

**Statement of Meyer S. Frucher,
Chairman and Chief Executive Officer, Philadelphia Stock Exchange, Inc.,
Before the United States Senate Committee on Banking, Housing and Urban
Affairs
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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 United States 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 anti-competitive 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

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

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%, 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 2000 stocks listed on the NYSE and American Stock Exchange (“Amex”) and over 1500 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 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 inter-market competition.²

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

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's 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 they compete for business."³ In layperson's

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

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 Exchanges⁴ 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

⁴ Release No. 34-38672 (May 23, 1997).

⁵ Release No. 34-40760 (December 8, 1998).

to non-exchange 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.

At the same time, recognizing that this structure would potentially give a competitive edge to alternative trading systems, the SEC adopted a rule that

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

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

⁷ Rule 19b-5

⁸ See Spratt Microstructure Address at p. 3.

SEC envisioned as possibilities – discrimination, inaccessibility, fragmentation and discrimination – and some that were perhaps not so clearly foreseen, such as issues raised by sub-penny 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” (i.e., 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 exchanges⁹ 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 exchange “facilities,”¹⁰ and (ii) questioning the role of

⁹ Release No. 34-50699 (November 18, 2004).

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

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:

1. 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

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).

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;

2. The new market data revenue allocation formula adopted in Regulation NMS rewards a particular type of business model, namely electronic SROs. 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;

3. 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;

4. 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

5. 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.

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

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

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

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

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.