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Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, on behalf of the Security Traders Association ("STA") thank you for the opportunity to testify regarding the structure of the US equities markets, and more specifically the Securities and Exchange Commission's ("SEC") proposed Regulation NMS.

Security Traders Association

The STA is a worldwide professional trade organization that works to improve the ethics, business standards and working environment for our members. We have approximately 6,000 members, all engaged in the buying, selling and trading of securities. Our members participate in STA through 28 national and international affiliate organizations and represent the interests of the trading community and institutional investors. The STA provides a forum for our traders, representing institutions, broker dealers, ECNs and floor brokers to share their unique perspectives on issues facing the securities markets as they work together to promote their shared interests in efficient, liquid markets as well as investor protection.

Given the disciplines represented by the STA, one would expect that they often have differing perspectives on market structure issues. We have diligently worked through the issues presented by the Commission in proposed Regulation NMS, and have in most instances reached consensus on recommendations that we believe are beneficial for the market as a whole, not the individual interests of our constituencies. I request that the STA's comment letter on Regulation NMS be included as part of the hearing record.

STA White Paper

The Securities Acts Amendments of 1975 direct the facilitation of a National Market System and set forth objectives for the "protection of investors and the maintenance of fair and orderly markets".[1] Technological advancements and innovations, and the dramatic increase of individual investor participation, continue to transform the US equities markets.

[1] Securities Exchange Act of 1934, Section 11A(a); (15 USC 78k-1)

The STA has consistently called for SEC action to address these and other developments in the markets. In August 2003 we issued a White Paper entitled "Fulfilling the Promise of the National Market System," in which the STA made three key recommendations:

1. Improve intermarket linkages and trading rules.
2. Require consistency of core trading rules across markets.
3. Eliminate access fees.

The White Paper discussed in detail the STA's views on the current state of the US markets and the issues it felt must be dealt with in order to make those markets stronger and more liquid. While not a one-for-one parallel with the Commission's Regulation NMS proposal, our concerns are remarkably similar to those addressed by the Commission in the Proposing Release. At that time, we expressed the view that the new environment led to issues for market structure that met at the fulcrum of technology and access. Similarly, the four proposals promulgated in Regulation NMS and the supplemental release deal with various facets of a fundamental problem: inadequate access to the best priced quotes of all market centers, on market neutral terms.

Proposed Regulation NMS

The STA commends the Commission for its efforts in addressing these structural problems. The White Paper addresses many of the same issues discussed in Proposed Regulation NMS, and we believe the SEC's proposal is an important and positive step toward advancing the objectives of the national market system as envisioned by Congress in 1975. Since we see the current problems as arising from access to quotes on market neutral terms, I will address those issues first, followed by the various issues related to sub-penny quoting, trade through, and market data.

Access Fees Should be Eliminated

Best execution obligations are negatively impacted by access fees. Since access fees are not included in the quotations that ECNs display in the consolidated quotes through an SRO trading facility, they undermine transparency of prices and represent hidden costs. Access fees distort the true price offered through that SRO facility and complicate a non-subscriber broker-dealer's best execution obligations.

Access fees for non-subscribers do not provide choice. It is important to understand the differences between access fees charged to subscribers of ECN systems and non-subscribers attempting to access a quotation displayed in the consolidated quotes. Subscribers to an ECN have affirmatively chosen to pay the access fees for access to the system. Conversely, non-subscribers have not chosen to pay for such a service, but may instead be required, in order to fulfill best execution obligations, to interact with an ECN quote and pay an access fee.

The STA has consistently maintained that access fees for non-subscribers of ECN systems should be eliminated. An ECN should be limited to charging fees to its subscribers just as a market maker may only charge fees to its customers. Elimination of access fees would end the rebate schemes and economic incentives causing locked and crossed markets.

The Commission's proposal to permit all markets to charge access fees would only serve to exacerbate the problems. While we appreciate the thoughtfulness behind the Commission's proposal to permit all markets to charge access fees, we believe that this will exacerbate the problem rather than lessen it. We believe a far more effective approach would be to simply ban ECNs from imposing access fees when their best priced quotes are traded through an SRO execution facility such as NASDAQ's SuperMontage. At the same time, the STA believes it is unnecessary for the Commission to ban or restrict the access fees that an ECN may charge its subscribers for providing them with direct trading access to its quotations, including depth of book displays.

Ban Sub-penny Quotations

The STA fully supports the Commission's proposal to eliminate sub-penny quotations. It is important that the Commission act now to prevent the negative impacts of sub-penny quoting.

The STA has consistently called for the elimination of sub-penny quoting. One of the principal benefits of the transition to decimals was clarity and simplicity in the market information provided to public investors. Further, the international decimal standard provided a reference and comparison standard for investors both in the US and abroad. These goals have been achieved, and the Commission's mandate to switch to decimals has, after some adjustment by participants, been recognized overall as a positive development. A move to sub-penny quoting will substantially undermine the benefits of decimals, and will not improve markets, but will lead to greater inefficiency and confusion.

