III. 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.