We concur with the Commission's description of the problems of sub-penny quoting. Among the negative impacts, sub-penny quoting results in a decrease in market depth at the NBBO and incentives to step ahead of limit orders. For example, an SEC staff study concluded that sub-penny trades cluster at the $0.001 and $0.009 price points, suggesting stepping ahead behavior.[2] In addition, sub-penny trading increases the number of price points available, resulting in less liquidity at each price point and negating any perceived benefits to investors.

Trade-Through and Best Execution

Based on our analysis and understanding of the current problems in the market structure, and the Congressional mandate that we move towards a true NMS, our view is, as we recommended in the White Paper, that we achieve "…adequate, efficient, and appropriate connectivity between, and access to all market centers and their platforms…." We believe that if traders have access to all quotes with immediate execution and refresh capability, the problem of trading-through might simply go away.

In light of that, our recommendations are as follows:

[2] Securities Exchange Act Release No. 49325 (February 26, 2004) 69 FR 11126.

Phased Approach: *The Commission should adopt a phased implementation schedule for the proposal. We have, and continue to assert that access lies at the heart of achieving an NMS.*

Specifically, in Phase One, the STA recommends that the SEC adopt a rule requiring all market centers to provide automated access to their publicly displayed quotes. This should include standards for automated execution, access on economically efficient terms (including the elimination of access fees), and automated quote refresh capabilities. These standards of connectivity, access and immediate execution are key components to achieving the objectives of the national market system.

After this Phase is fully implemented and the empirical evidence of the effects are analyzed, the Commission will be in a position to determine whether a uniform trade-through rule is necessary. Finally, a phased approach would provide greater opportunity to identify whether adjustments to the proposal are necessary, and in doing so, would reduce the potential for unintended consequences.

Exclusion of manual quotes: *The rule should exclude manual, or slow, quotes from the consolidated national best bid and offer (NBBO).*

Since manual quotes would not support automatic execution capabilities, excluding them from the NBBO would provide an incentive for markets to become fully automatic. But to encourage consistent behavior, it is important that the Commission limit the ability of a market from switching between manual and automated quotes.

As discussed above, the trade-through rule should not be extended to other markets unless it determines, based upon empirical evidence, that connectivity and automation are insufficient to protect against inferior trades.

Safe Harbor: *Adoption of a safe harbor would recognize that a broker-dealer may, consistent with its best execution duties, trade through a quote that is not accessible for automated execution.*

SEC policy on best execution is consistent with this standard as it recognizes that factors other than price may be considered when evaluating best execution. Certain state regulators and the NASD; however, have sometimes focused on price as the only measure of compliance, ignoring the fact that some quotes may not have neutral economic or access terms. For example, certain transactions may appear to be executed at something other than the "best price." However, if a quote at the NBBO is not immediately accessible, it is unfair to have standards that would require a broker-dealer to execute against such a quote. Such a safe harbor would protect a broker against best execution liability under state law in situations permissible by the Commission.

Trade-Through Exemptions: *If the Commission determines that a trade-through rule is necessary, the STA supports, to varying degrees, the automated order execution, flickering quote, and limited opt-out exemptions.*

The automated order execution exemption, without limitation, is desirable to provide an incentive for slow markets to become more fully automated. The SEC's Supplemental Release questions whether the exemption should distinguish between automated and manual quotes (rather than markets as initially proposed). Such an approach could be acceptable, but only if manual quotes are excluded from the NBBO, as discussed above.

Some stocks display quotes that change at such a rapid pace that they "flicker." As such, a flickering quote exemption should be adopted, recognizing that an apparent trade-through of such quotes is not an actual trade-through (but rather a "false" trade-through).

If the SEC requires connectivity and automated execution, an opt-out becomes less necessary. The STA cautiously favors a limited opt-out exemption if the Commission moves forward with a trade through rule. In this case, there may be certain instances that require an opt-out for specific types of trades, such as large block or volume weighted average price (VWAP) trades.

Importantly, rather than the proposed varying *de minimis* amount at which a trade-through can occur, there should be no limit placed on trading through a manual market.

Market Data

There are substantial problems regarding the allocation of market data revenues that need to be addressed. While we are not in a position to comment on the details of the precise formula proposed for distribution of market data revenues, the STA supports the allocation of market data revenues to reward providing quality quotes that are tradable and improve price discovery and the NBBO. The formula should only reward automated quotes accessible for trading, rather than inaccessible quotes of manual markets. In addition, the formula should not reward a market's quote-related revenue share if it has a high ratio of quote changes to actual prints. We recommend that the Commission reconsider its proposed market data revenue formula, possibly by creating an industry working group, to take into account these and other factors to reward price discovery.

Conclusion

Proposed Regulation NMS, with appropriate modifications, is a much needed step toward achieving the objectives of the National Market System set forth by Congress in 1975. The STA recommends a phased implementation of a connectivity-based approach mandating automated access to quotations on market neutral terms. Only then should the Commission proceed with a trade-through rule across all markets.

The STA appreciates the Committee's oversight role and interest in promoting efficient, competitive and fair US markets. On behalf of the individual members of the STA, I thank you for the opportunity to participate in this important dialogue.